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OVERVIEW

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BETTER POLICIES FOR BETTER LIVES

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Summary

- *Main findings*
- *Key recommendations*

Main findings

Improving the macroeconomic framework to support sustainable and inclusive growth. India enjoyed nearly a decade of strong economic growth sparked in part by structural reforms, during which poverty was cut in half. However, growth faltered between 2012 and 2014 as gains from past reforms diminished, and fiscal and monetary stimuli could no longer be sustained due to high inflation and current account deficit. External factors also played a role. As fiscal and monetary policies have been gradually tightened, the fiscal deficit and inflation have started to decline while the current account deficit has narrowed. Activity has rebounded in 2014 and is projected to accelerate but the implementation of reforms is critical. The government efforts to simplify regulations and administrative procedures should enhance rule of law. Still-high inflation, the fiscal deficit, rising non-performing loans, and structural bottlenecks are also key downside risks. Large energy and fertiliser subsidies and delays in passing key tax reforms constrain the public investment in physical and social infrastructure, including education and health, needed for long-term growth and lower inequalities.

Raising employment and valued added from the manufacturing sector. The manufacturing sector could contribute more to income, export and employment growth. In recent years, structural bottlenecks have affected the manufacturing sector more than services. Labour and tax regulations are complex and raise cost of doing business above a certain size. Manufacturing firms therefore tend to be small and their productivity is low. Firms often cannot find employees with the right education and training. Frequent power outages, difficulty in acquiring land and poor transport infrastructure also make it difficult for firms to be competitive and reach new markets.

Increasing female economic participation. Creating more and better employment for women has a high growth potential. Female economic participation is low, reducing growth and living standards. Many women work in marginal jobs and have much lower pay than men. A host of factors constrain women in the labour market, including cultural norms, safety concerns, lack of child care and poor infrastructure. At the same time, high unemployment among educated women, revealed preference for work in surveys, and low net job creation point to demand problems.

Improving health outcomes for all. Health outcomes have improved substantially but remain below countries at a similar level of development. Lack of access to a clean water supply, nutrition deficiencies and smoking all lower health but the recent initiative on sanitation should help. And when they fall sick, most Indians do not have access to high quality medical services. The low level of public resources invested in health, the lack of health care professionals, poor regulation of health services, large out-of-pocket payments and inequality in access to health care are serious issues, in particular for the poor and those living in rural areas and urban slums.

Key recommendations

Improving the macroeconomic framework to support sustainable and inclusive growth

- Implement flexible inflation targeting.
- Pursue fiscal consolidation while avoiding one-off measures and cuts in growth-enhancing spending.
- Shift public spending away from energy subsidies towards investment in physical and social infrastructure. Implement a national value-added tax (GST) with only limited exemptions.
- Strengthen bank supervision by early recognition of asset deterioration and stricter provisioning standards.

Raising employment creation and valued added from the manufacturing sector

- Reduce barriers to formal employment by introducing a simpler and more flexible labour law which does not discriminate by size of enterprise.
- Continue improving access to education, especially at the secondary level, and better focus on the quality of education at all levels. Provide better and earlier vocational training.
- In the infrastructure sector, impose clear timelines, rationalise documentation, and implement single-window clearance.
- Continue improving the business environment and opening up the economy.

Increasing female economic participation

- Extend female quotas to state and national parliaments.
- Further modernise labour laws to ensure equal work opportunities for women.
- Enhance the implementation of gender-related laws.
- Expand secondary and higher education for women and skills training for female entrepreneurs.

Improving health outcomes for all

- Increase public spending on health care with particular focus on preventive and primary care, especially in rural areas and urban slums.
- Expand the number of health professionals and up-skill professionals located in rural areas.
- Strengthen the management of public health care facilities and ensure that private facilities and their employees meet minimum quality standards.

Assessment and recommendations

- *Recent economic developments and projections*
- *Enhancing the monetary and fiscal policy frameworks*
- *Addressing structural problems in product, labour and financial markets to promote inclusive and greener growth*

India experienced strong inclusive growth between 2003 and 2011, with average growth above 8% and the incidence of poverty cut in half. This reflected gains from past structural reforms, strong capital inflows up to 2007 and expansionary fiscal and monetary policies since 2009. These growth engines faltered in 2012. Stubbornly high inflation as well as large current and fiscal deficits left little room for monetary and fiscal stimulus to revive growth. The prospect of "tapering" monetary stimulus in OECD countries and the reversal in capital inflows, as well as the difficulty to pass reforms to remove growth bottlenecks in the run-up to the 2014 general elections further weighed on India's economic performance.

In 2014, the economy has shown signs of a turnaround and imbalances have lessened. Fiscal consolidation at the central government level has been accompanied by a decline in both inflation and the current account deficit. Confidence has been boosted by on-going reforms to the monetary policy framework, with more weight given to inflation. The large depreciation in the rupee has also helped revive exports. Industrial production has

Table 1. **Macroeconomic indicators and projections**[1]

Annual percentage changes

(Fiscal year basis)	2011	2012	2013	2014	2015	2016
GDP, at constant prices[2]	6.6	4.7	5.0	5.4	6.6	6.8
Inflation[3]	8.6	7.2	6.9	6.9	5.4	5.6
Consumer price index (CPI)[4]	9.5	10.2	9.5	7.1	6.3	6.0
Wholesale price index (WPI)[5]	8.9	7.4	6.0	4.3	3.8	4.3
Short-term interest rate[6]	8.1	7.9	7.6	7.8	7.2	6.6
Long-term interest rate[7]	8.4	8.2	8.5	8.6	8.2	7.8
Fiscal balance (per cent of GDP)[8]	-7.6	-6.8	-7.0	-6.9	-6.6	-6.2
Current account balance (per cent of GDP)	-4.2	-4.7	-1.6	-1.7	-1.7	-2.5
Memorandum: calendar year basis						
GDP, at constant prices	**7.8**	**4.9**	**4.7**	**5.4**	**6.4**	**6.6**
Private final consumption expenditure	10.4	5.6	4.0	5.6	5.9	6.2
Government final consumption expenditure	6.2	7.4	4.4	6.1	4.0	5.0
Gross fixed capital formation, total	11.5	2.3	1.0	4.1	9.0	11.1
Total domestic expenditure	8.0	6.2	2.8	3.8	6.1	7.1
Exports of goods and services, National Accounts basis	20.6	8.0	5.4	7.1	8.1	9.1
Imports of goods and services, National Accounts basis	18.2	11.6	-1.0	1.2	6.8	10.6
Net exports, contribution to growth in real GDP	-0.8	-1.8	1.7	1.4	0.0	-0.9

Note: Data refer to fiscal years starting in April.
1. The projections shown here are those presented in the *OECD Economic Outlook No. 96*.
2. GDP is measured at market prices, which corresponds to GDP measured at factor costs plus indirect taxes less subsidies.
3. Percentage change in GDP deflator.
4. Percentage change in the consumer price index.
5. Percentage change in the all commodities index.
6. RBI repo rate.
7. 10-year government bond.
8. Gross fiscal balance for central and state governments.

Source: OECD Economic Outlook 96 Database.

rebounded and business sentiment has surged, triggered by a decline in political uncertainty. Reducing macroeconomic imbalances further is key to sustaining consumer and investor confidence and to containing external vulnerabilities – this will require adhering to the fiscal roadmap and implementing the proposed changes to the monetary policy framework.

Structural reforms would raise India's economic growth. In their absence, however, growth will remain below the 8% growth rate achieved during the previous decade (Table 1). Infrastructure bottlenecks, a cumbersome business environment, complex and distorting taxes, inadequate education and training, and outdated labour laws are increasingly impeding growth and job creation. Female economic participation remains exceptionally low, holding down incomes and resulting in severe gender inequalities. Although absolute poverty has declined, it remains high, and income inequality has in fact risen since the early 1990s. Inefficient subsidy programmes for food, energy and fertilisers have increased steadily while public spending on health care and education has remained low.

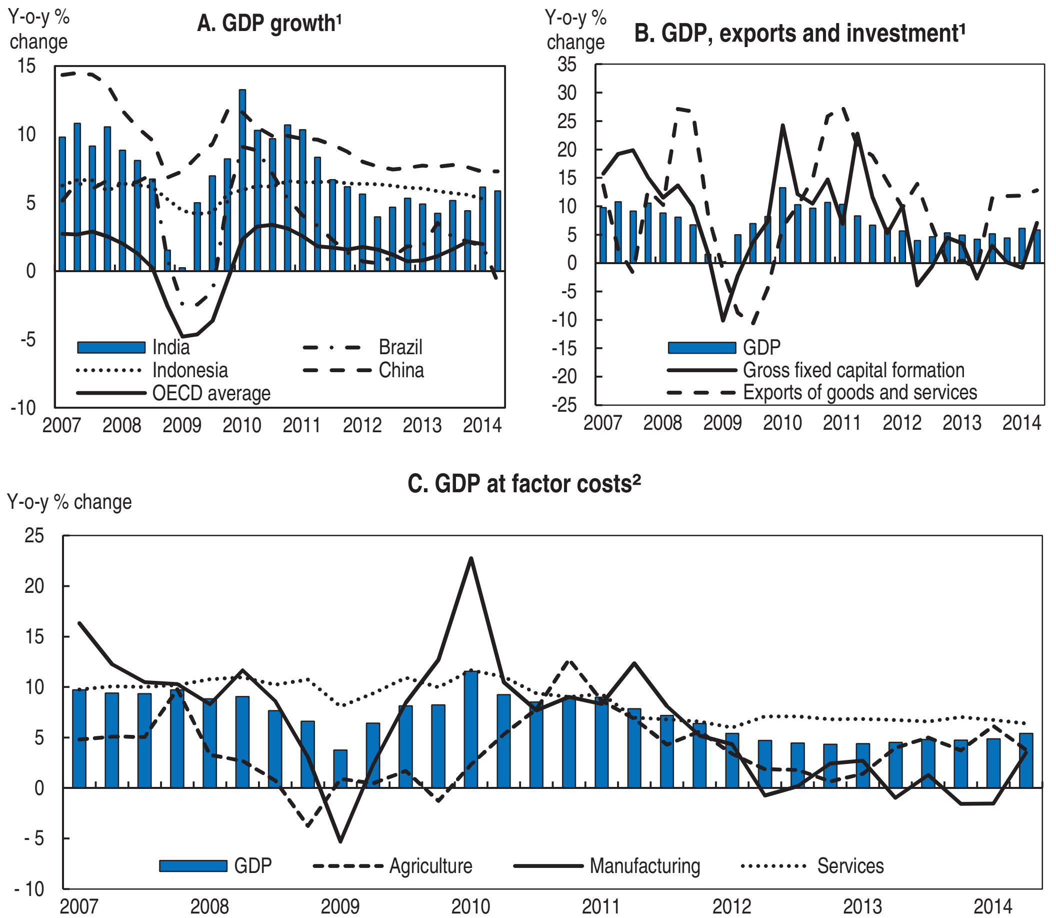
Recent economic developments and projections

The economic slowdown since mid-2011 has been more pronounced in India than in the OECD area and many other emerging economies (Figure 1). In 2013, GDP growth measured at market prices was at its weakest since 2003 – 4.7% compared to an average of 8% over the period 2003-11 – and the manufacturing sector contracted in volume terms for the first time since 1991. By contrast, financial and business services continued to grow at 10% or more. On the demand side, investment and private consumption have been weak, while exports rebounded in the second half of 2013 following the rupee depreciation. Weaker exports of goods during the first months of 2014, however, suggest that competitiveness remains an issue.

Structural bottlenecks have taken a toll on economic growth and on the manufacturing sector in particular. As an illustration, due to unreliable power supply, around half of the manufacturing companies experienced power cuts for more than 5 hours each week (FICCI, 2012). Lengthy authorisation processes and uncertainty surrounding land acquisition have held back infrastructure investment, while corporate investment has suffered from rising input prices which have squeezed corporate margins. Job creation has been sluggish and most jobs remain informal despite some pick-up in formal employment, mostly in services.

Consumer price inflation has remained much higher than in the OECD area and in other BRIICS (Figure 2). A series of one-off factors have contributed to inflation, including: adverse weather conditions, adjustment in administrative prices for core food items, oil products, electricity and railways; the extension of the National Rural Employment Guarantee Scheme (NREGS) which established a wage floor in rural areas; the rupee depreciation in the summer 2013. Supply-side constraints in the food sector – including the lack of cold storage and refrigerated transport facilities – have also contributed to food price volatility. The decline in inflation in the first half of 2014 is encouraging but inflation expectations have remained stubbornly high.

Figure 1. **The economic slowdown has been marked, driven by sluggish investment and manufacturing**



1. At market value and constant prices.
2. At factor costs and constant prices.

Source: OECD Economic Outlook 96 Database.

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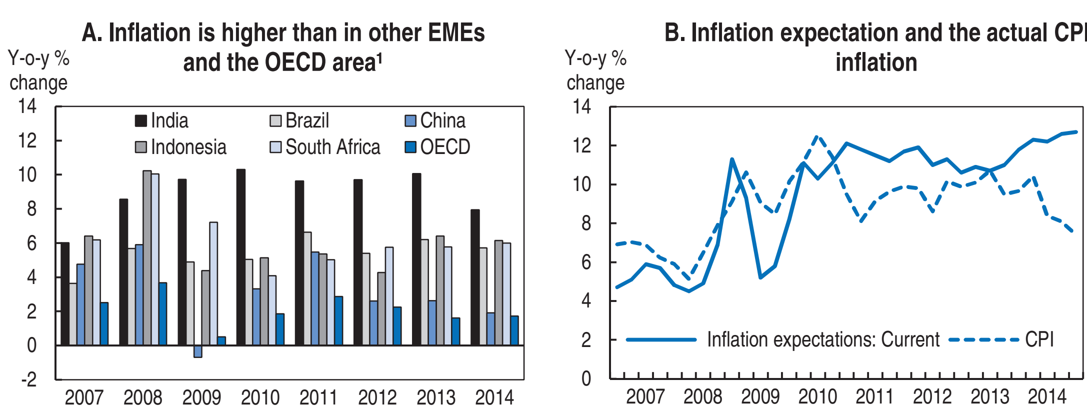
Figure 2. **Inflation has long been high and inflation expectations remain unabated**



1. The consumer price index (CPI) inflation is shown. Year 2014 is based on the data of the first nine months.

Source: OECD Outlook 96 Database and Reserve Bank of India.

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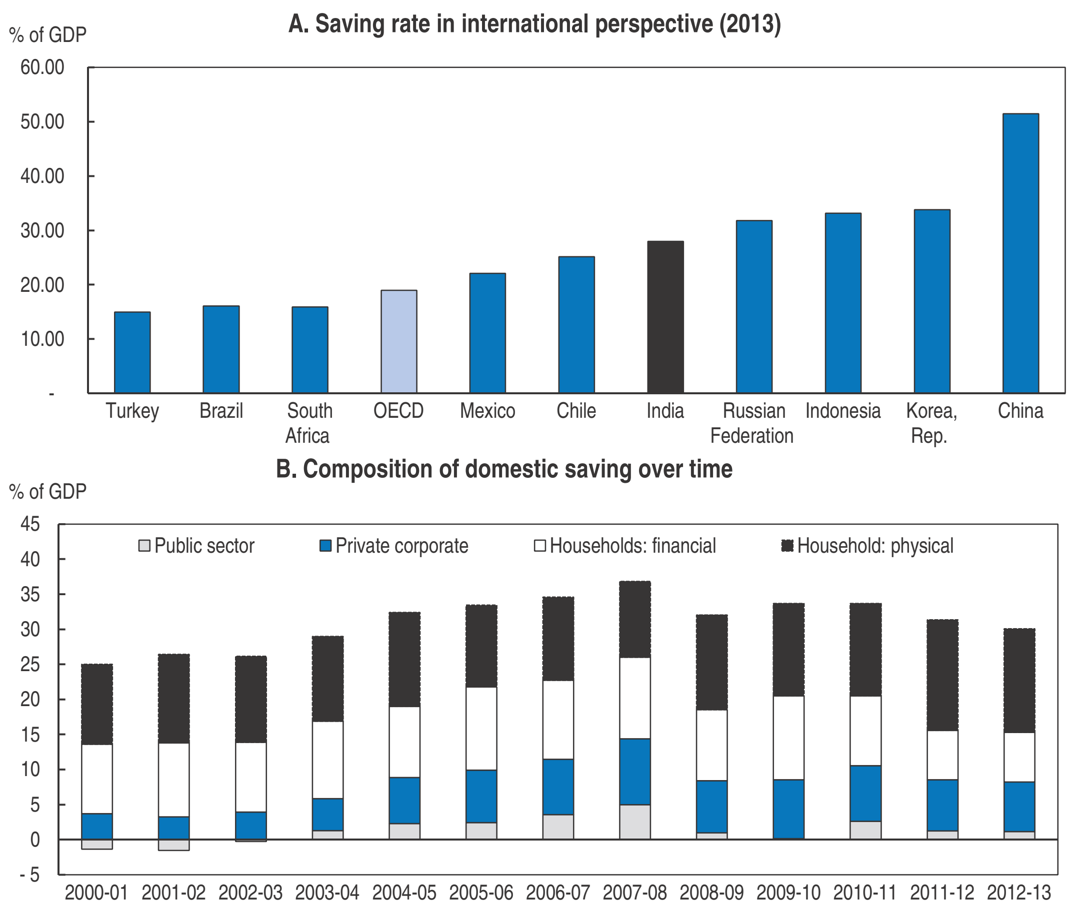
Although the gross national saving rate, at over 30% of GDP, is high by OECD and BRIICS standards, it declined by 6 percentage points of GDP between FY 2007-08 and FY 2012-13 (Figure 3), reflecting the decline in public and corporate saving. At the same time, high inflation and negative real interest rates on bank deposits have distorted household behaviour. Gold and real estate have been preferred to bank deposits. In response, the government introduced bonds indexed on wholesale price inflation in early 2013 and on consumer price inflation later in 2013. To choke off demand for gold and ease the associated current account pressures, the government raised import duties on precious metals. Some industrial companies, in particular large conglomerates, have rapidly increased their debt levels (Morgan Stanley, 2014) which could threaten an investment recovery and, as nonperforming and restructured loans have risen steadily, weakened the banking system.

