Rakesh Mohan: Human development and state finances

Speech by Mr Rakesh Mohan, Deputy Governor of the Reserve Bank of India, at the inaugural session of the 3rd Programme on "Human Development and State Finances", Mumbai, 7 November 2005.

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Introduction

It is a pleasure to be amidst officials of the State Governments who are instrumental in implementing government policies that aim to improve economic and social welfare. In India, bulk of the responsibilities pertaining to expenditure in social services including education and health are placed in the domain of the State Governments. Thus, the nature of state finances has important implications for improving human development in India. In this context, the theme of today's discussion 'Human Development and State Finances' is very topical as well as relevant.

The Reserve Bank of India (RBI) bears a special relationship with the State Governments in its multiple role as the banker, debt manager and fiscal adviser. The interactions between the RBI and the State Governments have been stronger through the interface provided by the bi-annual Finance Secretaries' Conference organised by the Reserve Bank since 1997. This Conference has provided a common platform to discuss all aspects concerned with the fiscal affairs of the States and facilitated the evolution of a consensual approach on various key issues through active participation of State Government officials. Some of the outcomes include setting up of Consolidated Sinking Funds (CSF) for debt servicing, constitution of Guarantee Redemption Funds (GRF) to meet guarantee obligations, setting of Ways & Means Advance (WMA) limits for States, fixing limits for guarantees, and most recently, enactment of the Fiscal Responsibility Legislation (FRL).

In this forum, in two earlier occasions, my colleague Deputy Governor Shyamala Gopinath had focused on the broad contours of human development and state finances while Deputy Governor Shri V. Leeladhar had dwelt on certain critical aspects of human development in the Indian context. Today I will first discuss the importance of economic growth for human development, poverty eradication and overall social welfare; second, I will briefly give an overview of the performance on the human development at both the national level and across the states; third, I will review the stylized facts relating to finances of the State Governments as they relate to their impact on expenditure in the social sector; fourth, I will mention some of the new initiatives taken by the Government both at the Centre and States' level for accelerating human development in India; and finally, I will touch upon some further policy options.

Economic growth and human development

The concept of human development signifies improvement in the quality of life of the people in terms of various health and educational indicators. Through betterment of health, education and skills, human development creates human capabilities that can then lead to productivity enhancement and acceleration in economic growth. In a broader sense, human development also implies improvements in terms of human rights and participation and freedom of choice. The credit for bringing special focus to human development can mainly be attributed to the noted economist Mahbub Ul Haq. He was instrumental in the evolution of the Human Development Index (HDI), which has emerged as a composite measure of development across the countries. The HDI is an index measuring the basic dimensions of human development, namely, long and healthy life, education and decent standard of living. Indian economist and Nobel laureate Amartya Sen has also made valuable contributions towards the formulation of HDI. According to the Human Development Report, 2005, published by the United Nations Development Programme (UNDP), all the countries (177 in total) are categorized into three broad groups, such as, (i) High Human Development, (ii) Medium Human Development, and (iii) Low Human Development. India is placed in the group of Medium Human Development countries and ranks at 127 amongst total of 177 countries in 2005.

High economic growth facilitates reduction of poverty. Growth in production of goods and services leads to growth in incomes and, hence, to poverty eradication. As might therefore be expected, acceleration of economic growth in India has led to a marked reduction in poverty in recent decades. Compared to average economic growth rate of close to 3.5 per cent in the first three decades since

Independence, the Indian economy moved to a higher growth trajectory experiencing an average growth rate of around 6 per cent during 1980s and 1990s, and in the most recent period, the growth rate has been hovering around 7 per cent. More importantly, per capita income growth has witnessed a spectacular rise to about 5.5 per cent in the recent years as against a rise of around 1 – 1.3 per cent in the three decades after Independence. Reflecting this there has been significant decline in poverty in India. Between 1977-78 and 1999-2000, the proportion of people living below the poverty line (BPL) came down from 51.3 per cent to 26.1 per cent. In absolute numbers, the reduction has been from about 330 million to 260 million during the comparable period.

