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Financing for Development

India: Lessons from the Past; Needs of the Future

by

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Introduction

Over the past few years, there has been an upsurge of international concern regarding the growing gap between developed and developing countries and the persistence of acute deprivation in several parts of the world. It is again being recognized that poverty and deprivation are not matters of concern merely for national governments, but for humanity as a whole[1]. As a consequence, the issue of development has come back to the centre-stage of international discourse after a gap of almost two decades. The tragic events of September 11, 2001 have further underscored the dangers to stability and peace in the world from poverty, underdevelopment and, most importantly, disenfranchisement.

A number of high level international conferences were held during the 1990s covering various facets of development and the challenges thereto. The Earth Summit in Rio de Janeiro in 1992, the 1994 Population Summit in Cairo, the 1995 Beijing Summit on Women, the Summit on Social Development in Copenhagen and the 1996 Summit on Human Settlements in Istanbul are a few notable instances. In each of these, it was repeatedly highlighted that the objectives and approaches would require significant commitment of financial resources to make them credible.

This process culminated in the historic United Nations Millennium Declaration adopted by the United Nations General Assembly in September 2000, in which the various strands of development were brought together into a comprehensive framework. The Declaration endorsed a set of International Development Goals to be attained by 2015 towards which the international community and the national governments would collectively work. Broadly, these Goals were :

- To cut in half the proportion of people living in extreme poverty, of those that are hungry, and of those who lack access to safe drinking water.
- To achieve universal primary education and gender equality in education.
- To achieve a three-fourths decline in maternal mortality and two-thirds decline in mortality among children below the age of 5.
- To halt and reverse the spread of HIV/AIDS and provide special assistance to AIDS orphans.
- To improve the lives of 100 million slum dwellers.

The Millennium Declaration also explicitly acknowledged the importance of developing a

[1] Such concern was also much in evidence during the 1950s and 1960s when the world was experiencing the decolonisation process with all the idealism that it generated. From the 1970s, however, the focus shifted from idealism to ideology. Developed countries were preoccupied with economic stabilisation consequent to the two oil price shocks and the Latin American debt crisis, on the one hand, and global *real politik*, on the other. During this period, developing countries were more or less expected to boot-strap their own development.

strategy for raising the necessary resources to fund the attainment of the International Development Goals. To this end, an International Conference on Financing for Development was held in Monterrey, Mexico, in March 2002. A number of preparatory steps were taken for this Conference, the most important of which was the convening of a High Level Panel on Financing for Development by the Secretary General of the UN. This Panel was chaired by Mr. Ernesto Zedillo, former President of Mexico, and its terms of reference was to "... recommend strategies for the mobilization of resources required to accelerate equitable and sustainable growth in developing countries as well as economies in transition, and to fulfill the poverty and development commitments enshrined in the United Nations Millennium Declaration".

The Report of the Zedillo Panel was circulated by the Secretary General in June 2001 for consideration by the Member States. This Country Paper is an attempt to critically examine the Zedillo Panel Report and its recommendations from the Indian perspective and experience. There are two important dimensions to such a review. First, India's long experience in development planning for a large federal democracy with a more or less market-oriented economic system makes it perhaps unique in terms of the problems it has faced and the lessons that have been learnt. Some of this could possibly be of value to other countries as they attempt to reorient their economies. Second, despite considerable progress over the years, India as a nation continues to be home to the largest number of the world's poor, and no international development goals can be achieved unless India performs adequately. Thus, the implications of the Zedillo Panel recommendations for India are important not only for itself, but for the attainment of the Millennium Declaration.

It is hoped that this study will contribute to the broader debate regarding the considerations that need to inform the strategies for mobilisation of developmental resources. In particular, if this study can help sensitize the developed world to the constraints and trade-offs faced by developing countries in managing their economies and improving the lot of their peoples, it would have served its purpose.

The Zedillo Panel Report: A Critical Review

The Report of the Zedillo Panel is a remarkable document. Its breadth of coverage places it well beyond any other such attempt and reflects not only the lessons learnt over five decades of development experience, but also the composition of the Panel. Although it is a terse document, it is backed by a fairly detailed Technical Report, which lays out the theory and logic underlying the key findings of the Panel[2]. The objective of this section is to examine the main features of the Zedillo Panel Report in light of India's development experience. No attempt is made to describe or discuss the details or the logic and arguments behind the recommendations of the Report, since these are readily available in the public domain. The principal objective is to highlight some inadequacies and to give an indication of those features of the Report which need to be strongly supported.

Domestic Resource Mobilisation

The Report clearly and unambiguously recognises that: "The primary responsibility for achieving growth and equitable development lies with the developing countries themselves"[3]. In other words, it is up to the governments of developing countries to create the conditions which make it possible to obtain and effectively utilise the financial resources necessary for development. It is, however, also recognised that many developing countries lack the institutions and the capacities for doing so, and that more and better assistance is needed from the international community to help create these conditions[4]. We will have more to say about this issue later. There are five main elements to this responsibility that have been identified, and which are discussed below *ad seriatim*.

The first is good governance, which is defined to include: (a) the consent of the governed; and (b) the existence of effective and impartial rule of law[5]. While there can be no quarrel with the latter, the explicit preference for a democratic mandate appears questionable, whatever its ethical merits[6]. There is no compelling evidence to suggest that non-democratic forms of government have systematically performed less well in terms of economic growth and development than the democratic. An unfortunate consequence is the impression conveyed that for a large

[2] It should be noted that the Report of the Panel is by no means a condensed version of the Technical Report. There are clearly approaches and proposals on which the Panel has differed with the Technical Report. Nevertheless, the Technical Report provides valuable insights on issues which have found place in the Report of the Panel and has, therefore, been used extensively by us.

[3] As the Technical Report points out: "The domestic economy is virtually always the dominant source of savings for investment, and the domestic policy environment is a decisive determinant of the *desire* to invest."

[4] In this context the Report makes the most valid point that "... experience shows that imposing tough policy conditionality on poor countries without helping them to build their domestic capacity is a recipe for frustration and unsatisfactory results."

[5] Combating corruption is an integral component of any reasonable rule of law, and is so recognised.

[6] It is of course recognised that the UN by and large supports democratic forms of government. While this preference is perfectly valid in the political spheres, it may not necessarily be justified in the economic.

number of developing countries political change would have to precede development; and, worse, that international support could be conditional on such change. Surely this is not the intent. It should be sufficient to insist upon good governance and, at the most, social legitimacy of laws and rules, regardless of the form of the government.

The second is macroeconomic discipline, which is deemed essential for promoting domestic savings and high quality national investment. This has been interpreted to mean that inflation and the current account balance should be consistent with sustained growth. In general terms this is certainly true. Indeed, the point should have been made with even greater force since all evidence suggests that high inflation has a disproportionately larger impact on the poor. What is less supportable is the excessive reliance that the Report appears to place on monetary policy for correcting inflationary pressures. For a number of countries, including India, inflationary episodes have been the outcome of transient exogenous shocks, which have frequently been contractionary in nature[7]. In such situations, contractionary monetary policy will prevent the necessary realignment of relative prices and may indeed precipitate an entirely avoidable recession. The consequences of such an eventuality on the poor may be even worse than some amount of inflation. A judicious mix of supply-side initiatives with perhaps a slightly accomodative monetary stance may serve the purpose better in such situations. This is only one instance of the rigidities that have to be taken into account in developing countries while devising a suitable and sensitive macroeconomic policy. These kinds of problems are less likely in developed economies with more complete and better functioning markets, and in any case the human impact is significantly lower.

Fiscal discipline too has been recognised as a critical element. Deficit financing and excessive accumulation of public debt are considered inimical to avoiding inflation and to promoting private investment. These are certainly valid principles, but at particular stages of development it may be necessary to violate them. Indian experience suggests that at low levels of development, particularly of the financial sector, and of monetisation of the economy, both deficit financing and accumulation of public debt can have a positive role to play. There is an implicit presumption that private investment demand is at all times adequate to absorb the available investible resources. This is a questionable assumption and there are ample instances in Indian economic history when unconstrained private investment demand has simply not been adequate. In such situations, if public investments are not adequately stepped up, considerable growth potential may be lost.