Figure 3. **Saving has declined and shifted to less productive assets**



Note: Savings is equal to the difference between gross national disposable income and final consumption. Public sector includes public enterprises. The public sector saving is equal to public sector net lending plus net capital outlays.

Source: World Bank World Development Indicators, Central Statistics Office of India.

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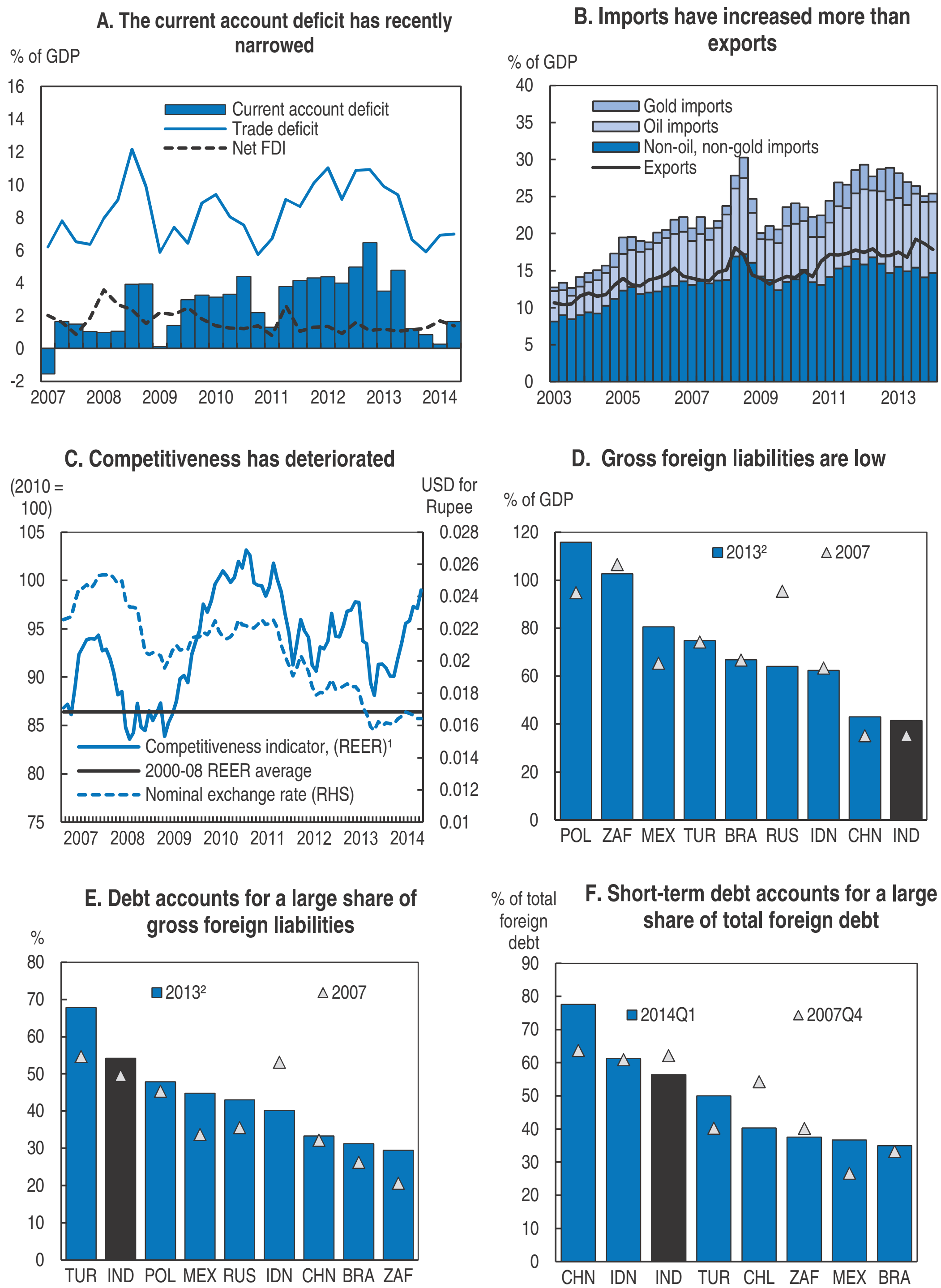
External vulnerabilities pose medium-term risks. Trade openness has increased steadily in India. The ratio of merchandise imports to GDP was approaching 25% in 2013, twice higher than 10 years before, although the exports to GDP ratio increased less dramatically (Figure 4, Panel B). As the saving rate fell, the current account deficit widened,

Figure 4. **External vulnerability remains a medium-term concern**



1. Real effective exchange rate (REER) based on consumer prices. An increase implies a loss of competitiveness.
2. Or latest available figures.

Source: India Ministry of Commerce and Trade, Reserve Bank of India, OECD – *International Trade and Balance of Payments Database*, OECD – *National Accounts Database*, Bank for International Settlements and IMF Balance of Payments Statistics.

StatLink http://dx.doi.org/10.1787/888933163135

reaching an all-time high of 5% of GDP in 2012 (Figure 4, Panel A). The trade deficit is considerably larger, and has been pushed up by rising oil imports (encouraged by low regulated domestic prices) and gold imports (to hedge against inflation). The October 2014 deregulation of diesel and a hike in gas prices may contain import growth. Sluggish domestic demand, the import duties on precious metals along with a lower international price for gold and stronger exports helped to sharply narrow the current account deficit to about 1% of GDP in the second half of 2013.

Maintaining the current account deficit near its sustainable level, estimated at around 2.5 % of GDP by the RBI (Goyal, 2013), requires dealing with its structural causes. Key among these is a deterioration in competitiveness. Gains in export market shares were rapid in the previous decade but have stalled since 2011, and despite the sharp depreciation over the summer of 2013 the real effective exchange rate remains above its long-term average (Figure 4, Panel C). In addition, supply-side constraints, particularly in transport and energy infrastructure, as well as stringent labour regulations have held back manufacturing exports. Services exports, by contrast, have grown strongly, with software exports doubling from 2% of GDP in FY 2003-04 to over 4% in 2012-13.

The widening current account deficit was financed largely by portfolio and short-term debt inflows in 2013. Foreign direct investment (FDI) has stagnated at about 1.25% of GDP since 2010. India's foreign liabilities to GDP are well below those of most EMEs, but the debt component is large and increasingly short-term (Figure 4, Panels D, E and F).

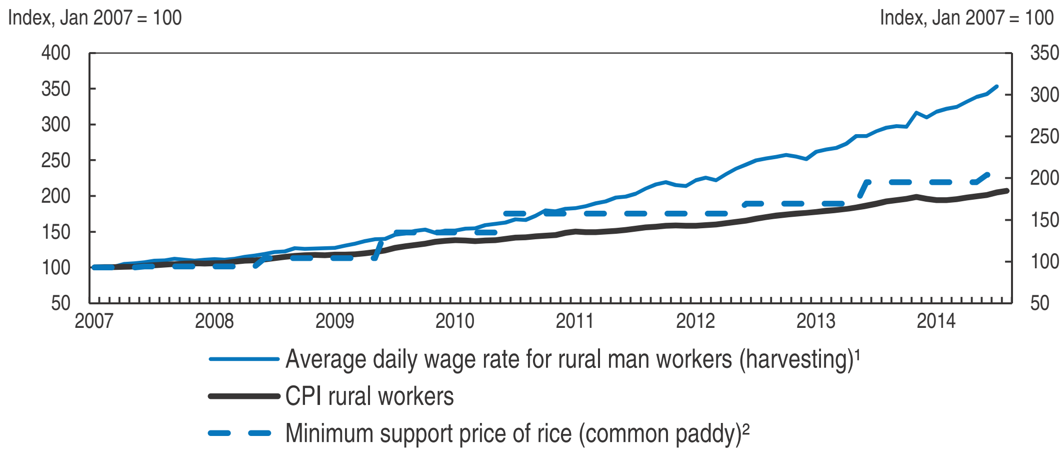
The government has adopted a series of measures to boost capital inflows, including increasing the cap for foreign institutional investment in government securities and corporate bonds, deregulating the interest rate on non-residents' deposits, allowing public financial institutions to raise funds abroad through quasi-sovereign bonds (i.e. with implicit government guarantee) and easing restrictions on external commercial borrowing. Recent FDI deregulation for selected sectors (including telecom, civil aviation and multi-brand retail in 2013, as well as defense and insurance in 2014) is not yet fully reflected in the numbers. However, the uptick in FDI early in 2014 may signal a shift away from debt financing.

Prospects and risks

Activity is projected to pick up gradually. Private consumption should grow steadily, in particular in rural areas, reflecting past rises in agricultural minimum support prices (MSPs) and rural wages (Figure 5). Investment should recover as the decline in political uncertainty has boosted business sentiment. If successful, efforts to put large stalled infrastructure projects back on track would also raise investment. The projected rebound in external demand should boost exports. Tight monetary and fiscal stances and high corporate leverage will restrain domestic demand. Inflation and inflation expectations are projected to decline gradually, reflecting some moderation in wages and food prices as well as the implementation of the new monetary policy framework.

Current risks are broadly balanced, although for the medium term risks are on the downside, contingent on the implementation of reforms. Exports, which have been showing signs of recovery after the rupee depreciation in the summer 2013, may be restrained by supply-side bottlenecks. High corporate leverage and deteriorating asset quality in the banking sector may put the investment recovery at risk. Poor weather conditions (a deficient monsoon) could weigh on agriculture and add to inflation pressures.

Figure 5. **Past hikes in minimum support prices and rural wages sustain private consumption**



1. Among rural activities, harvesting has been chosen as representative of the dynamics of wages in rural areas. There is a break in the series in October 2013. Starting from this date the series on wage for harvesting, winnowing and threshing was used.
2. Among the products covered by minimum support prices (MSPs), rice has been chosen because it has the highest weight in the WPI index. Changes in MSPs for rice over the period are broadly similar to most other MSPs.

Source: Indian Department of Agriculture and Cooperation and Reserve Bank of India.

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A slower than projected recovery, coupled with the impact of the depreciation of the rupee on oil and fertiliser subsidies, could make the planned fiscal consolidation more challenging, potentially undermining macroeconomic stability. On the other hand, a firm commitment to contain both inflation and the fiscal deficit would boost confidence and thus investment and consumption. Implementation of badly needed structural reforms would boost growth and, if properly designed, could also hasten the short-term recovery.

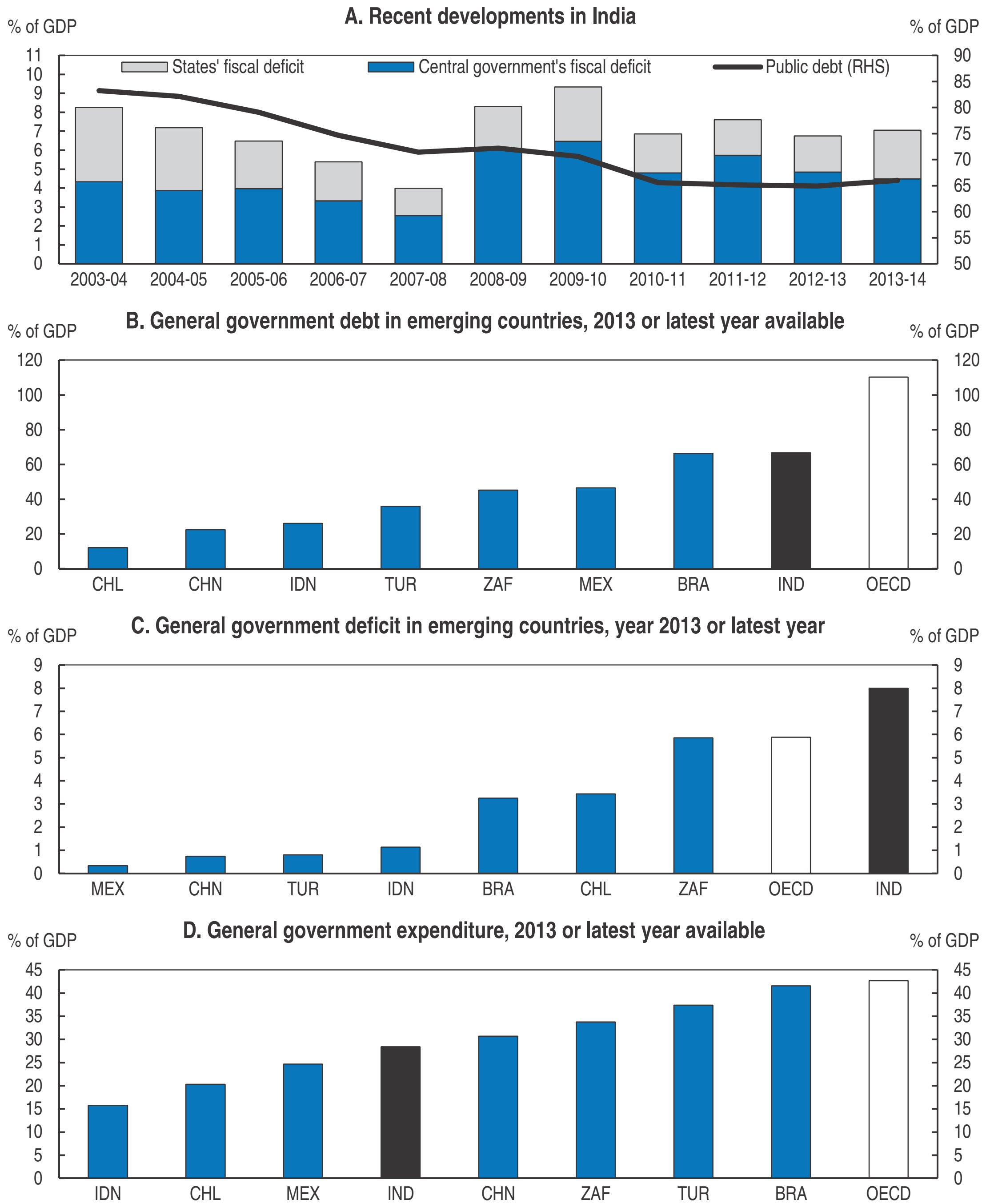
Fiscal and monetary policies have been gradually tightened

India's public deficit and debt are high compared with other emerging economies. Although the debt to GDP ratio has fallen significantly over the past decade (Figure 6), the combined central government and states deficit remained high following the economic slowdown and because of the higher oil and fertiliser subsidies.

In September 2012, a new fiscal consolidation roadmap was adopted to cut the central government deficit by 0.6% of GDP each year to 3% in FY 2016/17. The FY 2012/13 target was met and the FY 2013/14 was overfulfilled, thanks to cuts in non-wage spending, in particular investment, delayed subsidy payments (estimated at between 0.6 and 1% of GDP) and larger dividends paid by public enterprises. Still, fiscal pressures remain large. In particular, the 2013 Food Act extended the food subsidy from one to two-thirds of the population at an estimated cost of between 0.2% to over 1% of GDP when the Act is fully implemented (Gulati et al., 2012). The cooking gas subsidy was also raised again early in 2014 and taxes on the production of capital goods were lowered from 12% to 10% to revive the manufacturing sector.

The budget presented by the incoming government for FY 2014/15 confirms India's commitment to fiscal consolidation. The emphasis on capital expenditure with a focus on

Figure 6. **Government debt and deficit remain high**



Source: Brazilian Ministry of Economics, CEIC, Chinese Ministry of Finance, IMF, *OECD Analytical Database*, *OECD Economic Outlook 96 Database* and World Bank.

