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India
Inclusive Growth and Service Delivery: Building on India's Success

Development Policy Review

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ABBREVIATIONS AND ACRONYMS

APDRP	Accelerated Power Development and Reform Program
ARWSP	Accelerated Rural Water Supply Program
ASER	Annual Status of Education Report
ASHA	Accredited Social Health Activist
BPL	Below Poverty Line
CDMA	Cadre management authority
CHC	Community Health Center
CSS	Centrally Sponsored Scheme
DPR	Development Policy Review
DVB	Delhi Vidyut Board
EGS	Employment Guarantee System
EU	European Union
FCI	Food Corporation of India
FRBMA	Fiscal Responsibility and Budget Management Act
GDP	Gross domestic product
GQ	Golden Quadrilateral
GSDP	Gross State Domestic Product
HDI	Human Development Index
HDR	Human Development Report
IAS	Indian Administrative Service
IBT	Increasing Block Tariff
IDA	Industrial Disputes Act
IMR	Infant Mortality Rate
IR	Indian Railways
JNNURM	Jawaharlal Nehru National Urban Renewal Mission
MSP	Minimum Support Price
NACO	National AIDS Control Organization
NFHS	National Family and Health Survey
NGO	Nongovernmental organization
NHAI	National Highway Authority of India's
NHDR	National Human Development Report
NREGA	National Rural Employment Guarantee Act
NS-EW	North South-East West
OCMS	Online complaints and monitoring system
PAC	Public Affairs Center
PESA	Panchayats Extension to Schedule Areas
PHC	Primary Health Center
PPI	Private participation in infrastructure
PPP	Public-private partnerships
PRI	Panchayati Raj Institutions
RFAS	Rural Finance Access survey
RKS	Rogi Kalyan Samiti's
RNTCP	Revised National Tuberculosis Control Program
SC/STs	Scheduled Castes and Scheduled Tribes
SGRY	Sampoorna Grameen Rozgar Yojana
SGSY	Swarnjayanti Gram Swarozgar Yojana
SHG	Self-Help Group
TFC	Twelfth Finance Commission
TFP	Total Factor Productivity
ULB	Urban local body
UPA	United Progressive Alliance
URIF	Urban Reform Incentive Fund
USOF	Universal Service Obligation Fund
VWSCs	Village Water and Sanitation Committees

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Introduction

I have no promises to make, but I have promises to keep

Prime Minister Manmohan Singh, August 15 2004

A review of India's current development challenges and policies could perhaps best begin from a long-run perspective. Relative to the often dire expectations expressed at its birth, India has been successful, and increasingly so. India has maintained electoral democracy, not only holding free and fair elections for the nation's government, but now over 3 million people hold elective office in its local governments. The specter of famines has been banished, absolute poverty cut by more than half, illiteracy dramatically reduced, health conditions vastly improved. India has become, in purchasing power parity terms, the fourth largest economy in the world. India's economic growth since 1980 has been among the most rapid—and India managed its one incipient crisis in the early 1990s and avoided the catastrophic losses elsewhere. While many feared that exposing India's economy to global competition would reveal India's economic weakness, it has rather revealed strengths (often unexpected strengths in new areas no planner would have dreamed of). India is increasingly taking its place on the global stage and in international forums as a 21st century superpower. The generations of politicians and policy makers who have been part of leading India to where it is today can be justifiably proud of the transformation. But achievements create new challenges, and this report focuses on two of those: improving service delivery, particularly to the poor, through greater accountability and expanding the benefits of rapid growth—across sectors, regions, and people.

Part I: Increasing accountability for improved service delivery

While the challenge is expressed in different ways—"improving quality of public expenditures" or "increasing institutional capacity" or "more effective implementation" or "better service delivery"—all agree that India's core publicly provided services, such as water supply (both rural and urban), power, education, policing, sanitation, preventive and promotive health services, road construction, and implementation of poverty programs, face enormous pressures. These new challenges are rooted in five achievements:

- *Achievement.* Economic progress and rising incomes means that citizens are demanding more, and higher quality, services and have more income to seek those from the private sector if the public sector provision is inadequate.
    - *Challenge.* This revolution of rising expectations for reliable public services means that governments are under pressure to deliver services like never before.
- *Achievement.* Massive investments in asset creation success have made the goal of physical access (to a road, to a clinic, to a school, to a market) achievable.

- *Challenge.* The achievement of access creates the challenge of the "access/satisfaction" gap. People have access to the physical facilities but are largely dissatisfied with the services that are actually available as frequently staff are missing, facilities lack key inputs, assets are not maintained and are dysfunctional. According to one survey while 70 percent of respondents had *access* to the Public Distribution System, less than 10 percent were fully *satisfied* with the services delivered—a finding that cuts across all services.

- *Achievement.* The flourishing of electoral democracy and its expansion to include newly powerful social groups—has meant the competition for control of the public sector is intense and more and more citizens and groups feel empowered to participate.
  - *Challenge.* This political situations creates the temptation of using the politics "jobs, contracts and subsidies" to provide patronage to narrow groups and private benefits to insiders rather than improved service delivery as the means of satisfying constituencies and supporters.
- *Achievement.* Government agencies have managed to accomplish logistical goals and, for the most part, are organizationally viable, so for example, the education program of Sarva Shiksha Abhiyan is being implemented and the target of universal enrollment is close to being achieved.
  - *Challenge.* These same organizations need to move to the next level of performance in service delivery—from quantity to quality, from physical targets to outcomes. This often requires different approaches (more demand driven and less technocratic, more focused on external accountability and pleasing the "citizen" and less on compliance with internal procedures) that are require organizations to undertake difficult changes.
- *Achievement.* There has been a revolution in aspirations and expectations of upward mobility among all segments of Indian society.
  - *Challenge.* This empowerment creates new demands and pressures on services to be more inclusive as the increased connectivity of rural India and the increased fluidity economically and socially means the aspirations of all are mounting.

This collection of successes has led to a situation in which the capability of the public sector, in its current configuration, has not kept pace with the services demanded by citizens. For instance, India, in spite of its rhetorical commitments to universal health and universal education and water provision is *de facto* quite privatized. Only five countries in the world have a *lower* portion of health spending in the public sector—the proportion of health spending in the private sector is *twice* as high in India as in the "free market" USA. In urban areas in more than half of the major states a higher fraction of children are in private elementary school than in the largely "privatized" system in Chile. Nearly all new capacity created in irrigation recently has been private (e.g. tube wells), not public. Even in Delhi's water supply more than half of the total cost of water is borne privately (as people invest assets or time in coping with the irregular water supply). In fact, many knowledgeable observers believe that the configuration of circumstances are leading organizational and institutional quality to not just not keep pace with economic

progress, but to deteriorate absolutely. The interaction of a "jobs, contracts and subsidies" pressure from politics with weakening public sector capacity, elite withdrawal from demand for publicly provided services with a "top down" input and asset creation orientation for public policy can indeed create a situation in which the public sector's ability to deliver on core responsibilities deteriorates.

This is not a pessimistic assessment, it is rather a realistic assessment about the magnitude of the challenges faced (which are often created by previous success) but this Report is optimistic about the capability of India, its citizens and government, to face and surmount these challenges. Tackling the new challenges requires confidence from past achievements but not complacency about the magnitude of the challenges to be faced and the Government has put institutional reforms of the various agencies and service providers right(ly) at the top of its agenda. In fact, one should be less optimistic about the likelihood of success if one begins with a falsely rosy scenario that provides an inadequate assessment of the true magnitude of the challenges, and the deep causes of these challenges, faced in reaching the next level of focus on the quality of service provision.

There are many successes across states, sectors and agencies that point towards viable new approaches for creating greater accountability of the state and of service providers to deliver. These approaches, while disparate in many ways and adapted to the contextual features of the sector and place, tend to have five features in common:

- Clearer *delegation* of responsibility of providers for outputs and outcomes—moving away from merely responsibility to compliance with internal processes in the use of inputs.
- An *unbundling* of the roles of government between the general *responsibility* for a sector and the *production* of the outputs—moving away from situations in which line agencies are both umpire (responsible for setting standards, creating and disseminating information, monitoring compliance, evaluation) and player (responsible for day to day management of providers).
- Greater *autonomy* to the providers (both organizational and frontline) in how they achieve their goals and insulation from top down or narrowly political micro-management.
- Increased *external accountability* which requires greater transparency and better flows of *information* and *social mobilization/empowerment* to make that information effective.
- Greater *enforceability* so that citizens and communities as the direct "clients" of service providers (both public and private) can have greater voice (over the responsible level of government) and choice across providers (as an effective mechanism to exercise power).

Internal reforms of public sector actors. While the public sector faces systemic challenges, it also shows promise. There are many examples of institutional innovations in service delivery at the Center (such as the creation of the National Highway Authority of India) and in the states (e.g. *Bhoomi* for land records in Karnataka, Education Guarantee Scheme in Madhya Pradesh). There are ways these successes can be

promoted. For instance as one example, many successes are driven by "reform champions" within the public sector as many examples of successful "internal" improvements in services happen when civil servants are given a clear political mandate for reform, adequate time, and autonomy. One of the most worrisome features of the current system is the shortening duration of top civil servants in their posts as it both detracts from their capability to carry through and reflects an undesirable politicization of the civil service.

Information for greater external accountability. There is now widespread recognition that if citizens are to create pressure for better services they need better information, and information that meets the three Rs: *reliable, relevant*, and *regular.* There are a variety of promising initiatives. The government has recently passed a Right to Information law, that creates enormous scope for citizens to know what is happening—but it is only a promise that will require support to become a vehicle for service improvements and not merely a means for political grandstanding. The use of survey information via "citizen report cards" that began in Bangalore shows the need for persistence—while "once off" efforts can generate agitation and fleeting press attention—it is only when people take it to heart as a regular indicator can it be used to drive reforms. There are also a variety of efforts to make information available from the bottom up through existing channels—such as the Gram Sabha or user committees in various sectors—such as the nongovernmental organization Pratham's efforts to make information on learning performance available in villages and districts.

Merely putting the letter "e" in front of something doesn't magically make it better and "e-governance" can be as much caught up in "jobs and contracts" as governance without an "e." But there are examples of the use of the *occasion* of making functions of government "e" to undertake what would otherwise be organizationally and politically impossible fundamental business process changes—including eliminating functions and limiting the potentially abused discretion of government officials.

Decentralization to PRIs. More than a decade ago India's 73rd and 74th constitutional amendments launched an effort to improve local governance through devolving responsibilities to democratically elected bodies heading autonomous units of local government. But decentralization alone is no panacea--services can get better or worse--as with all other reforms implementation is everything. Currently in most states decentralization is "unbalanced" in that political decentralization has moved ahead and India now has more than 3 million citizens serving in locally elected bodies. Moving forward with a well-designed decentralization requires aligning the "three Fs": funds, functions, and functionaries in ways that make it possible to have technically effective services with both "accounting" (the capability to provide reliable budget control and reporting) and "accountability" (the ability of citizens and communities from the bottom up to hold elected officials and providers responsible for outputs and outcomes). This "activity mapping" of the three Fs cannot be done by slogans or ideology, as a functional activity mapping will vary from sector to sector, vary within sectors (e.g. hospitals versus *aanganwadi),* and even vary by function (e.g. asset creation versus operation), but can be informed by general principles. Two general tendencies do emerge. First, decentralization creates an opportunity to *unbundle* responsibilities across tiers of

government in order to create checks and balances in the interests of the tiers of government—so that one tier reports on the performance of another—in order to assist citizens in getting the information they need to create accountability for performance. Second, decentralization, in creating new lines of responsibility also creates opportunities to strengthen the "demand side"—the mobilization of communities from the bottom up to demand better performance with better information and greater scope for voice and choice.

Non-state providers in service delivery. Public-private partnerships (PPP) can play an increased role in the provision of infrastructure services, and India is in the position to build on successes in the transport and communications sectors. However, a concerted effort to build capacities, particularly at the state level, will be important. The role of PPP, as another way of promoting better services, is not limited to infrastructure. In health, in education, even in the implementation of poverty programs there are promising ways to use the empowerment generated by allowing people to make their own choices by channeling funds to people first rather than providers.

Part II: Rapid and inclusive growth

While India has been growing very rapidly—even with some acceleration in the last few years--international experience shows that a recipe for slow growth is complacency about pushing ahead with reforms when growth is high. Most countries with rapid growth in any one decade show marked deceleration of growth rates in the next. India has so far been able to avoid that, as adroit response to an incipient slow-down in the 1990s restarted another episode of rapid growth. The reform momentum has been sustained across changes in government so that the basic direction of reform continues. While there are many areas of policy that require attention, and any analysis of the "investment climate" or of specific sectors will reveal a long list of desirable changes, we want to focus on the few "binding constraints"—those areas that, without attention, are the most likely to be obstacles to sustained rapid growth; relieving these constraints would be a growth accelerator.

India's successes have not been shared equally and it is obvious that, particularly since the reforms of the 1990s, some states have done much better than others; even in thriving states some cities have thrived while rural areas have stagnated, and, given the pattern of economic growth, people with skills have done much better than those with less education. This Report follows the framework of the World Bank's recent World Development Report on Equity and Development which emphasizes that the primary concern is equity of opportunity—which is a notion of fairness and justice—and absolute well-being—elimination of economic and social deprivation not narrow measures of inequality of outcomes. The government of India's justifiable concern with the inclusiveness of economic growth can be addressed by focusing on *expanding* the regional scope of economic growth, *expanding* access to assets and thriving markets and *expanding* equity in the opportunities for the next generation of Indian citizens no matter who they are or where they live. While reforms that are growth accelerators are important, even more pressing is the need for *equalizing accelerators*—actions that

promote more rapid growth in those areas, sectors and groups where it is needed the most.

Infrastructure, for example, has impacts on economic growth of both types. Some investments in infrastructure are needed to maintain rapid growth—ports and airport modernization, improved highways. But infrastructure is also important to equalize growth—investments that raise productivity and farmer incomes in agriculture, infrastructure that help jobs move to people, as well as the infrastructure that is needed to connect rural India with the benefits of a growing economy.

Potential Binding Constraint: Infrastructure. A major concern for maintaining rapid growth in India is the provision of adequate infrastructure as there are some suggestions that, while the "high skill" services sector will continue to thrive, a greater ability of India to engage in manufacturing that is intensive in semi-skilled labor is desirable. Services are, to a large extent, either reliant on the infrastructure sector that has made the most progress (telecommunications) or able to cocoon themselves from service inadequacy. But engagement in manufacturing, particularly export oriented manufacturing that typically requires integration of supply chains, or in higher value added agriculture will require substantial improvements in basic transport infrastructure (roads, ports, airports, railways) and in more reliable power and water. But while everyone agrees that infrastructure is a constraint, the question is *how* to address the problem—this report argues this is not merely a financing problem of mobilizing additional billions but rather the emerging infrastructure constraints require systemic reforms that not only "fix the pipes" but also "fix the institutions that fix the pipes."

India must invest around 3-4% more of GDP on infrastructure to sustain growth of around 8%, address existing gaps and meet policy-driven coverage goals. The private sector can play an important role in providing such levels of resources, including through PPPs, although improving implementation capacity and the quality of investment will be as or more important than increasing the quantum of funds available. A greater emphasis must be placed on the actual delivery of services rather than completion of infrastructure: this will include shifting resources to maintain existing assets and making service providers more accountable to consumers and their owners. In all sectors reforms are underway, but these must be accelerated and difficult issues such as rationalizing user fees for services cannot be avoided.

Potential Binding Constraint: Fiscal Deficit. India has maintained a very high deficit by international standards for many years now. This creates three concerns.

- While for many reasons the burden of the deficit and debt in India have been surprisingly "light"—as India maintains much higher deficits and debt with much lower risks of internal or external crisis—no one has repealed the laws of gravity. Getting back on and staying on the Fiscal Responsibility and Budget Management Act targets for deficit reduction is essential to avoiding increased risk of crisis (especially if external factors such as interest rates were to turn less favorable) and associated higher domestic interest rates that could easily choke-off an expansion or cause a much higher fiscal burden of debt.

- The UPA government elected in 2004 has many areas in which they believe additional expenditures are desirable and is launching many potentially desirable initiatives: rural infrastructure (Bharat Nirman), employment (National Rural Employment Guarantee Act), education (Sarva Shiksha Abhiyan), rural health (National Rural Health Mission), urban infrastructure (National Urban Renewal Mission). But those new initiatives must be financed with some combination of higher taxes (or user charges), or cutting existing expenditures. The existing deficit leaves the government no *fiscal space* even for highly productive new spending which can sustain the current rapid growth. This means a focus on raising revenues in ways that do not choke off growth and cutting out unproductive government expenditure to make space for better, more effective, expenditures.

- Large deficits interact with an unreformed banking sector to reduce the ability of the private sector to obtain bank financing as risk averse bank managers can simply hold government debt and are under few pressures to innovate and find new customers and expand their portfolio.

Inclusive growth. Government policy is looking beyond just maintaining rapid growth to making growth more inclusive by addressing imbalances in the pattern of growth: too few jobs, too little growth in agriculture, lagging states and regions, and groups and people left out of progress. The foundation of these efforts is empowerment, which is key to expanding to expanding the equity of opportunity. But while social protection remains one element of inclusive growth, an empowerment approach does not seek to protect people *from* the market but rather it sees policy and public sector activity as facilitating success *in* the market. This makes empowerment foundational both for greater accountability and service delivery as well as for expanding the benefits of economic growth.

Equalizing Accelerator: Labor Regulations. Ill-designed labor regulations can lead to unnecessary conflict between legitimate concerns: protecting workers in jobs and creating new jobs and rising wages for workers. It is a major concern that for every person employed in the "organized" private sector (only around 8 million people in a country of a billion) there are four unemployed (roughly 36 million on a current daily status basis). Moreover, according to official government sources, the number of organized private sector jobs has been *falling* in recent years, and the "elasticity" of employment in the manufacturing sector to growth in output has been *negative* in recent years (rising output and falling employment). Current labor regulations seem to be protecting workers in jobs by "protecting" other workers from having jobs. This is not to say a regime of "automatic hire and fire" is the right solution (though this is of course the regime the vast majority of workers already face). Reforms ought to protect the interests of *all* workers by creating an environment for labor relations in which the legitimate social interests in fairness for workers can be met. At the same time the labor regulations should not exclude other workers from jobs by creating unnecessary and arbitrary regulations that discourages firms from hiring workers, forcing firms to stay inefficiently small, and inducing firms to use capital at the expense of labor. Properly done, labor regulation reform could be an equalizing accelerator.

Equalizing Accelerator: Financial Sector. On one level it appears that the demand for investment and not the supply of financing is the key issue: interest rates are relatively low, banks are holding substantially more government debt than they are required to, and, in aggregate terms, India has been (at least until quite recently) *exporting* capital as its national savings exceeded investment. However, what the aggregate picture masks is that the financial sector reforms have moved very far in *equity* markets and, with booming stock markets driven by portfolio investment large firms have been able to finance expansion easily—while massively reducing their leverage. But the combination of a closely regulated publicly owned banking sector, the interaction of a large deficit with fears of making new loans, and few incentives for innovation means that the sector has been slow to expand its lending to the private sector. Access to finance for small and medium scale enterprises (which are an important engine of growth and productivity) who are too small to be of interest to equity markets or portfolio FDI are stymied.

Lagging States. During the 1990s an interesting dynamic developed. If one divides states into the richer, middle income, and poorer states, what one finds is that while all groups of states enjoyed an acceleration of growth by about 2 percentage points in the 1980s compared to the 1970s, following the reforms of the 1990s the middle income states saw growth accelerate by another 2 percentage points while the poorer states stayed at exactly the same level of growth. Hence, the "lagging" states are lagging, not in that they have decelerated on average (though Bihar did) or because their incomes are declining but in the sense that they have not been able to yet create the investment climate conditions necessary to accelerate to the more rapid rates of growth experienced in the middle income states. The differentials in growth do produce wider disparities across the country, and while the Finance Commission allocations are progressive, compensating fiscal policy is not the long term solution.

There is policy play in three distinct policy arenas. First, it is important continue to pursue the policy reforms that lead to a completely integrated India in goods and labor markets by eliminating barriers and distortions to goods moving across states. Second, with integrated labor markets and large wage differentials there are incentives for either "people to move to jobs" (either permanently or temporarily) or "jobs to move to people." But for jobs to move to people the lagging states must address the deficiencies in the investment climate in order to attract industry: law and order, transport connectivity, regulatory burdens. Third, the lagging states need to focus on the rural areas – biggest bang for the reform buck in rural areas is the expansion of finance and infrastructure—for which, implementation is everything. Particularly in the lagging states simply building more rural branches of public banks in the presence of an unreformed banking sector or pouring more funding through line agencies in the absence of service delivery reforms are unlikely to unleash a booming rural economy.

Agriculture and the rural economy. One of the major concerns with the pattern of growth is the slowdown in agriculture and the effect that has on the rural economy and particularly on employment and wages (as rural and urban markets for casual labor are increasingly linked). But while subsidies have stabilized over the long sweep since the 1980s subsidies have doubled while public investment has fallen by more than half and public support for increasing yields has had diminishing impact—even though yields on

many crops in India are still half those of comparator countries. A workable strategy for acceleration of productivity growth in agriculture has to tailor the right mix of actions to promote four directions for agriculture in the overall rural economy with the specific potentials of regions:

- *Intensification:* increased cropping intensity of traditional crops via irrigation, HYVs, agro-chemicals, mechanization (Green Revolution)
- *Diversification*: shift to new more profitable crops (fruits, vegetables, higher value cereals, medicinal plants) and livestock
- *Non-farm linkages:* emphasis on value addition: trading, agro-processing. input supply
- *Exit* from agriculture, recognizing that as productivity increases fewer people will need to be employed in agriculture, and that the long-term strategy in areas with limited agricultural potential is off-farm activities.

The traditional approach of a relatively heavy handed promotion of intensification, primarily in food crops, with public investments coupled with input and output subsidies, has been successful in many ways, but is largely played out and is often promoting agricultural practices that are neither economically nor environmentally desirable. A new strategy should rely much more on a mix of policy of supporting input and output liberalization with land administration and tenancy reform, and support to R&D and extension that is tailored to specific needs that complements the needed investments in infrastructure.

Promoting a new strategy for agriculture and the rural economy would assist in addressing the problem of economically and environmentally unsustainable pattern of farming induced by the lack of restrictions on ground water usage, subsidized power, and price distortions. But it would be naïve to pretend that there are not very deep and difficult problems in the political economy of reforms in the subsidies given to farmers. Demonstrating that subsidies do not reach the poorest is one step, but to make progress the very real concerns of the middle and larger farmers need to be addressed head-on as while some are benefiting from access to power and water and doing well, there are many other farmers facing difficult circumstances even with power subsidies.

Fair access to markets. There has been a seismic shift from a view that the poor need to be protected *from* markets to the view that a better route out of poverty is to help them to strengthen their own livelihoods strategies through empowerment and fair *access to* markets for credit, labor, land and products. The Self-Help Group (SHG) movement has shown that with efforts at mobilization and empowerment even the poorest women can manage their own resources well and benefit from economic opportunities. The expansion of micro-credit is an important tactic in an overall strategy for rural growth. The experience of private firms with expanding into credit and into marketing (e.g. e-choupals of ITC) shows that there is no intrinsic contradiction between commercial viability and fair access for the poor.

A key disadvantaged group are tribals who suffer from both geographic and socio-cultural exclusion. A central factor affecting tribal livelihood possibilities is secure access

to and control over natural resources. The Panchayats Extension to Schedule Areas (PESA) Act, 1996, which attempts to redress inequities by transferring rights to ownership of minor forest produce to Gram Sabhas has had limited impact largely due to uneven implementation and inconsistencies with state government provisions. Draft legislation to confer forest rights to forest dwelling tribals is a progressive step in restoring social justice but its success will depend largely on resolving implementation constraints.

As unskilled labor is the key asset of the poor, it is a key concern. There are still social cleavages in the labor market across caste and gender. Women make only 55 percent of men's wages, even in casual labor markets and very little of the difference can be accounted for by the usual determinants of wages. In spite of far-reaching changes, some occupations continue to be caste based, even within the public sector. India has long had caste based reservations in jobs that until recently were the most coveted – regular salaried work in the public sector – and there is evidence to suggest that reservation policies are helping SC/STs to overcome occupational barriers. However, while there are positive impacts of some types of reservation, the mere extension of reservation to larger and larger spheres without accompanying reforms creates real risks of freezing up rather than freeing up opportunity. To make the playing field more even across castes and gender, the most significant reform that India can undertake is to reform labor laws. Perhaps paradoxically, the very dualism created between formal sector jobs and the casual and self-employed workers, created in large part by existing labor regulations, facilitates discriminations, such as gender and caste-bias, in hiring.

Equity in the creation of human capabilities. Investments in human development are important, not just to make the most of livelihood opportunities but also for ensuring that inequities are not perpetuated across generations. However, there are large gaps in human development outcomes across states and between rich and poor in most states. Many of the core public services addressed in part I are related to health, nutrition, and schooling. Implementing reforms in currently lagging areas is particularly important for addressing the inclusiveness of growth—the health, nutritional and educational outcomes for children today will determine their economic capability for decades to come.

Social Protection. Of course, even with the best of access to markets and opportunities there are needs for the government to engage in social protection to assist the poorest and help in coping with the risks and vulnerabilities that citizens face. Well-designed social protection systems can promote not only equity but also dynamic efficiency by mitigating market failures and enhancing opportunities for the poor. India has a long tradition of social protection. However, its social protection system has only just begun to adjust to developments in poverty and vulnerability in recent decades. While it spends a significant amount on social protection, this remains largely focused on social assistance and formal sector social insurance programs, with very limited efforts at insurance-type interventions for the unorganized sector. A strategy is called for which relies on a more balanced mix of efficient and accountable social assistance programs, expanded contributory systems where feasible (with provision for non-contributory programs for certain groups), and programs which perform an insurance-like function such as

workfare. The rebalancing of the social protection would also result over time in greater reliance on cash rather than in-kind benefits over time.

The new National Rural Employment Guarantee Act (NREGA) embodies the use of an employment guarantee in a bold effort to provide social protection and transform the rural economy. The international (and Indian) experience has been that a well designed employment program can be a useful component of a social protection strategy but the devil is in the design and implementation details, two in particular. First, keeping wages low is a key design element of employment schemes as it encourages self-selection among potential beneficiaries and prevents fiscal costs from "rationing" jobs (explicitly or implicitly). In this context the decision to set wages at the state agriculture minimum wage will likely prove problematic as, at that level of wage, demands may exceed available funding, an issue that may have to be addressed based on the experience with the first round of districts. Second, the desirability of employment programs depends to a large extent on the value of the assets they create. The success of the proposed use of greater PRI involvement in implementation of the Act is a promising initiative and could, if done well, constitute a model for other programs—but the accountability mechanisms for GPs will need to be strengthened.

Organization of the Report

A *guide* to the report itself is in order. Chapter 1 is a narrative of recent issues that justifies the attention to the two major themes: *service delivery reforms for greater accountability* and *sustaining rapid and inclusive growth*. Part I begins with chapter 2, which presents a diagnostic that motivates the attention to accountability and a framework of common principles for reform efforts. The next three chapters discuss various ongoing efforts to improve services: internal reforms and external accountability are discussed in chapter 3, how to make decentralization work to improve services is discussed in chapter 4, and the use of public-private partnerships—particularly in infrastructure, although the principles can be applied in the social arena as well--is discussed in chapter 5. Part II discusses actions to achieve more inclusive growth. Chapter 6 discusses potentially binding constraints to continued growth—infrastructure and the fiscal deficit. Chapter 7 discusses potential equalizing accelerators—reforms that both raise growth and expand inclusion. Chapter 8 is focused on agriculture and the rural economy (even in prosperous states). Chapter 9 treats the lagging states and regions while Chapter 10 addresses the issues of equity and opportunity for people.

A final word. This is the *World Bank's* Development Policy Review, which has four implications. First, in a county as large as India with reforms going on in many sectors and states driven both by government and by outside groups and advocacy we cannot provide detail on each area. Rather we try and present some factual evidence about the *issues* and context, an *analytic framework* and *common principles* for thinking through options, and promising directions for *pragmatic solutions*. Second, this document is intended as a synthetic document drawing almost exclusively on new research and analysis done within the World Bank and, while it draws on and is informed by research and findings on India from all sources, is not intended as a comprehensive review of all literatures on the topics discussed. Third, this document makes no pretense to represent

the voice of any group but the World Bank—not "the poor", not "the global community"—these are the views of the World Bank based on the particular expertise, experience, and evaluations of its staff. This is a view from a window not a mirror. Fourth, this makes no pretence to finality or certainty but is rather one view, our best judgments based on the available information and evidence, and hopes, at best, to be one additional voice in a vibrant ongoing dialogue. Taking off on the phrase Amartya Sen has recently popularized, we would hope nothing in this report is accepted by any Indian without argument.

Chapter 1. Overview of India's development progress and pressing challenges

Any observer of India today is struck by three puzzling observations:

- *Economic optimism is rampant and seems to outstrip the changes in fundamentals.* India's economic progress has been awe-inspiring and has awakened the world to India's potential as a global actor. People now speak of a future "tripolar" world with India, China, and the United States as the superpowers (Virmani 2005). Even though India's growth, at 7 percent, is already among the highest in the world, the constant talk is of "catching" the phenomenally rapid growth rates of China. But at the same time, by many individual measures of infrastructure capacity, corruption, education, and regulatory environment, India remains a difficult economic environment.

- *The economy is booming, but the public sector seems to be deteriorating.* India's sterling economic performance has been accompanied by a curious inversion. In past decades people would fret about economic performance, but marvel at India's institutional strengths in the public sector—a vibrant democracy, an extraordinarily talented top-tier bureaucracy (the "steel frame" of the Indian Administrative Service), and a set of organizations that could provide law and order, revenue collection, and a modicum of services in a sprawling poor country. Today, these concerns are almost inverted: it is easy to be optimistic about India's economic prospects, but there is growing concern that the basic institutions, organizations, and structures for public sector action are failing—especially for those at the bottom.

- *It is the best of the world, it is the worst of the world—and the gaps are growing.* The top students from the Indian Institutes of Technology are not just globally competitive, they have set the global standard. Yet, many, if not most, children in India finish government primary schools incapable of simple arithmetic. While there is increasing "medical tourism," where people travel to India for high-quality, low-cost medical treatments—the typical Primary Health Center doctor in Delhi is less competent than doctors in Tanzania. India's Supreme Court is justly world renowned, but local courts are backlogged and ineffective and local police are frequently a miasma of corruption and brutality. Similarly, in economic performance, while parts of urban India compete for business in software engineering and biomedical research, parts of rural India have poverty rates comparable to borderline "failed states," such as Haiti and Nigeria, and have child malnutrition rates higher than any country in the world.

This Development Policy Review starts from the premise that the goal of development is to improve human well-being in a sustainable way, with particular emphasis on the less well-off. The discussions of development and poverty reduction have been enormously enriched by the contributions of Amartya Sen, which emphasize that development is

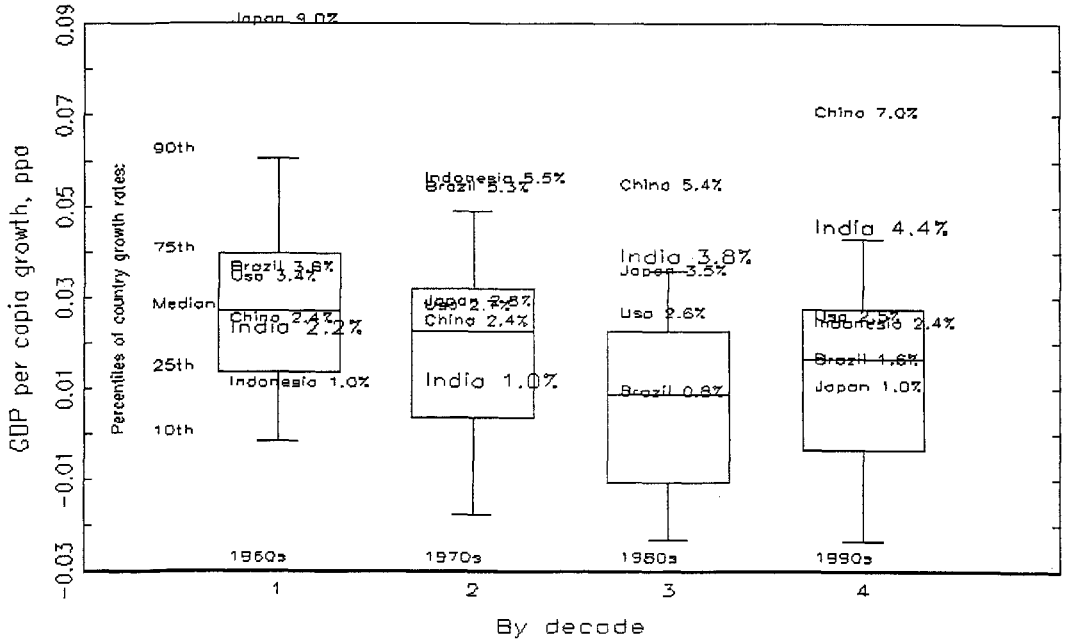
about much more than increasing material well-being, but also includes expansions in capabilities and in both positive and negative freedoms. A more consistent attention must be given to assessing development progress not simply as a measure of an aggregate of economic activity but as an assessment of the inclusiveness of economic growth, with emphasis not only on the distribution of gains but also on the security, vulnerability, empowerment, and sense of full participation the people may enjoy in social civic life.

India's growth patterns: a star performer

India's economy is growing rapidly by historical and global standards. Although different authors break India's post-war experience into various periods, all agree that growth began to accelerate in the 1980s and continued after the reforms of the early 1990s, perhaps at a modestly faster pace. This acceleration has taken India from being a below-average growth performer in the 1960s and 1970s to one of the most rapidly growing economies in the world in the 1990s (figure 1.1). Virmani (2005) shows India ranked ninth among 107 countries in per capita growth of gross domestic product (GDP) in the 1992/93–2003/04 period. Part of the reason there is so much attention to China's growth now is not because China is doing well and India not so well, but rather because China is one of the very few countries growing faster than India. Indeed, India is doing very well on growth and China spectacularly so.

Figure 1. 1: India has been in the top 10 percent of all countries in growth performance since the 1980s.

Distribution of GDP per capita growth rates across countries, 1960s to 1990s



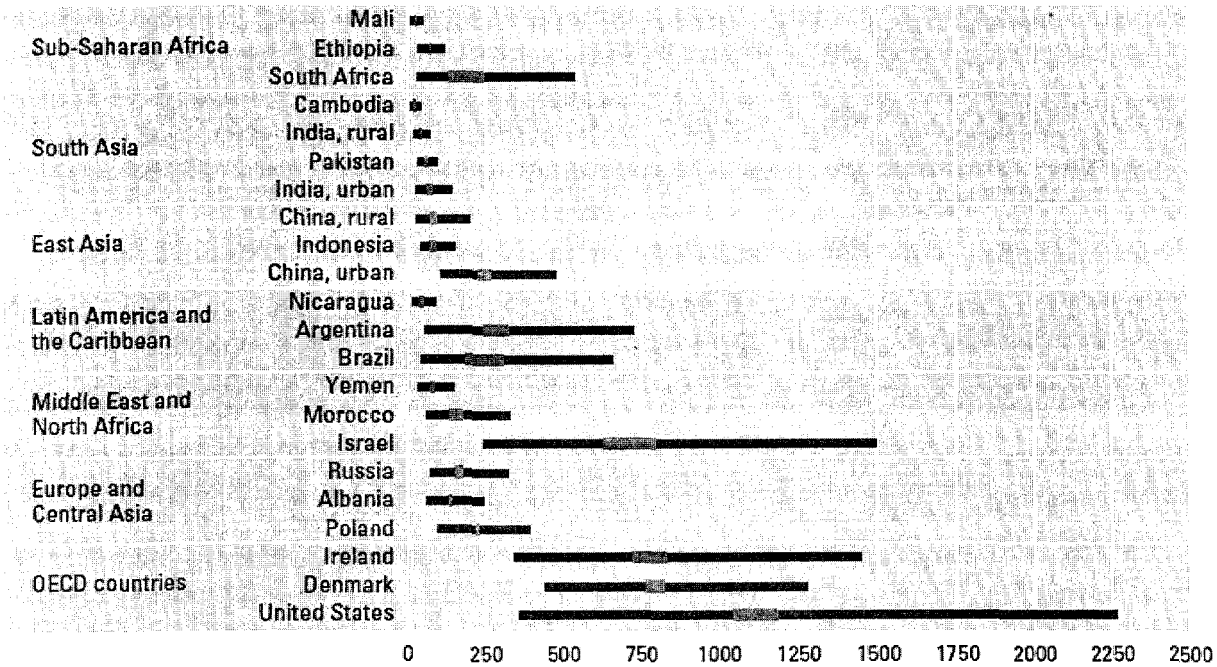
Note: Box plots show the median, 10th, 25th, 75th, and 90th percentiles.
Source: Author's calculations from Aten, Heston, and Summers 2001.

India's rapid growth has been accomplished, particularly since the reforms of the early 1990s, in what appears to be an economically sustainable way: although the persistent deficit is a concern, there is low inflation (by international standards), there have been no serious macroeconomic crises, and reserves are large and expanding as there are persistent current account surpluses (at least until very recently). While initially there were some fears *in* India of the implications of India's integration into the global economy, now there are mainly fears *of* India.

Although Indian growth has been among the highest in the world, especially in recent years, India remains a very poor country, because it started from a very low base. Rapid growth in India, even if it does not differentially benefit the poorest of the poor, does benefit people who are quite poor by any global standard. Even people at the 90th percentile of the income distribution in rural India have less than a fourth the income of a very poor person in Denmark (figure 1.2). The gap between the rich and poor within urban India is much smaller than the gap between a rich urban Indian and a very poor Dane. This is not to say that inequality within India is not a serious problem (much of the report is devoted to that issue), but that a country with global aspirations such as India should also gauge itself against a global standard. Applying that global standard, even growth that benefits some of the richer Indians more than poorer Indians dramatically reduces global inequality.

Figure 1. 2: An Indian at the 90th percentile of the income distribution has much lower income than those at the 10th percentile in OECD countries.

Range of monthly income and expenditures across countries, by region and income group (in 1993 purchasing power parity equivalents)



Note: Blue bars indicate the range in incomes. Orange bars indicate the range of expenditures.
Source: World Bank 2005d.

While there is a sense that rapid economic growth has put the "middle class" on a frivolous consumer binge, it is worth pointing out that the real middle of the Indian income distribution (the 50th percentile) did benefit from growth in the 1990s—in that a third of them bought a bicycle (so 35 percent of households own a bicycle, although still only 3.5 percent own even a motorcycle), bought a fan (still less than one in five own a television), and switched away from wood as a cooking fuel. A reality check on the gloss of the "middle class" is that in 1998, at the actual middle of the asset distribution in India two-thirds of households used wood for cooking fuel (Chaudhury and Hammer 2005). Broadly based economic growth brings not frivolous consumption, but enormous gains in basic well-being.

These gains in the basics from economic growth are also reflected in India's poverty statistics. There has been considerable debate about the poverty estimates from the latest available survey (the 55th round, 1999/2000)—to which this report will add nothing, as the issues are well and widely known (see Deaton and Kozel 2005 for a summary) and the next round of data will be available by early 2006 when the issues can be resolved (or at least re-debated with new information). But whatever the issues around the 1999/2000 estimates, it is clear the steady and rapid economic growth since the 1980s has led to spectacular reductions in poverty compared with previous periods. In 1979 (the last "pre-reform" estimate) headcount poverty was hovering at 50 percent—*higher* than the estimate for 1951, so that in almost 30 years from Independence to 1979 essentially no progress had been made. In decided contrast, the 1999/2000 official poverty rates of the Planning Commission were at *half* their 1979 levels.

Table 1. 1: The average pattern is for one decade's growth stars to fall to earth in the next, but India has defied that trend.

Change in growth rate, decade to decade, among countries with top performance, 1960s to 1990s (in percent)

Period	*Top ten growth performers of previous decade*	*All others*	*Growth slowdown of previous decade's stars versus other countries*
1970s vs. 1960s	-3.4	-1.0	-2.4
1980s vs. 1970s	-3.4	-1.0	-2.4
1990s vs. 1980s	-1.9	+0.2	-2.1

Note: Negative is a slowing in growth.
Source: Author's calculations.

Given the centrality of economic growth for improvements in well-being for the population at large, one key theme of this report is the importance of sustaining, and perhaps even accelerating, economic growth. India is sufficiently far from the global economic leaders that there is no risk of growth deceleration because India has "caught up": even at India's current rapid growth rates it would be almost 40 years (when any students reading this will be retiring) before India attains the level of U.S. per capita GDP *in 1950*, and 60 years (beyond the lifetime of most readers) to reach the current U.S. level. But, as table 1.1 illustrates, poorer countries cannot take rapid growth for granted—the past pattern is for rapid growth to slow—a pattern India has defied once and can, with

effort, defy again, but complacency about the need to push ahead with policy reform just to maintain rapid growth could lead to slow growth.

Recent growth experience

How does one apply the lessons of India's success (and that of other countries) to creating more success in the years ahead? This report aims to identify the most important constraints on economic activity, those policy changes with the biggest growth gains for the reform effort. While there are many areas of policy that require attention, and any analysis of the "investment climate" or of specific sectors will reveal a long list of desirable reforms, in designing a growth strategy policymakers should focus on the "binding" constraints—those areas that, without attention, are the most likely obstacles to sustained rapid growth. Relieving these constraints would be a growth accelerator.

The aphorism "In a desert one should find camels not hippopotamuses"[1] is a good guide to analyzing the pattern of economic growth. If rain is scarce, then one should find animals adapted to a scarcity of water, not those reliant on water. In an economic environment where, say, transport infrastructure is scarce, one should find "infrastructure camels"— those industries and firms that are thriving should be less than usually reliant on infrastructure. Similarly, if the cost of finance is high, one should expect to find "finance camels"—industries and firms that are not particularly reliant on capital intensity. This section does not attempt to give a comprehensive review of Indian economic growth, as there are many such reports from government (GoI 2005) and non-government sources (Virmani 2004a, 2005; Acharya 2002; Panagariya 2004), but rather focus just on those features of growth that are indicative of constraints on growth. What are the features of the recent Indian growth experience that give indications of what might be the next set of important constraints to growth in the medium term?

- The service sector is booming, agriculture lagging, and manufacturing performance is a mixed bag.
- Job creation in the private organized sector has been very weak.
- Wage expansion has been more rapid for those with already high wages.
- Investment, both domestic and foreign, has been relatively weak.

Thriving services, lagging agriculture, mixed performance in industry. The service sector grew at an average annual rate of 9 percent in the 1990s, contributing nearly 60 percent of the overall growth of the economy (World Bank 2004a). While the most visible growth has been information technology and business process outsourcing services, other sectors—including telecommunication, financial services, community services, and restaurants—have also grown considerably faster than GDP over time. Consequently, India's services share of GDP is higher than the average for low-income countries.

[1] This phrase is from Ricardo Hausmann. Our analysis is motivated by the "binding constraints" approach outlined in Hausmann, Rodrik, and Velasco (2005), which makes the point that a growth strategy is strategic in that it makes hard choices about which particular avenue to pursue rather than a check-list of all possible reforms that could have an impact on growth. While it is empirically difficult to quantify and rank the most binding constraints, examining the pattern of growth can provide clues to what important constraints to growth are likely to be.

Table 1. 2: India's growth rate has accelerated to 7-8 percent in recent years, driven by the continued service sector expansion and a recovery in industry

Real GDP growth, by sector, in India, 1992–93 to 2005–06

Sector	*Percentage change from the previous year (at factor cost)*					
	1992–93 to 2002–03 (avg,)	*Tenth Plan target*	*2002–03*	*2003–04*	*2004–05 (quick estimates)*	*2005–06 (advanced estimates)*
Agriculture	2.4	4.0	-6.9	10.0	0.7	2.3
Industry	6.3	8.9	7.0	7.6	8.6	9.0
Mining and quarrying	4.4		8.7	5.3	5.8	1.0
Manufacturing	6.8		6.8	7.1	8.1	9.4
Electricity, gas, water supply	5.4		4.8	4.8	4.3	5.4
Services	7.6	9.3	7.3	8.2	9.9	9.8
Trade, hotels, transport, and communications	8.5		9.1	12.0	10.6	11.1
Financial services	7.8		8.0	4.5	9.2	9.5
Community, social and personal services	6.7		3.8	5.4	9.2	7.9
Construction	5.5		7.7	10.9	12.5	12.1
Total GDP at factor cost	5.9	8.0	3.8	8.5	7.5	8.1

Source: Central Statistical Office.

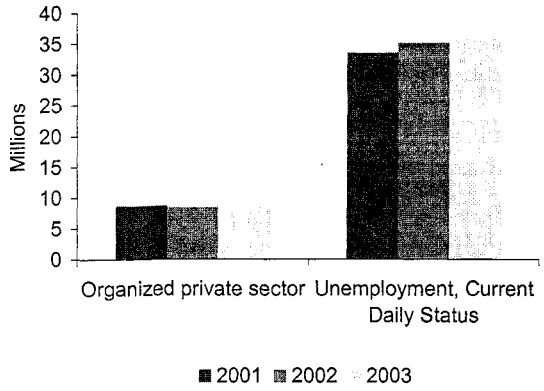
Perhaps the most worrying feature of the recent growth performance has been the performance of agriculture: average agricultural growth over the past three years has been 1.3 percent—against a Tenth Plan target of 4 percent per year. Agricultural growth appears to be decelerating: from 3.2 percent in 1980–92, to 2.4 percent in 1992–2003, and to 1.3 percent over the past few years. As two-thirds of India's people depend on rural employment for their main source of income, this is directly affecting many households. The deceleration seems to be general across all crops and appears to reflect a broadly based deceleration in productivity growth (GoI 2005).

Industry has grown rapidly, at 6.3 percent between 1992 and 2002/03—but this lags well behind services growth and, at 22 percent in 2004/05, the share of industry in GDP remains very low in India. The contrast with China is stark: in China the share of industry in GDP was 51 percent. Nagaraj (2005) shows that China's industrial growth rate is close to one-and-a-half times that of India, and estimates suggest that, although impressive Total Factor Productivity (TFP) growth has been achieved in India, India's level of industrial TFP is between about 33 percent and 40 percent of what it could be; and it is only half that of China.[2] Similarly, while India's expansion of manufactured exports has been impressive (in the first half of the 1990s India's manufacturing exports grew 30 percent faster than world trade in manufacturing), China's manufacturing exports grew 57 percent faster than India's. India's world market share in manufactures is still very small and still a small fraction of China's, which has increased from about 3 percent in the mid-1990s to over 6 percent in 2002.

Labor markets: little growth in formal jobs. A second major concern about the structure of economic growth in India is that the number of private sector jobs that have been created is small compared with the rapid growth of output. In 2003 only 8 million were employed in the organized private sector, out of a labor force of roughly 390 million people. Even though the labor force grew that year by 12 million people employment in the organized private sector fell by 200,000. The lack of employment growth is particularly stark in manufacturing where, according to one study, the "employment elasticity" between 1994 and 2001 was negative, as employment fell even though output rose by 5.3 percent per year. In 2003 for every worker in the organized private sector there were four unemployed (figure 1.3).

Figure 1. 3: For every worker in the organized private sector there are four unemployed—and the number of organized private sector jobs is falling.

Number of workers employed in the organized private sector or unemployed, 2001–03



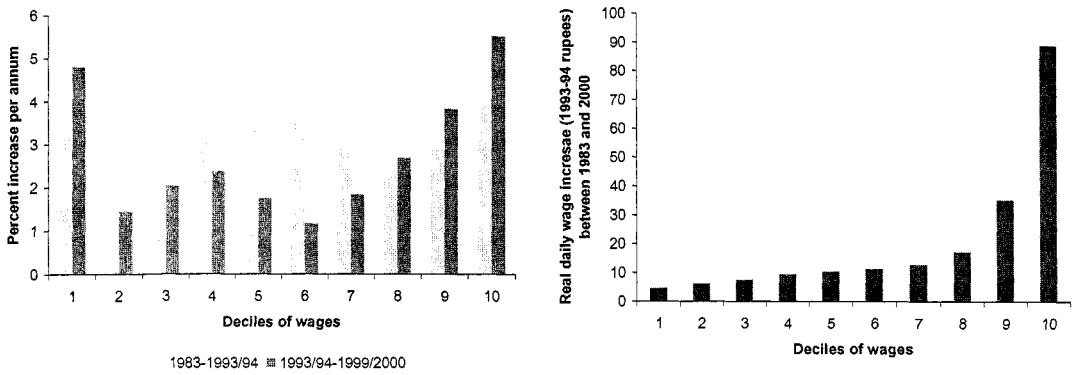
Source: GoI Planning Commission 2005b, tables 8.1 and 8.2.

[2] See Rodrik, Subramanian, and Trebbi (2004) and Rodrik and Subramanian (2004). Estimates are based on regressions of TFP based on the deep determinants of TFP.

Wage increases concentrated at the top. While wage growth has been impressive and helped to drive down poverty, there are some signs that excessive wage growth in the top 10 percent of jobs may reflect the increasing scarcity of highly skilled labor in the service sector (figure 1.4). Over the past decade, annual growth rates of 20–30 percent in the information technology sector have depleted existing talent pools, producing high-skilled labor shortages and driving up salaries that are thought to have quadrupled over the past five years for Indian IT engineers (Oxford Analytica, November 14, 2005). All three of India's leading software companies (Tata, Infosys, and Wipro) are reportedly looking to develop educational institutions to increase the number of high-skilled workers. Increasing returns to secondary education point to the general scarcity of skills at that level, while high unemployment of educated labor points to a possible mismatch between the skills of the labor force with tertiary education and the skills demanded by the market.

Figure 1. 4: Wage growth has been disproportionate at the top end of the labor market.

Increase in real daily wages, by decile, 1983 to 2000



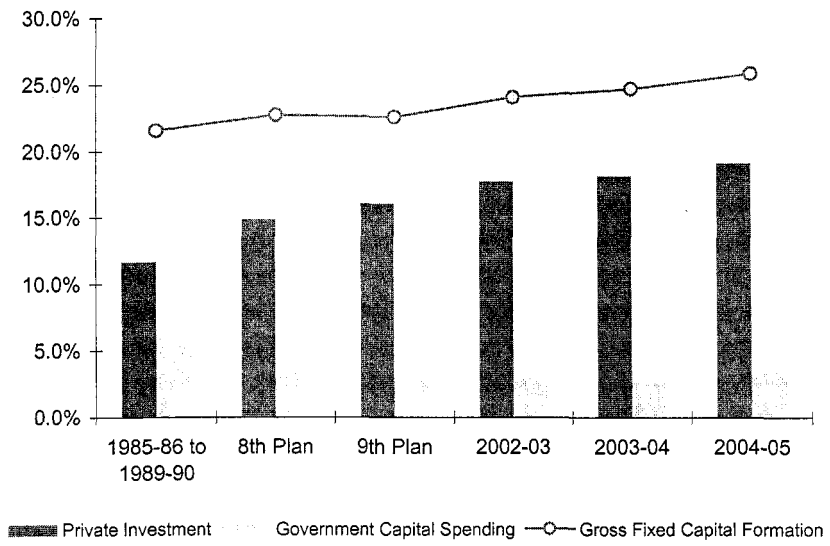
Source: Narain 2005.

Weak investment with low reliance on foreign sources: As outlined in the Tenth Plan Mid-Term Appraisal, the domestic savings rate has actually exceeded the plan's targets. The current account balance was also positive until (very) recently. Thus, India's growth pattern is unlike the old-fashioned "two gap" thinking that growth depended on investment and would be constrained by either low domestic savings or the inability to attract foreign savings. India's investment has been *less* than available savings and has actually been, in essence, *exporting* capital as burgeoning of foreign exchange reserves do not contribute to additional physical investment. Until very recently, India's record in attracting private investment has also not been very impressive; at around 15 percent of GDP over the past decade, private investment in India is below the average for low-income countries. Inward foreign direct investment to India has remained modest, averaging $5 billion annually over the past few years, in contrast to the $40 billion annually to China. Foreign direct investment in India is 1 percent of GDP, compared with 4 percent in China and between 2 percent and 3 percent in many emerging market

economies.[3] Some of this lack of investment has been reversed very recently, as the most recent data show investment increasing to more than 30 percent in 2005/06, driven by increases in private investment. Nonetheless, it is too early to say whether that upward shift will be sustained (figure 1.5).

Figure 1. 5: Private investment in India has been low—at least until recently.

Investment as a share of GDP, 1985–86 to 2004–05



Clues from the patterns of growth

This evidence suggests further examination of several questions in the remainder of the report:

- Is the more rapid growth in services than industry due to a tight constraint of infrastructure, as the service sectors are less reliant on moving physical inputs and outputs and hence are "infrastructure camels" that can easily cocoon themselves from infrastructure deficits?
- Is the low job creation in manufacturing the result of regulations that raise the cost of labor to firms by much more than they benefit laborers?
- Is it not the cost of finance, but rather access to it, that limits investment?

[3] One needs to distinguish between portfolio investment, which is very strong, and physical investments. Capital inflows remain buoyant, and the surplus on the capital account was $32.6 billion in 2004/05 (versus $20.9 billion in 2003/04 and $12.1 billion in 2002/03). The fastest increase has been in foreign portfolio investment, with India accounting for one-fourth of all portfolio flows to emerging Asia in 2004. Foreign direct investment in India remains low and is picking up only slowly, hindered by a difficult business climate as well as by caps in certain sectors (IMF- 2005a). So, the stock market has soared as people bid up prices for existing firms (and their assets).

Part II (chapters 6 and 7) of the report explores four issues as the most likely factors constraining aggregate growth in India in the medium term: (a) infrastructure, (b) the fiscal deficit, (c) labor laws, and (d) the financial sector. Of course, there are many other areas of policy that require attention—such as poor governance, unclear and insecure property rights, and unsustainable use of natural resources. While reforms in these areas are desirable, indeed critical, for a long-term development strategy, this report focuses primarily on the main obstacles to sustained growth in the medium term. In the Indian context, one additional question that merits further examination is whether the accelerators of growth will have an equalizing or disequalizing effect across states, regions, and people. Given concerns about the distribution of benefits from growth, as discussed below, there should be a focus on equalizing accelerators.

Core public services: implementation is everything

There are heated ideological debates about the proper role of government in some economic spheres, but there is near universal agreement that the government has a responsibility to its citizens in certain core areas: law and order, infrastructure, education, health, water resources, sanitation, social protection, and safety nets. Debates may continue over whether this responsibility is best discharged using direct production of services by the state or by other modes (e.g., contracting with private parties to build roads versus "force account," providing medical insurance versus care in public facilities) and how services in these core areas are to be financed (e.g., how much general taxation versus user fees). Few would argue, however, that the state should avoid responsibility for the quantity and quality of services in these core areas. But there is a growing sense among politicians, civil servants, and academics that the ability of India's existing institutions to deliver on those responsibilities is deteriorating—even as the economy booms.

It is a striking fact that economic renewal and positive growth impulses are now occurring largely outside the public sector.... In the governmental or public sector, on the other hand, we have seen a marked deterioration at all levels- not only in terms of output, profits and public savings, but also in the provision of vital public services in the fields of education, health and transport.

Bimal Jalan, *The Future of India: Politics, Economics and Governance*, 2004.

While the functions of the state in India have steadily increased, capacity to deliver has declined over the years due to administrative cynicism, rising indiscipline, and a growing belief widely shared among the political and bureaucratic elite that the state is an arena where public office is to be used for private ends.

Naresh C. Saxena, *Improving delivery of programmes through administrative reforms in India,* 2005.

The performance of India's public institutions has become a matter of serious concern both for the quality of the country's democracy and the well being of its people.

Devesh Kapur and Pratap Bhanu Mehta, *Public Institutions in India,* 2005.

India's structures for service delivery were designed to create the basic assets needed, and on that level they have been largely successful. If "access" to core services is measured crudely as proximity (to a school, to a water source, to a clinic), then the expansion in physical assets has lead ever larger portions of the population to have access.[4] But in 2004 the newly chosen prime minister signaled the mindset shift that has to occur if India's publicly delivered services are to keep pace with its booming market: from promises made to promise kept. Keeping promises will be neither easy nor quick, because it requires fundamental shifts in the way government and its line agencies typically go about their business. The shift is from an emphasis on outlays to an emphasis on outputs and outcomes, from a focus on asset creation to a focus on asset operation, from compliance with procedures to a drive for better performance. Since this document is a Development Policy Review, it is worth noting this shift is also away from policy design (e.g., stated objectives, chosen instruments, and sectoral or schematic expenditure allocations) toward policy implementation.

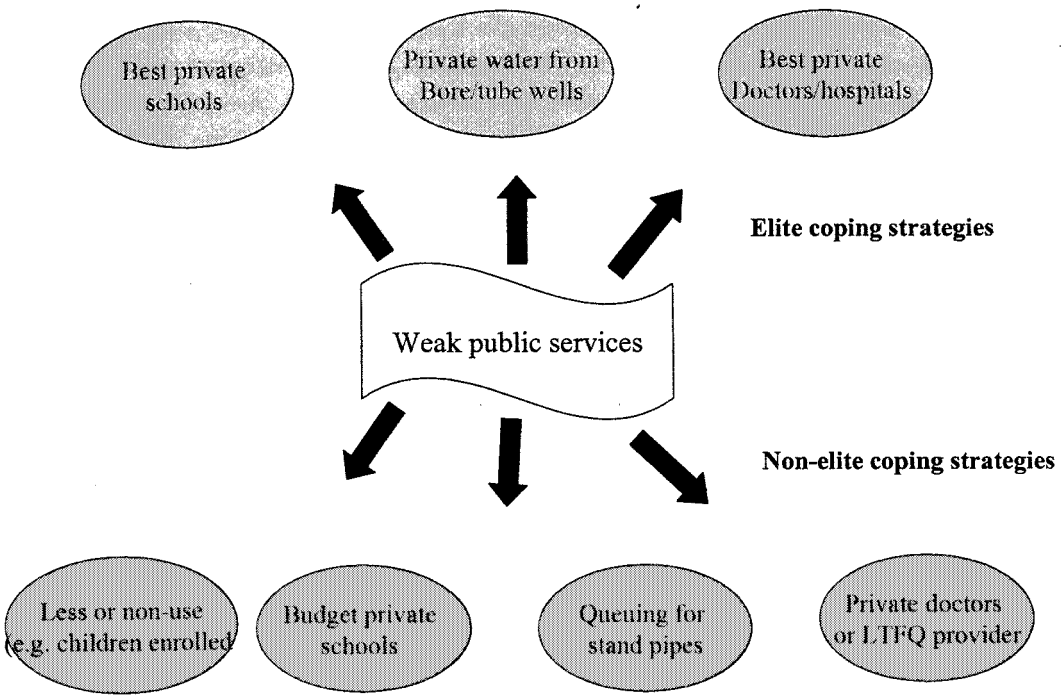
In spite of India's rapid growth and the accompanying rapid reduction in the headcount ratio of income poverty, there are other elements of a multidimensional approach to poverty in which problems remain stubborn and progress is slow. A recent World Bank report documented the persistence of extremely high levels of malnutrition in India: among the *middle*-income group *more than half* of children were underweight (less than two standard deviations below the norms of weight for age)—which is twice the level in

[4] This does not mean that all access problems have been solved (e.g., rural access to infrastructure is still poor in many areas).

Africa (World Bank 2005b). Infant and child mortality is a key indicator of well-being, and progress on this indicator slowed precipitously in the 1990s.

Figure 1. 6: Faced with inadequate public services, both elites and non-elites have developed ways to augment education, water, and health services in the private sector.

Elite and nonelite strategies for coping with dysfunctional or unavailable public services



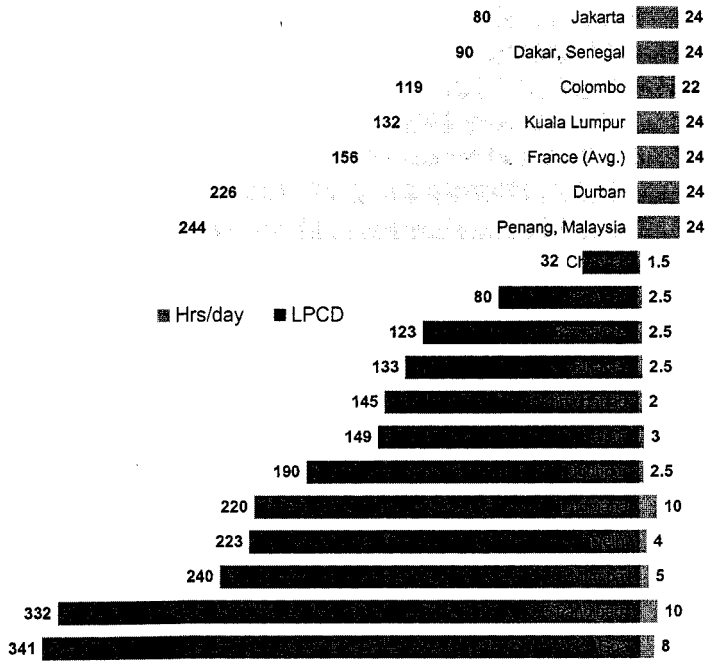
In the face of these stubborn problems, a striking feature of the recent Indian experience is a de facto shift from public to private provision of many core services. The attempt to discharge the governmental responsibility for core services exclusively through the direct production of services in the public sector has led to a completely ad hoc, unregulated privatization of services because of a systemic failure in the accountability of public sector for the quality of services. There are distinct "elite" and "non-elite" strategies for coping with public sector inadequacy, which are illustrated for water supply, health, and education in the next few paragraphs and in figure 1.6. Paradoxically, it appears that the route to privatization (and an ad hoc, unplanned, and unregulated privatization at that) is a blanket commitment to public sector producers—if that commitment to public sector producers comes without an equally strong commitment to public sector production. When people turn to providers who are not full-time employees of the government to meet core public sector responsibilities, their actions cannot be caricatured as "pro-privatization"; in fact they are simply pro fulfillment of public sector goals—no matter what the instrument—an outcome orientation that does not begin with any preconceived notion that core public responsibilities are best delivered by state functionaries, NGOs, private sector, community groups, or local governments.

Urban and rural water supply

Figure 1.7 shows that the daily supply of piped water in urban areas is much lower in India than in other developing-country cities around the world. Moreover, it appears that the availability of water has been declining—while water in Bangalore was available for 20 hours a day in the early 1980s, it is down to 2.5 today. In Chennai water was available 10–15 hours a day in the 1980s, but only 1.5 hours a day today. People cope with the declining availability in a variety of ways. A recent study of the costs of coping with inadequate water supply in Delhi found that the true total costs of water supply are already "privatized"—on average the private coping costs are 262 rupees per month (when capital costs are included) versus a monthly water bill of only 141 rupees per month (Misra 2005). The differences in how the elite and nonelite cope are stark: while those in authorized colonies pay the price for declining public service in capital expenses for pumps, boreholes, and overheard storage tanks, those in the slum areas pay the cost with their only asset: time. They spend almost two hours a day to collect water.

Figure 1. 7: While many major cities in developing countries maintain nearly 24-hour water supply, most Indian cities have service only a few hours a day.

Average hours per day of water service in selected Indian and comparator cities



Source: Ministry of Urban Development and Water and Sanitation Program benchmarking study, ADB utilities book, verified with relevant utilities.

For irrigation and rural drinking water, there is a similar recourse to the private sector. Tubewells are widely used for irrigation, as groundwater now supplies 70 percent of the irrigated areas, and boreholes account for 80 percent of domestic water supplies. Over 80 percent of newly irrigated areas have come through the expansion of private irrigation. As Shah (2005) puts it succinctly: "We need to recognize that self-provision of water is the best indicator of the failure of public water supply systems. Tubewells proliferate in canal commands because public irrigation managers are unable to deliver irrigation on demand. Urban households want their own boreholes because municipal service is inadequate and unreliable."

Health

A recent household survey for the Reproductive and Child Health Program found continuing progress in some dimensions of health care, but serious signs of slowing in others. Comparing the data from districts from household surveys in 1998/99 with those same districts in 2002/03 one revealed that, although there are some improvements in antenatal care, many dimensions of service provision outputs have worsened (table 1.3). The percentage of children delivered in public institutions fell by 5.5 percentage points to less than one in five births, while the percentage delivered in private facilities nearly

doubled. Women with timely visits from Auxiliary Nurse Midwives, never very high, fell even further to less than one in eight. Shockingly, the prevalence of children with full immunizations for childhood diseases, appallingly low to begin with, fell from 52 to 44.6 percent. According to the World Health Report 2005, immunization rates for in India are 81 percent for BCG, 71 percent for DTP, and 67 percent for measles, which are substantially lower across the board than in Bangladesh (95 percent, 85 percent, and 77 percent, respectively) and are similar to those of a much poorer country such as Cambodia (76 percent, 69 percent, and 65 percent).

Table 1. 3: While some indicators of health care rose, the share of children who were fully immunized, were delivered in a public hospital, and were attended by a visiting nurse declined.

Percentage of children receiving selected health services, 1998–99 and 2002–03

Health service	*1998-99*	*2002-03*	*Change (in percentage points of the population)*
Polio3	66.1	57.0	-9.1
Full immunization	52.0	44.6	-7.4
DPT3	64.6	57.5	-7.1
Delivered at a public institution	24.0	18.5	-5.5
Measles	58.1	55.2	-2.9
Auxiliary Nurse Midwives making home visit within two weeks	14.1	12.7	-1.4
Deliveries assisted by professionals	39.6	47.5	7.9
Full antenatal care	31.9	40.3	8.4
Any antenatal care	64.5	74.0	9.5
Delivered at a private institution	9.4	21.5	12.1

Note: Based on household survey and districts with household data in both periods.
Source: Implementation Completion Report of the Reproductive and Child Health Program I.

Although India has a constitutional commitment to universal provision of health care, the ratio of government to total expenditure in health is only 21 percent—half the public spending ratio of ideologically "free market" countries such as the United States (45 percent) or Chile (44 percent). If one takes expenditures as a measure, India is one of the most "privatized" health systems in the world—of the 195 countries listed in the World Health Report 2005, only five (Cambodia, Guinea, Myanmar, Sudan, and Togo) had a ratio of public to private spending lower than India. This high private spending in India is not the result of an announced public policy to reduce services, but rather a coping strategy to deal with the failure of the public sector to actually provide promised services adequately. A recent survey that tracked public facilities in Rajasthan continuously for a year found that, while use of public facilities is low for all income groups, the coping strategy of the poor is to visit facilities less and to rely more frequently on traditional healers (Banerjee, Duflo, and Deaton 2004).