It is important to note that with lower economic growth of the first three decades it was not possible to reduce the high levels of poverty that had existed in India for generations. However, the foundations of modern economic growth were laid in that period and we have observed significant growth acceleration since the 1980s. It is being increasingly recognized that eradication of poverty requires achievement of higher growth as it is only higher economic growth that can reduce poverty and provide sustainable economic security. No distribution can take place when there is nothing to distribute.

Human capital enhancement is essential to productivity growth. As higher physical capital investment takes place labour productivity is also enabled to grow. But such productivity can grow even faster with corresponding or even faster growth in human capital investment. Thus, per capita income growth is accelerated significantly by improvement in human development all round. Hence, we have a positive sum game: economic growth enables human development, and human development itself contributes to the acceleration of economic growth. Furthermore, for its own sake, in terms of augmenting people's own potential, human development is important.

Performance in human development: an overview

Key indices of human development relate to measures of health and education. Life expectancy at birth in India has grown from about 32 years in 1951 to 62 years in 1996. In 2003, it was 63 years. The literacy rate in India also witnessed significant improvement since independence from 18 per cent in 1951 to 52 per cent in 1991, and further to 65 per cent in 2001. In 2003, life expectancy index for India at 0.64 was close to the world average of 0.70. The education index at 0.61 and GDP index at 0.56 were however farther away from the world averages of 0.77 and 0.75, respectively.

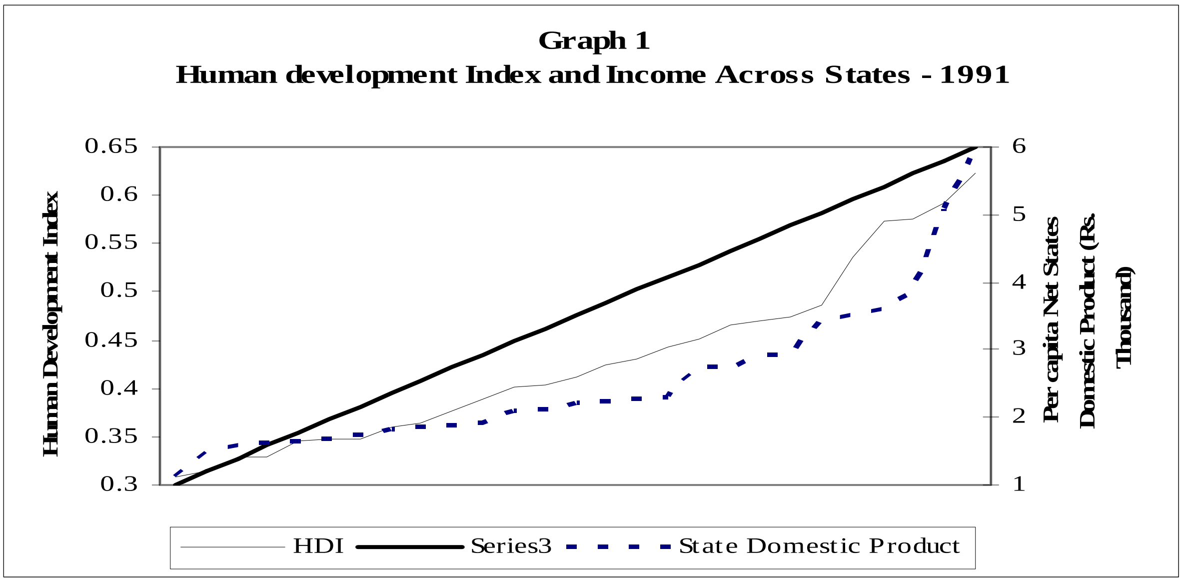
A perusal of the human development indicators across the States in India reveals that life expectancy does not exhibit significant variation across the States. In 2001-06, life expectancy at birth for males (all India average of around 64 years) varied from 59 years in Assam and Madhya Pradesh to around 70 years in Kerala and Punjab. For most of the States, the life expectancy at birth for males was in the range of 62 to 67 years. For the same period, life expectancy at birth for females (all India average of around 67 years) varied from 58 years in Madhya Pradesh, 60 years in Orissa to 72 years in Punjab and 75 years in Kerala. For most of the States the life expectancy at birth for females was in the range of 64 to 70 years. However, the National Human Development Report (NHDR) has revealed wide disparities in the level of human development across the States. States like Bihar, Uttar Pradesh, Madhya Pradesh, Rajasthan and Orissa had HDI close to just half of that of Kerala in 1981 (Table 1). The situation has improved since then. Besides Kerala, among the major States, Punjab, Tamil Nadu, Maharashtra, and Haryana have done well on HDI. In general, HDI is better in smaller States and Union Territories. In terms of the pace of development, Tamil Nadu, Rajasthan, Madhya Pradesh, West Bengal and Bihar improved their HDI significantly in the 1980s. In the 1990s this momentum was maintained in Rajasthan, Madhya Pradesh and Uttar Pradesh while it appeared to slow down in other less developed States. Nevertheless, state-wise analysis in the NHDR indicated a decline in such regional disparity during the last two decades. Further convergence can take place alongwith substantial improvement in the national human development index if efforts are focused on those states that have low levels of measured HDI. Strengthened policy measures and improvement in health, education and other aspects of rural development in these states will contribute greatly to the overall improvement in human development in the country.