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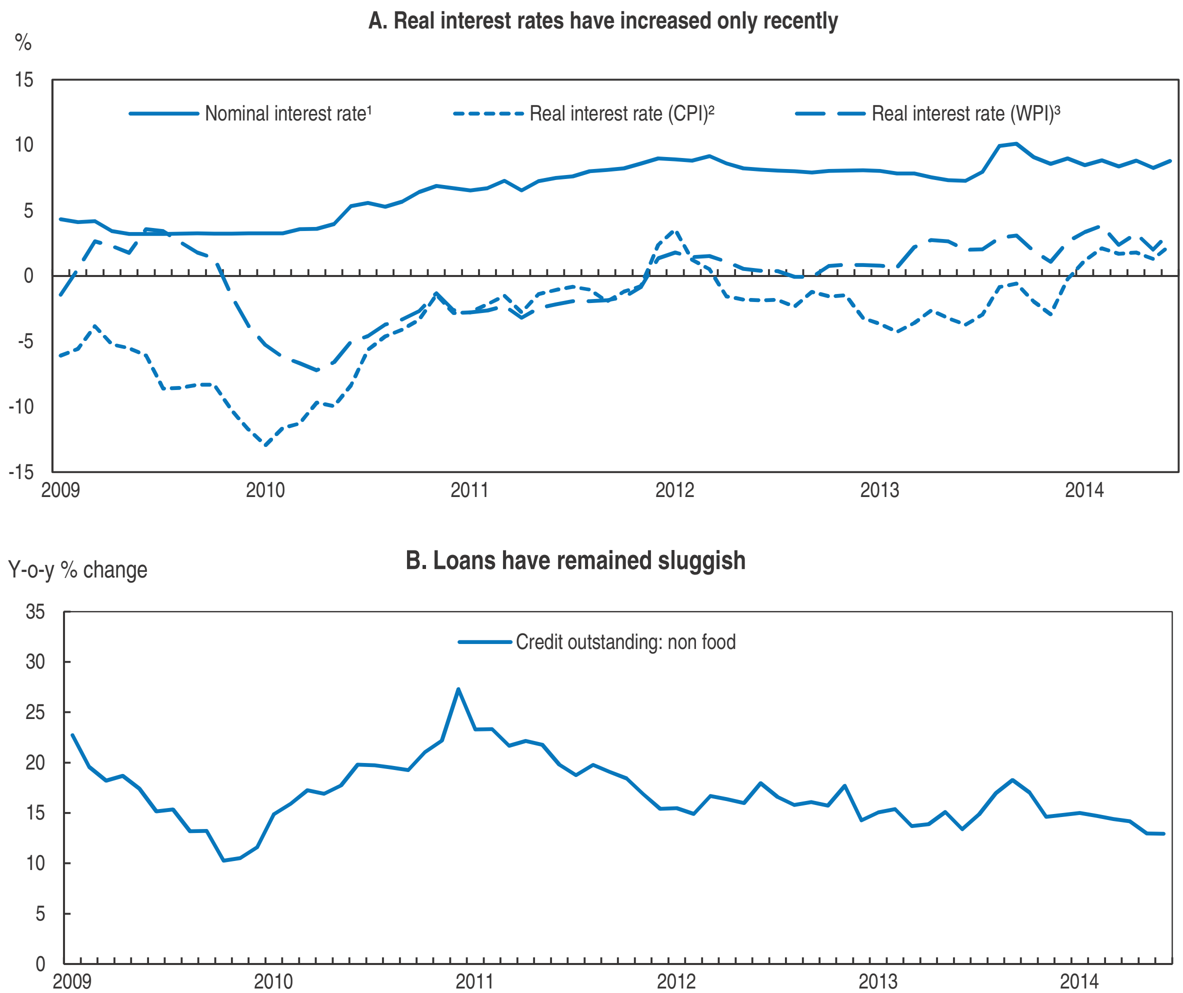
transport (road, rail and ports), clean energy, rural housing and sanitation is welcome, as such investment is badly needed to sustain economic and social development. This will also reduce the negative impact of fiscal consolidation on growth as the fiscal multiplier for investment tends to be higher (Bose and Bhanumurthy, 2013). The expected surge in privatisation receipts (which in India are included in the net lending position) will help finance these investments. The budgeted 17% increase in tax revenue seems optimistic, however. Achieving a sustainable and quality fiscal consolidation would require streamlining the many tax breaks which undermine revenues and contribute to the complexity of the tax system, as well as other public finance reforms (see below).

Against the backdrop of high inflation and high inflation expectations, the key monetary challenge is to sustainably reduce inflation. Interest rates have been below those implied by a simple Taylor rule for some years (RBI, 2014a) and real interest rates have long been low or even negative (Figure 7). At the same time, the exchange rate depreciation effectively loosened monetary conditions. However, this was not reflected in a rebound in loans. The planned tighter fiscal stance should help to sustainably reduce inflation but the stance of monetary policy will also have to remain tight.

Figure 7. **Real interest rates have long remained low or negative but loans have not rebounded**



1. Average interest rate at which overnight deposits are offered between prime banks on the wholesale money market or the interbank market.
2. Nominal interest rate minus inflation measured by the consumer price index for industrial workers.
3. Nominal interest rate minus inflation measured by the wholesale price index.

Source: Reserve Bank of India and *OECD Economic Outlook 96 Database*.

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Enhancing the monetary and fiscal policy frameworks

Reforming the monetary policy framework

In January 2014, an RBI expert committee recommended changes to the monetary policy framework to make it "transparent and predictable". This set of recommendations is a coherent roadmap towards a monetary policy framework largely consistent with global best practice:

- Inflation should be the nominal anchor for monetary policy, giving the headline Consumer Price Inflation (CPI) preference over Wholesale Price Inflation (WPI).
- The inflation target should be 4%, with a band of +/-2%, following a 3-year transitional phase (the target would be 8% for one year and 6% for the next two years).
- The RBI should publish an inflation report every 6 months.
- Monetary policy decision-making should be vested in a Monetary Policy Committee (MPC) which publishes with a lag of two weeks.
- The MPC will be held accountable for failure to achieve the inflation target by issuing a public statement stating the reason(s) for failure, remedial actions proposed and the likely period over which inflation will return to target.
- To improve monetary policy transmission, the government should comply with the fiscal roadmap and eliminate the practice of setting prices, wages and interest rates. The Statutory Liquidity Ratio should be reduced to a level consistent with Basel III prescriptions. Existing sectoral interest rate subsidies, in particular for agriculture, should be reconsidered.

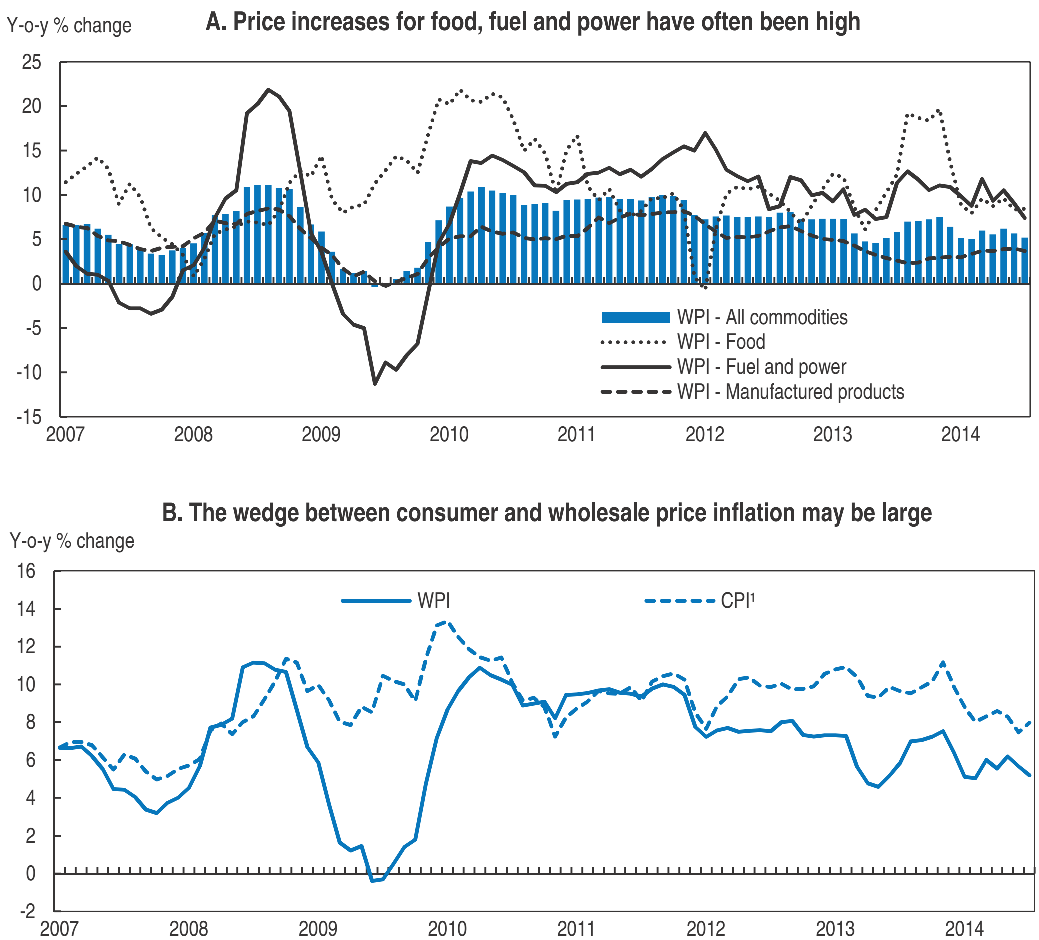
Currently, monetary policy in India has three main objectives: maintaining price stability; supporting economic growth by ensuring an adequate flow of credit to productive sectors and securing financial stability. In addition, the RBI intervenes in the foreign exchange market to avoid excessive exchange rate fluctuations.

Moving to an inflation targeting regime would focus the RBI on curbing inflation and steadying inflation expectations, which are key to promoting savings and investment and thus growth. Inflation above 4 to 5.5% reduces GDP growth (Mohanty et al., 2011). In the past, inflation has eroded the value of financial assets and, in particular the purchasing power of the poor. Inflation targeting has been successfully implemented in a number of emerging market economies, including Brazil, Chile, Colombia, Indonesia Mexico and South Africa. It has brought greater economic stability without compromising growth or other economic and social goals (Jahan, 2012). Nevertheless, the 2009 global financial crisis made clear that inflation targeting alone is not sufficient for economic stabilisation; fiscal policy and financial stability remain key macroeconomic policy pillars. Strict inflation targeting has high disinflationary costs. The influence of supply shocks, the still large weight of food items in the CPI basket and weaknesses in monetary policy transmission are key challenges. The inflation targeting framework should thus be implemented in a flexible manner.

Inflation targeting with a flexible exchange rate can be a challenge with volatile capital flows, which can cause large swings in the exchange rate with repercussions for price stability. Volatile capital flows also increase financial vulnerabilities from unhedged bank or company balance sheets with large foreign currency exposures. A number of studies have shown that in dealing with capital flow volatility it is preferable to let the currency depreciate than to raise interest rates and capital controls. This is because the latter tools tend to have more adverse output effects (Blanchard 2013; Blundell-Wignal and Roulet 2013a, 2013b; Forbes and Klein, 2013). Risks to inflation targeting from capital flow volatility can thus be contained by enhancing the credibility of the monetary policy framework to anchor price expectations and reducing financial vulnerabilities with macroprudential tools as suggested by Lim et al. (2011) and Saborowski et al. (2014).

The RBI has long used the wholesale price index (WPI) as the key inflation measure, partly because it was available more rapidly and frequently than the CPI. The WPI however fails to accurately reflect the cost of living, as it excludes services and puts a much lower weight on food which has experienced severe price pressures since the late 2000s (Figure 8, Panel A). As a result, it does not reflect the prices people experienced and, with WPI inflation lower than CPI inflation almost consistently since 2009 (Figure 8, Panel B), monetary policy credibility was eroded. The choice of a 4% CPI target with a relatively wide band is reasonable given the distorting effects of high inflation and the high volatility of consumer prices due to the large weight of food and energy in Indian consumption.

Figure 8. **Price increases vary significantly across sectors**



1. The new CPI (base 2010) was used. For the years before 2010 the back-casted series provided in the January 2014 Report of the Expert Committee to Revise and Strengthen the Monetary Policy Framework were used.

Source: Reserve Bank of India.

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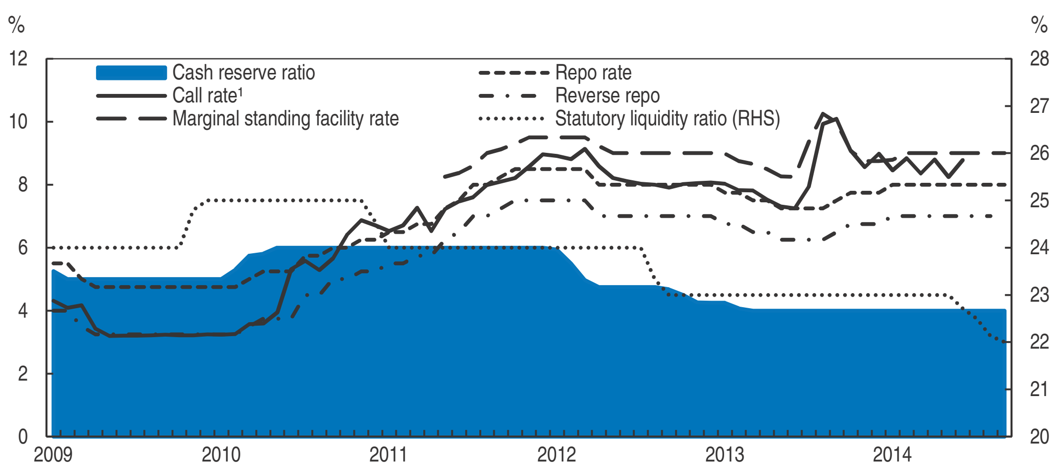
Establishing a Monetary Policy Committee and extensive reporting on policy discussion would greatly increase transparency and provide the RBI with important and regular channels of communication. This would also help anchor inflation expectations. The RBI already has some such channels; notably the minutes of meetings of the Technical Advisory Committee on Monetary Policy, which contains information on concerns expressed by members of the Committee, including dissenting opinions. However, this Committee does not make monetary policy decisions, a role currently reserved for the Governor.

The RBI has relied on a large set of direct and indirect instruments, including: the cash reserve ratio, the statutory liquidity ratio, the Liquidity Adjustment Facility and associated repo and reverse repo rates and open market operations (Figure 9). Over time and along with financial liberalisation, the RBI has gradually moved away from direct instruments towards the repo rate (Mohanty, 2011). A further move in this direction would clarify the RBI's policy stance, thus helping to anchor inflation expectations. Monetary policy transmission is still slow, however. Although this partly reflects the large share of fixed-rate loans, transmission would be improved sharply by reducing the scope of administrative wage and price setting and by a more robust financial sector.

Figure 9. **The RBI has relied on various instruments to adjust liquidity conditions**



1. The overnight Mumbai Interbank Bid Rate, or MIBID, is the average interest rate at which overnight deposits are offered between prime banks in the Indian wholesale money market or interbank market. Data represent the monthly average.

Source: Reserve Bank of India, National stock exchange of India.

StatLink http://dx.doi.org/10.1787/888933163180

Dealing with structural fiscal problems: More consolidation, more efficiency, more equity

The Fiscal Responsibility and Budget Management Act (FRBMA), adopted in 2003, established a fiscal framework that contributed to rapid consolidation up to 2007. It required the government to submit a series of documents spelling out its fiscal strategy and progress in achieving it. Between 2008 and 2009, fiscal support was introduced to cushion the impact of the global financial crisis and consequently the targets embodied in the FRBMA were not achieved. Fiscal targets embodied in the 2012 fiscal roadmap have been complied with so far, although compression of public investment, larger dividends paid by public enterprises and privatisation receipts cannot be long-term solutions.

Durably resolving the fiscal pressure will require both a stronger fiscal framework and the reconsideration of a number of spending and taxation policies.

Strengthening the fiscal framework

Multi-year spending ceilings would strengthen the budget balance targets that are already in the FRBMA and provide a guide for fiscal planning. Such ceilings need to take account of future spending plans – for example overall spending could rise in relation to GDP so long as tax revenues rose with it. One such expenditure is public investment, which is badly needed to remove bottlenecks that are holding back economic growth. The FRBMA "revenue" balance targets exclude capital spending, but it might be more coherent to recognise infrastructure needs explicitly and incorporate them in the spending ceiling.

Compliance with the fiscal targets and the credibility of fiscal policy would be strengthened by establishing an independent fiscal institution to examine budgets relative to deficit and spending objectives (Hagemann, 2010). A growing number of OECD countries have established such institutions, although they vary significantly in institutional set up and mandate. One option for India would be to empower the Parliamentary Committee on Finance.