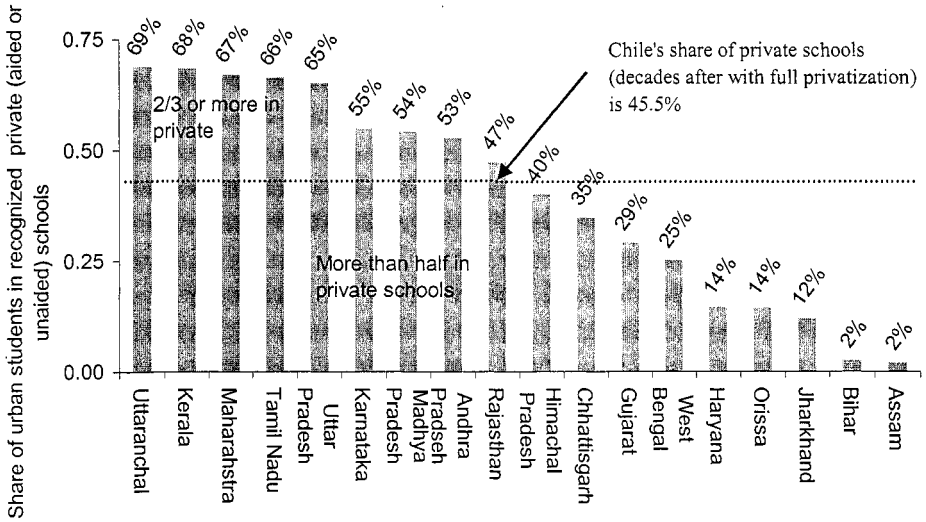
Elementary education

In education the government of India has launched a major initiative of Sarva Shiksha Abhiyan to expand enrollments, increase local capacity for planning and action, and ultimately raise learning achievement. Internal reports suggest massive reductions in the number of children out of school, which is estimated to have fallen from 25 million to around 13 million by 2005. Resolution of how much of the reported increase is due to expansion of government schools and how much due to increased demand and expansion of private schools will have to await the household data from the National Sample Survey. But whatever the trend, the share of private schooling in urban areas is very high. Figure 1.8 reports that in the urban areas of five states nearly two-thirds of enrolled children are in the recognized private schools, and in another five states more than 4 in 10 urban children are in private schools.[5] Unfortunately, the data do not distinguish between private aided schools (which are very widespread in Kerala, for instance) and private unaided institutions. Note that even in some states typically known for better than average public services and reasonable governance (e.g., Maharashtra, Tamil Nadu,) the private share is extraordinarily high, while it is low where public sector performance must be even worse (e.g., Bihar, Jharkhand). Again, there is no question of the government's constitutional, rhetorical, and legal commitments to universal elementary education. Nonetheless, the quality of services provided leads people, given the choice when alternatives exist (as in urban areas; in rural areas the private sector share is much lower), to opt out of government schools, even though this usually means paying the full cost of education themselves.

[5] What makes the high ratios in the official DISE data even more striking is that enrollment in the *unrecognized* private sector is widely acknowledged to be large and growing in some states. One study in seven districts of Punjab found 26 percent of all children enrolled were enrolled in unrecognized schools. While the DISE district report for Jaunpur, UP reports only 15 percent of enrollment in private schools, an independent study in four blocks found over 40 percent in private schools. A study in Haryana in four districts found seven unrecognized schools for every ten recognized schools so the "recognized only" figure would be far too low.

Figure 1. 8: In the urban areas of eight major states, more than half of the children in elementary school are in private schools.

Percentage of students in recognized private schools, by state



Source: Author's calculations with District Information System for Education 2004 State Report Cards.

This is not to say that private sector participation in any of these sectors is a negative thing—in fact, without a private sector *outcomes* could have been much, much worse. But the advent of private sector services is not the result of an official policy nor, in many instances, of a "public-private partnership." Instead, the private sector is a coping mechanism for failing public services. This report discusses instances of using the private sector, not to escape public sector responsibilities, but to meet core public sector responsibilities. How to strengthen the basic institutions of service delivery in core areas of government responsibility, one of the most pressing challenges facing India today, is addressed in part I of the report.

A booming economy with growing gaps

While the economy of India has been growing rapidly, with broadly based gains in absolute incomes and many outcomes, it is also the case that progress has differed widely across states, across regions within states, and among different people and social groups. Genuine concern for these gaps does not suggest a return to the "politics of envy" and a focus on the redistribution of income (which, at least rhetorically, drove many of the policies that led to neither rapid growth nor income redistribution). Rather, this report follows the shift to an emphasis on equity and on the expansion in opportunity—equal and expanded opportunities to obtain better services and to participate in the growth process. The fact that some states are growing faster than others does not mean the instruments of fiscal federalism are the solution—rather it is a signal that there are opportunities for the lagging states to accelerate their growth as well. The fact that some regions are not prospering implies the need for strategies for these regions. The fact that

some people might be prospering more than others does not suggest limiting opportunities to those, but rather aggressively expanding the equality of opportunity for all to access labor markets, assets, and product markets on fair terms and to expand the equality of opportunity for investing in the health, nutrition, and education of the next generation.

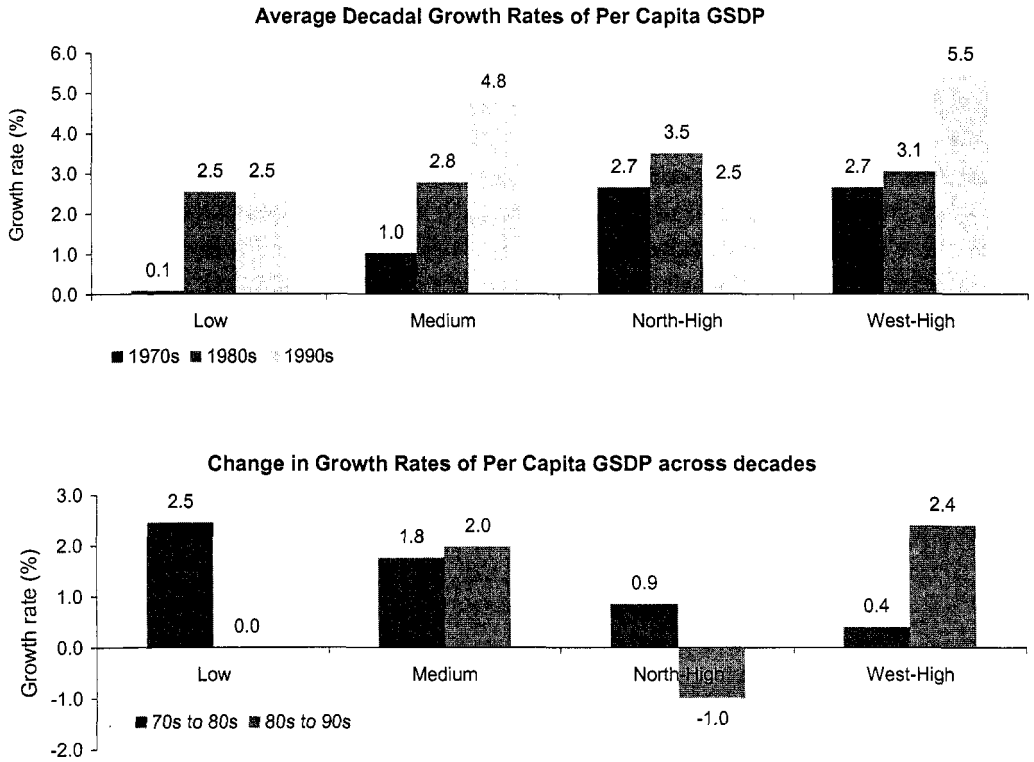
Differences across states and regions

India's average growth performance conceals very different growth experiences across states. Before the 1980s, growth rates were low—at most 2 percent a year over the decade—in all states other than the Green Revolution states of Haryana and Punjab and the state of Maharashtra. Growth was also extremely volatile, particularly in the lower-income states. The first stirrings of reform in the 1980s signaled a change in orientation of government from direct control on private activity to de facto lifting of controls and restrictions (Virmani 2004b). This led to a marked acceleration in growth in nearly every major state, more so in the slower-growing states, so that the dispersion in growth rates across states decreased. Deeper and more comprehensive reforms introduced in the 1990s were accompanied by a significant shift in growth patterns—in part, because average growth accelerated even further. But the truly dramatic shift was the large gap that emerged in growth rates between states.

Sharp differentiation across states since the early 1990s reflects acceleration of growth in some states but deceleration in others. High-growth performers were a mixed group, spread between rich states (e.g., Gujarat, Maharashtra) and middle-income states (e.g., Karnataka, Kerala, and West Bengal) and fairly well distributed regionally. Growth slowed down in the richer northwestern states of Haryana and Punjab, reflecting a marked slowdown in agricultural growth. More worryingly, growth failed to pick up in states such as Bihar, Orissa, and Uttar Pradesh that were initially poor to start with, with the result that the gap in performance between India's rich and poor states widened dramatically during the 1990s (figure 1.9).

Figure 1. 9: Growth accelerated in nearly all states in the 1980s, but gaps widened dramatically in the 1990s.

Decadal growth of per capita gross domestic product in Indian states, by income group or region, 1970s to 1990s

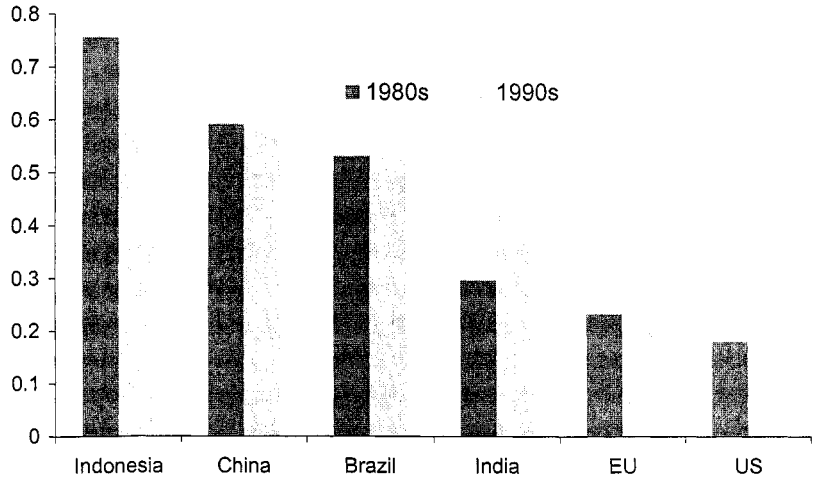


Note: Low-income states include Bihar, Madhya Pradesh, Orissa, Uttar Pradesh, and Rajasthan. Medium-income states include Andhra Pradesh, Karnataka, Kerala, Tamil Nadu, and West Bengal. North-High includes Punjab and Haryana, and West-High refers to Gujarat and Maharashtra.
Source: Author's calculations.

Increased dispersion in growth rates is not a failure, but a success of policy. The liberalization policy of 1991 allowed states to play a larger role in determining their development paths and attracting investment (Ahluwahlia 2000). The increasing gap between the middle-income and poorer states is not because growth slowed, on average, in the poorer states but because growth accelerated in the middle-income states. The comparison between India and other regions is interesting. Even with the increase, the current gap in income between the richest and poorest Indian states is much smaller than that of other large federal countries. Figure 1.10 shows the standard deviation in per capita output among internal provinces, states, or countries within India, Indonesia, China, Brazil, the United States, and the European Union (EU12)—all regions with more than 200 million people. While the variation in output across states increased in India, it is still substantially smaller than in Brazil, China, and Indonesia—but strikingly larger than the cross-state differences in the United States or the cross-country differences in the European Union.

Figure 1. 10: Inequality across states of India remains low compared with developing countries, but higher than integrated developed regions.

Standard deviation of GDP per capita in India and comparator countries, 1980s and 2000s



Note: Left bars indicate standard deviation in 1980s; right bars indicate standard deviation in 2000s.
Source: Authors' calculations using data provided by B. Milanovic. For details on conversion of provincial GDP per capita to constant equivalents of purchasing power parity, see Milanovic 2005.

At the same time, accepting that differences in growth performance across states will be a natural outcome of a liberalized policy environment does not mean that the low growth rates in India's poorest states should also be accepted as a matter of course. Most socioeconomic indicators are explained overwhelmingly by income (and education, which itself is driven by income). If large differences in growth rates between rich and poor states were to be sustained over long stretches of time, these could eventually translate into vast differences in material well-being. Low-income states already rank well below the other states on a number of social and economic indicators (table 1.4). Unless the poor states improve their performance, it will become increasingly difficult to accelerate poverty reduction and development in India.

Table 1. 4: Differences in income and output among Indian states are associated with large differences in human development indicators of health and education.

Ranking of India's poorest states by GSDP per capita and human development indicators

	Rank by GSDP per capita	*HDI rank[a]*	*Literacy rate[b]*		*Infant mortality[c]*		*Under-weight children[d]*		*Sex ratio[e] (0–6 years)*	
			Diff.	*Rank*	*Diff.*	*Rank*	*Diff.*	*Rank*	*Diff.*	*Rank*
Bihar	13	13	-17.9	13	-5.3	9	-7.4	11	15	5
Orissa	12	10	-1.8	9	-13.4	11	-7.4	12	26	3
Uttar Pradesh	11	12	-8.0	12	-19.1	13	-4.7	10	-11	8
Madhya Pradesh	10	11	-1.3	8	-18.5	12	-8.1	13	5	7
Rajasthan	9	8	-4.4	11	-12.8	10	-3.6	9	-18	10
West Bengal	8	7	3.8	5	18.9	3	-1.7	7	33	2
Andhra Pradesh	7	9	-4.3	10	1.8	8	9.3	4	34	1
Karnataka	6	6	1.6	7	16.1	4	3.1	5	19	4
Tamil Nadu	5	2	8.1	2	19.4	2	10.3	3	15	6
Haryana	4	4	3.2	6	10.8	5	12.4	2	-108	12
Gujarat	3	5	4.6	3	5.0	7	1.9	6	-44	11
Punjab	2	1	4.6	4	10.5	6	18.3	1	-129	13
Maharashtra	1	3	11.9	1	23.9	1	-2.6	8	-14	9
All-India (avg.)			**65.4**		**67.6**		**47**		**927**	
Kerala	7	1	25.5	1	51.3	1	20.1	1	33	3

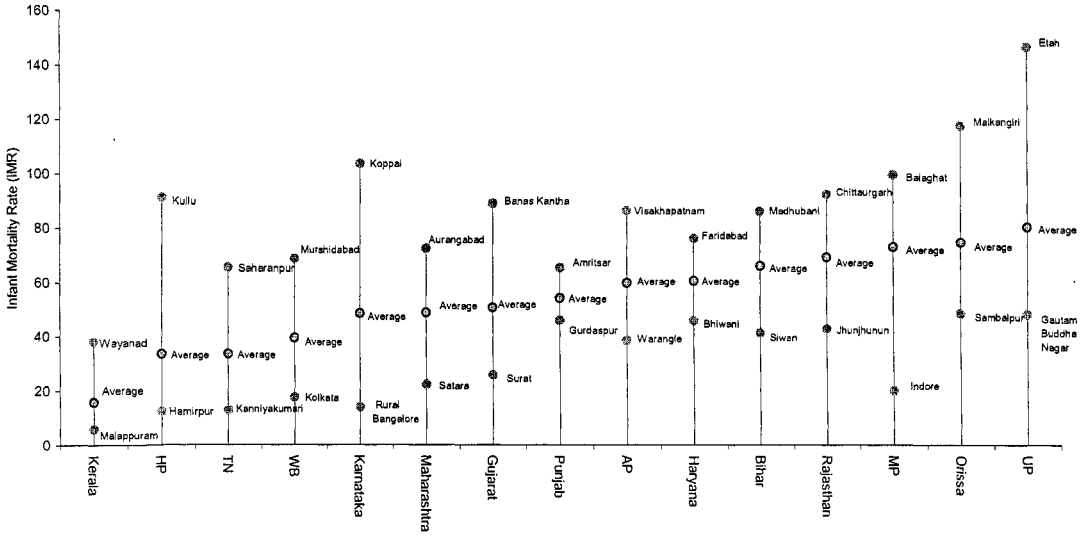
Note: GSDP refers to Gross State Domestic Product. Diff. refers to the difference between state-level indicator and All-India average. a: HDI ranking refers to the Human Development Index methodology in the UNDP Human Development Report 2001. Ranking across 16 major states, including Assam, b: 2001, percent of population 7 years and older, c: 1998/99, per 1000 live births, d: 1998/99, percent of children under 3 years of age, e: 2001, girls per 1000 boys in 0-6 years group

Source: 2001 National Human Development Report; 2001 Census, 1998/99 National Family and Health Survey, 1999 Sample Registration System.

Even within relatively prosperous states, there are regions that do not share the general dynamism of the state. There are a number of districts in prosperous states that have infrastructure and human development indicators comparable to the worst-off districts in the poorest states. For example, in one district of Maharashtra over 80 percent of households use clean cooking fuel, while at the same time less than 10 percent of households living in another district in the same state have access to this basic provision. Access to toilets, low in most states with the notable exception of Kerala, ranges from over 70 percent of households in one district to only 10 percent in another in the state of Gujarat. Figure 1.11 shows the average Infant Mortality Rate (IMR) and the IMR in the two best and two worst districts for each of the major states. There are large gaps in IMR across districts—the worst districts in Maharashtra have IMR comparable to or higher than the average of the poorest states.

Figure 1. 11: Conditions vary widely across districts in states. The worst districts in Maharashtra have IMR higher than the average of the poorest states.

Range of IMR in districts within Indian states, 2002–03

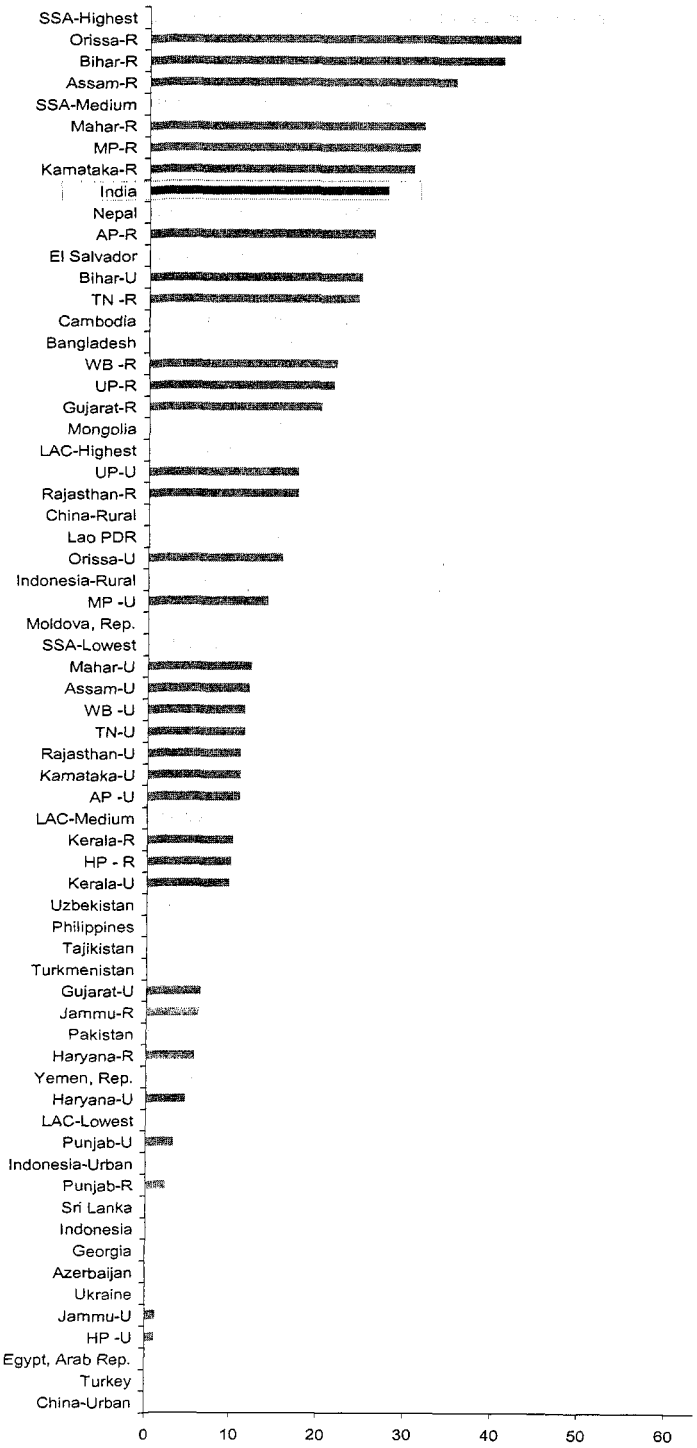


Source: Based on Reproductive and Child Health survey data for 2002–03, in Ram and others 2004.

One important dimension of the income gap *within* states is the rural-urban divide. During the 1990s, in most states, improvements in urban incomes outpaced rural incomes, widening the gulf between rural and urban India (Sen and Himanshu 2005). As with states, the concern is not that rural incomes have not grown at all, but rather that urban incomes have grown sharply and rural India has been left behind. A second dimension of within-state income disparities is the presence of "backward" regions within otherwise prosperous states. Karnataka, a middle-income state, has regions (Eastern and Northern) with poverty rates that are comparable to rural areas of the richest and the poorest states in the country. Maharashtra, India's highest-income state, is home to booming and prosperous Mumbai, but at the same time nearly 50 percent of the population in its Inland Eastern region is close to or below the poverty line. Improving incomes in rural India is critical to reducing poverty, because nearly three-fourths of the poor continue to reside in rural areas.

Figure 1. 12: Parts of India have poverty rates similar to those in many Sub-Saharan African countries, while other regions of India resemble richer Latin American countries.

Percentage of the population below the Indian poverty line, by country and Indian state



Source: Author's calculations based on data in the World Development Indicators

The gaps in the level of income and in the differences between rural and urban areas imply enormous differences across regions of India in poverty rates—from the best in the developing world to the worst. Figure 1.12 shows that rural areas of Assam, Bihar, and Orissa have poverty rates worse than many Sub-Saharan African countries, while rural areas of Karnataka, Madhya Pradesh, and Maharashtra have poverty rates that are only marginally lower. In contrast, urban areas of Haryana and Punjab have poverty rates similar to the richer Latin America countries and Turkey. Urban areas of middle-income states and the rural areas of better-off states have poverty rates comparable to the average Latin American country and are similar to national averages for China and the Philippines. The enormous diversity of poverty levels within India makes treating "poverty in India" as a phenomenon as if one lumped Africa and Latin America into a grouping and tried to discuss poverty in "LAFRICA".

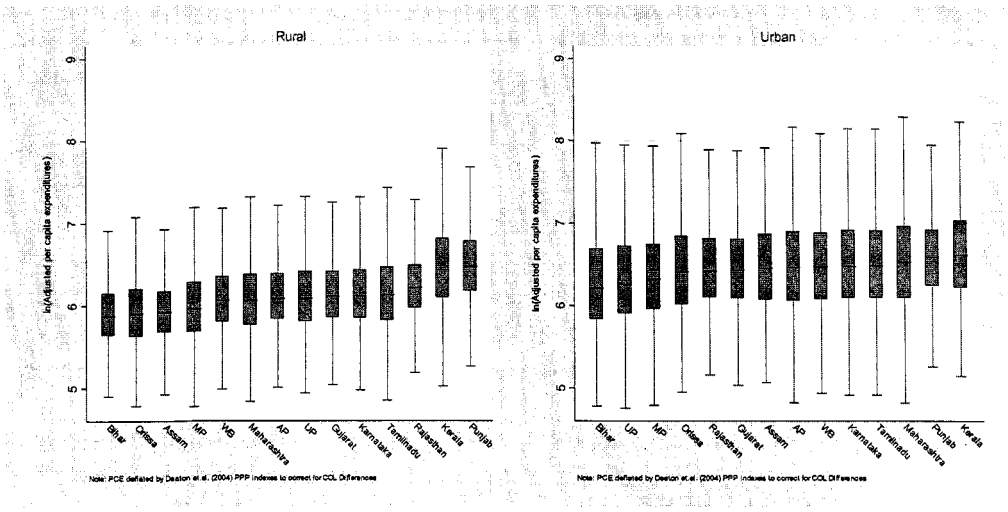
Differences across households and individuals

Widening disparities in the midst of a booming economy are most evident when comparing outcomes across households and individuals. The 1990s were a decade when economic inequality increased visibly, marking a significant departure from trends in previous decades when inequality had either been declining or remained stable. There is certainly a perception that inequality has increased sharply, very likely driven by the observation that rich Indians have done extraordinarily well during the boom of the 1990s. According to one study, in 1999/2000, the gap in per capita income between the 99th and 99.5th percentile (almost P$7,000 in purchasing power parity equivalents) was almost four times as large as the gap (P$1,750) between the median person and the 95th percentile (Banerjee and Piketty 2005). The super-rich at the 99.99th percentile, with growth in incomes of over 285 percent between 1987/88 and 1999/2000, enjoy annual incomes of around P$160,000 per person. Although the unprecedented prosperity of the super-rich is critical for perceptions of inequality, because it is largely confined to the top 0.1percent of the population of taxpayers, it is unlikely by itself to explain shifts in the overall income distribution.

There are three dimensions to the increase in income inequality. As discussed earlier, improvements in mean urban incomes outpaced rural incomes, widening the gulf between rural and urban India. Interstate inequalities widened as rich states grew faster than poor states. Within-state urban inequality also rose, reversing a previously declining trend (Sen and Himanshu 2005). The combined impact of the growing rural-urban divide and rising within-urban inequality has resulted in large within-state disparities across people. In fact, correcting for cost-of-living differences across states, the large differences across people within rich states implies that the poorer sections of more wealthy states are very nearly as poor as those in poorer states (figure 1.13).

Figure 1. 13: The poorer sections of the wealthier Indian states are very nearly as poor as those in the poorer states.

Distribution of per capita expenditures, by state, 1999–2000

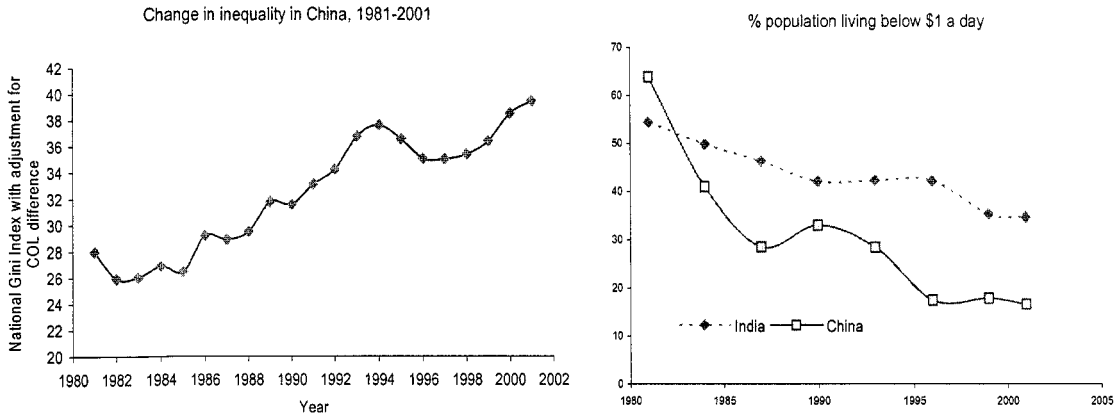


Note: The box plots show the 25th, median, and 75th percentiles and upper and lower adjacent values of the logarithm of per capita expenditures adjusted for cost-of-living differences across states.
Source: Authors' calculations using 1999–2000 Schedule 1.0 unadjusted 30-day consumption distribution and multilateral prices indexes for cost-of-living adjustments across states from Deaton and others 2005.

Rising inequality by itself does not necessarily imply that poverty reduction during the 1990s was lower than it might have been otherwise. There is a complex relationship between growth, inequality, and poverty, which depends on the underlying processes that lead to growth and changes in inequality (Bourguignon 2004). Microeconomic evidence points to a number of ways in which inequality can negatively impact growth, through its effects on the functioning of institutions, resource allocation, and collective decision-making processes (for a detailed discussion, see World Bank 2005a). In such cases, policies that redistribute some of the misallocated resources or otherwise correct market failures can improve both growth and the distribution of income. Nonetheless, even policies that worsen the distribution of income can be good for the poor, if their effects on growth are large enough (figure 1.14). For instance, one interpretation of China's recent experience with worsening inequality in the 1990s is that poverty went down *because* inequality was allowed to go up in order to provide incentives for investment and innovation, which led to extremely high growth (World Bank 2005c).[6]

Figure 1. 14: Growth, if it is fast enough, can reduce income poverty, even with inequality increasing.

[6] For the opposite viewpoint, see Ravallion and Chen (2004) who argue that in China, time periods (and provinces) in which inequality rose most were periods (provinces) of lowest growth and poverty reduction. They conclude that it is not the case that the rise in inequality has permitted higher growth rates; rather inequality has put a brake on the rate of progress against poverty.

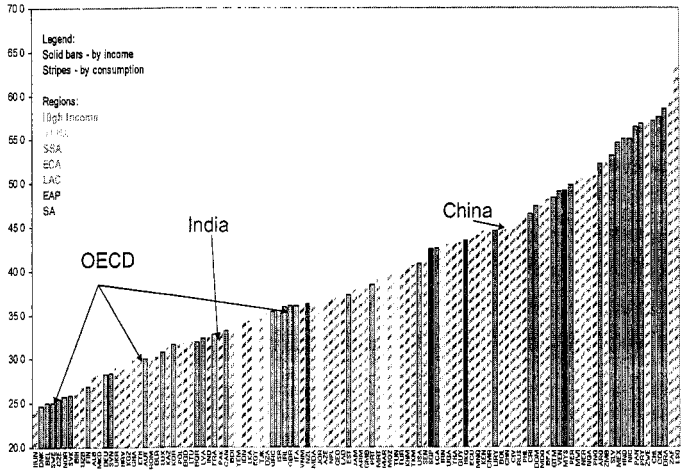


Source: Chen and Ravallion 2004 (LHS graph); Ravallion and Chen 2004 (RHS graph).

Compared with other countries, India remains a society of low inequality in income (figure 1.15). Even so, rising inequality is of concern for other reasons. Rapid but unequally distributed growth can create tremendous social and political pressures, possibly undermining consensus on economic policy, making reforms unsustainable, and stalling aggregate growth and poverty reduction. This concern is especially relevant in India, which is undergoing a shift in which rewards to skills are becoming more unequal, but these changes are occurring in a society that has had a legacy of social stratification and exclusion.

Figure 1. 15: Despite a decade of rising inequality, India remains a country with low income inequality by global standards.

Gini coefficients of inequality in income and consumption, by regions and country groups



Notes: latest data for each country for the 1995-2002 period.
Source: SIMA

Although India has low *income* inequality, by other measures of well-being it is a deeply unequal society. Gender disparities in India, particularly in health and education

outcomes, are among the largest in the world. In a typical non-South Asian country, child mortality rates between male and female children are roughly equal, but in India, a girl born in the early 1990s was 40 percent more likely to die between her first and fifth birthdays than a boy of the same age (Filmer and others 1998). Moreover, there is disturbing evidence of *worsening* gender gaps in child malnutrition (although gender gaps in educational outcomes have decreased), particularly in rural areas of northern and eastern states where nutritional status has been improving substantially more for boys than girls (Tarozzi and Mahajan 2005). India's rich northwestern states of Haryana and Punjab are well known for their extremely skewed juvenile sex ratios, which are much higher than most parts of the world and have been worsening since 1981. Many other measures of gender disparity (e.g., child mortality, enrollments, probability of seeking health care) also do not appear to be lower in high-income states. Gender disparity does not seem to be simply a phenomenon of poverty or a problem that economies "grow out of."

Another key axis of stratification in India is caste or ethnicity. By most indicators of outcomes and opportunities, Scheduled Castes and Scheduled Tribes (SC/STs) are particularly disadvantaged, compared with the rest of the population. Differences in outcomes are due in part to the fact that SC/ST households tend to be poorer, to have parents with lower levels of education, and to live in remote and marginal environments that have difficult terrain, poor infrastructure, and lower accessibility to the market economy. Indeed, controlling for observed household characteristics and location of residence, recent data from the Reproductive and Child Health Survey suggest that there is no significant independent effect of caste or tribal status on health outcomes such as infant mortality rates. This result, however, should not be interpreted to mean that membership in a social group does not affect health outcomes. Low income levels are themselves in part due to inferior returns to productive assets, reflecting patterns of past discrimination. Caste-based inequalities can be particularly insidious. There is evidence to suggest that individuals internalize their chances of success or failure and transform them into lower aspirations and expectations, and hence tend to reproduce the inequalities over time and across generations (Rao and Walton 2004; Hoff and Pandey 2004).

Guide to the rest of the report

From this overview there emerge two important themes that are addressed in the remainder of the report.

Part I addresses the question of improving service delivery: how can India's performance in core areas like schools, roads, water, sanitation, health, poverty programs be raised so that its transformation of services make it as much the global admiration as its economic performance? This Report takes the view that to improve service delivery one has to go deeper than sectoral budget allocations or scheme by scheme discussions of program design—when systems are failing, it is not enough to fix the pipes, one needs to fix the institutions that fix the pipes. The dual questions are: how can Indian citizens hold service providers accountable for quality services and how can providers be equipped (with budget, resources, capacity) to meet those demands?

Part II moves on to the discussion of creating more inclusive growth. To have inclusive growth, one must have growth, and sustaining rapid growth is central to achieving nearly everything else. But growth can be made more inclusive in several ways.

- A focus on reforms that are "equalizing accelerators"—actions that increase growth and make the benefits more equally distributed.
- Coming to grips with the poor performance of the agricultural sector, which directly and indirectly, has a central role in poverty reduction.
- Addressing the lagging states and regions—to continue rapid growth it will have to spread to those states that have not yet accelerated beyond their performance in the 1990s.
- Expanding opportunities for people by increasing access to markets and to assets—along with effective assistance and social protection.

One theme that runs throughout the report, both when discussing services and the public sector and incomes and the market, is empowerment. India has already embarked, irrevocably, on two transformations that, when successfully completed, will make India perhaps *the* great power of the 21st century. The first is the transformation from viewing the population as passive recipients of government initiative to citizens that are socially, politically, and institutionally empowered, not to be acted upon, but to be the actors in improving their satisfaction with the services they expect from the public sphere. The second is from viewing the market as something people need to be protected from to something all people should be empowered—through assets, skills, and capacity--to have fair and equitable access to, with social protection as an integral support.

Introduction to Part I: Improved accountability for better services

This Report takes a different approach than many reviews of service delivery, which proceed on a sector by sector, scheme by scheme basis. For instance, the Planning Commission has produced a Mid-Term appraisal of the Tenth Five Year Plan, which is an excellent overview and analysis of the current state of affairs (Government of India, Planning Commission, 2005b). Since this Report cannot hope to compete with the reporting on available information, depth of insider expertise, and encyclopedic scope of this excellent work, how can this Report, in the few dozen pages available, contribute to the ongoing dialogue about reforms of service delivery in India? We hope to emphasize the broad themes in the diagnostic that cut across all sectors and emphasize the common concepts that animate reform proposals across sectors as diverse as rural water, airports, education, and health.

The first step to helpful prescription is accurate diagnosis—which needs to go beyond identifying and listing symptoms to understanding the system. Chapter 2 lays out a diagnosis of the current state of service delivery in India and argues that, while there are many budgetary and technical reasons why services are weak, a weakness that cuts across many individual schemes, programs, and sectors is that the relationships of accountability between citizens, the state, and service providers are not well articulated. Chapter 2 suggests that successful reforms will improve service delivery by addressing one of the five key weaknesses in the current links of accountability:

- *Unbundling.* Don't ask a ministry to be simultaneously umpire, bowler, and batter and expect a good game—the roles of government as "policymaker" who sets the rules of the game and as one particular organization that provides services need to be clarified. Creating clearer roles and responsibilities amongst various actors facilitates accountability for fulfilling those roles.
- *Delegation.* The combination of two aphorisms: "you get what you pay for" and "what gets measured gets done"—implies that if one only pays for and measures inputs (wages, assets) then one will get inputs. Unless there is clarity about the delegation of responsibility for outputs and outcomes there cannot be accountability for outputs and outcomes.
- *Autonomy* to enabled providers. A stress on accountability is not an "attack" on providers, quite the opposite. When providers have clear goals and are given adequate resources the next step is allowing them sufficient autonomy to accomplish those goals. One cannot hold people accountable for not doing something with nothing.
- *Information.* Regular, reliable, relevant information is the key to any accountability relationship. This is true inside an organization (so that monitoring systems are essential), between parts of the government (so that a line agency can achieve goals cost-effectively), and between citizens and the state (transparency) and the citizen and providers (informed consumers).

- *Enforceability.* In government there are amazing dedicated and competent professionals striving to do their best to fulfill their responsibilities. Unfortunately, there is also malfeasance of all kinds (corruption in contracts, absenteeism from posts, lack of effort). If actions have no consequences this undermines the efforts of good providers.

An idea that should come easily to a nation influenced by a creation story that concludes that no one really knows how the world began is that there is no unique way to implement even a common set of principles. There is no one best system, there is no unvarying recipe for service delivery success: countries have managed to create functional schooling with systems that are largely private (Holland) and systems that are largely public (Germany), with systems that are largely centralized (France) and systems that are largely local (USA). But, systems have to work coherently as systems—there has to be a strategic choice about the direction for reform and then that has to be implemented. So, even in a single sub-sector one state of India might choose to pursue service delivery improvements by relying more on local governments while another might move to greater reliance on non-state providers (e.g. Public-Private Partnerships) while yet another might choose some type of internal administrative reform. Three chapters of part I articulate how different types of reform can implement the broad principles for improving services through greater accountability.

Chapter 3 addresses internal and administrative reforms, drawing on case studies of successful reform initiatives in India.

Chapter 4 discusses how to make local government systems work to improve services. This is not advocacy for local governments but rather a discussion of the question: if a state were to choose greater reliance on local governments (Panchayati Raj Institutions) as a mechanism for service delivery, how should the implementation of that be designed?

Chapter 5 discusses, with a particular emphasis on infrastructure services, the various modes of engagement with non-state providers—communities and user groups, contracting out, and public-private partnerships. Again, this is not saying these are the only possible paths for service delivery reform, but they are one approach that has proved successful in many contexts, and drawing on those lessons will help make these successful.

Whatever reform is being proposed, whether it be devolution to PRIs or contracting out or community level committees or "e-governance" one has to ask the same sets of questions of how the proposed arrangements will, for instance, create reliable regular and relevant information and make that available to involve stakeholders in a way that will lead to improved services.

Chapter 2. Service Delivery: A Diagnostic

I am convinced that the government, at every level, is today not adequately equipped and attuned to deal with this challenge and meet the aspirations of the people. To be able to do so, we require the reform of government and of public institutions ... No objective in this development agenda can be met if we do not reform the instrument in our hand with which we have to work, namely the government and public institutions. Clearly, this will be my main concern and challenge in the days to come.

Prime Minister Manmohan Singh, June 24, 2004.

In one of his first speeches, India's new prime minister signaled the shift that has to occur if India's publicly delivered services are to keep pace with its booming market: from promises made to promise kept. He also emphasized that keeping promises will be neither easy nor quick, because it requires fundamental shifts in the way government meets its responsibilities for services and its line agencies typically go about their business of producing services. One of the most important priorities for the government of India is not so much a new "policy" agenda as a shift in the way that policies are carried out across the board: a shift from outlays to outputs and outcomes, from asset creation to asset operation, from compliance with procedures to a drive for better performance, from policy design on paper to policy implementation on the ground.

Part I of the report discusses why this fundamental shift is necessary and the ways in which this complex and difficult cross-cutting effort can be successful. In doing so, the report tries to be realistic about the dire straits of service delivery in many sectors and states without being cynical or defeatist. While the challenges faced in adequately meeting core public responsibilities are large, as has been demonstrated, the capacity of India and Indians to address those challenges is larger.

A framework for understanding service delivery outcomes

> *If the Indian state has a weakness, it is this: most of the institutions and rules—courts, bureaucracies, police—are so riddled with perverse incentives structures that accountability is almost impossible.*

Pratap Bhanu Mehta, *The Burden of Democracy*, 2003.

There are many voices in India who believe that accountability is the key "binding constraint" to improved services—but also believe, as the above selection illustrates, that the existing system itself is structured to avoid accountability. In this chapter we focus on services such as education, policing, rural and urban water supply, health care (promotive, preventive, and curative), law enforcement (including civil law), tax collection, major irrigation works, land records, poverty programs, road construction and maintenance, and transport. These services, while different in myriad ways, share three characteristics. First, they are *core* public services—there is no question that there is, and

will remain, a fundamental public responsibility to deliver them. Whether the government chooses to discharge that responsibility by direct production through its own agencies or whether it chooses to rely on nongovernmental or private sector agents for production (e.g., toll roads, electrical power production, contracting out) is just a change in the government's mode of engagement. The government cannot and should not take a "hands off" attitude.[7] Second, these services are locally delivered and require thousands or millions of interactions between service providers and citizens every day and hence are *transaction intensive.* Third, the services discussed are more or less *discretionary* in that the service provider needs to take local and even individual specific conditions into account—a doctor actually needs to prescribe treatment on the basis of the condition of the patient.

What determines how well these core, transaction intensive, and potentially discretionary services are delivered? Start from the range of primordial interactions of citizen and service provider: a girl arrives at school—what determines whether she will learn? A pregnant woman arrives for a check-up—what determines whether she will be treated appropriately? Someone turns on the tap—what determines whether water will come out? A person entitled to rations through the Public Distribution System arrives at the shop—what determines whether she will get what she is entitled to? A smallholder shows up to register her land title—what determines whether she will get fair treatment? While the exact details are different, in each case in order for services to be effective there needs to be a frontline provider who:

- Knows what the service delivery goal is.
- Is technically capable of meeting that goal.
- Has at her disposal adequate assets and recurrent inputs to carry out the task.
- Is motivated to use her capability and available assets and inputs to meet the service delivery goal.

When one observes failure in service provision, it is often easy to point to the proximate cause of failure as a lack in one of those four categories: lack of knowledge, lack of capability, lack of assets or inputs, or lack of motivation. But an explanation of widespread service delivery failure that is adequate to be the grounding of institutional reform needs to be able to say why the proximate determinants were lacking and needs to be able to answer the question of why at a systemic level, for two reasons. First, as the old saying goes: "just because the tire is flat doesn't mean the hole in the tube is on the bottom"—an exclusive focus on the visible proximate determinants might miss the much more serious systemic problems. "Business as usual" attempts that focus on proximate determinants and treat logistics rather than fundamental problems will not be effective. Consider the case in which the proximate problem is that drugs are out of stock. Shipping

[7] This distinction is important because the word "privatization" carries metric tonnes of ideological and political weight and at the same time clouds discussions. Reliance on contractual arrangements with individuals who are not full-time employees of the state is not "privatization" in the sense that the government "leaves it to the market." In fact, as chapter 1 emphasized, the reliance on weak institutions of service delivery has implied more de facto privatization of the sector than in many countries that rely much more on private sector providers as implementers of government policy.

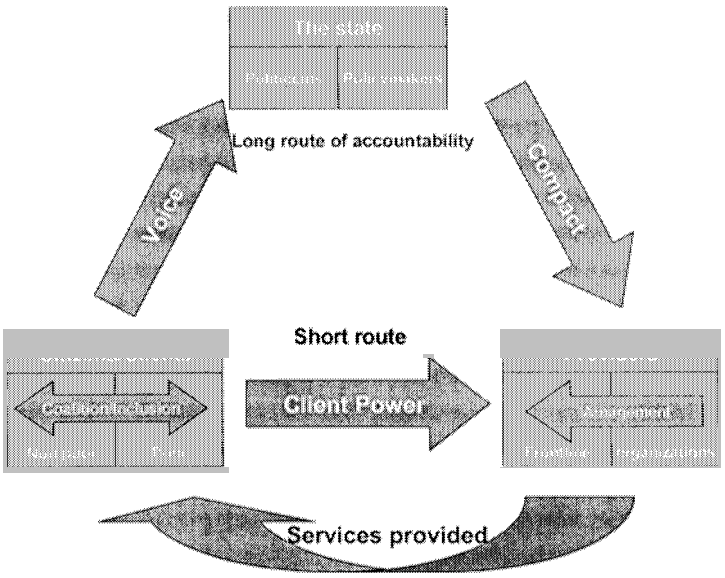
more drugs will not solve the problem if the drugs being shipped currently are being sold on the black market.

Second, no system creates good services by attacking or undermining the frontline providers of those services. A focus on proximate causes of failure can lead to a counterproductive tendency to put "blame" for failure on the individual provider, rather than to identify the systemic issues that trap even the best intentioned and capable people into dysfunctional systems. Many, if not most, frontline providers of services are dedicated individuals who struggle against the odds to fulfill their duties. So, for instance, the education system cannot thrive by being "*anti*–teacher," but rather it must be positively *pro*–good teacher—so that good teachers are given the mandate, resources, capability, and motivation to perform.[8]

To go beyond a sector-by-sector analysis of the proximate determinants (e.g., health care is poor because drugs are not in stock, learning achievement is low because learning materials are scarce, water reliability is low because of too little maintenance) to a systemic analysis of the causes of success and failure, one needs a framework and a few perhaps seemingly abstract concepts. Delivering services through public sector institutions involves a long route of accountability. First, in a democracy such as India citizens must be able to use the political processes to hold their state accountable for the services they receive, an accountability relationship called *voice*, although it could as easily be labeled politics. Second, the state, acting as an agent for its citizens must be able to hold the organizational providers (be they line agencies, departments, public sector bodies, nongovernmental organizations, for profit firms) accountable for the services they provide using public sector resources, an accountability relationship called *compact*—this might be an actual contractual arrangement (say, between the government and a contractor to build a road) or it might be internal to the government (as between the financing agencies, such as the Ministry of Finance or Planning Commission, and line agencies). Third, the organizational provider (again, of whatever type) must be able to hold the frontline providers who are delivering services accountable, a relationship of accountability internal to the organization called *management* (World Bank 2003a).

[8] By the same token, exploring the weaknesses in the public sector current delivery of services is not "*anti*–public sector," but rather, it is *pro*–public sector. Deliberate denial, which allows those who benefit from the current system to thrive and leads to an inability to come to grips with the depth of the problems in public sector delivery, has been a more effective privatization policy than privatization. A brutally honest diagnosis is the first step to a cure.

Figure 2. 1: Relationships of accountability



Source: World Bank 2003a.

A relationship of accountability is between a "principal" and an "agent" that acts on behalf of the principal. Each of the relationships of accountability (voice, compact, management, and client power) in figure 2.1 involves five elements: delegation, financing, performing, informing, and enforcing. Table 2.1 illustrates these five elements. While this is discussed as a sequential process (as it might be repeated annually in a budget cycle—from delegation to finance to performance to information to enforcement), it is important to note that the "agent"—be he/she a politician, an agency head, or a frontline provider—chooses her actions knowing the entire system and its consequences, so although performance might come before information and enforcement it is simultaneously influenced by the systemic pressures. So a politician may choose to channel private benefits to small groups of influential people rather than broadly based service provision because he/she know that the information available to voters to judge his/her performance on service provision is too weak to make it a decisive voting issue in the future election.

Table 2. 1: Three relationships in the "long route" of accountability, illustrated with the case of policing

Elements of an accountability relationship	*Voice: citizens to state*	*Compact: state to organizational provider*	*Management: organizational provider to frontline professional*
Delegation	Citizens delegate an array of responsibilities to the state of which maintenance of law and order and ensuring rule of law is one.	Police forces are given tasks via legislation, government orders, judicial instructions, and political directives.	Within the police force individuals (frontline providers) are given specific roles (inspectors etc) and tasks by their superiors.
Financing	Citizens pay taxes (direct and indirect).	Police forces are provided budgets (capital and recurrent).	Policemen are paid a salary and benefits.
Performing	Politicians and policymakers *choose* what action to take with regard to the police based on the *incentives* created through delegation, financing, information, and enforcement of citizens.	Organizational providers *choose* what actions to take based on *incentives* created through delegation, financing information, and enforcement of the state.	Frontline providers (constables/subinspector) *choose* what actions to take from day to day based on *incentives* created through delegation, financing, information and enforcement of the organization.
Informing	Citizens receive information about the quality of policing services via direct observation on their own interactions with police, personal observations on safety, the media, official reports, etc.	The state receives information on performance of police forces via internal reports from agency heads.	Information on the performance of individual policemen is generated internally by direct observation by their superiors, performance reports, official complaints—as well as possibly information from outside.
Enforcing	Citizens can hold the state accountable through elections (with crime and/or policing as one issue) or other avenues of pressure in a democracy (lawsuits, public agitation).	Politicians and policymakers control police forces through appointments, transfers, budget allocations, etc.	Individual policemen can be rewarded or punished for their performance through promotions, favorable postings, sanctions or even cases against then. Department has specific control over the police force with limited political interference (from home ministry).

There is, of course, the "short route" of accountability in figure 2.1, in which "client power" is expressed directly via a market relationship. In a market relationship, the same five relationships of accountability are present between buyer and seller—the buyer orders (delegation), the buyer pays (financing), the buyer gains information from the observation and use of what is delivered, and the buyer can enforce by choosing whether to make a repeat purchase (as well as, more rarely, legal recourse in the case of fraud, nonperformance, etc.). This is not to say that this is easy or always works well—for instance, in health care the buyer (patient) has a difficult time knowing whether the

provider is doing the right thing or not, which creates incentives for the provider to over-treat (discussed below).

Effective service delivery requires balanced relationships of accountability in all dimensions. Systems that work, work as systems. While there are many ways of piecing together a system of relationships that creates accountability (chapters 3, 4, and 5 discuss examples of different paths for systemic reform), all the pieces must fit into a coherent whole. Even the clearest delegation to frontline providers, in the absence of adequate financing of the necessary assets, inputs, and wages, leaves them unable to perform. Similarly, increasing information without creating any means of making that information effective in enforcement simply leads to frustration and cynicism. Increasing enforcement, for instance, on frontline providers through rewards and discipline without clear delegation and reliable information leads to confusion and resentment rather than motivation. So the strength of all of the elements of the relationships of accountability—delegation, financing, performing, informing, and enforcing—frame the choices made by agents, and one weak link can undermine accountability.

The state of service delivery and diagnosis

The broad picture that emerges from our analysis of the public feedback is that the quality of governance in many Indian states is appalling. Conventional technocratic answers for improving service delivery or a call to allocate more financial resources may not be an adequate response to this problem. The range of reforms required may cover a wide spectrum—from political leadership and administrative structures and incentives to service-specific changes including alternative delivery options.

S. Paul and others, "State of India's Public Services," *Economic and Political Weekly*, February 2004.

Service delivery: access and satisfaction

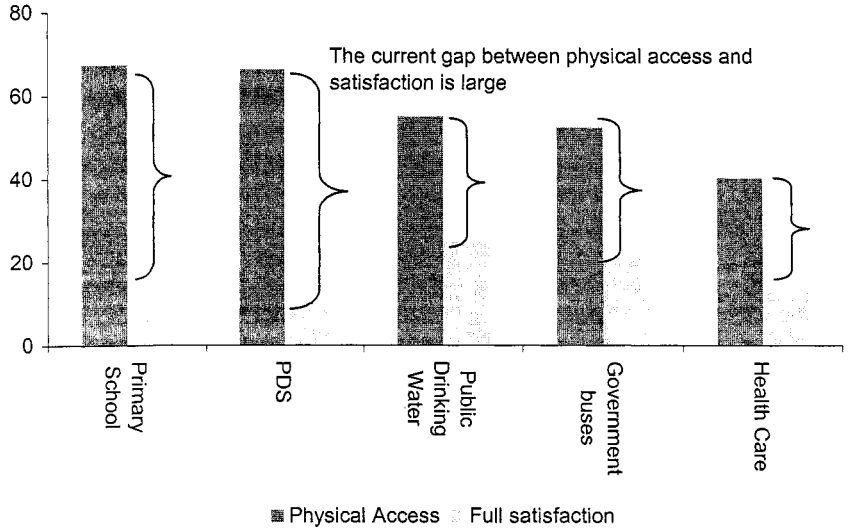
What does a typical citizen encounter when he/she seeks services from public sector producers? A recently published nationwide survey of citizen access, use, and satisfaction with public services illustrates the gap between the *access* created by investments in asset creation and citizen *satisfaction* with the quality and reliability of services (Paul and others 2004). For instance, while in this survey 78 percent of households reported using government (or government-aided) schools, only 16 percent reported being "fully satisfied" with the behavior of their child's teacher—including shockingly low values, such as only 1 percent fully satisfied in Punjab, 3 percent in Orissa, 5 percent in Haryana, and 6 percent in Rajasthan (figure 2.2). Similarly, while 72 percent of households used the Public Distribution System (PDS), less than one in ten were fully satisfied with the quantity, quality, or fairness of the system. Problems with access and satisfaction tend to be much worse in lagging states. The same survey placed Assam, Bihar, Orissa, Rajasthan, and West Bengal in the lowest tier in a ranking of the quality of service

delivery across 16 major Indian states. Moreover, poor households in the top tier of states rank access to all five public services—drinking water, transport, education, health, and the Public Distribution System—better than even the nonpoor households in the bottom five states. While there are millions of dedicated civil servants—teachers, health workers, policemen, engineers, registration officials—attempting to do their jobs well in spite of the systems that work against this, it also cannot be denied that all too often attempts to seek services from the public sector encounter workers who are absent, incompetent, indifferent, and outright corrupt.

The next few paragraphs present evidence from various sectors and places in India that illustrate these problems.[9] While the data in chapter 1 suggested that people are coping with inadequate services in many ways, including by large-scale recourse to the private sector when possible, this section emphasizes the specific aspects that add up to low service quality: *absence, incompetence, indifference,* and *corruption* of staff, as well as *underutilization* and *undermaintenance* of assets. Identifying the aspects of low satisfaction is key to a diagnosis.

Figure 2. 2: While physical access has improved greatly, satisfaction with services provided is very low across all sectors

Percentages of the population having access to public services and expressing satisfaction with those services



Source: Paul and others 2004, tables 2–6.

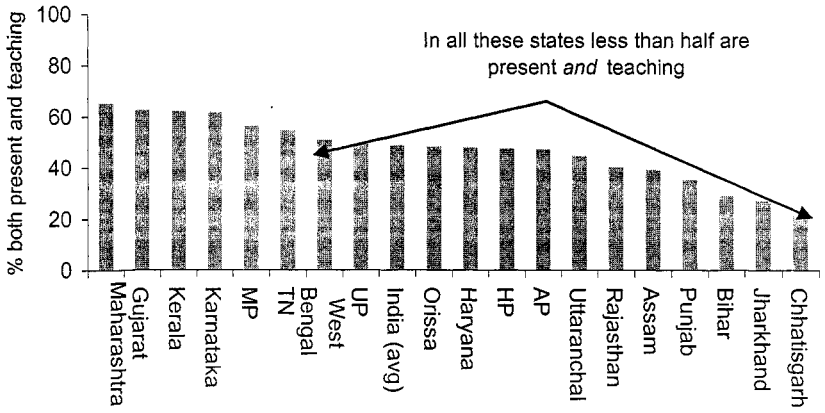
[9] That is, the specific examples given here are not meant as an exhaustive survey of all of the evidence, nor are they individually meant to be probative about the state of services—which of course varies widely across India and across sectors in India. Rather, the specific examples illustrate the specific issues that the weight of the evidence and experience suggests are generic.

State of service delivery: providers

Absence. Since the pioneering PROBE report on education in five Northern states raised the issue of teachers' widespread absence and lack of attention to classroom activity, these findings have been replicated nationwide, extended to health, and confirmed over time. Figure 2.3 shows an estimate from a large-scale nationwide survey in 2003 of the fraction of teachers present in the school and engaged in classroom activity during random visits from a research team. On average across India, only about half of teachers were both present on the school grounds and engaged in classroom activity. In the worst—typically the poorer—states only one in three teachers were engaged in teaching during school hours, while even the best performing states it was only two out of three. In the same study, things were even worse in the health sector, as on average 40 percent of health workers were absent altogether. One recent study in Rajasthan went further and carried out a continuous facility survey in which each of 143 public facilities was visited weekly during regular hours for an entire year. This study replicated the basics of previous findings—finding 45 percent of doctors absent from Primary Health Centers—but also found that at subcenters and aid posts the doors were closed 56 percent of the time (and field visits do not account for this, as only 45 percent of the time could the researcher find the health worker in the village). Worse, the patterns of absences and facility closures were essentially unpredictable, so people could not even count on facilities being open on certain days or at certain times (Banerjee and others 2004a).

Figure 2. 3: In a nationwide survey using unannounced visits less than half of teachers were both present and engaged in classroom activity

Percentage of teachers engaged in classroom activity, by state

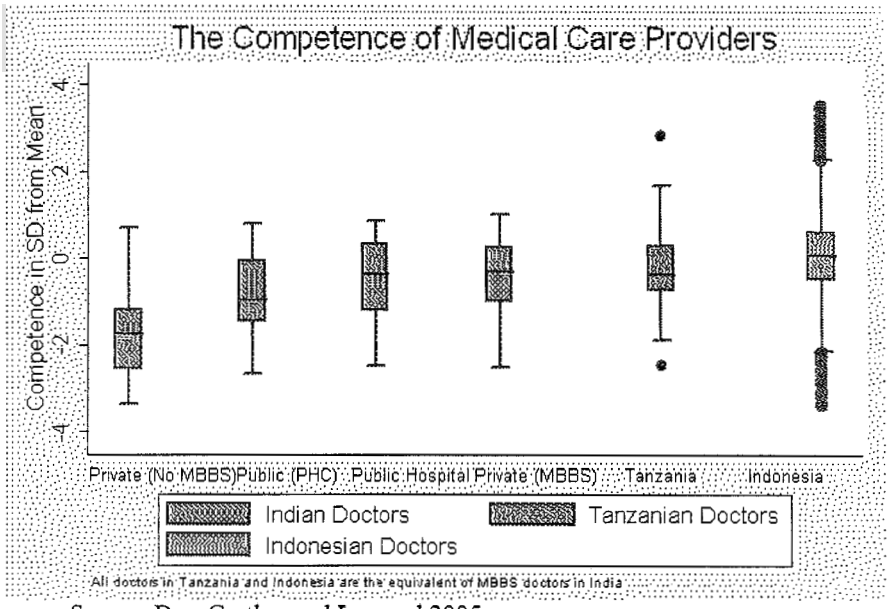


Source: Kremer and others 2004

Incompetence and low effort. Two World Bank researchers have carried out a painstaking evaluation of the quality of medical care in Delhi (Das and Hammer 2004a, 2004b). They first identified providers by asking people who they went to for care, so that they could generate not an official list of who was registered, but a roster of those from whom

people actually sought care. They measured the competence of those medical providers by presenting these providers with meticulously prepared "cases" of five common and important disease conditions—diarrhea, viral pharyngitis, tuberculosis, depression, and preeclampsia—to see if the people providing medical care knew which questions to ask and examinations to make, how to interpret those to make an accurate diagnosis, and how to recommend the appropriate therapy. The findings are shocking. Averaged over all five conditions, a public sector MBBS doctor in a Primary Health Center (PHC) in one of the three poorer neighborhoods had a greater than 50-50 chance of recommending a positively *harmful* therapy. What is perhaps even more shocking is that a comparison of Delhi with a national random sample in Tanzania and in Indonesia of the equivalent of MBBS doctors shows that (a) the "less than fully qualified" people providing medical care are strikingly incompetent, (b) the typical MBBS doctor in a Primary Health Center (not hospitals) in Delhi is *less* qualified than the typical provider in Tanzania and substantially less competent than doctors in Indonesia, and (c) even hospital-based public sector MBBS doctors only about reach the Tanzanian level—and are still below that of Indonesia (figure 2.4). In treating diarrhea, a basic health problem that 70 percent of providers report facing "almost every day," the typical provider recommended a harmful treatment three-quarters of the time.

Figure 2. 4: Public PHC doctors in New Delhi score less well on their competence than doctors in Tanzania or Indonesia

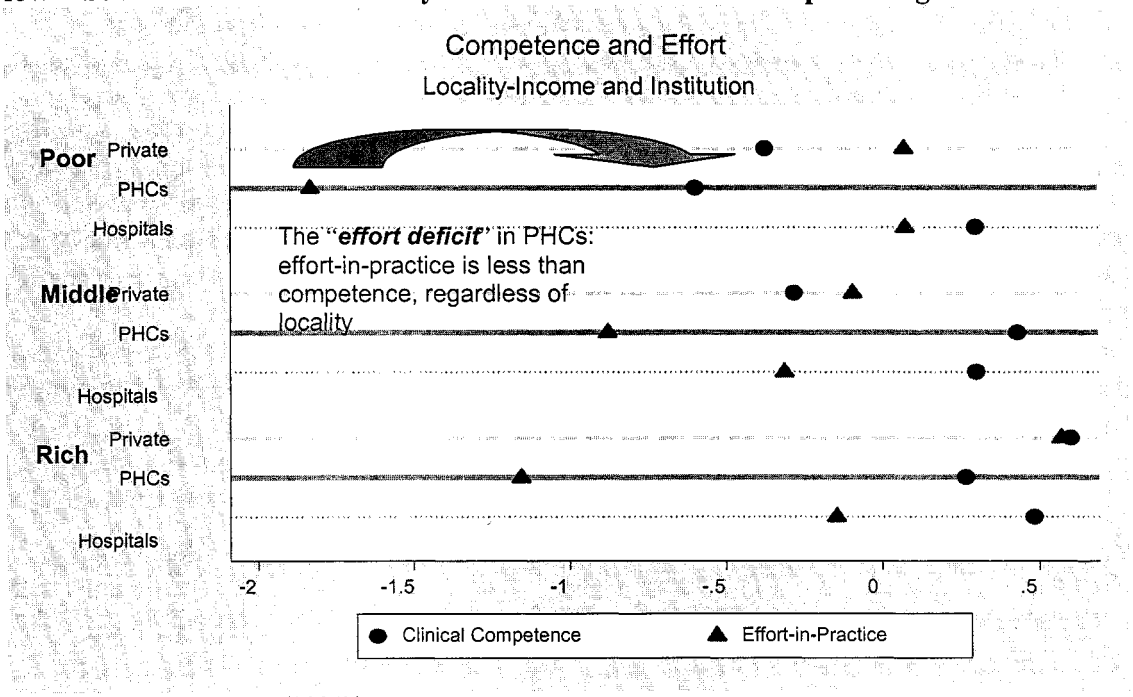


Source: Das, Gertler, and Leonard 2005.

The same study of medical care providers in Delhi also examined practitioners "effort" by direct observation of their actual clinical practice. The striking finding from observing effort was that, while the private, non-MBBS providers were not very competent in practice, they did what they knew, while the public MBBS doctors did not. In the hypothetical vignettes used to measure competence, about 30 percent of public sector doctors asked the right questions—but less than 10 percent did so in observed practice. In

contrast, private non-MBBS doctors knew to ask the right question only 20 percent of the time, but achieved that same level in practice. This low effort becomes even more striking when the public doctors in Primary Health Centers in the poorer neighborhoods in the study are examined—there both competence and effort was below even that of non-MBBS doctors—and both were much worse than in rich neighborhoods (figure 2.5). The contrast with the private sector is instructive: since private doctors are directly accountable to the patient, they put in effort, although they tend to over-prescribe medicines that are ineffective (at best) simply to please the client. One does not want to extrapolate from a single city, because Delhi's Primary Health Center doctors might be much better or much worse than in other parts of the country. We don't know, and that is itself an important fact.

Figure 2. 5: In poorer neighborhoods the competence and effort of all providers is low—but effort is PHCs is always low and "off the chart" in poor neighborhoods

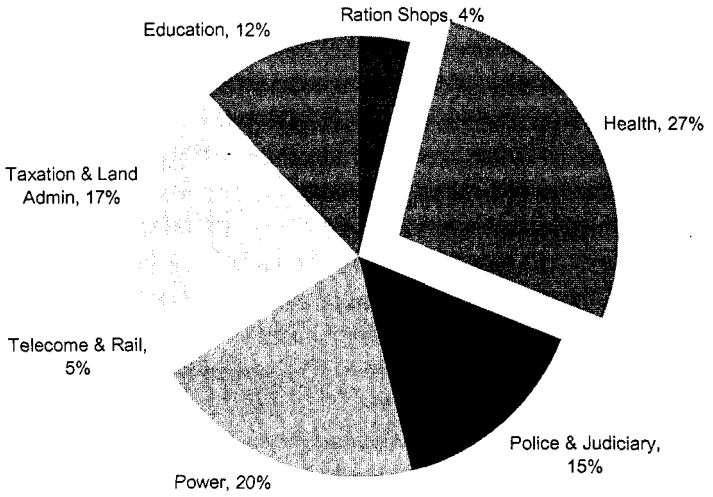


Source: Das and Hammer (2004b)

Corruption. Although India is among the most rapidly growing economies in the world, it is not rated as particularly outstanding when it comes to the control of corruption. In the Governance Indicators of the World Bank, India is 108th of 205 in "control of corruption," and in the recently published Corruption Perception Index India is tied for 88th place with countries such as Benin, Mali, and Tanzania. There are many forms of corruption, and the "retail" corruption associated with services is perhaps not the largest or more important, but it is the case that corruption has penetrated deeply into the provision of services (figure 2.6). Transparency International recently completed a study of the corruption that people face in their day-to-day interactions with the public sector in a variety of sectors (Transparency International 2002). Their estimate was that 26 crore was spent on this type of petty, "retail" corruption in India. In these estimates, 27 percent

of that total goes to the health sector—more than police, taxation, and land administration.

Figure 2. 6: Allocation of the total estimated outflow due to "retail" level corruption across sectors—the health sector is more than a quarter of all retail corruption



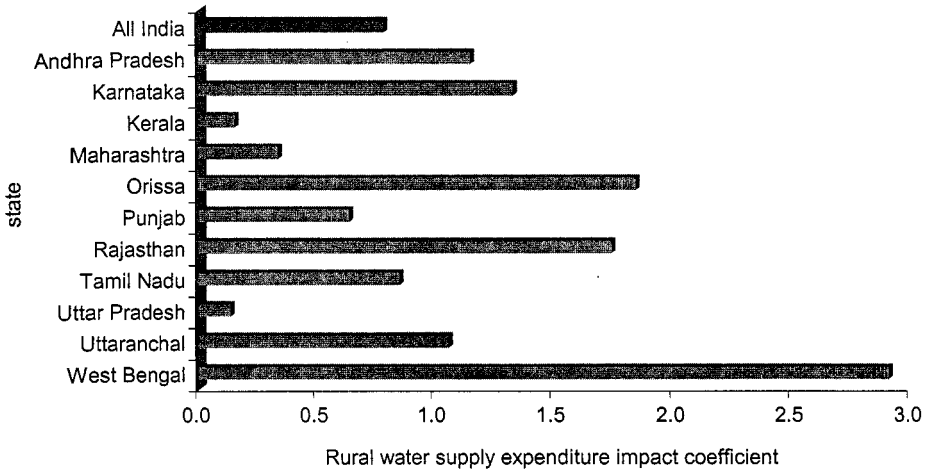
Source: Adapted from Transparency International 2002.

State of service delivery: assets

Inefficiency. A study of the rural drinking water sector in Indian states compared the incremental investment expenditures with the increase in connections realized; findings varied considerably across states (figure 2.7). These differences might reflect inefficiencies in investment planning and execution or other factors, such as assets becoming nonoperational in a short time because of inadequate maintenance or changes in raw water availability.