An important point that is made in the context of fiscal policy is that the most potent way to empower the poor and to integrate them into the market economy is to make public investments in social development. The Report rightly enjoins governments not to treat these investments as marginal expenditures, to be cut when times are difficult. Curiously enough, there is no mention of physical infrastructure, which is often as important and, in the short run, perhaps even more so. If a cut has to be made in public expenditures, the choice between these two forms of investment can be very difficult.

[7]Periodic failure of the monsoons and the oil-price shocks are cases in point.

The real choice lies between public investments, whether in social or physical infrastructure, on the one hand, and transfers and subsidies, on the other[8]. It would have helped if the Panel had taken a clear position on this. It is of course accepted that the choice is not always obvious. Well-targeted transfers and subsidies can play an important role in mitigating immediate hardship and deprivation[9]. Nevertheless, the political attractiveness of transfers and subsidies, particularly for democratic governments, can lead to excessive deployment of public resources in such measures. Once begun, such expenditure is notoriously difficult to control. Therefore, an agreed-upon position on this issue can help national and sub-national governments in taking difficult decisions.

Raising sufficient tax revenues to fund necessary public expenditure and control fiscal deficits is undoubtedly of the highest importance. There are, however, two issues which need consideration. First, in poor developing economies, raising taxes without impinging on the consumption of the poor is not easy. Excessive concentration on a limited tax base of the relatively affluent can lead to serious incentive problems, and thereby retard the growth process. Second, most developing countries have tax systems which are based either on traditional practices or on those which were prevalent in the West in the past. Most of these have the virtue of being administratively convenient and informationally undemanding. Modern tax systems, however, require both efficient tax administration and a certain degree of sophistication among taxpayers. It is quite likely that these conditions may not be met in several developing countries. The process of tax reforms, therefore, should be viewed in an evolutionary manner, and not something that can be transplanted readily.

The fourth critical element is the financial system. As the Report points out: "Every country needs a financial system that promotes savings and provides credit efficiently ...". To achieve this, the Report recommends a modern framework that progressively incorporates accepted international standards[10]. It also recommends arrangements for corporate governance and bankruptcy. While this is unexceptionable, and it is necessary for every developing country to establish a vibrant and modern financial sector, a certain degree of clarity is necessary regarding the position to be taken on traditional financial institutions. It needs to be pointed out that whatever the shortcomings, these informal financial institutions have an important role to play at different stages of a country's development. Premature closure of such institutions can prove extremely destructive and may in fact impinge adversely on the poor[11]. The objective should be to gradually supplant such organisations by formal financial institutions, and this process can take considerable time.

8 For the purposes of discourse, we shall treat salary payments to excess government staff as transfers.

9 Not to mention desirable relative price configurations.

10 Uncritical adherence to International standards can sometimes lead to unintended consequences. For instance, international norms for recognition of non-performing loans, which are usually 6 weeks of non-payment of servicing obligations, are designed on the basis of continuous income generating activities such as manufacturing or most services. In the case of agriculture, however, where the income streams are naturally discrete, occurring say every 4 to 6 months, almost every loan will necessarily have to be classified as non-performing, thereby forestalling further advances to the borrower.

11 Normal operating practices and prudential requirements of modern banking usually require a level of documentation that is seldom possible to be met by relatively small borrowers. Such agents therefore have recourse to no other form of finance than traditional financial organisations which depend more on personal knowledge and relationships.

It needs also to be recognised that establishing a comprehensive modern financial system may be beyond the abilities of even the relatively more sophisticated developing economies. The banking sector, including post offices, is relatively easy to establish, but equity and long-term debt markets are difficult to create even with technical assistance from the international community. Such markets require not only considerable institutional expertise and credibility, but more importantly a sufficient number of companies whose paper can be considered for long-term investment. Both these are usually in short supply in developing countries. In such situations, development banks have an important role to play and should be considered seriously, at least as a transitional arrangement. Since development banks require long-term funds to carry out their mandate, the modalities for funding them has to be clearly thought out. It is most unlikely that there will be sufficient availability of long-term funds in developing countries, except through the intermediation of the government. International support is thus critical.

The final element is the establishment of a pension system, which is desirable both as a social safety net and as a source of savings. The report recommends that for the greatest positive impact on savings, a defined-contribution pension scheme is to be preferred. It further recommends that such a scheme should be complemented by a tax-financed scheme to provide a minimum pension to the poor. There is merit in this proposal, but there is a glaring omission that needs to be noted. Pension schemes can provide a social safety net for the elderly, but it leaves out other vulnerable groups in society. It is for every society to consider whether the elderly are necessarily the most vulnerable, and therefore entitled to claim first charge on scarce resources.

An essential issue that remains unaddressed in the Report is the potential conflict between raising adequate domestic savings and meeting the Millennium goals. At low levels of income, increases in the savings rate inevitably involves a certain degree of exploitation, whether of agriculture or of labour. There are practically no historical instances where such exploitation has not taken place in the early years of development[12]. Thus, merely the creation of the enabling conditions as described by the Report is not enough. Consideration also needs to be given to the manner in which domestic savings can be raised without leading to significant worsening of income distributions. There is no ready answer, but accessibility to foreign savings is an option for bridging this divide, at least in the initial years. This consideration would need to underlie the discussions on the flow of international capital and the measures that developed countries can take to ensure that there is a trend towards equalisation of investment rates among countries.

Private Capital Flows

The Report points out that although "the bulk of savings will come from domestic sources, but foreign capital can provide a valuable supplement to finance investment and growth." It also talks about "tapping the vast pool of funds available in the forms of foreign direct investment, portfolio investment

[12] In the Indian case, for instance, the sharp rise in the savings rate during the 1950s, 60s and 70s was engineered first by a deliberate policy of capital intensive industrialisation, which was in effect anti-labour, and later by turning the terms of trade against agriculture.

and bank loans". The necessary measures are divided into three parts: (a) actions by developing countries; (b) actions by industrial countries; and (c) actions by the international community.

The actions required of developing countries are broadly similar to those outlined for creating a conducive environment for investment. In addition, the report recommends that foreign investors should be "treated no less favourably than domestic investors", and that their interests should be fully protected. Conversely, the report also recognises that foreign investors should not be exempted from domestic laws governing corporate and individual behaviour and should come under the purview of the domestic legal system. There are two issues which need consideration in this context.

First, it would have been desirable for the Panel to qualify the term "no less favourably". While there is certainly a case to be made out for free repatriation of capital and earnings by foreign investors in the context of restrictions on domestic agents, surely it is not intended that the developing countries cede all authority in determining the type of activities in which foreign investment would be permitted. The issue of "pre-establishment national treatment" is being hotly debated in the context of a multilateral agreement on investment, and the impression that is given by the Report is that it favours such treatment. This is unfortunate, particularly since most developing countries are agreed that while post-establishment national treatment is desirable, it is not the case with pre-establishment national treatment.

Second, the Report explicitly warns against excessive investment incentives and eroding of labour and environmental standards by developing countries for attracting foreign investment. Although the evidence supporting a "race to the bottom" is not very strong at present, the danger is very real[13]. Nevertheless, a distinction may have to be drawn between countries at different stages of development. In the case of some of the poorest countries, there may be no option but to offer significant incentives and exemptions from standards in order to attract foreign investment. Beyond a point, however, it would be necessary to evolve a code of conduct in order to prevent developing countries from following a "beggar my neighbour" policy.