It must be noted that inequalities across the States on HDI are less than the income inequalities in terms of per capita SDP (Graph 1). At a fundamental level, there is no conflict between economic growth and human development. Economic growth implies an improvement in the material well being of the people including better health, education and sanitation. However, the effect of economic growth on human development may be muted if the growth is not well distributed across all sectors and geographical areas. Even in a particular sector, the distribution of benefits of growth amongst all stakeholders in a just way is also important.

Table 1: Human Development Index for India – Combined

States	1981-Value	1981-Rank	1991-Value	1991-Rank	2001-Value	2001-Rank
Andhra Pradesh	0.298	9	0.377	9	0.416	10
Assam	0.272	10	0.348	10	0.386	14
Bihar	0.237	15	0.308	15	0.367	15
Gujarat	0.360	4	0.431	6	0.479	6
Haryana	0.360	5	0.443	5	0.509	5
Karnataka	0.346	6	0.412	7	0.478	7
Kerala	0.500	1	0.591	1	0.638	1
Madhya Pradesh	0.245	14	0.328	13	0.394	12
Maharastra	0.363	3	0.452	4	0.523	4
Orissa	0.267	11	0.345	12	0.404	11
Punjab	0.411	2	0.475	2	0.537	2
Rajasthan	0.256	12	0.347	11	0.424	9
Tamil Nadu	0.343	7	0.466	3	0.531	3
Uttar Pradesh	0.255	13	0.314	14	0.388	13
West Bengal	0.305	8	0.404	8	0.472	8
All India	**0.302**		**0.381**		**0.472**	

Source: National Human Development Report, 2001, Planning Commission, New Delhi



Source: National Human Development Report 2001, Planning Commission, New Delhi

It turns out that the economically less developed States are also the ones with low HDI and economically better off States are the ones with relatively better performance on HDI. However, the relation between the HDI and the level of development does not show any correspondence among the middle-income States in the country. In this category of States, some States like Kerala, have high attainments of HDI, at the same time, there are States like Andhra Pradesh, or even West Bengal, where HDI values are not as high.

Finances of state governments and social sector expenditure

Progress on human development requires adequate provision of funds. State Governments are responsible for most public expenditures for the provision of social services including health and education. Furthermore, the States are responsible for most infrastructure services except for telecommunications, civil aviation, railways and major ports. They are also responsible for law and order. Thus, the ability of the States to spend on social services has important implications for human development.