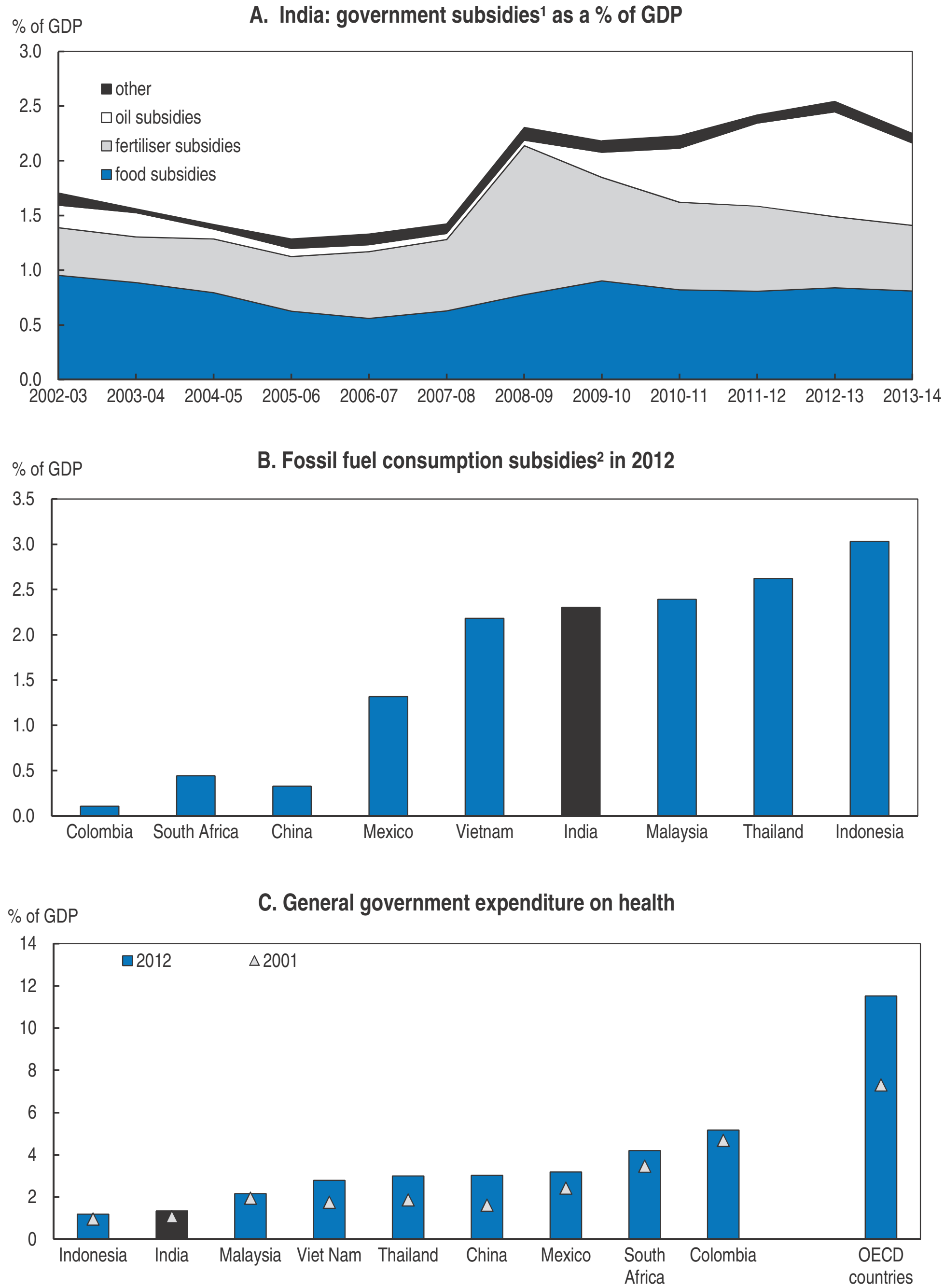
Spending reviews should also be considered for key programmes, in particular subsidy programmes, to assess whether outcomes could be improved and whether objectives could be achieved at a lower cost. The Expenditure Management Commission created by the new government is welcome in this regard. Better accounting rules would promote a more sustainable fiscal consolidation: accrual accounting would reduce incentives to record spending in the next budget year; allowance for capital consumption in the fiscal rule would help avoid a build-up in debt with no commensurate increase in assets (Blanchard and Giavazzi, 2004); and privatisation receipts should not be reflected in the fiscal deficit and be shown, instead, "below the line".

Spending: better targeting subsidies and reducing abuses

A key objective of subsidies has been to protect vulnerable households from rising and fluctuating prices for essential products. However, their cost has been increasing steadily (Figure 10) and they have disproportionately benefitted the rich and the middle-class. For rice and wheat, leakages in the food subsidy, including widespread diversion to the black market, have been estimated by Gulati et al. (2012) at 40%, and up to 55% by Jha and Ramaswami (2011). According to Jha and Ramaswami (2011), the poor benefit from only around 10% of the spending on food subsidy. Many of the poor do not benefit from the subsidy because the system fails to correctly identify who is eligible (in 2004/05 only about one third of the poor benefitted), while a large share of the recipients are non-poor (Jha and Ramaswami, 2011). For oil, Anand et al. (2013) estimated that the implicit subsidy is 7 times higher for the richest 10% of households than for the poorest 10%.

Subsidies crowd out important spending. Increasing public spending on infrastructure would have a stronger impact on long-term growth while public spending on health care, which contributes to reduce inequality in well-being, has remained very low in India (Figure 10, Panel C). Burniaux and Chateau (2011) estimate that phasing out fossil fuel subsidies in India would boost real income by more than 2%. Finally, energy subsidies raise energy intensity, encouraging energy imports and increasing greenhouse gas emissions.

Figure 10. **Energy subsidies are large while public spending on health is low**



1. Only subsidies recognised in the central government budget are shown. Oil subsidies, estimated at 0.8% of GDP in the central government budget in FY 2012/13, do not fully reflect the fiscal costs. As an indication, the so-called under-recoveries of the public sector Oil Marketing Companies (OMCs) – i.e. the difference between the revenues and (international) costs and revenues of distributing petroleum – amounted to 1.6% of GDP in the FY 2012/13. The OMCs' under-recoveries are partly financed by state-owned oil and gas production companies, thereby reducing the potential dividends these companies pay to the government.
2. The fossil fuel consumption subsidies refer to subsidies for oil, coal and natural gas. The IEA estimates subsidies to fossil fuels that are consumed directly by end-users or consumed as inputs to electricity generation with the price-gap approach. It compares average end-use prices paid by consumers with reference prices that correspond to the full cost of supply. They include also subsidies that result from the under-pricing of electricity generated by fossil fuels.

Source: CEIC, International Energy Agency 2011, World Health Organisation 2013.

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Recent initiatives to reduce the cost of subsidies and improve their effectiveness include hiking some administered prices (fuel, diesel, gas and railway fares), capping subsidised consumption (cooking gas and fertilisers) and partially deregulating the energy sector. As recognised in the FY 2014/15 Budget, better targeting subsidies would also help. Moving from price to cash subsidies would reduce diversion and leakages, thus reducing the cost and increasing the effectiveness of subsidies. Indonesia raised oil prices by 44% in the summer 2013 and simultaneously introduced a cash transfer for the poorest households. Even better would be, in the medium term, to expand the social safety net to protect the poor.

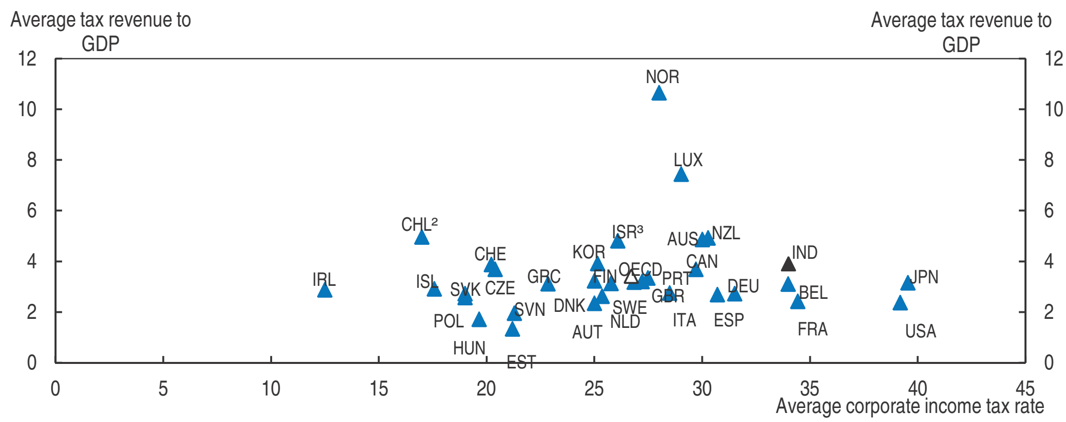
The Direct Benefit Transfer (DBT) scheme, introduced in 2013 and supported by a unique personal identification number (Aadhaar) and Aadhaar-linked bank accounts, is a welcome step in this direction. It could serve as an example of best practice for many countries. It should speed up benefit delivery and reduce costs and corruption, while promoting financial inclusion (Drèze and Sen, 2013; CGAP, 2013). As of January 2014, an Aadhaar number had been granted to 560 million citizens, or almost half of the population, and 28 subsidy programmes were managed through the DBT, mostly scholarship and pension programmes. Extending the DBT system to consumer subsidies, would capitalise on its success. In this respect, the 2013 decision to suspend the DBT/Aadhaar system for the subsidy on cooking gas (LPG) is a step back.

The National Rural Employment Guarantee Scheme (NREGS), fully in place since 2008, aims to provide a welfare safety net for rural inhabitants and to promote local development by funding small-scale farm and infrastructure projects. It provides off-season job opportunities for about 46 days a year per household at minimum wages. In 2013, about 46 million households benefitted from the NREGS. It has reduced rural poverty, improved rural infrastructure and, by providing equal pay and half the jobs for women, reduced gender wage gaps (Zimmermann, 2012) and encouraged many women to join the work force (Khera and Nayak 2009). However, it suffers from corruption, the economic impact of supported projects, mostly roads, is uncertain (Ghose, 2011; Imbert and Papp, 2013), and implementation has been uneven across states (Imbert and Papp, 2012; Comptroller and Auditor General of India, 2013). The scheme may also have crowded out private sector work. It would be useful to thoroughly assess the NREGS outcomes with a view to enhancing effectiveness. In this respect, the government's plan to better monitor outputs is commendable and should be implemented swiftly. The proposed promotion of sanitation projects within the NREGS is especially welcome, as better sanitation is closely linked to better health, well-being and productivity. More should be done, however. In particular, restrictions on the use of machines should be reconsidered. A study for instance showed that the durability of roads financed by the NREGS is low due to non-use of road rollers which are necessary for compaction (Ministry of Rural Development, Government of India, 2012).

Raising more revenue in a less distortive way

Tax revenues (excluding social contributions) stood at 17.1% of GDP in FY 2012-13, which is below the level in most other BRIICS. Tax rates tend to be high, but the base is narrow and compliance is low: central government tax expenditures are estimated at 6.5 % of GDP. The corporate income tax, for example, has a high tax rate – 30% on domestic companies *plus* a 5 to 10% surcharge for large companies – but only average revenue (Figure 11). The 2010 Direct Tax Code Bill aimed at reducing the corporate income tax rate

Figure 11. **The high corporate income tax rate fails to produce large revenue**[1]



1. 2007-12 average.
2. For Chile, data refer to years 2007-09.
3. For Israel, Luxembourg, New Zealand and Switzerland, data refer to years 2007-11.

Source: Indian Ministry of Finance and *OECD Tax Database*.

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to 30% and removing some tax allowances. The Direct Tax Code Bill lapsed, however. For individuals, the lowest marginal tax rate is applied at over 2.5 times the average wage or 3 times GDP per capita, a very high level compared to Brazil, China, Indonesia and South Africa (Gandullia et al., 2012). The Direct Tax Code Bill envisaged widening income slabs while also keeping most exemptions for saving, as well as on interest paid on housing and education loans. Since such tax reliefs entail significant revenue losses and tend to benefit the rich most, they should be abolished.

Much also remains to be done to broaden the bases of indirect taxes. A welcome move by the government has been to list the services exempted under the Service Tax, replacing a list of those to be taxed. The suggestion by the Tax Administration Reform Commission (TARC) to amalgamate the Direct tax and Indirect tax Departments, to make it easier for companies to file returns, has merit. The long-awaited Good and Service Tax (GST, a value-added tax), yet to be passed by the Parliament, provides an opportunity to restrict the use of reduced rates and exemptions. Replacing the existing complex and multilayer indirect tax system by a broad-based GST would promote growth and competitiveness (NCAER, 2009; Indian Institute of Corporate Affairs, 2011; Vaidya and Kanagasabapathy, 2013). International experience suggests that distributional concerns are poorly addressed by special and low VAT rates. In Colombia for instance, the implicit subsidy associated with VAT exemptions and reduced rates is more than 10 times higher for the 10% richest households than for the 10% poorest because the rich consume more in absolute terms than the poor (Joumard and Londoño, 2013). Expanding the social safety net or, in the short term, implementing targeted cash transfers within the Aadhaar system would be more effective to address distributional concerns.

Recommendations to strengthen the monetary and fiscal policy frameworks

Key recommendations

- Implement flexible inflation targeting.
- Pursue fiscal consolidation while avoiding one-off measures and cuts in growth-enhancing spending.
- Shift public spending away from energy subsidies towards investment in physical and social infrastructure. Implement a national value-added tax (GST) with only limited exemptions.

Further recommendations

- Monetary policy should err on the prudent side to restore confidence and avoid a rebound in inflationary pressures.
- Extend the current fiscal rules to include spending ceilings and improve the accounting framework.
- Carry out spending reviews for core spending programmes with the view to improve their effectiveness. Reconsider the prohibition on using machines for NREGS projects.
- Shift further from in-kind subsidies towards people-based cash transfers. Extend the Direct Benefit Transfer (DBT) to core subsidy programmes and use of the unique identification number (Aadhaar).
- Improve the Income Tax Act by further broadening its base, including by abolishing the tax allowance for interest paid on housing and education loans.

Addressing structural problems in product, labour and financial markets to promote inclusive and greener growth

Addressing structural bottlenecks – in particular gaps in energy and transport infrastructure, overly stringent labour regulations, the shortage of skills, and market and institutional failures that keep women outside the labour force – will promote job creation and inclusive growth.

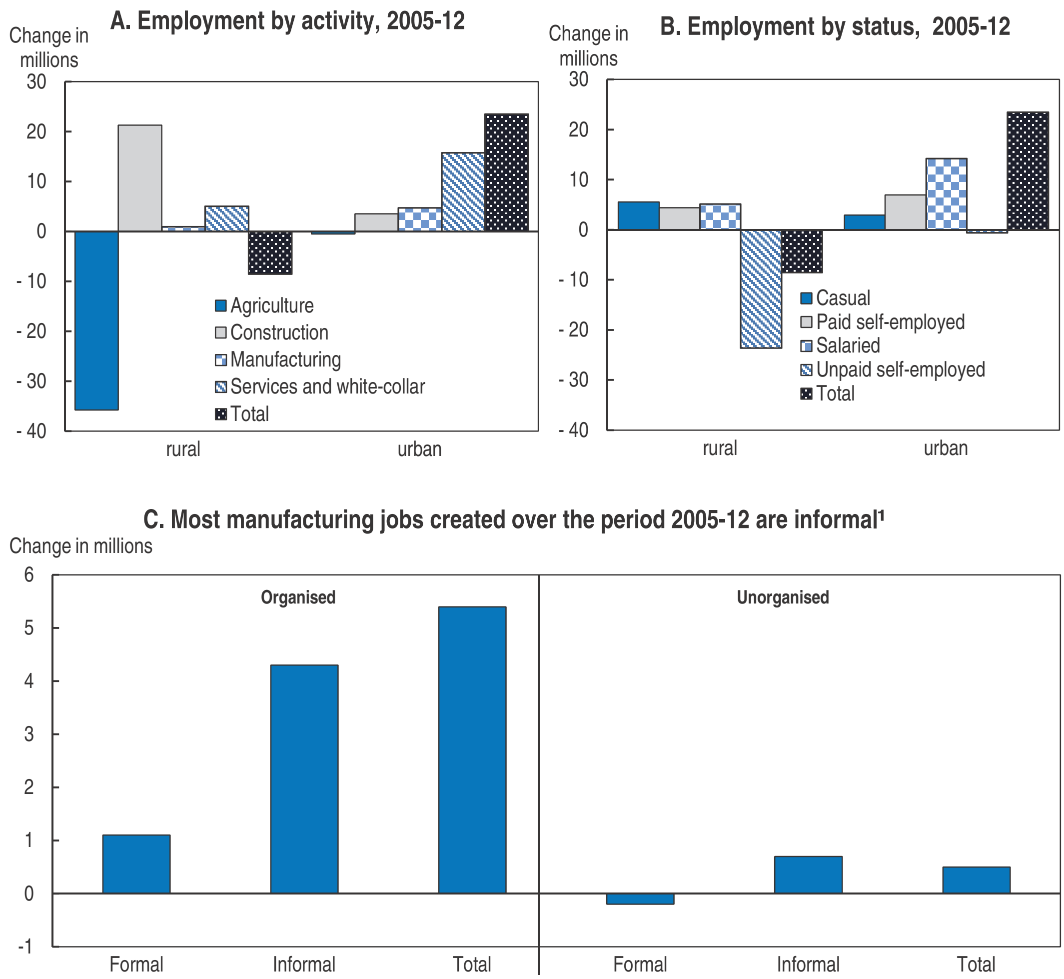
Boosting job creation

The labour market has performed poorly

Although the data are weak, it is clear that labour market performance is mixed. Almost 23 million net jobs were created over the period March 2005-March 2012 according to household survey data (NSSO). While agriculture employment fell by almost 37 million, employment surged in the rural construction sector and, to a lesser extent, in urban services (Figure 12). The unemployment rate is very low – slightly above 2%. However, under-employment is high and the rate of employment creation has been too low to prevent a decline in the employment to working-age population ratio (Figure 13). This ratio is now much lower than in most other BRIICS, partly because many women stay out of the labour force.

The vast majority of workers, particularly those in agriculture and the service sector, are not covered by core labour laws. In manufacturing, NSSO data suggest that about 65% of jobs were in firms with less than 10 employees in 2012 (Mehrotra et al., 2014) – the so-called "unorganised sector" – and thus not covered by Employment protection legislation (EPL) and many other core labour laws which apply only to larger firms.

Figure 12. **Jobs were created mostly in construction in rural areas and in services**



1. Informal workers are those with no social security benefits (Mehrotra et al., 2014).
Source: NSSO, Employment and Unemployment Survey, Rounds No. 61 and 68, and Mehrotra et al. (2014).