Figure 2. 7: Some states get more water connections for their money

Expenditure impact coefficients for rural water supply, by state, comparing changes in rural coverage with total government expenditure between 1999–2000 and 2004–05



Note: The government of India's definition of a fully covered rural habitation is one receiving 40 liters per capita per day from a source within 1.6 km or 100 m elevation.
Source: World Bank, forthcoming(c)

Low services delivered from assets. By and large, targets and reported goals still focus on the capital stock and its growth, implying that the objective is not access to a quality service, but access to physical infrastructure. A good example comes from the water sector. Here, India is well on its way to achieving the Millennium Development Goals for water, if access to infrastructure is used as the criteria. It is likely that in urban areas, access to what the government of India defines as a safe water source will be 100 percent by 2007 and will reach 100 percent in rural areas by around 2012 (World Bank 2005a). However, the definition adopted for the Millennium Development Goals calls for "sustainable access to safe drinking water" (the service), not simply access to infrastructure. This approach ignores whether consumers are really getting a service from the asset and to what extent this service is sustainable.

The emphasis on creation of infrastructure assets is evident in the way authorities focus mostly on the design standards of the system in terms of delivery capacity in liters per capita per day. Many different sources provide data on the number of taps, but few provide reports on the quantity, quality, and availability of water distributed. There is often little correlation between the delivery capacity of a system and the actual quantity and quality of service consumers receive. Households often have to revert to secondary sources when water from primary sources is insufficient in quantity and/or quality. More than 18 percent of rural households depend on more than one source to meet their needs, an indication of the nonreliability of the primary source (World Bank 2005a). Similar issues about assessing performance are seen in other sectors: for example, data on the quality of the road network is not widely available to policymakers or stakeholders.

Box 2. 1: The costs of deferred road maintenance

Maintaining India's existing highway network will require around Rs 70 billion, or three times the existing level of spending. While this would imply a substantial reallocation of resources, the evidence suggests important benefits to increasing spending on road maintenance:

- In some states Rs 1 spent on road maintenance generates net benefits of Rs 7.
- Road user costs increase by over 50 percent if roads are in poor, as compared to good, condition.

Increasing the resources devoted to road maintenance will both reduce the costs to road users that arise when roads are in poor condition as well as reducing the costs of rehabilitation needed because of a growing backlog of maintenance.

Source: World Bank 2003c.

Under maintained assets. India spends only around one-third of what is required on road maintenance, implying a deterioration of the existing road stock even while new capacity is being added. The situation is particularly bad for national highways, where actual expenditure in 2002 was less than one-quarter of what was required (World Bank 2004b). There is substantial evidence that there are major benefits to be obtained from spending adequately on maintenance (box 2.1), but this evidence has been around for many decades and still there is an overemphasis on asset creation rather than maintenance.

Low quality of sector outputs from providers and assets contributes to poor outcomes. This lack of attention to the actual delivery of quality services leads to low quality of outputs. In road construction, in distribution of benefits through the Public Distribution System, in health, and in education, the problem is not so much that the "policy" is wrong—the policy objectives are fine, and on paper the design seems adequate—but that the results on the ground do not match the objectives or designs. The result is that in the same country that is gaining a reputation as a place for "medical tourism," the typical public doctor in the capital city gives substandard care; in the same country that boasts technical institute graduates who set not just the national but the global standard, the typical Indian child is woefully undereducated. This is not just an issue of the availability of schools. Even when there are schools, the learning achievement is often low, in part because the accountability of the public sector providers is limited (table 2.2).

Table 2. 2: Examples of low learning achievement in primary schools from around India reveals shockingly low competence

Study and reference population	*Example of learning achievement*
Pratichi Trust 2002. Three districts in West Bengal.	Only one of 14 (7 percent) children in class 3 and 4 who were not privately tutored could write their own name.
Banerjee and others 2004. Urban schools in Vadadora and Mumbai.	Less than half of children in class IV (47 percent) reached Math Standard I competence.
Baseline diagnostic test districts of Andhra Pradesh.	Only 12 percent of children in class II to V could do single digit subtraction; only 54 percent could answer a question that required counting to three.
Baseline test in Jaunpur district in Uttar Pradesh of children age 7–14 in government schools.	72 percent could do no numerical operations and 51 percent could not read simple sentences.

Improving service delivery performance: more than business as usual

Efficiency in the civil services was always very narrowly defined; it was in terms of contempt for politics and adherence to rules, but never in terms of increased public satisfaction. Over the years, whatever little virtues the civil services possessed—integrity, political neutrality, courage and high morale—are showing signs of decay... a model in which politicians will continue to be casteist, corrupt and harbourers of criminals, whereas civil servants would be efficient, responsive and change-agents is not a viable mode. In the long run administrative and political values have to coincide.

N.C. Saxena. "Improving Delivery of Programmes through Administrative Reforms in India," 2005.

How does one explain the current configuration in India—a reasonable performance in asset creation, staffing, and public spending, but a huge gap between assets created and satisfaction with quality of services delivered? The political scientist James Scott described "bureaucratic high modernism" as the constellation of (a) the belief in "the state" as the progressive social force, (b) the use of the "modern" civil service bureaucracy as the instrument of implementation, and (c) the belief that social problems are technical problems solvable by using government resources to create assets that meet "needs" in a cost-effective way. India has been a classic case of this approach—as problems have been addressed with "schemes" and "missions" that are top down, with narrow objectives, and have been carried out by a civil service with exclusively internal accountability mechanisms. Overlaid on that "high modernist" approach has been a broadening and changing electoral politics, which has reduced the tendency of party politicians to take an "encompassing" view of the nation, the society, and the future and instead to focus on regional, identity-based, short-horizon politics. While any name is necessarily also an oversimplification, one way of characterizing the current Indian predicament with service delivery is that the system is "captured high modernism."

Using the basic accountability framework above, there are four key elements to captured high modernism: weak voice, weak citizen cohesion, blurred compact, and weak client power. Together, these four elements explain many of the symptoms:

- *Weak voice.* Accountability to the citizens and voters is systemically weak because *delegation* is weak (voters do not have a clear idea of what it is the government can accomplish), *financing* is weak (there is little connection between financing and delegation or performance), *information* is weak (the typical citizen has little or no reliable, relevant, timely, benchmarked information on performance in service delivery), and *enforceability* is weak (because so many other factors outside of the politicians control affect electoral outcomes). A key question is what kinds of changes to the system would make it more attractive for a well-meaning politician or policymaker to engage in reforms that would improve services?

- *Weak citizen cohesion.* One tremendously important aspect in India in creating voice for effective services is the temptation for groups to organize only to improve their benefits from the state, not services more generally. The politics of caste and other identity politics often work so that the benefits of winning elections are not to improve services but to control access to provider jobs or contracts.

- *Blurred compact.* A major feature of the institutional landscape is that two roles of the state are blurred: one is the state as a steward to ensure adequate services, and the other is the state as an organization that produces services. The result is that the exigencies (and temptations) of being a provider overshadow the responsibilities of being a steward. For instance, is the Ministry/Department of Health (at the center or state) responsible for improving health conditions in the population or merely the operator of one provider of some health services?

- *Weak client power.* Since neither organizational nor frontline providers depend directly on the served citizens (either as individuals or communities) for their financing and since the served citizens have little capacity to enforce their preferences, the citizens' information about provider performance plays little or no role in the prospects of the organization or frontline providers. As a result, "client power" plays almost no role in accountability.

With "captured high modernism," the state and its apparatus are treated not so much as a means of generating public goods, but rather as a means of generating private benefits for those who control the state. In particular, the power to grant contracts, choose beneficiaries, and fill government jobs conveys the potential for enormous benefits. When this power is exercised in the absence of any clear standards and external accountability to service delivery, the benefits of the public sector are for those in the sector.

If the problem with service delivery is systemic and the result of all of these dimensions of low accountability in the public sector, then tinkering solutions will not suffice. There

are many reforms that, although they might be popular and might have some limited impact, will not be capable of really improving services.

Increased budgets: business as usual with more money

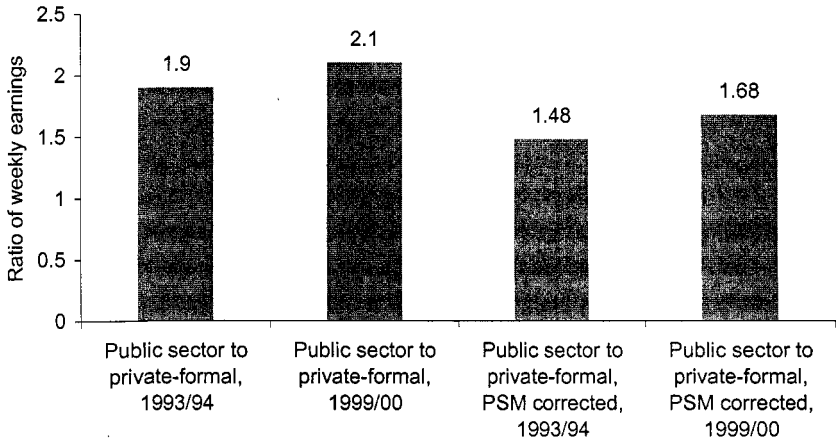
I must caution that outlays do not necessarily mean outcomes. The people of the country are concerned with outcomes. The prime minister has repeatedly emphasized the need to improve the quality of implementation and enhance the efficiency and accountability of the delivery mechanism.

Minister of Finance *Budget Speech,* February 28, 2005.

Nothing about the pattern of expenditures over time or across states suggests that budget outlays are the major determinant of either public sector outputs or development outcomes. As pointed out in the previous India Development Policy Review (World Bank 2003b), real spending in many sectors has increased substantially—while there is little or no evidence that service delivery has improved commensurately. Nonetheless, many discussions simply assume that, if the goal is improved infrastructure or better schooling or improved policing, the answer is to spend more. Often the "cost" of meeting targets, such as the Millennium Development Goals—for water supply coverage, for rural road coverage, for schooling, for immunization—is calculated simply assuming that business as usual, spending more in the same structure, will improve outcomes. In some instances, almost perversely, the policy *goals* of sectors are often stated as "increasing spending to X percent of GDP," rather than taking outcomes and outputs as goals with outlays, properly, merely as a means to a goal. If the existing system treats the "benefits" of public spending as gains to the public sector itself, then putting more money into this system without any accompanying reform will simply reinforce the existing systems.

Figure 2. 8: In 1999-2000 public sector workers had wages 68 percent higher than *equivalent* workers in the private-formal sector—up from 48 percent higher in 1993-94

Ratio of weekly earnings in the public sector to those in the private formal sector, 1993/94 and 1999/2000



Source: Glinskaya and Lokshin 2005.

Currently, services in India are not "low cost." As elaborated at length in the previous Development Policy Review (World Bank 2003b), a very serious problem with services is that, particularly with the implementation of the Fifth Pay Commission, India has moved toward a high-wage civil service. The weekly earnings of public sector workers in 1999/2000 were Rs 1,240 compared with Rs 224 for informal/causal wage workers. These enormous pay gaps are reflected in people's perceptions. For example, in a recent focus group discussion, women in Andhra Pradesh ranked different people's position on a "ladder of life." Their view was that government officials occupied the top step of the ladder—higher than "businessmen," higher than "money-lenders," and higher than "big farmers." Of course, public sector workers are employed in different occupations and have more skills and qualifications, so the absolute comparison is perhaps misleading. But even among equivalent jobs the public sector exceeds the private: a factory worker in a wholly central government-owned establishment makes 2.5 times more than in a wholly private establishment, regular public sector teachers earn several times more than the average among private teachers (or than teachers hired directly by communities). In fact, one of the drivers of higher wage inequality in the "liberalizing" 1990s was that public sector wages grew much faster than private sector regular job wages or informal casual work (figure 2.8). Real wages in the public sector increased by 44 percent over this period—increasing the public sector premium for (observationally) equivalent workers increased from 48 to 68 percent (Glinskaya and Lokshin 2005).

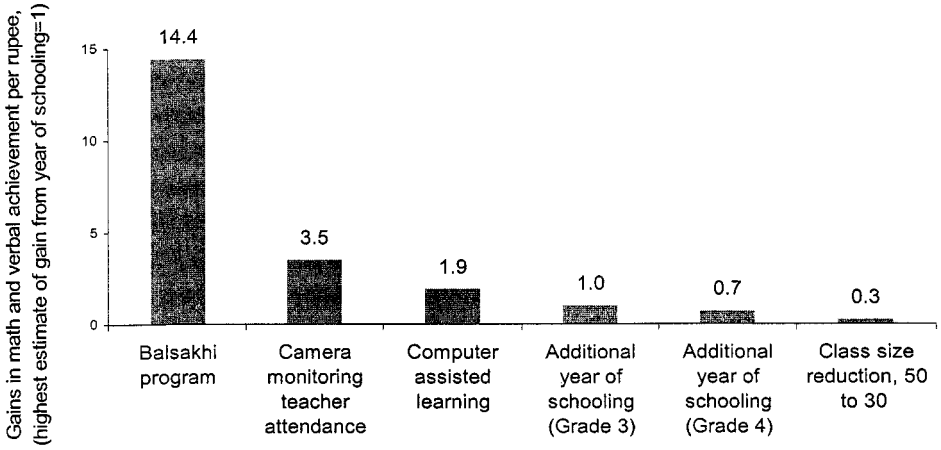
High wages with little accountability for actual service delivery make public sector agencies an obvious target for patronage hiring, which results at times in massive overstaffing. "The Mumbai Municipal Water Corporation has 35 workers per thousand

connections, whereas well-functioning utilities have about 3 per thousand. The UP Irrigation Department employs an astonishing 110,000 people" (World Bank, 2005e). The overstaffing often comes at very low levels of the organization. According to one analysis: "in most states about 70 percent of all government employees are support staff unrelated to public services—drivers, peons, clerks."

Another problem with the "business as usual with more money" approach is that in nearly every sector there are promising actions that are potentially much more cost effective for achieving sectoral goals than simply expanding the existing system. But the existing *system* of accountabilities is not built to look for cost-effective innovations and then replicate them when found—if anything the opposite is true, as costs to the public are revenues to the public sector. A recent study reported on a rigorous examination of the impact of an innovative educational technique on learning achievement. In each school the bottom 20 students in grades 3 or grade 4 were taken out of the classroom to work with a tutor (called a *Balsakhi*) for two hours of the four-hour school day. The tutor is almost always a young secondary school graduate from the community who is given two weeks of training and hired for the year at a salary of Rs 500–750 per month. By using the randomized placement of the program into schools, the researchers were able to estimate the impact of this tutoring on both the students who received the tutoring and the other students, who for two hours a day had a much smaller class size. The program was very effective: it increased the test scores of the students who participated by around 0.75 of a standard deviation. Moreover, the program was very cost effective—it would only cost Rs 386 for each student to increase by one unit in learning achievement. Achieving this same magnitude of achievement by an additional year of school would cost between Rs 5,500 and Rs 7,650—since the gain is small and the cost is large. This same study estimated the gains from reducing class size and found them consistently to be very near zero. Even if we take the most generous possible estimate of the learning gains from class size, it would take over Rs 20,000 to get the equivalent gain as the tutoring program produced with only Rs 386. Other innovations include the use of a time and date-stamped camera to encourage teacher attendance—this simple innovation in nonformal schools run by a nongovernmental organization —reduced teacher absence by 20 percentage points and raised learning achievement. But the point is not about these particular innovations. The question is whether the system is looking for cost-effective ways of improving learning achievement or whether it is focused on simple indicators—like class size—that may only have marginal and highly costly impacts on learning.

Figure 2. 9: Enormously cost effective options are available—but the systemic pressures are for more spending, not more and better services from the same spending

Cost-effectiveness of educational options to raise math and verbal achievement



Source: Adapted from Banerjee and others 2004b; Duflo and Hanna 2005.

Paradoxically, many sectors in India are simultaneously overfunded and underfunded. They are overfunded in that unit costs per output are very high—rupees per road mile constructed or rupees per household connected to improved water supply. Moreover, as we have seen, given the low attention to asset management, the service flow from the assets is low and the cost per unit of effective service is often extraordinarily high. In such a situation of high unit cost and low effective delivery, the system is likely to be underfunded relative to what it would take to accomplish outcome objectives. This is because the cost per output gain is so high. In Bangladesh, for instance, there have been rapid gains in Infant Mortality Rate in the past decade, even though expenditures are much lower than in India. Clearly, if public sector resources are being captured as private benefits (for patronage jobs, for services not rendered, or for services rendered to ineligible beneficiaries), then pouring more money into existing institutions runs the risk of reducing pressures for reform and in fact increasing the desirability of "capturing" the sector.

Greater electoral competition

The state is adjudged to be successful, the more opportunities it can create through its own spending, for large numbers of private individuals: if the number of government jobs expands, for instance, even when not required, this is adjudged to be a political success, regardless of the opportunity costs this form of job creation imposes on others. The state exists primarily to satisfy the private interests of collusive interest groups. ...The net result has been that almost never has that state been governed by a public philosophy; it is rather a high stakes competitive game in which individuals or groups seek advantages along particularistic lines.

Pratap Bhanu Mehta, *The Burden of Democracy*, 2003.

One of the puzzles of India is that active, functioning, highly competitive, electoral democracy has not served as an effective accountability mechanism for improving service delivery. India is the world's largest democracy and, seemingly against all odds, is one of the few continuously democratic developing nations, an achievement of which all Indians are justifiably proud. But, as discussed in chapter 1, service delivery outcomes in some states of continuously democratic India rival those of "conflict" economies or places ruled by autocrats. Authoritarian states on the "right" (Indonesia) and "left" (Vietnam) have far outstripped India's achievements, not just economically, but in outcomes in human development. At its worst, with "captured high modernism" the market provides the services the state is intended to provide (education, water, health) or those services are not provided at all (security, contract enforcement)—while the state is a "market" for control over the private benefits of allocating patronage jobs and giving contracts for asset creation. Since no one party can credibly promise to reform this system and base their claims for power on improved services to the general public, electoral competition proceeds by making appeals to voters along other dimensions. Thus, in spite of a situation in which the poor vote with more frequency than the rich, in which voters can choose among a wide array of political parties, and in which an "anti-incumbency bias" prevents any particular party from becoming entrenched, few see "more democracy" in the narrow sense of electoral competition as a solution for improved services. Of course, "less democracy" is also not a solution. Somehow there must be more accountability within democracy. But that will require some change in the ability of citizens to use real information to hold politicians and the state accountable for services.

Piecemeal reform and "recapture"

> *The discretionary powers of the bureaucracy and the attendant opportunities for rent seeking behavior provided by the existing system are powerful reasons for the functionaries to oppose any change which reduces their power.*
>
> Report of the *1991 Vaidyanathan Committee on Pricing of Irrigation Water,* GoI, Planning Commission, 1992.

The problem in India is not a scarcity of reform initiatives. Since there are enormous numbers of highly capable and well-meaning people in the public sphere—as politicians, as civil servants, as frontline providers—there are an enormous number of successful programs and projects in nearly every state of India. Even in the worst-functioning states of India, there are many examples of particular programs or projects that succeed against the odds. The problem is that most reform initiatives depend on a single reform "champion" (either individual or organization) and either exist outside the system altogether—and hence have difficulty coming to scale—or are dependent on a particular person—and hence are "reabsorbed" into the system after the champion moves on. Efforts at improving services often emphasize instruments that privilege technological quick fixes, internal management changes, and the creation of parallel channels of delivery that bypass weak public institutions.

The failures of the public delivery system in India today are an outcome of a systemic breakdown in accountability relationships within this institutional framework. Deep, systemic problems require deep systemic solutions. This doesn't mean these solutions are "big bang," attempting to change everything at once, but it does mean individual efforts, however incremental, need to be part of a larger vision and strategy for systemic reform.

What are the elements of a strategy for improving services? There are five elements that cut across promising reform initiatives that, not surprisingly, are the counterparts of the current weakness:

- Clearer *delegation*—the absence of delegation that would support accountability is seen in that there is only internal accountability for process and inputs without any clear monitoring and responsibility for outputs and outcomes.
- Stricter *unbundling*—a distinct separation—of the roles of the government as the entity that sets goals, gives financing, enforces the "rules of the game" and the role of government as a direct producer or services. When the umpire is a player everyone knows who will win.
- More *autonomy* for providers to use flexible means to reach their goals without undue political interference in decisions.
- Greater *external accountability* through better information.
- Better *enforceability* in the system—whether between citizens and their elected officials or directly on frontline providers—without that link many initiatives founder.

The answer is not "privatization" or "decentralization" or "e-governance"—any of these can be a way forward. The important thing is choose a design of decentralization or of administrative reform or of public private partnerships that creates a system that increases accountability by improving those five elements listed above. Our premise is that it is not so much which one chooses, but making a decisive choice and then implementing it well is important. "Decentralization" is not the only way forward, nor appropriate for all sectors, but a well-designed decentralization is a way forward. Chapter 5 discusses how to make decentralization work. "Public-private partnerships" are not the only way forward, nor appropriate for all sectors, but a well-designed partnership is a way forward. Chapter 6 discusses how to make public-private partnerships work. "Administrative reform" is not the way forward, nor is it appropriate for all sectors, but a well-designed administrative reform is a way forward. Chapter 4 discusses these reforms.

Chapter 3. Improving internal accountability:

"Don't fix the pipes, fix the institutions that fix the pipes"

The existing primary school system is crying out for radical reform.

Amartya Sen, 2002

Policymakers and observers of contemporary India acknowledge that strengthening service delivery in India requires, as Amartya Sen argues, not just new schemes or better logistics or managerial fixes but radical reform. Dr. Manmohan Singh, in one of his first public speeches as prime minister, emphasized the urgent need to reform the instruments (government and public institutions) if India is to respond effectively to the challenges of development. The portrayal of the systemic problems in chapters 1 and 2 should not lead to cynicism or pessimism—there are continually new reform initiatives, and many successes. Politicians and top policymakers can make reform happen. Two studies on successful reform in India conducted by the World Bank (2005a, 2005b)[10] draw lessons from recent experiments implemented by the government and civil society organizations and provide some insights to how reform can be achieved. Following the five elements of strategies outlined in chapter 2, three ongoing initiatives have demonstrated some success:

- *Strengthening the flow of regular, reliable, relevant information about performance on outputs and outcomes, both internally and externally.* Reorienting internal monitoring and evaluation toward outputs and outcomes—not only expenditures and process—strengthens internal accountability (of both the compact and management). When citizens have better information about how well governments are performing their responsibilities, citizen voice can improve enforceability.
- *Unbundling government's roles as the overall steward of the sector and as the provider of services.* Separation creates clearer lines of accountability. When roles are properly distinguished and goals clearly specified, it is possible to give much greater autonomy to civil servants.
- *Process engineering (often taking advantage of new technologies) that creates greater management control of service provision.* But simply adding new technologies to archaic systems can be dangerous—the biggest successes occur when the introduction of new technology is used as an opportunity for fundamental change.

Reforming institutions is a long-term process, and radical reform does not suggest that "big bang" or "stroke of the pen" efforts are needed (or would succeed). Success requires the initiation of a sequence of reform measures that build to radical institutional reform in

[10] This section draws heavily on two recent studies on service delivery successes conducted by the World Bank: *Amplifying Voice and Client Power* (2005f) and *Reforming Services in India: Drawing from Lessons of Success* (2005g).

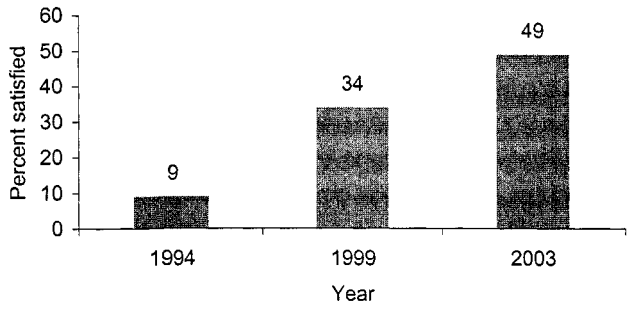
the long term. This pragmatic approach has been dubbed strategic incrementalism. But strategic incremental reforms also differ from piecemeal reform measures, which tend to be ad hoc and personality driven. In political environments that are resistant to radical reform and tend to undermine and reabsorb piecemeal reforms, strategic incremental reform privileges pragmatic reform initiatives as part of a larger, sequenced chain of events. The emphasis is on strengthening the weakest link in the chain, which in turn can work to develop the conditions necessary for long-term, institutionalized reform (World Bank 2003a). The challenge India faces is to identify the weakest link in the chain of accountability, then start there to develop initiatives that contribute to a larger reform agenda for institutional change.

Strengthening accountability for service delivery: Three Rs of information

Providing citizens with access to regular, reliable, and relevant information has proved significant in strengthening citizen enforceability on civic agencies. Information is better if it is regular, allowing citizens to track progress from year to year. Knowing that there were transmission and distribution losses of X percent or that water was available Y hours a day or that X percent of children were immunized is interesting. But regular reporting of progress toward a maintained goal is much better. This section examines two such initiatives, developed by civil society organizations, which helped strengthen the link between greater information and more effective services.

Citizen report cards. One of the most successful experiments in strengthening public services through information flows can be found in the work of the Public Affairs Center (PAC), a Bangalore-based nongovernmental organization (NGO). In 1994 the PAC introduced the concept of report cards on government performance to the citizens of Bangalore. Three report cards have been published, leading to a dramatic improvement in the quality of services provided by city agencies. PAC's experience highlights the importance of regular information flows. Any sufficiently well entrenched system can shrug off a one-time demonstration of its poor performance; only when information is expected to be regular can it help drive improved system performance. Interestingly, performance increases in Bangalore have continued, rising by almost 15 percentage points from 1999 to 2003. Progress has differed by sector. Public hospitals, for instance, improved from 25 percent to 34 percent satisfaction from 1994 to 1999 but jumped to 78 percent in 2003.

Figure 3. 1: Increases in citizen satisfaction with services in Bangalore following introduction of a citizen report card (CRC)



Source: Paul 2006.

Education report cards: A tool for public mobilization. Pratham, a national NGO working on primary education, has recently started an interesting experiment to strengthen information flows on the status of primary education. In 2004 it conducted rapid assessment surveys in 18 states on the status of schools and the learning ability of students. These surveys provided the preliminary basis for developing an education report card at the community, block, district, and state levels. The effort has been institutionalized in the form of the Annual Status of Education Report (ASER), with the first nationwide report published in 2005. The report includes positive news about access (93 percent of children aged 6 to 14 were enrolled) but, as expected, less positive news about functioning and learning achievement (cited in chapter 2). The way this program explicitly addresses the three R's—reliability, regularity, and relevance—is interesting as an illustration of promising initiatives. The program uses local partners, outside government, to enhance the reliability of the information. The first ASER report says "ASER will be conducted on an annual basis until 2010," emphasizing the importance of regular information. Any one-off claim about levels of learning achievement will generate some interest but also controversy about how learning was measured. But repeated measurements on the same standard can be used to build pressure by comparing performance not only across states but also within each state.

The ASER project also goes to great lengths to make the information relevant to governments, communities, and parents. The program's strategy for dissemination and community mobilization includes the preparation of annual regional reports and brief summaries at the district level. ASER aims to provide real-time feedback to parents about the performance of their children on basic literacy and reading skills. Results from these surveys will be used as a tool to mobilize communities to advocate for strengthening the primary schooling system. This is not the only or necessarily the best approach. A rigorous impact evaluation of ASER is being conducted through a collaborative program developed by MIT-Poverty Action Lab, the World Bank, and Pratham. The impact evaluation team recently conducted a baseline survey to initiate the process. Results suggest that this experiment has indeed generated widespread public interest in education and discussions on learning have increased dramatically in village meetings—but it is too early to know what the impact on learning will be. This type of initiative for generating regular, reliable, relevant information for (and with) citizens about the quality of services and their outputs and outcomes holds great promise.

Right to Information Act. The government of India recently passed an important piece of legislation: a right to information act. This is an important, if not historic, step forward because it commits the government to an unprecedented level of transparency. Formerly nearly all information generated within the government was aimed at internal accountability, so that reports were generated to monitor performance within government. The right to information will change the extent to which citizens and groups can use this same information for external accountability. The more the government creates information that is reliable, regular, and relevant, the more useful the legislation can be.

Improved compact: unbundling the roles of government

Improving the compact requires a clear separation of the roles and responsibilities of service providers and the tiers of government. Each tier should have clearly delegated and financed roles and responsibilities and the requisite autonomy to perform effectively. Several reform measures show some promise in this direction:

- Autonomy for accountability.
- Outcomes budget.
- Separation of regulatory and operational functions.
- Agency restructuring.

Autonomy for accountability. One of the most critical factors responsible for the current breakdown of accountability relationships in the compact is the frequent transfer of civil servants, often for blatantly political motivations. There is no shortage of thinkers (policymakers, government agency staff, politicians, academics) proposing ways to improve the public sector. One reform suggested nearly unanimously is to lengthen the time of service in posts of civil servants. Doing so has three benefits. First, most reform initiatives depend on a reform champion and this person is very often a career civil servant. Behind the success of many reforms in India one frequently finds a capable, energetic civil servant who was left in place for years. If vested interests and the bureaucracy perceive that a reform champion can or will be transferred soon, their ability to "slow roll" reform is strengthened. Second, although civil servants serve governments and governments are controlled by democratically elected politicians, there is growing concern that the ability to transfer civil servants as reward or punishment for actions that displease politicians undermines the integrity of the civil service. Third is a pragmatic factor: when average postings last only a year or two, the ability of career civil servants to really master a subject is called into question. The temptation is to not invest in the substance but just keep the machinery rolling until the next job.

Reducing transfers in the civil service is thus a priority issue on any reform agenda. Karnataka is one of the few states that have successfully moved toward resolving this problem (World Bank 2005g). Karnataka, which initiated reforms in 2001, owes its success partly to the political commitment of then Chief Minister S. M. Krishna. He announced a blanket ban on general transfers for 2001–02 and, despite opposition, maintained this ban through the next year. More important was the fact that critical institutional changes were introduced along with the ban to regulate the transfer process.

These changes included creating cadre management authorities (CDMAs) to screen transfers for all regular civil service posts; raising minimum tenures across groups of civil servants; notifying cadres exempted from transfers; imposing a qualitative ceiling on transfers; and creating a transfer database. Despite basic political commitment and institutionalized reform measures, Karnataka has yet to tackle the more politically contentious issue of senior Indian Administrative Service (IAS) transfers.

A difficulty with giving more autonomy and flexibility to providers in government programs is that the current payment method of salary and benefits only, combined with lifetime employment security, provides very weak incentives for performance. This is not to criticize government workers or suggest that all or even most would shirk their duties, but clearly—as evidenced by data on absenteeism—some do. Treating these workers the same as those who perform well can undermine morale, the sense of professionalism, and the intrinsic motivation of others in the organization.

Intriguing initiatives are proposed in new schemes. The Accredited Social Health Activist (ASHA) being created under the National Rural Health Mission, launched in April 2005, reflects a more innovative approach. The ASHA will not hold a regular government post; instead, she will be eligible for a range of honorary payments linked to her success in achieving higher levels of service coverage. For example, she is asked to identify pregnant women, counsel them on safe deliveries, and accompany them to qualified institutional facilities for delivery. The ASHA will receive a cash payment for every institutional delivery completed with her participation. This payment will be linked to cash incentives to the mother, to compensate for the increased cost to the family of institutional delivery. Demand-side incentives are also being more widely introduced. The national Reproductive and Child Health program includes a scheme to provide vouchers to pregnant women living below the poverty line, vouchers they can use to pay for qualified delivery services at accredited providers both government and nongovernment. Interestingly, government facilities will receive additional revenue from this scheme, but the additional revenue is based on their success in attracting patients, which will require improving how women perceive the quality of public sector services.

Outcomes budget. Another crucial weakness in the current institutional structure that has contributed to the breakdown of accountability relationships is the absence of clearly articulated outputs and outcomes on the basis of which performance can be assessed. Recently, the government initiated an important reform measure to address this weakness through the announcement of the outcomes budget in August 2005. The outcomes budget aims to make line agencies more performance oriented by increasing the clarity of delegation. It does so by making explicit the objectives, outcomes, and outputs expected from public expenditures and providing financing for those objectives. To be effective, this effort will have to be accompanied by increased information about how well the objectives were met. Enforceability will need to be exercised by using performance as the basis for determining subsequent budgetary allocations.

Box 3. 1: Launch of outcomes budget

The government recognizes that announcing an outcomes budget is merely one step on a long road. It highlighted in the announcement the additional steps necessary:

"Converting outlays into outcomes is a complex process, which differs from ministry to ministry and program to program. Some of the important steps in this conversion process are as follows:

- Outcomes to be specifically defined in measurable and monitorable terms; intermediate outputs should also be defined wherever required.
- Standardizing unit cost of delivery.
- Benchmarking the standards/quality of outcomes and services.
- Capacity building for requisite efficiency at all levels, in terms of equipment, technology, knowledge, and skills.
- Ensuring flow of right amount of money at the right time to the right level, with neither delay nor "parking" of funds.
- Effective monitoring and evaluation systems.
- Involvement of the community/target groups/recipients of the service, with easy access and feedback systems.

Efficient conversion of outlays into outcomes would, therefore, require making delivery systems effective with appropriate structures and processes, strengthening financial management systems, increasing the use of information technology, and meaningfully involving all the ministries, parastatals, state governments, local bodies, Panchayat Raj institutions, and self-help groups, in critical decision-making and implementation processes."

Source: GoI, Ministry of Finance, 2005.

The creation of an outcomes budget is an important step forward; however, developing quantifiable outcome and output indicators is a complex and difficult process (box 3.1 articulates some of the steps). The key to a successful outcomes budget lies in clear and concise identification of outcome indicators. Indicators also need to be tangible and realistic. Here the outcomes budget for 2005–06 falls short. Some very precise, quantifiable indicators have been articulated, but their benefit is offset by vague indicators for other aspects of the same service. The outcomes budget for the health sector illustrates some of these weaknesses, where the objective of the funding is described as "funding of the institutions" (table 3.1). The success of the outcomes budget as an initiative to improve services lies in effective monitoring and information flows on departmental performance and in the ability of line departments to articulate quantifiable, tangible, and realistic indicators—which as reforms elsewhere in the world have shown, is necessary, but difficult and time consuming.

Table 3. 1: A sample of outcome indicators developed by the Ministry of Health and Family Welfare reveals the devil in the details

Sl. no.	*Name of scheme/ program*	*Objective/outcome*	*Quantifiable deliverables*
I	National Vector-Borne Disease Control Program—Malaria	Reduce the incidence of malaria	• Annual blood examination rate (ABER): 10% of population covered under the program • Establishment of at least one Drug Distribution Center/ Fever Treatment Depot in each village in high-risk areas
XI	Hospitals and Dispensaries	Fund the institutions for providing secondary and tertiary health care services	• Provision of referral services • Delivery of secondary and tertiary health care services

Source: GoI, Ministry of Finance, 2005.

There is growing international experience with budget reforms as a tool for improving services. Because such reforms are difficult, mistakes will be made but as one expert recently advised: "India should make its own mistakes, not repeat those of others." Drawing on the experience of countries that have worked out the kinks will be helpful. There are two generic issues. The first response to pressure for outputs is simply to distort the reporting of outputs—a widespread problem in India and elsewhere. Avoiding this outcome reinforces the need for reliable monitoring systems that are not subject to manipulation. A second danger is to respond too narrowly if outputs are defined in a way that does not fully reflect the desired outcomes. For example, it is very hard to define the output of hospitals and dispensaries in a way that leads to clear, quantifiable deliverables (see table 3.1). Moving to simple output measures can distort incentives.

Agency restructuring and unbundling: separating regulatory and operational functions. Overlaps in the regulatory and operational functions of policymakers and providers tend to diffuse accountablity relationships, particularly for infrastructure-dominated activities such as the provision of water, sanitation, and electricity. Often, the politics of patronage results in the provider losing its autonomy and acting as an extension of the policymaker. Similarly, providers may acquire political influence and capture the policymaking process.[11] In such circumstances, reform instruments that aim to separate the roles of the policymaker and provider can go a long way toward improving the compact. Regulatory functions could include delegation of responsibilities and finance and information about performance and enforcement. One of the most successful reform instruments through which this separation has been achieved is public-private partnerships (PPP), discussed at length in chapter 5.

But unbundling is important in all sectors. Do the people in charge of the health ministries think of themselves as stewards for the health of the population or as just one among many operational providers tasked with running a complex organization whose purpose is to provide services? While running an orgnization that provides health service is a complex and difficult task—which can overwhelm even the most capable—it is just

[11] For a more detailed discussion, see World Bank (2003a, pp. 159–79).

one small part of the health system. But when bundled, the pressing can drive out the important. Moreover, as emphasized in recent work by V. Kelkar, one would not expect the heads of major private sector firms to be put in charge of regulating their industries. But when regulatory and operational functions are not unbundled, the temptation to regulate the sector to privilege the provider organization (say, by imposing burdens on competitors or protecting the budget for exclusively public sector providers) is often too tempting.

Weak internal managerial processes coupled with low performance incentives have contributed in no small measure to weakening accountability relationships. Reform measures aimed at redressing this weakness by restructuring agency processes have proved succesful in improving services. From an analysis of reforms in multiple statewide agencies, including the registration department in Maharashtra and the Karnataka State Road and Transport Corporation, as well as city agencies in Hyderabad, Bangalore, and Surat, the World Bank (2005b) highlights requirements for successful agency reform processes:

- A strong management team that can support the initiatives of the lead IAS officer.
- Re-engineered intra-organization processes.
- Empowerment of senior management through the creation of centralized monitoring systems.
- Improved interagency coordination.

Efforts to restructure agency processes without these components have failed. This is highlighted in the report's cross-state comparison of the experience of restructuring the stamps and registration departments in Maharashtra and Karnataka. In Maharashtra the experience was extremely successful, but the one in Karnataka failed because the reform process did not attempt to radically re-engineer managerial systems or to gain staff support for the restructuring initiative. And the tenure of the IAS officer leading the reform was cut short. This experience highlights the importance of managerial autonomy and radical restructuring. Tinkering at the edges of the agency without radically changing intra-organizational systems cannot lead to sustainable reform.

Using technology to strengthen services by process engineering

The concept of e-governance has taken the developing world by storm. For many, e-governance is the panacea for governance reform because it simplifies transactions between government and citizens and in so doing encourages accountable and transparent transaction processes. But simply putting an "e" before a word does not make it better. The key lesson from the use of technology (including information and communications technology) to improve governance is this: unless the change in technology is accompanied by a systemic revamping of processes to eliminate the opportunity for service providers to abuse their discretion, e-governance will not be successful (Shah 2005).

Computerizing dysfunctional systems produces computerized dysfunctional systems. The experience of Indian states with implementing e-governance substantiates this position.

Successful examples such as the e-*sewa* in Andhra Pradesh and the Bhoomi land registration process in Karnataka have been much discussed. But there are also many failures, which can be equally instructive. In Gujarat an attempt to reduce corruption and delay in the collection of entry taxes at the state border began with promise, but since the incentives of the agents to divert revenues into their own pockets (abetted by powerful others) were not checked by a complete re-engineering of the process, discretion crept back into the system. Similarly, an attempt to computerize the registration department in Andhra Pradesh did not produce the expected benefits; substantial bribes were still collected, even in the Computer-Aided Administration of Registration Department transactions. Thus computerized transactions do not help create the right incentives for good performance; instead, a significant revamping of organizational processes coupled with computerized transactions can go a long way toward creating transparent and accountable governance systems.

PRAJA, a Mumbai-based NGO that collaborated with the Brihan-Mumbai Municipal Corporation to set up an online complaint and monitoring system (OCMS), has been particularly successful in this regard. Organizational restructuring and the introduction of new technologies along with the OCMS system contributed to the success of this initiative.

Another critical area in which e-governance can be helpful, if undertaken in a context of business reengineering process, is procurement. In recent years, there has been increasing recognition that procurement is a critical component for effective service delivery since budgets get translated into services in large part through the operation of the procurement system. A constructive strategy for improving procurement outcomes combines a simplification and standardization of rules, increased transparency, and enhanced opportunities for participation by groups affected by decisions about what to purchase and the quality of the goods, works, or services that are delivered. Utilizing modern technology, in the form of e-government procurement, can be a vital tool in improving procurement outcomes since it supports simplification, transparency, and internal and external monitoring and management when done as part of a business reengineering process. Procurement reform has proved to be especially effective in reducing costs and improving the value for money when it takes place alongside complementary reforms in budgeting and financial management that allow agencies to retain savings obtained from improved procurement and reduce the costs engendered by late payments to suppliers. Countries as disparate as Uganda, the Philippines, South Africa, and the U.K. have generated large savings and significantly improved service delivery through sustained efforts to improve public procurement.

India has already begun to take important steps towards establishing a public procurement system that contributes to improved service delivery. Karnataka and Tamil Nadu have led the way in introducing comprehensive laws with simplified rules to guide procurement practices. States, such as Andhra Pradesh have introduced e-government procurement systems and have generated cost savings of almost 10% through their application. In addition, the Right to Information Law has established the foundation for greatly enhanced transparency in regard to all aspects of public purchasing.

Box 3. 2: Jawaharlal Nehru National Urban Renewal Mission: An integrated reform effort to improve urban services

The proposed Jawaharlal Nehru National Urban Renewal Mission (JNNURM) marks an important step toward improving urban services through strategic institutional reform. The JNNURM comprises a set of reform instruments aimed at providing incentives for cities and states to work according to integrated plans that lead toward broader institutional reform.

Reform measures include efforts to strengthen voice by creating formal urban institutional mechanisms for citizen participation. This involves establishing rigorous disclosure processes through the enactment of a public disclosure law to ensure that financial plans of urban local bodies are prepared with citizen participation and that performance information is regularly disseminated to all citizens.

JNNURM also aims to improve the compact through reform instruments that strengthen accountability relationships between policymakers and service providers. Reform instruments include drawing up PPP models for development, management, and financing of infrastructure development, and strengthening the role of urban local bodies by ensuring the adequate devolution of funds, functions, and functionaries.

JNNURM also aims to introduce reforms in financial and accounting practices within state agencies through information technology applications such as geographic information systems and management information systems, as well as modern accrual-based double-entry accounting in urban local governments.

While the proposed reform measures represent a well developed, integrated effort at strategic, incremental reform, success will largely depend on the extent to which reform measures promoted by state governments are developed as part of a larger integrated vision for institutional reform. Isolated reform measures, even in areas suggested by JNNURM, may not succeed in causing long-term change.

Handling the political economy of internal and administrative reform

One of the most important lessons to learn from the cases discussed above is that strategic reform measures can be implemented even in political environments that are largely resistant to radical reform. The challenge lies in creating the momentum necessary to initiate reform and in scaling up successful reform initiatives. This is a difficult task. For reforms to be successful, they require strong political commitment and public support. However, the everyday reality of politics in service provision makes attaining this support somewhat problematic.

Elected politicians and top policymakers in India, from the national to the state to the local level, are enormously capable, energetic, and ambitious. When services fail in India it is not because these people keep making mistakes or because the people who control the state cannot innovate. Rather, the incentives for these people to innovate are few. The costs of running a reform program in the current political environment are high. Every viable system has entrenched interests, and often these interests oppose change. Success is uncertain; many reforms do not work as planned immediately but require sustained commitment, which is difficult to maintain in a politicized climate. The electoral benefits of reform often seem dubious relative to the immediate benefits of jobs and contracts

allocated to supporters. Even for a more than typically public-spirited politician or top civil servant, the case for taking on reform is weak.

Another factor constraining reform initiatives is the difficulty of mobilizing sufficient public support. As discussed earlier, as the services delivered by the public sector deteriorate, people increasingly opt out of government provision to rely either on the private sector (education, health) or their own investments (tube wells, water storage tanks). Thus there are few incentives for more privileged citizens to mobilize in favor of radical reform. Similarly, for a parent paying for a child to be in a private school, the private incentives to spend time and energy to improve the public sector are diminished. This is particularly the case for reform measures that involve heavy capital investments and user charges. For instance, reform efforts aimed at providing pressurized piped water 24 hours a day, 7 days a week, must cope with the fact that the elite in urban areas already have on-demand pressurized water available; by investing in boreholes, water storage tanks, and pumps, the rich ensure that their supply is continuous, even though the public supply flows only a few hours a day. In this case paying more per liter for better service is unattractive because they have sunk costs in mitigating government failure.

A recent World Bank report (2005c) on the water sector (including irrigation) emphasizes the risks of the increasing pressures on the sector. It also recognizes that the political problems in initiating reform are difficult to surmount and that simply repeating the conventional wisdom of technocratic solutions is unhelpful. The report opts for "principled pragmatism"—"principled" because getting the principles of reform correct is essential, and "pragmatism" from experience and political necessity. The report neatly summarizes some aphoristic rules or principles of "principled pragmatism" or "strategic incrementalism" that reforming governments should keep in mind during the reform process (box 3.3).

Box 3. 3: Twelve lessons from reforms in a difficult sector

A recent World Bank report outlined the difficulties that India faces and will increasingly face with water resources. The report acknowledged that successful solutions will be difficult and that the art of political economy of reform is as important as the science of hydrology. It specified 12 lessons:

1. Water is different.
2. Initiate reform where there is a powerful need and demonstrated demand.
3. Involve those affected, and address their concerns with effective, understandable information.
4. Reform is dialectical, not mechanical.
5. It's implementation, stupid.
6. Develop a sequenced, prioritized list of reforms.
7. Be patient and persistent.
8. Pick the low-hanging fruit—nothing succeeds like success.
9. Keep your eye on the ball—don't let the best be the enemy of the good.
10. There are no silver bullets.
11. Don't throw the baby out with the bathwater.
12. Reforms must provide returns for the politicians who are willing to make changes.

Source: World Bank 2005e.

Both of the reviews of the cases on which this chapter draws demonstrate that positive changes and innovations are possible in India and point to positive lessons for success in service delivery. But review of the successful cases also highlights a major risk of incremental reforms that do not produce systemic change or complete process engineering. The risk of internal reforms is that they depend too much on a single champion inside the system (or a recent insider). These reforms may accomplish a great deal, but they are too easily subsumed by the system when the champion moves on.

Chapter 4. Local governments and service delivery in India

The United Progressive Alliance (UPA) Government will ensure that all funds given to states for implementation of poverty alleviation and rural development schemes by Panchayats are neither delayed nor diverted. Monitoring will be strict...devolution of funds will be accompanied by similar devolution of functions and functionaries as well...The UPA Government will ensure that the Gram Sabha is empowered to emerge as the foundation of Panchayati Raj.

National Common Minimum Program, United Progressive Alliance, May 2004

The government of India has stressed the urgent need for fundamental reforms in public institutions owing to their failure to adequately fulfill core public responsibilities. The national and state governments have signaled their commitment to accelerate the ongoing decentralization of government responsibilities to Panchayati Raj institutions (PRIs) as one way to achieve fundamental reform. Many recent initiatives of the UPA government—Bharat Nirman, National Rural Employment Guarantee Act, National Rural Health Mission—have articulated important roles for PRIs in implementation. Yet all would agree that decentralization is no panacea, that the PRIs have weak capacity, that they are often as ineffective and as corrupt as the line agencies, that local elite capture (replacing state and national elite capture) is a risk, and that simply plumping greater responsibility onto the PRIs without systemic reforms and capacity building is unlikely to lead to dramatic improvements in outputs and outcomes. Decentralization is not the solution to any problem but rather an opportunity to undertake needed reforms that create the greater accountability that leads to more effective services. But it is an opportunity that can easily be lost. (Using private providers to fulfill public goals is discussed in chapter 5 and other reforms in chapter 3.)[12]

Properly designed and implemented decentralization may effectively address the service delivery needs of local communities by more accurately reflecting local priorities for services and preferences for delivery systems and content. This has been the primary case made for a trend in government organization and better governance that has gained substantial currency. It has also been argued that the equalization potential is clearly greater in a centralized public sector. The more money the central government has to distribute, the greater is the potential to equalize. In other words, local government jurisdictions with large or predominantly poor populations would be likely to simultaneously face higher service deficits and a smaller resource base from which to address those deficits. Technical and administrative capacities are also likely to be lacking. It is therefore entirely possible that geographic or regional divergence may increase and service deficits may actually grow with decentralization. However, in terms

[12] This chapter does not advocate for decentralization generally nor attempt to answer the question of whether a decentralized governance structure is the only or even the right institutional arrangement for strengthening accountability in service delivery. Rather, it addresses the question "how can decentralization be done to improve service delivery?"—which is very different from "is decentralization the most attractive reform to improve service delivery?"

of expenditures on public services and benefits to the citizens, it is not clear whether the current system is effectively equalizing and whether it is a viable option for improving service delivery.

The design of administrative decentralization in India hinges on the "three Fs": funds, functions, and functionaries. India's experience with decentralization can be characterized as unbalanced, with political decentralization (Panchayat elections) running ahead of administrative decentralization. Functions have been devolved but PRIs have little control over funds (which come to PRIs tied to specific items) or functionaries (who remain appendages of the state government). This limited and unbalanced decentralization is unlikely to improve services significantly because it does not improve the delegation, financing, information, and enforcing elements of system accountability—and in some ways could make them weaker. This chapter reviews the status of administrative decentralization and presents an analytical framework for determining which activities will be conducive to improvements (to which tier of the PRI) through decentralization and how to align the three F's to improve services. The last section addresses transitional issues in building capacity for accounting, transparency, and social inclusion for accountability in the PRI system. Although this chapter discusses mainly rural decentralization, most of the same principles apply to urban areas and urban local bodies.

The three F's of decentralization: funds, functions, and functionaries

The 73rd and 74th amendments to the Indian Constitution, adopted in 1992, provide the legal framework for decentralization. The amendments mandated state governments to transfer some powers and responsibilities to Panchayats at the rural level and to urban local bodies (ULBs) so they could function as autonomous institutions of self-government.[13] The amendments also provided for regular elections to these local bodies and reserved one-third of the seats for women and a proportional number for Scheduled Castes/Scheduled Tribes (SC/ST) populations. Elections have been held in most states, resulting in the inclusion of more than three million people in the formal political system. However, few states have moved much beyond political decentralization to devolve funds, functions, and functionaries to local governments.

Funds

To provide for adequate resources, the 73rd amendment recommended that state governments endow PRIs with taxation powers and enhance their resources through increased transfers of discretionary funds from the state and central governments. In addition, all state governments were required to create state finance commissions, parallel to the national finance commissions. A comprehensive review (World Bank 2004c) of fiscal decentralization in Karnataka and Kerala (two states generally considered to have pursued decentralization more aggressively) found that:

[13] The 73rd amendment mandated the creation of a three-tier (district, intermediate, and village) local government system in rural India. These tiers are referred to as Zilla Panchayat (ZP), block or intermediate Panchayat, and Gram Panchayat (GP).

- Internal revenue mobilization at the Panchayat level is weak, and Panchayats are largely dependent on transfers (from the state and central government).
- Transfers usually come as tied grants, and Panchayats have limited expenditure discretion.
- State governments are reluctant to devolve finances, which, compounded with the dire state fiscal position overall, ensures that state governments continue to dominate local expenditures in key areas (health, education, irrigation, etc.).[14]
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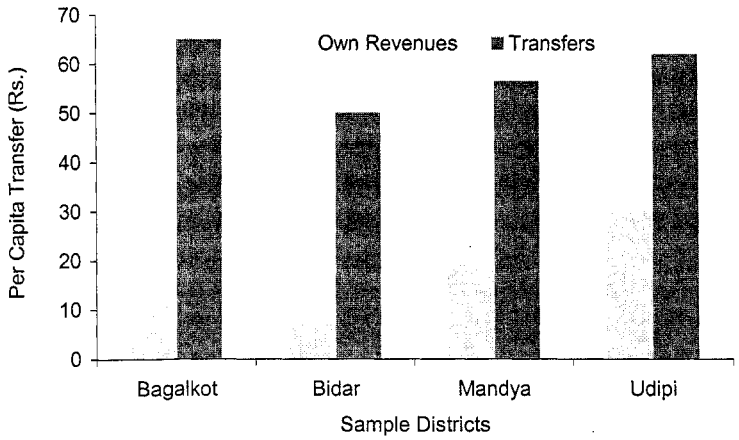
Figure 4. 1: Own revenues contribute little to Panchayat revenues in Karnataka, FY 2000–01



Source: World Bank 2004

Weak revenue efforts. In a well-designed decentralized fiscal system, local governments need powers to mobilize revenues. But even in such states as Karnataka and Kerala, Panchayat own source revenues (revenue through tax collections and user fees) amount to less than 1 percent of the state domestic product. In Karnataka, for example, GPs raised an average of only 19 percent of total resources from own source revenues in 2000–01. In Kerala own source revenue contributed only 17 percent or Rs 57 per capita to GP resources in 1998–99. A study conducted for the Twelfth Finance Commission reported that internal revenue mobilization of PRIs constituted only 4.2 percent of their total revenue.[15] This is extremely low, especially by international standards. Analysis suggests that tax collection remains low because of both design and implementation issues. For example, administrative procedures for collection are inefficient. In many cases Panchayats have not been legally endowed with a broad or productive tax base and, not surprisingly, local officials are unwilling to impose taxes, preferring to lobby the system for greater transfers.

[14] Although this study is limited to two states (both known for their far-reaching efforts to strengthen decentralization), subsequent analysis suggests that these findings reflect the status of Panchayat finances across India.
[15] As reported in the Government of India (2005a), chapter 8, p. 138.

PRIs have limited expenditure discretion. Even where subnational units have own source revenue, intergovernmental transfers constitute an essential component of local government revenue. Internal revenue mobilization is very weak in India, so Panchayat dependence on transfers is extremely significant. For transfers to be effective, local governments must have expenditure discretion over the bulk of the funds received. This enables them to tailor resource allocations and expenditures to suit local preferences and priorities and encourages cost-consciousness because the trade-offs are made at the local level. It does not preclude conditional grants to PRIs by upper tiers of government, to encourage expenditures in areas of national priority, although such grants should ideally be only a small part of local government resources.

Under the present system, however, Panchayat resources are dominated by earmarked transfers designed by higher levels of government, leaving PRIs with almost no expenditure discretion. A World Bank study (2004c) shows that in 2002–03 central and state schemes contributed to as much as 54 percent of the block Panchayat plan outlay in Karnataka. Because the funds come tied to schemes, even the micro-allocation of resources is determined by guidelines prepared by the state and central governments. Of the total funds devolved to Panchayats in Karnataka, 50 percent were earmarked for salaries, 20 percent for transfers, and the remainder for input purchases.[16] The fact that expenditures are tied (and that the fiscal system is not transparent) implies that state governments can easily withhold PRI expenditures. In Karnataka, for instance, the share of plan allocation to rural local governments in total plan expenditures was reduced from 8.3 percent in 2001–02 to 5.1 percent in 2002–03 owing to fiscal deficits in the state.

In recent years, partly because of fiscal tightness at the state level, Centrally Sponsored Schemes (CSSs) have come to dominate plan expenditures even in traditionally state services such as education, health, and water and sanitation (in 2002–03, 58 percent of the plan expenditure for elementary education came from the center). CSSs are also an important source of funding for subjects that fall within the domain of PRIs. A recent task force set up by the government identified as many as 154 CSSs—to the tune of approximately Rs 395 billion—that deal with subjects devolved to PRIs.[17] Funds received through CSSs are tied to specific guidelines (with greater or lesser flexibility even at the state level) and program implementation is generally undertaken through line departments. Even when PRIs are included, funds are tied and PRIs have little or no discretion over their use. For instance, Sampoorna Grameen Rozgar Yojana, a CSS for wage employment, contributes approximately 50 percent of the rural development ministry budget (both at the center and in most states). The program is implemented through PRIs, and funds for the scheme flow directly from the center to the ZP. However, use of these funds is tied to specific guidelines determined at the central level and PRIs have no discretion over them.

State governments continue to dominate expenditures in key areas. The typical Indian state devolves some functions without devolving the concomitant funds required for PRIs

[16] This study was conducted before the October 16, 2004, government order that recommended large-scale financial devolution to the PRIs.
[17] Government of India, Ministry of Finance, 2004.

to fulfill their roles (figure 4.2). As a result, the state governments continue to dominate. A survey in Belun Dhamashin GP in West Bengal reveals that in key sectors such as primary education, primary health, irrigation, and agriculture, line departments are responsible for as much as 67 percent of expenditure even though West Bengal's 1973 PRI Act mandates the devolution of these functions to the PRIs (CMIE 2005). The story is similar across India. Oommen (2005) found the expenditure of PRIs as a percentage of total combined expenditure (union, states, and local bodies) is only 4.7 percent. This contrasts starkly with more developed countries, where local governments normally account for 20–35 percent of total government expenditure (in Denmark and Finland it is as high as 45 percent and 41 percent).

The system of fiscal decentralization does not follow some basic principles—specifically, significant expenditure responsibility and discretion, and revenue-raising powers. Panchayats have weak revenue-raising capacities and limited expenditure discretion, and funds do not follow functions. Because devolution of funds is limited, they have mandates without resources. Thus accountability relations are obfuscated.

Functions: blurred delegation

For citizens to enforce accountability, the tiers of government must have clearly delegated functions or roles on the basis of which they can be monitored and their performance judged. Effective devolution of functions is thus critical to the design of a decentralized system. As a general principle, PRIs should have a key role mainly in service delivery activities such as rural drinking water, rural roads, rural electrification, water tanks, education, and health. They should not take on responsibilities such as operating parastatals in the productive sector. The devolution of functions to PRIs is determined by a list of 29 subjects identified in the XIth schedule of the Constitution. Although most state governments have devolved a significant number of functions to PRIs, functional devolution is incomplete and ad hoc and encourages concurrency.

- *Incomplete devolution of functions.* On paper, many state governments have chosen to devolve subjects to PRIs "wholesale"—without unbundling them into specific activities and subactivities. Yet public expenditures are budgeted and managed at the level of activity or subactivity (schemes or budget items). For example, most states assign responsibility for basic education to local governments, but leave the key activities and subactivities necessary to deliver basic education, such as building schools or hiring teachers, to the state line agency—rendering the devolution to PRIs toothless.
- *Ad hoc devolution.* There has been little rational consideration, on the basis of principles of public finance and accountability, of which services to devolve to which tiers. As a result, the higher tiers of government tend to have responsibility for most services.
- *Overlapping roles.* Most devolved services end up in a concurrent list, with different tiers of government sharing responsibility for them, allowing for the continued, usually dominant, role of the state government. For example, one state has 72 schemes for tribal welfare, involving all five tiers of government—from

center to village. In West Bengal, the 1973 Panchayati Raj Act assigns concurrent responsibilities for all subjects to block and district Panchayats.

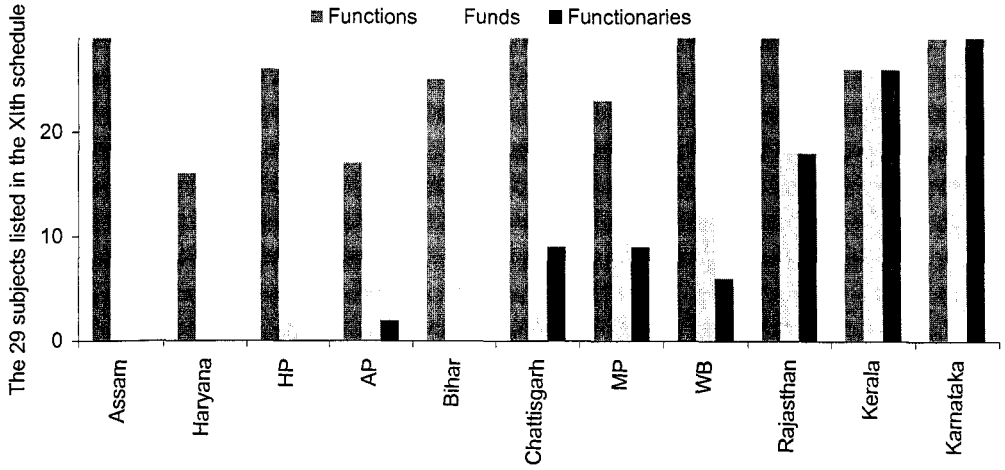
Functionaries

Across India, Panchayats have limited powers to hire staff (most state Panchayat acts provide minimal resources for GPs to hire secretarial staff) so they depend on state governments to depute functionaries from line departments. However, the mere devolution of functionaries is not sufficient because PRIs do not have any administrative powers over them (this holds true even in Kerala and Karnataka, where functionaries have been devolved in line with funds and functions). Deputed staff members are accountable only to the state government, which retains the power to hire, fire, and compensate. Consequently, PRIs are given functions but have little or no effective control over the people expected to carry them out. Naturally, because the state functionaries' careers and compensation are linked to state services, they are much more concerned with that than with responding to local governments.

Status of the three F's in PRI decentralization

Some consider that decentralizing to improve services and governance is a failed experiment, while others believe it has yet to be seriously tried. In a well-designed decentralized system, the tiers of government have clearly allocated functions (so that citizens know who is responsible), financing is commensurate with functions (so that governments can carry out their tasks), and functionaries are accountable to the body responsible for the service (so that the long route of accountability from citizen to government to provider is unbroken). The current system almost could not be more different, though some states have clearly made more progress than others. Although PRI officials are elected, PRIs serve not as truly autonomous levels of government independently responsible to voters for functions over which they have control but, at best, as implementers of activities, plans, and schemes made elsewhere (figure 4.2). They are delegated functions but only concurrently with other tiers of government that control funds and functionaries. In essence, the weak alignment of funds, functions, and functionaries has not created conditions for accountable governance.

Figure 4. 2: No alignment in the devolution of the three F's



Source: www.panchayat.nic.in.

Aligning the three F's for more effective services from local governments

A well-designed decentralized system of governance requires that functions are clearly delegated to individual activities consistent with a budgeting system; finances follow functions; performance is judged through well-designed monitoring and evaluation mechanisms and information flows down to citizens; and citizens can enforce accountability both with policymakers (voice) and between policymakers and providers (compact). We tackle these issues in a different order—functions first, then functionaries, and only then funds.

Functions

A key stumbling block in moving ahead with decentralization is the development of "activity mapping"—an exhaustive list of activities that governments undertake, with each activity allocated to a specific tier of government (center, state, district, block or its equivalent, GP).[18] Only if state finance commissions, for instance, agree on an activity mapping of functions could they allocate funds on some service-related basis. Hence the first and most difficult step is to identify the roles and responsibilities of the tiers of local governments in sufficient detail. Functionaries and funds can then be allocated on the basis of this mapping. A forthcoming World Bank study recommends mapping activity in three steps: unbundle into subsectors and functions within subsectors; apply technical first principles to align levels of jurisdiction with functional assignments, based on the specifics of the service; and apply first principles of accountability.

The first step is to unbundle sectors into detailed subsectors and from subsectors into identifiable activities. The study identifies at least six activities in any subsector:

[18] This section draws heavily on a forthcoming study on functional allocation and decentralization.

- Setting objectives and standards of service.
- Planning.
- Creating assets.
- Operating (nonstaff).
- Operating (staff).
- Monitoring and evaluation.

A key factor leading to accountability failure is having "the fox guard the chickens." When the same organization is responsible for all steps in provision (setting standards, planning, creating assets, operating, and monitoring and evaluation), the organizational incentives to generate transparent information suitable for external accountability are very limited. Decentralization to PRIs offers an opportunity to use the multiple tiers of government to encourage a creative tension. This enhances a citizen's ability to create checks and balances through expressing "voice." So, for instance, if one simply devolves responsibility for all aspects of running a Primary Health Center from the state to the district, the scope for improvement is limited. But if the state sheds operational responsibilities while maintaining responsibility for setting standards and monitoring and evaluation, it can use the arm's length relationship with the district to produce reliable, regular, relevant information about the performance of PHCs across districts.

The second step is to use sectorally relevant technical first principles. There are four basic principles:

- *Economies of scale: match political jurisdiction to technically feasible catchments area.* A "catchments area" is the geographic space from which the service provision unit (school, clinic, well, etc.) typically draws its consumer. This is determined by the relationship of transport costs to the value of the service. Economies of scale will vary both by subsector and by activity. In health, the catchments area for personal preventive care is small (requiring frequent, individual low-value transactions), while the catchments area for the surgical unit of a hospital might be a district or even a state. Even within an activity the economies of scale vary by function—so standards for personal preventive care can be set at the state or district level even if the operation of those services has little or no economies of scale.
- *Equity: set activities so that interjurisdictional fairness can be achieved.* Note that this need not have any implications for who is responsible for operation of the services.
- *Externalities: match the scope of the spillover impacts to the jurisdiction responsible.* A small jurisdiction might easily assume responsibility for personal preventive health activities (e.g., antenatal visits). But highly infectious communicable diseases may cause epidemics that spill over from one jurisdiction to the next—so the scope for controlling HIV/AIDS or avian flu is likely better served by state or central tiers.
- *Heterogeneity of demand: maximize local choice over priorities.* Because needs and demands are large, resources are scarce, and conditions vary widely, even within districts or blocks, allowing communities to choose where demands differ (while still meeting basic standards) is crucial.

The third step is to apply first principles of accountability. Each relationship of accountability involves delegation, financing, information, and enforceability. The question is, at what tier of government are those relationships potentially the strongest? Again, the answer is not the same for all subsectors or functions. Rather, it depends on three characteristics:

- *Degree of discretion.* The more discretionary the activity, the greater the need for local information and enforceability. A discretionary activity is one in which the successful delivery of a service requires the frontline provider to adapt to local conditions instead of providing the same thing every time. So, within health, immunizations are not discretionary—the health worker gives the same treatment to each child—while curative care is highly discretionary—the care provider must respond to each patient's symptoms.
- *Degree of transaction intensity.* The greater the transaction intensity, the greater the potential for local control. Transaction-intensive activities require repeated transactions at the local level. So, in education, textbook design is not transaction intensive (it is done once and then used by millions), while classroom instruction involves millions of individual teacher-student interactions every day.
- *Ability to observe performance.* For information and enforceability, activities should be allocated to the level in which the provider's performance is best observed. This depends to a large extent on how much technical know-how is required to determine whether the service was adequate. Every parent can know whether their child's teacher was present and can, know with some questioning, what happened in the classroom, but judging the adequacy of a curriculum or the validity of a testing instrument requires technical skills.

When applied, these first principles will give different answers for different subsectors and functions. Within each sector, subsectors will have different requirements: the appropriate scale for managing water supply, for instance, will be different for small villages and for urban areas (because economies of scale are different); and the appropriate scale for managing watershed issues depends on hydrological conditions (surplus, deficit) and links (because the spillover impacts of one jurisdiction on another differ). Moreover, when first principles are applied, the activities, even within subsectors, are allocated to different tiers. The analysis of first principles in the World Bank study (forthcoming(b)) on rural service delivery suggests three strong conclusions:

- *The same tier of government should not be responsible for operation and for (all) monitoring and evaluation.* External accountability (through either political voice or choice) requires information that no organizational provider has the incentive to create. The existence of five tiers of government gives scope for a creative tension in which higher tiers monitor the performance (on compliance with process, financial accounting, and outputs and outcomes) of lower tiers (or vice versa). A simple transfer of bundled subsectors is a lost opportunity to strengthen accountability.
- *The capability and commitment of higher tiers of government to set standards for outputs and goals for outcomes and to monitor performance and evaluate the impact of alternatives should be strengthened by decentralization.* Monitoring systems are

key to an effective decentralized system because they create incentives for performance. Good monitoring systems require that outcomes are clearly benchmarked and standards maintained. However, citizens also need to judge the performance of local governments (especially on functions such as operations and asset creation, which are locally observable). Thus monitoring must also be undertaken at the Gram Sabha level through mechanisms such as social audits—but monitoring compliance with the process elements of local accountability is also a higher-tier function.