Industrial countries are enjoined to facilitate private capital flows into developing countries through enhanced flow of information, insurance schemes and market access provisions[14]. They are also expected to discipline and moderate their own tax concessions which erode the relative attractiveness of investment in developing countries. An important suggestion is that industrial countries should remove a number of policy constraints that exist in permitting certain categories of the investors to enter emerging markets. These are very valuable suggestions and should be made with considerable force. In fact, it may be possible to argue in favour of a certain degree of preferential treatment.

Another important suggestion is that in order to prevent herd behaviour among private lenders, bonds issued by emerging market economies should have collective action

[13] See, for instance, G.H. Hanson, Should Countries Promote Foreign Direct Investment? (UNCTAD, G-24 Discussion Paper Series, No. 9, Feb. 2001) and C. Oman, Policy Competition for Foreign Direct Investment: A Study of Competition Among Government to Attract FDI (OECD Development Centre, 2000).

[14] The importance of insurance cover for foreign direct investments cannot be overstated. Arrangements like the OPIC of the United States have played an extremely important role in directing FDI to developing countries.

clauses[15]. Collective action clauses essentially permit a qualified majority of bondholders to approve changes in the payments obligations.

In order for such clauses to be introduced by developing countries without making their bonds relatively less attractive, the report suggests that all industrial countries should first make it mandatory for these clauses to be introduced in their own bond issues. Perhaps it should have been added that the institutional mechanism for making such clauses effective with sufficient speed needs to be put in place.

As far as action by the international community is concerned, the principal recommendation is that multilateral development banks should increase their role in co-financing and providing guarantees to foreign direct investment. It is also suggested that the prudential norms for banks should not be such as to make international bank loans prohibitively expensive for most developing countries. The latter suggestion appears slightly questionable. Surely what should matter is whether there is differential treatment between developed and developing countries in terms of prudential norms. If there is merely a scaling, it should not matter very much, particularly if it leads to greater stability of international banking system, and therefore a lesser need for bail-out mechanisms.

The above comments apart, the treatment of private capital flows appears somewhat incomplete. The first point that needs to be noted is that the approach taken to external capital in the Report appears to be restricted primarily to the financing aspect. This is, no doubt, the traditional approach, which stresses upon the role of external savings on bridging the savings and the foreign exchange gaps. There is also an implicit preference for foreign direct investment in the Report as compared to purely financial flows, such as portfolio investment and debt. The evidence on this, however, is by no means unambiguous. Numerous empirical studies suggest that foreign direct investment (FDI) should not be viewed as a source of balance of payments support over the medium run since quite often the foreign exchange outflows associated with FDI can be substantial[16]. To this extent, at least, external portfolio and debt flows would be more in consonance with the pure financing needs.

There is, however, another dimension which needs to be taken into account. In the case of a number of developing countries, foreign direct investment can make up not only deficiencies in the availability of savings and foreign exchange, but also weaknesses in domestic entrepreneurial capacity[17]. It is very often the case that developing countries simply do not have sufficient indigenous entrepreneurial capacity to effectively absorb the investible resources available. In such situations, foreign direct investment may not only raise the level of investment through utilisation of external funds, but also through better absorption of domestic savings. Entrepreneurial dynamism is central to achieving high rates of growth, and its absence may indeed be the dominant bottleneck in following a market-oriented

[15] Collective action clauses essentially permit a qualified majority of bondholders to approve changes in the payments obligations.

[16] A strong theoretical case has also been made for arguing that FDI flows can lead to a worsening of balance of payments even in the short run if domestic multipliers are strong enough.

[17] The role of foreign direct investment in transferring product, process and organisational innovations has been stressed in the literature and is quite well known. The point being made here is somewhat different, and is not widely understood.

development strategy in a number of developing countries[18].

To make matters worse, access to international financial capital is driven largely by the existence of a sufficient number of firms which can either borrow abroad directly or whose stocks are attractive to foreign portfolio investors[19]. In the absence of such companies, it is unlikely that the country would be able to attract external financial flows regardless of how appropriate the enabling conditions. It is little wonder then that most developing countries access external capital either in the form of sovereign loans or, at the very least, with sovereign guarantees in one form or another. The other option, namely routing such funds through the banking system, has proved to be potentially even more damaging, as the East Asian crisis has shown.

On the other hand, for countries which have sufficient entrepreneurial activity, relatively free access for foreign direct investment with restrictions on other forms of external capital may put domestic entrepreneurs at a serious disadvantage. This has not only to do with the access to relatively lower cost external funds, but also in terms of the competition for accessing domestic finance. Thus, the role that external private capital flows can play in a developing country is sensitive to the nature and extent of domestic entrepreneurial talent.

If the issue is seen in this perspective, then the treatment of private capital flows in the Report will need to be slightly different. In the first place, the emphasis should be shifted from the purely financial aspects to the contributions that foreign capital can make to the investment activity in general. Second, there should be some reflection of the limitations that exist in attracting private capital flows, especially in the less industrialised developing countries. Related to this issue, there is also need to discuss the balance that should be struck between FDI, on the one hand, and the pure financial flows, on the other; and the possibility of complementarity between these different forms of external capital. Finally, there should have been some reflection on the relationship between the financial sectors in developed and developing countries.

Trade

One of the most pleasant surprises in the Report is to find trade issues being included in a study of development financing. This is not standard, and many economists will no doubt question the validity of this inclusion. The traditional approach views development financing from the savings-investment balance of a country. The difference between the desired rate of investment and the rate of domestic savings determines the current account balance, which represents the external finance requirement. Although trade is implicit in the current account balance, it is not the determining factor. The focus is primarily on domestic savings and on the financing of the current account balance. It is, therefore, necessary to lay down clearly why we believe that trade issues are central to any discussion of external finance for development, and why the approach taken by the Report is to be strongly supported.

[18] Although this was not a problem in India earlier, recent evidence tends to suggest that ex-ante savings, both domestic and external, may be greater than ex-ante investment demand, and therefore some of the growth potential is not being realised.

[19] By and large, this condition requires the companies to be of a minimum size and/or with a fair degree of market capitalisation. Portfolio investment further requires the existence of an active and secure stock market and a secondary debt market. It is unlikely that countries in the initial stages of industrialisation will meet these conditions.

The traditional approach is perfectly valid in a context where the flow of external resources is in some sense exogenous or that it is not influenced by factors internal to the country under consideration. Thus, in a situation where the external flow of funds is limited to development assistance, issues of trade can more or less be ignored[20]. However, with the increasing importance of private investment flows in financing investment and growth, it becomes essential to take into account factors which influence the decisions of private investors. There are at least two important ways in which trade issues impinge on private investment decisions.

First, in any reasonable long-term or multi-period model of private capital flows, the decision to invest in a particular country would be contingent upon an appraisal by the potential investors of the country's ability to service the investment over the longer time period. There should, therefore, be at least some degree of assurance that the country will be able to generate a trade surplus in the future, which can be used to service its past external liabilities[21]. This will certainly be contingent upon the export potential and prospects of the country.

Second, at the micro level, the choice of the product or service in which investment will be made will depend upon the size of the potential market, particularly in such activities in which the country has comparative advantage. If the market is restricted to the domestic economy, it places a limitation on the amount of investment that can be attracted and absorbed. Exports provide an important means to widen the market and thereby increase the flow of investment. In brief, therefore, the ability of the country to attract private investment flows will depend to a large extent on its export potential. Thus, trade issues must be central to any discussion of private capital flows.

The Report rightly states that "... the main beneficiaries of trade liberalisation have been the industrial countries. Developing countries' products continue to face significant impediments in rich country markets". To correct this problem the Panel strongly endorses the launch of a new round of trade liberalisation to focus mainly on the trade needs of developing countries. The broad agenda for such a "development round" in the WTO should include the following:

The implementation of the Uruguay Round: In brief, this refers to the implementation issues that have been stressed by the developing countries at the Doha Ministerial, especially relating to the special and differential treatment to be accorded under the various WTO agreements. This is by and large unexceptionable, except perhaps a mention could also have been made of Sanitary and Phyto-sanitary measures, which are of relevance to market access for agricultural products in particular.