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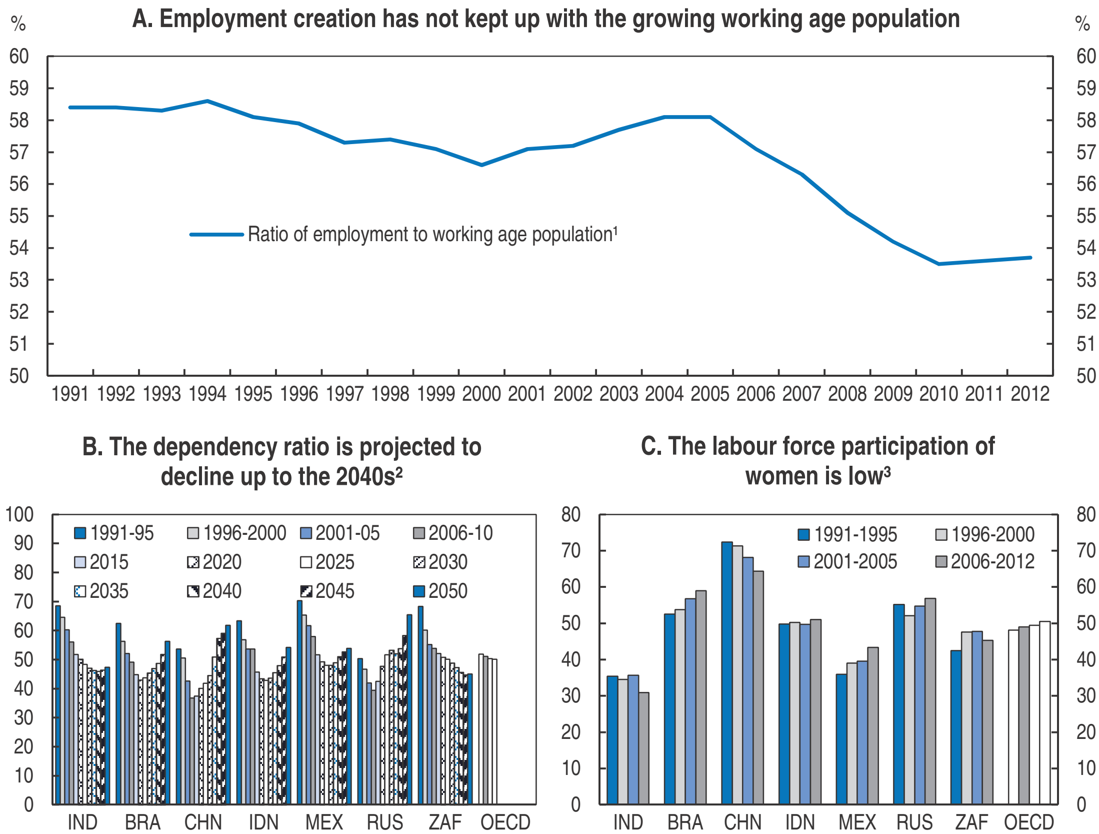
In addition, the Annual Survey of Industries (ASI) reveals that of those working in the organised manufacturing sector (more than 10 employees) 13% were on temporary contracts or employed by a sub-contractor ("contract labour") in 2010, up from 8% in 2000. Contract workers are also not covered by key employment or social protection regulations. NSSO data further suggest that earnings dispersion is significant.

To seize the demographic dividend and avoid a lost generation, the pace of job creation will have to pick up. Demographics will favour labour force growth for some years. The government projects the labour force to increase by 88 to 113 million people between 2010 and 2020, mainly through the entrance of the young who tend to be better educated. Moreover, the agriculture sector is projected to lose 15 million jobs (Government of India, 2013). The supply of labour available for non-agriculture sectors is thus projected to increase by up to 130 million between 2010 and 2020. An increase in the currently very low female labour force participation could add to the picture.

Figure 13. **The demographic challenge**



1. According to the ILO definition, working age population is made of individuals aged 15 or more.
2. The age dependency ratio is the ratio of the population younger than 15 or older than 64 to the working-age population, which is those aged 15-64. From 2015 World Bank projections are shown.
3. The labour force participation of women is equal to the percentage of working women aged 15-64 over the overall female population aged 15-64. Data refer to the simple average of the dependency ratio for each period.

Source: ILO (2013), *Key Indicators of the Labour Market (KILM) Database*, OECD (2014), *Perspectives on Global Development* and World Bank WDI databank.

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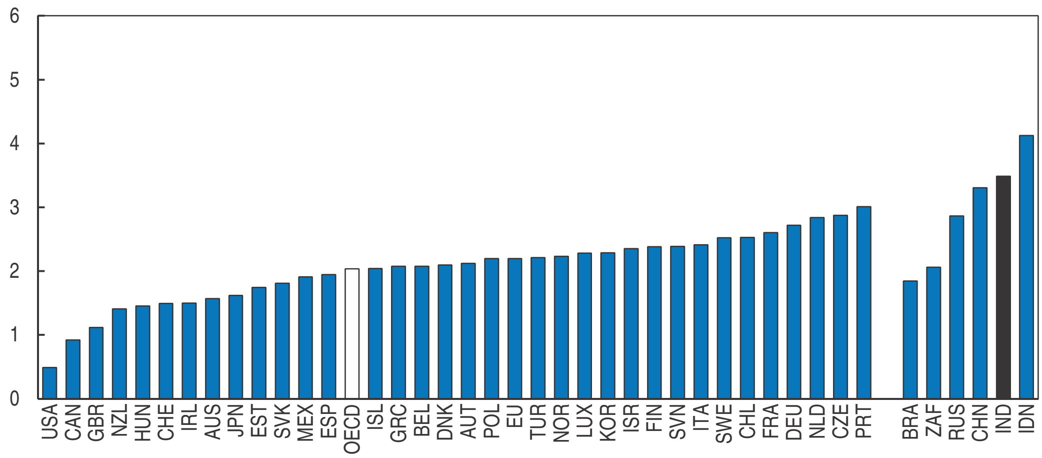
Creating more and better quality employment

Although direct labour costs are relatively low, labour regulations are complex and strict, in particular for large industrial firms. Employment protection legislation (EPL) is particularly restrictive compared to both OECD countries and EMEs (Figure 14). There is also uncertainty regarding enforcement since many labour laws are old and responsibilities are often shared across government jurisdictions. Companies have reacted by substituting capital for labour, staying small, or relying on informal or "contract" labour, and labour regulations have weighed on firms' productivity and on formal job creation (Dougherty, 2009 and Dougherty et al., 2011). Recent efforts at the central government and state levels to modernise labour regulations and reduce compliance requirements are steps in the right direction. A comprehensive labour law to consolidate, modernise and simplify existing regulations would allow firms to expand employment and output, and would be more enforceable, thereby extending social protection to more workers. One option would be to create a labour contract for new permanent jobs with less stringent employment protection legislation but with basic rights – standard hours of work, holidays, minimum safety standards and maternity benefits – for all workers irrespective of the firm size.

Figure 14. **Employment protection legislation is highly restrictive,**[1] **2013**



1. The OECD indicator of employment protection legislation (EPL) for regular employment measures the procedures and costs involved in dismissing individual regular employees. The indicator runs from 0 to 6, representing the least to most restrictive EPL. The last available data refer to 2012 for BRIICS countries.

Source: *OECD Employment Protection Database*, 2013 update.

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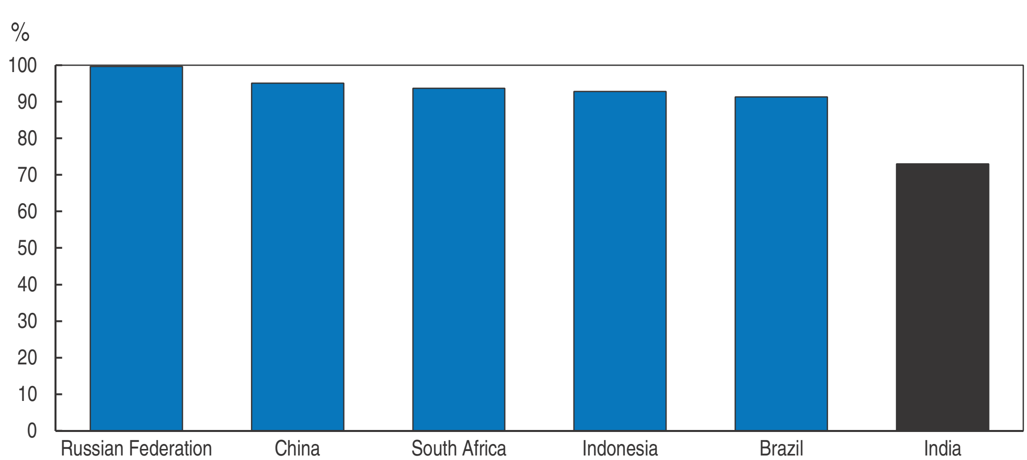
In this vein, the authorities should also consider gradually extending basic social benefits to all workers, while taking care to keep fiscal costs under control and reducing incentives to work in the informal sector.

Literacy is low compared to that in other emerging markets (Figure 15), and even those with higher education or vocational training (VET) are often ill-equipped and require significant on-the-job training (Crisil, 2014; World Bank, 2008). Still, India is now approaching near-universal enrolment in elementary education, spending on secondary education has risen significantly in recent years, and the 2009 "Secondary Education for All Action Plan" aims at providing universal access to secondary education by 2017. However,

Figure 15. **The literacy rate is low**[1]



1. Adult literacy rate (age 15 and above). For India the data concern population aged 7 and above, thus the figure slightly overestimates the literacy rate in comparison to other countries. For India and Indonesia, data are for 2011, for China and Russian Federation for 2010, for Brazil and Indonesia for 2009, and for South Africa, for 2012.

Source: World Bank WDI databank and Census 2011 for India.

StatLink *http://dx.doi.org/10.1787/888933163246* educational quality is poor. According to the 2009 OECD Programme for International Student Assessment (PISA), in which two Indian states participated, the average performance of 15-year-old students in India was far below the OECD average and well behind other emerging economies. To shift the focus to better educational outcomes, the authorities should implement a system to monitor school achievement and track implementation of reforms, and to strengthen employment incentives and training arrangements for public school teachers (OECD, 2011).

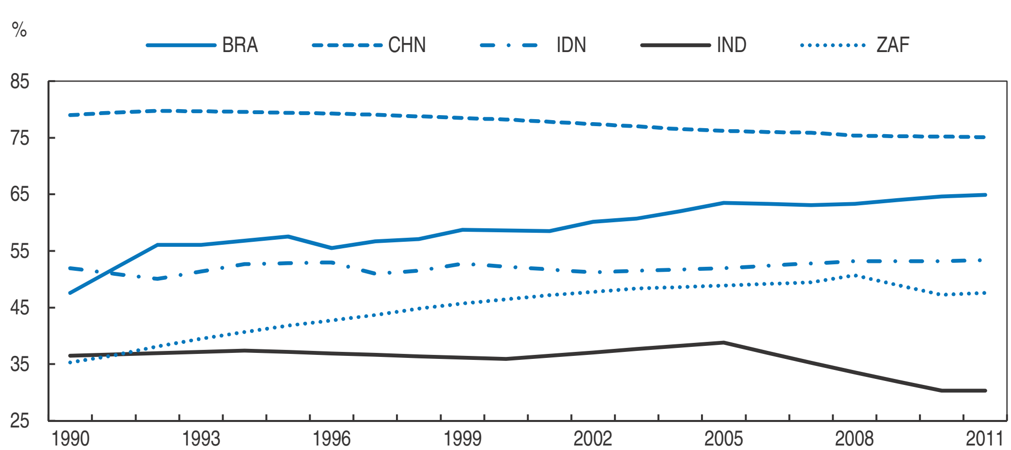
Vocational education should also be strengthened. Only 10% of the labour force aged 15-59 is vocationally trained (66th Round of NSS for 2009-10), and of those only a quarter received formal vocational training (Planning Commission, 2013). The National Policy on Skill Development, adopted in 2009 aims to increase skill levels of 500 million people by 2022, including 150 million through a public-private partnership – the National Skill Development Corporation (IDFC Foundation, 2013). However, it is important that industry skill requirements be better taken into account and that on-the-job training be an essential part of training (OECD, 2010). Curricula should be reviewed and updated more frequently, with inputs from academic and industry experts.

Raising female economic participation

India stands out with less than a third of working-age women in work; this is, for example, half that of Brazil (Figure 16). Female participation has in fact declined, especially since 2005. Men's wage employment has risen, increasing household incomes, and thereby allowing more women to stay home. This has been important for the large drop in participation of unpaid self-employed rural female workers. On the other hand, lack of jobs also led many women to drop out of the labour force (Table 2).

Participation is higher among the poor and somewhat surprisingly declines with education and family incomes (Figure 17). This reflects various supply and demand factors (see Technical background papers; Klasen and Pieters, 2013; Khera and Nayak, 2009), including social norms, as staying at home is often considered to increase the family's social status, although such influence is declining. There are also large regional

Figure 16. **Female labour force participation rate**[1]



1. Data refer to working age population (15 to 64 years).

Source: International Labour Organisation, *Economically Active Population, Estimates and Projections* (6th edition, October 2011).

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Table 2. **Employment trends**

Millions, 15-64 years of age

Net increase in…	2000	2012	Change 2000-12
Female			
Working age population	**304**	**403**	**99**
Labour force			
Employment	123	129	6
Unemployment	2	3	1
Remaining outside labour force			
In education	18	42	24
Not in education	161	229	68
Male			
Working age population	**326**	**427**	**101**
Labour force			
Employment	274	343	69
Unemployment	7	8	1
Remaining outside labour force			
In education	32	61	29
Not in education	13	15	2

Source: Working age population 15-64 years, estimates based on NSSO Rounds No. 61 and 68.

differences, with a much higher participation in Southern India (explained to some extent by religious customs in the regressions). Many women are self-employed in low productivity jobs as unpaid helpers as more formal jobs are scarce (Table 3), and only 6% of women who work, mostly those in the public sector, get social benefits. Affordable child care is inadequate, keeping many urban women out of the labour force. Female participation is also hindered by weak infrastructure, as time available for women to work is limited due to unsafe transport and unavailability of electricity or water.

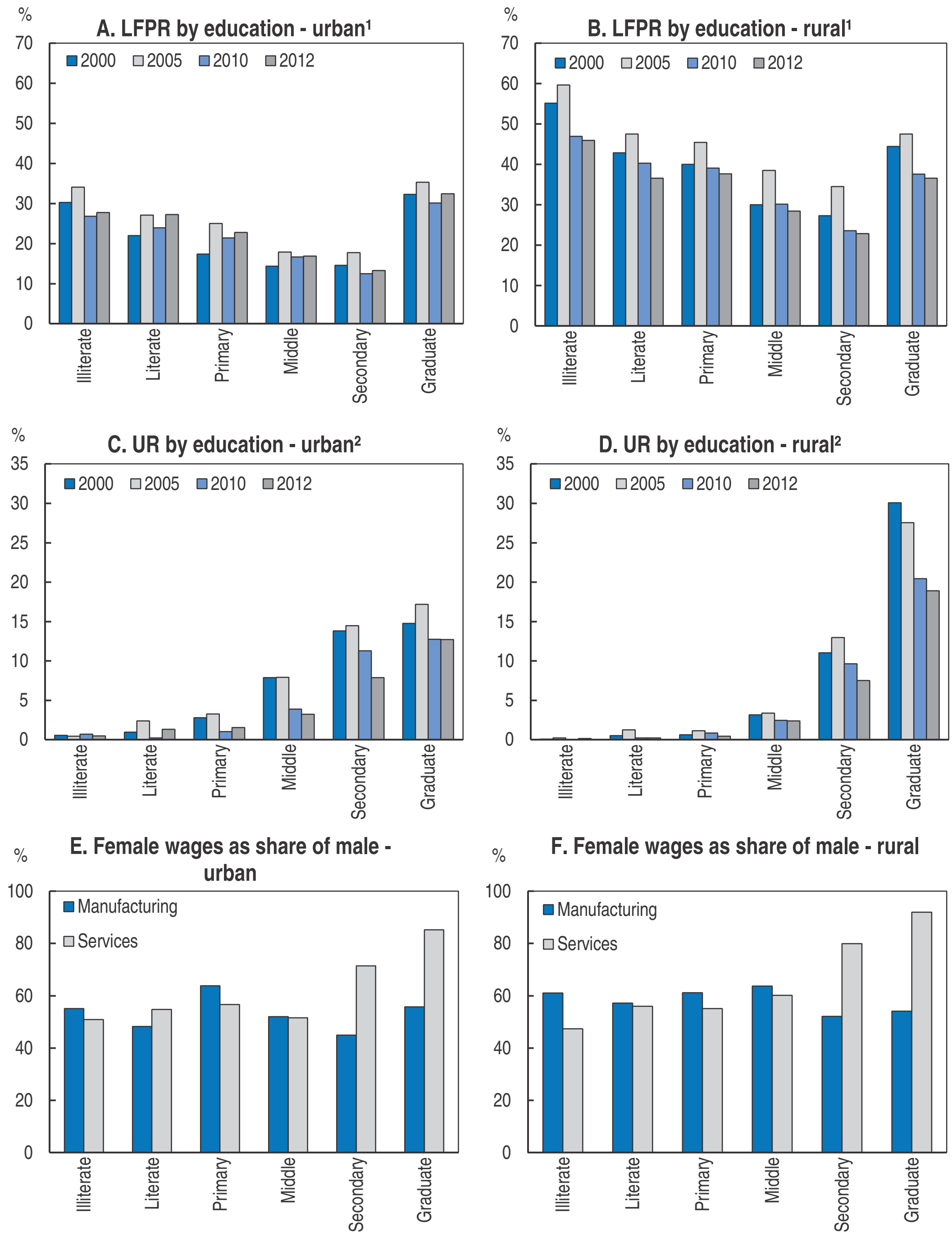
Weak implementation of and remaining gender biases in laws also affect women's opportunities for work. India ranks poorly compared to other BRIICs in the OECD Social Institutions and Gender Indicator (SIGI), which measures the impact of laws and socioeconomic or religious factors on women's status (Figure 18). While many laws provide for gender equality, they are often not implemented in practice. Despite equal pay laws, wage differentials remain large (van Klaveren et al., 2010, Rani and Belser, 2012, Figure 17) and in 2012 60% of women with salaried or casual jobs were paid below the minimum wage, compared to 25% for men (Rani and Belser, 2012). Women are also disadvantaged by inheritance laws, which restrict financial independence, access to credit and independent decision making (van Klaveren et al., 2010). Finally, labour laws restrict women's working hours and access to certain occupations.