As widely documented, States have experienced significant fiscal stress since 1998-99 due to a variety of factors. While factors like 5th Pay Commission recommendations, decline in Central transfers, increase in committed expenditure, such as, interest payments and pensions, and low economic growth rate account for the acuteness of the ailment, there are also underlying structural reasons for the persistence of fiscal deterioration. As evident from Table 2, average revenue deficit of all States combined as a percentage of GDP more than doubled from 0.71 during 1990-95 to 1.65 during 1995-2000. It increased further to 2.41 per cent during 2000-04. Similar movement was exhibited by the gross fiscal deficit (GFD) as well. This has had a significant deleterious impact on the States' social expenditures including on education and health. Developmental expenditure as a percentage of GDP had declined from 9.92 per cent during 1990-95 to 8.97 per cent during 1995-2000. Expenditure on social services in general and education and health in particular witnessed a fall as a percentage of GDP during the second half on the 1990s as compared to the first half. The fall in States' expenditure on education and health due to fiscal deterioration impeded their role in promoting human development.

Table 2: Deficit Indicators and Social Expenditure of States

(As Percentage of GDP)

Period	RD	GFD	Developmental Expenditure	Social Services Expenditure	Education Expenditure	Health Expenditure
1990-95	0.71	2.82	9.92	4.88	2.62	0.81
1995-2000	1.65	3.45	8.97	4.84	2.59	0.75
2000-04	2.41	4.28	9.35	4.98	2.67	0.71
2004-05 RE	1.44	4.00	10.18	5.08	2.47	0.69
2005-06 BE	0.75	3.21	9.35	4.94	2.39	0.70

RE: Revised Estimates, BE: Budget Estimates

Notes: RD: Revenue Deficit, GFD: Gross Fiscal Deficit

Education includes Sports, Art and Culture Health includes Family Welfare

With active initiatives of the States towards fiscal correction and consolidation, some signs of improvements have been visible in state finances in the recent period. The revenue deficit as a percentage of GDP came down to 1.44 in 2004-05 (RE) which is budgeted to further decline to 0.75 per cent in 2005-06. Similarly, GFD as a percentage of GDP was reduced to 4.00 per cent in 2004-05 from the average of 4.28 per cent in 2000-2004 and is budgeted to decline further to 3.21 per cent in 2005-06. With improvement in state finances, there is a reversal of the trend of developmental expenditure also. The ratio of developmental expenditure to GDP increased to 10.18 per cent in 2004-05 compared to an average of 9.35 per cent during 2000-04. States' expenditure on social services witnessed similar movement during the comparable period. However, expenditures on health and education as a percentage of GDP, during 2004-05, still remain below the level of the 1990s and early 2000s. In 2005-06, development expenditure and social expenditure of the States as percentage of GDP are budgeted to be lower than the previous year.

New initiatives

The Union Budget 2005-06 has provided a special focus on enhancing human capital investment in the country in an accelerated manner. Particular emphasis has been given to significant increases in allocations to the flagship schemes of Sarva Shiksha Abhiyan (SSA), National Rural Health Mission (NRHM), Employment Guarantee Scheme (EGS), Rural Electrification, and the like. Sarva Shiksha Abhiyan is the cornerstone of the Government's support in basic education for all children. The allocation for this programme has been enhanced to Rs. 7,156 crore in 2005-06 as against Rs. 3,057 crore in the previous year's budget. A non-lapsable fund called 'Prarambhik Shiksha Kosh' has been created for funding this programme. NRHM envisages strengthening primary health care through grass root level public health interventions based on community ownership. Total allocations for the Department of Health and the Department of Family Welfare will be enhanced from Rs. 8,420 crore in the current year to Rs. 10,280 crore in the next year when NRHM will be launched. Increase in the funding is envisaged to finance NRHM and its components like training of health volunteers, providing more medicines and strengthening the primary and community health centre system. The allocation for the Integrated Child Development Scheme (ICDS) has also been enhanced significantly.

The Union Budget 2005-06 also proposed launching of a massive rural electrification programme beginning in 2005-06 with the objective of covering 1,25,000 villages in five years with high emphasis on the deficient States. Similarly, higher allocations have been made for provision of drinking water and sanitation facilities in rural habitations. Furthermore, a corpus of Rs 8,000 crore was provided in the current year for the Rural Infrastructure Development Fund for improving the basic infrastructure in the rural India. The Pradhan Mantri Gram Sadak Yojana (PMGSY) was launched in December 2000 as a 100 per cent centrally sponsored scheme to provide rural connectivity. It is funded by the diesel cess in the central road fund and through borrowings from domestic financial institution and multilateral funding agencies. Without appropriate connectivity, it is difficult to bring about the kind of improvements envisaged for human development.

