Boost Infrastructure To Speed Up Growth

by Ramtanu Maitra

The Confederation of Indian Industry (CII) on Nov. 11 revised projections for the growth of Indian economy in fiscal 2003-04 to 7.2%—up from the 6.8% forecast during the Summer. CII chief economist Omkar Goswami attributed the increase to an "excellent monsoon, higher than expected food grain growth and agricultural income, and significantly better performance of the industrial, manufacturing, and service sectors." The breakdown of the growth rate predicted by the CII indicates that the agricultural sector, which accounts for 24% of India's GDP, would grow by 7.5%; the industrial sector (26% of GDP) by 6.3%; and the services sector (almost half of GDP) by 7.5%.

Although a 7.2% growth rate is a definite improvement over the last year's 5.7%, it is evident—and Goswami spelled it out in no uncertain terms—that to sustain this growth rate in the future, India would need to concentrate on building infrastructure.

Performance varies widely from state to state. The states of Andhra Pradesh, Gujarat, Karnataka, and Tamil Nadu—all having better infrastructure than most other states—have recorded close to 10% growth over the last five years. On the other end of the spectrum, Bihar, Orissa, Jharkhand, and Assam—all with poor infrastructure—have been close to a 4% growth rate.

At the same time, there is now in India a new self-confidence, based on the country's steady trade growth, despite worldwide economic recession, and a positive outlook in business expectations.

New Delhi's Illusions

The growth figures, however, fall significantly short of what the recently published Tenth Five Year Plan for 2002-07 had projected. Goaded by the Vajpayee government to come up with a growth rate which would be able to find employment for 10 million or so Indians who join the job market every year, the Planning Commission decided on an 8% annual growth rate. This was a bold announcement, in light of the fact that the government had shown no intent to create a reserve fund (separate from annual budgetary allocations) to accumulate the vast sums needed for development of India's decrepit infrastructure—education, health care, railroads, power and water supply, in particular. The 8% figure also meant that those states which are growing at a rate of 4% or so, would suddenly find it possible to double their growth rate.

The present multi-party coalition government, led by the Bharatiya Janata Party (BJP), will have to go to the polls before October 2004. Having emerged on the Indian political scene in 1998 as the instruments of change, after the country had gone through almost 45 of its 51 years of existence under one-party rule by the Congress Party, the BJP was not short on promises. But it is evident that the BJP-led government has done little to satiate the Indians' demand for growth and yearning for a less uncertain life.

The failures of the BJP-led government's economic policies were not so much in what they did not do, but in what they could have, and should have, done. This is especially evident in light of the growing economic muscle of China. In the early 1980s, India and China were almost at par economically; but in the last 18 years or so, the economic balance has shifted dramatically in favor of China. The Chinese leadership, despite the umpteen obstacles they faced, remained steadfast in bringing up their country's physical infrastructure, qualitatively and quantitatively.

In contrast, India moved slowly forward, undeterred by economic recessions and booms elsewhere in the world, doing little to strengthen the cornerstone of its economy: infrastructure. Now, more than ever, Indian businessmen and wage earners put the blame squarely on the succeeding governments for the decrepit infrastructure and relatively low economic growth.

Beside its "benign neglect" of the key sub-sectors of infrastructure, the BJP-led government went on to foster a lot of illusions—illusions that were not their creation, but which they latched on to nevertheless. The administration has serious shortcomings in its understanding of the real problems facing an economy which is as large and diverse as that of India. Moreover, belonging to the opposite end of the economic ideological spectrum dominated by the socialists and the liberal Fabians for decades, the BJP had all along been a strong proponent of less government regulations and more private sector interventions. The administration defines privatization as a panacea for all economic ills, and Prime Minister Atal Behari Vajpayee has pursued this mirage with utmost devotion. As a result, economic growth suffered, the employment situation failed to improve, and more damage was inflicted on the basic sectors.

In the Indian context, privatization and disinvestment are one and the same thing. The objective of privatization was ostensibly to unshackle the growth potential of the facilities involved, and to use the proceeds from the sale of publicly owned shares in enterprises, to bring money into the central government's coffer for developmental requirements. Both these goals have been exposed as illusions.