At the same time, female entrepreneurship is increasing, especially in manufacturing where women account for 40% of entrepreneurs (Table 4). However, the increase is almost entirely accounted for by subsistence self-employed entrepreneurs, who work from home or as street vendors; the number of female entrepreneurs who have one or more employees has remained broadly stable (see *Technical Background Paper* No. 3). Entrepreneurship has been facilitated by education, work experience and role models, including through quotas in political representation on rural councils (Ghani et al., 2013; *Technical Background Paper* No. 3).

Weak demand is also contributing to lack of job opportunities. Double-digit unemployment among highly educated women suggests that many are willing to work if

Figure 17. **Female labour market indicators in India**

Working age population (15-64 years)



1. LFPR denotes the labour force participation rate of females.
2. UR denotes the unemployment rate of females.

Source: NSSO, Employment and Unemployment Survey, Rounds No. 55, 61, 66 and 68.

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they had access to jobs that matched their skills. Similarly, according to surveys, many women who stay at home report that they would like to work more, especially from home, were suitable work available (NSSO). Jobless growth has also reduced opportunities, and

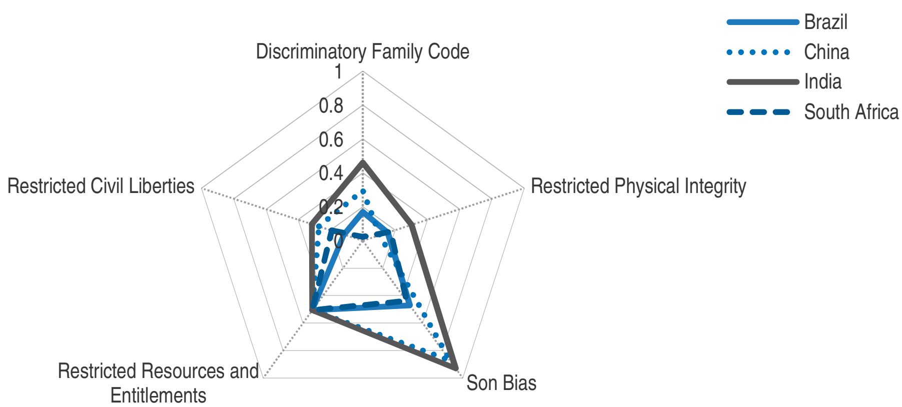
Table 3. **Distribution of employment by type**

In per cent

	2000		2005		2010		2012	
	Female	Male	Female	Male	Female	Male	Female	Male
Salaried	8	19	9	19	11	20	14	22
of which with social benefits	*n/a*	*n/a*	*4*	*9*	*5*	*9*	*6*	*9*
Casual	37	31	30	28	36	32	30	29
Paid self-employed	17	37	17	39	18	37	20	33
Unpaid self-employed	38	13	43	14	35	11	35	18
Total	100	100	100	100	100	100	100	100

Source: NSSO.

Figure 18. **Social institutions and gender index (SIGI)**[1]



1. Each of the SIGI variables is coded between 0, meaning no or very low discrimination, and 1, indicating very high discrimination.

Source: OECD, Gender, Institutions and Development Database 2012.

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Table 4. **Female entrepreneurship in India in the unorganised sector**

% of all entrepreneurs

	2000	2010	Number
Entrepreneurs			
Manufacturing	6	5	142 416
Trade	4	3	81 149
Services	6	6	188 339
Self-employed			
Manufacturing	29	46	6 542 649
Trade	6	10	1 770 225
Services	6	8	1 282 522

Source: NSSO.

the fact that most jobs were created in construction that tends to employ men. OECD estimates that annual growth of the economy could be up to 2.4 percentage points higher following the implementation of a package of pro-growth and pro-gender policies (see *Technical Background Paper* No. 1).

India has pioneered many creative programmes to raise female status and participation in the economy, including training, gender budgeting, quotas for women in local councils, requiring women on boards in the 2013 Companies Bill and a Women's Bank. India has also pledged to raise female economic participation in its G20 commitments. However, to realise the potential of higher female labour market participation, stronger gender specific measures are needed (World Bank, 2012; Duflo, 2012). It is important to reinforce the implementation of the many existing laws that provide for gender equality and women's rights, and to remove discriminatory legal measures. Specific issues that need to be addressed are:

- Expand the Aadhar programme to enlarge women's opportunities by providing bank accounts for more women.
- Raise social protection, maternity benefits, as well as child and elderly care to free more women to enter the formal labour force.
- Reinforce policies by the Ministry of Women and Child Development to promote training and access to credit to further increase entrepreneurship, including from home.
- Revive a proposal from 2002 to extend gender quotas to national and state parliamentary level. The female quotas in local councils (from 30 to 50% of seats and rotating chair) have raised women's status by showing that women can do the job, and has improved decision making (Beaman et al., 2012).
- Extend compulsory education for girls and change inheritance and dowry laws to raise marriage age and thereby permit women to invest more in skills (World Bank 2012; Duflo 2010; *Technical Background Papers*).
- Expand training programmes in various skills by the government and NGOs that have been helpful in matching skills and job requirements.

Recommendations to improve labour market performance

Key recommendations for reforming labour regulations while improving the education and training systems

- Reduce barriers to formal employment by introducing a simpler and more flexible labour law which does not discriminate by size of enterprise.
- Continue improving access to education, especially at the secondary level, and better focus on the quality of education at all levels. Provide better and earlier vocational training.

Key recommendations to enhance economic opportunities for women

- Extend female quotas to state and national parliaments.
- Further modernise labour laws to ensure equal work opportunities for women.
- Enhance the implementation of gender-related laws.
- Expand secondary and higher education for women and skills training for female entrepreneurs.

Further recommendation

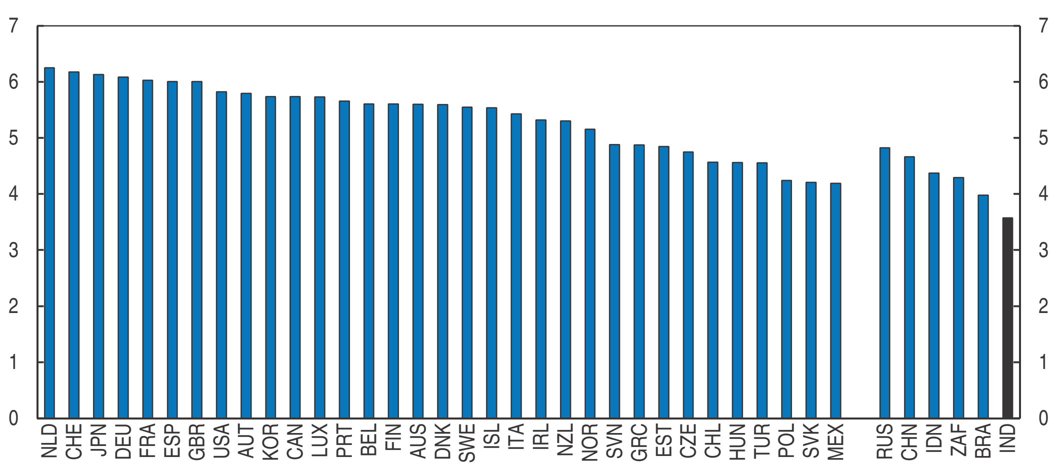
- Take account of industry skill requirements in vocational education; curricula should be reviewed and updated more frequently, with inputs from academic and industry experts.

Improving infrastructure

India's infrastructure, especially electricity supply, is poor (Figure 19). As a result, those activities that are heavily dependent on infrastructure, notably manufacturing, have grown more slowly Gupta et al. (2008). Infrastructure is high on the government's agenda, and the Twelfth Plan (2012-17) foresees an increase in infrastructure investment to 8.2% of GDP in the 5-year period (from 7.2% during the 11th plan). Around half of the total is to come from the private sector (Planning Commission, 2011). However, past plans have suffered huge delays and cost overruns (Ernst & Young and FICCI, 2012). The Cabinet Committee on Investment (CCI) established in December 2012 should help fast track large infrastructure projects, but it will be more important to simplify the myriad bureaucratic hurdles that projects face. The "minimum government, maximum governance" approach put forward by the new government and the consolidation of several ministries into large ones (e.g. for energy and for transport) should promote faster and more efficient decision-making.

Land acquisition has been the main cause of delay for around 70% of delayed infrastructure projects (IDFC and 3i Network, 2009; Ernst & Young and FICCI, 2012). Acquiring land can take up to three years even in the absence of resistance from local communities (Mahalingam and Vyas, 2011). The Right to Fair Compensation and Transparency in Land Acquisition, Rehabilitation and Resettlement Law, adopted in September 2013, increased the compensation paid to those displaced or otherwise affected by land acquisition, and should thereby reduce disputes and litigation. In addition, the required social and environmental assessment studies need to be done efficiently and with as little delay as possible. The required prior consent of at least 80%, and 70% of the affected families in the case of acquisition for private companies and for public private partnership, respectively, may also be a constraint. As pointed out in the *2011 OECD Economic Survey*, clarifying land title is also needed, as land records tend to be outdated, inaccurate and incomplete.

Figure 19. **India's infrastructure quality is poor**



Note: World competitiveness indicator – Infrastructure score.
The Global Competitiveness Indicator on infrastructure covers in equal weights the quality of transport, electricity and telephony infrastructure. Most of the information is based on surveys that ask business leaders what they think about the quality of each subcomponent in infrastructure.
Source: World Economic Forum 2014-15.

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In the last five years India has had the highest amount of infrastructure investment co-financed with the private sector among the low and middle income countries (World Bank, 2014). To promote the flow of long-term funds into infrastructure, the government has recently set up Infrastructure Debt Funds, raised limits on foreign institutional investment for infrastructure projects and liberalised external borrowing limits. Banks still contribute the bulk of infrastructure financing (City of London, 2012), but their ability to extend further long-term loans for infrastructure is limited by asset-liability mismatch. Many banks are also close to their prudential ceilings for exposure to the infrastructure sector. Deregulating the financial sector and deepening bond markets as suggested below would allow more capital to be raised and bring in new investors.

Recommendations to improve the quality of infrastructure

Key recommendation

- In the infrastructure sector, impose clear timelines, rationalise documentation, and implement single-window clearance.

Further recommendation

- Improve the land registry. Assess and amend as needed the new land acquisition law. The government should review the timelines within the Bill and aim to make land acquisition faster.

Reforming the financial sector

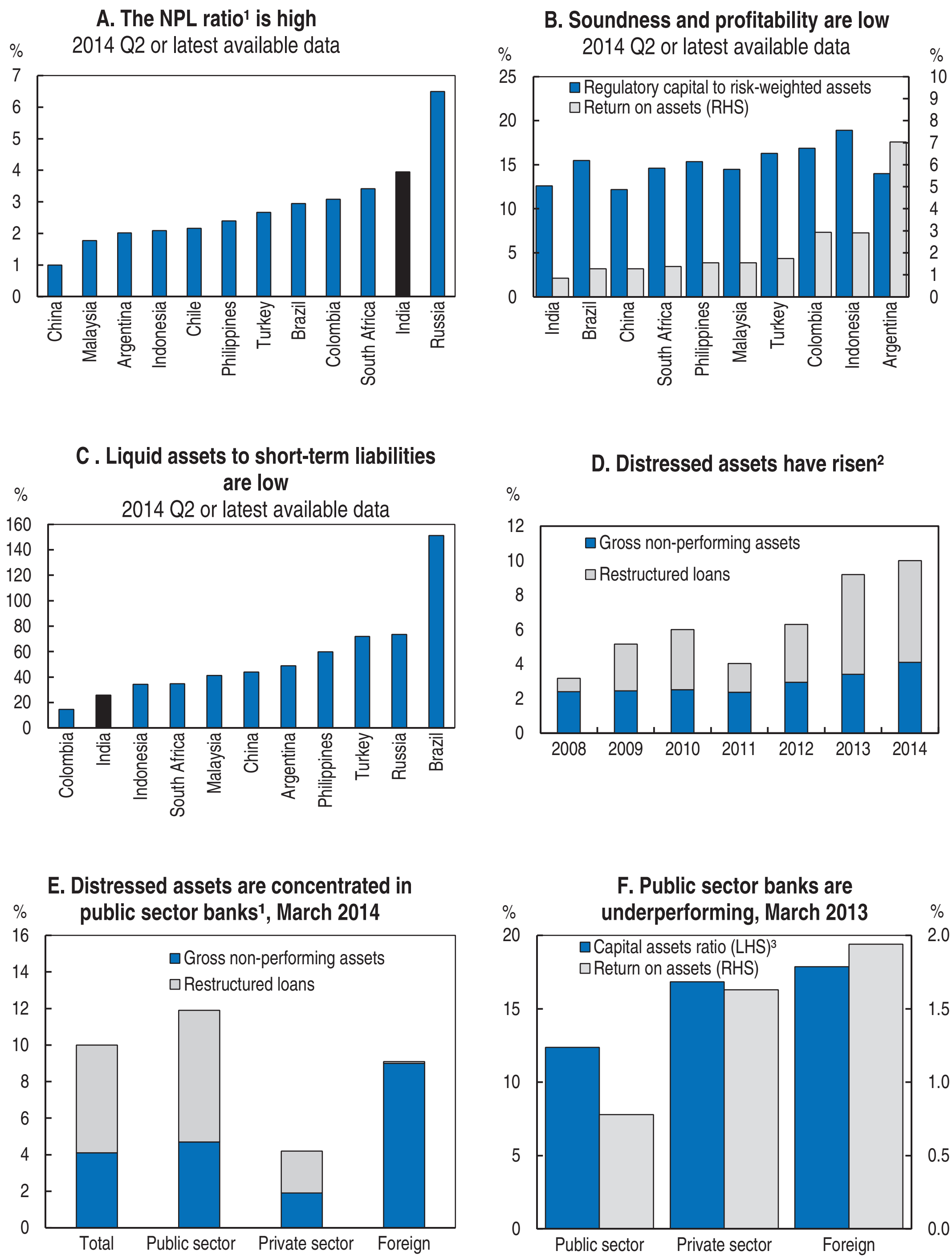
The government has long had a large presence in the financial sector, with a view to supporting priority sectors and promoting access to financial services for the poor. Public banks hold more than 70% of total commercial banking sector assets (RBI, 2013c), but public banks are the least profitable, have the weakest capital positions (Figure 20, Panels E and D), and hold an outsized share of non-performing loans (NPLs).

The limits of this strategy have become clear as households have diverted their savings away from the financial sector, non-performing loans have soared and public money has had to be used to bail out banks. Reform holds the promise of providing higher financial returns to savers (including poor households) and steering funds to their most productive use (including infrastructure). In 2013 the Financial Sector Legislative Reform Commission (FSLRC) recommended a single, unified legislative framework based on the principles of independence, accountability and transparency.

India imposes strict capital requirements on banks and was one of the first countries to move towards implementation of Basel III rules (expected to be fully implemented by March 2018). According to RBI stress tests, the capital position of banks is strong and a further deterioration in bank assets or adverse macroeconomic shocks would not push the capital ratio of the banking sector below the regulatory threshold (RBI, 2013a and 2013b). However, while the capital ratio – total capital to risk-weighted assets – generally remains above the national regulatory minimum of 9%, it has declined (RBI, 2013c). Moreover, Indian banks do not perform well on a number of measures (Figure 20, Panels A, B and C).

The steady rise in the share of non-performing loans (NPLs) and restructured corporate debt in total loans is of concern (Figure 20, Panels D and E). Banks have been allowed to reclassify certain loans as restructured rather than non-performing (lowering

Figure 20. **The performance of banks has deteriorated and compares poorly with other EMEs**



1. In percentage of gross advances. The NPL ratio is the ratio between the value of non-performing loans (NPL) and the total value of the loan portfolio.
2. In percentage of gross advances. Non-performing loans are loans which ceased to generate income for the bank. A restructured asset is an asset whose terms have been modified. The data shown refer to the value in March of each year.
3. The Capital to risk-weighted assets ratio (CRAR) is equal to the capital of the bank divided by aggregated assets weighted for credit risk, market risk and operational risk.

Source: *IMF Financial Soundness Indicators Database* and Reserve Bank of India.

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provisioning requirements), and many banks have turned to "extend and pretend" practices (Rajan, 2013). Overall, stressed assets – i.e. NPLs and restructured loans – accounted for over 10% of total loans outstanding in September 2013 (RBI, 2013b) and they were concentrated in the state banks. The provisioning requirement for all fresh restructured loans was recently increased from 2% to 5%, and the RBI released a framework, effective from April 2014, to encourage early identification of problem assets and swift restructuring of those that are considered viable. The RBI will also establish a central large-borrowers' database, thus facilitating the supervision of large exposures (RBI, 2014b). Early recognition of impaired assets and stricter asset classification need to continue (IMF, 2013 and 2014). Commercial banks should ensure independence of credit appraisal bodies and exert more control over the end-use of funds (RBI, 2013b).