It is also important to note that following the recommendations of the Twelfth Finance Commission (TFC), it has been decided by the Government of India to provide specific grants for education and health to those States which are unable to spend adequately in these sectors because of deficiencies in fiscal capacity. TFC has recommended specific grants amounting to Rs 10,171 crore to eight States[1] for education and Rs 5,887 crore to seven States[2] for health over its award period of 2005-10. The grants for both the sectors are an additionality over and above the normal expenditure to be incurred by the States in these sectors. Furthermore, it recommended specific grants to local bodies amounting Rs. 25,000 crore meant to improve basic amenities, viz., water supply, sanitation, solid waste management, etc. which are expected to improve the quality of life both in rural and urban areas.

As regards States' initiatives, many States have embarked upon the path of fiscal correction and consolidation in the recent period. Increase in the Central transfers in the light of TFC recommendation has a comforting impact on State finances. With the debt relief benefits linked to enactment of the Fiscal Responsibility Legislation (FRL) by the TFC, there has been increasing incentive to observe fiscal discipline. As of now, while 15 States have already enacted FRL, 2 States have introduced the Bill and 2 more States have proposed to introduce FRL Bill in their respective Budget for 2005-06. As all the states put into effect fiscal improvement measures, their ability to make focused expenditures on health, education, nutrition and rural infrastructure will increase substantially.

Policy options

For sustained social sector development, it is important that the high growth rate of the economy is maintained over a sustained period. Similarly, macroeconomic stability in terms of lower inflation is also critically important to protect the poor and vulnerable segment of the population. It is here that the role of the Reserve Bank and Monetary Policy becomes important. In addition, prudent fiscal management through expenditure prioritization and revenue augmentation is also essential. Thus, the recent initiatives by the State Governments to enact FRL is a welcome move.

As I have been emphasizing in many of my writings and speeches, widespread and bold imposition of user charges on all non-merit goods is very important for revenue augmentation of the States. The

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1 Assam, Bihar, Jharkland, Madhya Pradesh, Orissa, Rajasthan, Uttar Pradesh and West Bengal.

2 Assam, Bihar, Jharkland, Madhya Pradesh, Orissa, Rajasthan, Uttar Pradesh and Uttaranchal.

pattern and organization of provision of public services in India has been done in such a way that the public has got used to not paying economic charges for these services. This includes key services, inter alia, power, water supply, irrigation and transport. The larger consumers of these services are typically the better off. Thus, appropriate levy of user charges also promotes better income distribution. Moreover, by strengthening the finances of the agencies that supply these services, it also enhances their capacity to improve and expand services and to serve the less well off. According to one estimate, the hidden subsidies on these non-merit goods amount to as much as 10.7 per cent of GDP on an annual basis. The combined fiscal deficit of the Centre and States in recent period is around 2 to 3 percentage points lower than this as a percentage of GDP. This highlights the need for augmenting revenue from user charges. However, it can be noted that with the poor quality of public services provided in India, the public is loath to pay higher charges. Hence, imposition of higher user charges has to be accompanied by perceptible improvements in the quality of services.

Apart from the above, rural connectivity plays a critical role for higher human development index. Evidence suggests that the states like Kerala, Tamil Nadu, Goa, Punjab and Himachal Pradesh that have invested heavily in the provision of better rural connectivity are also better placed in terms of human development. Thus, better rural infrastructure and connectivity is necessary to accomplish developmental programmes related to human development. The direct benefits of rural development and connectivity in terms of better roads, electrification and communication also enable the doctors, health workers, and teachers to stay in the villages. Such personnel, who have with great effort and difficulty, educated themselves can scarcely be expected to stay in habitations that lack basic infrastructure and connectivity. They obviously have aspirations for their own children and families. Investment in social sectors like health and education is unlikely to be successful unless accompanied by complementary investment in rural infrastructure. The indirect benefits of better communication would be in terms of better dissemination of information on all aspects of agricultural products, particularly that on agricultural prices. Farmers suffer greatly from the large difference between market prices of agricultural products and farm level prices due to large transportation costs and lack of information. Thus, better rural connectivity in terms of both transportation and communication, will promote better price discovery and help in improving farmers' income and, hence, their human development. The extension of institutional credit, be it through banking institutions or microfinance institutions, will also be enabled by better rural connectivity. The improvement in farmers' income from better rural connectivity will itself improve their credit worthiness leading to lower applicable interest rate and further improvements in incomes and human development.