To begin with, the disinvestment money was never put into any pool to take care of India's physical economy; in-

TABLE 1
India's Fiscal Deficit
(% of GDP)

	Combined	Center	States
1990-91	9.4	6.6	3.3
1996-97	6.4	4.1	2.7
2000-01	9.9	5.7	4.5

Source: Reserve Bank of India.

stead, it went to reduce the annual budget deficit—otherwise known as the "bottomless hole." India's disinvestment policies have scarcely generated more than $2 billion revenue in any given year. But even that amount, over 10-15 years, would create a significant fund for developmental activities. On the other hand, India's fiscal deficit is close to $50 billion, and rising (see **Table 1**). With such a huge fiscal deficit, in a country where the tax base is still very low and budgetary requirements very high, pumping the disinvestment money in to reduce the huge gap serves nothing. It merely takes away the funds which could have been used for development of the physical economy.

Poor Execution

Despite the central government's disinvestment of 10% of the equity of the public sector enterprises (PSEs), this has made no impact on the reduction of government debt. Nor has it helped the performance of the disinvested public enterprises, even where majority shares of such enterprises were sold. In addition, the procedure that was adopted to sell the shares of the PSEs has raised questions. Analysts pointed out that by announcing the outfits to be divested, the central government was responsible for bringing down the share prices, making the sale more profitable to the private buyer and less so for the central government. Moreover, disinvestment was made at a time when India's capital market was suffering from slow growth of the overall economy.

On the other hand, efforts to ensure that public enterprises improve their managerial efficiency do not get sufficient priority, although some of the best-run companies in India, such as the Indian Oil Corporation (IOC) and National Aluminum Corporation Ltd. (NACL), are still in the public sector. A Ministry of Finance report shows that in 1991-92, the 237 PSEs recorded the ratio of gross profit/capital employed as 11.6%, while 235 PSEs in 1998-99 raised the figure to 14.6%.

While there is a consensus that disinvestment must go hand in hand with strengthening managerial efficiencies and the technological base of the PSEs, the actions of the BJP-led government go against this. Even India's Supreme Court, which stopped the privatization of India's two top revenue-generating companies—Hindustan Petroleum Corp Ltd (HPCL) and Bharat Petroleum Corp Ltd (BPCL)—has implicitly questioned why profitable PSEs should be hawked.

Yet another pointer is the fact that, as India's private sector has become globalized, so have many government companies, such as Oil and Natural Gas Company Videsh (overseas), Indian Railway Construction Co, and Engineers India Ltd, while remaining profitable. This simple fact raises a political question, whether the government could have been more circumspect on the privatization issue. But the government has not been able to spell out a clear policy on the matter.

New Mantras

The second illusion of the present Indian administration is the increasingly heavy dependence on the service sector for economic growth. It is not that the Indian service sector cannot enjoy sustained growth; but it is almost impossible to find a historical case where service-sector growth was sustained without a buoyant industrial sector, which, in turn, depends mainly on well-functioning physical infrastructure.

The proponents of service sector-based economic growth point at India's success with Information Technology. Of the four sectors of the IT industry—the production of main frame, network and PCs in the hardware sector, as well as their operating systems and service providers in the software sector, India serves only the last one.

New Delhi is expecting a huge contribution of the IT sector in the employment of educated youth in the coming years. According to recent reports, India's software sector added 130,000 personnel in fiscal 2002, bringing employment in the sector to 650,000. The National Association for Software and Services Company (Nasscom) had predicted earlier that the IT-related employment would be as high as 1.41 million by April 2005. It is almost a certainty that the numbers were highly exaggerated.

Similarly, a Nasscom-McKinsey report on annual revenue projections for India's IT industry in 2008 pegs the number at $87 billion. By the end of Fiscal 2002, annual revenue of the same was about $16.5 billion—a tidy sum, but one which requires almost a magical growth rate to achieve what is being projected for 2008. Such optimism is also expressed in the export potential of the IT sector. While the export earnings by the sector were $7.2 billion last fiscal year, the Nasscom-McKinsey report projects that exports will shoot up to $50 billion in 2008. Out of 181 countries, nine account for the bulk of India's electronics hardware and software services exports in 2002-03. The United States accounted for 58% of total exports, followed by the United Kingdom with 13%, Germany with 4%, and Singapore and Japan with 3% each, it said.

What the analysts tend to overlook, is that all the major importers of India's IT services are in deep recession. A straight extrapolation of growth in such a recessionary condition is a gross mistake.