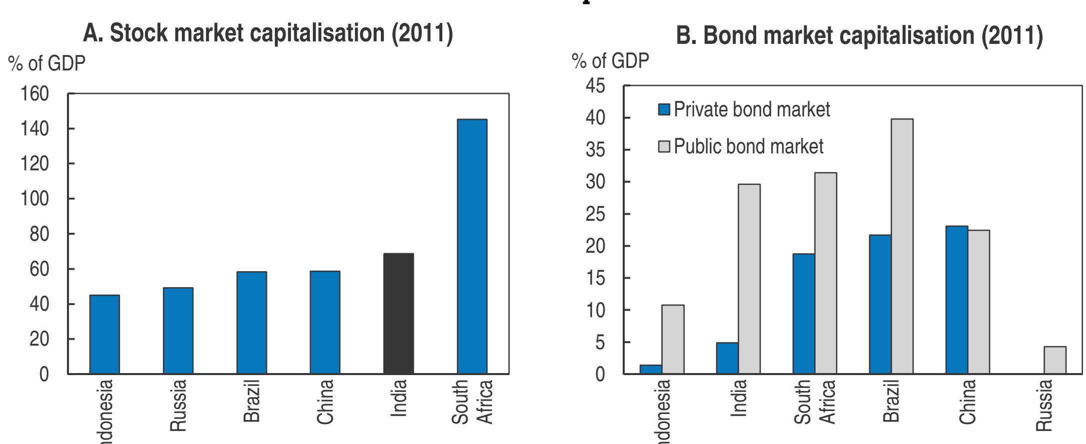
Regulations on the allocation of bank resources are strict

Two restrictions on banks increase financing costs for the private sector and lower the apparent (although not the true social) cost of debt-financed public spending. Banks are required to allocate at least 40% of their net credit to "priority sectors" determined by the government – agriculture, small-scale industry and a number of other "weaker" socio-economic categories. Furthermore, the Statutory Liquidity Ratio (SLR) requires banks to hold 22% of their deposits in government securities. Recent reduction of the SLR is a welcome step, although in general, banks' holdings of government paper exceed the SLR, because only government securities in excess of SLR can be used in repo transactions for liquidity management.

The RBI has recently taken steps to increase competition and efficiency in the banking sector. As argued in the *2011 OECD Economic Survey*, the entry of new private banks has raised the efficiency of India's banks in the past. Efficiency will rise further as, from 2014, more banking licences will be granted, banks will be able to open branches without prior RBI permission, and foreign banks will be allowed to open branches and subsidiaries.

Another potential source of competition is the corporate bond market. However, it has a capitalisation of only 5% of GDP (Figure 21), and there is a limited CDS market. It is therefore ill-equipped to meet long-term financing needs, notably of infrastructure

Figure 21. **The equity market is well developed while the private bond market is below par**



Source: World Bank Financial Development and Structure Dataset.

StatLink http://dx.doi.org/10.1787/888933163307

projects. Domestic institutional bond investors, such as pension funds and insurance companies, have to hold a large share of their assets in government bonds, and foreign institutional investors face a cap on corporate bond holdings. This contrasts with the equity market, which has become world-class thanks to liberalisation and sound regulation. As with the equity market, the authorities should liberalise the bond market by gradually relaxing the restrictions on domestic and foreign investors. Strong supervision will be required to ensure confidence in the liberalised market.

Financial inclusion is a priority

Access to financial services through bank accounts helps protect assets, and people with access to savings accounts, or even informal savings technologies, have higher income, consumption and productivity (OECD 2012, World Bank 2012). They invest in preventive health and have reduced vulnerability to illness and other unexpected events (Dupas and Robinson 2013, 2011; Ashraf et al., 2010). Bank accounts also enhance women's ability to make independent decisions on resource use in households (Duflo, 2012) and as entrepreneurs (OECD, 2012).

Despite a high density of bank branches – almost all villages with a population of more than 2000 have a branch (RBI, 2013c) – financial inclusion remains low in India. The use of basic bank products – deposits and credit – has risen, but only 35% of adults have an account at a formal financial institution, compared to 56% in Brazil or 64% in China (Demirguc-Kunt et al., 2013; Demirguc-Kunt and Klapper, 2013). In August 2014, the incoming government introduced the Jan Dhan Yojana scheme that aims at opening 75 million bank accounts by end-January 2015. Holding an account through the scheme will entitle a holder to an accidental insurance cover and, after 6 months of operations, to an overdraft facility. Under certain conditions life insurance cover is included.

Opening branches seems to be an expensive and inefficient way to reach the poor. 20% of respondents report cost as a reason for not having a bank account, and those in the bottom fifth of the income distribution are particularly likely (34%) to report cost as a major factor. To enhance financial inclusion, more attention could be given to less costly service provisions such as mobile phone banking as mobile penetration in India is high. This has been a success in countries like Kenya and the Philippines (World Bank, 2012). Financial services could also be offered through local gas stations or shops, as in Mexico or Brazil.

The most frequently reported source of new loans is friends or family, and people rely heavily on informal lenders. On the other hand, self-help groups (SHGs) and micro-finance institutions (MFIs) have been expanding rapidly over the past few years. In part this is because lending by banks to these two groups of institutions counts towards banks' priority loan targets, but they still represent only a minor share of total loans by commercial banks (OECD, 2011). MFIs are not allowed to offer saving accounts, which blocks one possible source of funding and denies the poor an alternative way of saving.

Recommendations to raise the effectiveness of the financial sector

Key recommendation

- Strengthen bank supervision by early recognition of asset deterioration and stricter provisioning standards.

Recommendations to raise the effectiveness of the financial sector *(cont.)*

Further recommendations

- Wind down bank lending obligations to priority sectors and gradually reduce the proportion of government bonds required to be held by banks and institutional investors (statutory liquidity ratio). Further ease restrictions on bond market investments by foreign institutional investors.
- In promoting financial inclusion, rely further on mobile banking and branching through local businesses, allow MFIs to take deposits.

Improving the business environment

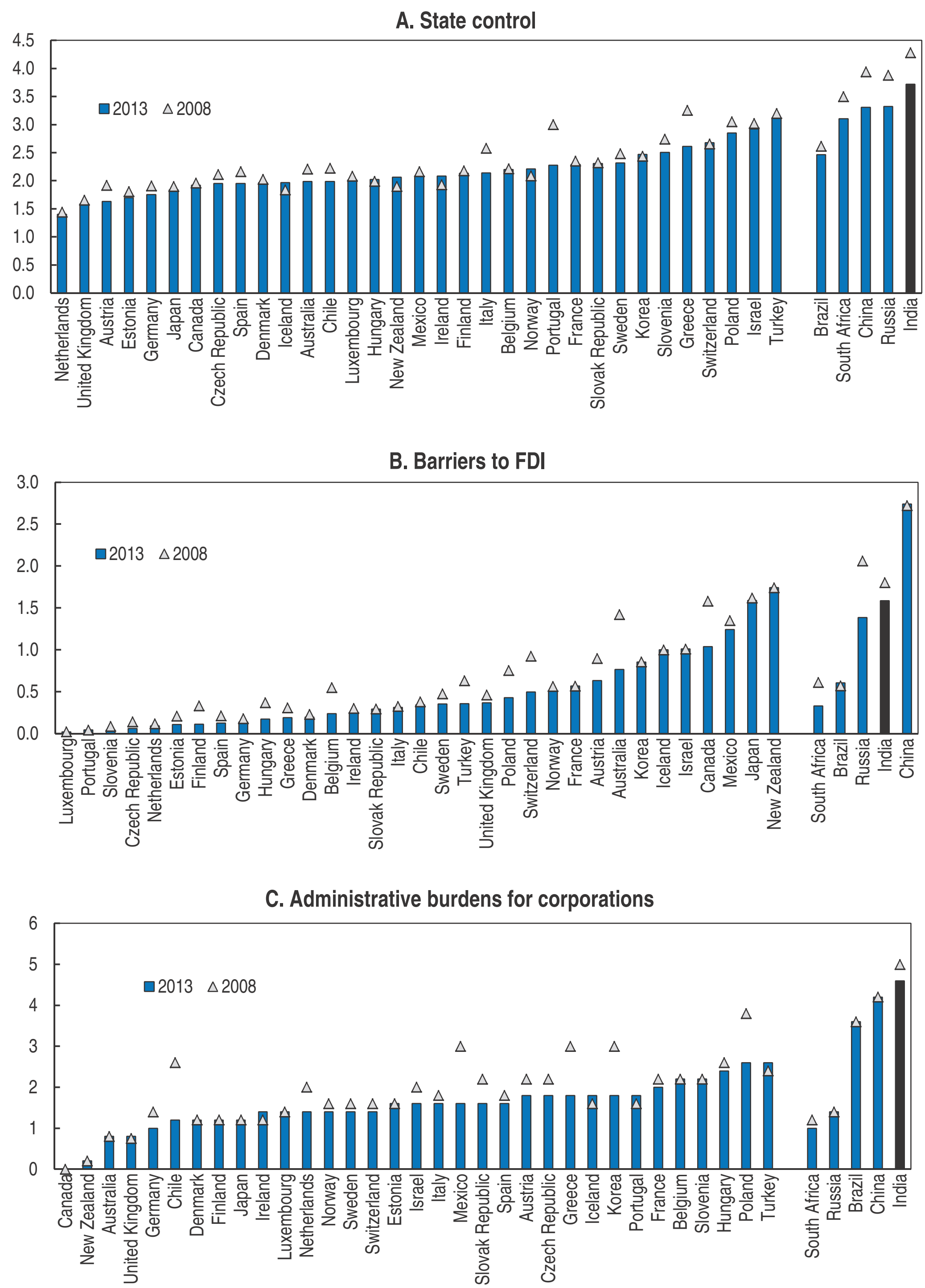
In 2013, India had the highest level of state control of the economy among 36 countries covered by the OECD product market regulation indicator, although the level has fallen since 2008 (Figure 22). While public ownership does not necessarily imply lower competition, in practice publicly owned enterprises enjoy a degree of commercial power and they face softer budget constraints, if only because they are backed by the state. For example, accumulated financial losses in the power sector, largely controlled by governments, amounted to 2.4% of GDP in FY 2011-12 (PFC, 2013).

India also has complex regulatory procedures and high administrative burdens for firms, which impede growth, keep prices high and create opportunities for corruption. As discussed also in the *2007 Economic Survey,* overly complex administrative procedures increase discretion within government bureaucracy, thereby enabling corruption. Bellver and Kaufmann (2005) find that institutional and political transparency is strongly negatively correlated with corruption. In Transparency International's Corruption Perceptions Index, India ranks 94 out of 177 countries in 2013, and its relative rank in control of corruption has declined over time (Worldwide Governance Indicators). Due to poor administration and corruption, a large part of subsidies (electricity, food and fuel) does not reach the poorest groups; lack of proper monitoring and lax accountability mechanisms result in waste, leakages and corruption (Rangarajan, 2005). Recent efforts to simplify administrative procedures – e.g. the online single window for providing clearance and filing compliance – and to repeal archaic rules are welcome and should contribute to reduce corruption.

There have been initiatives to simplify and improve government administration, including through ICT, to increase transparency. However, such efforts need to filter down to departmental hierarchies and to be implemented at the lower levels. More attention needs to be devoted also to implementation challenges. Many good initiatives at the top level never reach the ground due to lack of political will and capability in the administration. States in India have direct responsibility for a number of areas, but their attitudes and efficiency with which they administer basic laws can differ considerably. The Central Vigilance Commission, the key anti-corruption authority, needs to be strengthened, including by making the process for appointment of its head more independent.

Exit barriers are also high. Insolvency procedures average 4.3 years, compared to 1.7 years in OECD countries, and the recovery rate of assets from bankrupt firms is low (Figure 23). As a result, resources get locked up for prolonged periods in economically

Figure 22. **Product market regulation is restrictive**[1]



1. The OECD Indicators of Product Market Regulation (PMR) are a comprehensive and internationally-comparable set of indicators that measure the degree to which policies promote or inhibit competition in specific areas. The indicator runs from 0 to 6, representing the least to most restrictive. Shown is a subset of the PMR indicators for relevant areas.

Source: OECD Product Market Regulation Database 2013.

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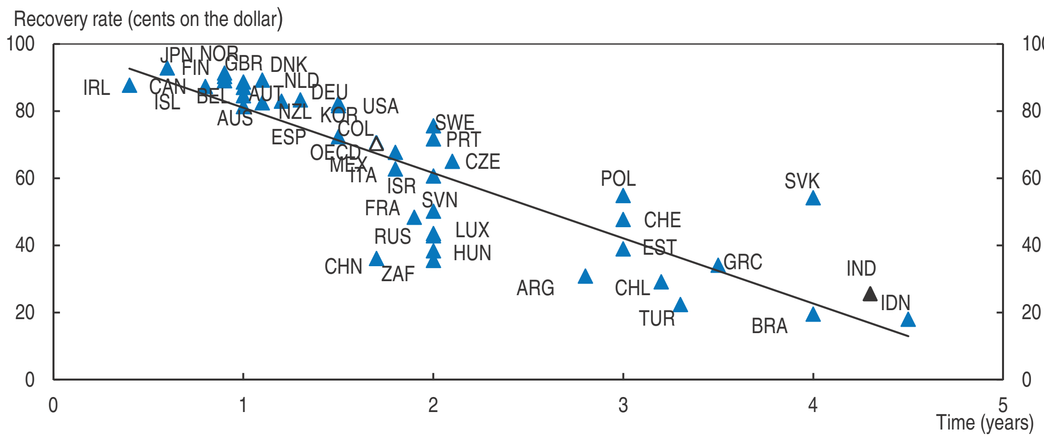
Figure 23. **There is scope to improve the insolvency legislation and debt-recovery rates**



Source: World Bank Doing Business Database.

StatLink http://dx.doi.org/10.1787/888933163324

unviable companies, causing difficulties for creditors, including the banks. Together with stringent employment protection legislation, these factors explain the extremely large share of the informal sector. The new Companies Bill will speed up company registration and, for companies in distress, give greater powers to creditors to supervise a rescue plan and restrict the powers of the incumbent management. More needs to be done, however. Reducing red tape and barriers to exit, notably by reforming bankruptcy legislation, would increase economic dynamism and growth.

While India is considerably more open to FDI than China, the barriers to FDI are much higher than in most OECD economies. FDI inflows remain low as a share of investment (OECD, 2011), stripping India of a valuable source of stable financing, technology transfer and growth. Recent measures – increased openness in the retail sector from 2013 and further deregulation in defence and insurance in 2014 – are steps in the right direction.

Recommendations to improve the business environment

Key recommendation

- Continue improving the business environment and opening up the economy.

Further recommendations

- Strengthen governance of state-owned enterprises, and reduce public ownership over time.
- Further simplify regulations and reduce administrative burdens on firms. Introduce a modern bankruptcy law.

Achieving better health outcomes in a cost-effective way

India has a national health care system which in principle provides a comprehensive array of services to all and at no cost, but in practice it struggles to do so consistently. The strength of public health care services is their comprehensive geographical footprint, especially in rural communities where the poor are located. Considerable progress has been achieved – infant mortality has almost halved since 1990, life expectancy has increased and in early 2014 India celebrated its victory over polio. However, health outcomes remain poor, even compared with countries at a similar level of economic development. High mortality rates from avoidable diseases, particularly among infants, are illustrative. This undermines well-being, suppresses labour force participation, diminishes returns to education and limits the ability and incentives to save. Paying for health care pushed 60 million Indians below the poverty line in 2010 (Marten et al., 2014).

India's low life expectancy reflects a high number of deaths among the youth from communicable diseases that are inextricably linked to poverty, and in this sense the most significant gains in improving health will come from population-wide measures outside of hospitals (Chow et al., 2007). Improving sanitation and access to clean water, as well as better sex-education and child immunisation are examples of needed measures. Increasing taxes on tobacco; reducing the use of solid fuels in cooking; reducing salt intake and improving road safety can all play a major role in increasing the life expectancy of the poor.

Meeting India's enormous health care needs will require more public resources, greater public sector efficiency and more private sector involvement. The system today suffers from small budgets; shortages of trained personnel and poor management. While public health spending has increased slightly in recent years, at 1.2 % of GDP it remains very low compared to other BRIICS. As a result, public facilities are not available where needed; are overcrowded and lack basic supplies. Private health care providers have grown, but they range from unqualified persons offering services in poor areas to high-end services equal to the best of the OECD. At the same time, private health insurance is underdeveloped and primarily targeted at the rich, and as a result health care costs account for a large share of poor households' budgets (Ladusingh and Pandey, 2013).

To attain universal health coverage, India will need more than was foreseen in the previous government plan to raise spending from 1.9% to 2.5% of GDP. Much of the anticipated spending towards this target is directed at improving water and sanitation. The National Rural Health Mission, launched in 2005, complemented in 2013 by a National Urban Health Mission, already increased health care funding to the states and brought significant improvement of public health care services. More is needed, however. The cost of delivering a benefit package of key services across the population is estimated to range between 0.4% to 1% of GDP by 2017, over and above the government target (World Bank, 2013). The central government will need to take the lead in providing additional funding, as states have limited and uneven revenue-raising capacity.