- *There is enormous scope for increasing local control of asset creation and operations.* Many subsectors of service delivery involve operations that are discretionary, transaction intensive and locally observable and for which there are no technical constraints to local operation (e.g., rural water supply, primary education, personal preventive health, minor curative care). These are prime candidates to be taken on by the lowest tier of the PRI—the GP. Again, this decision should be the result of analysis: not all education (e.g., universities) or all health care (e.g., tertiary hospitals), or even all aspects of rural water supply (e.g., large pipelines) can be delegated to the GP, just as not all aspects of education, health, or water supply can be delegated to the state level, as in the current system.

Funds

Funds must follow functions, so that Panchayats can fulfill their mandates—through both increased own revenues and improved transfers. Improving the tax system and user charge collection levied by GPs is perhaps the most important area for reform in the current system. There is an urgent need to broaden the tax base for GPs, improve the design and collection of property taxes, and increase the capacity to generate user fees for services. The Twelfth Finance Commission has attempted to address these problems through recommendations that include the need to improve evaluations of the tax base, incentives for revenue collection at the local level, and property tax assessments.

Transfers to PRIs could be improved in three ways:

- *Move funding design from schematic to thematic.* Typically, revenues are micromanaged by the design of individual projects and programs, often with multiple schemes for the same purposes (there are more than five CSSs for water supply). These can be bundled in a theme (such as water supply), so that PRIs can choose to allocate funds to their highest priorities. This would allow PRIs to have more open menus in the allocation of funds within a sector.
- *Give GPs more untied block grants.* There have been some recent efforts in this direction. For instance, in October 2004, a government order in Karnataka transferred all schemes that deal with subjects identified in schedule XI to PRIs. Approximately Rs 34 billion (about 30 percent of the state plan budget) was devolved to PRIs, of which Rs 15.88 billion was devolved directly to GPs.[19] At the national level, the

[19] Some of these funds have been brought back to the state accounts because of concerns related to revenue deficits in the state.

Twelfth Finance Commission recommends a quantum increase (Rs 200 billion) in financial allocations to PRIs. This is a significant increase in comparison with the Eleventh Finance Commission, which recommended an ad hoc annual grant of Rs 16 billion or Rs 8,000 over five years for Panchayats.

- *Define Panchayat expenditures.* One specific detail with large ramifications is that all transfers to Panchayats are defined as revenue expenditures (according to the accounting laws in India). The government has adopted the Twelfth Finance Commission recommendation that all states should have zero revenue deficits by 2006 or face penalties that affect their consolidated fund allocation. This makes allocations to PRIs—even when they finance investments—more difficult and gives states (abetted by the interests of their line agencies) an excuse to not devolve revenues.

Functionaries

The issue of functionaries is somewhat more complicated than those of functions and funds because of legal constraints. Ideally, PRIs should have their own cadres of employees with powers of enforceability (understood as the ability to hire, fire, and reward). However, even if they did, the provisions of Article 311 of the Constitution would extend to Panchayat employees, creating conditions of weak incentives and poor performance, similar to those at the state and center. One way out could be to authorize PRIs to hire employees on a contractual basis. Such contracts should be renewable subject to satisfactory performance. In addition, PRIs should be able to outsource technical expertise on a needs basis (from both higher tiers of government and the private sector). States such as Karnataka, where GPs are allowed to contract engineers from a district pool of engineers, have experimented with this idea. These experiments have had some measure of success and could be extended to PRIs across the country.

Box 4. 1: Urban Decentralization and the three F's: a status review

The 74th amendment provides the legal framework for urban decentralization in India. A recent World Bank review (2005) of the status of decentralization in urban areas argues that the devolution of funds, functions, and functionaries to urban bodies has been relatively weak. Some key findings:

Funds. Urban local bodies (ULBs) suffer from poor-quality financing with weak revenue-raising powers and limited discretion. Revenues collected by ULBs account for a mere 3 percent of all revenues collected in India as a whole. Dependency on transfers is thus significant. But transfers are not stable, timely, or predictable—and in the final analysis, they are not equalizing. ULBs have limited discretion over transferred funds. Almost 40 percent of these funds go to salary payments. Other funds come tied to schemes designed by the state and central governments (ULBs get grants from at least 30 CSSs on a myriad of urban governance issues). Just as with PRIs, fiscal deficits at the state level have led to delays and reductions in transfers to ULBs. This in turn has contributed to mounting local fiscal arrears. Budgetary expenditures undertaken by ULBs are thus very low, amounting to a mere 0.8 percent of GDP (for FY 1997/98).[20] As a result, state governments continue to dominate. For instance, in Karnataka, during the 10th plan period, ULBs spent Rs 47 per capita on urban water supply while the state government spent as much as Rs 128 per capita.

Functions. The constitutional amendment identifies 18 functions that state governments could assign to ULBs. In practice, functional responsibilities to local bodies are confined to infrastructure-related activities such as water supply, sewerage, and solid waste management. In some instances, ULBs have been assigned functions related to education and health care. The limited functional responsibilities of ULBs tend to be compromised because of the proliferation of state boards and other agencies with overlapping roles and responsibilities. The problems of concurrency are further exacerbated by the lack of coordination and consultation between these bodies.

Functionaries. Like their rural counterparts, ULBs depend on state government officials to fulfill their administrative responsibilities. Senior municipal officials are appointed from the IAS or the State Administrative Service, limiting the ability of local politicians to hold staff accountable. Overstaffing is a problem, because state governments control the number and distribution of employees across categories.

Current debates in India consider urban and rural decentralization separately and for the most part emphasize rural decentralization. This is problematic: there are many complementarities between rural and urban decentralization because they draw from the same revenue source—the state government. For instance, greater tax discretion at the urban level (since urban centers are naturally better sources of tax revenue than rural areas) could free resources for rural areas. Thus when designing a model for decentralization, particularly fiscal decentralization, rural and urban decentralization should be viewed in conjunction.

Source: World Bank 2005g

Capacity building for accounting and accountability with social inclusion

The constitutional amendments have created a political space for PRIs and elections are held regularly in most states (if only by judicial insistence in such reluctant states as Bihar and Andhra Pradesh). But many argue that both PRIs, especially at the lowest level, and ULBs lack capacity and that decentralization would lead to even more elite capture because local politics are exclusionary. As this chapter stresses, no one should

[20] Compared with their urban counterparts across the world, the expenditure responsibility of local governments in India is extremely low. Even in countries with few social service responsibilities such as Morocco and Greece, budgetary expenditures by ULBs in FY 1998 accounted for 3.3 percent and 2.1 percent of GDP, respectively (World Bank 2005g).

expect that decentralization will improve services overnight or that achieving better services will not require major investments in capacity, in deepening democracy, and in promoting greater community capacity to organize for collective action and to demand services. Building capacity for local governance therefore goes beyond local governments and will involve three major strands:

- Building PRI capacity for accounting—planning, budgeting, accounting, and auditing effectively.
- Building greater accountability, both internal and external.
- Strengthening the "synapse" between households and communities and local governments by strengthening community capabilities and promoting greater inclusion in the processes of local government.

Accounting: capacity building for financial management

> *We need to build the capacity of decentralized bodies and their elected representatives and this is best done through effective transfer of funds and functions to them.*
>
> *Prime Minister Manmohan Singh, August 15, 2004*

The potential problem of weak capacity among local PRI representatives is well recognized. The capacity issue is essentially a "chicken and egg" problem: capacity cannot be built in a vacuum. Until PRIs have sufficient control over thematic and untied resources for financial management they will necessarily lack capacity. At the same time the weak capacity argument is often used by state governments and line departments as an excuse to reduce or withhold the allocation of the very resources needed to build capacity. Thus as the prime minister emphasizes, the best solution for capacity building is to make it necessary to have capacity.

Efforts have been made by both government and civil society organizations to fill the capacity gap. However, a consistent implementation and support plan for PRIs has yet to evolve. Capacity inputs aim to strengthen the sectoral capabilities of PRIs (partly because of the schematic nature of funding) rather than their capacities to perform functions generic to local governments, thereby limiting any spillover impact. Strengthening generic capacity includes capacity for financial management (budgeting, planning, auditing), procurement, and performance monitoring. Capacity-building initiatives could include the creation of resource cells staffed with accountants, engineers, and other technical experts at the block level and the provision of inputs in basic accounting and procurement procedures. This would build the back office support necessary for PRIs to effectively use thematic, untied funds. In essence, capacity-building initiatives need to be part of a sequenced devolution process that strengthens the power and resources available to Panchayats while strengthening their capability to manage these resources.

Strengthening accountability

Besides periodic democratic elections, the 73rd amendment provides for two additional mechanisms that aim to strengthen voice at the grassroots and encourage a more inclusive polity: reservation of seats for women and for SC/ST (discussed below) and the Gram Sabha. Gram Sabhas provide the space for citizens to articulate their needs and priorities and to monitor the actions of their elected representatives (including whether programs are well targeted and reach intended beneficiaries). While it is difficult to generalize, there is a widespread perception that the Gram Sabhas have proven very weak: on most occasions they are not even held and when held the quality of participation is extremely poor. For instance, in 2002-03 as many as 75 percent of Gram Sabhas in Himachal Pradesh (generally a quite functional state) had to be adjourned for lack of a quorum—and a quorum requires only 10 percent attendance. Rao and others (2005) collected data from more than 4,000 households across four south Indian states (generally advanced on the PRI agenda) and found (a) a quarter of the GPs surveyed did not even hold Gram Sabhas; (b) only 20 percent of households had ever attended a Gram Sabha; and (c) Gram Sabhas reflected social inequity prevalent in the village, because women and the landless were much less likely to attend and speak in meetings.

Rao and others found that despite low attendance, where Gram Sabhas are held they do yield some positive results. Participation is associated with a better chance of the landless, illiterate, and SC/STs obtaining Below Poverty Line ration cards (probability of an 8–10 percent increase). This analysis suggests that the Gram Sabha (when held) can encourage political participation and social inclusion. The challenge lies in ensuring that they are held and in strengthening participation in them.

The analysis by Rao and others found that literacy rates are positively correlated both with individuals hearing about Gram Sabhas and with individuals attending them. Krishna's (2005) study on determinants of political participation yielded similar results. Along with education, Krishna found a significant correlation between information and political participation. The experiment by Pratham (a national NGO) with providing real-time feedback to parents about the performance of their children on basic literacy and reading skills has generated widespread public interest in education, and the number of discussions in Gram Sabhas on learning has increased dramatically. Pratham's experience has important policy implications, because it highlights the important role that facilitating reliable, relevant, and regular information flows can play in strengthening Gram Sabha participation. Similar experiments in other sectors have the potential to contribute greatly to the quality of Gram Sabha participation.

Box 4. 2: An impact evaluation of communitisation in Nagaland

"The genius of communitisation is its simplicity. But in is simplicity is the difficulty of unlearning all that governance has become today—people alienating, unfriendly, centralized behemoths. The call to communities is a call not to decentralize but to recreate a new vision of relationship between people, governing structures, and institutions based on an inclusive, egalitarian and democratic vision."

Executive Summary

In 2002 the Government of Nagaland launched an ambitious effort to transfer ownership of resources, delegation of governmental powers to village committees, devolve control of employees (via control of salaries) and give control over assets—including responsibility for maintenance in three sectors: elementary education, health, and power.

An impact analysis undertaken in 2004 found broadly positive impacts in all three sectors. In education, the study reported higher teacher attendance (with attendance rates over 90 percent in 18 of 28 schools studied), higher student attendance, lower drop-outs, and higher passing percentages. In many villages students transferred back from private to public schools as they improved.

Source: Government of Nagaland, 2004

Strengthening the "synapse" between communities and governments for better local governance

Thus far, we have discussed the importance of and the mechanisms through which to design an effective decentralized governance structure. However, the extent to which design translates into practice depends on the role that PRIs, as political institutions, play in strengthening voice and political representation—access and inclusion of the marginalized. PRIs will be effective only if they are able to broaden the democratic base (by tackling political exclusion) and thereby improve citizens' capacities to influence the provision of public services. Participation of SC/STs and other backward classes in the decision making process at the grass root level is a critical element of bridging the gaps in decentralization. This can be achieved formally through measures such as reserving seats and informally by bridging the gap between community organizations and local governments.

Reservations

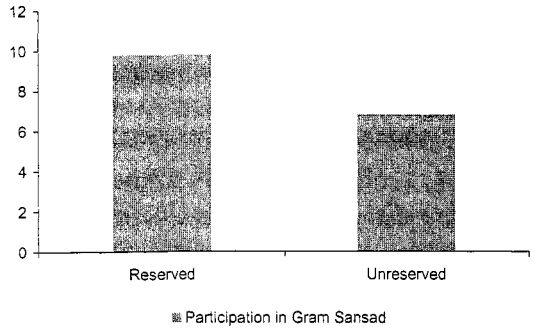
Mandatory provisions for reserving seats for women and SC/ST were introduced in the 73rd amendment as a means of addressing traditional forms of social exclusion at the village level. It is no surprise that reservations have not undone social exclusion in a few short years nor that elite capture remains a problem. But recent empirical work suggests that reservations (for both women and SC/ST) are having some mixed impact. Chattopadhyay and Duflo (2004) examined the impact of reservations on women's political participation through a cross-state comparative analysis of GPs in one district each in West Bengal and Rajasthan. In West Bengal reservations led to increased participation of women—from 6.9 percent to 9.9 percent—in the Gram Sabha in GPs

with a woman Pradhan (head of the council of elected ward members). They also found that in the villages studied women and men ask substantially different questions: 31 percent of women asked about drinking water versus only 17 percent of the men. These differences lead to differences in outputs—and not always in predictable ways: in West Bengal there is more investment in water and roads and less in schools in GPs with women Pradhans.

Many expected that reservations for women would lead to no changes at all because discussions would be dominated by men anyway. However, this study demonstrates that, despite weak preconditions for leadership, the very presence of women in the political system encourages women to participate in political processes at least in some states, thereby contributing to more inclusive politics.

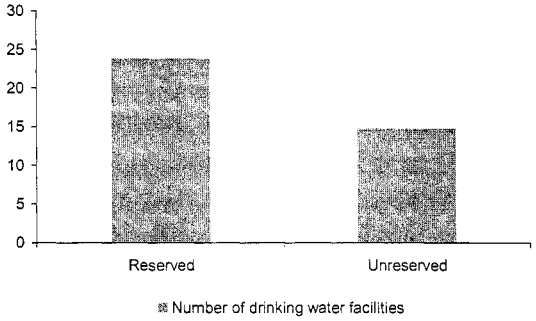
Figure 4. 3: Reservations for women and SC/STs is having some impact

Women's participation in gram sansad's is higher by 3% points in GPs with women Pradhans



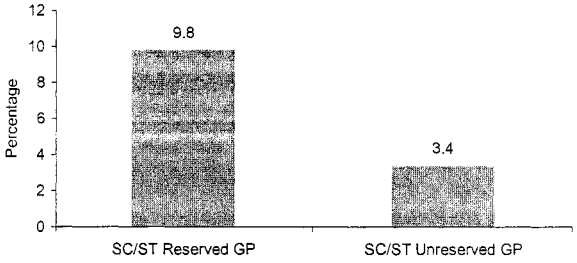
Source: Chattopadhyaya & Duflo (2003)

There are significantly more investments in drinking water in reserved GPs



Source: Chattopadhyaya & Duflo (2003)

SC/ST households are more likely to access government schemes to build house/toilet or for private water/electricity where GP Pradhan is SC/ST



Source: Rao et al (2005)

Analysis of the impact of reservations for SC/STs finds similar outcomes. Rao and others (2005) found that on average, SC/ST households are approximately seven percentage points more likely to access government schemes in GPs where the Pradhan is an SC/ST. These results need to be viewed with some caution, because there is evidence to suggest some private appropriation of public goods by the political elite. The same study found

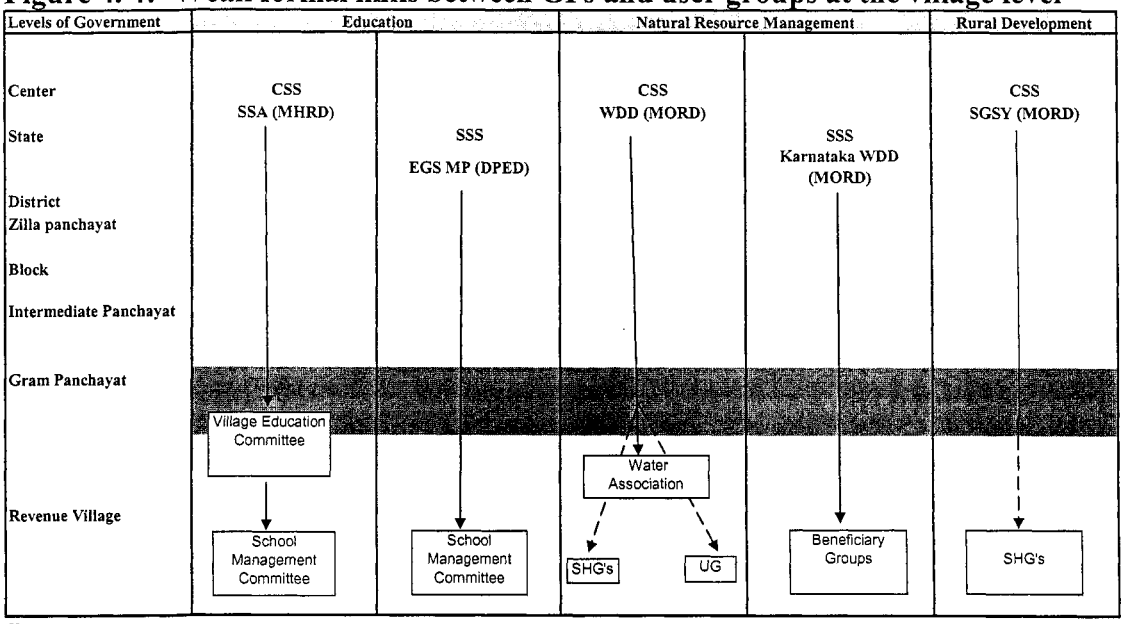
that politicians benefit from a higher incidence of overall targeting and from the provision of toilets and public works programs. Thus, although reservations do encourage some level of equity in access to public goods, political capture and private appropriation remain serious problems.

Local governance and user and community groups

The push toward decentralized government reform in India in the early 1990s was accompanied by a parallel movement that privileged another kind of local organization as a key actor in rural development: user and community groups.[21] It is argued that the rural poor can be empowered both individually and collectively through the creation of social capital. User groups are typically formed vertically—i.e., they are sector specific (watershed development, rural water supply, education, microcredit), often outside formal government structures, and part of a scheme- or project-specific design (created by a line agency or society). There are few serious links (often only a dotted line) between the user group and the local government. Thus two institutional arrangements (the PRIs and the user groups) coexist, creating multiple institutional arrangements for service delivery at the village level (figure 4.4). Most observers today believe that the two approaches to local governance need convergence, drawing on the strengths of both approaches while avoiding the weaknesses of each.

[21] We use the term "user groups" generically to refer to any association (community-based organizations, self-help groups, etc.) of individuals who come together to implement a specific project.

Figure 4. 4: Weak formal links between GPs and user groups at the village level



Key

⟶	Strong formal relationship		
- - - →	Weak relationship		
CSS	Centrally Sponsored Schemes	SHG	Self Help Group
SSS	State Sponsored Schemes	UG	User Group
SSA	Sarva Siksha Abhiyaan	SGSY	Swarnajayanti Gram Swarozgar Yojna
EGS	Employment Guarantee scheme	MHRD	Ministry Human Resource Development
DPED	Department of Primary Education	MORD	Ministry of Rural Development
WDD	Watershed Development		

Source: World Bank, forthcoming(b)

The strength of decentralization through PRIs lies in the fact that they are the legally grounded representative institution at the grassroots. However, in the absence of effective checks and balances, these institutions are susceptible to elite capture, political exclusion, and corruption. The user group approach is advantageous because it encourages an inclusive decision-making process at the local level by directly targeting the poor. It enhances project effectiveness because it contributes to a greater sense of ownership and commitment to project objectives. Crucially, recent analysis suggests that membership in user groups contributes positively to participation in the Gram Sabha, thereby directly affecting the voice element of accountability relationships (Narayana 2005).

In India the user group approach has tended to be viewed in parallel or opposition to PRIs. Privileging user groups over GPs has had the following consequences:

- It encourages a schematic approach to development at worst and a sectoral approach at best, undermining accountability. Information flows remain restricted to user group members rather than open to citizens at large.
- In some cases an exclusive emphasis on user groups can undermine the GP. Many state governments tend to privilege user groups over GPs and devolve finances directly to the user group, leaving GPs starved for funds.[22]

[22] Andhra Pradesh's Janmabhoomi program best exemplifies this phenomenon. While it has many positive features that illustrate the strengths of the user group approach, it is also the case that where resources for

- User groups can be manipulated so that rather than putting bounds on elite capture they simply reallocate among elites. In a field study of 18 villages in 2 districts, Powis (2003) found that filling powerful positions within user groups (such as chairperson of the water user association) are often used as opportunities to relocate important local leaders who are unable to find a space in the formal political system. These local elites then use their positions to usurp powers and resources meant for the GP and often access resources for schemes that even GP members are unaware of.
- Capacity building is often project or scheme specific and has limited spillover impacts in other sectors.

A recent study on local organizations in three sectors (women's development, drinking water and sanitation, and watersheds) by Alsop (2005) highlights the dilemmas. The study finds that PRIs have a limited role (usually restricted to monitoring) and are often ineffective. The presence of user groups in such an environment encourages an informal transfer of functions between local organizations, where user groups emerge stronger and take over functions such as financing, capacity building, and monitoring and evaluation that are formally mandated either to support organizations (NGOs/line departments) or to PRIs. At the same time, although user groups take on a multitude of functions, their sustainability is questionable. Given the role that PRIs can play in ensuring sustainability and in reducing weaknesses associated with user groups, and the concomitant role that user groups can play in instituting checks and balances on PRIs and enhancing project effectiveness, social inclusion, and community ownership, convergence between these two arrangements could be a powerful instrument to enhance developmental effectiveness. This suggests that effective service delivery requires different kinds of local organizations to operate in tandem.

Convergence for better local governance

Strong and effective decentralization needs both strong user groups and strong GPs. Convergence of these two institutional arrangements can lead to more effective development outcomes. One way to achieve this convergence is through the mechanism of subcommittees at the GP level. For example, the government of Karnataka (in collaboration with the World Bank) has formed Village Water and Sanitation Committees (VWSCs) as subcommittees of the GP. The Gram Pradhan is the chair and all GP members and selected community stakeholders are members of the committee. There are significant risks associated with this approach. For instance, Pradhans can choose not to cooperate (as in some villages in Karnataka). However, with the right kind of facilitation and capacity building, the VWSC could pressure the Pradhan to perform effectively (World Bank 2001a). Subcommittees could also operate as umbrella organizations for user groups at the village level. Other means of encouraging convergence could include transferring financial resources to user groups through GPs and introducing information-sharing and feedback mechanisms at Gram Sabhas.

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rural development were dropped straight to user groups, Panchayats remained starved for funds (only 5 departments have officially devolved funds to Panchayats). See Jayal (2004).

Box 4. 3: Strengthening accountability and encouraging political inclusion in urban settings

The means by which urban communities mobilize for collective action and its impact on urban governance structures such as ULBs is relatively understudied. A recent study by Jha and others attempts to fill this gap by examining the dynamics of local leadership, collective action, and formal governance structures in urban slums in New Delhi. The study reveals that urban slum dwellers participate in the formal political system through intermediaries in the form of informal local leaders. The form of this leadership depends on many factors, including the demographic profile of the slum. More homogenous slums transport traditional leadership structures from the villages into the slums while newer, heterogeneous slums depend on leaders who gain authority through political connections and education. In general, they found that although slum communities have access to politicians (as much as 30 percent of their sample had interacted with local politicians), they interact with political structures through their Pradhan, who for the most part represents their needs. Thus slums with a higher degree of community organization have greater voice and access than those with weaker spaces for collective action. This study has critical policy implications because it identifies forms of collective action that could be enhanced to ensure better local governance in urban settings.

Source: Jha and others 2005.

Handling the transition

The political economy of local governments is complex. The *ideas* behind the creation of local governments and assigning functions have been accepted—and established in the Constitution. The question is one of how far each State will choose to go in practice, some, like Kerala, have moved very far while others, like Bihar are just having PRI elections in 2006 (though with a 'blank slate' this may allow the government to move very fast). In part the difficulties have been technical: aligning the "three Fs" to create clear delegation between the state and PRIs, between the PRIs and line agencies, and across the tiers of the PRIs is a challenging exercise. But in addition to the technical difficulties there are two issues that need to be addressed to make PRI reform viable.

One objection to placing the entire responsibility on the PRIs is "what if they fail?" Many suggest that while having greater responsibility at the local level, if well designed, may lead to improvements in some places there are fears that if one relaxes the "control" from the State or Center that key functions (like primary schooling or immunizations) may fail altogether or that low capacity areas might get even worse. Certainly in a country as large and varied as India this is a very real risk. But a well designed assignment of functions, funds, and functionaries by creating clear delegation of responsibilities can also create the possibility of a "fail safe" mechanism whereby a higher tier of government can assume responsibilities (and receive the funding) in areas in which clearly designated criteria are met. An unconstrained authority of higher tiers (states over districts, districts over GPs) to intervene will lead to confusion and conflict (and politicization of decision making)—and there is not guarantee the state will do a better job. But having some clearly defined mechanism to avoid catastrophes will help ease the transition.

Perhaps the main obstacle to moving more authority and funding to the PRIs is internal to government—existing line agencies at the State level are often less than enthusiastic about losing control of funds and functions—and functionaries even less so. The transition on employees is very difficult, and almost certainly will have to take place with the creation of a new set of employment relationships and these becoming the norm with gradual expansion rather than changing the status of existing employees (which may itself be unconstitutional). On the budget side there will also have to be a transitional period which provides some guarantees to line agencies to avoid disruption while incremental funds flow through new systems (as is being done with many of the government's new initiatives such as NRHM and NREGA).

Chapter 5: Community and Private Sector as Providers: Infrastructure and More

In addition to administrative reforms aimed at improving performance of existing agencies (chapter 3) and a move towards greater reliance on local governments (chapter 4) a third potential path for better service provision is greater reliance on providers outside the traditional public sector. This can come in two forms, either greater reliance on communities and user groups (as is increasingly the case in rural water) or in "public-private partnerships" that are arrangements between the government and either not-for-profit or for-profit private providers. This chapter discusses these efforts, particularly in the context of infrastructure, but also drawing on examples from other sectors such as health and education.

Any discussion of how to improve services in infrastructure must unfortunately begin by a warning against a "one fits all" or "miracle cure" approach. While the different "infrastructure" sectors have some common features, they are as much different as alike technically and economically. The scope for effective competition (which depends on economies of scale and scope, extent of network linkages), desirability and feasibility of user charge recovery, and possibility of direct cooperation of users varies enormously. Even if increased competition and private sector entry has worked wonders in telecommunications--it does not mean the same approach will work for power or highways. Even if greater community engagement is the most promising way forward in improving rural water supply—it doesn't mean the same mechanisms would work in urban settings, or for highways. Rather than organize this chapter in either the usual "sector by sector" approach or by the types of reform, this chapter will discuss how the promising reforms are all exploring different ways of coming to grips with the complex and difficult issues of increasing accountability outlined in chapter 2: *unbundling of roles, clear delegation of goals, autonomy for service providers, informed external accountability,* and *enforceability (though both consumer choice and citizen voice).* The chapter finishes with a discussion of the most difficult element of all reforms: the political economy.

A focus on infrastructure services

Infrastructure is important for many reasons. Sustained rapid overall growth in India is at risk if the modernization of economic infrastructure cannot keep pace with the demands—improvements in airports, ports, power and transport (rail and highway) are a potential constraint to sustained, job creating growth. Infrastructure is about more than just sustaining rapid growth, it is also central to making growth more inclusive—while airports are crucial for linking India to the world, rural roads are central to linking India to the world and ensuring rural areas gain and irrigation and water control infrastructure are essential to progress in agriculture. Moreover, infrastructure is about more than just sustaining economic gains: access to reliable and clean drinking water is fundamental, adequate sanitation (in both urban and rural areas) is a must. But, as stressed in chapter

2, the issue is not just "access" or asset creation; it is satisfaction with services through the operation of assets and maintaining those assets. Infrastructure is an example of the difficulties facing service delivery in India today and examples from just three sectors: roads, power, and water supply illustrate both the challenges and ongoing efforts.

Roads. At the national level reforms to project monitoring and management have reduced cost over-runs from 60% in the early 1990s to around 20% at present (IMF, 2005). Notable progress has been made in recent years with the National Highway Authority of India's (NHAI) Golden Quadrilateral (GQ) project, which links Delhi, Mumbai, Chennai and Kolkata. The North South-East West (NS-EW) highway project is slated for completion by December 2008. If so, it will be a creditable achievement. The Comptroller and Auditor General of India estimated that even the NHAI had only completed 29% of its planned program by the target completion date of June 2004. Completed works suffered delays of up to 28 months and there were cost over-runs of 22% on average.

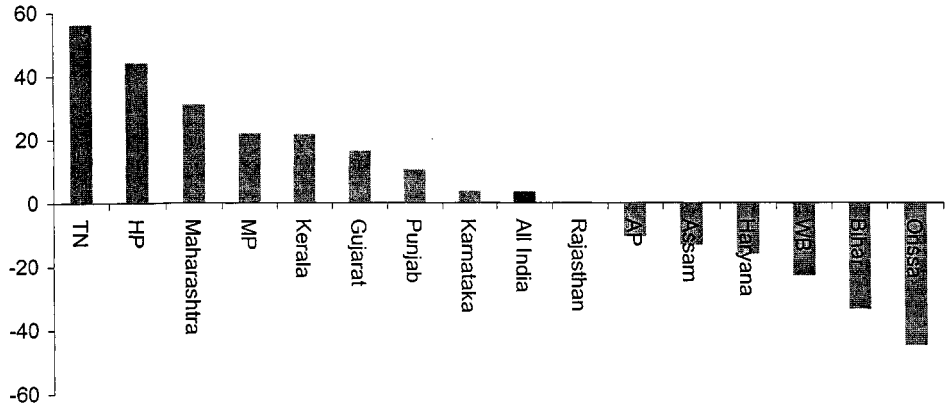
One suspects that these problems in the states are more severe and little evidence is available on the extent to which road improvements have been realized at the state level. India increased road investment from around US$ 1bn per year in the 1990s to around $4 billion per year at present. But this has not been matched by improvements in implementation performance. A lack of readiness of construction sites, the overall procurement process and contract management, capacities of implementing agencies and the capacity of the construction industry in India are all factors in the implementation difficulties that result in only a fraction of investments delivered on time and at cost—but with incentives to initiate new works.

Power. Despite some successes and the implementation of important reforms to date, the most critical problems in the sector remain difficult to resolve. Losses of electricity due to theft and technical factors remains stubbornly high, at around 32-35% of net generation on average, and much higher in some states. Inefficiencies in the collection of bills means that aggregate technical and commercial losses are around 40-60% depending on the state. Financial losses in the power sector have been reduced somewhat, from around 1.5% of GDP to 1.2% of GDP, but are still excessively large. Payment discipline imposed by central power utilities and independent power producers, the development of the regulatory framework and the actions of regulatory agencies at the central and state levels, and incentives provided by the center to states to improve performance of their power sectors, have all played a role in the modest improvements that have taken place to date. However, the financial performance of the sector is not improving quickly enough. There has been variable progress on implementation of the Electricity Act (2003) which is mandating steps by state governments and regulators to increase competition and accountability in the sector. Some states have made active strides in the separation of transmission and trading and the development of open access regulations. However, there has been little movement on the phase-out of existing cross-subsidies although the National Tariff Policy is expected to help in this regard.

Water Supply and Sanitation. Adequate water in quantity and quality is a core government responsibility—but, as documented in chapter 2, is far from being met in terms of sustainability and satisfaction. And access to piped water has actually declined in some states (figure 5.1). More spending alone through existing agencies has produced mixed results. As shown in chapter 2, the more effective states produce two to three times as many water connections per rupee expenditures as the less effective states. This suggests there are enormous improvements possible in the efficacy of public spending.

Figure 5. 1: Access to piped water has declined in some states between 1991 and 2001

Percentage of population with access to piped water, by state, 1991–2001



Source: Census 1991 and 2001.

Three modes of external reform: communities, contracting out, and PPPs

There are multiple modes of reform being pursued that aim to improve service delivery by moving functions outside of the channels of the existing line agency structure. As discussions of these reforms are often hotly charged--particularly around the word "privatization"—it is worth making three points. First, there are multiple types of non-state providers—communities, user groups, non-for-profit organizations, for-profit firms—and multiple modes of engagement with each (contracting out, regulated entry, market based regulation, demand side transfers). Engagement with non-state providers doesn't mean less government, but it requires different government, in the sense of a different role, with different skills and capacities to develop, manage, and monitor service agreements. But a commitment to effective provision and a commitment to a particular set of providers (e.g. the current employees of line agencies) are not synonymous. Second, the accountability approach to service delivery tries to avoid ideological positions that something must be good because it is called "private"—the question is whether a particular reform would improve services or not, not what it is called. Third, poor quality public services create a *de facto* privatization that is more thorough-going, unregulated and inefficient than any proposed plan to engage non-state providers: when

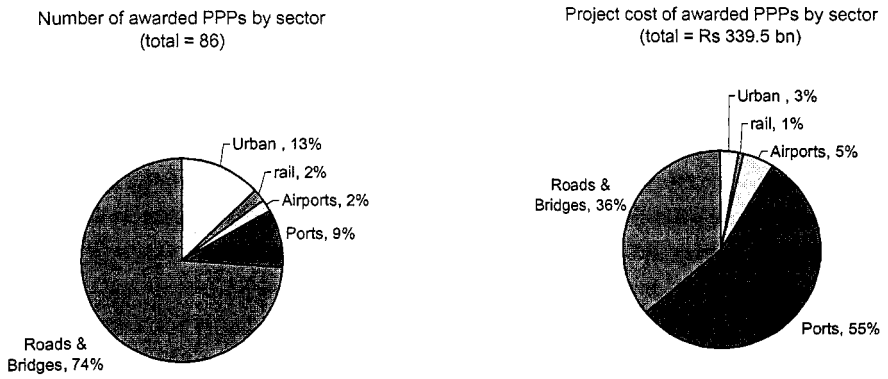
canal irrigation fails, tubewells result; when power is unreliable private firms and households buy backup systems; when railways are ineffective shippers use trucking. The question is not whether or not the private sector will be involved in services, but on what terms and how to make that engagement as productive as possible.

Engaging communities. One mode of improving services is to push for greater community involvement—particularly by the users of the services. Particularly in rural water supply (but also in other rural infrastructure) there has been a shift towards demand-driven schemes in which the communities take responsibility for functions. A recent study estimated that in Uttar Pradesh rural water supply schemes that are demand-driven schemes, such as *Swajaldhara*, see 90% of funds reaching beneficiaries in terms of new capital expenditures, whereas for supply-driven schemes the figure is as low as 40% (Misra, 2005a). The use of communities is not unique to infrastructure. Madhya Pradesh's innovative development of Rogi Kalyan Samiti's (RKS), local health facility committees to manage fund-raising, has been copied in several other states. The national Reproductive and Child Health program will now support the development of RKS's for primary level health facilities such as Community Health Centers (CHCs) and Primary Health Centers (PHCs) as well.

Contracting out. A second mode of engagement with non-state providers is through the contracting out of specific services, without transfer of ownership of assets. This is commonly used in infrastructure where the assets are large and competition is not feasible—but managing the assets is important. The recent moves towards management of airports are an example (more below). Again, contracting out is not limited to infrastructure and there are numerous examples from the health sector. A number of states (Karnataka, Gujarat, Tamil Nadu, among others) contract NGOs to run primary health care facilities (PHCs, CHCs). The RCH program made extensive use of contracting out to nongovernmental organizations (NGOs) of specific maternal and child health services. The Revised National Tuberculosis Control Program (RNTCP) contracts NGOs and private physicians and medical laboratories to provide specific services as part of tuberculosis control efforts. Services include case finding, diagnosis, and treatment. The National AIDS Control Organization (NACO) which finances state- and local-level HIV/AIDS control activities operates largely through service delivery contracts to NGOs for targeted interventions, behavior change communication, and other services.

Public-Private Partnerships. PPPs can play an important role in meeting infrastructure demand, particularly when investment needs for new assets are large, but require the public sector to strengthen capacities. Both the central government and the states are aiming to use public private partnerships (PPPs) more intensively to help meet gaps in the provision of infrastructure services. India has made progress recently in other sectors, such as ports and roads. A survey undertaken by the World Bank showed almost 90 PPP projects in the transport and urban sectors that were either operational or at an advanced stage of implementation, with total project costs of around Rs 339.5 billion (World Bank, 2005i).

Figure 5. 2: PPPs are making a growing contribution to financing of infrastructure in India

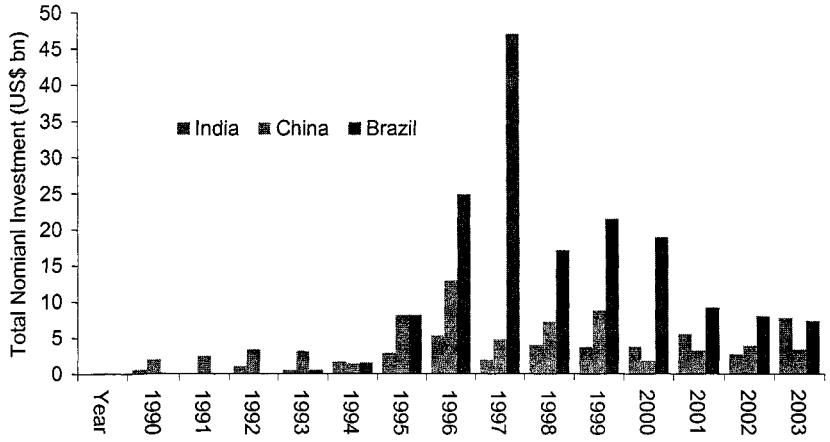


There is scope for PPPs to contribute more to meeting India's infrastructure gaps. Over the last decade, private investment in infrastructure has averaged around 1% of GDP in India. Other countries have achieved higher levels. Since 1996 private investment in Chile has averaged 3-4% of GDP; in Brazil it has averaged 1.5% and in Colombia around 2-3% over the same time period. In China, private investment has accounted for around 10% of total investment in the road program, compared to around 4% in India. Were private investment to increase to 3% of GDP it would represent $20bn per year.

PPPs in infrastructure require at the minimum willing investors. Presently, private investment in infrastructure in middle and low-income countries is much lower than the peaks seen in the late 90's. These were driven by privatizations in Latin America and investments in East Asia but the increased perceptions of risks involved in investing in infrastructure have reduced transactions volume and the number of investors participating in the market. India did not participate in the boom of private participation in infrastructure (PPI) in the '90s. However, with its recent moves to expand the role of PPPs, it managed to attract a higher level of investment commitments to private infrastructure projects than either Brazil or China in 2004 (see Figure 5.3).

Figure 5. 3: India has overtaken Brazil and China in attracting PPI

Investment Commitments in Private Infrastructure Projects: India, China and Brazil



Source: World Bank Private Participation in Infrastructure Database

Unbundling, delegation, autonomy

One key way that engaging non-state providers in infrastructure potentially improves performance is that it leads to greater clarity about unbundling of functions, more specificity in delegation, and greater day to day autonomy. For instance, in water and sanitation clarifying and separating policy, regulatory, financing, and service provision roles, which are presently usually combined in one agency, is an important step.

Sector regulatory agencies, now present in telecommunications and ports at the national level and in power at the state and national level, have been an important part of attempts to increase accountability and performance. An independent regulatory agency is a crucial step in unbundling government roles as it clearly separates the "policy maker" function of government from the "provider" function so that, even if both are public sector bodies this creates checks and balances by creating incentives for generating performance information.

That said, particularly in the power sector at the state level, these agencies operate under difficult circumstances. They have been successful in increasing transparency in the sector, in particular consumer participation and better information on the inefficiency of power utilities. However, evidence of poor performance and the pressure of regulators only transforms into service improvements if those responsible for service provision – the owners of the utility and the management – act upon them. Without this, even effective regulators will struggle to make much of a difference. This emphasizes the need for "enforceability" to accompany information—if consumers have no effective choice then even with better information on performance the providers can remain unresponsive.

Even within the existing constraints, regulatory agencies in India could be strengthened by a reduced reliance on retired government officers or judges as commissioners, better funding, and clearer mandates stemming from more consistent legislation. The courts have often not proved to be an efficient venue for the resolution of appeals against regulatory decisions. The use of a specialized tribunal in telecommunications can be extended to other infrastructure sectors.

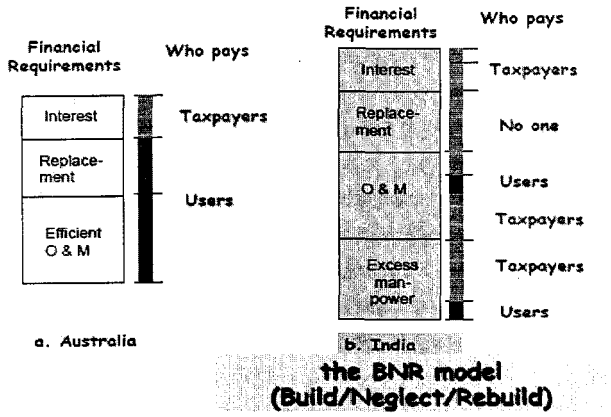
Examples from the health sector suggest that PPP may be particularly promising in some areas of lagging states, where government infrastructure is still poorly developed or in a significant state of disrepair and understaffing. Where governance is weak, PPP offers an alternative to higher risk investments in state public sector delivery approaches. A well designed PPP can create greater transparency than may be possible through the standard treasury expenditure method in which all transactions are internal. The extensively documented experience of the Janani Program in Bihar, which has managed to set up a very large network of primary and secondary level service delivery points using a social franchising model is a case in point. In some cases, private Janani-linked facilities can be found operating successfully in close proximity to virtually defunct government facilities, which still draw significant budget support.

Enforceability: Subsidies and user fees

The need to both expand the national highways network and ramp up maintenance expenditures highlights the challenges of infrastructure finance. Even if the GQ and the NS-EW projects are implemented on schedule by the end of 2008, India will have reasonably well surfaced, four-lane national highways accounting for just 22% of the national highways and none of the state highways. India has some 470,000 km of 'major district roads', and another 2.65 million km of 'village and other roads', which are typically unpaved. It is estimated that the present system of road user charges will only generate around Rs 1600 billion *total* over the next 10 years, leaving a funding gap of Rs 1050 billion *per year* given investment targets and maintenance needs. The same calculations of "funding gaps" can be produced for sector after sector.

Any expansion in infrastructure services in India raises the question, who will pay? The answer to that is clear: the citizens of India will pay. Whether services are produced by line agency, NGO, for profit private, community or local government in the end the citizens of India pay as users or citizens of India pay as taxpayers. There are five reasons why a larger proportion of the costs of infrastructure should be borne by citizens of India as *users* of infrastructure rather than by all citizens of India as *taxpayers*.

Figure 5. 4: Comparing the sources of finance: Either users or taxpayers pay—but sometimes for inefficiency and shortfalls create neglect of assets



Source: World Bank 2005e.

First, transforming users into paying consumers would help make service providers more responsive to their customers. The more aware individual users are of the true cost of services they receive, the more likely they are to take action to exercise their voice.

Second, it matches financing automatically to services and helps to improve the financial sustainability of the sector. For instance, in only a few mega-cities do tariffs cover even the operational and maintenance costs of water supply. This leaves the water supply agency dependent on general public sector funding, which can increase or decrease for reasons having nothing to do with the provider—and tends to leave maintenance costs squeezed out by wages and investment costs (the jobs and contracts nexus). Figure 5.4 illustrates the "build/neglect/rebuild" mode with an example from irrigation systems. When nearly all the funding comes from taxpayers there is a tendency both for excessive cost and for crucial functions like replacement and operations and maintenance to be under funded.

Third, user charges are, in many instances, fairer. Very often low prices are justified on the grounds that these prices are for essential services and that higher prices would hurt the poor. In water, as in electricity, industrial and commercial consumers cross-subsidize domestic consumers, with the rationale being that this is pro-poor. The evidence suggests that, by and large, the subsidies that prevail in the Indian water system do not benefit the poorest domestic consumers (see Box 5.1). In the power sector, subsidized tariffs for agriculture benefit richer farmers more than the poor: a flat rate per pump benefits those who have more land to be irrigated by each pump. One study estimated that payments for electricity represented 6% of gross farm income for larger farmers and 13% of income for marginal farmers (World Bank, 2001b). The available evidence suggests that subsidies are not at all well targeted. Distorted tariffs for water, as with most other infrastructure services, mean that industrial and commercial consumers cross-subsidize domestic consumers, but these subsidies are not well targeted towards the poor. Moving towards user charges does not mean ignoring the very real concerns of poorer citizens—

but tariffs can be increased to reflect sound commercial principles whilst protecting the poorest.

Box 5. 1: Do water subsidies in India reach the poor?

According to one estimate, subsidies in the water sector in India amounted to around 0.5% of GDP in the early part of this decade. Though justified on the grounds that they help ensure that the poor receive an essential service, the evidence suggests that the non-poor are likely to benefit from these policies more than the poor do.

A survey of water usage and pricing in Bangalore revealed that the richest 10% of the population receive 2-3 times the subsidy received by the poorest. Public stand-posts are heavily subsidized and reach a large proportion of the poor (77% in Bangalore) and are not much used by the rich. However, the Increasing Block Tariff (IBT) which sees charges increase in line with water usage benefits the rich who have private taps and does not benefit the poor who do not. It was estimated that around 70-80% of the subsidy associated with private taps through the IBT goes to the non-poor.

Source: World Bank 2005e

Moreover, low monetary usage charges does not mean that the poor do not pay--consumers however do pay despite the subsidies—they pay through coping expenditures, they pay through time. These costs can be borne disproportionately by the poor. Studies in Haryana and Andhra Pradesh estimated that the costs of repairing irrigation pump motors, burnt out by erratic voltages, amount to 10% of gross income for marginal farmers but only 2% for large farmers (World Bank, 2001b). In Delhi, a recent study estimated that households living in JJ colonies spent around Rs 160 per month in coping costs – much of it time spent collecting water – compared to Rs 220 per month on average for households living in authorized colonies (Misra, 2005).

Increasing the quantity of water and reliability of service can bring substantial benefits, particularly to the poor. A study of water municipalities in Argentina (Galiani et. al., 2005) showed that those which had brought in private participation saw the biggest declines (5-9%) in child mortality attributable to water borne diseases. The impacts were greatest in the poorest areas, which was where services were worst. The study attributed the declines to improved pressure and hours of service which resulted from higher investments in the privatized utilities. A broader review of experience (World Bank, 2005j) shows that private participation in water in Latin America lead to increases in coverage in line with historical trends but strong improvements in water quality and continuity of service. Where the poor were already consumers, price increases caused negative impacts and in some cases high connection fees dissuaded the poor from taking up water connections. The latter can be avoided, as was done in the renegotiation of the Buenos Aires metro water concession, by levying a fee on all consumers to promote the expansion of access that can substitute for high connection costs. All of this points to the need for careful design of water and sanitation reforms and pricing for these essential services.

Fourth, user charges give users the right incentives. Increasing the cess on fuel – as has been proposed - will help to close some of financing gap and by linking road costs to road usage helps in having private individuals and firms take into account the true social

cost of vehicle use. Moreover, user charges can be useful to address some of the existing distortions: for example, lower taxes on diesel mean that heavy trucks do not even cover short run attributable costs and buses are more heavily charged than multi-axle trucks which impose substantially higher wear on roads. The obvious distortion in use are power tariffs which encourage continuing and increased pressure on ground and surface water resources as farmers do not have to incorporate the full social cost of their actions.

Fifth, "user pays" as a general principle makes the rationale and design of public sector subsidies when they are adopted clearer and more transparent. Subsidy design also has to take account of the extent to which they either hinder or benefit the activities of an incumbent provider in competitive segments of their market.

For example, Indian Railways (IR) is required to function as a commercial operation, providing critical transport services to the economy. However, it is also mandated to perform social functions, in particular the provision of passenger services at highly subsidized fares. It has already lost freight traffic to road haulage and now faces increasing competition for its profitable premium passenger services from the growing budget airline market. Despite the fact that freight services earn IR most of its surplus, inadequate investment in rolling stock in recent years means that failures of infrastructure and stock on high density corridors have lead to congestion and deterioration in service quality for their most profitable services.

Although there has not been much progress in realigning and better targeting subsidies there has been some progress in the management and design of subsidy regimes. The Electricity Act (2003) has set targets for the phase-out of cross-subsidies. Some states – for example Andhra Pradesh – have been making cash transfers to power utilities for politically mandated subsidies. More generally there is a greater awareness on the need for better targeting of subsidies towards poorer consumers.

Finally, the Government of India has developed two funds - the Universal Service Obligation Fund (USOF) for telecommunications and the Viability Gap Fund – which will use competition to select service providers and to determine the cost of the subsidy to government.[23] There is considerable scope for making the auctions for USOF subsidies more competitive (Noll and Wallsten, 2005). Tying the provision of subsidies to the actual delivery of service will also help make service providers more accountable for the funds they receive.

External accountability and information

Where it can be introduced, competition can be a powerful method for introducing accountability and improving performance. This has been most marked in

[23] The USOF has been established as one method of supporting the roll-out of telecommunications in less profitable rural areas through the competitive award of subsidies. The Viability Gap Fund will provide subsidies to PPP projects in the infrastructure sectors that are felt to be economically justified but not commercially viable, and will also rely on the subsidy being set by a competitive bid for service provision.

telecommunications, where it has been a powerful force to reduce prices and expand access in India. There has been particularly rapid growth in cellular phone usage and the rates charged to Indian consumers are some of the lowest in the world. Competitive pressures generated by the entry of new service providers have also improved the efficiency of incumbents, seen not just in telecommunications but also in ports.

Better monitoring of ex-post outcomes and returns to investment projects are also needed. Benchmarking the costs of providing key services and investments, might be useful in pointing out differences in efficiencies between implementing agencies and approaches.

A higher contribution by PPPs in India will need careful selection, structuring and oversight of projects. This will require the government to be selective about which projects are best done through the PPP route, and which better done through traditional public procurement. It also requires the capacity to understand what is needed to make PPPs attractive to the private sector and when they are likely to perform well. It is still the case that too often PPPs are viewed primarily as a source of financing to undertake investments that the government cannot afford to do. This ignores the claims that PPPs place on public resources. Also, in many sectors (roads, water and power) revenues from user fees will have to be supplemented by taxpayers funds for projects to achieve commercial viability. In particular, India has the scope to build on its successes to date and see an expanded program of PPPs in the transport sector, in particular highways, ports and airports. PPPs will likely be more controversial in the utilities sector, such as power and water, as they have been elsewhere. The starting point has to be an assessment of how well the present system is performing, and the costs that this imposes on different users.

Creating a greater role for PPPs requires addressing the key constraints to their greater use at present. The Viability Gap Fund, which will provide subsidies to PPP projects in the infrastructure sectors that are felt to be economically justified but not commercially viable, is a good step forward. A key principle is the use of competitive bidding to minimize the subsidy to be provided by the government, an approach used by Chile and other Latin American countries for the promotion of rural infrastructure in telecommunications and power.

This will help but other measures will be needed to see an increased use of PPPs. Most countries engaged in a broad-based PPP program have felt the need to develop a cross-sectoral PPP unit although the role that this unit plays is sometimes restricted to information dissemination and the preparation of guidance material. The design response to two key issues – the role of a cross-sectoral unit vis-à-vis line ministries and the role of a national unit in sub-national PPPs – will be driven by the business practices within governments and the fiscal, and other, relations between the center and the states. Nationally, capacities for PPPs must be strengthened in line agencies but a cross-sectoral pool of expertise, most likely that running the VGF, can help disseminate and introduce good practices more quickly. At the state level, dedicated PPP units can both broaden the PPP program and strengthen capacities to prepare and oversee these projects. Finally,

funds to help defray the costs of preparing PPPs would lead to better designed projects, particularly at the state and municipal level.

Political economy of external reforms of service provision

Systems persist because they have powerful constituencies. This makes the political economy of any reform a difficult matter. Reforms that engage non-state providers often prove particularly difficult—as they both threaten existing providers and necessitate some "more for more" arrangement whereby users get better services—but are expected to pay more. Naturally both of these create resistance and the lessons learned need to be incorporated into future plans.

The global reduction in PPPs illustrated in figure 5.3 to some extent also reflects changes in assessments, not of the benefits, but of the viability of the political economy of PPPs. Latin America saw the greatest use of PPPs for infrastructure services but in recent years public perceptions of the results have become unfavorable, despite broadly positive evaluations of their impacts (see Box 5.2), as the highly visible failures are widely touted by opponents and the less high profile successes downplayed. In sectors where competition can readily be introduced, such as telecommunications, deregulation and privatization lead to large and immediate gains and have been widely popular. In sectors with little competition but for which consumers are not the general public, such as ports and airports, PPPs (often contracting out of management) have also been, by and large, successful as both costs and benefits of reform are concentrated. Problems and controversies have arisen more often in power and particularly water, where revenues from users have rarely covered costs and political economy problems are greater as users are diffuse and coverage issues are important. Although well-designed transactions in these sectors have produced good results, these issues have made them more difficult to sustain.

Box 5. 2: PPPs in Latin America: an assessment

Latin America has attracted around half of the total of $786 bn in infrastructure transactions with private participation. As a result there were major shifts to the private provision of infrastructure, with around 60% of electricity connections being managed by private companies. Public opinion in the region is hostile towards PPI in essential infrastructure services. But in contrast most analyses show broadly positive results although there have been variations in performance.

The poor have not been negatively impacted and have often gained from improvements in coverage. Efficiency has improved, profits have not in general been excessive, and prices have fallen as well as risen following the introduction of the private sector. Negative public sentiment may reflect a number of things: a more general rejection of "Washington consensus" reforms; poorly managed perceptions and expectations; concerns about transparency of PPI transactions, or perhaps the public placing a different weight on some of the outcomes than economists do. Renegotiations and concerns over weak regulatory agencies that cannot adequately protect consumers have fuelled the opposition.

Source: World Bank, 2005j.

There is similar experience in India. Despite some promising results, the Delhi power privatizations remain the subject of much debate (Box 5.3). The proposed water reforms in Delhi are meeting resistance as well (Box 5.4).

Box 5. 3: Power Privatization in Delhi

The distribution business of the Delhi Vidyut Board (DVB) was privatized in July 1, 2002 with the sale of 51% equity in each of the three distribution companies. BSES Limited, now Reliance Energy Limited, acquired a majority stake in two of the companies and Tata Power acquired the majority in the third, NDPL. The companies were given targets for loss reductions and subsidized bulk power costs for the period through to end 2005/2006. There has been considerable public debate on whether the reforms thus far have achieved their objectives.

On the one hand, the companies had, at the last regulatory review, met or exceeded their targets for loss reduction, in the case of NDPL by as much as 7 percentage points. Limited information on improvements in the quality of supply suggests that reliability has improved somewhat. Prices have however increased considerably. Though less than had been forecast by the Government at the time of privatization, tariff increases in 2003 and 2005 have lead to protests by consumers.

In response the Delhi government has provided subsidies, in the order of Rs 140 crores to the companies to reduce the required price increases for targeted consumer groups. Consumer complaints have perhaps been strongest over delays in meter replacement, inaccurate billing and what they regard as a slow response by their companies to these complaints. As with utility privatizations in other countries, it is clear that consumers expect rapid service performance improvements once the company is turned over to private hands.

Box 5. 4: Delhi Jal Board Reforms

The quality of water supplies in most of India's major cities remains poor by international standards. The Delhi Jal Board, was recently at the center of controversy over plans to contract out services on a pilot basis in some areas to the private sector, provides what can only be described as poor quality service. Despite a high availability of water, at 250 liters per capita per day, the Board can only distribute water for around 3-4 hours per day. This level of performance puts it behind many water utilities that serve major cities in Africa. More affluent consumers can still provide themselves a 24x7 service through overhead tanks and boreholes, the latter adding to the rapid depletion of the water table. In contrast, the poor do not have this option, and spend considerable amounts of time to meet their water needs. As mentioned above, the coping costs for households in slums in terms of time wasted are nearly as large as the money costs in more affluent neighborhoods.

But however dire the current performance or large the potential benefits, reforms need both to have a transparent process and a strategy for addressing the concerns of the public. Transparency and consultation in identifying and implementing reforms are essential, both in ensuring that all stakeholders have confidence in the process and can make their voices heard, but also to ensure that the right service options are developed and price structures that reflect what consumers are looking for. Also, delay in responding to concerns about not just the substance but also the processes around the reform lead to greater controversy and can damage the reputation of reforms.

There are four lessons from the experience to date:

- Transparent and consultative methods for involving stakeholders in the decision-making leading to the solution is critical. There is no guarantee that good process will avoid later criticism, but can improve design by anticipating problems and gives a more solid platform for responding to critiques that emerge.
- Particularly when higher user charges on existing users finance expansion of coverage, it must be acknowledged that those with coverage (who tend to be powerful) will be worse off if services are not improved. So, either the newly served have to be mobilized as a reform constituency or the service improvements have to be immediate and tangible.
- A communications strategy is an integral element of a reform package—which includes both explanations to users on the process of decision making, the choices made, their benefits, and for responding rapidly to criticism that comes (and it will come). This is difficult because the civil servants and technocrats in charge of reform may not be empowered to respond to public criticisms.

The role of the center in promoting—or delaying--reform

The need for reforms in the infrastructure sectors have been examined and highlighted in a number of cross-cutting and sectoral reviews and commissions, of which the India Infrastructure Report (1996) was one of the earliest and the most comprehensive. The political difficulties encountered in implementing reforms in the individual states has been recognized by the Government of India which has in recent years established programs to encourage and incentivize state governments to reform, namely the *Accelerated Power Development and Reform Program (APDRP)* and the *Urban Reform Incentive Fund (URIF)*. Both have broken ground by targeting support to the

implementation of sector reforms. Key areas for the URIF were the regulation and taxation of real estate markets, with aims at incentivizing reforms in the Urban Land Ceiling Act, stamp duties, rent control and property tax rates and collection. The APDRP was structured somewhat differently, with one component incentivizing critical physical investments to improve the performance of the distribution sector, and a second smaller component to provide incentives to state governments that were improving the financial performance of their power sectors.

Both have, however, had limited impacts. As reported by the Planning Commission in their 10th Plan mid-term appraisal, the investments in distribution projects under APDRP are around one third of the level of funding allocated. The incentive component paid out under APDRP has been around one quarter of budgeted levels, partly reflecting the difficulties in improving the financial performance of the sector. However, this incentive component can be paid out for merely increasing the average revenue realization – for example shifting sales from low-tariff users to higher-tariff users – rather than more narrowly by reducing aggregate technical and commercial losses.

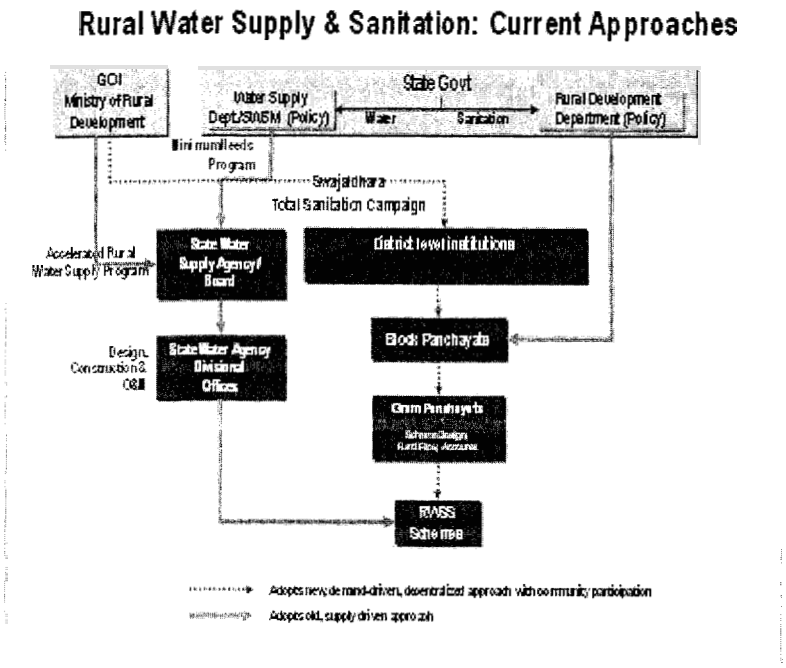
The URIF offered only a relatively small amount – Rs 500 crores in total – for a substantial package of reforms, particularly when compared to funds available that were not conditional on reforms.[24] The reforms involved require a cross-sectoral effort at the state level, and state Ministries of Urban Development and Local Development by and large lack the convening power to bring together the main players, including Finance. Finally, the milestones for progress under the URIF were not clearly specified and half of the funds were released on the basis of the signature of Memoranda of Understanding between the state government and the center. The Jawaharlal Nehru National Urban Renewal Mission (JNNURM) is being developed as a successor to the URIF, bringing together a number of reform based initiatives into an integrated program linked directly to the financing of infrastructure projects at the city level as opposed to budgetary support at the state level. Some of the lessons learnt from implementation of the URIF are being incorporated, including providing the program greater visibility and coordination under an authority to be chaired by the Prime Minister. However, the JNNURM may result in prolonging the time frame within which states must implement key reforms, as they now have until 2010 to implement core reforms rather than 2007 under the URIF.

Both initiatives have been important in helping place reforms further on the map and in providing models by which central government funding to incentivize reforms can be developed. There are several important lessons from these two efforts. Firstly, the incentive effect will not be large if a much greater quantum of funds can be made available unconditionally. Secondly, the measures being supported have to be clearly specified and readily measurable, as well as being important steps in the overall reform process and ones that can realistically be implemented. Given the paucity of data on the cost of service provision, cost recovery in urban services would prove a difficult target to monitor.

[24] The total URIF funds to be released over five years amount to about one sixth of HUDCO releases and one-twentieth of HUDCO sanctions.

A paradigm shift in policy directions is required to improve the coverage and sustainability of the rural water supply sector, including a demand-responsive approach, community participation, and decentralization of powers for implementing and operating drinking water schemes. To address these issues, the GoI has launched a national program "Swajaldhara", with guidelines on policies, institutions, technology options and user contributions. The main challenge is the implementation and scaling-up of this ambitious program to deliver 'reliable, sustainable and affordable' services. At present, the traditional supply driven programs, including the Accelerated Rural Water Supply Program (ARWSP) continue to fund most of the rural water supply activities. Since the States can get financing under the traditional supply driven program, it does not have any incentive to scale up the sector reforms. Further, the Twelfth Finance Commission (TFC) recommends grants that can be utilized by PRIs for repairs / rejuvenation and O&M cost of rural water schemes, thus reducing any incentive for financing O&M through user charges. The recently announced Bharat Nirman funds follow the ARWSP guidelines and continue to reinforce supply driven programs. Ideally, these funds should be used as incentive funds to scale up reforms. Unless the trend is reversed and the Swajaldhara funds overtake the traditional funding, there is hardly any motivation for the States to adopt reforms (see Figure 5.5)—or communities to support them.

Figure 5. 5: Most funding programs still adopt traditional supply driven approaches.



Source: World Bank 2006

Introduction to Part II

India's success in fostering economic growth has created new challenges, as outlined in the overview. This part of the report focuses on how India can sustain that success and expand the opportunities for all to participate in it and benefit from it.

Although India has been growing very rapidly, international experience shows that complacency about pushing ahead with reforms when growth is high is a sure recipe for slower growth. As argued in Chapter 6, infrastructure has now become a major constraint on economic performance. It would nevertheless be unwise to ramp up government infrastructure spending in the hope that this will lead to a growth spurt and lower the debt-to-GDP ratio without a simultaneous comprehensive fiscal reform. Chief among the fiscal policy priorities are steps to improve the composition and efficiency of existing expenditure and revenue mobilization. Revenue deficits need to be lowered and capital expenditure raised. The recommendations of the Twelfth Finance Commission (TFC) aim precisely to do this.

Notwithstanding India's impressive growth performance, fiscal adjustment continues to be a live issue as India has shown little sign of growing out of its debt problems. This could be compounded by interest rate risks looking forward, growing quasi-fiscal deficits, and the persistent problems from food, fertilizer, and implicit power subsidies. The composition of government expenditure remains in dire need of improvement. Given the large needs in infrastructure and the many other things the government would like to do that require additional resources, the current fiscal position leaves no "space" to fund them. To undertake new initiatives existing spending has to be restructured and taxes have to increase so that governments, both at the central and state level, can continue to meet their fiscal adjustment targets. Chapter 6 thus argues that, unless addressed, infrastructure and the fiscal deficit are the most likely obstacles to overall sustained rapid growth.

India's successes so far have not been shared equally, as some states and people have done much better than others, particularly since the reforms of the 1990s. Given the concerns about the distribution of the benefits from economic growth, a special focus needs to be on those areas for action that would accelerate growth by expanding opportunities, which could lead to a more equitable distribution of the benefits of growth. The search for "equalizing growth accelerators" in chapter 7 focuses on reforming labor regulations and the financial sector. Current labor regulations seem to be protecting workers in jobs by "protecting" other workers from having jobs. Properly done, labor regulation reform could be an important equalizing accelerator. Financial reforms have made much headway, but have so far primarily focused on serving larger companies, as in the case of equity markets reform. Improving access to finance for small and medium-size enterprises is a second important growth accelerator.

The need to accelerate growth in India's agricultural sector prompts special consideration in chapter 8 because of the impact of the current slowdown on agricultural production, employment, and wages. The traditional, relatively heavy handed approach has been to

promote intensification, primarily in food crops, through public investments coupled with input subsidies. Although this approach has been successful in many ways, it is largely played out and is often promoting agricultural practices that are neither economically nor environmentally desirable. A new strategy should rely much more on policies to liberalize agricultural inputs and outputs by reforming land administration and tenancy requirements and by supporting research and development that is tailored to specific needs. A workable strategy to accelerate productivity in agriculture has to promote four directions for agriculture in the overall rural economy:

- *Intensification.* Increase the productivity of traditional crops through greater use of irrigation, high yield varieties, agrochemical inputs, and mechanization.
- *Diversification*. Shift to new more profitable crops (fruits, vegetables, higher value cereals, medicinal plants) and livestock.
- *Nonfarm linkages.* Emphasize related activities that add value to agricultural products, such as trading, agroprocessing, and supplying inputs.
- *Exit.* Switch from agriculture to other, more productive activities.

The government of India's justifiable concern with the inclusiveness of economic growth can be addressed by focusing on *expanding* the regional scope of economic growth, *expanding* access to assets and thriving markets, and *expanding* equity in the opportunities for the next generation of Indian citizens no matter who they are or where they live. These issues are covered in the final two chapters of the report.

Chapter 9 discusses the issue of lagging states. Actions are recommended in four policy areas. First, it is important continue to pursue policy reforms that help to integrate India's goods and labor markets by eliminating barriers and distortions to goods moving across states. Second, with integrated labor markets, the large differences in wages across states create incentives either for people to move to jobs (either permanently or temporarily) or for jobs to move to people. But for jobs to move to people in the lagging states, those states must address the deficiencies in their investment climate, such as the need for law and order, transport connectivity, and streamlined regulations, so that they can attract industry. Third, the lagging states need to focus on the implementation of reforms in rural areas, where the greatest benefits are likely to come from the expansion of finance and infrastructure. Finally, fiscal federalism and Finance Commission allocations can assist in making the lagging states more effective development agents.