Over the last four years, Cabinet ministers have made it a mantra to announce at every opportunity how well the economy is doing, citing India's high foreign exchange reserves. In 1991, India's foreign exchange reserves were less than a billion. With more than $90 billion in foreign loans at the time, and a perpetual trade imbalance, New Delhi was under massive financial pressure from abroad. It is therefore no mean success to build up foreign exchange reserves to more than $90 billion by the Summer of 2003. The upswing is mainly attributable to the resurgence in exports in the last four quarters; increase in capital inflows, including foreign investment; and appreciation of the rupee. Further, the reduction in the current account deficit (from a deficit of $1.3 billion in 2001 to a surplus of $2.5 billion in 2002) contributed to a 20% increase in reserves.

However, the question is not how high the reserves are, but whether the $90 billion-plus has been put to good use. It must also be noted that around $50 billion of these reserves is "hot money." Once the hot money component is omitted, the actual reserves are around $40 billion. Most of the foreign exchange reserves were kept parked abroad. doing little to help the Indian economy.

Does it make sense for India to hold such high reserves and keep them virtually idle, earning a meager 2-3% interest? Being a developing economy with a large and growing manufacturing sector, India's import demand is going to be continuously high in the coming years, and will require large foreign exchange reserves, especially when export growth may not be able to keep pace with import demand.

Therefore, India must begin to use much of these reserves for import of capital goods and technology. Part of the inflows could also be used to replace external commercial borrowings (ECBs). Thus, the contradictory situation, where there is more commercial borrowing (large foreign exchange inflows) and lack of demand for domestic rupee resources, can be avoided. Further, a sizeable proportion of resources, taking the stock of foreign reserves available, can be used for domestic investment, particularly in building up India's infrastructure.

Need for Investment

The task before the Indian political leadership is to generate off-budget sources for funding an infrastructure build-up. According to Indian economist Prahlad Basu, India needs immediate investment of at least $100 billion to meet the current gap between supply and demand in electrical power, telecommunications, roads, and bridges. If one adds to the list the modernization of railroads, education, health care, and port development, the financial requirement could be as high as $300 billion.

The low growth rate of industry over almost 12 years has created a massive investment famine, in a country where the real cost of capital remains as high as 8%. The plethora of local taxes, as well as the emerging competition from China after the abolition of restrictions on imports which took effect in April 2001, are further causes of investment famine.

TABLE 2

Foreign Direct Investment Inflows

($ Billions)

	1996	1998	2000
India	2.6	2.6	2.3
China	40.2	43.8	40.8
Brazil	10.5	28.5	33.5
Malaysia	7.3	2.7	5.5
South Korea	2.5	5.4	10.2

Source: UNCTAD, *World Development Report 2001: Promoting Linkages.*

Confronted with this situation, the central government resorted to absurd promises, such as to bring in more and more Foreign Direct Investment (FDI) in the coming years to build infrastructure.

In its *World Investment Report, 2003,* released recently, UNCTAD said that FDI flows to India rose from $3.40 billion in 2001 to $3.44 billion in 2002, sustaining its position as the largest recipient in South Asia. UNCTAD also said that though India and China both received increased FDI flows, their performance had been strikingly different. While China would continue to be a magnet of FDI flows and India's biggest competitor, FDI flows into India were set to rise, helped by a vibrant domestic enterprise sector, if policy reforms continued and the government remained committed to attracting FDI. In fact, China attracted seven times more FDI than India in 2002, its share being 3.2% of its gross domestic product (GDP) compared with 1.1% for India (see **Table 2**).

What New Delhi never tells its citizens, is why the FDI bypasses India. It would like to give the impression that the much-needed infrastructure would be taken care of, once the FDI starts flowing in. But there are a number of reasons why the FDI will not flow into India the way it does to some other countries.

To begin with, in many developing countries, a lot of FDI has gone into export-oriented manufacturing industries which supply the global markets. The Indian economy, on the other hand, is not an export-oriented economy—for good or ill. The reasons include its labor laws, its policy of small-scale industries reservations (instead of going for modernization of these industries), the weakness of its infrastructure base, and a slow-moving bureaucracy. In addition, while craving FDI, India sets caps on foreign equity holding in the telecom, airline, banking, and insurance sectors, amongst others. It is to be noted that the foreign direct investors, many of which are financial predators, look for buying up well-oiled manufacturing or service-sector outfits. The setting of caps on foreign equity holding surely keeps the predators at bay, but, at the same time, reduces the FDI potential in the country.