Liberalisation in agriculture: the Report has stressed upon obtaining significant improvements in market access is, elimination of export subsidies and tightening of support to domestic producers in developed countries.

[20] Much of the theory behind development finance was developed at a time when the bulk of international flows were in the form of aid and/or debt, and private investments were perceived to have little role to play. In the case of debt as well, the role of domestic factors was underplayed by an implicit assumption of sovereign guarantees.

[21] In the short run, it may be possible to manage the balance of payments through some form of Ponzi finance, which would in any case not be credible for any length of time and would only attract speculative capital.

Although this has been a long-standing demand of developing countries, it is not entirely obvious that the benefits of such liberalisation will accrue predominantly to them. As things stand at present, the main beneficiaries will be the Cairns group, which consists mainly of developed and the better-off among the developing countries. The agricultural sectors of most of the developing countries do not as yet have levels of productivity which would enable them to address the international market in any meaningful way. A danger that needs to be guarded against is that in attempting to improve market access in developed countries, the developing countries do not also lose control over their own agricultural sector. The main issue that needs to be addressed in this context is the agricultural subsidies that are given under various forms by a number of developed countries, which are seriously distorting the international market for agricultural products. The net result is that a number of developing countries, including India, are finding it increasingly difficult to provide adequate price support for encouraging productivity growth in their agricultural sector. Emphasis, therefore, must be placed more on controlling agricultural subsidies than necessarily on increasing market access[22].

The total elimination of remaining trade barriers in manufacturing: The Report also calls for the removal of all trade barriers in manufactured products, which are mostly at the expense of developing countries. Presumably this refers to the existing tariff peaks and tariff escalations that are directed at protecting the relatively low skilled occupations in developed countries. Although this is certainly true, particularly for textiles, clothing, and a wide range of processed foods, the non-tariff barriers are more pervasive and pernicious. Some of these issues may be covered under the implementation agenda, but it would be desirable to specifically identify these for further action.

There is a brief mention of the welfare gains that could accrue if the new round also liberalises trade in services. It appears that the Panel was hesitant to address this issue more strongly, perhaps on the grounds that migration and movement of natural persons would be too delicate a matter to take up at this stage[23]. Nevertheless, liberalisation of trade in services, particularly in non-financial services, even without the movement of people would be of immense benefit to developing countries, provided that international assistance was forthcoming for providing the appropriate technologies and for developing the necessary infrastructure and human resources. The non-binding nature of the existing general agreement on trade in services (GATS) seriously dilutes the benefits that can accrue.

It is also recommended that international assistance be provided to the least developed countries to build up the capacity for trade negotiations and to help them to diversify their exports. To this end, generous financing of the Integrated Framework is proposed. This is no doubt an important recommendation, but perhaps some reflection on the effectiveness of the Integrated Framework would have been desirable. It is not possible to develop either trade strategy or effective negotiation without considerable analytical work going in to the role of trade

[22] If the choice is to be made between reduction in tariffs or reduction in subsidies, the overall impact would be significantly greater for the latter.

[23] Although there is a brief mention towards the end of the Report.

in the development strategy of a country. A number of the least developed countries simply do not have the technical expertise to carry out any meaningful strategic analysis, and in such a situation merely emphasising the trade issues would be incomplete.

There are two other suggestions which are made and deserve further consideration. The first is the restoration and improvement of the IMF Compensatory Financing Facility, which was scaled back during the 1980s. The issue here is that the CFF, when it existed, was not particularly successful in preventing erosion of earnings from commodities from destabilising the countries concerned. In order to make such a facility effective, there would have to be considerably greater support from the developed countries as well as a more sophisticated implementation system. It is to be considered whether the IMF, which is already hard pressed to meet its primary obligations in an increasingly volatile international financial scenario, will have the capacity to take up this function as effectively as would be desired.

The second suggestion is the establishment of a multilateral commodity risk management scheme for less developed countries. Although the main report does not discuss the nature of the scheme, there is some information provided in the Technical Report. In essence, the scheme appears to be a combination of a minimum support price mechanism and an insurance scheme. Although the idea is a good one, its effectiveness would depend largely upon the efficiency and sensitivity of the international agency which administers it. It is felt that there is a serious underestimation of the complexities involved in administering such a scheme at the level of a small farmer in a less developed country, especially given the complex chain of intermediaries that are usually involved in trade in a gricultural products. Indeed, such a scheme if not administered properly can possibly lead to perverse results for the farmers.

The main weakness of this analysis, however, is that it does not go far enough in addressing the constraints that limit the exports of developing countries to developed country markets. Improving market access in the sense of creating enabling conditions addresses only part of the problem. The larger problem lies in the institutional framework which actualises the export potential of a country. Unless a country has the right type of companies which can take advantage of more liberal market access, little progress can be made. Therefore, demanding greater market access, which invariably has some *quid pro quo* involved, must go hand in hand with taking measures, usually domestic, to ensure that the full benefits can be realised. Otherwise the net effect is only greater concessions being granted to the developed countries. The Integrated Framework is only partial solution to this dilemma. More active participation by developed countries through various forms of marketing assistance and linkages is called for. It is also necessary to link trade issues with the foreign investment issues discussed earlier.

International Development Cooperation

The Report recognises that even if sufficient progress is made in domestic policy reforms, private capital inflows and trade liberalisation, international development cooperation will remain vital to the process of development. There are four principal roles that are envisaged:

- Helping to initiate development
- Coping with humanitarian crises

- Providing or preserving the supply of global public goods
- Confronting and accelerating recovery from financial crises.

An attempt has also been made to estimate the international resources required to fund these roles. As far as pure development aid is concerned, it is estimated that roughly $50 billion would be required annually just to meet the International Development Goals, which is almost double the present level of ODA. The funding of humanitarian crises is currently made out of the available ODA funds, which leads both to a serious underfunding of humanitarian aid as well as a diversion of resources from the development function. It is suggested that the donors need to make a long-term commitment for humanitarian relief through a contingency budget without diverting funds from other assistance. The estimated provision for humanitarian relief is $8-9 billion in a typical year as compared to around $3 billion at present[24]. As far as global public goods are concerned, it is again the case that their funding is made out of the existing aid budgets. The estimated requirement for this purpose is at least $20 billion. Thus, the total requirement on these three counts works out to around $80 billion annually, which is almost four times the total ODA available at present.

The Report clearly makes the point that it is imperative to separate the funding for each of these three causes, so that there is no ambiguity regarding the resources available for each of them[25]. This is an extremely important recommendation since development assistance can be effective only when there is sufficient assurance that the resources would be available over an extended period of time. Placing all the requirements in one basket invariably leads to a certain degree of uncertainty regarding the volume of resources that can be available for a particular cause at a particular point in time. More importantly, the considerations underlying each of these needs are very different, and would have to be reflected not only in the nature of the funding but in the institutional arrangements as well.

Consider first the issue of humanitarian assistance. By its very nature, such requirements are episodic, non-country specific and often for a limited duration[26]. Thus, provisioning for such assistance has to be made on a contingent basis without disturbing the regular system of aid flows. Since the expenditures involved are usually either in the nature of consumption or of reconstruction of assets, the assistance must be made in the form of grants. A distinction frequently has to be made between such flows on the basis of the cause of the emergency. There are two main categories of disasters – natural calamities and those arising from breakdown of governance[27]. In the case of the former, the normal governmental channels, with perhaps some strengthening, can be used for the

[24] Presumably this estimate does not include adequate financial support of the UN system, which is the central actor in practically all humanitarian aid efforts.

[25] The resources required for aiding recovery from financial crises has not been specifically mentioned in this context, and it is presumed that the Panel expects such resources to be found elsewhere, presumably with the IMF, without cutting into these provisions.

[26] There are of course countries where disasters of one kind or another are a more or less regular phenomenon and therefore require a constant inflow of humanitarian relief. In such cases, aid flows can conceptually be accommodated as part of a broader development assistance programme.