Chapter 10 focuses on the role of public action in equalizing opportunities by promoting equality in access to markets and assets and by scaling up efforts to strengthen livelihood strategies through empowerment. Even with the best of access to markets and opportunities, there are needs for the government to engage in social protection to assist the poorest and help in coping with the risks and vulnerabilities that citizens face. Social protection measures are important to combat extreme deprivation, but can have equally important dynamic efficiency effects by allowing people to bear risks and undertake profitable investments.

Chapter 6. Easing constraints to sustain rapid growth

India's experience has been very influential in the continual reshaping of views about growth. This is not surprising as, besides being large in population and economic size (on the basis of purchasing power parity, India is now the fourth largest economy in the world), India is also one of the very few countries that have accelerated growth in the 1980s and 1990s to rapid levels, avoided a severe macroeconomic crisis, and maintained steady economic growth averaging about 6 percent a year over the past quarter century. A recent World Bank report compares the experience of India, China, and Vietnam (the globalizing formerly socialist economies) with that of Latin America, Africa, the Middle East, and the former Soviet Union. Key conclusions from that report and the implications for India are discussed in box 6.1.

Box 6. 1: Lessons from the 1990s

The recent World Bank report *Economic Growth in the Nineties* compares international growth experiences and highlights the following four lessons.

- *Initiating success does not require getting everything right, but it does require getting the right things right.* A growth strategy is not simply a list of all of the things wrong in the economy with a reform package for each. Rather, the essence of a strategy is to identify accurately the binding constraints—those that would have the biggest growth payoff if they could be eliminated—accurately and address them effectively. I
- *Sustaining a boom requires continuous action.* Growth accelerations are relatively common—countries have a one-in-four chance of experiencing an "episode of rapid growth"[25] in any given decade—but growth in most developing countries tends to be highly unstable, involving booms, busts, and periods of stagnation alongside periods of rapid growth. Very few countries have experienced consistently high growth rates over several decades. The good news is that growth often comes, the bad news is that growth nearly always goes—almost half of the periods of rapid growth were followed by slow or negative growth. Complacency with high growth is a recipe for slow growth. Sustaining growth requires attacking the binding constraints in turn, before the bind bites.[26]
- *Common principles, heterogeneous implementation.* The experience of the 1990s has not demonstrated that the fundamental principles of economic growth are wrong—macroeconomic stability, an investment climate conducive to high rates of private investment, and fulfilling core public responsibilities are keys to growth—but it is the case that there are many ways to achieve those principles, and a rigid orthodoxy about *how* those fundamentals are achieved cannot be supported.
- *Credible steps with institutional continuity: sustained implementation is key.* A final lesson, again consistent with the Indian experience, is that even modest steps, if they are credible and are
- implemented well, can create a positive dynamic of expectations that sustains growth—while "big bang" changes, even in the right direction, may have no impact if they are not expected to persist and implementation is lacking.
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Source: World Bank 2005k

[25] A growth acceleration is defined as an increase in per capita growth of two percentage points or more. To qualify as an acceleration, the increase in growth has to be sustained for at least eight years and the post-acceleration growth rate has to be at least 3.5 percent per year (Hausmann, Pritchett, and Rodrik 2005).
[26] Moreover, international experience suggests that it is very difficult to accelerate from fast to faster growth, and that only a few countries that have done it (Hausmann, Pritchett, and Rodrik 2005). See also Acharya (2002).

India's aggregate growth performance in recent years has been particularly robust as the industrial slowdown observed during the Ninth Plan period (1997/98–2002/03) has been reversed as industry has recovered, while the services sector has continued its rapid expansion. As discussed in Pinto, Zahir and Pang (2006), this robust recent growth performance is closely linked to the still on-going microeconomic restructuring of firms in response to the 1991 economic liberalization. Evidence shows that serious industrial restructuring began only in 1996, towards the end of the Eight Plan Period, when companies felt the heat from rising import competition and falling profit margins.[27] After 1996, companies started reinventing themselves. By 2002, companies had substantially restructured financially and had raised production efficiency and quality while lowering costs. Starting in 2003, companies resumed investing in new capacity with a noticeable pick-up in momentum in 2005.

Notwithstanding India's stellar growth performance, with GDP growth averaging 6.5 percent in the first three years of the Tenth Plan, meeting the Tenth Plan target of 8 percent no longer seems within reach.[28] In fact, the Tenth Plan Mid-Term Appraisal has lowered the expected growth rate to 7 percent and has revised the target for the Eleventh Plan from 9.3 percent to 8 percent.

This chapter aims to identify the most binding constraints on economic activity, where policy changes could yield the biggest growth gains for the least reform effort. We explore two issues as the most likely candidates for important constraints to aggregate growth in India in the medium term: the infrastructure and the fiscal deficit.[29] With the process of industrial restructuring reaching a point where firms are gearing up to make large new investments, infrastructure is emerging as an increasingly critical gap. As discussed below, inadequate infrastructure will particularly hurt high employment-generating, labor-intensive small enterprises; precisely the sector which has the greatest potential to absorb India's fast-growing working-age population. Alleviating the infrastructure constraint is unavoidably going to involve a government role and increased public spending on infrastructure, although the costs of filling the infrastructure gap and the relative roles of the government and private sector need to be defined.

Other constraints, most notably labor laws and the financial sector, are important equalizing accelerators and are key factors to achieving inclusive growth. They are covered in chapter 7. Chapter 8 focuses on the challenges posed by the agricultural sector. Because the vast majority of India's poor resides in rural areas and draws their livelihoods from agriculture, rural development is key to inclusive growth in India. Chapter 9 addresses the particular problems of accelerating growth in the lagging states. There are many other areas of policy that require attention—such as poor governance, unclear and insecure property rights, and unsustainable use of natural resources. While reforms in these areas are desirable, indeed critical, for a long-term development strategy,

[27] See also Forbes (2002) and Mohan (2004).
[28] Achievement of the plan targets is therefore only possible if GDP growth in the last two years averages nearly 11 percent per year.
[29] Pinto, Zahir and Pang (2006) highlight the interdependence between the soundness of public finances and the microfoundations of growth.

we focus primarily on the main obstacles to sustained growth in the medium term. Some of these areas are covered in box 6.2.

Box 6. 2: Other issues for growth

In 1991, faced with a balance of payments crisis, India embarked on a historic set of reforms to make the economy more productive by unleashing competition and innovation. The view of this report is that the two largest policy issues to be addressed to sustain or accelerate growth in the medium term are infrastructure and the fiscal deficit. That said, there are many other issues that could very productively be addressed—it should not be inferred that other reforms are unimportant.

The burden of business regulation. Regulatory procedures governing entry, exit, and day-to-day operations of businesses are particularly cumbersome in India. Objective indicators on the cost of doing business are considerably higher in India than in a number of comparable countries, including China. It takes three months to open a business in Mumbai: two of the months are spent in obtaining the Personal Account Number and the Tax Deduction Account Number, and the business is not allowed to start while waiting to formalize the tax number. There is also room to speed contract enforcement: currently businesses must go through 40 steps, costing well over a year (425 days) and an average 43 percent of the contract value to enforce a contract through Indian courts. Although secured debt enforcement was recently improved with the Securitization Act, other contract enforcement remains inefficient. The greatest delay comes from enforcing the judgment: an average of 306 days, and this assumes that the debtor does not oppose the seizure.

Trade restrictions, tariffs, and regulatory barriers. At the time of the trade reforms in 1991 it was feared that lowering barriers would not be possible and that India could not export sufficiently to prevent a current account imbalance. Subsequently, there was a boom in exports, but although India is much more open, it remains a relatively protected economy, with tariffs averaging 22 percent (18 percent in trade-weighted terms)—above the average tariffs of 9.5 percent in emerging Asia and 11.5 percent globally (see *Trade Policies in South Asia*, World Bank 2004 (Rep. No. 29949)). Moreover, exemptions and partial exemptions are sometimes granted, often in an opaque fashion. Significant nontrade barriers also remain. Further progress in dismantling tariff and nontariff barriers will be key to sustaining growth rates. For instance, there is significant scope to streamline procedures for importing and exporting goods across borders. In India, it takes significantly more time to import and export goods than in, say, China, Malaysia, or Russia. The number of documents that Indian importers and exporters have to complete is also much higher than in competitor countries, as is the number of signatures needed.

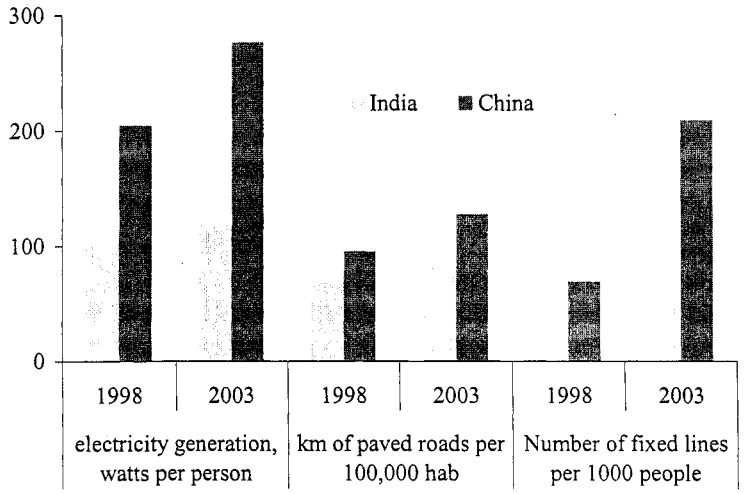
Urban land markets. Yet another set of constraints relates to the use and transfer of land, which critically affect the performance of firms, particularly larger firms. Obsolete tenancy and rent control laws keep a large part of urban real estate off the market. The freezing of rents at unrealistically low levels in Mumbai, for instance, has raised rents for new properties to phenomenal levels, while keeping rents for old but desirable properties very low. Practices such as this hamper the growth of domestic retail trade and construction by making it very difficult for new players to start up businesses. A report on "India's Growth Imperative" by the McKinsey Global Institute (2001) argues that land market distortions account for about 1.3 percent of lost growth per year. The central government has abolished the Urban Land Ceiling Act, which made changes in land use very difficult; however, only a few states have repealed their corresponding Urban Land Ceiling Acts, and this needs to be extended to all states.

Infrastructure as a binding constraint

The massive demands now on power networks, transport, urban infrastructure, and ports are the result of India's success in promoting economic growth. The danger is that poor infrastructure now will be put a brake on that growth. Moreover, because infrastructure

bottlenecks may be affecting the poor disproportionately, overcoming these bottlenecks can help to equalize as well as accelerate growth.

Figure 6. 1: Infrastructure stocks in India and China, 1998 and 2003



Source: World Development Indicators.

The comparison of the India and China is instructive. In 1980 India had higher infrastructure stocks—power, roads, and telecommunications—but China has invested massively in infrastructure, has overtaken India, and is widening the gap (figure 6.1). From 1990 to 2000, China's installed power capacity increased by 136 percent, compared with an increase of 51 percent in India.[30] China has been investing annually around 8–10 times India's level in highways since the mid 1990s.[31] The gap in infrastructure stocks is now so large that for India to catch up only to China's present levels of stocks per capita, it would have to invest 12.5 percent of GDP per year through 2015.

The greatest pressures on Indian infrastructure are probably in electricity, roads, and urban infrastructure. India's power sector problems are legendary. According to a survey of private investors, power outrages occur almost every other day for the average business in India, as compared to once every two weeks in China and once a week in Brazil. The average manufacturer in India loses 8.4 percent in sales annually on account of power outages, as opposed to less than 2 percent in China and Brazil. The frequency and average duration of outages are such that generators are standard industrial equipment in India, accounting for as much as 30 percent of a business's power consumption in many cases. Almost 61 percent of Indian manufacturing firms own generator sets; the comparable figures are 20 percent in Malaysia, 27 percent in China, and 17 percent in Brazil. Moreover, India's combined real cost of power is 74 percent higher than Malaysia's and 39 percent higher than China's. Although power sector

[30] Generation capacity grew at around 10–12 percent per year before the 1990s. It is estimated that during the 1990s captive generation capacity grew at around 9 percent, compensating for the slow rate of growth of public generation capacity.
[31] World Bank, 2004b.

reforms have proved demanding, both technically and politically, solutions must be found that meet growing demands while reducing the fiscal burden. The discussion of power sector is brief in this report as the issues have been well covered elsewhere.

Infrastructure constraints in India are most binding on manufacturing, particularly export-oriented manufacturing. India is well placed to be a much more significant presence in the world market for exports. The share of exports and imports in India's GDP today is less than half that of China's, and at 2.5 percent, India's world market share in the trade of goods and services is a small fraction of China's (10.5 percent). Nonetheless, India exports an impressive mix of goods quality —India's current export composition is similar that that of countries with income almost five times as high (Hausmann and others 2005).

So, while India is well placed in terms of industrial experience, technical capacity, and available labor, infrastructure hinders India's success in global trade. Increasingly manufacturing exports are part of a supply chain in which firms source their production in many different countries, often with many countries producing inputs or components of a final product. This type of manufacturing is particularly demanding of infrastructure, particularly reliable and efficient transport and production. Because the value of inputs brought in is large relative to the value of the exports, the margin of competitiveness is low, and high transport costs eat significantly into those margins—thus to be competitive firms have to pay lower wages. India is just beginning to attract this type of export-oriented manufacturing, and it is a potentially important component of future growth, one that can help to equalize growth because it employs more semiskilled labor than do the export-oriented services.

Of course, this report is hardly breaking new ground in pointing out the weaknesses in infrastructure: the problems are widely recognized, not least by the government. It is clear that India has not invested sufficiently in expanding infrastructure assets. The 1996 India Infrastructure Report called for an increase in investment to around 8 percent of GDP by 2005/6. Recent estimates produced by the Bank suggest that India might need to invest 8 percent or more of GDP over the period 2006–10 to sustain annual GDP growth at near 8 percent and replace old capital stocks. Over the past decade, however, estimates suggest India has invested only 3–4 percent of GDP in infrastructure. There are also significant regional and income-related differences in access to much-needed infrastructure, which the government is seeking to address and which also require investment. Much of the funding will have to come from public resources. This raises the issue of "fiscal space" addressed later in this chapter.

Implementation and absorption capacities will have to improve to take advantage of any increase in the resources devoted to infrastructure. The Planning Commission, in its recent midterm review of the Tenth Plan, estimated that only 75 percent of planned power capacity will be realized by the end of the Tenth Plan period. At the national level reforms to project monitoring and management have reduced cost overruns from 60

percent in the early 1990s to around 20 percent at present (IMF 2004).[32] Better monitoring of outcomes and returns to investment projects are also needed (see part I).

Policy discussions recognize that a "business as usual" approach will not ease the emerging binding constraints to growth posed by infrastructure: even "spending an additional X percent of GDP within the usual institutional structures" will not suffice. Rather, institutional and organizational reforms are needed to make spending more effective and to mobilize more nontax revenues for infrastructure costs. Many of these issues were discussed for infrastructure generally in chapter 5, while this chapter focuses on how these apply to the infrastructures key to overall economic performance: transport (ports, rail, national highways, and airports) and power. Many different reform initiatives are now underway in the infrastructure sectors, with varying degrees of success. Below we discuss some of the ongoing efforts and promising approaches in a number of sectors.

Asset maintenance/asset creation. This issue is particularly acute in road and rail transport. For many reasons it is more attractive to launch a new project than to finish an existing one, or even less, maintain a completed project. Actual expenditures for maintenance on national highways are less than a quarter the required level (World Bank 2004b). A Special Railway Safety Fund was set up to fund a backlog of arrears in maintenance. Poor financial performance of the power utilities has reduced spending on maintenance.

Competition. Competition in the market is a powerful force, and technological and regulatory changes in telecommunications, for example, revolutionized the sector. But in other areas of economic infrastructure, such as highways, ports and airports competition *in* the market is less viable and competition has to be *for* the market. This can take the form of contracting out the operation of assets with no change in ownership (e.g. for airport modernization) or public-private partnerships that involve the expansion of assets (e.g. power, highways). Competition for the market is much more technically demanding than merely allowing competition in the market (even regulated competition) as it requires the assessment of bids that are complex and, not matter how stringent the process, will always involve some degree of contestation. Nevertheless, there are successful experiences around the globe—and in India--in the use of PPPs for infrastructure expansion.

Financing economic infrastructure. The enormous costs of infrastructure expansion raise two related, but distinct, issues: who will *pay* for infrastructure (to cover the various costs, including operation, maintenance, replacement and financing charges) and who will *finance* infrastructure. As stressed in chapter 5, citizens of India will pay for the costs of infrastructure either as users or as taxpayers—and this is true no matter who

[32] Little evidence is available on the extent to which improvements have been realized at the state level. India has increased road investment from around $1billion per year in the 1990s to around $4 billion per year. But this has not been matched by improvements in implementation performance, with only a fraction of investments having been delivered on time. The comptroller and auditor general of India estimated that NHAI had completed only 29 percent of its planned program by the target completion date of June 2004. Completed works suffered delays of up to 28 months, and there were cost overruns of 22 percent on average.

finances the infrastructure. If the government borrows money to finance a highway then Indian citizens have to pay the interest—either as taxpayers or users. If a private contractor builds a highway and finances the construction themselves (perhaps on a Build-Operate-Transfer) basis then Indian citizens have to pay the interest—either as taxpayers or as users. The advantage of private sector engagement in infrastructure finance in a country like India is not that it puts additional resources on the table in net present value (as was made clear by the proposal to finance against accumulating Central Bank reserves)—it is that PPPs often offer a transparent commitment to finance the additional infrastructure by users, not taxpayers. As the needs for economic infrastructure are large and the fiscal space small this is an important advantage. Again, as emphasized in chapter 5, PPPs do tend to work better in purely economic infrastructure with fewer numbers of users, who therefore recognize and are willing to pay for service improvements.

The fiscal deficit as a binding constraint

India's fiscal deficit is a concern for two reasons.[33] First, there is always some risk of a macroeconomic crisis, which can easily undo extended growth episodes (as in Indonesia). Second, there is a "fiscal space" problem, given the large needs in infrastructure and the many other things the government would like to do that require additional resources, the deficit leaves no "space" to fund them. To undertake new initiatives, —either existing spending has to fall or taxes have to increase, as the deficit cannot go higher. Below we briefly review recent fiscal developments, and we elaborate on the two issues identified above.

Continuing fiscal adjustment

Table 6.1 presents fiscal trends for India's general government revenues and expenditures from 1985/86 to 2005/06. It shows that revenues fell by some 2.5 percentage points during the Ninth Plan period (1997–2002), compared with the second half of the 1980s, largely as a result of structural reforms. Capital spending fell even more sharply: from 6.6 percent of GDP in the second half of the 1980s to 3.1 percent in the Ninth Plan period. The fiscal improvement following the 1991 crisis involved a large compression of capital spending. Although it had been hoped that this compression would be offset by rising private investment in infrastructure, this has not really happened, with the notable exception of telecommunication.[34]

Table 6. 1: Fiscal trends in India, 1985/86–2005/06
(percent of GDP)

[33] Although some have suggested that the large deficit has crowded out private investment, this argument is currently not persuasive because interest rates have not gone up and the commercial banks are holding significantly more government paper than they are required to. Nevertheless, in the absence of fiscal adjustment now, crowding out could become a binding constraint to growth in the future.
[34] This section is based on Pinto and Zahir (2004).

	85/86-89/90	*8th Plan*	*9th Plan*	*10th Plan*			
	Avg.	*Avg.*	*Avg.*	*2002-03*	*2003-04*	*2004-05* [1/]	*2005-06* [2/]
Revenues	19.4	17.9	16.9	17.8	18.1	19.1	19.6
Current Expenditure [3/]	22.0	21.5	24.0	24.6	24.1	23.5	22.9
Social Services	5.4	5.0	5.5	5.3	5.1	5.4	5.3
Economic Services	6.5	5.8	5.7	6.3	6.4	5.8	5.6
General Services	9.5	10.3	12.4	12.6	12.1	12.0	11.7
Capital Expenditure [4/]	6.6	3.7	3.1	2.9	3.1	3.7	3.7
Gross Fiscal Deficit	9.2	7.2	10.1	9.8	9.1	8.1	7.0
Memo							
Primary deficit	5.4	2.1	3.8	3.2	2.7	1.9	0.8
Revenue Deficit	2.6	3.6	7.0	6.8	6.0	4.4	3.3
Interest	3.8	5.1	6.3	6.5	6.4	6.2	6.1
Education/GDP	2.9	2.8	3.0	3.0	2.8	2.9	2.8
Health and Family Welfare/GDP	1.0	0.8	0.9	0.8	0.8	0.8	0.9
(Irrigation+Power+Transport)/GDP	4.0	3.1	3.1	3.6	4.2	3.8	3.9
(Interest+ Admin.+ Pensions)/GDP	6.3	8.1	9.2	10.2	9.9	9.8	9.8
(Interest+ Admin.+ Pensions)/Revenue	32.6	45.1	54.2	57.6	54.9	51.5	50.0

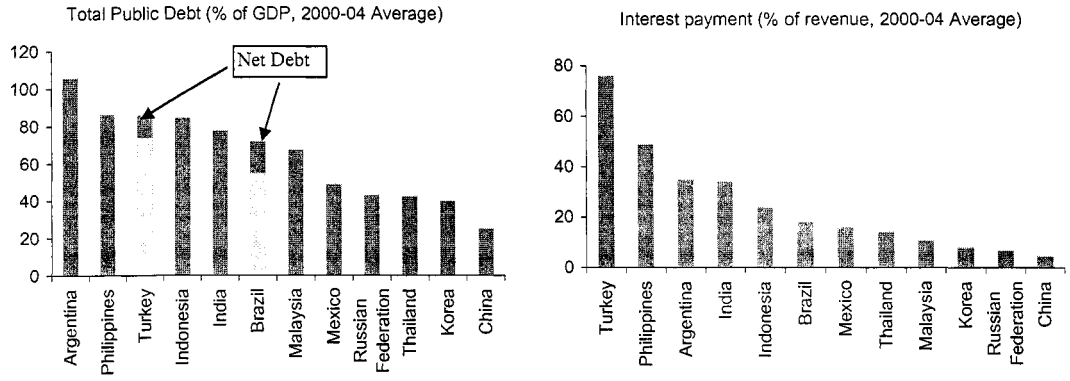
Notes: [1/] Actuals for the Center and revised estimates for the States; [2/] Revised Estimates for the Center and budget estimates for the States; [3/] Current Expenditure refers to Revenue Expenditure. Net of power bonds in 03/04; [4/] Refers to capital outlay and net loans and advances from the Center to States. Recovery of loans is net of power bonds in 03/04.

Table 6.1 highlights a number of remarkable achievements. First is the big rise in revenues so far during the Tenth Plan period, relative to the Ninth Plan period. The numbers depict a dramatic improvement in 2004/05: revenues have risen to around 19 percent of GDP, reminiscent of the late 1980s; the primary deficit has fallen to 2 percent of GDP, comparable to the levels seen during the fiscal consolidation that occurred during the Eighth Plan period. Nevertheless, although the general fiscal deficit is estimated to have fallen from more than 10 percent of GDP in 2001/02 to 7-8 percent currently, the deficit in India remains among the largest in the world. Over the period 2000–04, India's fiscal deficit was exceeded only by that of Turkey. China's deficit averaged 3 percent of GDP, while Korea ran a surplus. These fiscal deficits are largely financed by borrowings and explain the large increase in government debt, which has only just begun to stabilize.

While significant improvements characterize fiscal outcomes in recent years, India is not growing out of its debt problem. Notwithstanding the low interest rates over the Tenth Plan period, interest payments have continued to increase. Moreover, capital expenditures remain low. [35] Government indebtedness has risen even as the spending composition has shifted away from capital and development expenditures.

Few people think India is in any imminent danger of a macroeconomic crisis, nor does the World Bank, but the fiscal situation is serious. Figure 6.2 presents an average over 2000–04 of the ratio of public debt (external plus domestic) to GDP for 12 countries, every one of which, except China, had a macroeconomic crisis. In India's 1991 crisis, the main issues were low reserves and liquidity, and, unlike in Argentina, Brazil, Russia, and Turkey, where default risks were judged high by the market, solvency was not an issue. However, India's ratio of public debt to GDP, in excess of 80 percent,[36] is more than three times higher than China's. India's interest payments averaged 6 percent of GDP (and 35 percent of revenue), exceeded only by interest payments in countries with chronic fiscal and debt problems such as Turkey, Argentina, Brazil, and Philippines (in descending order of interest payments) over 2000–04. In contrast, the fast-growing economies have had interest payments averaging around 2 percent of GDP (Korea and Thailand) or less (1 percent in China). Nevertheless, the growth rate of India far exceeded that of other highly-indebted countries, with only China and Russia growing faster in the 2000-04 period.

Figure 6. 2: Total public debt and interest payments in India and selected countries, 2000–04



[35] As discussed in Pinto, Zahir and Pang (2006), when outcomes are compared with the benchmark period, 1985/86-1989/90, we see that capital expenditure cuts have served to exactly offset the rise in interest payments and fall in revenues, a remarkable persistence of the response that began during the Eighth Plan period.

[36] Brazil and Turkey conventionally report net debt, whereby certain items on the balance sheet of the central bank are subtracted from the government's debt. The figure reports gross debt for comparability, but also shows net debt.

Source: Pinto, Zahir and Pang (2006). IMF WEO, IMF country and Article IV reports, and World Bank staff estimates. For India, the sources are Government Budget Documents, Handbook of Statistics on Indian Economy, RBI Bulletins (for Turkey, GNP not GDP).

As discussed further in Pinto, Zahir and Pang (2006), the apparent disconnect between growth outcomes and public finance indicators for India can be rationalized by appealing to "country-specificity". India is not likely to have a major crisis for well-known reasons: limited capital account convertibility, a pliant banking sector, high foreign exchange reserves and a flexible exchange rate.[37] India also has relatively low levels of contingent liabilities in relation to its financial system. Currency mismatches on the balance sheets of banks, enterprises and the government are virtually unknown—unlike in Brazil, Turkey and especially Argentina. Therefore, vulnerability is low and in particular, the government is not at the mercy of the external debt market.

With India's increased integration into the world economy, its external position has strengthened. Foreign exchange reserves have grown rapidly, and they currently exceed India's gross external debt exposure. The balance of payments also remains comfortable: after three years of current account surpluses, the current account has now begun to show a deficit. Significant deficits on the trade account (some 5 percent of GDP in 2004/05) are balanced by large inflows in the invisibles account, including remittances from abroad (net invisibles grew at 21 percent in 2004/05). Figures for 2003/04 put private transfers at $18.9 billion, making India the largest recipient in the world. But with large debt stocks and already large fractions of revenue devoted to interest payments, increases in interest rates (which have been at historic lows) can cause the financing costs to rise very rapidly.

The key question going forward is how to get back on track to meeting the Fiscal Responsibility and Budget Management Act (FRBMA) targets, while creating the needed space for developmental spending. Fiscal policy is set to turn expansionary in the 2005/06 budget, with a number of important new schemes proposed.

Increasing priority developmental spending

The United Progressive Alliance government elected in 2004 is launching many potentially desirable initiatives that require additional expenditures for rural infrastructure (*Bharat Nirman),* employment (NREGA), education (SSA), rural health (NRHM), and urban infrastructure (JNNURM). But those new initiatives must be financed with some combination of higher taxes (or user charges) or lower expenditures (cutting other existing funding). The existing deficit leaves the government no fiscal space even for highly productive new spending that can sustain the current rapid growth. This situation calls for a focus on raising revenues in ways that do not choke off growth and cutting out unproductive spending to make space to support better programs.

[37] Ahluwahlia (2002a). Shah and Patnaik (2005) argue that the rupee is *de facto* pegged to the dollar.

A fundamental challenge facing India is that greater capital investment and developmental spending are needed, but the fiscal position is tight. Some have argued that the government should alleviate the infrastructure constraint by increasing public investments even if this means a further rise in the fiscal deficit. The argument in favor would say that with strong micro-foundations, growth and revenue collections would accelerate, bolstering government solvency and leading to a steady fall in the debt-to-GDP ratio. However, a sustained and large jump in growth rates would be required for India to grow out of its debt problem and such growth rates are highly unlikely to materialize.[38]

A preferable alternative would be to address the weaknesses in the public finances and the infrastructure gap simultaneously through an overhaul of the public finances. While increased tax revenue is part of the answer, as is increased private sector financing of infrastructure, expenditure restructuring will also be particularly important.

Higher taxes? Significant progress has been made in strengthening revenue performance since the 1990s. Gross central tax revenues have increased from 8.2 percent in 2001/02 to 10.2 percent in 2004/05, in line with the goal of the authorities to raise taxes to 10.3 percent by the end of the Tenth Plan. General government revenues have also been growing and are now at around 19 percent of GDP. In spite of these recent improvements, further growth in revenues is essential to ensure that developmental spending is sufficient to achieve the desired outcome and that fiscal indicators are sustainable. Moreover, India's combination of high marginal effective tax rates and numerous tax exemptions is distorting and constraining investment and growth.[39] Stamp duties on property transactions are among the highest in the world (sometimes above 10 percent, compared with 1–2 percent in many countries), as are combined central and state indirect taxes (often 30 percent, compared with half that in many Asian countries). These high rates are combined with a narrow base, reflective in particular of the inability of India's states to tax agriculture and services. Thus the great bulk of taxes are raised from industry, which only constitutes 25 percent of the economy. One of the key challenges facing India's states is thus to broaden the tax base. Another is to simplify India's tax system and reduce corruption. India's indirect tax system is probably the most complex in the world, and surveys have shown state tax offices to be among the more corrupt government agencies in the country.[40]

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[38] An illustrative example in Pinto, Zahir and Pang (2006) shows that if capital expenditure had been maintained at 6.4 percent of GDP, the benchmark level during the Eighth Plan Period, growth would have had to be substantially higher to keep debt-to-GDP on its observed path: an average of 3.6 percentage points higher over the Eighth Plan period; 5.4 percentage points over the Ninth Plan period; and 3.1 percentage points over the Tenth Plan period. Further, this rise in the growth rate is a lower-bound as all other macroeconomic variables are kept at their observed levels: at a minimum, we would expect a rise in real interest rates and an increase in noninterest current spending (such as O&M) to complement the increase in capital expenditure. These would then require an even faster counterfactual rate of growth to keep debt-to-GDP on its observed path.

[39] IMF (2005b), Carey and Rabesona (2002).

[40] A survey of industries in Karnataka found that 31 percent of respondents paid bribes to the Commercial Tax Department, a higher number than for any of the other 13 agencies mentioned (Public Affairs Centre 2002).

Revenue performance in recent years has been excellent, on the back of a buoyant economy and reforms in tax policy and administration. Nevertheless, there is further scope to increase government revenues. Removing exemptions and broadening the service tax base is critical; a tax reform allowing for lower rates and broader bases would enhance India's low tax productivity compared with that in other countries. Efforts are underway to broaden the tax base, for instance with the inclusion of new taxable services. The introduction of the value added tax on goods in many states in April 2005 has been an important achievement. Nonetheless, the preparations for a national goods and services tax should be continued, as this tax would be broader based and more efficient, thus helping to achieve FRBMA revenue targets with relatively lower rates. Tax administration reforms and improved interstate and center-state coordination are arguably even more important than tax policy reforms. Strengthened enforcement technology and procedures, coupled with better staff incentives, management flexibility, and effective anticorruption institutions might well have the greatest potential to lead to a significant and sustained revenue increase.

Getting rid of unproductive expenditures. There is some scope to increase revenues, but the emphasis should be on fiscal "rightening" not only to ensure fiscal sustainability, but also to make governments more effective agents of development. Any significant increase in public investment and developmental spending needs to be largely compensated by accelerated reduction of the revenue deficit and movement toward generating revenue surpluses. Not only the quantity, but also the quality of the deficit remain a concern: both the center and the states continue to borrow to finance current spending. The share of interest, administration, and pensions remains high, having actually risen from the already high levels during the Ninth Plan period. Spending on education and on health and family welfare has stagnated. Moreover, as summarized in box 6.3, international experience suggests that the more successful fiscal adjustments rest at least partly on the restructuring of recurrent expenditures. Fiscal consolidations achieved through cutting the wage and subsidy bills tend to be more lasting and trigger higher growth rates than adjustments based solely on revenue increases and cuts in more productive spending. Moreover, protecting capital expenditures during a fiscal adjustment leads to higher growth, as does an increase in the share of current spending on nonwage goods and services. While increasing revenues is critical for India's central and state governments, the revenue side cannot bear the entire brunt of adjustment.

Box 6. 3: International experience with fiscal adjustment

Over the past decade a number of studies have evaluated the success of fiscal adjustments. This work is based largely on experience of countries in the Organization for Economic Co-operation and Development (OECD), although one study has found the same results for low-income countries (Gupta and others 2002).

Following Alesina and Perotti (1995), fiscal adjustment strategies are sometimes broadly divided into two categories: Type 1, which relies primarily on cuts in recurrent spending, and Type 2, which relies primarily on tax increases, with spending cuts mostly limited to public investment. In a study of 20 OECD countries for the period 1960–94, 60 episodes of fiscal consolidation were identified. Of these episodes, only 16 were lasting, and among these successful cases 73 percent were based at least in part on recurrent spending cuts. Although most fiscal adjustment efforts rely on tax increases to lower the deficit and the debt burden, those successful in addressing fiscal imbalances rely more heavily on cuts in current expenditures than tax increases. McDermott and Wescott (1996) find similar results for 74 episodes of fiscal adjustment in 20 countries during 1970–95. Whereas a little less than half of the Type 1 adjustment cases were successful,

only one out of the six Type 2 adjustment cases was successful. They also found that Type 1 adjustments are more likely to reduce the public debt ratio. Complementary to this, research by Alesina and Ardagna (1998) finds that the success of fiscal stabilization is not just determined by the size of the adjustment, but also by the composition. Adjustments including cuts in government transfers and wages are more likely to succeed in reducing the primary structural balance. In addition, such adjustments not only last longer, but can also be expansionary. Adjustments relying more heavily on tax increases and cuts in public investment tend to be contractionary and unsustainable (von Hagen, Hallett, and Strauch 2001).

There are problems with unproductive spending at both the center and the state levels, as also discussed in World Bank (2003b). One key issue is that of salaries and pensions, which are estimated to account for roughly 25 percent of general government spending. With the states having responsibility for the major services of health, education, and law and order, much of this spending is at the state level.[41] It is estimated that at the state level salary spending alone accounts for about a third of all public spending, so the success of any expenditure reform strategy will depend heavily on strategies adopted in this area. As discussed in Howes and Murgai (2004) there are significant savings that can feasibly be extracted from the salary bill, through both wage and hiring restraint, without sacrificing expenditure quality. If real wage increases are avoided, the combined state-central government salary bill could fall by two percentage points of GDP over the coming decade. Such wage restraint does not seem uncalled for, since survey data show that public sector employees in India are greatly overpaid relative to their private sector counterparts (see Chapter 3). At the senior level, civil servants are widely regarded to be underpaid, but this is evidently swamped by overpayment at all other levels. A large public-private wage differential exists in all states, with average premiums in 1999/2000 ranging from 89 percent in Maharashtra to 170 percent in Rajasthan.[42]

Pensions are also a rapidly mounting liability, and the pension bill cannot be expected to decline as a share of GDP. Although the data are uncertain, estimates suggest that central and state pension liabilities could amount to 25 percent of GDP, with a significantly higher relative figure for some states. The issue here is containment of costs through reforms of pension characteristics and structure. A mandatory defined contribution scheme for new central civil servants was introduced in 2004, and 13 states have joined so far. The passage of the pending Pension Bill, which would among other things set up a new regulator, will also help to improve long-term fiscal sustainability. Nonetheless, these reforms will not have an immediate fiscal impact and thus need to be complemented by reforms to the existing system, which can have a large fiscal impact now. Attempted and possible reforms include: (a) use of longer averaging periods for the

[41] In 2000/01, 57 percent of India's total government expenditure was financed by the states, as was 97 percent of irrigation maintenance, 90 percent of public health spending, and 86 percent of public education spending. In fact, India's states are responsible for a higher proportion of general government spending than in any other developing country, except China.

[42] In part, the premiums reflect differences in human capital as the public sector tends to employ workers with greater education and experience. Adjusting for these differences in characteristics brings down premiums, but they are still large, ranging from between 62 percent to 102 percent with the private formal sector and between 164 percent and 259 percent over the private-informal sector, depending on the type of methodology used for adjustment (Glinskaya and Lokshin 2004). The premiums are highest in states like Punjab, Rajasthan, Tamil Nadu, and Uttar Pradesh that have been less restrained than others in their pay awards.

calculation of benefits; (b) reduction of pension abuse; and (c) use of a lower limit for the maximum amount that can be commuted at retirement.

Subsidies, another area of unproductive spending in India, have remained stubbornly high. As discussed in Government of India (2004a), there has been very little change in the share of subsidies to GDP since 1987/88. At the central level, the largest subsidies are for food, fertilizer, and the below-cost provision of propane and kerosene. At the state level, explicit subsidies are relatively small, and the largest subsidies are implicit, most notably power sector losses.

Most of these subsidies are both inefficient and regressive. For instance, the propane subsidy benefits largely the urban middle class (World Bank 2003b). A large portion of the subsidy on food goes to cover food storage costs. About 73 percent of the rice and 84 percent of the wheat purchased by the Food Corporation of India (FCI) is from Haryana, Punjab, and Andhra Pradesh, even though these states produce only 26 percent of India's rice and 35 percent of its wheat. Farmers in these states enjoy guaranteed sales at prices that are much higher than in states where the FCI is not active. High purchase prices for food benefit net producers, but harm net consumers in rural areas, who tend to be poorer. The Indian government (2004a) estimates that nonmerit subsidies accounted for 58 percent of total subsidies in 2003/04. The National Common Minimum Program pledged "all subsidies will be sharply targeted at the poor and the truly needy," but no concrete action has been taken yet, although there are numerous proposals to address the food and fertilizer subsidies without adversely affecting the rural and urban poor. Subsidies have proved difficult to cut, largely for political reasons.

To make further progress in power sector reform, tackling the lack of commercial discipline in the sector has to be a top priority. Interest savings will largely follow from reduced borrowing, but states can also take advantage of a low-interest regime by aggressive debt restructuring. The quality of spending at the state level can and must also be improved, as discussed in part I of this report.

All in all, the next section shows that a sustained cross-sectoral program of state and central reforms could enable an elimination of the revenue deficit by 2008/09, while increasing capital spending as a share of GDP by some three percentage points. For this scenario to be achieved, it is particularly important that institutional and organizational reforms discussed in part I of this report are pursued.

Prospects and risks

India's future success in sustaining growth and expanding opportunities is closely linked to progress in the policy areas discussed throughout this report. Below is a demonstration of the net effect of the proposed policy measures by comparing two of many possible macroeconomic scenarios.[43]

[43] Actual outcomes could fall within or even outside the range; the scenarios are primarily designed to show the impact of different broad development strategies.

Prospects under scenario 1. The first illustrative scenario shows the results of a haphazard implementation of structural reforms and the failure to attain a high-quality fiscal adjustment—all of which would be associated with a disappointing (but in this scenario not dismal) total factor productivity performance (table 6.2). Even though growth is sustained at 5 percent under this scenario, India's past successes are not taken forward further. Under this scenario the composition of public spending would not support shared economic growth. Interest payments as a share of GDP would increase from 6 percent currently to 8 percent by the end of the period, and as a result the consolidated deficit would reach nearly 10 percent of GDP. In spite of these increasing deficits, there would be no room for increased capital and developmental spending. Moreover, not only is the composition of spending suboptimal in this case, but so too is the quality of spending: the sense of "bang for the buck" would leave much to be desired. It is obvious that such a policy environment would not be conducive to advancing India's social agenda.

Prospects under scenario 2. Under a different illustrative scenario, India has much greater success (table 6.3). It reaches much higher growth rates than under the first scenario, reflecting high-quality fiscal adjustment and key policy reforms. Real GDP growth is projected to reach up to 9 percent in the outer years. Further fiscal reforms at the central and state levels would increase revenues and improve the composition of public spending, with a lower share spent on civil service wages and interest and a higher share spent on operations, management, and key public investments, which would also stimulate private investment. The strong growth performance would arise from actions to ease the key binding constraints, including the reduction of the deficit and the removal of infrastructural bottlenecks, especially in India's rural areas. A more effective delivery of key services would accelerate progress in education, health, and other measures of social welfare. Many more states, regions, and people would be able to share in India's success under scenario 2 than under scenario 1.

Risks. As highlighted throughout this report, shared growth and improved human development outcomes in India cannot be achieved without addressing the special need to expand opportunities to people in lagging states and regions. Failure to address these challenges can pose risks to the sustainability of India's overall growth process and can thwart its development prospects. It also increases the important and real risk that the reform effort is delayed or derailed by political concerns.

Other risks could threaten development prospects. Interest rates have already started to increase from their historic lows. Even a small increase in the assumed interest rate in the scenarios would lead to a significant diversion of resources away from productive spending and to debt service purposes. Another key downward risk facing India currently is that of sustained high oil prices. Nevertheless, neither increasing interest rates nor high oil prices are likely to derail the overall trajectory of the economy.

Table 6. 2: Projections of selected variables under scenario 1
(annual percentage change)

Variable	*1997–98 to 2001–02*	*2002–03*	*2003–04*	*2004–05*	*Projections*				
					2005–06	*2006–07*	*2007–08*	*2008–09*	*2009–10*
National income									
GDP at factor cost (% change)	5.6	3.8	8.5	7.5	8.1	7.0	6.0	5.5	5.0
Agriculture	3.5	-6.9	10.0	0.7	2.3	2.6	2.8	3.0	3.0
Industry	3.1	7.0	7.6	8.6	9.0	8.0	7.0	5.5	5.0
Services	8.3	7.3	8.2	9.9	9.8	8.1	6.6	6.3	5.6
Investment (% of GDP)	23.7	25.3	26.3	28.5	27.0	26.0	24.0	22.9	22.7
Private investment	16.8	19.1	19.8	21.3	20.0	19.0	16.5	16.4	16.2
General government finances (% of GDP)									
Total revenue	17.0	17.8	18.1	19.1	19.6	19.8	19.8	19.8	19.8
Total expenditure & net lending	26.3	27.5	27.2	27.2	26.5	28.5	28.6	29.1	29.2
Revenue expenditure	23.0	24.6	24.1	23.5	22.9	25.5	25.6	25.8	26.0
Capital expenditure & net lending	3.2	2.9	3.1	3.7	3.7	3.0	3.0	3.3	3.2
Gross fiscal deficit	9.2	9.8	9.1	8.1	7.0	8.7	8.8	9.3	9.4
Revenue deficit	6.0	6.8	6.0	4.4	3.3	5.7	5.8	6.0	6.2
Primary deficit	3.5	3.2	2.7	1.9	0.8	1.5	1.4	1.6	1.5
Total debt	74.3	85.7	85.8	83.6	81.7	83.2	83.7	85.0	86.2
Domestic debt	63.9	77.4	78.9	77.4	76.1	77.1	78.0	79.8	81.5
External debt	10.4	8.3	6.9	6.3	5.6	6.1	5.7	5.2	4.7
Interest payments	5.7	6.5	6.4	6.2	6.1	7.2	7.4	7.7	7.9

Source: Central government budgets, RBI Bulletin on State Finances, RBI Handbook of Statistics, and World Bank staff estimates.

Table 6. 3: Projections of selected variables under scenario 2
(annual percentage change)

Variable	*1997–98 to 2001–02*	*2002–03*	*2003–04*	*2004–05*	*Projections*				
					2005–06	*2006–07*	*2007–08*	*2008–09*	*2009–10*
National income									
GDP at factor cost (% change)	5.6	3.8	8.5	7.5	8.1	7.5	8.0	8.5	9.0
Agriculture	3.5	-6.9	10.0	0.7	2.3	2.8	3.2	3.5	4.0
Industry	3.1	7.0	7.6	8.6	9.0	7.8	8.0	8.5	9.0
Services	8.3	7.3	8.2	9.9	9.8	9.2	9.7	10.2	10.5
Investment (% of GDP)	23.7	25.3	26.3	28.5	27.0	27.0	28.0	29.0	30.0
Private investment	16.8	19.1	19.8	21.3	20.0	19.8	20.1	20.7	21.0
General government finances (% of GDP)									
Total revenue	17.0	17.8	18.1	19.1	19.6	20.7	21.6	22.3	23.0
Total expenditure & net lending	26.3	27.5	27.2	27.2	26.5	27.4	27.9	27.7	27.8
Revenue expenditure	23.0	24.6	24.1	23.5	22.9	23.8	23.2	22.0	21.4
Capital expenditure & net lending	3.2	2.9	3.1	3.7	3.7	3.6	4.7	5.7	6.4
Gross fiscal deficit	9.2	9.8	9.1	8.1	7.0	6.7	6.3	5.4	4.8
Revenue deficit	6.0	6.8	6.0	4.4	3.3	3.1	1.6	–0.3	–1.6
Primary deficit	3.5	3.2	2.7	1.9	0.8	0.3	–0.1	–0.6	–1.0
Total debt	74.3	85.7	85.8	83.6	81.7	80.9	78.1	74.8	70.8
Domestic debt	63.9	77.4	78.9	77.4	76.1	72.8	70.6	67.8	64.4
External debt	10.4	8.3	6.9	6.3	5.6	8.1	7.5	7.0	6.4
Interest payments	5.7	6.5	6.4	6.2	6.1	6.4	6.4	6.0	5.8

Source: Central government budgets, RBI Bulletin on State Finances, RBI Handbook of Statistics, and World Bank staff estimates.

Chapter 7. Accelerators to equalize the benefits of growth

Although there is a strong link between overall economic growth and the speed of poverty reduction, easing growth constraints can have either an equalizing or a disequalizing impact across states, regions, and people—even when growth is particularly robust, as it has been in India. This chapter focuses on reforms in two constraining areas that are most likely to accelerate efforts to equalize the benefits of growth: labor laws and the financial sector.[44]

Labor laws

Suggesting that labor laws have become a binding constraint to growth is controversial. The National Common Minimum Program "recognizes that some changes in labor laws may be required," but also states that "the UPA rejects the idea of automatic 'hire and fire'" and that "such changes must fully protect the interests of workers and families." This report agrees: labor regulations to protect the interests of both workers and employers are important, and India should not simply adopt some simple "solution" to labor regulation. But, by the same token, ill-designed regulation can have large economic costs and, even worse, can be disequalizing among workers. The existing labor regulations, in fact, do not protect "workers and families," but only protect those workers with protected jobs. If, as it increasingly appears, those regulations prevent good jobs from being created, they are working against the general interests of workers and their families.

Investment climate surveys and recent research suggest that Indian labor laws are among the most restrictive and complex in the world.. Firms with more than 100 workers consider labor regulations to be as important a constraint to the investment climate as power shortage problems (World Bank, 2004e). Labor laws have been "criticized as being ad hoc, complicated, mutually inconsistent, if not contradictory, lacking in uniformity of definitions and riddled with clauses that become outdated and anachronistic" (ILO, 2004). There are four interrelated issues. First, clause 5(B) of the Industrial Disputes Act (IDA) places onerous administrative and judicial constraints on retrenching workers. Second, some parts of IDA and court decisions that have stressed the bargaining power of workers in industrial disputes also work to raise labor costs and discourage employment. One example of this is seen in the share of workers involved in major work stoppages (strikes and lockouts); at about8–10 percent between 1995 and 2001, India's share is high by international standards. Third, too many laws in place govern a host of practices in the formal sector, relating to service conditions, industrial relations, wages and benefits, social security, and insurance. A typical firm in Maharashtra thus has to deal with 28 different acts pertaining to labor. Fourth, the labor dispute settlement mechanism has grown more unwieldy and complex, with the state government and courts increasingly playing a more prominent and costly role in settling enterprise-level disputes. Numerous, not always consistent, court decisions create uncertainty regarding the interpretation of these laws. While protecting firms from arbitrary and capricious actions by other firms is desirable, the current situation has not done enough to allow firms to protect themselves from capricious actions by workers: labor courts

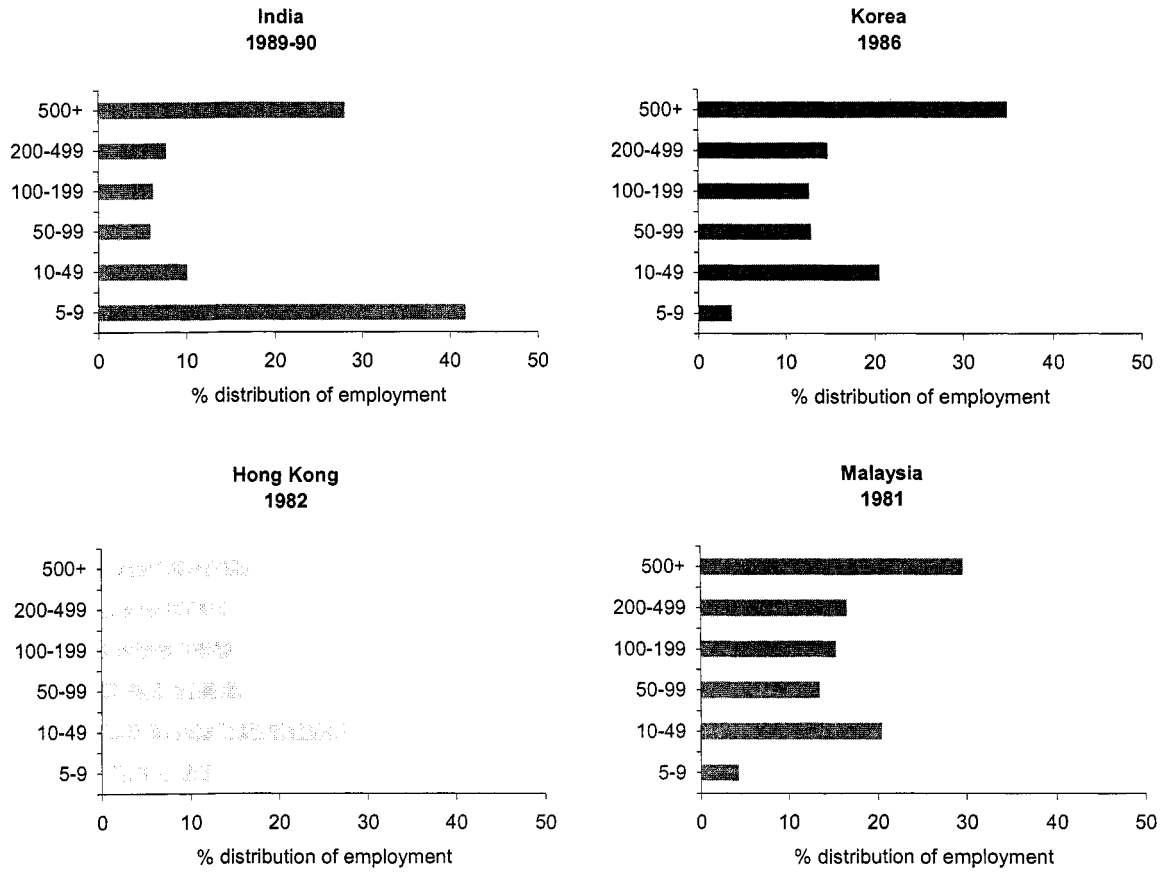
[44] Cross-country evidence suggests, for instance, that growth is more powerful in reducing poverty in some countries than in others: greater poverty reduction is observed where policies are in place to enhance the capacity of poor people to participate in growth. (World Bank, 2005k)

have prevented firms from shedding workers who have stolen from the company or carried out criminal assaults on company employees.

Labor law reform should not be caricatured as taking the side of workers against firms or vice versa—rather the real interest is providing all workers with the best possible opportunities. The current protections do not benefit "workers" as a whole. Although they might benefit the roughly 7 percent of workers in the organized sector, this protection comes at a high costs to other workers. In an economy with four times as many unemployed as organized private sector workers, the primary concern should be vibrant creation of employment. Recent research has demonstrated that these restrictive labor laws and practices impose large costs—in lost output and productivity growth, in lost job growth, in distorting the size of firms, and in casualization of labor.

Lall and Mengistae (2005) use data from manufacturing plants located in 40 cities to show that both inadequate power supply and the rigidity of labor laws result in lower productivity. Besley and Burgess (2004) show that states that amended the Industrial Disputes Act to increase restrictiveness in shedding workers and to increase worker bargaining power in disputes had substantially slower manufacturing value added growth and slower expansion of manufacturing employment. Ahsan and Pages (2005) find that more restrictive labor laws or even more restrictiveness in the application of the existing laws adversely affects manufacturing value added, employment, and productivity growth. The formal manufacturing sector, where these laws have the widest application, has had slower output growth and less robust employment growth than the less-regulated service sector.

Figure 7. 1: Manufacturing employment in India and selected Southeast Asian countries, 1980s



Source: Mazumdar (2005); World Bank, forthcoming(a).

The costs that a firm must bear for joining the formal sector or reaching the size of enterprise subject to labor law enforcement can be inferred from the size distribution of firms. In India, much more than in other countries, there are many small firms, a few very large firms, and much less in between—a highly bimodal size structure with a missing middle (figure 7.1). In 1989–90, more than 40 percent of the employment in manufacturing took place in firms with five to nine workers, compared with only 4 percent in such firms in Korea. Recent data suggest that dualistic trends have persisted, as the share of firms belonging to the formal organized sector (employing more than 10 workers) is less than 2 percent, and its share of employees has declined to 25 percent. These distortions to avoid labor laws have severe consequences: productivity in these small firms was only 20 percent or less than that of large firms (Mazumdar 2005, World Bank forthcoming(a)). Specifically, restrictive labor laws appear to create diseconomies of scale, particularly for middle-size firms whose scale is not large enough to overcome the higher labor adjustment costs imposed by laws. Interviews suggest it is the medium- and small-scale firms that suffer the most from these diseconomies in labor adjustments and are the most threatened by permanent loss of business and clientele in prolonged disputes. A recent McKinsey report on India's textile industry has pointed out that Indian manufacturers often set up multiple small plants instead of a single big one to take advantage of easier labor laws. As a result, Indian

clothing plants typically have 10 to 20 percent of the capacity of Chinese plants and work at lower levels of efficiency (*Business Standard* February 19, 2005).

Restrictive labor laws thus end up creating a bias to protect already employed formal workers at the expense of creating more and better jobs for workers outside the formal manufacturing sector or encouraging firms to enter the formal sector. These laws create massive inequality. They divide a tiny enclave of relatively better-paid salaried formal sector workers, who have good job security and benefits, from the vast majority of informal or unorganized sector workers, who work for much lower wages and with little or no social protection. Salaried workers make about 28 percent more than casual workers—even when workers are similar in age, education, etc. Moreover, as discussed in chapter 9, the dualism created between "good" jobs and casual work or self-employment allows discrimination against women and facilitates caste bias in hiring.

It is worth emphasizing that the dualism in Indian labor markets is not between the rural and urban sectors, but between the "organized" and "unorganized." After adjusting for human capital characteristics, such as age, gender, and education, there is little evidence of any premium between real wages for rural and urban casual labor, which together account for close to 40 percent of the total labor force and 75 percent of the wage labor market. The convergence between rural and urban casual wages, the fast growth of even casual agricultural wages, which are at the bottom of wage distribution, and the relative slowdown in rural to urban migration (compared to migration within rural markets), all tend to support the notion of some convergence in the urban-rural casual labor market.

Of course, it will be difficult to address the restrictive practices that make the labor laws a binding constraint on growth and job creation, while still maintaining adequate and appropriate protection of worker rights. The lessons learned from previous reforms will be valuable in tackling this hard issue. Those lessons point to the need for solutions specific to India (not imported from abroad or assumed to be a single solution), for institutional continuity with credibility for future progress (which will require consultation among all parties, including trade unions), and for attention to implementation.

The financial sector

After more than a decade of financial reforms and deregulation, India's financial sector has changed, in some respects, beyond recognition (see Basu 2005). Beginning in the early 1990s, interest rates were largely liberalized, and the burdens of priority sector requirements eased. Capital markets were deregulated, restrictions on capital inflows were gradually eased, and private entry was allowed. As a result, large firms can now access equity markets as a source of finance. Although the bank's required holdings of government debt have been reduced, a high proportion of bank assets continues to be invested in government debt. As of March 2005, about 38 percent of bank assets were invested in government debt, far in excess of the prescribed statutory minimum ratio of 25 percent. Indian banks have one of the highest ratios of government debt to deposits in the world.

Reforms so far have maybe been most effective in liberalizing equity markets—mostly benefiting India's largest firms. Banking is still tightly regulated and mostly government owned.

Although India's financial sector has been successful in mobilizing resources following reforms of 1990s, small and medium-size enterprises are not able to receive credit at the levels one would expect. The ratio of private credit (from deposit money banks and other financial institutions) to GDP in India remains low at under 40 percent, compared with over 100 percent for countries such as China, Korea, and Malaysia. Financial sector risks and reform issues have been covered elsewhere, including in Basu (2005) and also in the previous Development Policy Review (World Bank 2003).

On one level is appears that the demand for investment, not the supply of financing, is the key issue: interest rates are low, banks are holding substantially more government debt that they are required to, and, in aggregate terms, India has been (at least until quite recently) exporting capital as its national savings exceeded investment. However, what the aggregate picture masks is that the financial sector reforms have moved very far in equity markets, but have stalled in direct lending to the private sector. With booming stock markets driven by portfolio investment, large firms have been able to finance expansion easily—while massively reducing their leverage. But the sector has been slow to expand its lending, especially to small and medium-size firms, because of a combination of factors: the banking sector is closely regulated and publicly owned; the large deficit prompts fears of making new loans; and few incentives encourage innovation. Access to finance for small and medium-size enterprises (which are an important engine of growth and productivity) is further stymied because they are too small to interest equity markets or other foreign direct investment.

Improving the efficiency of financial intermediation and ensuring broader access to financial services is a critical accelerator for equalizing growth. Problems in accessing finance are often cited as a major impediment to the performance of small and medium-size businesses in India. The ratio of private credit (from deposit money banks and other financial institutions) to GDP in India remains low, at under 40 percent, compared with over 100 percent for countries such as China, Korea, and Malaysia. Only 54 percent of small businesses in India have active bank credit lines, against Brazil's 75 percent. Problems in credit access are rooted in: (a) weaknesses in the legal framework for loan recovery, bankruptcy, and contract enforcement, together with inefficiencies in the court system, with the latter largely accounting for interstate variations in the time and cost of loan recovery and bankruptcy; (b) institutional weaknesses, such as the absence of good credit appraisal and risk management and monitoring tools in banks, which increase transaction costs in dealing with small and medium-size enterprises; (c) the absence of reliable credit information on such enterprises; and (c) the lack of sufficient market credibility among small and medium-size enterprises. It is difficult for lenders to assess risk premiums properly for small and medium-size enterprises, creating differences in the perceived versus real risk profiles and resulting in untapped lending opportunities.

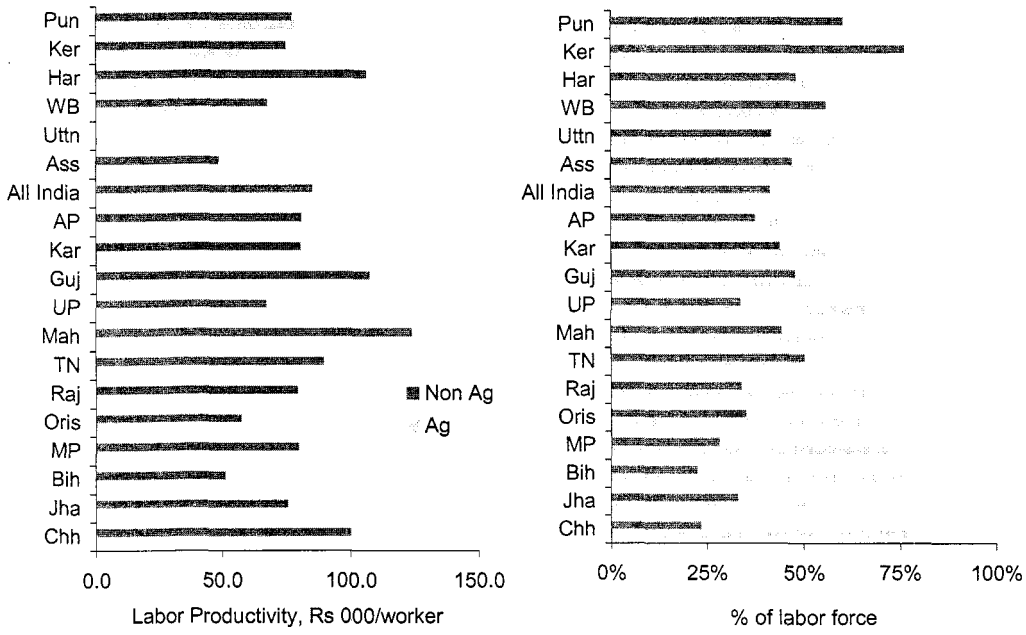
A recent World Bank (2004b) study indicates that over 60 percent of India's rural poor do not have a bank account, and 87 percent have no access to credit from a formal source. Informal financiers, who charge exorbitant rates of interest, remain a strong presence in rural India. If the financial sector is to contribute more fully to inclusive economic growth, it must reach out to more people. Indeed, there is a growing consensus, based on theoretical and empirical work, that better access to finance can be an extraordinarily effective tool for promoting economic growth and poverty reduction. Finance helps the poor catch up with the rest of the economy as it grows,

and it helps to extend the range of individuals, households, and firms that can get a foothold in the modern economy. Policies to expand competition in the finance markets for rural and small and medium-size enterprises and to improve the governance and management of financial institutions can go a long way in helping the underserved access finance on better terms. These policies need to be accompanied by better laws and regulations governing financial transactions; a judiciary that can enforce contracts, however small; the demarcation of property; improvements in land titling; and better credit information.

Chapter 8. Reforming agriculture to combat rural poverty

Home to nearly three-quarters of India's poor, rural areas are the ground on which the major battles against poverty are waged. Even within relatively prosperous states, some cities have thrived while rural areas have stagnated. Getting the rural economy moving will require measures to facilitate rural (nonfarm) entrepreneurship, as discussed in chapter 9.But, with over half of the labor force still employed by the agricultural sector, raising rural incomes will also require sustained efforts to improve agricultural productivity and enhance agricultural growth (figure 8.1).[45] Furthermore, because agriculture has such a profound impact on the rural economy and particularly on employment and wages (as rural and urban markets for casual labor are increasingly linked), sustained agricultural growth can be an important accelerator for equalizing growth. However, agricultural performance has been poor in recent years. Such weak agricultural performance, especially among the poorest states, makes it more difficult to narrow India's widening income disparities and reduce poverty.

Figure 8.1. Labor productivity and share of the labor force in agriculture in Indian states, 2001



Source: Census 2001, Ministry of Agriculture.

The productivity of agricultural labor is low, particularly in India's poorer states. This is linked to the large number of workers tied to agriculture in almost all states, the slowing of agricultural growth, and limited opportunities for rural nonfarm employment. The challenge of improving

[45] According to the 2001 census, 58 percent of the total labor force, numbering approximately 235 million people, is employed in the agricultural sector in India. These include 127.6 million cultivators and 107.4 million agricultural laborers (Government of India, Department of Census and Statistics, "Provisional Population Totals: India, Census of India 2001").

agricultural productivity over the longer term is complicated by increasing environmental degradation in many areas. The signs of degradation include soil nutrient imbalances due to unbalanced applications of fertilizer, declining groundwater tables due to overpumping of groundwater, and waterlogging and salinity of soil due to overapplication of surface irrigation.

Table 8. 1: Average yields of major crops in India and other major producing countries, 1998–2000
(in kg/ha)

Crop	*India*	*Brazil*	*China*	*Indonesia*	*Pakistan*	*Thailand*	*Vietnam*
Rice	1938	2,875	6317	4283	3000	2501	4101
Wheat	2619	1713	3790		2299	639	
Sorghum	801	1612	3484		610	1624	
Maize	1768	2767	4938	2693	1730	3523	
Groundnut	1007	1819	2956	1715	1087	1583	1389
Rapeseed/mustard	833	1551	1420		961		
Soybean	1106	2375	1743	1209	1240	1445	1159
Sunflower	522	1508	1599		1222		
Sugarcane	71514	68340	68902	64783	47981	54831	50094
Potatoes	17053	16375	14212	14480	15690	12505	10970
Cotton	640	1995	3130	1281	1776	1396	994
Tea	1906	1906	772	1442		296	951

Notes: The period 1998–2000 was selected to eliminate impact of successive droughts in the early 2000s.
Source: FAO Statistical database (http://apps.fao.org/page/collections?subset=agriculture), Center for Monitoring the India Economy, 2002.

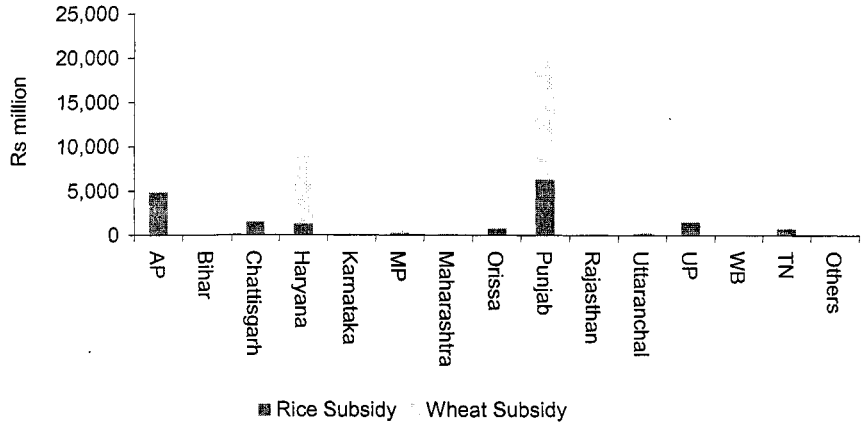
The pace of agricultural growth decelerated in the second half of the 1990s, from 3.4 percent during 1985/86–1994/95 to 1.8 percent in 1995/96–2002/03, with the largest decline in the Green Revolution states, even though yields of many crops in India are still half those of comparator countries (table 8.1). Weather shocks, particularly extensive droughts in many states due to poor monsoons[46] and flooding in some northern states, contributed to the recent slowdown in agricultural growth, but do not fully explain it. Even under better circumstances, it is unclear whether India could regain its past agricultural growth performance—or attain an even higher growth trajectory—without fundamental changes in agricultural policies and strategy.