Besides, physical connectivity, economic empowerment of the vast segment of our population who have hitherto remained financially excluded is an important issue for human development. The programme of linking Self Help Groups (SHGs) with the banking system has emerged as the major micro-finance programme in the country. At present, micro-finance institutions (MFIs) depend on the banks including commercial banks, Regional Rural Banks (RRBs) and cooperative banks to obtain finance according to the guidelines issued by the RBI. There is an increasing emphasis to promote MFIs which provide small-scale credit and other financial services to low income households and small informal businesses. Empowering MFIs will facilitate their role as intermediary between the lending banks and the beneficiaries. The Union Finance Minister, in his Budget Speech 2005-06, has prescribed that the commercial banks should appoint MFIs as the 'banking correspondents' to provide transaction services on their behalf.

In response, RBI appointed an Internal Group on Rural Credit and Micro-finance to look at the broad aspects of increasing "financial inclusion" and promoting MFIs. I am glad, indeed, that the Principal and the faculty of this College, have been associated with the preparation of the report which is now being closely examined for implementation.

The report has recognised both the supply and demand side constraints and circumstances that has made mass scale financial inclusion elusive. Pragmatically appreciating that the large-scale expansion of physical infrastructure supported by multifarious policy initiatives could not accelerate the inclusion of a vast majority of rural population into the ambit of formal financial institutions, the report suggested that if "financial inclusion" is to be made a reality, we need to leverage socially active organizations and persons to work with people, particularly those with small means, empower them and bring them closer to financial services provided by the formal financial institutions on the one hand. On the other, these agencies and persons can be harnessed to bring aggregation of quantities so that the constraints of reaching large numbers of dispersed, far-flung and socio-economically disadvantaged clientele is minimized. To translate this into action, the report has suggested that banks may use the services of the "Business Facilitators" to bring people and the banks together without having to handle cash and the “Business Correspondents” who will bring them together and will also handle cash for providing doorstep services. NBFCs, NGO-MFIs, Section 25 Companies, Cooperative societies, corporate entities, post-offices, etc. can be identified as possible correspondents while even informal entities like farmers’ clubs, NGOs, cooperatives, Rural Kiosks, socially conscious individuals, etc. can work as the facilitators.

All of us at RBI and our Governor, in particular, have appreciated the suggestions and we hope that the banks will use these avenues to accelerate the process of financial inclusion.

Before I conclude let me compliment CAB, UNDP and the Planning Commission for very thoughtfully designing the programmes mainly for the State Government officials who are at the cutting edge of human development initiatives.

The programme on “Human Development and State Finances” covers substantially the whole gamut of human development and financing issues. All of you will have the opportunity to hear and interact with well-known academicians and practitioners like Shri Sridharan, Dr. Seeta Prabhu, Prof. J B G Tilak, Prof. D K Srivastava, Dr. Amarjeet Sinha besides UNDP Administrator, Dr. Kemal Dervis, Shri Jayant Patil, Finance Minister, Government of Maharashtra and other experts in the high power panel discussion scheduled in Mumbai. I will also urge you to use this programme as a platform to interact among yourselves and share experiences as seldom you have an occasion when so many development practitioners come together at one place and get also to hear from so many renowned people. I am sure this programme will help you realize the importance of your role in the process of the country’s development and reinvigorate you intellectually and emotionally to seize the opportunity to realize the Millennium Development Goals of the UN and human development goals of the Tenth Five Year Plan.

I wish your deliberations in the programme a grand success.