[27] There are certainly situations where both can occur simultaneously. In such cases, the governance issue will have to take precedence in identifying the appropriate delivery mechanism.

delivery of relief, and therefore a temporary blurring of the line between humanitarian assistance and development aid can be accommodated. In the latter case, however, alternative, non-governmental institutional arrangements may have to be established for delivering relief. In almost all such situations, the relief agency will require a certain degree of assurance on the adequacy and continuity of support for it to be able to function effectively.

Global public goods are another matter altogether[28]. In the first place, there is as yet no general agreement as to the constituents of such goods. Even in the indicative list given the Report, some of the items would most likely be questioned by developed countries. Second, as international concern regarding global public goods has increased, it has manifested itself as additional restrictions being placed on the utilisation of normal development assistance. Frequently it is difficult for developing countries to resist this pressure since some of the activities are clearly in their own self-interest and, in any case, they need the funds for balance of payments support. Nevertheless, it leads to a dilution of the resources available for attaining other development targets. It needs to recognised, therefore, that if the issue of global public goods is to be addressed adequately, a distinction would have to be drawn between those activities which a developing country would carry out as part of its development strategy and those which it would not. For the latter, specific funding would have to be provided, usually in the form of grants since such activities are normally not income generating, and this would have to be done on an ongoing basis. The former can gradually be absorbed as a part of normal development assistance.

As far as traditional development assistance is concerned, it is by and large viewed as transitional financing until such time as domestic resources become adequate to maintain the growth process on a sustainable basis and the country is in a position to attract sufficient private investment from abroad. Seen in this manner, the finances can be provided in the form of loans, provided of course that the terms are such that debt servicing does not become a burden too early in the development process. Unfortunately, the experience has been that the net flow of development assistance has turned negative much too early in the case of a number of countries. The problem has been further compounded by various conditions that are attached to aid, which significantly reduce their impact. In particular, development aid has rarely been properly integrated with the development strategy of the recipient country. Frequently, parallel delivery systems have had to be established in order to implement the externally assisted projects at the insistence of the donors. As a result, countries have often been saddled with additional expenditure commitments even after the aid flow for that particular purpose has ceased.

In recognition of this, the reduction in the debt burden of the heavily indebted poor countries through the HIPC Initiative has been welcomed by the Panel, despite the fact that it has not been fully financed by additional ODA[29]. Given the gravity of the situation, there is need

[28] The items that have been identified as global public goods are broadly: peacekeeping, prevention of contagious diseases, research in tropical medicines, vaccines and agricultural crops, prevention of CFC emissions, limiting carbon emissions, and preservation of biodiversity.

[29] The implications of the existing and proposed funding of the HIPC Initiative on the other poor developing countries has been admirably done in the Technical Report and bears careful consideration.

to enhance the HIPC scheme in order to make the debt position of these countries sustainable and enable them to attract private finance[30]. It needs to be noted that an additional inflow of aid is not necessarily equivalent to debt relief. The former is usually restricted in where and how it can be applied, and therefore reflects more the donor's priorities, whereas the latter allows a greater flow of resources to the entire gamut of development expenditures[31]. This difference can be a double-edged sword. In the case of countries with good governance and commitment to development, debt relief will probably be far more effective than an equivalent amount of additional aid. The opposite may, however, be true of countries which do not meet these conditions. This is not merely a moral hazard problem, which potentially exists with any debt write-off, but an argument for distinguishing between countries while deciding upon the nature of the development intervention[32].

The more critical issue, however, is how to prevent the re-emergence of such a situation in the future. The lesson that needs to be learnt is that the terms and conditions of aid that has existed in the past are simply not generous enough to prevent developing countries from slipping into the red. It is, therefore, imperative that the existing loan/grant ratio of development assistance be reconsidered, especially for the poorest countries. In particular, it needs to be considered whether the soft loan windows of the multilateral development institutions, such as the IDA, should be converted to grants as has been proposed by the USA. There is merit in this proposal, but it can lead to moral hazard problems. Perhaps a better method would be to evolve a system by which loans automatically get converted to grants on the achievement of pre-specified development milestones[33].

An important suggestion made by the Panel is that donors should put their aid resources into a common pool to support the development strategy of a given country. It needs to be clearly clarified that this proposal should apply only to normal development assistance and not to either humanitarian aid or financing of global public goods. If this suggestion were implemented, it would go a long way towards improving the effectiveness of aid. The Indian experience has been that donors acting individually not only leads to diffusion and duplication of programmes as well as establishment of parallel delivery systems, but more importantly impinges adversely on the programmes run with domestic resources[34]. Ideally, the country should be responsible for designing the programmatic structure of its development strategy and the donor community should plug in to those which are

30 One of the most positive aspects of debt relief is that it significantly improves the country's position with regard to attracting private capital. An equivalent amount of additional aid does not have this effect since aid funds cannot be appropriated to meet general financing needs. Thus, this initiative should be seen as a measure to permit leveraging of aid funds.

31 This distinction gets blurred when the HIPC initiative is coupled with restrictions on how the resources saved from debt servicing can be applied.

32 This discussion suggests that the debt write-off route should perhaps be also considered for moderately indebted developing countries, particularly those for which the net flow of external assistance has already turned negative.

33 Although this proposal reeks of additional conditionalities, some such mechanism is necessary both for the comfort of the donors and to ensure that the recipients become conscious of their responsibility.

34 Since most governments are fiscally constrained, the counterpart funds for accessing international aid are almost invariably found by cutting back domestically funded programmes, which may actually rank higher in development priorities. The other side of the coin is that when development concerns outweigh balance of payments needs, there is underutilisation of aid funds.

consistent with their mandate, without necessarily demanding ownership and control[35]. Some initial steps have been taken in this direction with the World Bank's Comprehensive Development Framework (CDF) and the UN's Development Assistance Framework (UNDAF), but in neither case are they properly integrated with the national development strategy. Of course it also needs to be recognised that a number of developing countries simply do not have the institutions or expertise to draw up a comprehensive development plan, and externally drawn up strategies are no substitute for a national effort. For this process to become meaningful, the international system needs to support capacity building in development planning, which is easier said than done in view of a more than 20 year-long successful campaign to denigrate planning[36].

The Panel has also made another extremely important suggestion that donors should distribute ODA across countries according to two criteria : (a) the depth of poverty; and (b) the extent to which the country's policy is effectively directed to reducing poverty. The intent of this suggestion is clearly to reduce the political content of national aid policies, which have led to an extremely skewed pattern of distribution of aid funds, and therefore needs to be strongly supported. However, the second criterion, as it stands, leaves scope for considerable subjectivity, and can end up diluting the intent of the proposal. In order to obviate this problem, it becomes necessary to evolve a non-partisan, multilateral institutional framework which is empowered to determine the distribution of all aid funds on the basis of objective criteria. The existence of such a body is also necessitated by the proposal for the pooling of aid resources.

Finally, the Report calls upon the donor countries to commit 0.7 per cent of their GNP towards ODA as recommended by the Pearson Commission. Achieving this target will lead to an annual availability of aid funds of around $100 billion, which would be sufficient to meet the assessed minimum requirements plus have something left over for accelerating the achievement of the Millennium Goals. Such commitments are unlikely to be forthcoming without strong political backing and a well-coordinated campaign to raise the level of public awareness about the importance of the Millennium Goals, both as a measure of compassion and to achieve greater peace and security in the world. Unfortunately, the track record on this count does not warrant any great optimism. Therefore, after having made the plea, the Panel should have prioritised the existing commitment of funds to the three broad areas of assistance. The responses of the various donor countries to such a proposed allocation would be most interesting and revealing.

Systemic Issues

The section on Systemic Issues is perhaps the most important and comprehensive part of the Report. The focus that it brings to bear on

[35] On the other hand, at the micro level in India, it has been found that externally assisted programmes have, by and large, been run more efficiently than the domestically managed ones. There are many reasons for this, not the least of which is the expertise and commitment brought by the external programme managers. This would suggest that recipient countries should be flexible about ceding management control of key externally assisted programmes to their donor partners. Getting on to the sovereign high horse does not help matters.