The government of India's agricultural strategy, which was largely founded on achieving food self-sufficiency through high price supports, large input subsidies, and highly regulated markets, has been successful in many ways. Now, however, that approach is largely played out and is often promoting agricultural practices that are neither economically nor environmentally desirable. The government's price supports for rice and wheat and its input price subsidies (including those on fertilizer, sugar, electric power, and canal irrigation) encourage the perpetuation of unsustainable and environmentally harmful cropping practices and discourage agricultural diversification that could also enhance agricultural growth. The unbalanced composition of expenditures in favor of subsidies crowds out productivity-enhancing investments in rural infrastructure and services and limits available resources for operations and

[46] Relative to the long-term average, taken as 100 percent, 1999 had 96 percent of average rainfall, 2000 and 2001 had 92 percent and 2002 had 81 percent (Ministry of Finance Economic Survey 2002–03).

maintenance to sustain past investments. Notably, these price subsidies are often highly regressive and tend to benefit only some farmers in a few states, with the larger share of the benefits generally captured by large farmers (World Bank 2005k) (figure 8.2). Markets are overregulated (such as through the Essential Commodities Act, Agricultural Produce Marketing Regulations Act, and trade controls), which raises transaction costs, reduces competitiveness, and discourages private investments.

Figure 8. 2: Food grain price subsidies, by state, 2001/02



Note: Price subsidy = (minimum support price – total cost of production) x procurement volume.
Source: World Bank 2005l.

Box 8. 1: Priorities in the Tenth Five-Year Plan for agriculture

- Utilization of wastelands and unutilized or underutilized lands.
- Reclamation and development of problem soils and lands.
- Rainwater harvesting and conservation for the development of rainfed areas.
- Development of irrigation, especially minor irrigation.
- Conservation and utilization of biological resources.
- Diversification to high-value crops and activities.
- Increasing cropping intensity.
- Timely and adequate availability of inputs.
- Strengthening of marketing, processing, and value addition infrastructure.
- Revamping and modernizing the extension systems and encouraging private sector to take up extension services.
- Bridging the gap between research and farmers yields.
- Cost-effectiveness while increasing productivity.
- Promotion of farming systems approach.
- Promotion of organic farming and utilization of organic waste.
- Development of eastern and northeastern regions and hill and coastal areas.
- Reforms to introduce proactive policies for the farm sector.

Source: GoI, Planning Commission, 2005b.

The Tenth Five-Year Plan (2002–07) identifies a number of priority areas for raising the agricultural growth rate to 4 percent a year (box 8.1). In maximizing the impact of these measures on agricultural growth and poverty, some strategic prioritization will be critical. Indian

agriculture is not homogenous, and the potential for achieving a higher agricultural growth trajectory in any area is significantly influenced by area-specific natural, infrastructural, and human capital endowments and by access to input and output markets. A workable strategy for acceleration of productivity in agriculture has to tailor the right mix of actions with the specific potentials of regions; a "one size fits all" agricultural strategy will not be effective. Pursuing a differentiated strategy, across states and within states, will require a shift in the government's stance from "command and control" to a more market-oriented approach—in agricultural marketing, land policy and administration, agricultural research and extension, and watershed management. This calls for a changing role for the government, a shift from direct market participation to catalyst and facilitator through policies and investments. As discussed later, implementing a new agricultural strategy is, however, complicated by political dynamics. The tradeoff is between retaining present productivity levels and protecting farm incomes today versus sustaining natural resources and creating a more equitable system for tomorrow. The strategy will have to be one of negotiated rationalization of the present system.

Agricultural productivity and growth

Agricultural performance and potential varies widely across Indian states, and even within states, presenting challenges and opportunities for achieving more rapid growth (table 8.2). One approach to assess a state's or area's potential to achieve higher agricultural growth is to differentiate agricultural systems based on their endowments.[47] For simplicity, three broad categories are considered here:

- High potential irrigated systems with good access to markets
- Moderate to high potential areas with limited access to markets
- Marginal drylands.

These categories could cover broad regions (including several states) or subregions within a state.

Table 8. 2: Variation in agricultural performance, input use, and infrastructure across Indian states

Region/state	*Agric. labor productivity 2000/01 (Rs000/ worker)*	*Avg. annual agric. growth rate (%)*		*Average yield, TE 1999/2000 [b] (kg/ha)*					*Average fertilizer use, 2001/02 (kg/ha)*	*Households using improved seeds, 2003 (%)*	*Share of villages connected by roads, 1997 [a] (%)*
		1985/86–94/95 [a]	*1995/96–2002/03*	*Rice*	*Wheat*	*Maize*	*Sugar cane*	*Cotton*			
States with low agricultural labor productivity											
Jharkhand	7.9		5.1	729	1,070	804	19,024			22	
Bihar	8.4		4.6	1,538	2,071	2,092	45,978		88	34	48
Chhattisgarh	10		-3.1	596	547	899			46	12	100
Madhya Pradesh	13.9		-2.1	853	1,733	1,435	41,512	105	40	29	28
Orissa	14	0.6	-0.7	1,241	1,273	1,336	59,838	287	40	19	49
States with moderate agricultural labor productivity											
Rajasthan	16.3	4.5	-2.2	1,213	2,507	1,130	45,919	250	41	54	52
Tamil Nadu	16.5	5.5	0.3	3,370		1,604	111,085	302	144	56	51
Maharashtra	16.6	5.8	1.2	1,655	1,185	1,538	87,364	132	76	70	71
Uttar Pradesh	17.9		1.8	2,089	2,625	1,343	59,010	67	130	48	50

[47] These typologies and the discussion of development pathways that follows draw extensively from World Bank 2005m.

Gujarat	18.9	4.0	-3.9	1,553	2,307	1,547	70,274	329	90	62	94
Karnataka	19.8	4.0	3.2	2,499	706	2,865	99,083	226	103	68	100
Andhra Pradesh	20.3	4.3	3.0	2,611	572	3,154	75,608	237	150	33	86
Assam	22.9		0.4	1,384	1,196	730	40,266		37	64	75
Uttaranchal	23.3		1.2	1,976	1,873	1,386	61,559	153	98		
States with high agricultural labor productivity											
West Bengal	34.4	5.4	3.0	2,243	2,221	2,709	74,028		123	63	49
Haryana	39.5	4.6	1.6	2,472	3,912	2,086	54,657	320	163	47	99
Kerala	71.7	4.9	-3.2	2,079			80,445	278	59	16	99
Punjab	78.3	4.0	2.2	3,323	4,294	2,319	59,649	247	171	44	99
Average for India	22.2	3.4	1.8	1,937	2,618	1,766	70,941	219	91		57

Notes: a: Values for Bihar, Uttar Pradesh, and Madhya Pradesh are for unsplit states; b: While more recent crop yield data are available, triennium ending (TE) 1999/2000 figures are used to eliminate the impact of widespread droughts during the early 2000.
Source: CMIE 2004.

Punjab and Haryana qualify as having high-potential irrigated systems (figure 8.3). Irrigated areas often tend to be relatively better provisioned in terms of access to roads and transport systems, markets, electricity, communications, and other public services. Other states or regions, such as Bihar, Eastern Uttar Pradesh, Madhya Pradesh, Andhra Pradesh, and Northeast India, have moderate to high agricultural production potential because of their good biophysical endowments (e.g., good climate and soils and access to surface or ground water), but maximizing their potential is hampered by weak linkages to input and output markets. Limited communications and road connectivity increase transaction costs, which leads to lower farmgate prices and limits diversification to higher value crops, tying farmers to the production of nonperishable products or food for home consumption.

Figure 8. 3: Agricultural production systems: a national perspective

Connectivity to input and output markets (roads, telecommunication, markets, etc.)

Strong		*Weak*
High-potential irrigated areas	*Moderate- to high-potential areas*	*Marginal drylands*
Fertile soils, good rainfall or irrigation	Moderate to good soils, moderate to good rainfall or irrigation	Marginal lands, drought prone
"Green Revolution areas" (Punjab, Haryana, Western Uttar Pradesh, Tamil Nadu)	Bihar, Eastern Uttar Pradesh, Madhya Pradesh, Andhra Pradesh, Orissa, Northeast states	Western Rajasthan, Northern Karnataka

Marginal arid areas are generally sparsely populated and often remote, with very limited agroecological potential and poor access to markets. Agricultural activities there are subject to high production risks because of droughts. Livestock production, dominated by hardier animals such as goats and sheep, and off-farm employment are often important sources of livelihood. Still, people living in these marginal areas are often very poor. Two areas with these characteristics are Western Rajasthan and Northern Karnataka.

Regions or districts within a state can also be classified according to these three broad agricultural production systems (table 8.3 applies this framework at the district level in

Rajasthan). The characteristics of the production systems will favor particular crops or livestock. Production of more water-sensitive crops, such as wheat, rice, and maize, is concentrated in the areas with moderate to high agricultural potential and the high-potential irrigated areas, while less water-intensive crops, such as jowar and groundnuts, are concentrated in the marginal dryland areas. Hardier livestock is concentrated in the marginal, drought-prone areas in the state.

Table 8. 3: Agricultural systems in Rajasthan, by soil conditions

Production system/district	*Soil quality*	*Availability of water*		*Market access: avg. % of villages connected by road, 2001*	*Average agriculture National Domestic Product per cultivated area (Rs/ ha)*
		Avg. rainfall (mm)	*% of area irrigated*		
Marginal drylands					
Jodhpur, Ajmer, Churu, Bikaner, Jaisalmer, Barmer, Tonk	Desert soils and sand dunes, seirozones	100–500	13.2	25.8	7,008
Moderate to high agricultural potential					
Sikar, Jhunjhunu, Jaipur, Chittor, Udaipur, Ganganagar	Desert soils, seirozones, yellowish brown, medium black, red loam, silty clay	100–700	41.2	37.1	15,271
High-potential irrigated					
Jalore, Sirohi, Alwar, Bharatpur, Kota, Banswara, Bundi, Sawaimadhopur, Jhalwar	Sandy and hilly soils, alluvial black and yellowish soils, yellowish brown, medium black, red loam	300–750	67.4	40.8	20,011

Notes: Marginal drylands are those with marginal soils and limited rainfall and irrigation. Moderate- to high-potential areas have moderate to good soils and moderate rainfall or moderate access to irrigation. High-potential irrigated areas have good soil and high rainfall or good irrigation (greater than 60 percent).
Source: Government of Rajasthan.

Development pathways for growth

Four possible development pathways could be explored to maximize agricultural growth potential and achieve the government of India's agricultural growth goals. These are intensification, diversification, nonfarm linkages, and exit.

Intensification

Intensification involves increasing the output of existing activities. This could be achieved through a number of means, including (a) increasing cropping intensity by expanding access to irrigation, (b) increasing yields and/or reducing losses through the adoption of improved farm practices, seed varieties, and livestock breeds and through the use of other inputs, and (c) relaxing some binding constraints, such as labor shortages through the use of mechanization, water shortages through the use of drip irrigation, or access to credit through the use of warehouse receipts.

The development on irrigation systems improves agricultural potential, especially in highly fertile areas, in a number of ways. It improves agricultural productivity and performance directly by increasing yields and by enabling multiple cropping, but also indirectly by increasing the returns to other factors of production, such as improved seeds, fertilizer and other agrochemicals, and labor. It reduces rainfall-related output volatility and risks, which also makes agricultural diversification to higher-value crops more economically viable. Irrigation expansion, however, is becoming difficult and costly in many states, because the best areas have been developed and expansion is being pushed to more difficult areas. Moreover, increasing water scarcity and competition for water from other sectors (industry and drinking water) further heightens the need for better allocation and management of water resources in many states.

Diversification

Diversification involves the shift in production to higher-value crops or products (fruits, vegetables, higher-value cereals, medicinal plants, and livestock) to take advantage of new, more profitable market opportunities. The potential gains from diversification come from improving crop rotations, spreading labor demand, raising incomes, and reducing risks. Agricultural diversification is often viewed as a possible panacea for raising agricultural performance everywhere in India. Agricultural diversification for sustained increases in household income, however, is most successful if it is market driven.

Nonfarm linkages

Connections between farms and related economic linkages can be strengthened through activities that foster greater value addition, such as trading and agroprocessing, as well as activities that provide inputs to the farm sector.

Exit

Exit is the shift away from farming to nonagricultural occupations. Exit can imply migration of farm workers to a new location to take advantage of higher-paying employment opportunities in the industry or service sectors, usually in a town or city. Or it can also simply mean the reallocation of labor to the rural nonfarm economy within the same local area.

Matching agricultural strategies with production potential

Just as the development pathways for achieving more rapid agricultural growth will vary across the different productions systems, so too must the agricultural strategies vary from region to region (table 8.4). In high-potential irrigated areas, increasing land and water scarcity heightens the importance of diversification to higher-value products and value addition as a means to maximize the returns from existing resource endowments. Changing consumer demand, as incomes grow, cities expand, and markets and trade are increasingly liberalized, will provide huge opportunities for producers to diversify into higher-value products, including fruits, vegetables, livestock, aquaculture, and associated livestock feeds and forages. Demand for

processed products also increases with rising incomes, which presents new opportunities for moving up the value chain into agroprocessing and related services. Given the pressures on the natural resource base in high-potential irrigated areas, another development path is also the shift in employment from agriculture to the industry and service sectors through measures to strengthen rural nonfarm entrepreneurship and develop human capital.

Table 8. 4: Tailoring development pathways to agricultural production systems

High-potential irrigated areas	*Moderate- to high-potential areas*	*Marginal drylands*
Diversification of production to higher value products to cope with increasing land and water scarcity. *Value addition* through agroprocessing to cater to increased perishability of most high value products. *Exit* to services/industry sectors.	Increased *intensification* through increased adoption of high-yield varieties, irrigation, and modern inputs. *Diversification* by further improving linkages to markets.	Short- and medium-term: *Sustaining production.* Long term: *Exit* through off-farm employment (agroprocessing, services, industry).

In moderate- to high-potential areas, good biophysical endowments offer the opportunity to maximize their untapped potential through further intensification of production and agricultural diversification. But this necessarily involves improving linkages to markets.

In contrast, the strategy for improving livelihoods in marginal drylands, because of the limited production potential and significant associated production risks in those areas, needs to be differentiated between the short to medium term and the long term. In the short to medium term, the focus will need to be on maximizing or at a minimum sustaining agricultural (crop and livestock) and nonfarm incomes from existing natural endowments. Over the longer term, an important pathway to reducing poverty is to exit agriculture by encouraging the shift to other higher-paying employment locally or in other areas, as well as more profitable nonfarm uses for the land, such as manufacturing and services to conserve natural resources and promote off-farm employment. Because exit is a longer-term objective, especially in poorer areas, where opportunities to participate in nonagricultural labor markets are fairly limited, an intermediate step is to reduce poverty by developing those agricultural systems that can be viable. Improvements at the farm level should help rural households enhance food security, conserve natural resources, and if possible enter markets for selected products in which they have a comparative advantage (e.g., arid zone fruits and nuts, spices, honey, herbs, agroforestry, and small livestock). The development process in marginal areas needs to be managed carefully to ensure a smooth transition for rural households over time. They will need a combination of risk management at the farm level, safety nets at the household level, and other forms of transitional support. These differentiated strategies in turn have important implications on the policies and investments for promoting agricultural and rural growth. These are elaborated in the following sections.

Strategies for high-potential irrigated areas

Fostering agricultural diversification and value addition in high-potential areas requires reorienting policies to ensure that incentives favor diversification and sustainable agricultural practices and fostering new institutions to meet the modern marketing needs of higher-value products (table 8.5). Key public sector institutional changes, reforms, and investments required to provide such an environment are:

- Continuing liberalization of agricultural market and trade policy (e.g., removal of movement and storage restrictions, except during emergencies; amendment of the Agricultural Produce Market Act to allow direct sales by farmers; and removal of FDI restrictions on retailing, etc.).
- Expanding agricultural risk management mechanisms, such as negotiable warehouse receipts, forward and futures contracts, and crop insurance, and developing financial systems for savings, capital redistribution, and risk management.
- Encouraging investment in infrastructure for irrigation (development and rehabilitation), markets (e.g., market yards, cold chains, port infrastructure), and agricultural services (e.g., agricultural research, extension, market intelligence and information systems).
- Supporting capacity building for businesses to conform to market grades and standards and for public agencies to regulate and certify food quality and safety.
- Strengthening agricultural research and technology transfer systems. With land and water becoming scarce in many states, diversification and productivity growth will become highly knowledge-intensive processes.

Indian farmers will require more market-oriented agricultural research and extension systems to supply new technologies and information. The private sector can play an important role in these innovation systems, but to do this, appropriate incentives must be available, such as a business-friendly investment climate. To improve the effectiveness of the public research system the roles and responsibilities of the Indian Council of Agricultural Research institutes and state agricultural universities need to be redefined to minimize overlaps and duplication and to focus on the key constraints facing farmers. For strengthening strategic focus and building the critical mass of scientific human capital in priority areas, there is need for consolidation of research programs, amalgamation of some institutes and departments, need-based redeployment of human resources, and establishment of a long-term human resources development plan. A rigorous priority-setting exercise is necessary to ensure that resources are allocated to drive the future agricultural growth and diversification agenda.

The growing consensus to reform land policy, particularly land tenancy policy, and the land administration system at the state level can help to drive action and should be encouraged. While land distribution has become less skewed, land policy and regulations to increase the security of tenure (including restrictions or ban on land rentals or conversion to other uses) have had the unintended effect of reducing access by the landless and discouraging rural investments. In considering land tenancy reform, the experience of states that do not have tenancy restrictions can provide useful lessons in this regard. State government initiatives to improve land administration through computerization of land records have reduced transaction costs and increased transparency. For example, Lobo and Balakrishnan (2002) found that the computerization of land records in Karnataka reduced processing delays by 1.3 million person days per year and eliminated petty corruption estimated at Rs 800 million per year. But it has

also brought to light operational and institutional weaknesses, such as institutional fragmentation[48] and problems of inconclusive proof of ownership.[49] Over the longer term, a more holistic approach to land administration policies, regulations, and institutions is necessary to ensure tenure security, reduce costs, and ensure fairness and sustainability of the system. Priority actions include the expansion of the computerization of land records in all states, the integration of the systems for records of rights and registration, and progress toward a single integrated land administration agency.

Table 8. 5: Policy and investment implications of a differentiated agricultural strategy

High Potential Irrigated Areas	*Moderate to High Potential Areas*	*Marginal Drylands*
Policy ▪ Market (input/output) deregulation ▪ Land policy (tenancy) and administration ▪ Water resource allocation and management ▪ Price risk management	**Policy** • Market (input/output) deregulation • Land policy (tenancy) and administration • Price risk management	**Policy** • Natural resource management • Drought risk management
Public Investments ▪ Research and extension to support diversification, SPS requirements ▪ Rehabilitation and maintenance of irrigation systems	**Public Investments** • Irrigation development and management • Research and extension to support intensification/ diversification • Rural infrastructure (roads, electricity, markets)	**Public Investments** • Watershed management • Minor irrigation • R&D on drought tolerant crops, small ruminants, NRM • Disaster management-safety nets during droughts • Rural infrastructure to attract nonag investments
←	**Improved human capital and governance**	→

With increasing competition for water expected, especially in high-potential irrigated areas, better management of water resources will be essential. Many states lack both the incentives and the policy, regulatory, and institutional framework for efficient, sustainable, and equitable allocation and use of water, or for internalizing the environmental costs of inefficient use. Public expenditures on irrigation have tended to put lower priority on operations and maintenance, leading to the rapid deterioration of existing infrastructure. Improving the planning, management, and allocation of water resources requires placing greater priority on (a) the establishment of institutions for state-level water resource management and allocation; (b) adopting new instruments to govern incentives for water use (e.g., water entitlements, management contracts, water pricing); (c) reforming and modernizing Irrigation and Drainage

[48] The Revenue Department is responsible for handling the record of rights, while the Department of Stamp Duties handle the registration of deeds. There is generally no link between the databases of these departments.
[49] Existing land documentation does not provide adequate proof of land ownership. Land registration does not require proof of ownership, and the government is not responsible for any errors in registration.

Departments to integrate the participation of farmers and other agencies in irrigation management; (d) improving the efficiency of irrigation through appropriate water pricing and cost recovery and through conversion to higher-value crops combined with the provision of agricultural technical assistance; (e) rationalizing public expenditures, with priority to completing schemes with the highest returns; and (f) allocating sufficient resources for operations and maintenance for the sustainability of investments.

Off-farm employment is vital to the strategy for high-potential irrigated areas. Upgrading rural infrastructure and facilitating access to finance, as discussed in chapter 7, will help to ease two key constraints to growth in the nonfarm sector. Growth in the farm sector can also spur growth in the nonfarm sector by increasing the demand for labor to trade, process, and package food and other products. This requires well-functioning product markets, which can be developed by carefully reorienting the government's role away from direct intervention and overregulation toward creation of an enabling environment for greater private sector participation.

Strategies for moderate- to high-potential areas

Creating the enabling environment for growth in moderate- to high-potential areas will require many of the same elements outlined in the strategy for high-potential areas. The main difference is that in contrast to high-potential areas, moderate-potential regions still have scope for improving productivity through agricultural intensification. For both intensification and diversification in these areas, substantial public and private investments to increase labor and land productivity are needed. A key priority is the expansion of irrigation where economically feasible, as it has the potential to generate higher returns and agricultural employment (table 8.6). As discussed earlier, however, a number of reforms are needed to achieve the full potential of irrigation.

Table 8. 6: Impact of irrigation on agricultural production and employment

Variable	*All farms*	*Irrigated* [a/]	*Rainfed* [b/]
Total crop value (Rs)	44327	50224	29655
Crop area (acres)	6	7	6
Total labor (man days)	173	186	140
Family labor (man days)	60	61	58
Hired labor (man days)	112	125	81
Total labor expenditures (Rs.)	7595	8509	5322
Value of agricultural assets (Rs)	43620	51267	24596
Observations	4161	2968	1193

Notes: These states include Assam Bihar, Madhya Pradesh, and Uttar Pradesh (unsplit states), Gujarat, Haryana, Himachal Pradesh, Karnataka, Himachal Pradesh, Kerala, Maharashtra, Orissa, Punjab, Rajasthan, Tamil Nadu, and West Bengal. a: Irrigated: Share of irrigated area > 0.25; b: Rainfed : Share of irrigated area <0.25.
Source: Jin and others forthcoming 2005.

Another critical priority will be to raise farm profitability by improving access to markets for inputs and outputs. Market development requires support for key market institutions. Support

will be needed for institutional innovations that facilitate coordination along the supply chain, including contract farming, out-grower schemes (in which an agribusiness complements its supplies through arrangements with surrounding smallholders), and farmers' and traders' association. Capacity building is required for regulation and monitoring, which are crucial institutional elements for agricultural markets to function well. It may be necessary to develop official systems of grades and standards and well-functioning market information systems.

Access to markets must be improved, but so must access to new technologies and advisory services to improve profitability and expand smallholders' awareness of market opportunities. To meet these needs, agricultural research and extension priorities for these areas will increasingly have to focus on issues relating to marketing policy, post-harvest technologies and practices, livestock and high-value commodities with strong market demand, and cost-saving technologies.

As the productivity and profitability of food crop production increases, priority should also be given to diversification. By strengthening links to market outlets (for example, through investments in roads, markets, electricity, and information systems), farmers can produce more crop and livestock products for the market. Diversification to products that require more inputs, processing, and handling will also offer additional nonfarm employment opportunities. To help farmers cope with changing markets and production systems, investments must be made in financial systems for managing risk (e.g., futures markets, crop insurance schemes, warehouse receipt systems, commodity exchanges, and social safety nets).

Giving greater priority to agricultural diversification, however, does not imply phasing out support for further productivity improvements in the traditional crops. Although India has reached food self sufficiency, and growth in demand for traditional foodgrain crops is slowing down, the bulk of demand will probably still have to be met through domestic production. It will not be feasible for India to import large volumes of foodgrains from the world market without substantially increasing world prices. Thus, the need will remain to support public investments in agricultural research and technology transfer to increase the productivity and profitability of staple crop production. The returns to greater input use are declining in many of the Green Revolution (high-potential) states, and further intensification in these areas will exact a heavy toll on the environment. There is growing consensus in India over the need to foster the shift of the breadbasket to the moderate- to high-potential eastern and northeastern regions of the country, which can support rice-wheat systems more sustainably over the long term. However, achieving such a transition will require a radical shift in the government's price policies, as well as significant investments to strengthen agricultural support services and infrastructure.

Strategies for marginal areas

While the long-term strategy in marginal areas with limited agricultural potential is exit to off-farm opportunities, through promotion of nonfarm entrepreneurship and development of human capital, as a transitional strategy, policy should focus on those aspects of agriculture that are viable in the harsher agroecological conditions of marginal dryland areas (see table 8.5). This necessitates increased priority to the research, development, and diffusion of drought-tolerant crop and livestock varieties, suitable livestock feed and fodder, appropriate soil and water

conservation measures, and technical advice on alternative cropping systems that can mitigate agriculture production risks associated with low rainfall. Because the returns to research and extension associated with dryland crops and environmental resource conservation are limited, the government will have to play a major role in delivering these services.

Box 8. 2: Issues for effective watershed management at the national, state, and local levels

Recent experience with watershed programs in India points to a number of institutional, design, and implementation issues that are hindering the programs' full effectiveness. Institutional constraints include (a) a multiplicity of programs financed and delivered through different central agencies; (b) weaknesses in state government capacity for watershed management planning, monitoring, and evaluation; (c) weak coordination among different government agencies charged with planning and delivery; (d) lack of coordination between decentralization policy and local authority capacity for delivering watershed programs; (e) weak community institutions in many projects; and (f) uncertainties relating to the legal framework for common lands. Design and implementation concerns include (a) unequal distribution of benefits across households; (b) lack of sustainability of some assets created; (c) insufficient attention to hydrology in projects; (d) inadequate consideration to externalities; and (e) weak systems for monitoring and evaluation and for management information.

At the national level, some options for improving the effectiveness of watershed programs include (a) consolidating different watershed programs at the national level; (b) strengthening national knowledge-sharing and learning networks to help build government capacities; (c) developing state and community capacities and participatory microplanning before undertaking major field investments. Key state and local institutional reforms include: (a) increasing local exposure visits to help build community capacities; (b) establishing district-level technical coordination units within the lead implementation agency for line agencies to work with; (c) increasing support for nongovernmental organizations in community institution building, monitoring, etc.; and (d) seeking agreement between the local agency and community over rights to use and share benefits from common lands.

The strategy for marginal dryland areas will require making the best use of scarce water resources, reducing soil erosion and water runoff, and conserving natural pastures and vegetation. The success of watershed management programs in many states shows that well-designed and targeted initiatives can reverse resource degradation and/or improve productivity. These successes generally combine elements of water conservation or small-scale irrigation, management of natural resources held in common, and grants to communities for small-scale infrastructure and income-generating activities, both on and off the farm. But there are areas for improvement, requiring concerted efforts at the national, state, and local levels (box 8.2).

Livestock are often the key to improving food security and reducing poverty in marginal drylands. Thus, the availability of feed is a critical variable, and efforts are often needed to reduce the effects of annual and seasonal variations in feed availability through strategic fodder production (e.g., in higher potential sites in dryland areas), range management, and livestock marketing. For livestock producers to gain access to regional markets, they require access to veterinary services, animal health products, and more developed market channels, including provisions for compliance with sanitary standards (to minimize the risks of spreading contagious diseases) and food safety standards (to ensure safe processing).

Safety nets, discussed in chapter 10, will be appropriate in certain circumstances to ensure that people attain a minimum standard of living (especially when there is a drought). Investments in producers' capacity to prepare for and respond to drought should provide for preparedness

training, early warning systems, better drought management capabilities, and assistance to recover from drought.

The political dynamics of rural reform

Implementing the government of India's agricultural development strategy is complicated by the political dynamics of reform. Increasing public expenditures in productivity-enhancing investments, such as agricultural research and extension, irrigation, rural infrastructure, and market support services, will be critical to reinvigorating agricultural performance and meeting the goal of 4 percent average annual growth per year. Providing the budgetary resources for these investments, however, is made difficult by the current large fiscal burden of agricultural subsidies. These include the food and fertilizer subsidies of the national government and the power (for groundwater pumping) and irrigation subsidies of state governments. Recent studies have shown that the present agriculture subsidy regime is inequitable and inefficient, directly benefiting mainly owners of bigger farms in better off districts. But rationalizing subsidies is a politically complex and sensitive subject, and a strategy of negotiated rationalization of the present regime will be required.

The political rationale for agricultural subsidies

The government is aware of the problem of misdirected and unsustainable subsidies. In its approach paper to the Mid-Term Appraisal of the Tenth Plan (2002–07), the Planning Commission stated that the present price support and procurement systems combined with input subsidies on fertilizer, electric power, and canal water "have led to a sharp increase in subsidy based support while public investment in agriculture has suffered. The outcome is distributionally inequitable since the subsidies typically go to the richer farmers in areas of assured irrigation, while the lack of public investment hurts poorer farmers and those in arid regions."[50] The subsequent Mid-Term Appraisal has identified the adverse effects of several current pricing and subsidy mechanisms and has recommended "focus on reducing those subsidies that lead to distortions and have deleterious effects on natural resources and cropping patterns."

In his last budget speech, the finance minister spoke of the need to "now take up the task of restructuring the subsidy regime."[51] And the prime minister has stated that "the future direction of policy clearly has to recognize that we are no longer in an era of chronic shortage, and that our emphasis now has to be on providing rapid growth in agriculture-based livelihoods. For this we would need to correct the various distortions that have crept into our policy framework both in terms of geographical focus as well as incentives to specific crops."[52] Despite this recognition of the problem, however, there is no visible strategy of how the government proposes to address the

[50] Explicit central subsidies amounted to 4.2 percent of GDP in 2003–04; implicit subsidies and state subsidies are similarly significant. The main agriculture-related central subsidies are on food and fertilizers, while states subsidize irrigation and power.

[51] Chidambaram, P., Budget speech, February 28, 2005, available at http://indiabudget.nic.in/ub2005-06/bs/speecha.htm.

[52] Singh, Manmohan, interview, *IFPRI Forum*, newsletter of International Food Policy Research Institute, Washington, March 2005.

issue in practice. There is a proposal to make grain procurement more cost effective through decentralized mechanisms, especially in nontraditional states, and a working group in the department of fertilizers is examining next steps in a new fertilizer pricing scheme proposed to come into effect from April 1, 2006. But a politically feasible strategy to restructure the agriculture subsidy regime has yet to be unveiled or discussed.

The complexity and sensitivity of reforms

Subsidies, especially those directed at agriculture, are a politically complex and sensitive subject. Since 2004, several states, such as Punjab, Tamil Nadu, and Andhra Pradesh, that had made a beginning in reforming their power sectors reversed track to once again provide free power to their farmers. Most states have yet to begin seriously addressing the issue of sustainable water management, and the national government too is cautious about touching the Minimum Support Price (MSP) regime.[53] The logic that the present regime benefits better-off farmers disproportionately has failed to carry much political weight with either the rural elite or the rural poor. Richer farmers believe that they are better off precisely because of these subsidies and that they still need the subsidies for sustenance, and to avoid falling into poverty. Besides, being better off does not necessarily free one from vulnerability, given that even so-called big landlords in Green Revolution areas often operate smaller than optimal farms or own scattered parcels of land. For the landless poor and marginal farmers, there is a big stake in the present system, despite its obvious inequity, as their employment opportunities stem from the subsidized viability of bigger farmers. And small and medium farmers (especially those in arid areas) depend crucially on subsidized inputs, such as seeds, fertilizer, and groundwater (often purchased cheaply from a richer neighbor using free electricity to operate a pump to mine it). Attacking subsidies, therefore, translates politically into a direct assault on all farmers' interests. Farmers understand the benefit of moving to a more sustainable and nondiscriminatory system based on agricultural technology and infrastructure investments instead of subsidies, but neither rich nor poor farmer is confident of withstanding the transition.

These insecurities stem from the small-farm structure of the rural economy and the vast numbers dependent on it. Among policymakers, there are many who argue that in a sector with low returns, high risk, uneconomic average farm size, and excess labor, the government will have to subsidize production in one way or another. In a set-up of numerous small holdings, goes this argument, subsidized incentives are a more workable way of improving productivity than capital-intensive technology, and removal of subsidies now will cause both decline in production and pauperization of many.[54]

Several other factors contribute to political resistance to reform in agriculture. The first is the broad perception in larger Indian society that the present regime has led to increased farm

[53] In his 2005 budget speech, Finance Minister Chidambaram made clear that food grain procurement would be made cost effective "without impairing the present MSP-based procurement." This is not to say that sometimes the government of India does not "touch" the MSP in a backdoor fashion. The minimal adjustments to the MSP since 2002 have resulted in the MSP declining in real terms—which has incentive and fiscal effects.

[54] For example, the Expenditure Reforms Commission (2000) estimated that if the farmgate price of urea were raised to its import-parity price without a corresponding increase in the procurement price of food grain, production would fall by 13.5 million tons.

productivity, helped the country achieve self-sufficiency in cereals, expanded economic access to food, and is thus an investment in national food security. The second, which also finds support in broader society, is the view that it is unfair to dismantle the protections available to vulnerable Indian farmers when advanced economies such as the United States, Europe, and Japan provide huge subsidies to their farmers. The third, a sentiment emanating from the farm community, is that it is not right to target rural support mechanisms when urban populations continue to receive heavily subsidized services, such as electricity, water supply, and urban transportation, when the industrial sector too receives various benefits, and when government employees are cushioned against all risk. Linked to this is a perception in rural areas that the urban middle class has benefited from liberalization and globalization in a manner that the rural community has not. These sentiments together translate into political pressure from all rural classes to not just retain but even expand the present regime.

For political decision makers, the tradeoff is between retaining present productivity levels and protecting farm incomes today versus sustaining natural resources and creating a more equitable system for tomorrow. The political compulsion universally is to lean in favor of today. The fiscally logical argument that saving wasteful subsidies will make greater resources available for investment is not one that works politically, for this assurance is not demonstrable in the short term and its potential beneficiaries are too diffused a political constituency. In contrast, those who stand to lose are already politically influential, more visible to each other, therefore better able to organize and so politically more potent.

More directly, the high level of risk and vulnerability in Indian agriculture produces a political response, which leads to the breakdown of commercial discipline in rural subsidy delivery mechanisms. Announcing subsidies, reducing tariffs, refusing to collect dues from farmers—these are important signaling devices that enable politicians to demonstrate their responsiveness to the difficulties of the rural community. For all these reasons, there appears to be, perhaps more than the apparent unwillingness to pay, a political reluctance to charge. In the wake of these political constraints, it is clearly overoptimistic to expect subsidies to be eliminated or even substantially restructured. Nonetheless, it is entirely possible, as India's economy grows, agriculture's share in it falls, and rural investments enable more farmers to access electricity and irrigation connections, that governments might be tempted (or pressured) to find the fiscal space to continue indulging the present regime.

Negotiated solutions

The strategy will have to be one of negotiated rationalization of the present system. Drastic reforms are neither politically feasible nor even desirable given the vulnerabilities of India's farmers, both big and small. The challenge before India's political and bureaucratic leadership, then, is to devise an acceptable strategy that leads to more rational management of the present system while correcting its imbalances and inequities over time. A concerted focus on addressing the fundamental issues of land productivity, water management and rural off-farm livelihoods with specific strategies for different regions is more likely to yield long-term solutions than the present tactic of fiscal arithmetic driving minor advances on the subsidy front only to be followed by dramatic reversals under political compulsion.

There are forms of negotiated rationalization already happening in surface irrigation. A strategy of linking increased cost recovery of irrigation operations and maintenance with the (a) transfer of irrigation systems management to water user's association (participatory irrigation management) and (b) improved quality of service, have helped to increase buy-in of the pricing reform from both politicians and farmers. Of course the process has not always been smooth (e.g., Andhra Pradesh), but the move is in the right direction. To encourage states even more, the Planning Commission has an Accelerated Irrigation Benefits Program wherein, if states increase the recovery of operations and maintenance costs, they are rewarded with additional funds to complete some irrigation systems. Several states have taken this up—Maharashtra, Rajasthan, Madhya Pradesh, Uttar Pradesh.

The approach must be to address farmers' problems rather than attack their perceived interests. Making appropriate infrastructure investments, creating a climate to encourage off-farm job creation, and utilizing participatory mechanisms to introduce new cropping incentives, improving targeting, recovering user costs, and managing common assets and resources would together result in more change and rationalization in the agriculture sector than any top-down attempt to enforce reform.

Chapter 9. Bringing up lagging states

Seven poor states—Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh, Orissa, Rajasthan, and Uttar Pradesh—are together home to over 40 percent of India's population and nearly 50 percent of India's poor. These states, as shown in chapter 1, have failed to produce sustained accelerated growth in the 1990s. Although they are growing at modest rates, they are increasingly lagging the rest of the country in investment, manufacturing, and income. These lagging states accounted for just 23 percent of total investment in 2003, while six richer states—Andhra Pradesh, Gujarat, Karnataka, Maharashtra, Punjab, and Tamil Nadu—attracted over 66 percent of the total. Just four states (Maharashtra, Tamil Nadu, Karnataka, and Gujarat) along with Delhi, accounted for 72 percent of foreign direct investment, while the seven poor states captured just 13 percent. The share of the lagging states in manufacturing output declined from 30 percent in 1990/91 to only 17 percent by 2002/03, and their share in All-India GDP fell from 32 percent in 1990/91 to 25 percent by 2002/03. As a result, the average per capita income of these seven lagging states relative to ten large richer states[55] decreased from 71 percent in 1980/81 to only 54 percent in 1999/00.

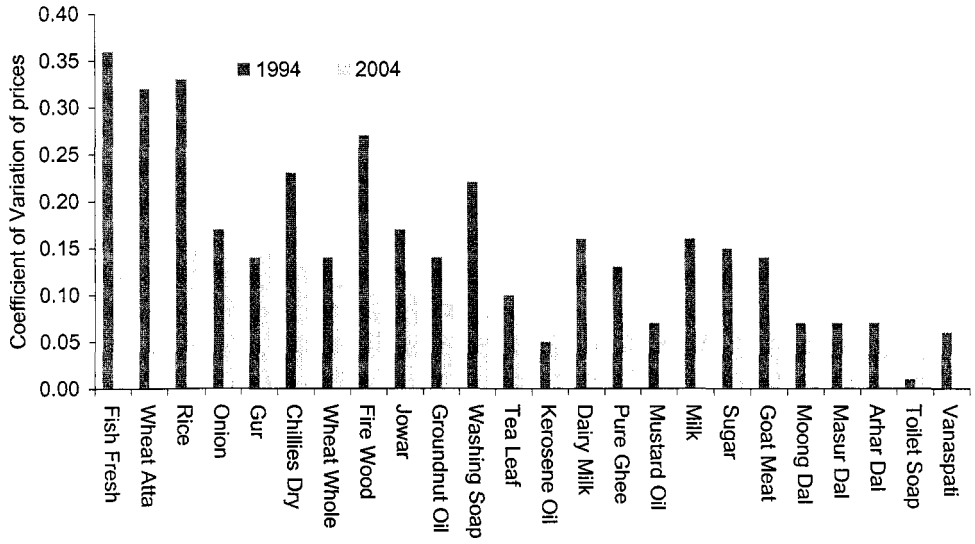
The gaps across states are widening in India, not because growth in the lagging states has decelerated, but because growth in the middle-income states has accelerated. And this is largely because the middle-income states were much better placed to capture the gains of the economic liberalization program launched in 1991, and they have managed to attract much more private investment over the past decade than the lagging states. But there is no reason why the lagging states cannot, accelerate their growth as well, through improving their investment climate. While it is the states themselves that ultimately need to take advantage of the growth opportunities presented, compensating transfers in state fiscal flows, especially against the background of the challenges created by increasing income disparities across states of India, can also play a role. This is discussed in the final section of this chapter.

Integrating India: goods and labor

The most straightforward way to address disparities across regions within a country is to ensure that there is a nationally integrated market in assets, goods, and labor. Policies that fragment markets—such as border taxes—can make it difficult for lagging states to attract job-creating investments. A recent study (Virmani and Mittal, 2005) commissioned for this report examined whether India was becoming more or less integrated as a national market by examining the differences in prices across regions of India. It appears that commodity markets are much more integrated in 2004 than a decade ago: the coefficient of variation of prices (the ratio of the standard deviation of prices to the mean), which is a measure of dispersion of prices across markets, fell for nearly every commodity, and the median fell from 0.14 to only 0.08 (figure 9.1). Continuing to eliminate barriers to movement of goods across state borders and across regions is important to make the lagging states more attractive as a location for production for the domestic (or international) market.

[55] These states are Andhra Pradesh, Gujarat, Haryana, Karnataka, Kerala, Maharashtra, Punjab, Tamil Nadu, Uttaranchal, and West Bengal.

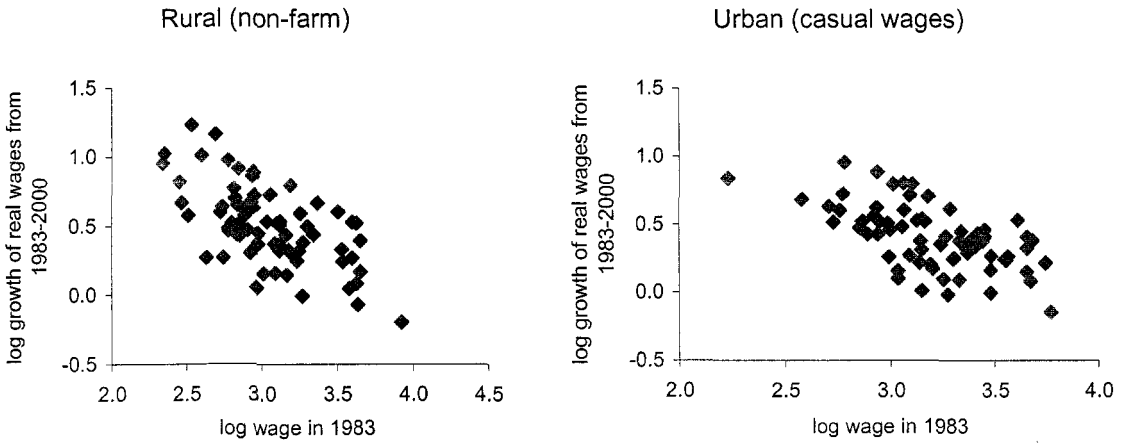
Figure 9. 1: Dispersion of prices across markets in India, by commodity, 1994 and 2004



Note: CV of prices indicates the coefficient of variation in prices (the ratio of the standard deviation of prices to the mean). It is a measure of dispersion of prices across markets.
Source: Virmani and Mittal 2005.

It has long been argued that, for a variety of social and economic reasons, labor markets are not well integrated across Indian regions and states. Wage differentials across regions create pressures for people to move, either temporarily or permanently, to regions with higher wages. There are signs of convergence in wages across regions, albeit at a slow rate. Figure 9.2 plots the growth of real rural (nonfarm) and urban casual wages from 1983 to 2000 against initial wages in 1983.

Figure 9. 2: Growth in casual wages in Indian states, 1983–2000



Source: Ahsan and Pages (2005)

There are other signs of important movements of population that have economic impacts. Figure 9.3 shows the growth of population and Gross State Domestic Product (GSDP) per capita on

equally spaced axes as a box with dimensions set at the 10th and 90th percentiles of the states on each of those axes. If population movements across regions are large and differences in per capita growth are small, consistent with labor markets that are very tightly integrated, then the box is a long and thin rectangle (which is true of economically integrated, highly mobile countries, such as the United States or Canada). In contrast, if movements in labor are small and differences in growth in output per person are large, then the box is a tall thin rectangle, consistent with poorly integrated labor markets (and which is true of data across countries). Over time, it appears that differences in population growth across states have grown—the 10th/90th box is wider in the 1990s—while the dispersion in output growth rates across states has not diminished. So, although the evidence on wage convergence suggests some increasing integration of labor markets, so far labor mobility has not been sufficient to cause convergence across states in India.

Figure 9. 3: Decadal growth of per capita gross state domestic product and population in India, 1961–99

Source: Author's Calculation

Unleashing the industrial potential of lagging states

A fully integrated national market is the first key step to addressing the issue of lagging states. With an integrated market, wage differences will cause some mix of people moving to jobs and jobs moving to people. While it is important to allow all Indians the freedom to pursue job opportunities no matter where they are, it is also important to encourage opportunities close to home—jobs moving to people—to encourage growth especially in the lagging states. But for that to happen, the lagging states have to be able to attract the investment sufficient to create jobs. And the investment will likely have to be in industry, particularly manufacturing, which still has the greatest potential to provide high-wage employment for the large proportion of the labor force still working in subsistence agriculture or as casual laborers and to integrate these workers into the modern, formal economy. Hence, the improvement in the climate for investment in industry in the lagging states is a priority, but a difficult one.

Table 9. 1: Investment performance of India's lagging states

The lagging states are:	*The better performers are:*
Bihar	Andhra Pradesh
Jharkhand	Gujarat
Madhya Pradesh	Karnataka
Chhattisgarh	Maharashtra
Orissa	Punjab
Rajasthan	Tamil Nadu
Uttar Pradesh	
Account for 23 percent of investment in 2003; 13 percent of foreign direct investment during the 1990s. Share in All-India GDP: 25 percent. Average per capita income: 54 percent of the average per capita income of other major states.	Attracted over 66 percent of the total investment in 2003; 72 percent of foreign direct investment during the 1990s.

Industrial output and employment in India remain concentrated in a few, better-performing states (and within them, in a few major metropolitan areas) (table 9.1). This reflects large gaps in manufacturing labor productivity across states (and cities). According to the World Bank's India Investment Climate Assessment 2004, labor productivity is almost 20 percent higher in the six states that have attracted the most foreign direct investment to the country, compared with the rest of India.[56] In part, this is because states with high foreign direct investment have managed to attract more investment in plant and equipment than other parts of India. The rate of plant-level net fixed capital formation in those states is 6.3 percent (against 1.6 percent in other states).[57] The cumulative outcome of these differences in capital formation is that the average employee is better equipped with machines and tools in states with high foreign direct investment (and in cities with low costs) than in other states and cities. Furthermore, because wage rates are higher in the high-investment states and the low-cost cities, the average employee there is more skilled and motivated.

[56] It is also 85 percent higher in about half a dozen metropolitan areas in the better performing states than in all other major cities.

[57] The rate of plant-level net fixed capital formation in low-cost cities is 10.3 percent (against under 2 percent in high-cost cities).

However, gaps in workforce skills and equipment are only part of the explanation of the spatial disparities in manufacturing labor productivity. Even if there were no skill gaps between states and between cities—if every employee was paid the same, exerted the same effort, and used the same technology—labor productivity would still be considerably higher in high-investment states (and low-cost cities) than in other parts of India because of the differences in external economies stemming from the geography of locations and the policy environment in which businesses operate—that is, in the investment climate. While external economies arising from the (economic) geography of any location are given in the short to medium term, unfavorable productivity gaps arising from deficiencies in the investment climate can, by definition, be remedied through appropriate policy changes.[58]

The binding constraints on manufacturing productivity in the current investment climate in India's lagging states are (a) inadequate infrastructure—particularly unreliable power supply, which leads to excessively high power costs for firms, and poor road networks, which add to firms' costs; (b) poor economic governance—particularly the red tape involved in starting and closing businesses, and the continuing burden of the "Inspector Raj," characterized by the interference of government inspectors, such as tax and labor inspectors, in the daily operations of firms—which places an excessive regulatory burden on firms and raises the costs of doing business; (c) serious law and order problems; (d) access to land; and (e) access to finance.

Reducing infrastructure bottlenecks

Table 9. 2: Infrastructure index ranking of Indian states

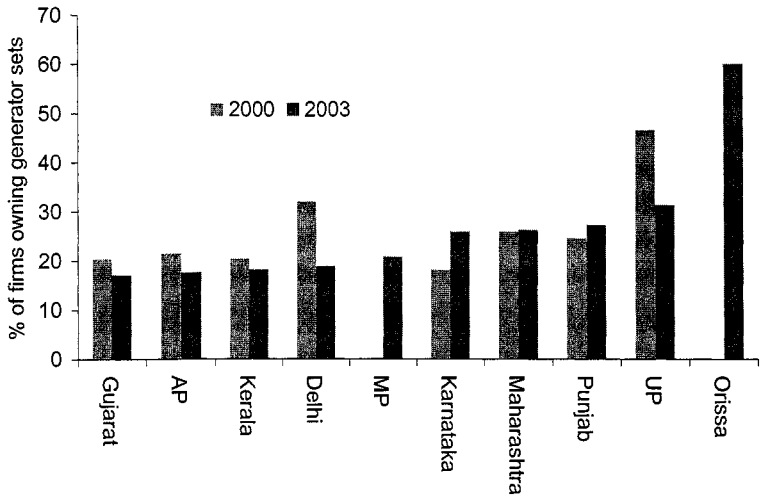
Rank	*State*
High	Goa, Maharashtra, Punjab
High middle	Gujarat, Haryana, Kerala, TN
Middle	AP, Karnataka
Lower Middle	HP, MP, Orissa, UP, Uttaranchal, WB
Low	Arunachal Pradesh, Manipur, Meghalaya, Jharkhand, Mizoram, Nagaland, Assam, Chhattisgarh, Sikkim, Tripura, Bihar, Rajasthan

Source: Report of the Twelfth Finance Commission, Government of India, 2005.

In the Infrastructure Index presented in the report of the Twelfth Finance Commission (Government of India 2004), among the major Indian states, Jharkhand, Chhattisgarh, Bihar, and Rajasthan are ranked in the lowest category for access to physical infrastructure, while Madhya Pradesh, Orissa, and Uttar Pradesh are in the second lowest category (table 9.2).

[58] See India Investment Climate Assessment , World Bank 2004e (op. cit.).

Figure 9. 4: Access to power in India's lagging states

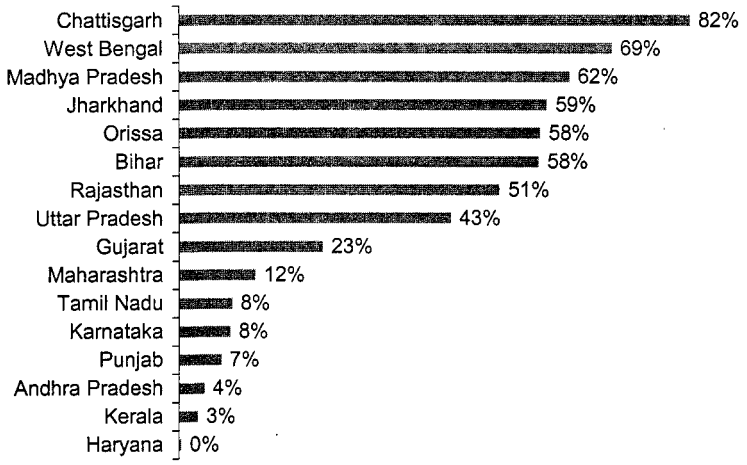


Source: World Bank 2004a

According to the India Investment Climate Assessment 2004, the problem that firms in India's lagging states face in accessing reliable power at reasonable cost is among the most significant factors constraining business profitability, and thus it is a key factor in reducing the attractiveness of these states as investment destinations. With a few notable exceptions, firms in India's lagging states generally have inferior access to power from the grid than firms in the richer states. This leads to heavy reliance by firms on their own generators (figure 9.4). By far the worst situation appears to be in Orissa, where 60 percent of the firms surveyed reported relying on their own generators; in Uttar Pradesh, over 30 percent of firms report owning generator sets. Contrast this with the better states, such as Gujarat, where just 17 percent of the firms surveyed rely on their own generators, or Andhra Pradesh, where the figure is 17.6 percent (similar to Brazil and lower than in China). In turn, this translates into very high costs of power for businesses located in the lagging states, reducing profitability. Indeed, firms in Uttar Pradesh's capital city, Lucknow, currently report paying $0.10/kwh for electricity, compared with the Indian average of $0.08/kwh for industrial use, and lower costs in some Indian states. Our calculations presented in the World Bank's India Investment Climate Survey 2004 indicate that, if the cost of electricity for firms in Lucknow were to be reduced to the nationwide average, firm-level profitability would increase by almost 8 percent. Furthermore, if prices were around those of Thailand at $0.05/kwh, then profits would increase by almost 30 percent relative to the baseline scenario.

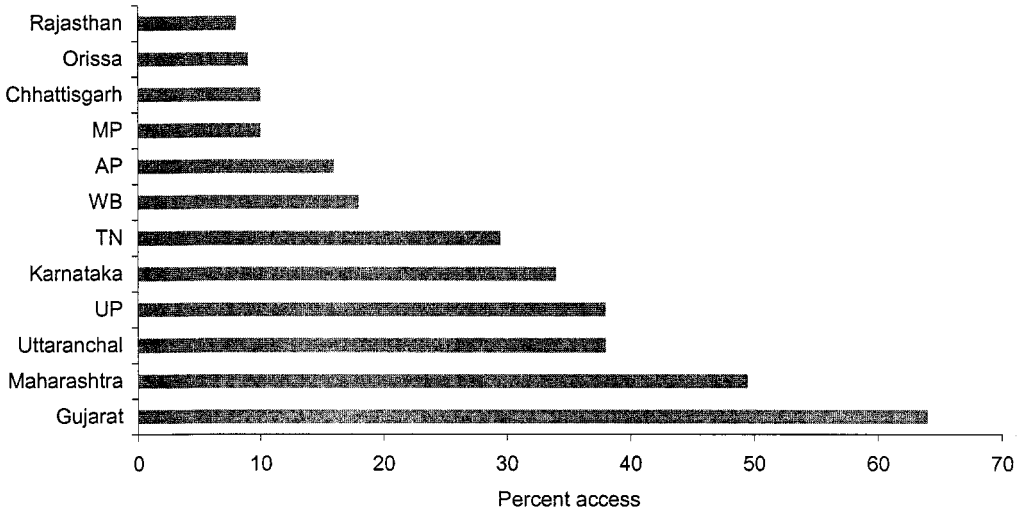
In general, the lagging states also have poorer access to other infrastructure services. For instance, among the major Indian states, Madhya Pradesh has among the highest proportion of habitations unconnected by roads, with Orissa, Rajasthan, and Uttar Pradesh not that far behind (figure 9.5). As shown in figure 9.6, access to sewerage facilities also differs greatly across states. The challenge of reforming infrastructure has been discussed earlier in chapter 6.

Figure 9. 5: Percentage of habitations not connected by roads, by Indian state



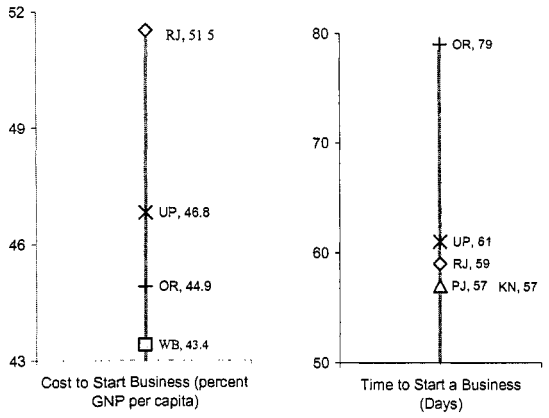
Source: All data from Ministry of Rural Development, Government of India.

Figure 9. 6: Percentage of the population with access to sewerage facilities, by Indian state



Source: Central Public Health & Environmental Engineering Organization, 2000.

Figure 9. 7: Cost and time required to start a business in India's lagging states



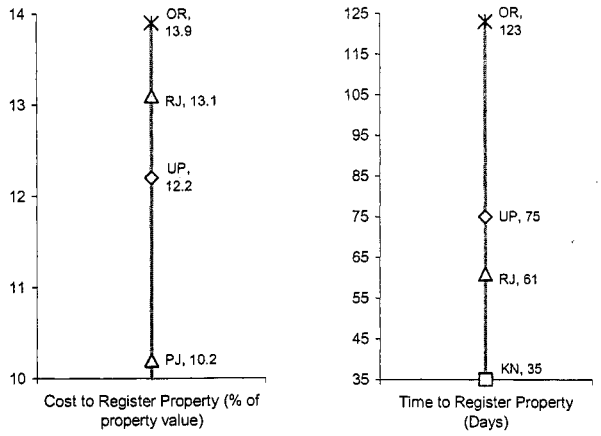
Source: World Bank 2004h

Improving economic governance

Poor economic governance—characterized by red tape and regulatory hassles—places a burden on businesses across India, but the problem is particularly severe in the lagging states. Regulatory procedures governing entry, exit, and day-to-day operations are cumbersome and require private investors to deal extensively with the state bureaucracy. Delays and harassment in these interactions are common complaints, and such governance failures impose severe costs on firms. In 2004, starting a business cost 51.5 percent of per capita income in Rajasthan, 45.8 percent in Uttar Pradesh, and 44.9 percent in Orissa (figure 9.7). This was considerably higher than the cost of startup in West Bengal (the best state in terms of the cost of business startup). Similarly, while it took as many as 79 days to start a business in Orissa (most countries in which it takes as many days or more to start a business are concentrated in Sub-Saharan Africa), it took 57 days in Karnataka or Punjab (the best states on this indicator). As these better states introduce measures to further streamline business startup, they can look to other emerging market economies (China: 48 days, Russia: 33 days, or Malaysia: 30 days).

Another entry indicator is property registration. Registering a property takes longer in India (on average, 67 days), than in China (32 days), Brazil (47 days), or Russia (52 days). But the gap between India's better states and the lagging states is much wider (figure 9.8). It took, for example, 123 days to register a property in Orissa; this number is comparable to many Sub-Saharan African countries. In contrast, registering a property in Karnataka (the best Indian state on this indicator) took 35 days, not much longer than what it took in China (32 days). Similarly, the cost to register a property was much higher in lagging states like Orissa, Rajasthan, or Uttar Pradesh, compared with Punjab (the best Indian state on this indicator).

Figure 9. 8: Cost and time required to register a property in India's lagging states



Source: World Bank 2004h

A key challenge for the lagging states is to introduce reforms to streamline clearances and approvals. They can learn from the experience of the better states. Some states (e.g., Karnataka) have increasingly moved away from "in-principle" to "actual" clearances and from sequential to concurrent approvals. Andhra Pradesh has introduced "deemed clearance." The better states have also introduced improved legal frameworks for business entry (e.g., Karnataka Industries Facilitation Bill). Another set of reforms is the introduction of business facilitation agencies (e.g., Gujarat's Index B, Maharashtra's Udyog Sarathi, Tamil Nadu's Industrial Guidance Bureau, and Andhra Pradesh's APFIRST for information technology firms). Simplified application forms for starting a business or registering property have also been introduced in many places, as have improvements to the functioning of the court system.

Cumbersome bankruptcy procedures make exit as difficult as entry. In 2005, it took 10 years to close a business in India, compared with 2.3 years in Malaysia, 2.4 years in China, and 3.8 years in Russia. Recovery rates in India, while higher than in China, were significantly lower than in Malaysia or Russia. The ease of closing a business also varies significantly across India. In 2004, closing a business took more than 15 years in Uttar Pradesh, 11.34 years in Orissa, and 10.42 years in Rajasthan. Contrast this with Karnataka (the best Indian state on this indicator), where it took 8 years to close a business; while considerably worse than in most emerging East Asian countries, this was still better than Brazil, where it took 10 years to close a business in 2004. Recovery rates are also much lower in Uttar Pradesh, Orissa, or Rajasthan, compared with Karnataka.

While the License Raj has been substantially reduced at the center, the pervasive Inspector Raj survives at the state level, as previously noted. Indian manufacturers face, on average, 7.4 visits a year from government officials who visit firms to inspect compliance with various laws and regulations (e.g., on tax, labor, and environmental standards) and to renew business permits. This is an improvement over the reported 11.7 visits a year that firms faced from government inspectors in 2000, and the number is lower than in Brazil and much lower than in China. But government inspectors still appear to take up a higher proportion of the time of senior

management in Indian firms each year (14.2 percent) than in China (8.1 percent) or Brazil (7.8 percent) (table 9.3). The burden of the Inspector Raj also varies across the Indian states. While firms in Maharashtra faced just five inspections a year, and those in Delhi faced less than four inspections a year, their counterparts in Orissa faced many more inspections a year.

Table 9. 3: Number of inspections a year and required management time in India and comparator countries

	No. of inspections a year	*Senior management time spent dealing with regulations (percent)*
India	7.4	14.2
Brazil	9.6	7.8
China	36.0	8.1

Source: World Bank, 2004e.

A key challenge for the lagging states that face a particularly heavy burden of the Inspector Raj is to streamline business procedures to reduce delays and opportunities for rent seeking. This may require reengineering the entire gamut of processes governing business operations, on the basis of clear principles of transparency, absence of discretion, and accountability. The experience of the better-performing states points to some important lessons. For example, in Karnataka, only a random sample of firms is inspected. In Andhra Pradesh, statutory inspections have been reduced to once a year. In Gujarat, the inspection process has been outsourced to accredited private agencies. Some states have introduced "self-certification": in Andhra Pradesh, barring major hazardous industries, all industries can self-certify compliance with labor laws. Annual returns and registers for labor regulations have been streamlined in Andhra Pradesh, Tamil Nadu, Gujarat, and Karnataka.

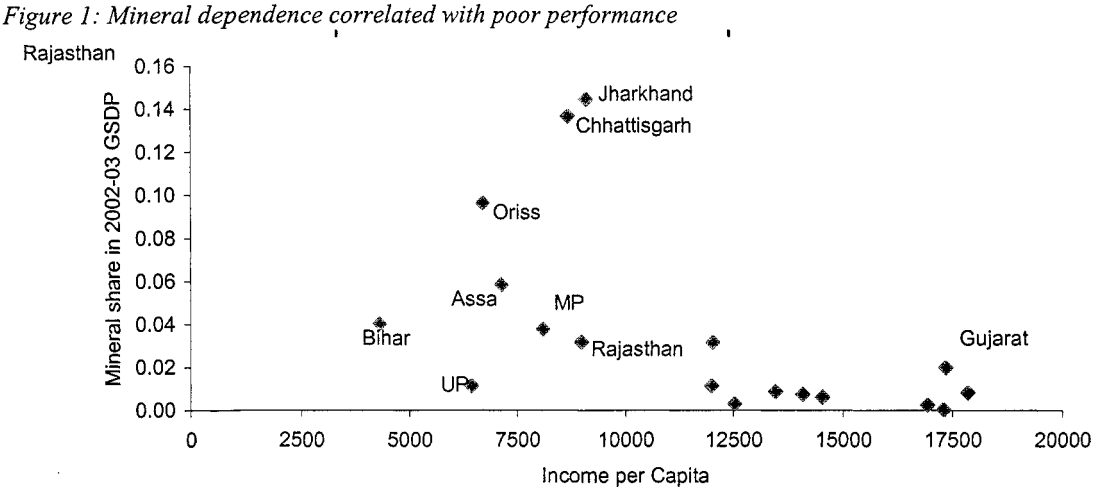
Some of India's lagging states—including Bihar, Jharkhand, Orissa, and Rajasthan—have a rich mineral resource base that could be developed by mining and quarrying enterprises. But many of the bottlenecks identified above have prevented these states from achieving their potential in this sector (box 9.1).[59] Some states have also questioned the current royalty regime which governs the distribution of benefits between the center and states.

Box 9. 1: Natural Resources in India's poorer states

Figure 1 presents a simple plot of per capita state income and the share of mineral production in state gross domestic product. India's lagging states generally have a higher dependence on mineral resources, but lower per capita incomes. Other measures of development produce a similar pattern: the mineral dependent states have consistently poorer human development scores, lower growth rates and higher levels of infant mortality. Global evidence indicates that in many countries, a high level of mineral dependence is associated with weaker economic performance, lower growth rates and inferior development outcomes. In particular countries that are dependent on point resources – i.e. resources extracted from a narrow geographic base (such as minerals) – perform poorly across a range of development indicators. This result is termed the *resource curse.*

[59] See "Turning the Minerals and Metals Potential of Eastern India into a Goldmine," CII and McKinsey, April 2005; "Rajasthan Economic Report," World Bank 2005; "Orissa—Investment Climate Assessment," World Bank 2005o.

Figure 1: Mineral dependence correlated with poor performance



There are numerous explanations as to why the resource curse might occur, but there is a broad consensus that weak governance, coupled with the technology of mining, are a key explanation. Extractive industries tend to be highly capital intensive, rely on a small number of skilled workers and are geographically concentrated. To establish linkages with the mining sector and catalyze growth across the economy requires good institutions and an investment climate that enhances the opportunities for firms to invest and create jobs. But the evidence shows that mineral dependent economies tend to have weak institutions that impede investment and development. Many of the reforms that are necessary to create a growth friendly investment climate place few demands on the budget. Hence the problem is not merely due to a shortage of finance. Instead, the prospect of rapid gain from mining reorients institutional and administrative priorities from concerns about the size of the pie (*growth*) to concerns about the share of the pie (*distribution*). Minerals and other point resources are an enticing target for rent seeking.

However, this outcome is not inevitable. Many countries have judiciously harnessed their resource wealth to create prosperous economies. Reviewing the diversity of outcomes indicates that there is no single recipe for success. Norway and Australia's strong accountable institutions ensure that minerals are exploited judiciously, environmental impacts are minimized and the windfalls are used to deliver public goods that sustain broad based development. In the developing world, Botswana's unique governance structure and fiscal rectitude promotes benefit sharing through the provision of infrastructure and public
goods that promote investment, while Chile's deep reform agenda has generated cross-sectoral growth. In so far as there are common threads, they include the following three elements of success: (*i*) a strategy that generates broad based growth, (*ii*) strong institutions and (*iii*) sequencing of reform.

- *Broad Based Growth Strategy*: Mining in isolation is unlikely to generate broad based growth and development. The success stories are in economies where mineral extraction has spurred or complemented development in other sectors of the economy. But this can only occur if there is an investment friendly climate that promotes linkages with upstream or downstream industries, or creates investment opportunities in other sectors. These generate the jobs and growth that spread the benefits of mining. Broad based development is therefore a necessary adjunct to a mineral dependent growth strategy.

- *Strong Institutions*: Strong institutions are needed to prevent the capture of benefits and promote investment. Institutions are also necessary to address the many and varied environmental and social costs of mineral extraction that impede growth.

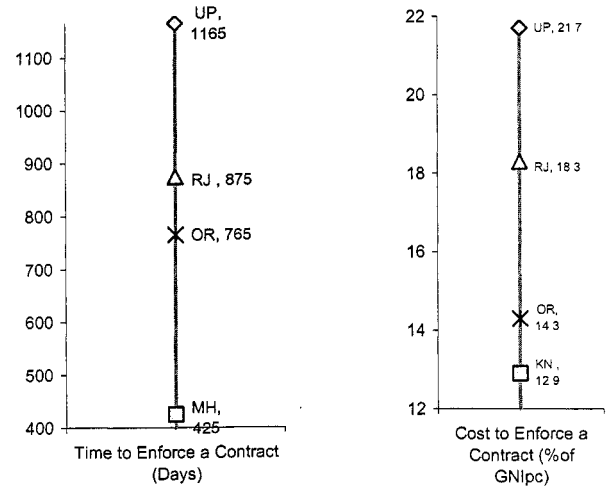
- *Sequencing of Development*: Mineral developments in countries with strong and accountable institutions have produced virtuous outcomes (e.g. Norway and Australia). Where institutions are weak, similar developments have had negative outcomes (e.g. Nigeria and Venezuela). Hence the timing of reform and development matters. Institutional strengthening and reform should be the center piece of a mineral intensive growth strategy.

Introducing law and order

A pressing concern faced by investors, particularly in India's lagging states, is the more basic problem of law and order. Investors will not invest unless their investments can be preserved and protected. A recent survey by *India Today*,[60] which provided a ranking of states according to their ability to maintain law and order, found that Bihar and Uttar Pradesh had the worst security situation among the major India states in 2005. The situation in Jharkhand, which has the lowest number of policemen (32) per 100,000 people, is not that much better.