Government sponsored health insurance schemes targeted at the poor have grown quickly to promote equity in access. The Rashtriya Swasthya Bima Yojana (RSBY, literally "National Health Insurance Programme"), the largest of such insurance schemes, was launched in 2008 for the below-poverty-line population and informal sector workers. It now covers 38 million out of an estimated 60 million below-poverty-line families. It reimburses private hospital care for the poor and introduces incentives to raise public hospital activity and efficiency by allowing performance-based payments in public hospitals. Still, poor families rarely use health care services financed by the RSBY, partly because they lack information on their coverage. Efforts should thus be made to raise awareness among the targeted population. The government's plans to expand the RSBY to primary health care services. Public clinics in deprived areas (rural communities and urban slums in particular) should be given priority since improving primary care will have a greater impact on the poor.

India has too few qualified health personnel despite increases in the number medical students since 2009. The most pressing concern is the low number of nurses, as they lead the delivery of basic health care services to the poor. As a result, doctors are doing too many basic tasks. The government's policy of doubling the number of training colleges for health workers is welcome but needs to be coupled with other reforms. The deregulation of medical education and a growing number of private colleges have increased capacity but establishing a quality framework and ensuring that education costs remain reasonable will be critical to securing a pipeline of well-trained doctors and nurses. Central government should also be more aggressive in prioritising the Northern states with more severe shortages of professionals when it decides the location of medical colleges.

There is also scope to improve the education of existing medical workers. The proposal to establish a shorter rural medical degree to meet the basic needs of under-served communities deserves support. Similarly, as was done in Korea and pioneered in the states of Tamil Nadu and Maharashtra, traditional medical workers should have the opportunity to undertake a "bridging" medical or advanced nursing degree. The new "Continuing Nursing Education Programme" is a positive development to help nurses upgrade their skills. The government should go further and encourage the development of nurses with expert medical skills in specific fields (known as advanced professional nurses), as in the United States, Canada and Ireland (OECD, 2010).

Governments and universities should also encourage professionals to work in rural areas. Australia and Canada have established a compulsory training rotation in rural and primary care facilities. Likewise, Tamil Nadu reserves a share of postgraduate education posts for those who have worked in government facilities. A similar practice should be adopted by other states.

The quality of care varies widely in private medical facilities, as certification is weak. Enforcing quality regulation would help to ensure that private health care services meet minimum standards of care and medical professionals hold the minimum qualifications. The recent Clinical Establishments Act provides a basis for regulating private facilities but it should be implemented more quickly; be better enforced and adopted by all states. An up-to-date register of qualified medical professionals is a key to verifying expertise and identifying instances of malpractice. While in most OECD countries medical associations maintain registries and oblige doctors to keep their medical knowledge current, this has not been adequately undertaken by the Medical Council of India. As has occurred in Israel and Turkey, the government should step in if the medical profession cannot do so.

To better monitor the use of funding and performance, the quality and timeliness of data on services actually provided needs to be improved. This would require reforming the Health Management Information System (HMIS) by training and motivating grass-root functionaries (Husain et al., 2012). States' ability to deliver health care also needs to be strengthened. For example, states with better trained managers perform better (Muralidharan et al., 2013), suggesting that management training should be expanded. The Indian Public Service practice of frequent rotation should be modified so managers can be held responsible for policies that take some time to come to fruition. Increasing the reliance on performance-based payments for hospitals (such as Diagnosis Related Groups), primary health care centres and health professionals should also be considered to improve efficiency of existing resources.

Recommendations to improve health outcomes for all

Key recommendations

- Increase public spending on health care with particular focus on preventive and primary care, especially in rural areas and urban slums.
- Expand the number of health professionals and up-skill professionals located in rural areas.
- Strengthen the management of public health care facilities and ensure that private facilities and their employees meet minimum quality standards.

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ANNEX

Follow-up to previous OECD policy recommendations

This annex reviews policy recommendations from previous Surveys. *They cover the following areas: public finance, subsidies, tax system, education, labour market, product and service markets (including public enterprises), financial reform, and infrastructure. Each recommendation is followed by a note of actions taken since the* 2011 Survey. *Recommendations that are new in this* Survey *are listed in the relevant chapter.*

Public finance

Fiscal framework

Recommendations from previous Surveys	Actions taken
Revise government accounting principles to recognise depreciation. Introduce three-year detailed rolling budgets that fit with the medium-term deficit strategy.	No action taken
Introduce new legislation to create a permanent Finance Commission to oversee implementation of fiscal rules.	No action taken

Public spending

Recommendations from previous Surveys	Actions taken
Further experiment with cash transfers, including conditional cash transfers, to provide direct assistance to the neediest. Improve the efficiency of the Public Distribution System by introducing food tokens which could be redeemed at fair price or commercial shops, or instead by providing cash transfers.	The Direct Benefit Transfer (DBT) programme was launched in 2013. For various welfare schemes, beneficiaries receive money directly on bank accounts flanked with a unique identification system, thus eliminating middle men and corruption. The DBT however has not been extended to key subsidy programmes, in particular the food subsidy and the rural employment programmes, while the experiment to extend the DBT to gas cylinders has been put on hold. A pilot project for the kerosene subsidy was launched in 2011 in Rajasthan. The Food subsidy was made more generous in 2013 but no significant reform has been introduced yet to make the Public Distribution System more efficient.
Fully liberalise diesel prices. Establish a timetable for the removal of kerosene and LPG subsidies. Stick to the pledge made in the 2010-11 Budget not to issue any more oil bonds.	In 2013, the government set up a path of gradual hikes in diesel prices so as to eliminate the diesel subsidies. Diesel prices were deregulated in October 2014. Caps on subsidised LPG cylinders were lowered in 2013 but raised again. The natural gas price was hiked in October 2014. No oil bonds have been issued since the 2010-11 budget.
Liberalise fertiliser prices.	No action taken
Ensure that future adjustments to the wage offered under the National Rural Employment Guarantee Scheme are not excessive relative to the market wage.	No action taken

Tax reform

Recommendations from previous Surveys	Actions taken
Reduce the extent of exemptions for corporate taxation, agricultural incomes, excise taxes and tariffs, and lower standard rates of taxation.	No action taken
While moving to a General Sales Tax, introduce a two-tier state and central VAT, abolish service tax and central excise taxes, and countervailing duty.	No action taken
Ensure that tax incentives in new SEZs are neutral between labour and capital-intensive projects which produce the same pre-tax return.	No action taken

Fiscal federalism

Recommendations from previous Surveys	Actions taken
Unify formulae used for transfers to states by the Finance Commission and the Planning Commission.	No action taken
Improve the administration of central government schemes for transfers to states.	No action taken

Education

School education

Recommendations from previous Surveys	Actions taken
Participate in additional international surveys of learning achievement in order to facilitate international benchmarking of Indian school students in a larger number of states.	No action taken
Consider linking levels of reimbursement for private schools to student performance.	No action taken
Improve performance incentives for public school teachers by strengthening dismissal mechanisms for repeated absenteeism or unsatisfactory performance. Improve access to in-service teacher training for all teachers.	No action taken
Explore options for introducing conditional cash transfers to help further boost enrolment and completion rates. Ensure an adequate increase in government funding to expand secondary schools in particular.	Rashtriya Madhyamik Shiksha Abhiyan (RMSA) is a major initiative for the development of *secondary education* in public schools, launched in 2009. 75% of the funding is provided by the central government. The budgetary allocation by the central government rose significantly.

Vocational and tertiary education

Recommendations from previous Surveys	Actions taken
Devolve more managerial responsibility to vocational training institutions and further strengthen industry linkages.	No action taken
Improve incentives for stronger performance by making funding less input-based. Tie funding to accreditation and assessment outcomes and increase share of project-based funding for research.	No action taken
Encourage the entry of quality foreign higher education providers by minimising the regulatory burden. Reform promotion arrangements for academics by focusing more on performance.	No action taken

Reforming product and service markets

Regulation of internal markets

Recommendations from previous Surveys	Actions taken
Undertake a comprehensive review of regulations at all levels of government to re-engineer processes, eliminate unnecessary steps, and optimise the process at the back-end before a service is delivered. Carry out Regulatory Impact Analysis to assess significant new regulatory proposals.	No action taken
Use ICT to increase transparency and reduce opportunities for corruption and introduce severe penalties.	No action taken
Amend the Companies Act 1956 to facilitate liquidation procedures for firms when necessary.	The Companies Bill was passed in 2013. For companies in distress, it gives greater powers to creditors to supervise a rescue plan and restricts the powers of the incumbent management.

Foreign Direct Investment and trade

Recommendations from previous Surveys	Actions taken
Continue to reduce trade and FDI barriers, especially in services and network industries.	There has been FDI deregulation for selected sectors. 100% FDI is allowed in the telecom sector and single-brand retail. FDI in commodity exchanges, stock exchanges and depositories, power exchanges, petroleum refining by public sector undertakings and courier services are now allowed under automatic route (without prior approval by the authorities). Under the new government, FDI limits were raised in defence sector. Construction, operation and maintenance of specific activities of the railway sector are now opened to 100% foreign direct investment under automatic route. The cabinet eased foreign direct investment limit in the insurance sector to 49%.
Complete the move to a 5% import tariff for all manufactured products, including textiles, cars, tobacco and alcohol.	No action taken.

Reforming the labour market

Labour regulations

Recommendations from previous Surveys	Actions taken
Redesign and moderate the framework for employment protection, making it neutral across different types of firms and employees. This would at least include substantial revisions to the Industrial Disputes Act, removing the most restrictive provisions that require prior government permission for employment termination and exit decisions.	No action taken.
Reduce the number of labour laws to just a few simplified laws that provide basic legal coverage and protections for all employees, increasing fairness.	The government is considering introducing a single window – a website – to help business meet compliance requirements for various labour laws
Move toward a quarterly small-sample labour force survey so that employment outcomes can be better assessed between large-scale National Sample Survey rounds.	A quarterly employment survey was started in 2008 by the Labour Bureau but covers only eight sectors which were likely to be affected by the global crisis.

State-level reforms

Recommendations from previous Surveys	Actions taken
States should accelerate their own labour reforms in all areas, including offering special treatment for Special Economic Zones. Broadening the allowances for the use of contract labour and fixed-term contracts could also effectively reduce the overall level of employment protection legislation.	Some states have adapted labour regulations, e.g. Rajasthan has raised the thresholds above which the Contract labour Act and Factories Act apply.

Reforming financial markets

The banking sector

Recommendations from previous Surveys	Actions taken
Give greater freedom to banking operations by introducing a plan for a gradual reduction of the proportion of government bonds to be held by banks, setting out a plan for ending priority lending.	The Statutory Liquidity Ratio has been reduced from 24% in 2011 to 22% in August 2014. Priority lending requirements have not been reduced, however.
Improve competition in the banking system by establishing a meaningful deposit insurance corporation, recapitalising public-sector banks through equity issues, and lowering entry barriers for banks and banking.	The RBI has announced that from 2014 more banking licences will be granted, banks will be able to open branches without prior RBI permission and foreign banks will be allowed to open branches and subsidiaries.

Capital markets

Recommendations from previous Surveys	Actions taken
Reduce the extent to which the bond market is dominated by constrained investors. Allow greater direct participation in the government bond market.	No action taken

Regulation of financial markets

Recommendations from previous Surveys	Actions taken
Ensure that plans to implement a transparent market in corporate debt are implemented. Widen the scope of trading of corporate default swaps.	No action taken
Modify capital controls to allow more foreign investment in the government and corporate bond market.	Limits on investment by foreigners have been gradually relaxed over time. Since 2013, foreign investment limits in rupee-denominated bonds no longer distinguish between asset classes or investor classes. There is now a single limit of investing up to USD 25 billion in government securities and USD 51 billion for corporate bonds.
Ensure that all financial intermediaries undertaking a given activity are supervised by the same regulator. Improve the functioning of regulatory bodies.	The government set up the Financial Sector Legislative Reforms Commission (FSLRC) in March 2011. The Commission submitted its Report in March 2013. The legislative aspects of the recommendations aim at reforming the legislative framework of the financial-sector regulatory architecture through a non-sectoral, principle-based approach and by restructuring existing regulatory agencies.

Improving infrastructure

Regulation in general

Recommendations from previous Surveys	Actions taken
Enact a competition policy that sets out the overarching framework for the regulation of infrastructure sectors.	No action taken
Separate the regulatory, policy-making, and ownership functions. Ensure strong governance and independence for regulators.	In telecommunication, the government converted the historic provider of land lines from a government department into a public corporation. It also created an independent regulator – the Telecom Regulatory Authority of India (TRAI) to fix and regulate tariffs and interconnections – and auctioned frequency for private-sector providers of mobile telephony services. A new airport economic regulatory authority to control the pricing of aeronautical services in the major airports was created in 2009.

Land acquisition

Recommendations from previous Surveys	Actions taken
Streamline land titling to reduce uncertainties with land acquisition. Strengthen efforts to improve land record management by clarifying land boundaries.	In 2008, the government launched the National Land Records Modernisation Programme aimed to modernise management of land records. The major components of the programme are computerisation of all land records, digitalisation of maps and integration of textual and spatial data. The Right to Fair Compensation and Transparency in Land Acquisition, Rehabilitation and Resettlement Act came into force in 2014.

Electricity

Recommendations from previous Surveys	Actions taken
Reduce transport and distribution losses through metering, feeder separation, introduction of high-voltage distribution systems and strict anti-theft measures. Eliminate cross-subsidies.	A scheme for financial restructuring of state-owned distribution companies was approved in 2012 whereby 50% of the outstanding short-term liabilities of distribution companies is to be taken over by state governments and the remaining 50% is to be restructured. This restructuring has to be accompanied by concrete and measurable action by the states and distribution companies to improve their operational performance. The central government will provide incentives proportional to the reduction in Transmission & Distribution as well as commercial losses (aggregate technical and commercial losses) and partial support with the repayment of the principal on the liabilities taken over by the state governments.
Improve the functioning of electricity distribution through privatisation or franchising to private operators.	No action taken

Transport

Recommendations from previous Surveys	Actions taken
Reconsider the role of the Tariff Authority for Major Ports. Convert the port authorities into corporations. Grant multiple concessions at a single port.	A number of ports have awarded concessions to private operators for developing infrastructure and rendering services.
Eliminate cross-subsidies between freight and passenger transport in rail. Corporatise India Rail and unbundle regulatory, policy-making, and ownership functions.	A Railway Tariff Authority has been set up tobetter assess costs and subsidies. Railway fares were automatically linked to fuel costs (diesel and electricity), and there have been hikes in rail fares, disproportionally higher in the passenger segment.

Coal

Recommendations from previous Surveys	Actions taken
Remove impediments to full competition with imported coal. Accelerate pricing reforms in the coal sector with the objective of fully liberalising coal pricing.	In June 2013, the government approved a coal regulatory authority to specify the methodology for setting the coal price. It also allowed energy producers to pass on to consumers the higher price of imported coal that they buy to make up for domestic shortfalls.
Open the coal sector to the private sector. Allow free bidding for new coal concessions.	The government has proposed the use of public-private partnerships (PPP) to finance coal mining. The current proposal stipulates that the mine and the coal will remain in public ownership while the private partner will receive a fee for the coal mined.

Thematic chapters

Chapter 1

Challenges and opportunities of the manufacturing sector

The manufacturing sector has contributed little to income and its share in total merchandise exports has been declining, as economic growth has been primarily led by services. Manufacturing has not brought much new employment, and most of the recent rise in employment has been in informal labour, where workers are not covered by social security arrangements.

Productivity of the manufacturing sector is low, partly because the relatively small size of manufacturing firms makes it difficult to exploit economies of scale. Despite abundant, low-skilled and relatively cheap labour, Indian manufacturing is surprisingly capital and skill intensive. Furthermore, firms have little incentive to employ and grow, since by staying small they can avoid taxes and complex labour regulations. Land acquisition is slow, companies face frequent power outages and transport infrastructure is below par. This is especially harmful as manufacturing is highly reliant on well-functioning infrastructure.

Stronger manufacturing would increase productivity and make growth more inclusive, while contributing to improved current account balance. In particular, India should aim for more formal jobs, as these tend to be the most secure and of highest productivity.

Chapter 2

Raising the economic participation of women in India – A new growth engine?

India has narrowed gender differences in health and education, but gaps in economic participation remain large despite high economic growth over the past decade. The reasons are complex: family status increases if women stay home, housework has become more attractive than poorly paid market work as husband's incomes have risen; and safety concerns and poor infrastructure keep women from market work. Nevertheless, high unemployment among educated women and revealed preference for work in surveys indicate that many women would work if conditions improved.

Specific gender policies will be needed to enlarge economic opportunities for women (World Bank, 2012, Duflo 2012). This chapter analyses the determinants of low female economic participation and recommends policies for raising it. The chapter also estimates long-term growth effects of raising participation with selected policies.

The 2014 Economic Survey of India was prepared in the Economics Department by Isabelle Joumard and Urban Sila, under the supervision of Piritta Sorsa. Statistical research assistance was provided by Hermes Morgavi and Annamaria Tuske with general administrative assistance provided by Anthony Bolton. The Survey also benefitted from contributions at different stages by Pierre-Richard Agénor, Ankit Kumar, Lalita Som, Arnaud Daymard, Jan Mares, Ankit Mishra, Yuvraj Pathak, Mathilde Didier, Cioa Guimaraes, Marie Rabate and Gen Tang.

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