[36] This factor is now starting to be recognised. The World Bank's Poverty Reduction Strategy Papers (PRSP) are nothing but development plans in another name. No PRSPs are prepared for India. Also, while India has an UNDAF, it is not among the countries for which a CDF is prepared.

the importance of global governance and the international institutional structure, not only for development financing but also for reducing the sense of alienation and disempowerment among a number of developing countries, bears careful consideration. It rightly makes the point that "... global interdependence without global rules and institutions is in nobody's long-term interest", and goes on to elaborate the nature of the problem as it exists today.

The Panel rightly points out that the international economic system is fragmented, and there is an absence of a long-term strategic framework that can guide the evolution of the global economy. It is, therefore, proposed that a Globalisation Summit of a few key heads of State be convened as a prelude to establishing a Global Council to provide leadership on issues of global governance. The Council would not have legally binding authority, but would use its political stature to find solutions to issues of global economic and social governance. While this is a proposal that needs to be supported in principle, since the political content of the existing global arrangements is most inadequate, it is not clear what the authority of the Council would be. The Panel appears to have stopped short of recommending the economic equivalent of the Security Council. Thus the credibility and the moral authority of the Council will be determined by its membership. This is likely to be a contentious issue, since the membership of the Council is intended to be limited. It is necessary, therefore, to guard against the Council becoming a more formalised version of the G-20, and thereby not commanding the full confidence of the developing countries[37]. For this purpose, the modality of selecting the membership of the Council will have to be thought through carefully. There are seven main dimensions of the systemic issues that the Global Council is intended to address immediately. These are discussed below.

Support for multilateralism: Strengthening of the multilateral approach to handling global issues is the first principle that should be endorsed by the Council. The developing countries clearly have a strong stake in promoting multilateralism, which is possibly the only available bulwark against excessive domination by individual developed countries. The United Nations system in particular, because of its more democratic constitution, has been extremely important in this respect. The other multilateral institutions are less representative, and must be encouraged to move in this direction. The obvious merit of this apart, the fact remains that no common pool approach to aid can be effective without the strong political backing that the Council can give.

Reform of the international financial architecture: This is an issue that has come into prominence in recent years due to the spate of financial crises that have occurred around the world. The need for such reform, however, should be articulated from a more long-term strategic perspective. With the growing importance of private capital flows, a model which was based essentially upon the flows of public funds is becoming anachronistic. As things stand at present, the international financial architecture is reactive, with little or no direction being provided to private capital. The proposal to shift the focus of the IMF to crisis prevention and timely detection of external vulnerability is

[37] The problem is particularly complex today since the developing countries as a collective do not have the kind of solidarity and widely accepted leadership as it did earlier, notwithstanding the G-77.

welcome, but it is by no means clear that the instruments available to the IMF at present are adequate for the purpose. Similarly, the task of making IMF conditionalities more sensitive to the capacities of the domestic authorities and to perceptions of private investors will require significant strengthening of the capabilities of the IMF and the extent of its engagement with developing country governments.

The Report has also suggested that the World Bank should accelerate its support to the longer- and medium-term structural and social reforms, particularly those for preventing crises. This is no doubt important, but it is equally important that the World Bank significantly enhances its role in helping to attract private capital to developing countries. This does not mean an expansion of merely the commercial arms of the World Bank, but an integration of the entire assistance package with the prospects offered by the international capital market.

Reinforcement of the WTO: the Panel has rightly observed that the WTO is in need of reform and support in certain critical areas, and that these changes are unlikely to be achieved from within. In particular, it has identified the decision-making system in the WTO as selective and exclusionary. The WTO also has very limited capacity to provide technical assistance to developing countries, arising primarily due to underfunding and understaffing. Given the obvious importance of WTO in the global economy, and the steadily increasing role that it is being called upon to play, it would be in everybody's interest to ensure that this organisation is sufficiently strengthened and empowered.

An additional factor that the Panel should have perhaps considered is the fact that the WTO, particularly its dispute settlement mechanism, is quasi-judicial in nature and, as a result, many of the rules of international commerce are being determined not so much by the formal Agreements, but by case law. This has two dimensions. First, most developing countries simply do not have the legal expertise to effectively articulate their position, nor to fully appreciate the implications of the case law for their future action. As a consequence, the application of the WTO Agreements is being driven more by access to legal talent than by merit. Second, there is no proper mechanism for the review of case laws by the General Body to ensure that the intent of the Agreements is not been violated by its interpretation. It is imperative therefore to ensure that the normal processes of legal assistance and legislative review, which are present in all democratic societies, are also introduced in the WTO through suitable strengthening.

Environmental and Labour issues: the Panel has correctly diagnosed the pressure on the WTO to address environmental and labour issues as arising from its capacity to impose sanctions. Recognising that this would seriously distort the mandate of the WTO, it has been recommended that alternative fora be given these functions with adequate instruments of enforcement. Strengthening of the International Labour Organisation and the creation of a single Global Environment Organisation, through a merger of existing bodies, have been recommended. Both these proposals need to be supported strongly.

Innovative sources of finance: the Panel recognises the need to establish stable and contractual new sources of multilateral finance, but it also recognises that taxing for global problems will be politically much more difficult than taxing for purely domestic purposes. This is indeed true, and recent experience shows the unwillingness of some developed country governments to impose costs on their own people even if it is for the common good of humanity[38]. The Panel has, therefore, proposed that the first issue that needs discussion is whether or not the world should have global imposition of taxes instead of only sovereign ones. This is a very sensible suggestion, and there are two issues that need to be considered carefully. First, there is a distinct possibility that the imposition of a global tax may lead to a severe dilution of the commitment by developed countries to voluntarily contribute to international assistance[39]. The net result may actually be a decline in the resources that become available. Second, the effective operation of any tax system is critically dependent upon the coercive power of the State. In the case of an international tax, enforcement of compliance may not be easy unless there is full political commitment by all concerned governments and these taxes are either built into national tax laws or are given some alternative form of statutory support. Alternatively, a method of sanctions would have to be developed, which could be further problematic, and not to be recommended.

The two taxes proposed in the Report, namely a currency transactions or Tobin tax and a carbon tax, are both likely to be most unpopular in developed countries. Of the two, the Panel has rightly been cautious about the first, and has advised further study before a definitive conclusion is reached. This is a position we agree with, since the little available evidence suggests that the negative consequences of such a tax on the international financial system may significantly outweigh the benefits. The carbon tax, on the other hand, has much to recommend it. The global negative externalities of carbon emissions are sufficiently well-documented to merit a system of disincentives, and such a tax fulfils this role admirably. Care, however, has to be taken to ensure that the basis for application of such a tax is properly specified. For instance, if methane emissions are taken into account, then the rice growing areas of the world would be unfairly targeted. It is, therefore, suggested that the carbon tax should be restricted to the burning of fossil fuels, which would also have the added advantage of discouraging the use of an exhaustible natural resource.

It is actually surprising to find that the Report has not discussed the issue of taxing “global commons”. This issue has been briefly touched upon in the Technical Report, where it has been mentioned that activities such as satellites and seabed mining have been not considered on the grounds that the proceeds from such tax would be negligible. Even if this were the case, there are strong theoretical and ethical reasons to impose a tax on global commons with an eye to the future.

Finally, the report has suggested the revival of the special drawing rights (SDRs) by the IMF, which allows developing countries to build up international reserves without imposing real costs. This is an important suggestion and should be fully supported since in recent years

[38] The withdrawal of the USA from the Tokyo protocol is a case in point.

[39] The strong motivating factor of compassion can easily be lost if there is perceived to be an imposition, which can actually lead to further polarisation between developed and developing countries.

the need to build up reserves for precautionary reasons is imposing serious costs on developing countries, and this can only grow as private capital flows increase relative to ODA [40].