A fundamental component of the rule of law is the ability to enforce a contract. The inefficiency of the court system in the lagging states means that it takes much longer to enforce a contract (1,165 days in Uttar Pradesh, 875 days in Rajasthan, and 765 days in Orissa) than in the best Indian state on this indicator (Maharashtra, 425 days) (figure 9.9). The cost of enforcing a contract was also much higher in Uttar Pradesh, Rajasthan, and Orissa, compared with the best Indian state on this indicator (Karnataka).

Figure 9. 9: Time required to enforce a contract in India's lagging states



Source: World Bank 2004h

Improving the efficiency of land markets

Some 90 percent of land parcels in India are reportedly subject to disputes over ownership, which take decades to settle in court. Furthermore, obsolete tenancy and rent control laws keep a large part of urban real estate off the market. The central government has abolished the Urban Land Ceiling Act, which made changes in land use very difficult; however, only a few states have repealed their corresponding acts, and the lagging states are typically not among these

[60] See "State of the States Survey," *India Today*, August 2005.

states. The inefficiency of land markets is a constraint to business development outside of the cities, too.

Improving access to finance for business

Problems in accessing finance are often cited as a major impediment to the performance of small and medium-size businesses in India, particularly in the lagging states. Per capita credit-to-deposit ratios are considerably lower in lagging states such as Bihar, Orissa, and Uttar Pradesh than in better-performing states such as Andhra Pradesh, Karnataka, Maharashtra, and Tamil Nadu (figure 9.10).

Figure 9. 10: Access to finance in Indian states, 2003
Per capita credit to deposit ratio, March 2003 (%)

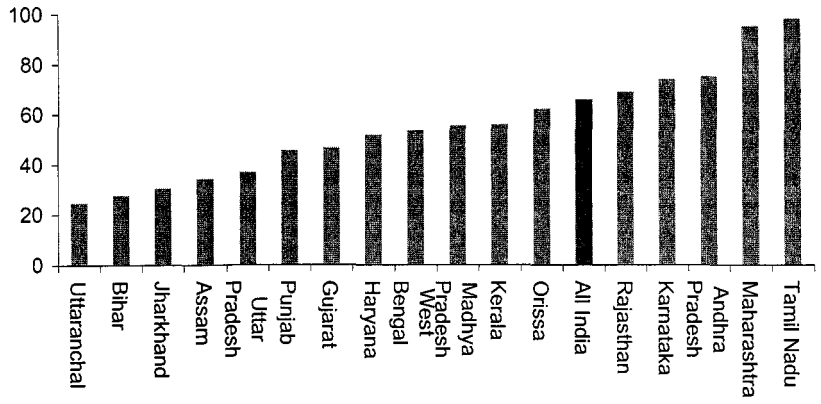
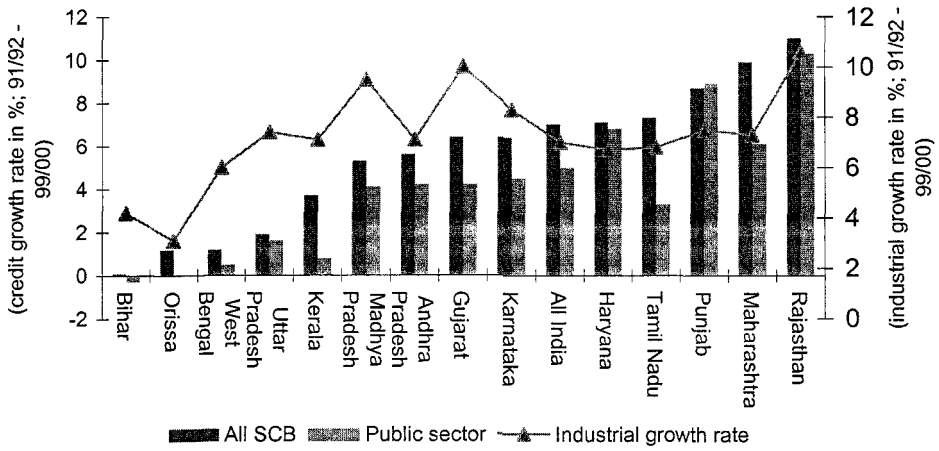


Figure 9. 11: Growth in credit and industrial output in Indian states, 1991/92–1999/2000



Another indicator of the difficulty that firms face in accessing finance is the flow of credit to small-scale industry. The data cover credit to small-scale industry units in 14 major states by all scheduled commercial banks and public sector banks for the period 1991/92 to 1999/2000. On this indicator, too, Bihar and Orissa perform the worst (figure 9.11).

Problems in credit access are attributable to a combination of factors that are rooted in (a) weaknesses in the legal framework for loan recovery, bankruptcy, and contract enforcement, together with inefficiencies in the court system, with the latter largely accounting for interstate variations in the time and cost of loan recovery and bankruptcy; (b) institutional weaknesses, such as the absence of good credit appraisal and risk management and monitoring tools in banks, which increase transaction costs in dealing with small and medium-size enterprises; (c) the absence of reliable credit information on small and medium-size enterprises; and (d) lack of sufficient market credibility for such enterprises. It is difficult for lenders to assess risk premiums properly, creating differences in the perceived versus real risk profiles of small and medium-size enterprises. As a result, these enterprises are often unable to tap lending opportunities.

All of these business constraints—infrastructure bottlenecks, government red tape, legal enforcement problems, and obstacles to securing land and finance—impose a heavy toll on productivity. Calculations presented in the India Investment Climate Survey 2004 attempt to quantify some of the cost. If, for example, power supply problems could be resolved so that the typical business need not rely on its own generators, manufacturing labor productivity in lagging states would increase by more than 80 percent. Reforms that would improve business regulation would increase productivity by more than 60 percent. If both reforms took place at the same time, along with reforms increasing access to land and to formal finance, average manufacturing labor productivity would rise by more than 160 percent.

These counterfactuals for the level of labor productivity translate to large gains in business growth and business investment rates from the same hypothetical reforms in the investment climate. For example, a 10 percentage point reduction in the indicators of deficiency in power supply, tax and customs administration, access to land, access to finance, and labor regulation that we have used in this report would raise the average firm-level sales growth rate from the current 11.3 percent to 15.9 percent a year.

Transforming the rural economy of lagging states

Even if all of these binding constraints to industrial growth and employment in the lagging states could be put in place, there would still be a need to get the rural economies of these states moving, given that the overwhelming majority of people in the lagging states still live in rural areas. Transforming the rural economy of lagging states will require not only improving agricultural productivity—addressed in chapter 8—but also facilitating rural (nonfarm) entrepreneurship. The latter calls for efforts on a number of fronts—but with particular attention to the binding constraints of rural infrastructure and rural finance.

Upgrading rural infrastructure

A better rural infrastructure (including access to power, roads, and telecommunications) is critical to rural economic transformation. Better access to roads can play a dramatic role in transforming the rural landscape by integrating the rural population into the formal economy. But more than 50 percent of rural habitations are not connected by road in the states of Bihar, Jharkhand, Madhya Pradesh, Orissa, Rajasthan, and West Bengal, and in Chhattisgarh, for instance, some 82 percent of rural areas remain unconnected by road (figure 9.5). Investing in road infrastructure is a critical priority in these states. Access to power can also have a transformative impact on the rural economy. Among the major Indian states, the challenge of rural electrification is the greatest in Uttar Pradesh, which reports the lowest proportion of electrified villages (under 60 percent). Access to a phone line can help link rural producers with markets, raise incomes, and change lives. Again, the lagging states, particularly Bihar, Chhattisgarh, Jharkhand, and Uttar Pradesh, have much catching-up to do on this front.

To address the issue of upgrading rural infrastructure, the United Progressive Alliance government recently (May 2005) announced the Bharat Nirman program. Under this program, the government is set to earmark a major investment for rural infrastructure in six areas: irrigation, drinking water and sanitation, roads, electrification, telecommunication, and housing:[61]

We are committing over Rs1,74,000 crores Bharat Nirman should unleash the growth potential of our villages...in the next four years we need to ensure that every habitation has potable water. Every village of over 1,000 population or over 500 in hilly and tribal areas, must have an asphalted road...we must also ensure that over one crore hectares of land is irrigated and that at least 60 lakh houses are built."[62]

While Bharat Nirman signals the government of India's commitment to the transformation of the rural economy and is a potentially useful program, the key to success will lie in the implementation. Bharat Nirman can be a vehicle for changing the way business is done by addressing the issues highlighted in part I of this report on service delivery—or it can be a fiscally costly continuation of business as usual.

Rural finance

Beyond rural infrastructure, another critical ingredient of rural transformation is access to finance. A growing body of research from around the world—some of it by the World Bank—shows that well-developed and inclusive financial systems are associated with faster growth and better income distribution. Finance helps the poor catch up with the rest of the economy as it grows. Finance also helps extend the range of individuals, households, and firms that can get a foothold in the modern economy, and it reduces damaging concentrations of economic power. Largely thanks to microfinance, there is now a growing appreciation of the "empowerment"

[61] http://www.hindu.com/2005/08/21/stories/2005082112900800.htm.
[62] Prime Minister Speech on October 2005. See http://news.indiainfo.com/2005/10/08/0810nirman-flagship-upa.html.

dimension of finance, of the extent to which it can give ordinary people and the poor access to opportunity and the ability to escape ossified social structures.

The financial sector strategies of successive post-Independence governments in India have been shaped by the goal of "serving better the needs of the development of the economy in conformity with the national policy and objectives."[63] To this end, the 1950s and 1960s saw the growth of a large number of rural credit cooperatives across India. The late 1960s witnessed the nationalization of commercial banks, which were charged with loosening the grip of traditional informal sector moneylenders through the use of targeted, low-priced loans. Between 1969 and 1980, thousands of new bank branches were established across rural India. Rural credit planning, involving quantitative credit targets and subsidized credit, became the order of the day. Mandatory requirements were placed on banks to direct large proportions of their credit to priority sectors, including agriculture and small-scale industries, identified as critical for bringing about economic and social change in rural areas. Competition was limited by the "service area approach," which limited entry. Severe constraints were placed on the operational and financial autonomy of banks.

While the 1990s saw increased competition and liberalization in the Indian financial sector, some of the key features of rural credit planning have persisted. Over the past decade, interest rates have been largely deregulated, although lending rates on small loans (under Rs 200,000) are capped at the prime lending rate, which banks are free to set; there is also a floor on short-term deposit rates. Priority sector credit requirements have been eased, but remain high at 40 percent. Debt or interest waiver schemes are used frequently. Competition in the banking sector has increased, but the public sector banks (including the nationalized banks, the State Bank of India, and regional rural banks) continue to dominate the banking system, accounting for 73 percent of commercial banking assets and 52.4 percent of the assets of all financial institutions in the system. Competition is particularly weak in rural areas, although the Reserve Bank of India's recent decision to dispense with some of the restrictive provisions of the service area approach may help stimulate the entry of new branches in rural areas.

But the evidence suggests that the provision of directed credit to farmers and small-scale rural industry on subsidized terms through the public sector banks has not met with much success (Basu 2005b). Recent data from a World Bank-NCAER Rural Finance Access Survey (World Bank 2003d) indicate that access to formal finance is a problem across rural India and is a particularly severe problem in some of the lagging states, such as Uttar Pradesh, where 80 percent of all rural households have no access to formal credit, and 87 percent of poor rural households have no access to credit from a formal source (Basu and Srivastava 2005). According to the Rural Finance Access Survey 2003, for those rural households that do have access to formal finance, commercial banks are by far the most dominant source. They account for 51 percent of household deposits and are also the most important source of credit. Regional rural banks account for 34 percent of household deposits and 31 percent of credit. Other formal sources, such as credit cooperatives and post office branches, appear to play a modest role in providing savings and credit services to rural households.

[63] Reserve Bank of India: Functions and Working, Mumbai, 1983.

For the minority with access to finance from a formal source, transaction costs are high. The 2003 survey indicates that all types of formal institutions demand bribes before approving loans. The bribe amounts are hefty, and higher in Uttar Pradesh than in Andhra Pradesh. Procedures for opening an account or seeking a loan are cumbersome and costly, with loan processing times tending to be much longer in Uttar Pradesh than in Andhra Pradesh. Longer processing times for loans, together with bribes, result in high effective costs for small borrowers (table 9.4).

Table 9. 4: Aspects of formal borrowing in Andhra Pradesh and Uttar Pradesh

	State Banks of India		*Regional rural banks*		*Coops*		*Others*	
	Andhra Pradesh	*Uttar Pradesh*	*Andhra Pradesh*	*Uttar Pradesh*	*Andhra Pradesh*	*Uttar Pradesh*	*Andhra Pradesh*	*Uttar Pradesh*
Interest rate (median) as percent per year	15	12	12	14	12	14	21	14
Loan amount received as percent of amount applied	87	93	81	95	88	79	72	95
Households reporting bribes as percent of all households	1.9	38.8	4.4	47.4	2.6	19.2	0	19
Bribes as percent of amount approved	6.5	10.2	9.8	23.8	4.5	16.7	0	13.9
Time taken to process a loan application (weeks)	25.7	36.5	25.9	32.3	25.4	22.0	7.5	22.0

Source: World Bank 200d.

Fiscal federalism and the Twelfth Finance Commission recommendations

Just as the overall performance of India's states has been increasingly divergent, so has the fiscal performance of its states, with fiscal indicators deteriorating much more rapidly in poorer states. Not only have the poor states suffered greater variability in revenues, with higher debt stocks and salary bills, they have also suffered more from recent expenditure shocks. Interest payments as a share of own revenues are nearly twice as high in poor states as in other states: in Bihar and Orissa debt service preempts more than 90 percent of own revenues. The tight fiscal situation in many of India's states is severely hampering the role of the state as an effective developmental agent.

Against this background, the recommendations of the Twelfth Finance Commission are welcome, and their implementation should assist the states in becoming more effective agents of development. As a result of the commission's proposals, there is a one percentage point increase in total taxes transferred to all states as a share of the government of India's tax take (from 29.5 percent to 30.5 percent). An even bigger increase is projected in grants: the average annual grants for all states are 143 percent higher during the Twelfth Finance Commission's tenure (2005–10), compared with the previous five-year period (2000–05). Loans to states from the government of India, however, will be much lower, consisting only of on-lending of external loans and credits. The commission has thus correctly sought to reverse the damaging trend established over the 1990s of fewer transfers and more loans.

Nine of the ten grants that the Finance Commission has rewarded are tied. The Twelfth Finance Commission has set up a Debt Relief Facility to replace the Fiscal Responsibility Facility. The total incentive offered by the Debt Relief Facility is bigger that the previous arrangements and is made up of two schemes. Enacting fiscal responsibility legislation qualifies states for restructuring of old central debt at significantly lower interest; and the second scheme offers a waiver on debt servicing as a reward for meeting prescribed annual targets for reducing the revenue deficit. Tied grants for maintenance (separate grants for roads, buildings, and forests) are conditional on states' increasing their own spending in these areas, as are the health and education grants, which are only for the poorer states. The obvious challenge for the states is to ensure that these funds are productively spent (box 9.2).[64]

Box 9. 2: State financial accountability issues

The World Bank has recently undertaken a series of State Financial Accountability Assessments, from which a number of lessons have emerged on public expenditure reforms:

Budget realistically and implement the budget as passed. A good budgetary set-up is one in which it is difficult to get some project into the budget, but then, after budget approval, implementation is automatic. In most Indian states, the opposite is the case. States are endemically overstretched, and their reach far exceeds their grasp. Any number of initiatives are introduced, and then underfunded. This shows up in a number of ways. Budget revenue estimates are systematically overly optimistic: for the five years ending 2002/03, budget revenue estimates exceeded actuals by an average of 8 percent. The systematic nature of this bias suggests that the problem is a political one and that revenue forecasts are inflated to allow artificially high expenditure levels to be projected. And then during the year, new projects are added through policy pronouncements and supplementary budgets, which often add another 5–10 percent to total spending. The result is that not only do deficits exceed targets, but cash and administrative rationing has to be used to prevent too many budgeted projects from actually proceeding. Projects thus lie incomplete, huge arrears of unpaid bills pile up, and an enormous amount of administrative time is consumed in persuading Finance to release funds. The most important budgeting reform that state governments could undertake would be to base the budget on realistic revenue forecasts, to restrict new policy initiatives to the budget period, and then to relax post-budget central controls on spending. This is harder than it sounds. It requires very tough decisions to be made on what governments can and cannot afford to d, and strong political leadership and ownership of the budget.

Enhance departmental accountability and flexibility in the budgetary process. In India's states, budgets are typically put together by scheme, rather than by department, and there is very little discussion of what money is being spent to achieve. Departments need to be given much more flexibility to spend money as they best see fit to achieve agreed targets within an agreed envelope of resources. This reform itself needs to be seen within the larger context of focusing departments on targets and results. Most departments do not have mission or vision statements; transparent performance monitoring is often absent, as is systematic citizens' feedback on services provided and individual accountability; management information systems are rudimentary; and anticorruption institutions are often ineffective.

Tighten budgetary controls over open-ended obligations and capital projects. While many of the micro controls typically exercised by finance departments can be relaxed, there are some areas where controls are too weak. Most subsidy obligations are open-ended and need to be redefined on the basis of "purchaser-provider" agreements, under which Finance commits to a certain subsidy level in return for an agreed delivery of services. Similarly, control over

[64] The TFC has set up a Debt Relief Facility to replace the Fiscal Reforms Facility. The principles of the two funds are the same: states are rewarded for revenue deficit reduction, albeit now in the form of debt relief or restructuring rather than the cash grants given earlier. However, the corpus of the Debt Relief Facility is much bigger than that of the Fiscal Reforms Facility. States can get significant restructuring simply for passing a Fiscal Responsibility Act, which has to meet certain minimum elements including the elimination of the revenue deficit by 2008/09 and a reduction of the fiscal deficit to 3 percent of GDP. If states not only pass such an act, but also reduce their current deficits on track to reach zero by 2008/09 and contain their fiscal deficit, they will in addition have their interest and principal repayments waived on outstanding debt to the government of India for the period of the TFC.

capital projects (over both their entry into the budget and their implementation) is weak, with far too many capital projects receiving minuscule amounts of funding and thus never being completed.

Tighten accounting and audit arrangements. India's accounting and audit arrangements are fine on paper, but neglected in practice. State governments have little information on their accounts in the course of the year; audit observations are not responded to; and many local governments do not even produce accounts, let alone audits. The challenge is to reactivate the system to reduce the gap between theory and practice.

Source: World Bank 2004a.

Not only does the Finance Commission aim to reduce the quantity of loans, but it also has tried to reform the borrowing regime, which has been characterized by soft budget constraints in the past. This is particularly important because India's states seem to be the most highly leveraged in the world.[65] While it is welcome that the central government has agreed to the commission's recommendation to stop direct lending from the central government to the states, it is unfortunate that the central government continues to compel states to borrow all the proceeds of the rapidly growing "small savings" fund (largely savings mobilized through India's post offices). This is a form of "forced savings," which is expensive and which teaches the states that they should borrow whatever is available, not what they can afford. The commission is silent on reform of small savings, but this is in fact the next important area of center-state fiscal reform.

Unfortunately, despite an expressed intention to make transfers more progressive, India's Twelfth Finance Commission seems to have made them marginally less progressive. The four biggest gainers in percentage terms are the richest states: Punjab, Gujarat, Haryana, and Maharashtra; while the average gainers are the poor states.[66] It is important to note though that these changes are made at the margin, and that overall the Finance Commission's transfers to the states remain progressive. In fact, although central transfers do not come close to achieving anything like horizontal equalization, Finance Commission transfers are still the most progressive of all the various channels of transfers from the central government to the states (negatively correlated with the level of income of states).[67]

For all that the center can do, through implementation of Twelfth Finance Commission's recommendations and other, follow-up reforms, India's states will ultimately be the masters of their own fiscal destiny, as shown in the case studies of Rajasthan and Bihar in the following annexes. The combination of a large increase in grants and tighter controls over borrowing will reverse the adverse resource trends the states have experienced since the early 1990s and will provide an ideal framework for fiscal adjustment by the states. But, while compensating transfers in state fiscal flows are important, in the end it is the states themselves that need to take advantage of the growth opportunities presented.

[65] In 2000, for all of India's states combined, the ratio of debt to revenues stood at 203 percent. Canada was next with 189 percent, followed by Brazil with 170 percent and Pakistan with 100 percent.

[66] Howes and Prasad (2005).

[67] Beyond these formal transfers there are hidden or implicit revenue transfers among states. For instance, a large hidden transfer is associated with the purchases of farm produce by the Food Corporation of India, which procures at above-market prices from some states. Attempts to quantify the benefits of this subsidy (World Bank 2004) suggest that Haryana and Punjab together account for 67 percent of the subsidy and receive more in Food Corporation of India subsidies than they do through the formal transfer system. These informal transfers vitiate the modest progressivity of the formal transfer system.

Annex 9. 1: Rajasthan: closing the development gap

Long considered one of India's lagging states, Rajasthan, in fact, made significant progress during the 1980s and 1990s: growth rates accelerated to become one of the fastest among Indian states; literacy and school enrollment increased rapidly, and poverty rates declined sharply. Indeed toward the end of the 1990s Rajasthan presented an example of how a lagging state could make progress in closing the development gap with India's more developed states. Now, though, Rajasthan presents an example of the deep challenges to sustaining development even after two decades of progress.[68]

Development prospects are now under threat from several directions. While India, on average, is growing rapidly, Rajasthan's growth has faltered markedly. A growing crisis in water supply and erratic rainfall calls for fundamental changes in agricultural and water management policies. Falling private investment rates—at a time when investment flows to other faster growing states are rapidly increasing—increase the risks that Rajasthan will be caught in a low-level development trap. Inadequate public investment in the late 1990s, poor maintenance, and management have led to a large shortfall in infrastructure. Weak public service delivery mechanisms impede further progress in human development, a key requirement for long-term growth.

This report recommends a medium-term reform strategy built around four goals:

- *Reviving growth.* If Rajasthan is to close its development gap with the national averages, its economy has to grow at a sustained rate of 7–8 percent annually, well above the trend of 4–5 percent in recent years. Agricultural diversification, supported by liberalizing agricultural marketing, modernizing research and extension, and a regionally differentiated strategy, will be critical to reviving agricultural growth. Since nonagricultural sectors account for three-quarters of gross state domestic product, restoring and accelerating growth in these sectors to at least their trend rate of the 1990s will be crucial. Rajasthan can expect to increase private investment rates significantly only if it offers a better investment climate than competing states. To achieve this, the government has to address still extant significant barriers to entry in key sectors, labor market rigidities in general, and poor infrastructure. The public-private partnership framework needs to be strengthened to attract private investment, and road connectivity needs to be improved through public investment in new roads and better maintenance. And while much has been achieved in increasing power supply in the state, large power sector losses threaten future supply and the state's fiscal stability.
- *Creating fiscal space for development and using it effectively.* After several years of acute fiscal stress, fiscal adjustment in the past two years has created fiscal space for much needed public investment. But because Rajasthan's fiscal position continues to be fragile, the main priority now will be to sustain the fiscal adjustment trend by effectively implementing the Fiscal Responsibility and Budget Management Act recently passed by the Rajasthan Assembly. With larger fiscal space and additional resources to spend, ensuring the quality of public expenditure has assumed greater importance. It will be particularly important to ensure that the rapidly increasing capital expenditures have high returns and are not thinly spread over too many programs. Containing expenditures on salaries will also be crucial for fiscal adjustment.
- *Strengthening civil service, local governments, and public accountability.* Despite strengths in some traditional areas of government, service delivery mechanisms in Rajasthan are weak, contributing to poor human development outcomes. The government of Rajasthan needs to take steps to improve the skills and composition of the civil service, reduce transfers and increase tenure, and make service providers more accountable for better public service delivery. Fiscal decentralization needs to be strengthened and an effective local government civil service cadre introduced to realize the full potential of local governments.
- *Sector specific interventions for human development and social protection.* While Rajasthan has made substantial progress in expanding education, challenges remain in enhancing its quality, closing the gender gap in secondary education, and extending services to disadvantaged groups. The health sector remains a cause for serious concern, even though there have been some improvements in recent years. Nonetheless,

[68] This annex draws on the Rajasthan; Closing the Development Gap (Economic Report) World Bank 2006

immunization rates have stalled, and child and maternal mortality rates remain high. Given the recurrence of droughts, social protection has assumed greater significance in Rajasthan. Rajasthan's weak monitoring and evaluation systems need considerable improvement to help achieve the state's human development and social protection goals.

Annex 9. 2: Bihar: toward a development strategy

A recent World Bank report (2004) identifies the key challenges that face Bihar: reducing poverty; increasing and sustaining the growth rate; improving the delivery of services, in particular in health and education; strengthening the accountability, performance, and transparency of institutions and government systems; and improving the law and order situation.

The report suggests that making economic and social development objectives central to government policy is vital for transforming Bihar's human and economic landscape. A development strategy for Bihar will require a multidimensional approach across sectors and institutions. For improving educational and health outcomes, it means working with different communities and organizations—private, public, and nongovernment—to leverage scarce resources. To strengthen institutions and update systems, it also means developing a vision and strategy for reforming the administrative system. It will also require improved fiscal performance to manage the mounting debt and carefully shepherd the state's scarce resources in the right direction.

The report suggests that the basic development strategy presented for Bihar could rest on two pillars:

- Enhancing Bihar's growth performance by establishing a better investment climate to encourage entrepreneurship, investment, and the spread of improved technologies, particularly in the rural sector.
- Supporting human resource development through improved quality and access to social services, particularly for the poor and socially disadvantaged communities.

The most critical feature the state needs to strengthen to improve growth is the delivery of core public services. Chief among these are the improvement of basic infrastructure, particularly in rural areas; the support of agricultural research and extension services; and the provision of basic law and order. Key infrastructure services in which the private sector cannot substitute public delivery include road and water management, especially for boosting investment and output in agriculture, agroindustry, and related services, such as transport, storage, and marketing. The public sector has an important role in basic capital investment and maintenance of large and medium-scale water management systems. Private and community management of small-scale and feeder systems has been effective in some pilot cases where communities have organized themselves, and this now needs to be scaled up.

To underpin the development strategy, efforts to reform public finance and public administration will be essential. Bihar is more dependent than other states on the government of India's support to the State Plan and Centrally Sponsored Schemes to meet its development expenditure. One of the challenges confronting the government of Bihar is to increase its utilization of the fairly substantial amount of resources allotted to the state under Centrally Sponsored Schemes. Bihar's relatively low utilization under these schemes is a concern also shared by the central government. In addition, the government of Bihar must build capacity for absorbing additional assistance from external donors in due course. A central constraint that has been flagged in the report and is recognized by government of Bihar, is the weak public expenditure management environment in the state. Addressing Bihar's large administrative reform agenda is fundamental both to efficient use of public resources and for improving government performance.

Chapter 10. Achieving equitable growth

India's rapid progress in the 1990s has not been uniformly shared among its people. As documented in chapter 1, income inequality has risen, although India still has a relatively balanced distribution of income by global standards. By other measures of well-being, it remains a deeply unequal society. There are large differences in education and health status, for example, across groups defined along axes of wealth, gender, caste, ethnicity, and location of residence.

In principle, beyond some absolute threshold of deprivation, inequalities in status may not be a cause of worry, as long as they reflect differences in preferences, effort, talent, or luck. Indeed, income differences play an important role in providing incentives to invest in education and physical capital, to work, and to take risks. However, inequality in opportunities across people is of concern for intrinsic reasons and also because it may have an instrumental impact on the development process.[69] The 2006 World Development Report on Equity and Development focuses on two broad sets of channels through which inequality in opportunities can constrain long-run development (World Bank 2005a). First, there are many market failures (notably in markets for labor, land, credit, and insurance) that distort resource allocation, so that resources do not flow to those who have the highest returns. For example, highly capable children may fail to complete primary school, while others who are less able may finish university. Second, high levels of inequality tend to lead to economic institutions and social arrangements that systematically favor those with more influence. Society as a whole is likely to be more inefficient and miss out on opportunities for investment and growth.

Policies that promote equality of opportunities can thus not only enable the poor and excluded to participate in the development process, but can also lead to more rapid long-run growth. In general, correcting the market failures that lead to structural differences in opportunities is the ideal response. Where this is not feasible, or too costly, some forms of redistribution (e.g., assets, access to services) can increase economic efficiency. It is important to note that pursuit of equity as defined here in terms of equality of opportunities does not imply a focus on redistribution of income, which at least rhetorically drove many of the regulatory policies pursued from the 1950s to the 1970s, without achieving either growth or redistribution. Liberalization of the last two decades has unlocked enormous potential and shown India's capacity for sustained growth and poverty reduction. To make the most of this potential, the challenge is to continue rapid growth, but also to make the growth and development process more inclusive.

This chapter discusses the role of public action in equalizing opportunities by promoting equality in access to markets and assets and by scaling up efforts to strengthen livelihood strategies through empowerment. Even with the best of access to markets and opportunities, there are needs for the government to engage in social protection to assist the poorest and help in coping with the risks and vulnerabilities that citizens face. Social protection measures are important to

[69] Inequality of opportunities implies that individuals born in different groups (e.g., caste, gender, or class) have unequal chances of acquiring assets, earn unequal returns to equivalent assets (for similar effort), have unequal access to adequate quality basic services and are treated unequally in the processes that govern economic, social and political life.

combat extreme deprivation, but can have equally important dynamic efficiency effects by allowing people to bear risks and undertake profitable investments.

Equality of access to markets and assets

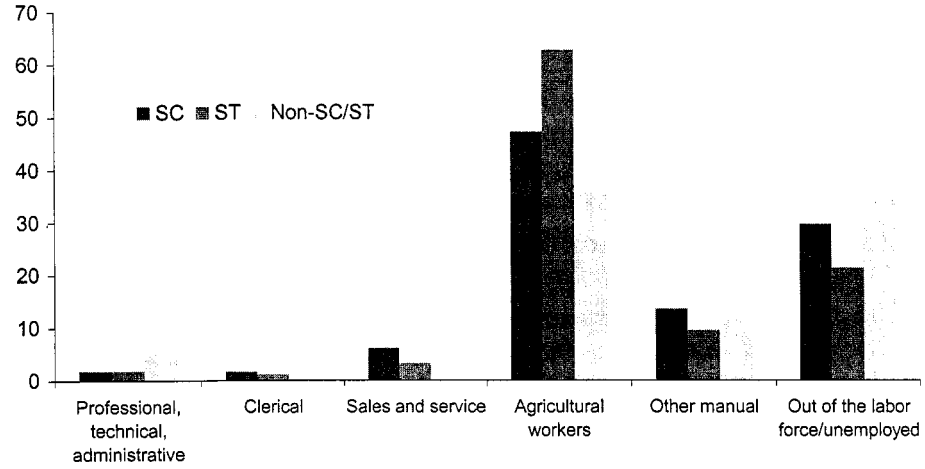
There has been a seismic shift from a view that the poor need to be protected *from* markets to the view that a better route out of poverty is to help them to strengthen their own livelihood strategies through empowerment and fair *access to* markets for labor, credit, land, and products. This section focuses on policies to expand access to markets for labor, a key asset of the poor, and for credit, which imparts both economic and empowerment benefits.[70] Despite a variety of schemes and policies, tribals remain one of the most marginalized groups in the country. For tribals, the critical issue is not access to markets; rather, a central factor affecting them, as described below, is secure access to and control over natural resources. Finally, this section considers government and private sector initiatives to strengthen rural livelihoods by improving people's access to markets and services, focusing at the same time on increasing people's sense of empowerment.

Addressing caste and gender bias in labor markets

Caste has historically been the key axis of stratification in India, responsible for major inequalities in access—in areas as diverse as jobs, technology, education, and health. Caste is especially important for labor markets because it has at once a ritual and an occupational logic. Thus, strict rules of dining and marriage, based on ritual purity and pollution, have historically governed the relations between castes, and an equally strict division of labor has meant that only certain castes or subcastes undertook certain occupations. In spite of far-reaching changes, some occupations continue to be caste based (figure 10.1). Even within the public sector, members of the Scheduled Castes (SCs) dominate the manual jobs of sweeping and cleaning—historically assigned to them in the caste hierarchy. Other occupations—notably the nonagricultural semiskilled jobs—also tend to be caste-based. Members of the Scheduled Tribes (STs) are less beset by this demarcation, since they were traditionally assigned a role outside the pale of the caste system and since they for the most part own some land for subsistence agriculture.

[70] Measures to improve the functioning of land and product markets have been discussed in chapters 8 and 9.

Figure 10. 1: Distribution of occupations in India, by caste status, 1983–2000



Source: Das 2005.

The differences in occupation by caste are in part related to differences in education levels, but this is only a part of the story. Differences in occupation between SC/STs and other groups persist even when "observationally equivalent" persons (i.e., people with the same level of education, in the same region, etc.) are compared. Even controlling for such characteristics, SC/STs are much more likely to be in casual labor and less likely to be engaged in nonfarm self-employment (Das 2005). Recent evidence on the low mobility in the Indian labor market also finds significant effects of caste-based occupations (Munshi and Rosenzweig 2005).

Gender is another important axis of stratification that has a bearing on labor market participation. In India, despite robust growth rates, female labor force participation rates have remained stubbornly low compared with other developing countries. This has happened despite rising education levels among women; in fact, in a pattern peculiar to India and Pakistan, education lowers the likelihood of labor force participation by women. Two kinds of explanations have been articulated for women's low labor force participation in India. First, family honor in many parts of India rests on women's restriction to the home, thus affecting their ability to work outside the house (Chen 1995). These norms, however, tend to be lax among the poorest, who cannot afford the cultural trappings of status. Hence, the majority of women who do enter the labor force are those with weak options—uneducated women who take to casual labor. Second, there is evidence to suggest that low participation rates of educated women are caused not merely by cultural norms of status and seclusion, but in large part by lack of labor market opportunities for educated women (Kingdon and Unni 1997). A recent study shows that nearly a third of the women who do only domestic work state that they would like to be employed—primarily in regular part-time jobs—and the response does not vary by education level, suggesting that lack of appropriate employment opportunities is likely a constraint (Das 2005).

Apart from scarcity of good jobs, there is also evidence of wage "discrimination," which is probably a further deterrent to female labor force participation. One study finds that among casual laborers, women get about half the wages of men, and observed differences in

endowments, education levels, and demographic characteristics explain only 28 percent of this differential in wages. Unobserved explanations, such as type of work, skill not reflected in education levels, and outright discrimination against women in the casual labor market, accounts for the rest of the wage gap (Das 2005). Other studies have also found similarly high levels of wage discrimination in the urban labor market (Kingdon and Unni 1997).

In the current context, job reservations are a tool for promoting labor market participation by those who are excluded. India has long had caste-based reservations in jobs that until recently have been the most coveted—regular salaried work in the public sector. Preferential treatment for SC/STs (and more recently for the group identified as Other Backward Castes) in other areas (such as age relaxation, waiver of application fees, etc.) and quotas in public employment works also aim to make labor markets more inclusive. While it is difficult to evaluate precisely the impact of these affirmative action policies, there is some evidence to suggest that these policies are helping SC/STs to overcome occupational barriers. In regular salaried work—which is still predominantly in the public sector and where the reservation policy operates—there is actually an advantage to SC/ST status in urban areas (Das 2005). However, while there are positive impacts of some types of reservations, the mere extension of reservation to larger and larger spheres without accompanying reforms creates real risks of freezing up rather than freeing opportunity. The same analysis finds that SC men suffer a disadvantage in regular salaried jobs, if they have more than primary education. This appears to indicate that educational attainment of SC men has risen over time, and the reservation policy, which seems to work well, also creates a system of rationing of jobs for SCs, exacerbating the existing shortage of formal sector jobs.

To make the playing field more even across castes and gender, the most significant reform that India can undertake is to reform labor laws. As discussed in chapter 7, current labor market protections benefit the small share of workers in the organized sector at the expense of creating more and better jobs for workers outside this sector. The dualism created between formal sector jobs and the casual and self-employed workers facilitates discrimination, such as gender and caste bias, in hiring.

Facilitating access to finance for the poor

As with labor markets, credit markets show considerable evidence of market failure. The vast majority of India's rural poor still do not have access to formal finance. According to a recent Rural Finance Access survey (RFAS 2003), 87 percent of the poorest households surveyed (marginal farmers) do not have access to credit, and 71 percent do not have access to savings from a formal source. This has resulted in a heavy reliance among poor rural households on informal finance, mostly moneylenders and shopkeepers, who charge exorbitant interest rates (World Bank 2004). In the rural sector, interest rates are high, but they are also variable. A survey of six villages in Kerala and Tamil Nadu found that, while the rich pay a relatively low rate (33 percent), the poor pay rates of 104 percent and get only 8 percent of the credit. There may be many economic reasons for interest rates to vary across borrowers, including informational asymmetries, lack of collateral, etc. However, these market failures affect the poor disproportionately, in ways unrelated to their investment opportunities, thus leading to both greater inefficiency and the perpetuation of inequalities.

There have been several initiatives to improve access to finance for the rural poor, through centrally sponsored credit-oriented rural livelihood schemes—starting with the Antyodaya Program in the early 1970s, followed by the Integrated Rural Development Program,[71] which was later revamped into the Swarnjayanti Gram Swarozgar Yojana (SGSY) in 1999. These programs have typically not yielded the intended outcomes.[72] The most notable effort is the Self-help Groups Bank Linkage model, the growth of which—from just 500 self-help groups linked to banks in the early 1990s, to over 700,000 by 2003—has been remarkable. Data from the RFAS 2003 show that the bank linkage program appears to have targeted the rural poor effectively, reducing the vulnerability of clients. One particularly successful scaling-up of the bank linkage model is the Indira Kranti Pratham project in Andhra Pradesh (box 10.1).

Box 10. 1: The Indira Kranti Pratham Project in Andhra Pradesh

After a long gestation period, beginning with the Development of Women and Children in Rural Areas groups in 1982–83, followed by the UN Development Programme's South Asia Poverty Alleviation Project in 1995, which was then scaled up across the state with the formation of Velugu (recently renamed Indira Kranti Pratham) in 2000, this movement has experienced exponential growth. To date approximately 6 million rural poor women have been organized into self-help groups and village organizations at the village level, Mandal Samakhyas at the block level, and Zilla Samakhyas at the district level.

Building on the growing capacity of these self-help groups and the mandatory lending that National Bank for Agriculture and Rural Development provides, Velugu has made significant strides in linking the self-help groups and their federations with the financial sector by increasing the access to commercial credit. Total annual credit to poor households and their groups has increased twelvefold from Rs 2.3 crore in 2000 to Rs 27.6 crore in 2005. The total credit flow from commercial banks to these groups since 2000 has grown to Rs 63.1 crore and is expected to reach 100 crore by the time the project closes.

As this movement has matured, it has expanded in scope. It now provides access to social safety nets and risk management instruments (insurance products) and greater food security (rice credit lines). The project is also supporting livelihoods promotion and expansion in several key areas of agriculture, horticulture, services, and agribusiness.

In recent years, other models of microfinance—modeled on the Grameen Bank model pioneered by Muhammad Yunus in Bangladesh—have also emerged in India, although the outreach of these specialized microfinance institutions is modest in comparison to the Self-help Group Bank Linkage and microfinance institutions elsewhere in the world. The collective outreach (concentrated mainly in the south) of Indian microfinance institutions is limited: in March 2004, the microfinance sector had loans outstanding of about Rs 5 billion ($116 million), reaching less than 2 million people, a tiny fraction of India's poor.[73] Furthermore, Indian microfinance institutions tend to have a narrow scope, offering a limited range of financial services beyond credit. Only a handful of institutions, such as VSSU (West Bengal), offer savings as a service.

[71] The program was rife with elite capture, poor loan recovery, as well as nonproductive investments.

[72] A large number of self-help groups were formed under this scheme, but as of 2003–04, only one in every 50 self-help groups had taken on economic activities.

[73] In contrast, MFIs in Bangladesh are estimated to reach more than 60 percent of the poor, with the larger programs such as Grameen, BRAC, and ASA all reaching over two million clients, each. Grameen Bank's loan portfolio alone exceeds that of the entire microfinance sector in India by a factor of over two whereas both BRAC's and ASA's portfolio is more than one and a half times that of all microfinance institutions in India.

Few provide insurance, and only the top three in India offer a composite set of services to their customers.

The limited scale and scope of Indian microfinance institutions, relative to the giants in Indonesia and Bangladesh, reflects, at least in part, the absence of an enabling policy and a legal and regulatory framework, which limits the ability of microfinance institutions to mobilize member deposits, trade in equity, and raise debt from external sources. Microfinance institutions are also constrained by the lack of adequate capacity and skills in financial control and management, information systems, new product design, etc. Furthermore, since most microfinance institutions in India lend to self-help groups, this means that microfinance institutions in India are constrained by many of the same factors that have held back the outreach and scale of the Self-help Group Bank Linkage. In particular, capacity, time, and cost issues related to group formation have posed constraints. Strengthening the microfinance and self-help sector can, in the short term, serve as a quick way to deliver finance. But the medium-term strategy to scale up access to finance for the poor should be to "graduate" microfinance clients to formal finance institutions where they can access standard individual loans, possibly on a fully commercial basis. Efforts to promote microfinance should go hand in hand with efforts to make the formal sector better at "banking the poor," and both the government and the private sector can play a critical role in this context.

A better deal for tribals. Notwithstanding the provisions of reservation, affirmative action, and a multitude of schemes designed to enhance their economic and social status, tribals are among the most marginalized groups in the country. Tribal populations, constituting 8 percent of the population, suffer from geographic and sociocultural exclusion, as they inhabit relatively underdeveloped, remote, sparsely settled areas with inadequate access to basic amenities (roads, communication, education facilities, and drinking water). Their lack of representation and powerlessness result in an inability to negotiate with the state.

The central factors affecting tribal livelihoods are secure access to and control over natural resources. Large numbers of tribals, who live in and around forest areas, have depended upon forests for their livelihoods for generations. However, their customary rights over land and forest produce have not been adequately recognized and recorded at the time of reservation of these areas. As a result, they continue to be treated as encroachers in forest records, and their vulnerability is further exacerbated by perceived conflict with conservation priorities and displacement by development projects (mining, dams, etc.).

One important policy to redress inequities is the Panchayats Extension to Schedule Areas (PESA) Act, 1996. The act formally recognizes the tribal traditional system as the basic unit of self-governance, by empowering tribals to redefine their own administrative boundaries, and their village council (Gram Sabha) becoming their core institution. In addition, PESA gives rights to the ownership of nontimber forest produce to the respective Gram Sabhas. However, the envisaged transfer of decision-making power to the traditional Gram Sabhas has not been reflected in the state laws. Similarly, tribals have not yet gained rights to nontimber forest produce and corresponding benefits because of uneven implementation of the act, inconsistencies between PESA and state government provisions, and continued state control over collection and trade of key nationalized high-value nontimber forest produce.

A more recent effort, based on the assurances given in the Common Minimum Programme, is legislation to recognize and vest the unrecorded forest rights and occupation in forest land in forest-dwelling Scheduled Tribes and to provide for a framework for recording the forest rights. The draft bill has attracted broad support and also intense criticism (particularly from some conservation activists). The central issues of the debate relate to reconciling social justice concerns with ecological concerns (particularly related to parks, sanctuaries, and biodiversity hot spots) and to implementing the bill, given the doubts over the institutional capacity and commitment of the implementing agencies. One set of critics also argue that, while resolving social justice for tribals, the rights of forest-dwelling nontribal poor communities are not addressed by the proposed bill.

While the bill represents a progressive step in restoring social justice, at least partly, its success will depend largely on resolving implementation constraints. Unless the governance system (including institutional issues and accountability mechanisms) is addressed along the lines envisaged by PESA, affirmative action or other policies alone will not produce desired outcomes on the ground. What needs priority attention is developing a tribal development framework and strategy that addresses empowerment, service delivery, and livelihood dimensions in a holistic manner, with a clear focus on implementation.

Promoting rural livelihood and empowerment. The government of India and state governments are simultaneously working from the bottom up by implementing a number of rural livelihood initiatives to help ensure inclusive agricultural and rural growth. These initiatives focus on three key priorities: (a) economic support of livelihood activities that could increase incomes and reduce vulnerability; (b) strengthening the delivery of basic services, such as drinking water supply, education and health services, and access to rural infrastructure (rural roads, minor irrigation); and (c) empowerment, to enable the poorest to manage their resources well and benefit from economic opportunities. For example, the Madhya Pradesh District Poverty Initiative Project provides large grants to common interest groups of men and women federated by economic activity. The groups undertake a variety of activities, ranging from income generation (animal husbandry, service sector and village industries) and development of village infrastructure (e.g., water storage facilities) to land-based activities (e.g., land leveling, investment in tubewells, etc.). The private sector has also launched a number of initiatives aimed at expanding credit and linking rural people more effectively to input and output markets (box 10.2). These initiatives show that there is no intrinsic contradiction between commercial viability and fair access for the poor. With concerted efforts at mobilization, some types of livelihood interventions, such as the credit-oriented self-help groups, have been found to have significant impact on the confidence, communication skills, and decision-making abilities of women (table 10.1).

Box 10. 2: Examples of private sector initiatives to improve rural livelihood

ICICI banking services for the poor
To address the rural poor's unequal access to finance, ICICI Bank has led multiple initiatives to provide banking services at an affordable cost to the poor. ICICI has partnered with others to colocate automatic teller machines with rural Internet kiosks and explore SmartCard technology to provide secure, low-cost transactions and loan management. More important, ICICI Bank has created a network of 8,000 self-help groups, covering about 160,000 women, to serve as the vehicle for creating successful, microfinanced businesses. In the process, ICICI Bank has given these women the means to transform their social and economic lives, their families, and their villages.

ITC e-Choupal
ITC e-Choupal illustrates how improvements in technology and communications infrastructure can be good for both equity and efficiency in product markets. ITC e-Choupal today reaches out to and empowers over 3.5 million farmers in 31,000 villages by enabling them to readily access crop-specific, customized, and comprehensive information in their local language. Vernacular websites provide real-time information to even the smallest marginal farmers on the prevailing Indian and international prices and price trends for their crop, expert knowledge on best farming practices, and microlevel weather forecast. This significantly improves the farmers' decision-making ability, thereby helping them better align their agricultural produce to market demand and ensure better quality, productivity, and price discovery. The ITC e-Choupal model has been specifically designed to tackle the challenges posed by the unique features of Indian agriculture, which is characterized by fragmented farms, weak infrastructure, information asymmetry, and numerous intermediaries. Over the next decade, the ITC e-Choupal network aims to cover more than 100,000 Indian villages, representing a sixth of rural India, and to create more than 10 million e-farmers.

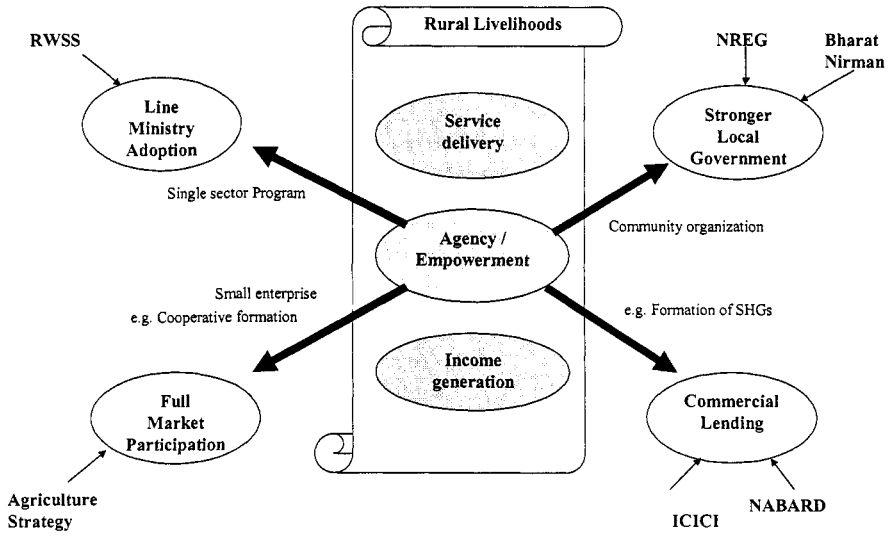
Table 10. 1: Impact of participation in self-help groups on women's attitudes and behavior

Indicator of change	*Before participation in self-help group (percent)*	*After participation in self-help group (percent)*
Self confidence and self-worth		
Exudes confidence	21	78
Can confidently meet financial crisis	33	85
Gets respectful treatment from family	40	89
Comes out to help neighbors/others	51	95
Decision-making		
Makes joint decisions on purchase of household assets	39	74
Makes joint decisions on social matters, such as education of children and marriage	42	69
Communication skills		
Speaks out freely	23	65
Talks only if asked	40	9
Behavior changes		
Protests drinking and gambling	37	81
Protests wife-beating by husbands	52	78
Suffers domestic violence	67	49
Has increased mobility	45	75

Source: Prahlad 2005.

These efforts are an important tactic within an overall growth strategy. Policies to create a thriving rural economy also require complementary approaches to ensure inclusion of all into that thriving economy—neither can fully succeed without the other. For rural livelihood interventions to be successful, their design and mode of empowerment needs to be tailored to local conditions. Depending on the key constraints in an area, livelihood interventions can vary in focus, with some credit-oriented (e.g., self-help group, SGSY), asset-oriented (e.g., Madhya Pradesh District Poverty Initiative Project), and market-oriented (ITE e-Choupal) programs. Successes in one state may not necessarily be perfectly transferable to others, because local conditions (natural, institutional, human, and cultural endowments) matter. Ultimately, the goals of the program will determine the optimal approach taken, in terms of who finances and who delivers the service (figure 10.2).

Figure 10. 2: Alternative paths for scaling up rural livelihood initiatives, depending on the objective and mode of empowerment



Providing social protection

The social protection system can play a role not only in mitigating poverty and inequality through redistribution, but also in helping address distortions that limit the opportunities for the poor to participate more fully in growth. In contrast to earlier thinking that assumed a tradeoff between equity and growth, recent research indicates that well-designed and well-implemented social protection systems can enhance current and future opportunities by mitigating failures in credit, insurance, and other markets that affect the poor most strongly.[74] They can also play a role in facilitating efficiency-enhancing reforms. Thus, social protection can have equity and dynamic efficiency functions.

India has a long tradition of programs that have attempted to mitigate chronic poverty, most notably the Public Distribution System, but also housing programs for the poor; categorical cash transfers to the destitute elderly, widows, and people with disabilities; and stipends and other programs targeted to SC/STs.[75] There have also been many promotional programs that attempted to smooth or raise permanent income, including public works schemes, subsidized

[74] See World Bank (2005a). See Townsend (1994); Morduch (1995, 2003); Ravallion and Chaudhuri (1997), and Munshi and Rosenzweig (2005) for evidence on informal support networks in promoting consumption smoothing.
[75] Programs to support the elderly are likely to become increasingly important over time as the population ages and, as already evident, traditional co-residence patterns become less common.

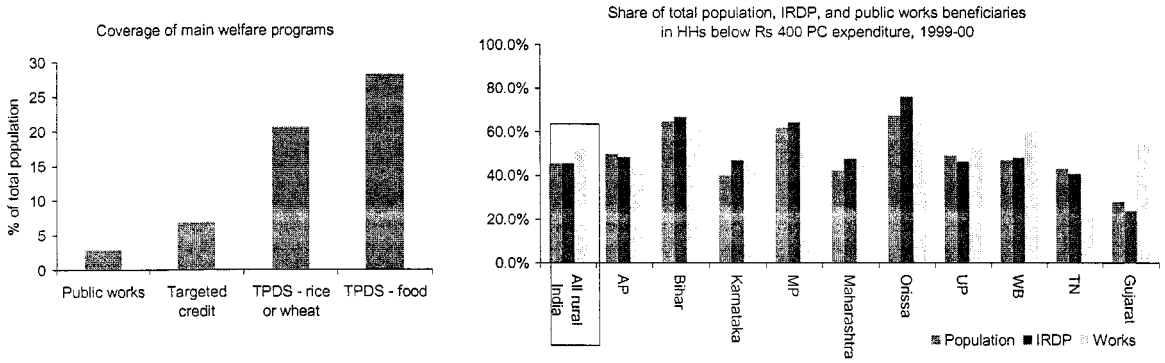
credit for the rural poor, and school feeding programs. This section reviews the extent to which performance has achieved objectives of redistribution, protection, or opportunity enhancement.

India appears to have entered a phase of expansion in social protection spending, driven in large measure by a shift toward greater central financing. Spending on core antipoverty programs has expanded in most recent years in real terms (and as a share of total spending in GDP). The expansion has been driven primarily by an increase in public works programs (which reversed a decade-long real decline), as well as the scheme to provide midday meals. While it is unlikely that the rate of expansion will continue, legal commitments (such as the rural employment guarantee) and initiatives (such as the expansion of social security to the unorganized sector) suggest that reversal is unlikely.

Institutional arrangements for social protection are unusually complex in India. This is partly driven by the multiplicity of programs and partly by the multitiered structure of governance. Despite the commitment of the government of India to rationalize programs,[76] and some progress in that respect (e.g., consolidation of multiple programs into SGSY), institutional responsibility for different social protection efforts is fragmented. The political economy of program reform may also militate against consolidation. The situation is made more complex by the increased role for PRIs in implementation, which brings in the new challenges of building capacity, delineating responsibilities, and increasing local flexibility in program design.

The impact of the major social protection programs in achieving redistribution and protection objectives appears relatively limited. With the exception of the Public Distribution System, coverage of the main social protection programs is very low, suggesting rather low redistribution (figure 10.3). Even within the Public Distribution System, coverage is still surprisingly low on core food items. At the household level nationally, targeting of public works is mildly progressive, and targeted credit is neutral. However, the variation across states is significant, with no clear pattern by income levels. Targeting performance is not particularly impressive by international standards, and overall the mitigation of poverty is likely to be low.[77]

Figure 10. 3: Coverage and targeting of major social protection programs



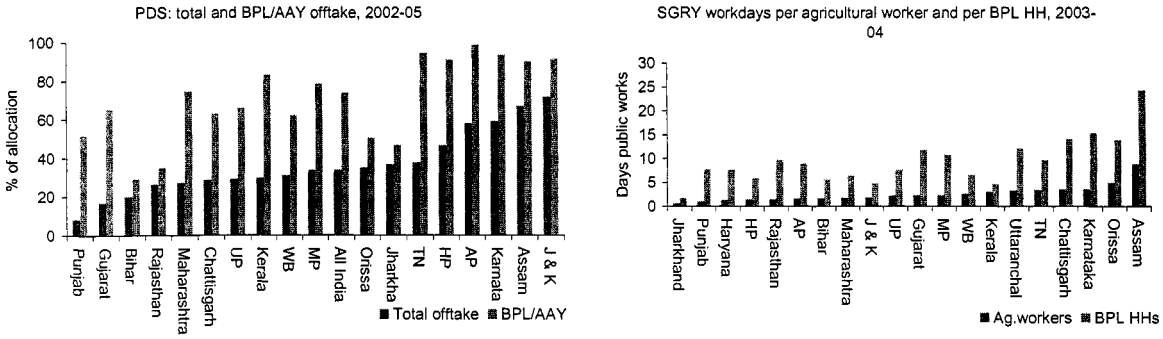
[76] See the Tenth Five-Year Plan.

[77] Coady, Grosh, and Hoddinott (2004) for targeting evidence from developing country transfer programs.

Notes: TPDS refers to Targeted Public Distribution System. IRDP refers to Integrated Rural Development Project.
Source: Public Distribution System, 58th NSS; credit and works, 55th NSS. Bank staff estimates.

Administrative data indicate that differentials in implementation across states have lessened the redistributive impact of social protection programs (figure 10.4). For the Public Distribution System, most poor states are notably below national averages in both total offtake and offtake of Below Poverty Line/Antyodaya Anna Yojana grains. The ratio between the grains offtake and total offtake is also generally lowest in the poorest states. The picture for public works is more mixed. In all states, employment generation has been well below policy targets. Across states, some of the poorest states (e.g., Bihar and Jharkhand) have achieved even more marginal employment generation, while others such as Orissa have performed better than average.

Figure 10. 4: Differences in implementation of social protection programs, by state



Another factor driving targeting outcomes is the Below Poverty Line (BPL) system, which in its most recent version is a form of proxy means test and is required for access to various schemes. Despite its importance, the BPL current and previous methodology has been persuasively criticized,[78] and claims of abuse, including inflation of BPL rolls and exclusion of very poor households, have been widespread. The claims appear to be supported by evidence on estimated BPL households and issued BPL ration cards. While the two figures match at the national level, they often do not match in individual states, where both over- and undercoverage are pronounced (table 10.2).

Table 10. 2: Implementation of the BPL targeting system, by state, 2000

State	*BPL households (A)*	*BPL ration cards (B)*	*Ratio B/A*
All-India	652.0	655.5	1.0
AP	40.6	128.1	3.2
Karnataka	31.3	63.6	2.0
Orissa	33.0	43.4	1.3
UP	106.8	74.4	0.7
Rajasthan	24.3	18.6	0.8
MP	41.3	42.6	1.0

Source: Indiastat.com from Department of Food and Public Distribution.

[78] See Sundaram 2003.

While social protection spending is significant, the government of India's evaluations indicate that spending has not been cost-effective in promoting social protection for the poor, in part because of rigid program designs and in part because of major implementation problems driven by ineffective accountability mechanisms.[79] Major issues in implementation include (a) poor absorptive capacity, particularly in poorer states; (b) significant leakage of funds and food grains (e.g., 58 percent of Public Distribution System grains do not reach BPL households, according to the Planning Commission); (c) lack of public information for the target population on scheme eligibility and fund usage; and (d) weak monitoring and evaluation systems. Increased social protection spending therefore risks promoting greater inefficiency in resource use and exacerbating governance problems, unless a range of well-known design and implementation issues can be addressed.

A further factor in assessing the structure of social protection spending is the major role of food in transfer programs. The Public Distribution System remains the largest program, with workfare programs relying significantly on food (typically, 75 percent of wages). The midday meal program by its nature is food-based. Such reliance on food-based transfers is unusually strong in South Asia, while other regions and other lower-income developing countries have relied more on cash-based systems.[80] Untied cash transfers to the poor remain remarkably limited in India. The National Rural Employment Guarantee Act (NREGA) may improve the balance between food and cash, if proposals eventuate to make the center-to-state transfer in cash. There is also a proposal within the Ministry of Finance to experiment with greater use of cash in the Public Distribution System. However, to date the heavy reliance on food transfers limits options for poor households in the range of opportunities that transfers provide.

Interventions that enhance opportunities for the poor have operated in India for some time, but have been insignificant in spending terms and/or beset by implementation problems that have diluted their potential impact. Promotional programs include social insurance, targeted credit, and to some extent public works. Social insurance spending in India is concentrated almost entirely in the organized sector (and within that, the public sector). Spending is dominated by civil service pensions, which accounted for 2.1 percent of GDP in 2003–04, with one of the fastest rates of spending growth in recent years.[81] As a result, coverage of social insurance remains very low, with the exception of life insurance (table 10.3), and its contribution to risk management for the population remains minimal. There have been several attempts at the national level to promote coverage of social insurance in the unorganized sector, but they have failed to achieve significant penetration.[82] A number of states have also introduced welfare funds, and insurance schemes through nongovernmental organizations are proliferating (e.g., SEWA; Yeshasvini). Welfare funds have in some states achieved significant coverage, but there are concerns about weak financial protection, financial viability, and high administrative costs. Community-based schemes in contrast are more focused, but face challenges of scale. The

[79] See Government of India evaluations of SGSY (CAG, 2003), TPDS (Planning Commission, 2005a), EAS (Planning Commission, 2002). See also Radhakrishna et al (2004); Dev et al. (2001); Nayak, Saxena, and Farrington (2002).

[80] See Coady, Grosh, and Hoddinott (2004), which found that simple cash transfers accounted for 27 percent of programs in the poorest countries, but 54 percent in higher-income developing countries.

[81] A DC pension scheme has started in several states and national legislation is proposed for early 2006. This could contribute to a declining civil service pension/GDP ratio over time.

[82] See ILO (2003); Dev et al. (2001); O'Keefe (2005).

government of India is again proposing a major social insurance program for the unorganized sector, covering health, life, maternity, disability, and old age insurance. While the draft proposals address issues of intermediation and transactions costs ignored by previous efforts, they seem very ambitious in light of Indian and developing country experience.

The benefit of public works programs in enhancing opportunities for the poor has been largely disappointing, with notable exceptions, such as the Maharashtra Employment Guarantee System in the 1970s and 1980s. Public works programs were hoped to provide implicit insurance functions for the poor, to create assets that could boost economic performance, and to encourage gender equality by promoting opportunities for women. Most of these benefits either have not been realized (e.g., women's share in public works is less than their overall rural labor force share) or have not been measured because of poor evaluation methods (e.g., the economic impact of assets created; insurance functions). The National Rural Employment Guarantee Act offers an opportunity to achieve better outcomes (and measure them), but previous experience also suggests major risks (box 10.3). Subsidized credit for the poor, primarily through the Integrated Rural Development Program in the 1990s and subsequently through SGSY, has also failed to achieve significant penetration because of a range of supply and demand problems.

Table 10. 3: Coverage rates of social insurance in India's organized and unorganized sectors, 2004

Social insurance program	*Organized sector coverage (percent)*	*Unorganized sector coverage (percent)*
Public schemes		
Employees' Provident Fund	25.1	0.18
Employees Pension Scheme	12.2	0.02
Government Pension Scheme	48.7	0.24
Government Provident Fund	54.0	0.21
Contributory Provident Fund	4.0	0.02
Commercial schemes		
Life insurance (endowment)	54	23
Personal accident insurance	3.6	1.2
Private health insurance	2.0	0.5
Nonlife general insurance	2.8	1.4.

Source: ADB/MOF survey 2004. Bank staff estimates.

Box 10. 3:The National Rural Employment Guarantee Act

The National Rural Employment Guarantee Act (NREGA) is the government of India's most ambitious public works initiative, guaranteeing every rural household at least 100 days employment per year at the agricultural minimum wage, subject to a nationally mandated minimum of 60 Rs/day. Coverage would initially be confined to 200 backward districts, with nationwide rural coverage within five years. Analysis to date suggests a mixed picture on costs and benefits. First, there is significant potential for a lean season Employment Guarantee System (EGS). Simulations of a nationwide 100-day EGS suggest (Murgai and Ravallion, 2005):

- The lean season rural poverty rate could be reduced from 37 percent to around 23 percent, or to around 30 percent on a yearly basis.
- The fiscal cost would be around 1.7 percent of GDP annually, if implemented nationally.
- The gains should be progressive, with the poorest quintiles accounting for 29 percent (and the

richest quintiles for 10 percent) of participants, and gains from EGS coming to 51 percent of pre-EGS consumption levels for the poorest quintiles (7 percent for the richest). The bulk of expected participants would be casual laborers.

However, there are design issues that raise concerns of effectiveness, efficiency, and potentially equity. They include:

- Using state agricultural minimum wage rates as the scheme wage rate is likely to be problematic. Scheme rates above market rates typically result in rationing, which experience from Maharashtra EGS confirms applies also to "guarantees."
- The direct transfer impact of EGS is significantly less than an untargeted transfer, because of the opportunity costs of participation. An untargeted transfer using the wage portion of EGS only would reduce poverty to around 15 percent—as against 23 percent from EGS. While the comparison is imperfect, because it measures only the transfer impact of EGS and not other economic impacts, nontransfer gains from EGS would need to be substantial to dominate an untargeted transfer.
- The point highlights the importance of achieving significant economic returns to EGS assets and for the poor to capture a reasonable share of the gains. A shortcoming of previous public works programs in India (and internationally) has been the absence of evaluations of the economic impact of assets.
- A significant improvement of NREGA over previous works schemes is the strengthened role for panchayats in design, implementation, and monitoring. However, it will be important to develop accountability mechanisms which avoid the bundling of functions by specific actors (in particular DRDAs), which has contributed to implementation problems in previous schemes. It remains to be seen if the incentive and accountability structure ensures that GPs are at the heart of NREGA implementation. In addition, the act offers limited guidance on funds flow mechanisms. If GPs are to be empowered, it would be important for them to have direct control over a greater portion of scheme funds than currently stipulated.
- The scheme benefits from a stronger monitoring and evaluation system than previous works schemes, including earmarked funds. To expand the system of concurrent evaluation to include robust impact evaluation, it will be critical to collect good baseline data before beginning the scheme.

Looking ahead to a more coherent social protection system

What is the desirable trajectory of social protection systems in India over the coming 10–20 years? Three lessons are clear from India's experience. First, the program mix between equity and opportunity-enhancing interventions for the poor should become more balanced to maximize both redistributional and dynamic efficiency objectives. There should also be flexibility for states to tailor programs to their conditions (e.g., food-based schemes are less needed in some states, where cash-based transfer options could be considered). Such an approach could in time evolve into a broader, conditional block grant system. Second, even in programs with a strong equity focus—which will remain crucial—policy reforms are needed and accountability mechanisms need major improvement, if they are to realize their redistributional objectives more effectively, particularly in several poorer states. Third, the mass expansion of contributory social insurance requires a sequenced strategy that takes account of country and state-level conditions and avoids the past experience of public schemes with high "announcement value," but limited impact. Differences across states in the pace of demographic transition, presence of intermediary organizations for unorganized workers, and other factors suggest that the states have very different potential for broad-scale insurance programs in the unorganized sector.

Improving safety nets

Because a major expansion of social assistance spending in India is unlikely, given India's current commitments and trends in other countries,[83] it is thus all the more important for India to be more efficient in the way it spends safety net funds. The improvements needed to increase accountability in program delivery have been reviewed in numerous assessments by the government of India and others. Specific, high-priority actions include:

- *Greater accountability.* There is a need to consider where different elements of responsibility for implementation should lie within the system. This will in a number of cases require "unbundling" implementation functions to exploit the comparative advantage of different levels of administration and local bodies.[84]

- *More innovation and flexibility at the local level.* Accountability improvements should be accompanied by policy adjustments to broaden the scope for innovation in the Public Distribution System (e.g., vouchers, increased community involvement in distribution, decentralized procurement, and possibly cash-based transfer options).

- *Better targeting.* There is a need to refine targeting mechanisms in programs that do not rely on the BPL system (e.g., community-based targeting, well-grounded proxy means testing, and categorical targeting where appropriate).

- *More cooperation with local groups to benefit the poor.* In improving access to credit for the poor, the government could collaborate with local organizations by, for example, permitting stronger roles for nongovernmental organizations and self-help groups in preparing poor people and groups to access credit programs.

- *Better implementation of public works programs.* Workfare can play a potentially important role as an insurance-type intervention, if it is well designed and well implemented.[85] However, the NREGA and SGRY will need to overcome a range of implementation problems that have plagued works schemes. The most critical is enforcing a credible accountability structure at all stages of implementation. There are also a number of design issues in NREGA that raise concerns of effectiveness, efficiency, and potentially equity.

- *More links with human capital development.* It may be worth linking existing social assistance transfers to human capital development in the form of conditional—or partly conditional—transfers. While the supply-side issues are substantial, experience in

[83] Even in OECD and transition countries, social assistance spending averages only around 2 percent of GDP, a level that India will approach as the NREGA is rolled out.
[84] See World Bank (forthcoming(b)) for recommendations on the appropriate functions by administration and PRIs at different levels in the context of public works.
[85] Walker and Ryan (1990); Cain and Lieberman (1983) on South Asia; Pritchett and others (2002) on Indonesia.

education in Bangladesh and more recently Punjab in Pakistan suggests that there may be a role for demand-side interventions, even in a difficult supply environment.