International Tax Organisation: one of the most important suggestions made in the Report is the establishment of an International Tax Organisation. The functions of such an organisation have been spelt out clearly, and each has considerable merit. This proposal should be supported strongly, although there will be considerable resistance from multinational corporations and certain governments. Issues of transfer pricing and tax havens have created enormous problems for developing countries, and an organisation that can address these issues will no doubt considerably reduce the suspicion that domestic governments have regarding multinationals, and thereby improve their faith in global governance. In addition, as globalisation progresses, there will be need for a certain degree of harmonisation of tax systems, especially to prevent undesirable tax wars, which will require the existence of a body that is already familiar with the diverse tax systems and carries a certain degree of credibility. At present, the IMF does have some familiarity with fiscal matters, but this is by no means its primary function, and nor should it be.

Migration Policies: the Panel has suggested that the time may be ripe to develop international cooperation on the movement of labour across countries without risking national interests. This is certainly true, particularly in view of the demographic changes that are taking place in developed countries which, if not addressed today, may cause serious disruptions in the not so distant future. This is, however, a highly charged political and emotive issue, and its resolution cannot be left to diplomats and bureaucrats. A high-level political body, such as the Global Council, will be essential to evolve an acceptable compromise between the contending interests.

[40] Building foreign exchange reserves on the basis of external borrowings and/or investment essentially amounts to reverse transfers in the form of *seignorage*.

Indian Prospects and Development Finance Needs

Having critically examined the Zedillo Panel recommendations in the light of past Indian experience, it may be desirable to briefly describe the development finance situation in India as it exists today and the strategic approach that is likely to be taken in the immediate future. The objective is to lay out the considerations that would need to inform India's position not only in the forthcoming Monterrey Conference, which is no doubt important, but also in its approach to development finance in general.

The first point that needs to be appreciated is that, by all appearances, India seems to have an embarrassment of riches as far as investible resources are concerned. With a domestic savings rate of above 24 percent of GDP and non-aid capital flows of nearly 2% of GDP, a sustained growth rate of between 6 to 6.5% per annum without serious balance of payments difficulties appears very much on the cards. Such growth rates will almost certainly place India among the fastest-growing countries in the world over the next decade. This, coupled with a steady decline in the population growth rate, should lead to rapid increases in per capita incomes of somewhere in the region of 4.5 to 5% per annum – i.e. a doubling of real per capita incomes in the next 15 years. Foreign exchange reserves of more than $60 billion, equivalent to about 12 months of imports, lend a further measure of solidity to Indian economic prospects. Indeed, these features of the Indian economy, taken with the fact that the ***net*** flow of external assistance has turned negative in recent years, have prompted a number of observers to take the view that today India can do without development assistance on the strength of her domestic savings and private external flows[41].

On the poverty reduction and social indicator fronts too India has been performing reasonably well over the last two decades. At current rates of progress, the Millennium Goals are well within reach. The rate of reduction of the poverty ratio has been averaging about one percentage point per year, and if this rate can be maintained, the incidence of poverty should be below 15% by 2015[42]. Literacy rates too have been increasing rapidly in recent years and it is expected that it will reach 75% by 2007 and over 90% by 2015[43]. The rate of progress in reducing gender disparities in education is also reasonably good. As far as the health indicators are concerned, the targets on maternal and infant mortality rates should be achievable, despite the relatively slow rate of progress during the 1990s.

[41] Net development assistance to India at present is a little more than minus half a billion dollars annually.

[42] Preliminary estimates made by the Planning Commission for the Tenth Five Year Plan indicate that if the economy grows at an average annual rate of 6.5%, the poverty ratio will decline to about 21% by 2007; and if the growth rate can be accelerated to 8% per annum, the poverty rate would be about 19%.

[43] Universal literacy may take a while longer given the huge back-log of adult illiteracy, but universal coverage of the school-age population should be achieved by the end of the decade.

Despite these positive trends, there is no cause for complacency. To begin with, although a sustained growth rate of 6 to 6.5% appears impressive by any standard, it needs to be seen in the context of requirements. The most compelling factor that will guide India's development strategy over the next few years is the fact that although the rate of population growth is dropping quite significantly, the rate of growth of the population in the working age group will peak during the coming decade at around 2.5% per year[44]. There is still considerable uncertainty about the likely rate of growth of the labour force, since there are two possible contradictory forces in operation. On the one hand, the increasing trend in the average years of education will reduce the rate of addition to the labour force; while, on the other, greater work participation by women will tend to increase it[45].

Nevertheless, the likelihood is that the labour force will increase faster than the economy's current ability to provide gainful and decent employment. During the 1980s and the early part of the 1990s, the average rate of growth of employment, which is a proxy for work opportunities, has been below 2 per cent per year. There is evidence that this has dropped even further during the latter half of the 1990s[46]. Therefore, if the past trends in work creation continue into the future, the country faces the possibility of adding at least half a percentage point of the work force - that is over 2 million people - to the ranks of the unemployed each year. Such a situation is clearly insupportable. Unemployment not only entails high human costs, but also imposes significant costs on society in terms of social unrest and deterioration of law and order.

This is only the macro picture. The national demographic trends hide wide variations in the regional distribution and skill composition of the emerging work force, which are critical components in devising an appropriate development strategy. The process of demographic transition has begun in most of the states of the country, and it appears that the bulk of the future growth of population will be concentrated in only four or five states. This needs to be viewed in the context of a poorly integrated labour market in the country and considerable barriers to inter-state migration[47]. Therefore, the geographical pattern of work creation will have to be such that these states register significantly higher growth rates of labour absorption than the national average. Attainment of the national target without the appropriate regional distribution will lead to a situation in which certain parts of the country will experience labour shortages and others will have to cope with high unemployment. The inevitable widening of disparities in wages and standards of living across regions that is entailed can lead to serious social tensions as migration pressures increase. Thus, sub-national considerations must also inform the nature, quantum and flow of development resources.

It also has to be noted that the emerging work force reflects the skill distribution arising from

[44] This is the outcome of the rapid rate of population growth that occurred during the 1970s and the early 1980s.

[45] Although the recent data seems to suggest that women are withdrawing from the work-force, particularly in rural areas, it is not obvious that this is a voluntary phenomenon and it may simply reflect the non-availability of appropriate work opportunities. With economic growth and improvements in female literacy, the situation can change dramatically.

[46] The latest NSS data indicates that the growth rate of employment between 1993-94 and 1999-2000 has been below 1% per annum.

[47] There is of course significant seasonal migration that does take place in the country, especially for agricultural occupations. This, however, entails considerable human costs and is in no way an enduring solution to the problem.

the spread of the educational and training systems in the past, and it has to be ensured that the pattern of work opportunities is consistent with the skill profile. In this context, cognizance has to be taken of the fact that nearly 60 per cent of the emerging work force will have little or no literacy skills. Therefore, the pattern of work opportunity creation in the immediate short run must be such that it absorbs a large number of persons whose skills are of a traditional nature. On the other hand, there is also a growing trend of educated unemployment in the country, particularly in some of the states which have attained relatively high educational levels in the past. Although migration is somewhat less of a problem in such cases, nevertheless the development strategy cannot ignore the need to create work for the educated labour force of these states in a manner that is least disruptive.

On the other hand, the high rate of growth of the labour force taken with the declining growth rate of population implies that the "dependency ratio" - which is the number of dependents per working person - will also be declining. This creates a window of opportunity during which, if gainful employment is provided to all job seekers, average family incomes can increase faster than ever before, thereby leading to rapid decline in the incidence of poverty.

Thus the demographic trends in the country set the essential parameters of the growth strategy that will have to be followed. This is a fundamental message that must inform all discussion on financing for development. There is no *a-priori* minimum rate of growth which is appropriate for all countries and at all times. Growth requirements will vary depending upon the manner in which demographic trends evolve over time. For instance, successful health interventions for meeting the Millennium Goals can in themselves generate even further requirements of development finance in order to ensure that the income-related objectives of the growing population can be adequately met[48]. Therefore, the notions of resource requirements have to be sensitive to the changing dynamics of social and economic developments in every country, and international aid flows will have to take these into account.

Returning to the Indian context, at the over-all level, it becomes essential to target a GDP growth rate that will generate the requisite number of work opportunities and, at another level, it is also essential to ensure that the structural and regional pattern of growth meets the demands of the work force. Consider first the issue of the aggregate growth rate. Estimates of the elasticities of employment to sectoral output suggest that the necessary work opportunities can be created only if the growth rate is at least 7% per annum, preferably closer to 8% if the quality of employment is also taken into account. At the trend value of the incremental capital-output ratio (ICOR), which is around 4.3 for an average growth rate of 6%, a sustained 7 per cent growth rate could be achieved with an ICOR of about 4.2 and 8 per cent growth with an ICOR of around 4[49]. Thus, the need to create adequate employment demands that the

[48] In this context, it needs to be noted that in India the poverty ratio actually went up during the 1950s and 1960s despite fair progress on the economic front (average annual growth rate of about 4.2%) due to rapidly increasing population. Even in the 1980s, when the growth rate further accelerated to 5.6%, the absolute number of poor rose, although the percentage declined, due to population growth.

[49] Theoretical and empirical evidence suggest that the ICOR tends to decline as the growth rate accelerates. See P. Sen, "*A Note on Growth Projections for Capital-Constrained Economies*", (Planning Commission Working Paper No. 2/2001-PC).

investment rate should be in the range of 29 to 32 per cent of GDP over the next decade. With household sector savings expected to be about 20 per cent of GDP and corporate savings a little above 5 per cent, public savings and external capital inflows together will need to be somewhere between 4 to 7 per cent of GDP. It is the distribution of this additional resource requirement between the two sources that needs careful consideration.

The current trends in public savings in India do not give cause for any great optimism in the near future. Although the savings of the public sector undertakings have more or less remained constant at around 3.5 per cent of GDP, savings of the government, Centre and states together, have been falling steadily and stands at over minus 4 per cent at present. Although efforts are being made to reverse this declining trend, not too much can be expected in the immediate future unless there is a significant increase in the extent of political commitment to a full-scale reassessment of the system of subsidies and transfers and to streamlining of tax administration at all levels[50]. Thus, in the foreseeable future, considerable reliance will have to be placed on external capital inflows for financing the desired growth target.

As far as external capital flows are concerned, in the past the country has relied primarily on external debt. Even when a fair component of this debt was concessional, the country slid inexorably into an external debt trap – exemplified by the crisis of 1991. The situation is worse now. Over the past two decades, the share of aid and concessional debt in international financial flows has been steadily declining, and today, as mentioned earlier, there is a net outflow on this account. Shifting entirely over to external commercial debt would be a very dangerous strategy indeed, given the relatively high interest costs on such debt, particularly with India's external credit ratings as they stand at present. The recent crisis is East and South-east Asia exemplifies the danger of unrestricted inflow of external debt. The solution really lies in accessing higher inflows of non-debt external capital.

Although the possibilities of attracting higher levels of non-debt private flows do exist, prudential considerations demand that the current account deficit (CAD) not be allowed to widen excessively. Estimates of sustainable CAD for India indicate that to the extent possible it should be contained in the range of 2.5 to 3 per cent of GDP[51]. If these limits are accepted, then the necessary growth target can be achieved only if either government savings turn positive or there is a much larger inflow of ***concessional*** external assistance, which would allow a relaxation of the CAD limit[52].

The availability of adequate resources, however, is only half the story. It is becoming

[50] Even with such commitment, it is estimated that government dissavings will continue to be around 2.4% of GDP on the average over the tenth Plan period (2002-07). It is sometimes argued that much of the problem can be taken care of through a faster pace of disinvestment and privatisation of public sector enterprises (PSEs). This is not entirely correct. It needs to be remembered that disinvestment proceeds are capital receiots, and represent a claim on private savings, not a net increase in the savings of the economy.

[51] Sustainability of the current account deficit takes into account the view that foreign investment is no less a liability of the country than external debt, and that the return to such investment flows would be at least the average return on capital in the economy. At present, however, the CAD for India is less than 1% of GDP, and therefore no apparent danger is perceived, but any acceleration in growth will reverse this prognosis.

[52] External assistance in the form of grants addresses both these dimensions in that it reduces the government's revenue deficit (expenditures remaining constant), as well as allows a relaxation of the CAD limits.

increasingly clear that investment demand in India may not be sufficient to absorb even the investible resources that are in sight. The reasons for this vary from sector to sector. As far as the government itself is concerned, the Centre is increasingly finding an institutional constraint in undertaking public investment. Earlier, the principal vehicles for central government investment were the public sector undertakings (PSUs). With the advent of the disinvestment/privatisation process, most of the PSUs have virtually suspended all investment activity. This applies not only to the government resources, but also to the internal resources generated by these units. Although some PSUs in the infrastructure sectors are continuing their investment programmes, most of them have physical and organisational limitations in expanding their investment activity any further. The state governments, on the other hand, have somewhat better institutional capability to invest, but practically all of them face serious financial problems, which restricts their investment capacity.

To make matters worse, the Indian corporate sector simply does not appear to display the kind of entrepreneurial dynamism that is necessary for it to occupy the activities that are being vacated by the public sector. There may be many reasons for this, but it appears that an unwillingness to dilute the promoters' stake for fear of take-overs may be an important contributory factor. The private non-corporate sector, on the other hand, has sufficient entrepreneurial dynamism, but face serious constraints in access to investible funds. The Indian financial sector, due mainly to policy and legal rigidities, have high levels of non-performing assets (NPAs), and are therefore becoming increasingly sensitive to their risk exposure. The brunt of this over-sensitivity is borne by the small and medium enterprises (SMEs). The one positive development in recent years has been the success of the micro-credit schemes of organised financial sector companies which target self-help groups (SHGs). But this has a long way to go before it can emerge as a major absorber of investible resources[53].

Thus, as can be seen, the future course of development in India vividly illustrates the proposition that is implicit in much of our earlier review of the Zedillo Panel recommendations – namely, international development finance strategy should not only be about the supply of resources, but must explicitly take into account the nature of investment demand as well. Flow of resources without the institutional capacity to absorb them effectively does not solve the development problem. A natural corollary to this proposition is that the ***nature*** of external flows matters. In the Indian case, for instance, FDI is more valuable than FPI not for the foreign currency that is brought in, but for the embodied entrepreneurship. Similarly, aid flows to sub-national governments are likely to be more productive than those to the central government. Such considerations need to inform every aspect of the discussion on development assistance.

[53] Regional imbalances are perceptible even in the disbursement of micro-credit, and therefore it does not appear to solve the sub-national distributive issues.

The Monterrey Consensus: Does it Meet the Bill ?

The previous sections reviewed the Report of the Zedillo Panel in light of the experiences gained from the Indian development process and the development strategy that is being pursued by India for accelerating its growth and development. On the whole, despite the various weaknesses in the Zedillo Panel Report noted above, it is an important step forward in the discussions on development financing. Its most important contribution lies in the fact that it explicitly acknowledges the political nature of this activity, and that solutions to the most pressing problems will have to be found in the political domain.

Seen in this light, the draft Monterrey Consensus document comes as a grave disappointment. It no doubt covers every major issue, and indeed is more comprehensive in this respect than the Zedillo Panel Report, but it shies away from any radical solution. Reading this document leaves one with a lingering sense of *deja vu* – been there, done that; now let us collectively just do it better. It is a document by international bureaucrats for national bureaucrats; shorn off all the political insights and initiatives of the Zedillo Panel. In the final analysis, the Monterrey process is probably far more valuable than its likely outcome.