- *Greater reliance on cash transfers.* More proactive efforts to expand the relative role of cash rather than food in social protection programs seem overdue. Such reforms are linked to reforms in the public procurement system, but seem warranted both by the evidence of inefficiencies and governance problems in the use of food transfers and by the likely empowerment benefits of allowing poor households greater choice in how they use transfer income.

- *More attention to monitoring and evaluation.* Monitoring and evaluation of social protection programs needs to move beyond the practice of concurrent evaluations to include several additional tools: (a) impact evaluations based on timely survey baselines that address a broader range of impacts than the input/output focus of most concurrent evaluations; (b) periodic use of process evaluation tools, such as public expenditure tracking surveys, for programs where leakage is substantial; (c) effective implementation of social audits, which are allowed for in some schemes but rarely used in practice (though effective when used, as Rajasthan's experience demonstrates); and (d) experimentation with tools such as citizens' report cards, which have proved valuable in states such as Karnataka. The new Right to Information Act should in principle facilitate social audits.

Expanding social security coverage

Expansion of social insurance coverage is closely linked to the level of formality in the labor market. Thus, reforms are needed outside the social protection system in order to create incentives for employers and workers to participate in the formal sector. Specific, high-priority actions include:

- *Wider coverage of the pension system.* Roll-out of the proposed DC pension system seems desirable on several fronts. Fiscally, it will gradually create space for social protection interventions covering a wider population. Administratively, it may provide a platform into which existing unorganized sector initiatives may "plug in" through group insurance. In equity terms, it should reduce the current public subsidy to a relatively privileged group.

- *More evaluation of existing initiatives.* Efforts to expand social security to the unorganized sector should be preceded by a comprehensive evaluation of existing initiatives, including public, private, and nongovernmental efforts. This should focus on features that are common to successful initiatives (such as effective intermediaries between workers and insurers) and those common to failing or unsustainable schemes (such as high transactions costs, and benefits with no actuarial linkage to contributions). This would inform a realistic strategy for gradual expansion of social insurance coverage. This is likely to focus first on the "organizable" sector (i.e., workers for whom intermediary organizations exist) and on forms of insurance such as life and disability, where moral hazard is lower, administration less complex, and premiums less costly.

- *More consideration of noncontributory pension schemes.* Given the challenges of expanding contributory social insurance to the unorganized sector, rigorous evaluation of social pension schemes should be undertaken with an eye to a possibly expanded role for such benefits as a noncontributory pension system. A number of developing countries have implemented such schemes as a stepping stone in broadening social security coverage, where labor market and institutional conditions have made contributory systems challenging.[86]

[86] See Palacios (forthcoming). Brazil, South Africa, Bolivia, and Nepal provide examples of this approach.

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Statistical Annexes

Statistical Annex
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Table A1. Gross Domestic Expenditure and Product

(Shares based on current price data, percent)

	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
A. Shares of gross domestic expenditure at market prices												
1. Final consumption	78.3	76.3	75.3	76.7	75.8	77.7	77.5	76.6	76.7	74.7	73.5	71.8
a) Public Sector	11.4	10.7	10.8	10.7	11.3	12.3	12.9	12.5	12.3	11.8	11.2	11.3
b) Private	66.9	65.6	64.5	66.0	64.5	65.4	64.6	64.1	64.5	62.9	62.4	60.6
2. Gross capital formation	21.3	23.4	26.5	21.8	22.6	21.4	26.1	24.3	24.3	25.3	26.3	28.5
a) Gross fixed capital formation	21.4	21.9	24.4	22.8	21.7	21.5	23.3	22.7	23.1	24.1	24.7	25.9
i) Public sector	8.0	8.8	7.7	6.9	6.4	6.5	6.6	6.4	6.5	6.3	6.6	6.7
ii) Private sector	13.4	13.2	16.7	15.9	15.3	15.1	16.7	16.3	16.6	17.8	18.1	19.1
b) Change in inventories	-0.2	1.4	2.2	-1.0	0.9	-0.1	2.8	1.6	1.2	1.2	1.6	2.6
3. Total Absorption (1+2)	99.5	99.7	101.8	98.5	98.4	99.1	103.7	100.9	101.0	99.9	99.8	100.3
4. Resource balance	0.0	-0.3	-1.2	-1.2	-1.3	-1.7	-1.9	-0.8	-0.6	-0.4	-1.5	-3.4
a) Exports of goods & services	10.0	10.0	11.0	10.6	10.9	11.2	11.6	13.8	13.5	15.3	14.9	19.0
b) Imports of goods & services	10.0	10.3	12.2	11.8	12.1	12.9	13.6	14.5	14.1	15.7	16.4	22.4
5. Gross domestic product	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
6. Net income from abroad	-1.4	-1.3	-1.1	-1.0	-0.9	-0.9	-0.8	-1.1	-0.9	-0.7	-0.7	-0.6
7. Gross national income (5+6)	98.6	98.7	98.9	99.0	99.1	99.1	99.2	98.9	99.1	99.3	99.3	99.4
8. Net current transfers from abroad	1.9	2.5	2.4	3.2	2.9	2.5	2.7	2.8	3.2	3.2	3.8	2.9
9. Gross national disposable income (7+8)	100.5	101.2	101.3	102.3	102.0	101.6	101.9	101.7	102.3	102.6	103.1	102.4
10. National savings (9-1)	22.2	24.9	26.0	25.6	26.2	23.9	24.4	25.1	25.6	27.9	29.6	30.5
a) Public Sector	0.6	1.7	2.0	1.7	1.3	-1.0	-0.9	-1.8	-2.0	-0.7	1.0	2.2
b) Private Sector	21.6	23.2	23.9	23.9	24.9	24.9	25.2	26.8	27.6	28.6	28.6	28.3
B. Shares of GDP by Industrial Origin												
1. Agriculture	28.2	27.5	25.5	26.5	25.4	25.4	23.2	21.7	21.4	19.1	19.4	17.8
2. Industry	23.9	24.5	25.4	24.9	24.9	24.3	23.3	24.1	23.5	24.6	24.4	24.9
Construction	4.7	4.6	4.6	4.6	5.1	5.3	5.4	5.5	5.5	5.7	5.8	6.0
Gas, electricity, water	2.2	2.4	2.3	2.2	2.3	2.5	2.3	2.2	2.1	2.2	2.0	1.9
Mining and quarrying	2.3	2.2	2.1	2.0	2.2	2.0	2.1	2.2	2.1	2.6	2.4	2.4
Manufacturing	14.6	15.3	16.3	16.1	15.2	14.5	13.5	14.3	13.8	14.1	14.1	14.5
3. Services	38.9	38.5	39.4	39.5	41.0	42.1	45.1	45.8	47.1	48.4	48.4	48.4
4. Statistical discrepancy	-1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
5. Total value added at basic prices	90.9	90.5	90.3	90.9	91.3	91.8	91.5	91.6	91.9	92.1	92.1	91.1
6. Taxes less subsidies on products	9.1	9.5	9.7	9.1	8.7	8.2	8.5	8.4	8.1	7.9	7.9	8.9
7. GDP at market prices	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Memo Item (Rs. billion)												
Gross domestic product at market prices	8592	10128	11880	13682	15225	17410	19588	21077	22813	24497	27602	31214

Source: Central Statistical Organization, National Accounts Statistics.

Table A2. Gross Domestic Expenditure and Product

(Rs. billion at current prices)

	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
A. GDP by Expenditure												
1. Final consumption	6725	7728	8946	10494	11539	13534	15186	16149	17508	18290	20301	22422
a) Public Sector	977	1086	1288	1457	1722	2140	2523	2644	2804	2889	3078	3516
b) Private	5748	6642	7658	9037	9817	11394	12663	13505	14704	15402	17223	18906
2. Gross capital formation	1826	2368	3152	2979	3437	3722	5122	5116	5545	6190	7256	8892
a) Gross fixed capital formation	1843	2222	2894	3119	3304	3743	4572	4786	5273	5896	6820	8069
i) Public sector	689	889	916	943	971	1123	1293	1357	1477	1548	1810	2099
ii) Private sector	1154	1334	1978	2175	2333	2620	3280	3429	3795	4348	5010	5970
b) Change in inventories	-17	145	258	-140	133	-21	550	330	272	294	436	823
3. Total Absorption (1+2)	8551	10096	12098	13472	14976	17257	20308	21265	23052	24481	27557	31314
4. Resource balance	1	-31	-142	-162	-191	-295	-380	-159	-142	-94	-407	-1056
a) Exports of goods & services	861	1016	1307	1449	1652	1953	2277	2902	3076	3759	4121	5938
b) Imports of goods & services	860	1047	1450	1610	1843	2247	2657	3061	3218	3853	4528	6994
5. Gross domestic product	8592	10128	11880	13682	15225	17410	19588	21077	22813	24497	27602	31214
6. Net income from abroad	-121	-131	-135	-131	-132	-150	-154	-227	-201	-167	-183	-179
7. Gross national income (5+6)	8471	9997	11745	13551	15093	17260	19434	20849	22612	24330	27420	31035
8. Net current transfers from abroad	165	254	285	439	440	432	531	587	734	793	1049	919
9. Gross national disposable income (7+8)	8637	10251	12030	13990	15533	17693	19965	21437	23347	25124	28469	31954
10. National savings (9-1)	1912	2523	3084	3497	3994	4158	4779	5287	5839	6833	8168	9532
a) Public Sector	54	168	241	229	203	-172	-167	-371	-464	-162	280	694
b) Private Sector	1857	2355	2843	3267	3792	4330	4946	5658	6303	6995	7888	8839
B. GDP by Industry of Origin												
1. Agriculture	2420	2788	3031	3626	3870	4425	4541	4572	4874	4685	5347	5561
2. Industry	2052	2485	3018	3411	3785	4235	4556	5076	5358	6016	6724	7760
Construction	406	466	550	628	778	920	1051	1152	1245	1389	1594	1864
Gas, electricity, water	190	238	277	300	353	436	447	462	476	539	564	607
Mining and quarrying	201	227	253	277	334	357	416	458	484	628	661	752
Manufacturing	1255	1554	1938	2207	2320	2522	2641	3004	3153	3460	3905	4537
3. Services	3342	3897	4684	5398	6246	7321	8826	9653	10742	11854	13364	15118
Transportation	511	611	707	836	975	1126	1318	1463	1630	1787	2094	2404
Trade	994	1192	1463	1717	1945	2208	2541	2804	3124	3464	3989	4593
Dwellings	484	529	590	655	728	855	1271	1482	1672	1861	2111	2422
Banking	417	501	661	720	840	956	1057	1057	1250	1448	1584	1636
Public administration	436	486	573	652	800	996	1197	1262	1349	1419	1539	1739
Other	500	577	690	817	958	1180	1443	1585	1718	1876	2047	2324
4. Statistical discrepancy	0	0	0	0	0	0	0	0	0	0	0	0
5. Total value added at basic prices	7813	9171	10733	12435	13901	15981	17923	19302	20974	22556	25434	28439
6. Taxes less subsidies on products	779	957	1147	1247	1324	1429	1665	1775	1839	1942	2168	2775
7. GDP at market prices	8592	10128	11880	13682	15225	17410	19588	21077	22813	24497	27602	31214

Source: Central Statistical Organization, National Accounts Statistics.

Table A3. National Income and Product at constant prices

(annual growth rates, in percent)

	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
A. GDP by Expenditure and Income											
1. Final consumption	4.2	6.5	7.4	3.8	6.9	7.2	1.9	5.2	1.2	7.0	6.7
a) Public Sector	1.2	8.0	4.5	11.1	12.9	13.2	0.3	1.7	-0.6	2.4	9.2
b) Private	4.6	6.2	7.9	2.6	5.8	6.1	2.3	5.9	1.6	7.9	6.3
2. Gross capital formation	12.8	19.3	1.6	2.2	8.6	8.6	-4.6	3.3	9.8	11.9	13.5
Gross fixed capital formation	11.8	19.3	1.5	2.1	8.7	8.6	0.0	5.0	9.9	11.3	9.5
i) Public sector	18.0	-6.5	-5.9	-2.8	9.4	4.9	1.3	3.9	2.2	13.7	8.6
ii) Private sector	8.1	36.1	4.8	4.1	8.4	10.0	-0.6	5.5	13.0	10.5	9.8
3. Total Absorption	6.0	9.4	6.0	3.4	7.3	7.5	0.3	4.8	3.2	8.3	8.5
4. Exports of goods & services	13.1	31.4	6.3	-2.3	13.9	18.0	-7.2	5.6	21.9	9.8	20.0
5. Imports of goods & services	22.7	28.0	-2.5	13.2	20.8	7.0	-24.8	3.4	10.3	11.7	47.1
6. Capacity to Import [1]	18.9	19.0	-2.7	12.8	17.2	5.5	-16.9	4.2	12.6	4.2	37.2
7. Gross Domestic Income at market prices	8.0	6.4	6.3	6.3	6.4	5.5	2.9	5.1	2.5	7.7	9.9
8. Gross national income	7.4	7.8	7.7	4.5	5.9	7.3	3.7	5.4	3.8	8.4	8.6
9. Gross national disposable income	8.1	7.7	8.5	4.2	5.5	7.5	3.7	5.9	3.8	9.0	7.7
10. Gross national savings	21.8	11.4	11.6	5.6	1.7	8.5	9.4	7.7	11.2	14.2	10.2
B. GDP by Industrial origin											
1. Agriculture	5.0	-0.9	9.6	-2.4	6.2	0.3	0.0	6.2	-6.9	10.0	0.7
2. Industry	10.2	11.6	7.1	4.3	3.7	4.8	6.3	2.7	7.0	7.6	8.6
Construction	5.5	6.2	2.1	10.2	6.2	8.0	6.1	4.0	7.7	10.9	12.5
Gas, electricity, water	9.4	6.8	5.4	7.9	7.0	5.2	2.0	1.7	4.8	4.8	4.3
Mining and quarrying	9.3	5.9	0.5	9.8	2.8	3.3	2.5	1.8	8.7	5.3	5.8
Manufacturing	12.0	14.9	9.7	1.5	2.7	4.0	7.7	2.5	6.8	7.1	8.1
3. Services	7.1	10.5	7.2	9.8	8.4	10.1	5.6	7.1	7.3	8.2	9.9
4. Total value added at basic prices	7.3	7.3	7.8	4.8	6.5	6.1	4.4	5.8	3.8	8.5	7.5
5. GDP at market prices	7.5	7.6	7.4	4.5	6.0	7.1	4.0	5.3	3.6	8.3	8.5

[1] Exports delfated by import price index.

Source: Central Statistical Organization, National Accounts Statistics.

Table A4. Gross Domestic Product by Expenditure, National Income and Savings

	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
A. GDP by Expenditure and Income	1993-94 Prices							1999-00 Prices					
1. Final consumption	6725	7004	7458	8012	8313	8885	9525	15186	15480	16290	16489	17645	18830
a) Public Sector	977	989	1069	1116	1240	1400	1584	2523	2530	2573	2558	2620	2862
b) Private	5748	6015	6389	6896	7073	7486	7941	12663	12950	13716	13930	15025	15968
2. Gross capital formation	1826	2061	2458	2496	2551	2772	3010	5122	4888	5051	5544	6207	7044
a) Gross fixed capital formation	1843	2061	2458	2495	2548	2769	3008	4572	4571	4801	5276	5874	6430
i) Public sector	689	813	759	715	695	760	798	1293	1310	1362	1391	1582	1718
ii) Private sector	1154	1248	1698	1780	1853	2009	2210	3280	3261	3439	3885	4292	4713
b) Change in inventories	141	378	252	189	343	140	508	550	293	-29	282	561	1015
3. Total Absorption (1+2)	8551	9065	9916	10509	10864	11657	12535	20308	20368	21341	22033	23852	25874
4. Resource balance	1	-82	-71	43	-163	-290	-144	-380	115	166	442	441	-160
a) Exports of goods & services	861	974	1280	1361	1329	1514	1786	2277	2112	2231	2719	2985	3581
b) Imports of goods & services	860	1055	1351	1318	1492	1803	1930	2657	1997	2064	2277	2543	3742
5. Gross domestic product	8592	9233	9939	10674	11152	11820	12663	19588	20370	21445	22223	24063	26115
6. Trading gains or losses	0	50	-61	-175	8	53	-132	0	-219	-257	-497	-670	-405
7. Gross domestic income (5+6)	8592	9284	9878	10499	11161	11874	12531	19588	20151	21187	21726	23393	25710
8. Net income from abroad	-121	-132	-126	-107	-106	-120	-112	-154	-225	-207	-188	-178	-169
9. Gross national income (7+8)	8471	9101	9813	10567	11046	11700	12551	19434	20144	21238	22035	23885	25946
10. Net current transfers from abroad	165	232	238	339	322	292	344	531	562	680	714	908	759
11. Gross national disposable income (9+10)	8637	9333	10052	10906	11368	11993	12895	19965	20707	21918	22749	24793	26705
12. Gross national savings (11-1)	1912	2329	2594	2894	3056	3107	3370	4779	5227	5628	6260	7148	7875
Memo Item:													
Capacity to import	861	1024	1219	1185	1337	1567	1654	2277	1893	1973	2222	2315	3177
B. GDP by Industrial origin													
1. Agriculture	2420	2541	2519	2761	2694	2861	2870	4541	4539	4819	4487	4937	4974
2. Industry	2052	2261	2524	2702	2818	2923	3063	4556	4844	4976	5324	5730	6224
Construction	406	428	455	465	512	544	587	1051	1115	1160	1250	1385	1559
Gas, electricity, water	190	208	222	234	252	270	284	447	456	464	486	509	531
Mining and quarrying	201	220	233	234	257	264	273	416	427	434	472	497	526
Manufacturing	1255	1405	1614	1770	1797	1846	1919	2641	2846	2918	3117	3338	3608
3. Services	3342	3579	3953	4238	4654	5043	5550	8826	9321	9985	10714	11593	12739
Transportation	511	562	623	674	730	789	876	1318	1467	1588	1806	2080	2387
Trade	994	1100	1259	1355	1458	1569	1682	2541	2667	2924	3118	3435	3714
Dwellings	484	499	527	550	580	613	659	1271	1387	1470	1550	1669	1809
Banking	417	452	501	550	648	705	800	1057	1036	1130	1258	1267	1396
Public administration	436	442	472	491	562	622	704	1197	1218	1247	1262	1320	1429
Other	500	525	571	617	676	744	829	1443	1547	1626	1720	1822	2003
4. Statistical discrepancy	0	0	0	0	0	0	0	0	0	0	0	0	0
5. Total value added at basic prices	7813	8380	8996	9701	10166	10827	11484	17923	18704	19781	20526	22260	23937
6. Taxes less subsidies on products	779	853	944	974	987	993	1179	1665	1666	1664	1697	1803	2178
7. GDP at market prices (5+6)	8592	9233	9939	10674	11152	11820	12663	19588	20370	21445	22223	24063	26115

Source: Central Statistical Organization, National Accounts Statistics.

Table A5. Exchange Rates and Prices

	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
Exchange Rates (Rs. per US$)												
Nominal official average exchange rate	31.37	31.40	33.45	35.50	37.16	42.07	43.33	45.69	47.70	48.41	45.95	44.93
Real effective exchange rate (1985=100)	61.59	66.0	63.6	63.8	67.0	63.4	63.3	66.5	68.4	72.8	74.1	77.0
Price Indices												
Wholesale price index (1993-94=100)	100.0	112.5	121.6	127.2	132.8	140.7	145.3	155.7	161.3	166.8	175.9	187.2
Consumer Price Index (1993-94=100)	100.0	107.6	118.3	129.4	138.5	156.7	162.0	168.0	175.2	182.4	189.2	196.8
CPI (% change)	5.0	7.6	10.0	9.4	7.0	13.1	3.4	3.7	4.3	4.1	3.7	4.0
Manuf. Exp. Unit Value Index (1990=100)	106.7	110.5	117.0	111.3	103.5	99.6	99.4	97.3	95.9	95.9	95.9	95.9
Implicit Deflators (1993=100)												
Real gross domestic product	100.0	109.7	119.5	128.2	136.5	147.3	100.0	103.5	106.4	110.2	114.7	119.5
Exports of goods and services	100.0	95.9	97.9	93.9	80.4	77.5	100.0	72.8	72.5	72.3	72.4	60.3
Imports of goods and services	100.0	100.8	93.2	81.8	81.0	80.2	100.0	65.2	64.2	59.1	56.2	53.5
Terms of trade Index	100.0	95.1	105.0	114.8	99.4	96.6	100.0	111.6	113.0	122.4	129.0	112.7

Sources: IMF; Reserve Bank of India; GOI, Ministry of Industry; and World Bank.

Table A6. Central Government Finances Summary
(Rs billion at current prices)

	1993–94	1994–95	1995–96	1996–97	1997–98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06 R.E.	2006-07 B.E.
Revenue	755	911	1101	1263	1339	1495	1815	1926	2013	2308	2638	3060	3485	4035
Tax Revenue	534	675	819	937	957	1047	1283	1367	1335	1585	1870	2248	2741	3272
Customs[a]	222	268	358	429	402	407	484	475	403	449	486	576	642	771
Union Excise[a]	172	211	222	235	255	286	349	685	726	823	908	991	1120	1190
Income Tax[a]	14	35	43	47	36	58	91	318	320	369	414	493	662	774
Corporate Tax	101	138	165	186	200	245	307	357	366	462	636	827	1036	1130
Other	26	23	32	41	64	51	375	49	28	58	59	82	130	364
Non-Tax Revenue	220	236	282	326	382	448	532	559	678	723	768	812	743	763
Interest Receipts	151	158	184	221	253	301	339	328	355	376	385	324	212	193
Other	69	78	98	105	129	148	193	231	322	347	383	489	531	570
Expenditure[b]	1307	1447	1618	1828	2080	2449	2879	3135	3459	3791	4040	4356	4970	5560
Non-Plan Expenditure	932	1037	1219	1368	1572	1887	2219	2429	2611	3018	3489	3654	3649	3913
Interest Payments	367	440	500	595	656	779	902	992	1075	1178	1219	1267	1298	1398
Defense	218	232	269	295	353	399	471	496	543	557	601	759	817	890
Subsidies	116	119	127	155	185	236	245	268	312	435	443	437	469	462
Other Non-Plan Expenditure	230	245	324	323	378	474	601	673	682	848	1226	1192	1065	1162
Plan Expenditure	437	474	464	535	591	668	762	827	1012	1115	1223	1323	1438	1727
Less: Recovery of Loans	62	63	65	75	83	106	101	120	164	342	672	620	117	80
Gross Fiscal Deficit	552	536	517	565	741	953	1063	1209	1446	1482	1402	1296	1485	1525
Financed by:														
Disinvestment of PSEs	0	51	4	4	9	59	17	21	36	32	170	44	24	38
Domestic borrowing (net)	502	450	510	531	721	875	1034	1113	1354	1570	1368	1104	1387	1404
External borrowing (net)	51	36	3	30	11	19	12	75	56	-119	-135	148	75	83
Memo:														
GDPmp	8592	10128	11880	13682	15225	17410	19588	21077	22813	24497	27602	31214	35292	39128
Fiscal Deficit / GDP	6.4	5.3	4.3	4.1	4.9	5.5	5.4	5.7	6.3	6.1	5.1	4.2	4.2	3.9
Revenue / GDP	8.8	9.0	9.3	9.2	8.8	8.6	9.3	9.1	8.8	9.4	9.6	9.8	9.9	10.3
Expenditure / GDP	15.2	14.3	13.6	13.4	13.7	14.1	14.7	14.9	15.2	15.5	14.6	14.0	14.1	14.2

BE = Budget estimates; RE = Revised estimates.

Notes :

a. Till 1999-00 net of state's share, after that gross receipts.

b. Net of loan recoveries and loans on small savings.

Sources : Ministry of Finance, Union budget documents and World Bank Staff Estimates..

Table A7. Budgetary Classification of Central Government Finances

(Rs. billion at current prices)

	1993–94	1994–95	1995–96	1996–97	1997–98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06 R.E.	2006-07 B.E.
Revenue receipts	755	911	1101	1263	1339	1495	1815	1926	2013	2308	2638	3060	3485	4035
Tax revenue	534	675	819	937	957	1047	1283	1367	1335	1585	1870	2248	2741	3272
Non-tax revenue	220	236	282	326	382	448	532	559	678	723	768	812	743	763
of which: Interest from states	96	112	130	152	178	212	254	270	283	296	286	253	132	128
Revenue expenditure (A+B+C+D)	1082	1221	1399	1589	1803	2165	2491	2778	3015	3387	3621	3850	4391	4873
A. Developmental	244	301	356	400	460	585	637	732	819	1036	1129	1173	1434	1638
1. Social services	41	47	66	84	106	131	156	156	185	195	212	279	345	402
2. Economic services	203	254	290	315	354	454	481	576	634	841	916	894	1089	1236
B. Non-developmental	613	708	817	943	1101	1303	1536	1648	1748	1892	1978	2102	2190	2345
Defence services	150	164	188	210	262	299	352	372	381	407	432	439	486	515
Interest payments	367	440	500	595	656	779	902	992	1075	1178	1219	1267	1298	1398
C. Grants-in-aid and contributions	211	205	218	238	232	264	304	384	432	441	496	553	739	863
of which: Grants to states	208	200	213	232	297	251	290	368	415	421	473	553	739	863
D. Revenue expenditure of UTs	14	7	8	9	10	12	14	14	16	17	19	22	28	27
Net current balance	-327	-310	-297	-327	-464	-670	-676	-852	-1002	-1079	-983	-790	-906	-838
Capital expenditure (A+B+C+D)	225	226	219	239	277	285	388	357	444	403	421	185	409	472
A. Developmental	56	74	50	47	73	76	108	93	116	132	152	184	51	51
1. Social services	3	7	5	7	6	10	11	8	-34	9	11	9	8	12
2. Economic services	52	67	45	40	67	67	97	85	150	123	141	175	43	39
B. Non-developmental	74	73	88	93	100	109	129	136	178	163	187	340	359	406
of which: Defence services	69	68	80	85	91	100	119	124	162	150	169	320	331	375
C. Capital expenditure of UTs	3	2	2	2	2	3	4	5	3	3	3	2	3	9
D. Loans and advances (net)	93	77	78	97	101	96	148	123	147	105	78	-342	-5	6
to States & UTs	51	46	48	69	76	75	117	88	105	109	105	-350	-32	-28
to Others	42	31	30	28	25	21	31	35	41	-5	-27	9	27	34
Gross fiscal deficit (World Bank Defn.)	552	536	517	565	741	954	1064	1209	1446	1482	1404	975	1315	1310
Financed by instruments														
Disinvestment of equity in PSEs	0	51	4	4	9	59	17	21	36	32	170	44	24	38
Market loans	289	203	331	200	325	690	703	729	877	976	889	460	1004	1138
Small savings	91	166	128	153	245	330	90	83	88	0	0	0	14	30
Provident funds	18	20	23	23	44	57	66	49	42	46	49	53	55	60
External loans	51	36	3	30	11	19	12	75	56	-119	-135	148	75	83
Other (inclues T-bills)	104	61	29	155	107	-201	177	251	347	548	432	270	144	-39

BE = Budget estimates; RE = Revised estimates.

Sources: Ministry of Finance, Union budget documents; Department of Expenditure, Finance Accounts; World Bank Staff Estimates.

Table A8. Budgetary Classification of State Government Finances
(Rs. billion at current prices)

	1993–94	1994–95	1995–96	1996–97	1997–98	1998-99	1999-00	2000-01	2001-02	2001-02	2002-03	2003-04	2004-05 R.E.	2005-06 B.E.
Revenue receipts	1051	1223	1373	1529	1790	1774	2049	2379	2547	2547	2763	3112	3705	4333
Tax revenue	687	806	932	1062	1248	1281	1461	1697	1809	1809	1983	2257	2660	3096
Direct taxes	50	70	81	84	94	100	115	132	160	160	176	205	237	268
Indirect taxes	415	487	558	627	718	790	911	1048	1121	1121	1246	1394	1637	1878
State share in central taxes	222	248	293	351	435	391	435	517	528	528	561	658	786	950
Non-tax revenue	364	417	442	467	542	493	589	682	738	738	780	855	1045	1237
of which: Grants from centre	208	200	213	232	297	251	290	368	415	415	421	473	553	773
Revenue expenditure [A+B+C]	1094	1285	1449	1690	1869	2204	2611	2911	3137	3137	3342	3761	4279	4529
A. Developmental (1+2)	708	790	893	1062	1138	1319	1515	1685	1735	1735	1806	2046	2321	2405
1. Social services	390	450	536	603	683	820	963	1045	1076	1076	1115	1200	1416	1512
2. Economic services	319	340	357	458	455	498	552	640	659	659	691	846	904	893
B. Non-developmental	374	482	542	609	699	847	1051	1181	1367	1367	1488	1662	1887	2058
of which: Interest payments	*166*	*201*	*229*	*269*	*318*	*379*	*463*	*528*	*631*	*631*	*709*	*828*	*918*	*970*
To centre	95	112	131	152	175	209	254	274	294	294	309	302	261	211
To others	71	90	99	117	143	170	209	254	337	337	401	526	656	759
C. Other expenditure[a]	12	13	15	19	30	35	45	50	47	47	61	69	80	88
Net current balance	-44	-62	-76	-161	-80	-430	-562	-532	-590	-590	-579	-649	-574	-197
Capital expenditure [A+B+C]	168	208	232	213	279	311	377	360	368	368	470	619	793	853
A. Developmental (1+2)	121	171	178	168	218	223	244	302	310	310	347	504	648	723
1. Social services	18	23	26	30	34	42	43	58	60	60	76	96	130	168
2. Economic services	102	148	152	139	184	181	201	245	250	250	271	408	518	556
B. Non-developmental	4	4	7	7	10	8	11	9	13	13	19	20	35	44
C. Loans and advances (net)	43	33	47	38	51	80	122	48	45	45	104	95	111	85
Gross fiscal deficit	211	270	308	374	358	742	938	891	958	958	1049	1268	1367	1050
Financed by instrument:														
Market loans	42	41	64	65	79	122	142	130	189	189	306	523	370	214
Loans from centre (net)	99	138	140	167	224	306	114	85	105	105	114	118	-329	-97
Small savings & Provident funds	43	48	49	54	62	120	179	131	102	102	99	337	387	393
Other	27	44	55	88	-6	194	504	546	562	562	530	290	939	540

Note: BE = Budget estimates; RE = Revised estimates.

a. Other expenditure include compensation and assignments to local bodies and panchayat raj institutions and reserve with the finance department.

Sources: Reserve Bank of India, RBI bulletins on state finances, World Bank Staff Estimates.

Table A9. Budgetary Classification of General Government (Center and States) Finances

(Rs. billion at current prices)

	1993–94	1994–95	1995–96	1996–97	1997–98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05 /a/	2005-06 /b/
Revenue receipts	1501	1821	2132	2408	2653	2806	3320	3668	3863	4354	4990	5959	6907
Tax revenue	1221	1480	1751	1999	2205	2328	2743	3063	3145	3568	4127	4908	5832
Non tax revenue	280	341	381	410	448	478	576	604	718	785	864	1051	1076
Revenue expenditure [A+B+C]	1872	2193	2506	2896	3194	3902	4557	5056	5466	6024	6639	7331	8070
A. Developmental	952	1091	1249	1461	1598	1903	2152	2417	2555	2842	3175	3493	3839
1. Social services	431	497	602	688	789	951	1118	1201	1262	1310	1413	1695	1857
2. Economic services	521	594	646	774	809	953	1034	1216	1293	1532	1762	1798	1982
B. Non-developmental	891	1078	1229	1400	1622	1938	2332	2559	2832	3084	3353	3736	4115
C. Other revenue expenditure	28	24	28	35	-25	61	73	80	79	98	111	102	116
Net current balance	-370	-372	-374	-487	-541	-1097	-1237	-1388	-1603	-1671	-1648	-1372	-1163
Capital expenditure [A+B+C+D]	339	393	417	392	575	538	629	631	698	718	868	1170	1293
A. Developmental (1+2)	176	245	229	215	292	299	352	396	426	479	656	832	775
1. Social services	22	30	32	36	40	52	54	66	26	85	106	139	176
2. Economic services	154	215	197	179	251	247	297	330	400	394	549	693	599
B. Non-Developmental	78	77	95	100	109	117	140	145	191	182	208	375	404
C. Loans and advances (net)	82	69	91	74	172	119	133	86	77	54	1	-40	111
D. Capital disbursements of UTs	3	2	2	2	2	3	4	5	3	3	3	2	3
Gross fiscal deficit	709	765	791	879	1117	1634	1866	2020	2301	2389	2516	2542	2455
Financed by Instrument:													
Disinvestment of equities in PSEs.	0	51	4	4	9	59	17	21	36	32	170	44	24
Market Loans	343	254	450	344	513	959	1008	1132	1331	1556	1882	1174	1574
Small Savings and Provident Funds	152	234	199	230	351	507	334	263	231	145	386	440	462
External Loans	51	36	3	30	11	19	12	75	56	-119	-135	148	75
Others (including t-bills)	164	192	134	271	233	90	495	528	646	776	214	736	321

/a/ Actuals for center and revised estimates for states.

BE = Budget estimates; RE = Revised estimates.

Sources: Union Budget Documents; RBI bulletin on state finances; World Bank Staff Estimates.

Table A10. Transfers between Center and States

	1993–94	1994–95	1995–96	1996–97	1997–98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06 R.E.	2006-07 B.E.
(Rs. Billlion)														
States' share in central taxes	222	248	293	351	435	391	435	517	528	561	658	786	944	1134
Grants to States	208	200	213	232	297	251	290	368	415	421	473	553	739	863
Loans to States	140	188	193	231	294	385	193	173	206	241	234	231	50	42
of which: on small savings	50	97	100	107	151	230	0	0	0	0	0	0	0	0
Loan Repayments by States	52	45	48	65	71	95	98	117	140	303	612	597	90	78
Interest Payments by States	96	112	130	152	178	212	254	270	283	296	286	253	132	128
Gross Transfers (Center to States)	571	637	699	813	1027	1027	918	1058	1149	1224	1365	1570	1733	2040
NET TRANSFER (Center to States)	423	480	521	596	777	720	565	672	726	625	466	720	1512	1834
Gross Transfers (Center to states without small savings)	521	540	599	706	876	797	918	1058	1149	1224	1365	1570	1733	2040
Net Transfers (Center to states without small savings)	373	383	421	490	627	489	565	672	726	625	466	720	1512	1834
(% of GDP)														
States' share in central taxes	2.6	2.5	2.5	2.6	2.9	2.2	2.2	2.5	2.3	2.3	2.4	2.5	2.7	2.9
Grants to States	2.4	2.0	1.8	1.7	2.0	1.4	1.5	1.7	1.8	1.7	1.7	1.8	2.1	2.2
Loans to States	1.6	1.9	1.6	1.7	1.9	2.2	1.0	0.8	0.9	1.0	0.8	0.7	0.1	0.1
of which: on small savings	0.6	1.0	0.8	0.8	1.0	1.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loan Repayments by States	0.6	0.4	0.4	0.5	0.5	0.5	0.5	0.6	0.6	1.2	2.2	1.9	0.3	0.2
Interest Payments by States	1.1	1.1	1.1	1.1	1.2	1.2	1.3	1.3	1.2	1.2	1.0	0.8	0.4	0.3
Gross Transfers (Center to States)	6.6	6.3	5.9	5.9	6.7	5.9	4.7	5.0	5.0	5.0	4.9	5.0	4.9	5.2
NET TRANSFER (Center to States)	4.9	4.7	4.4	4.4	5.1	4.1	2.9	3.2	3.2	2.6	1.7	2.3	4.3	4.7
Gross Transfers (Center to states without small savings)	6.1	5.3	5.0	5.2	5.8	4.6	4.7	5.0	5.0	5.0	4.9	5.0	4.9	5.2
Net Transfers (Center to states without small savings)	4.3	3.8	3.5	3.6	4.1	2.8	2.9	3.2	3.2	2.6	1.7	2.3	4.3	4.7
GDPmp (Rs. Billion)GDPmp (Rs. Billion)GDPmp (Rs. Billion)	8592	10128	11880	13682	15225	17410	19588	21077	22813	24497	27602	31214	35292	39128

Note: BE = Budget estimates; RE = Revised estimates.

Sources: Union budget documents; RBI bulletins on state finances; Finance Accounts; World Bank Staff Estimates.

Table 11: Outstanding Debt (Center and States)
(Rs. billion at current prices)

	1993–94	1994–95	1995–96	1996–97	1997–98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06 Est.
Outstanding Liabilities of Central Government													
Internal Debt	2457	2665	3079	3445	3890	4597	7143	8037	9131	10207	11417	12118	13287
Of which:													
Market Loans	1106	1309	1640	1841	2166	2854	3559	4288	5165	6191	7080	7590	8674
91 T-bills	326	323	438	565	16	15	15	19	50	97	72	83	85
182/364 T-bills	84	82	19	82	162	102	143	163	196	261	261	261	269
Small Savings, Deposits and Provident Funds	879	1064	1214	1390	1678	2065	664	963	1445	2264	2884	3905	4843
Other Accounts	725	858	920	1001	1241	1268	1344	1440	1642	1724	1681	1741	1856
Reserve Funds and Deposits	246	290	337	379	421	416	475	585	731	801	924	930	1012
Total Domestic Liabilities	4306	4877	5550	6214	7230	8346	9626	11026	12949	14996	16906	18693	20998
External Liabilities (at historical exchange rates)	473	509	512	542	553	573	584	659	715	596	461	609	684
External Liabilities (at current exchange rates)	1685	1790	1788	1756	1815	1929	2005	2020	2091	2034	1901	1953	1961
Outstanding Liabilities of State Government													
Internal Debt	309	358	438	499	617	712	1155	1723	2340	3325	4278	5246	6080
Market Loans	261	312	371	436	508	615	754	868	1040	1331	1795	2134	2296
Compensation and Other Bonds	1	1	1	1	1	1	1	1	1	1	188	211	211
WMA from RBI	13	6	19	12	32	-11	-35	-28	-56	13	8	-18	-38
Loans from Banks and Other Institutions	34	40	48	51	77	108	171	292	409	512	610	703	871
	0	0	0	0	0	0	0	0	0	0	0	0	0
Loans and Advances from Central Government	1012	1159	1306	1484	1717	2028	2355	2439	2549	2540	2681	2739	2913
Special Securities Issued to NSSF	..	..	..	..	..	..	264	590	947	1469	1677	2214	2741
Total Provident Funds	280	329	382	441	508	633	805	936	1038	1137	1230	1341	1436
State Provident Funds	230	268	310	356	408	508	656	764	844	916	986	1080	1158
Insurance and Pension Fund Trust and Endowments	50	61	72	85	100	124	149	172	194	221	245	261	278
Reserve Funds	82	90	106	123	145	173	198	229	274	322	386	448	490
Deposits and Advances	190	230	267	314	366	424	522	592	643	650	647	634	606
Total Liabilities	1879	2170	2508	2867	3363	3974	5050	5926	6855	7977	9223	10408	11525
Outstanding Liabilities of General Government													
Domestic Liabilites	5173	5888	6752	7598	8876	10291	12057	13923	16308	18964	21770	24149	26870
External Liabilities (at current exchange rates)	1685	1790	1788	1756	1815	1929	2005	2020	2091	2034	1901	1953	1961
Total Liabilites (with ext.debt at current exchange rates)	6857	7679	8540	9354	10690	12221	14061	15943	18399	20998	23671	26102	28831
Domestic Liabilites (% of GDP)	60.2	58.1	56.8	55.5	58.3	59.1	61.6	66.1	71.5	77.4	78.9	77.4	76.1
External Liabilities (% of GDP) at current exchange rates	19.6	17.7	15.1	12.8	11.9	11.1	10.2	9.6	9.2	8.3	6.9	6.3	5.6
Total Liabilites (% of GDP)	79.8	75.8	71.9	68.4	70.2	70.2	71.8	75.6	80.7	85.7	85.8	83.6	81.7

Sources : Central Budget, Reserve Bank of India, and World Bank Staff Estimates.

Table A12. Banking Survey and Interest Rates

	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
I. Banking Survey												
A) Billions of rupees- end year stock												
Net foreign assets	546	790	821	1055	1381	1779	2056	2498	3147	3937	5266	6520
Net Domestic credit	4417	4966	5486	5802	6372	6999	7905	8771	9602	11029	12244	14789
to public sector	2039	2224	2578	2886	3306	3867	4414	5124	5865	6765	7437	7625
to private sector	2378	2927	3446	3763	4333	4960	5866	6732	7563	8990	10205	12750
Reserve Money (M0)	1387	1693	1945	2000	2264	2593	2806	3033	3380	3691	4365	4891
Broad Money (M3)	4311	5276	5992	6960	8213	9810	11242	13116	15000	17180	20085	22692
Currency with Public	823	1007	1183	1321	1456	1689	1891	2096	2414	2716	3154	3574
Other Deposits with the RBI	25	34	33	32	35	37	30	36	29	32	51	65
Demand Deposits	660	882	932	1053	1187	1364	1497	1666	1783	1988	2580	2971
Time Deposits	2803	3353	3844	4554	5535	6719	7824	9318	10775	12444	14300	16082
B) Shares of GDP (%)												
Net foreign assets	6.4	7.8	6.9	7.7	9.1	10.2	10.5	11.9	13.8	16.1	19.1	20.9
Net Domestic credit	51.4	49.0	46.2	42.4	41.9	40.2	40.4	41.6	42.1	45.0	44.4	47.4
to public sector	23.7	22.0	21.7	21.1	21.7	22.2	22.5	24.3	25.7	27.6	26.9	24.4
to private sector	27.7	28.9	29.0	27.5	28.5	28.5	29.9	31.9	33.2	36.7	37.0	40.8
Reserve Money (M0)	16.1	16.7	16.4	14.6	14.9	14.9	14.3	14.4	14.8	15.1	15.8	15.7
Broad Money (M3)	50.2	52.1	50.4	50.9	53.9	56.3	57.4	62.2	65.8	70.1	72.8	72.7
C) Real annual growth rates (%)												
Net foreign assets		34.5	-5.5	17.4	22.3	13.9	11.8	17.1	20.8	20.2	28.9	19.1
Net Domestic credit		4.5	0.4	-3.3	2.6	-2.9	9.2	7.0	5.0	10.3	7.0	16.1
to public sector		1.4	5.4	2.3	7.0	3.4	10.4	11.9	9.8	10.8	6.0	-1.4
to private sector		14.5	7.1	-0.2	7.6	1.2	14.4	10.6	7.7	14.2	9.4	20.1
Broad Money (M3)		13.8	3.3	6.1	10.3	5.6	10.9	12.5	9.7	10.0	12.7	8.6
II. Interest rates (%)												
Money market rate (Call money rates)	7.0	9.4	17.7	7.8	8.7	7.8	8.9	9.2	7.2	5.9	4.3	4.6
Yield on GOI Securites (1 to 5 years)	11.86-12.86	9.75-11.76	6.00-14.28	5.21-16.21	5.50-17.69	4.45-17.73	3.18-14.30	4.94-16.66	5.32-10.96	5.12-10.98	3.93-7.16	4.32-8.14
Deposit rate (1 to 3 Years)	10.0	11.0	12.0	11.0-12.0	10.5-11.0	9.0-11.0	8.5-9.5	8.5-9.0	7.5-8.5	4.25-6.0	4.0-5.25	5.25-5.50
Lending rate (Minimum Lending Rate)	14.0	15.0	16.0	14.5-15.0	14.0	12.0-13.0	12.0-12.5	11.0-12.0	11.0-12.0	10.75-11.50	10.25-11.00	10.25-10.75
Real deposit rate *	1.6	-1.5	3.9	6.4-7.4	10.1-10.6	3.1-5.1	5.2-6.2	1.3-1.8	3.9-4.9	.85-2.6	-1- -.25	-1.15 - -0.9
Real lending rate *	5.6	2.5	7.9	9.9-10.4	9.6	6.1-7.1	9.3-9.8	3.8-4.8	7.5-8.5	7.35-8.1	4.75-5.5	3.85-4.35
Memo Item:												
Inflation rate (WPI)	8.4	12.5	8.1	4.6	4.4	5.9	3.3	7.2	3.6	3.4	5.5	6.4

* Nominal rates less Inflation

Source : Reserve Bank of India, Hand Book of Statistics.

Table A13. Balance of Payments
(US$ Millions)

	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
Current Account												
Exports of goods & services	27947	32990	39657	41607	45109	47484	53251	61720	61843	74537	89672	132157
Exports of goods	22683	26855	32311	34133	35680	34298	37542	45452	44703	53774	64723	80831
Exports of services	5264	6135	7346	7474	9429	13186	15709	16268	17140	20763	24949	51326
Imports of goods & services	31468	41437	51213	55696	59297	58565	67028	72488	70093	81584	98535	155657
Imports of goods, f.o.b.	26739	35904	43670	48948	51187	47544	55383	57912	56277	64464	80177	118961
Imports of services	4729	5533	7543	6748	8110	11021	11645	14576	13816	17120	18358	36696
Net trade in goods & services	-3521	-8447	-11556	-14089	-14188	-11081	-13777	-10768	-8250	-7047	-8863	-23500
Income receipts	395	886	1429	1073	1561	1935	1931	2682	3379	3522	4287	4694
Income payments	3665	4317	4634	4380	5082	5479	5490	7686	7585	6968	8259	8673
Net income from abroad	-3270	-3431	-3205	-3307	-3521	-3544	-3559	-5004	-4206	-3446	-3972	-3979
Private current transfer receipts	5287	8112	8539	12435	11875	10341	12290	13065	15760	17189	23183	20859
Private current transfer payments	22	19	33	68	45	61	34	211	362	802	350	400
Net private current transfers	5265	8093	8506	12367	11830	10280	12256	12854	15398	16387	22833	20459
Current Account Balance	-1526	-3785	-6255	-5029	-5879	-4345	-5080	-2918	2942	5894	9998	-7020
Capital & Financial Account												
Net official capital grants	368	416	345	410	379	307	382	252	458	451	563	589
Net total private investment inflows	4235	4807	4805	6153	5390	2412	5191	5862	6686	4161	14776	11944
Net direct investment inflows	668	983	2057	2841	3562	2473	2165	3272	4734	3217	3420	3037
Net portfolio investment inflows	3567	3824	2748	3312	1828	-61	3026	2590	1952	944	11356	8907
External Assistance, net	1901	1526	883	1109	907	820	901	410	1117	-3128	-2742	1922
Commercial Borrowings, net	3469	3181	2916	3048	2863	2705	3064	2924	3265	2846	3331	3656
Rupee Debt Service	1574	1663	2049	1947	1978	1906	2173	2514	2148	5974	6073	1734
NRI Deposits, net	607	1030	1275	2848	3999	4362	313	4303	-1585	-1692	-1526	5947
Other Capital	2889	4149	4251	7571	7371	7226	3187	9616	2684	3505	6574	8131
Reserves, net change (- Increase/ + Decrease)	-8537	-5787	1221	-6793	-4511	-4222	-6402	-6780	-11951	-17185	-31103	-25712
Other Series												
Foreign Exchange reserves (end of period, incl. gold)	19254	25186	21687	26423	29367	32490	38036	42281	54106	75428	111648	140076
Reserves (as months of goods imports)	8.6	8.4	6.0	6.5	6.9	8.2	8.2	8.8	11.5	14.0	16.7	14.1
GDP (billions of US$)	273.9	322.6	355.2	385.4	409.7	413.8	452.0	461.3	478.3	506.1	600.7	694.7

Source: Reserve Bank of India.

Table A14. Exports and Imports

(US$ million)

	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
A. EXPORTS												
A1. Exports (fob, US$)												
Total Primary Commodities	4916	5214	7257	8035	7687	6928	6524	7126	7164	8706	9902	12198
Oil Meals	741	573	702	985	924	462	378	448	475	307	729	690
Marine Products	814	1126	1011	1129	1207	1038	1183	1394	1237	1432	1329	1268
Ores and Minerals	888	988	1175	1172	1061	893	916	1153	1262	1996	2369	4193
Other Primary commodities	2473	2527	4369	4749	4495	4535	4048	4132	4190	4971	5476	6047
Manufactures	16657	20404	23747	24613	26547	25792	29714	34335	33370	40245	48492	58168
Gems and Jewellary	3996	4500	5275	4753	5346	5929	7502	7384	7306	9030	10573	13705
Readymade Garments	2586	3282	3676	3753	3876	4365	4765	5569	5007	5690	6231	6026
Other Manufactures	10075	12622	14797	16107	17325	15497	17447	21382	21057	25525	31687	38436
Total	22238	26331	31795	33470	35007	33219	36822	44560	43827	52719	63843	79247
A.2 Exports (constant prices- 1993-94)												
Total Primary Commodities	6166	6066	7232	8001	7278	7403	8414	9096	9873	11258	10586	
Oil Meals	986	770	920	1037	943	874	678	627	685	430	907	
Marine Products	789	904	891	999	999	962	1101	1186	1261	1526	1482	
Ores and Minerals	1289	1565	1885	1578	1285	1177	1439	1505	1942	2759	2272	
Other Primary commodities	3103	2826	3537	4386	4051	4390	5195	5777	5984	6543	5924	
Manufactures	16334	20248	24607	31574	34347	34360	42805	49185	49662	60820	52723	
Gems and Jewellary	3188	3841	4437	5374	4986	5610	5837	7824	6471	7209	6887	
Readymade Garments	3657	4210	4939	7678	10593	9743	11538	14452	16085	20687	15168	
Other Manufactures	9489	12197	15231	18522	18769	19007	25430	26909	27106	32924	30669	
Total	22277	25300	33157	35575	33330	34452	39806	49304	51203	62342	66055	
B. IMPORTS												
B.1 Imports (cif, US$)												
Food	327	1144	970	1214	1483	2524	2417	1443	2043	2411	3073	3014
Consumer Goods	3032	4249	5819	5115	5143	4307	4618	3722	4220	4249	5819	9022
POL and Other Energy	5754	5928	7526	10036	8164	6399	12611	15650	14000	17640	20570	29844
Intermediate Goods	7951	9696	12031	12845	16898	19094	21059	20779	21268	23614	30409	42619
Pearls, Precious and Semi-Precious Stones	2635	1630	2106	2925	3342	3760	5436	4808	4623	6063	7129	9423
Organic and Inorganic Chemicals	1371	2137	2566	2661	2956	2684	2866	2444	2800	3025	4032	5335
Other intermediate goods	3946	5929	7359	7260	10600	12650	12757	13528	13846	14526	19248	27860
Capital Goods	6243	7638	10330	9922	9796	10064	8966	8941	9882	13498	18279	22567
Total	23306	28654	36675	39132	41485	42389	49671	50536	51413	61412	78149	107066
B.2 Imports (constant prices, 1993-94)												
Food	539	729	728	1197	1598	2531	2198	2099	1670	1704	2822	
Consumer Goods	3189	4007	4478	4216	5270	5256	6461	5072	7329	7501	7925	
POL and Other Energy	6682	7028	8340	9206	10171	11309	11483	10938	11903	12472	13660	
Intermediate Goods	6749	-1488	9313	10744	16238	20825	23782	24691	22143	21441	28475	
Pearls, Precious and Semi-Precious Stones	2498	3098	3911	3888	4268	4890	5354	5300	5566	6090	7366	
Organic and Inorganic Chemicals	1644	1914	1914	2003	2498	2631	2965	2189	2341	2307	3873	
Other intermediate goods	2606	-6501	3488	4854	9472	13304	15464	17202	14236	13044	17237	
Capital Goods	10374	23868	20241	17484	13755	13973	15075	15612	18296	23999	28293	
Total	27533	34144	43098	42847	47032	53894	58999	58413	61342	67116	81176	
C. INDEXES (1993=100)												
C1. Volume Indices												
Merchandise Exports	100.0	113.7	149.2	159.9	149.9	155.0	179.0	221.7	274.7	340.2	421.4	521.9
Merchandise Imports	100.0	124.1	156.4	155.5	170.8	195.7	214.2	212.1	210.0	207.9	205.8	203.8
C2. Price Indices												
Merchandise export price index	99.8	104.1	95.9	94.1	105.0	96.4	92.5	90.4	86	85	97	
Merchandise import price index	84.6	83.9	85.1	91.3	88.2	78.7	84.2	86.5	84	92	96	
Merchandise Terms of Trade	117.9	124.0	112.7	103.0	119.1	122.6	109.9	104.5	102	92	100	

Source : Reserve Bank of India.

Table A15. External Debt and Debt Service

	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
I. (millions of US dollars)												
A. Debt Outstanding and disbursed												
Total long term	85676	93907	87040	85427	88606	93021	94354	95636	94775	101744	108731	106279
Public and pub. guaranteed	83906	87480	80422	78045	79398	84611	86410	83156	83101	88165	92822	93683
Private non-guaranteed	1770	6427	6618	7382	9208	8409	7944	12480	11674	13579	15909	12596
Short term	3626	4264	5049	6726	5046	4329	3933	3462	2742	4569	4736	4736
IMF	5041	4312	2374	1313	664	288	26	0	0	0	0	0
Total DOD	94342	102483	94464	93466	94317	97637	98313	99098	97517	106313	113467	111015
B. Debt Service												
Interest	4178	4633	4918	4364	4864	5120	3782	4182	3849	3785	6074	4090
Amortizations	5603	5144	6929	6644	6936	6574	6062	6661	5477	9493	14314	7197
IMF repurchases	134	1174	1719	972	613	390	262	25	0	0	0	0
Total	9915	10951	13566	11981	12413	12084	10107	10868	9327	13278	20389	11287
II. Ratios (%)												
Total DOD to GDP	34.4	31.8	26.6	24.3	23.0	23.6	21.7	21.5	20.4	21.0	18.9	16.0
Total DOD (% total exports)	280.5	244.1	190.4	169.6	161.1	163.4	145.7	127.9	120.4	111.6	96.9	70.4
Debt service (% total exports)	29.5	26.1	27.3	21.7	21.2	20.2	15.0	14.0	11.5	13.9	17.4	7.2

Source : Global Development Finance, 2006

Table A16. Financial Sector Indicators

	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
A. Banking System									
1. Depth and Structure									
Total domestic credit (%of GDP)	42.4	41.9	40.2	40.4	41.6	42.1	45.0	44.4	47.4
of which private credit (% of GDP)	27.5	28.5	28.5	29.9	31.9	33.2	36.7	37.0	40.8
Number of banks									
Public Sector	27	27	27	27	27	27	27	27	28
Private Banks						29	29	29	29
Foreign Banks						31	31	31	31
2. Efficiency and Strength									
Spread over LIBOR	10.4	8.1	8.0	7.1	5.8	8.3	10.1	10.2	9.2
Non-performing loans as % of total									
Public sector banks(27)	17.8	16.0	15.9	14.0	12.4	11.1	9.4	7.8	5.4
Private banks (34)	8.5	8.7	10.8	8.5	8.5	9.7	9.2	5.8	3.9
Foreign banks (45)	4.3	6.4	7.6	7.0	6.9	5.5	5.4	4.8	3.0
B. Stock Market									
Market Capitalization (%GDP)	31.9	31.2	25.4	41.4	32.4	23.0	25.7	46.5	56.1
Value Traded (%GDP)	24.9	38.6	35.8	62.4	111.5	2.0	38.7	47.4	54.8
No. of listed companies	5999	5843	5860	5863	5937	5795	5650	5644	4730
S&P/IFC investable index (annual % change)	-2.0	5.8	-23.0	81.0	-31.1	-19.9	6.8	76.5	20.1

Sources : RBI and World Development Indicators.

Table A17. Investment Climate

	Year	India	Low Income Average	Regional Average	Middle-Income Average
Private Investment Environment					
Domestic Credit to Private Sector (stock, % GDP)	2003	32.0	27.0	31.0	64.2
Starting a business					
Number of start-up procedures	Jan-04	11	11	9	10
Time required days	Jan-04	89	63	47	51
Registering Property					
Number of procedures	Jan-04	6	7	6	7
Time required days	Jan-04	67	100	56	80
Rigitidy of employment index (0 less rigid to 100 more rigid)	Jan-04	48	52	42	38
Enforcing contracts					
Number of procedures	Jan-04	40	35	30	31
Time required days	Jan-04	425	418	349	401
Disclosure index (0 less disclosure to 10 more disclosure)	Jan-04	4	2	3	3
Time to resolve insolvency (years)	Jan-04	10	4	5	3
Governance					
ICRG Corruption Rating (1-6, bad to good)	Oct-05	2.5			
ICRG Bureaucratic Quality Rating (1 - 6)	Oct-05	3.0			
ICRG Law and Order (1 - 6)	Oct-05	4.0			
Openness					
Trade (imports+exports)/GDP (%)	2004	32.6	34.9	24.1	58.3
FDI inflows (% GDP)	2003	0.7	1.3	0.7	2.4
WTO member?		Y			
Weighted Mean Tariff (%)	2002	8.9			
Infrastructure					
Paved Roads, % of total	1999	57.3	14.6	30.8	54.0
Motor vehicles (per 1000 persons)	2000	9.3	..	9.6	56.1
Cost of Calls to US (US$ per 3 min)	2001	3.20	4.5	2.70	2.3
Internet Users (per 1000 people)	2003	18	16	11	117
Electricity consumption (kwh per capita)	2002	380	313	344	1,388
GDP per unit energy use (PPP $ per Kg oil equivalent)	2002	5.2	4.3	5.3	4.3
Wages and Productivity					
Minimum Wage (US$ per year)	1995-99	408			
Labor Cost Per Worker in Manufacturing (US$ per year)	1995-99	1,192			
Value Added Per Worker in Manufacturing (US$ per year)	1995-99	3,118			
R&D Expenditure (% of GNI)	1989-2000	0.62	..	0.62	..

Source: World Bank, World Development Indicators Database, 2005.

Table A18. Vulnerability Indicators

	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
A. Market Indicators									
Annual percent change in average exchange rate (%)	6.1	4.7	13.2	3.0	5.4	4.4	1.5	-5.1	-2.2
Annual change in stock market index (%)	-2.0	5.8	-23.0	81.0	-31.1	-19.9	6.8	76.5	20.1
B. Risk Ratings									
ICRG composite (1-100, bad to good) a/	68.5	66.3	64.3	64.3	64	65.8	66.8	72.0	71.8
Euromoney (1-100, bad to good)									
Institutional Investor (1-100, bad to good)									
C. Financial									
Annual growth in real domestic credit (%)	-3.3	2.6	-2.9	9.2	7.0	5.0	10.3	7.0	16.1
Foreign currency to total deposits (%) b/	15.8	17.0	18.0	18.0	18.5	20.0	21.4	23.7	25.4
Non-perfm. loans of commercial banks (% of total)									
Public Sector	17.8	16.0	15.9	14.0	12.4	11.1	9.4	7.8	5.4
Private Banks	8.5	8.7	10.8	8.5	8.5	9.7	9.2	5.8	3.9
Foreign Banks	4.3	6.4	7.6	7.0	6.9	5.5	5.4	4.8	3.0
D. Reserve Cover Indicators									
Reserve cover of imports (months of imports)	6.5	6.88	8.2	8.2	8.8	11.5	14.0	16.7	14.1
Reserves to short term debt	3.9	5.8	7.5	9.7	12.2	19.7	16.5	23.6	29.6
Reserves/M2 (%)	12.2	13.2	13.7	14.8	15.3	18.0			
E. Prices									
Annual change in terms of trade (%)	-8.6	15.6	3.0	-10.4	-4.9	-2.2	-9.5	8.6	..
Annual Depreciation REER (%)	0.3	5.0	-5.3	-0.2	5.1	2.9	6.3	1.9	3.8
F. External									
Current account balance (% of GDP)	-1.3	-1.4	-1.0	-1.1	-0.6	0.6	1.2	1.7	-1.0
External Debt (% of GDP)	24.3	23.0	23.6	21.7	21.5	20.4	21.0	18.9	16.0
G. Fiscal sustainability indicators (Genral Govt.)									
Total Public Debt (% of GDP)	68.4	70.2	70.2	71.8	75.6	80.7	85.7	85.8	83.6
Fiscal Deficit (% of GDP)	6.4	7.3	9.4	9.5	9.6	10.1	9.8	9.1	8.1
Primary Deficit (% of GDP)	1.2	2.1	4.0	3.9	3.6	3.8	3.2	2.7	1.9

a/ End of the fiscal year ratings (for the month of March).

b/ Share of Net Foreign Exchange Assets to Total Deposits including Net Foreign Exchange Assets.

Sources: IFS, WDI, Reserver Bank of India and World Bank Staff Estimates.

Table A19. Millennium Development Goals Indicators

	1990	1995	1998	2001	2004
Goal 1: Eradicate extreme poverty and hunger					
Income share held by lowest 20%	..	..	..	9.0	..
Malnutrition prevalence, weight for age (% of children under 5)	64.0	..	47.0	..	..
Poverty gap at $1 a day (PPP) (%)	..	..	..	8.0	..
Poverty headcount ratio at $1 a day (PPP) (% of population)	..	..	..	35.0	..
Poverty headcount ratio at national poverty line (% of population)	..	36.0	..	29.0	..
Prevalence of undernourishment (% of population)	..	..	21.0	..	20.0
Goal 2: Achieve universal primary education					
Literacy rate, youth total (% of people ages 15-24)	64.0	..	..	..	76.0
Persistence to grade 5, total (% of cohort)	..	..	62.0	61.0	..
Primary completion rate, total (% of relevant age group)	..	77.1	72.6	75.8	88.5
School enrollment, primary (% net)	..	..	..	83.0	87.0
Goal 3: Promote gender equality and empower women					
Proportion of seats held by women in national parliament (%)	5.0	..	7.0	9.0	9.0
Ratio of girls to boys in primary and secondary education (%)	69.8	..	77.2	78.0	87.7
Ratio of young literate females to males (% ages 15-24)	73.9	..	..	..	80.5
employment)	13.0	14.0	16.0	17.0	18.0
Goal 4: Reduce child mortality					
Immunization, measles (% of children ages 12-23 months)	56.0	72.0	51.0	56.0	56.0
Mortality rate, infant (per 1,000 live births)	80.0	74.0	72.0	66.0	62.0
Mortality rate, under-5 (per 1,000)	123.0	104.0	..	94.0	85.0
Goal 5: Improve maternal health					
Births attended by skilled health staff (% of total)	..	..	42.3	42.5	..
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	..	540.0	..
Goal 6: Combat HIV/AIDS, malaria, and other diseases					
Children orphaned by HIV/AIDS	..	..	..	..	..
Contraceptive prevalence (% of women ages 15-49)	..	..	52.0	47.0	..
Incidence of tuberculosis (per 100,000 people)	167.8	..	..	..	167.8
Prevalence of HIV, female (% ages 15-24)	..	..	..	1.0	..
Prevalence of HIV, total (% of population ages 15-49)	..	..	..	1.0	1.0
Tuberculosis cases detected under DOTS (%)	..	0.3	1.7	23.8	57.1
Goal 7: Ensure environmental sustainability					
CO2 emissions (metric tons per capita)	0.8	1.0	1.1	1.1	..
Forest area (% of land area)	22.0	..	..	23.0	23.0
GDP per unit of energy use (constant 2000 PPP $ per kg of oil equivalent)	4.0	4.0	5.0	5.0	5.0
Improved sanitation facilities (% of population with access)	12.0	..	..	30.0	..
Improved water source (% of population with access)	68.0	..	..	86.0	..
Nationally protected areas (% of total land area)	..	..	..	..	5.2
Goal 8: Develop a global partnership for development					
Aid per capita (current US$)	1.7	1.9	1.6	1.7	0.6
Debt service (PPG and IMF only, % of exports of G&S, excl. workers' remittances)	29.0	32.0	23.0	13.0	20.0
Fixed line and mobile phone subscribers (per 1,000 people)	6.0	12.9	23.2	43.6	84.5
Internet users (per 1,000 people)	0.0	0.3	1.4	6.8	32.4
Personal computers (per 1,000 people)	0.3	1.3	2.7	5.8	12.1
Total debt service (% of exports of goods, services and income)	32.0	30.0	21.0	12.0	19.0
Unemployment, youth female (% of female labor force ages 15-24)	..	8.0	..	10.2	..
Unemployment, youth male (% of male labor force ages 15-24)	..	8.4	..	10.1	..
Unemployment, youth total (% of total labor force ages 15-24)	..	8.3	..	10.1	..
Other					
Fertility rate, total (births per woman)	3.8	3.4	3.3	2.9	2.9
GNI per capita, Atlas method (current US$)	390.0	380.0	420.0	460.0	620.0
GNI, Atlas method (current US$) (billions)	330.6	349.6	412.9	479.3	673.2
Gross capital formation (% of GDP)	24.1	26.5	21.4	22.4	24.1
Life expectancy at birth, total (years)	59.1	61.4	62.2	63.4	63.5
Literacy rate, adult total (% of people ages 15 and above)	49.3	..	..	..	61.0
Population, total (millions)	849.5	932.2	982.2	1032.5	1079.7
Trade (% of GDP)	15.7	23.2	24.1	27.7	41.6

Note: Where data is not available for the year mentioned, the closest year was taken.

Source: World Development Indicators database, April 2006

Table A20: Development Indicators - India and Comparator Countries

Indicator	Unit	Year	India	China	Brazil	Indonesia	Pakistan
Per Capita Income	US$	2004	620	1290	3090	1140	600
PPP Per capita income	US$	2004	3100	5530	8020	3460	2160
Population	Million	2004	1080	1296	179	218	152
Male literacy rate	Percent	2000-2004	73.4	95.1	88.3	92.5	61.7
Female literacy rate	Percent	2000-2004	47.8	86.5	88.6	83.4	35.2
Population below the poverty line [1]	Percent	Survey year in brackets	26.1 (2000)	4.6 (1998)	22.0 (1998)	27.1 (1999)	32.6 (1999)
Population below US$1/day	Percent	Survey year in brackets	35.0 (2000)	16.6 (2001)	8.2 (2001)	7.5 (2002)	17.0 (2001)
Infant mortality rate	Per 1000 live births	2003	63.0	30.0	33.0	31.0	74.0
Life expectancy at birth	Years	2003	63.4	70.8	68.7	66.9	64.1
Access to improved sanitation facilities	Percent	2002	30.0	44.0	75.0	52.0	54.0

[1] an alternate methodology used by Deaton and Dreze estimated the poverty headcount to be 28.6% in 1999/2000

Source: World Development Indicators, 2005, The World Bank; Poverty data on India (1999/2000) sourced from Planning Commission, GoI

Table A21: Unemployment Rates: Alternative Measures

Unemployment rates	Usual Principal Status (UPS)	Usual Principal and Subsidiary Status (UPSS)	Current Weekly Status (CWS)	Current Daily Status CDS)
All India				
1987-88	3.8	2.6	4.8	6.1
1993-94	2.6	1.9	3.6	6.0
1999-00	2.8	2.2	4.4	7.3
Urban				
1987-88	6.6	5.3	7.1	9.4
1993-94	5.2	4.5	5.8	7.4
1999-00	5.2	4.6	5.9	7.7
Rural				
1987-88	3.1	2.0	4.2	5.3
1993-94	1.8	1.2	3.0	5.6
1999-00	2.0	1.4	3.9	7.2