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Article — Published Version

India: Developmental challenges faced by a dual economy

Global Policy

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Suggested Citation: Yang, Yuqing (2023) : India: Developmental challenges faced by a dual economy, Global Policy, ISSN 1758-5899, Wiley, Hoboken, NJ, Vol. 14, pp. 104-112, <https://doi.org/10.1111/1758-5899.13272>

This Version is available at:

<https://hdl.handle.net/10419/288176>

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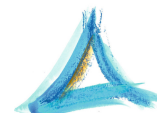
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India: Developmental challenges faced by a dual economy

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Funding information

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Abstract

With a population of over 1.4 billion surpassing China's in 2023, India has now become the world's most populous country. Despite its robust IT and service sectors propelling it to become the fifth-largest economy, India still grapples with low GDP per capita and significant poverty. The paradoxical nature of India's development necessitates a closer examination of its governance. Over 90% of the Indian population works outside the purview of formal democratic institutions and capital-intensive economic sectors. Challenges arise from the need to sustain a large poor population with limited resources while catering to the formal sector that generates more than half of its GDP. India's governance exhibits a deep mismatch between its institutional design, politics and developmental needs. This article explores the duality of informal and formal sectors underlying challenges in Indian governance by way of the Berggruen Governance Index.

1 | INDIA'S POLITICAL ECONOMY CHARACTERISED BY DUALITIES

India stands out as a multinational federal democracy, with an economy characterised by a strong service industry and weak manufacturing output relative to G7 and other G20 countries and a populace exhibiting a high degree of social and ethnic heterogeneity (West & Lansang, 2023). Before attaining independence in 1947, India comprised more than 500 princely states, each varying significantly in socio-economic capacities. Enduring cleavages like caste and language have the potential to weaken India's social fabric, but religion remains a more significant threat and could be used to lead to a majority–minority contest (Vaishnav, 2019). For example, the rise of Hindu nationalism, particularly the ascent of the Bharatiya Janata Party (BJP), which openly advocates Hindutva, has played a central role in India's sharp decline in democratic accountability since 2014, as seen in Figure 1.

In 1991, India initiated an economic liberalisation process after three decades of socialism. These economic reforms were incremental, with successive governments implementing policies aimed at market liberalisation and expanding the role of private enterprises. By 2001, India's economy was experiencing a surge as it established itself as an outsourcing and IT hub. The dot-com bubble and the Y2K crisis further fuelled the demand for

IT and business services, as the lack of staff necessary to overcome the crises led American companies to outsource work to India for its cheap labour (Greene, 2006). Capitalising on gradual reforms and an unprecedented global liquidity boom, India's service sector-dominant economy achieved an average growth rate of 7.3% from 2007 to 2018 (Greater Pacific, 2019).

India's development trajectory, characterised by its heavy reliance on the service sector and enormous diversity of culture, language and ethnicity, has generated a duality within its political economy. On the one hand, India boasts formal and democratic institutions that cater to a minority of its population. On the other hand, India's poor reside beyond the reach of democratic institutions, and an estimated 90% of Indians work in the informal economy, with no written contract, health benefits or social security (Ramana Murthy, 2019). There is also a skewed distribution of employment as a result of caste, gender, location and education (Chakradhar & Bairwa, 2020). While India's service sector generates over 50% of its GDP and provides jobs to less than one-third of its population, agriculture employs half of India's population and contributes less than one-fifth of the country's GDP (PIB, 2018; Statista, 2023a; Statista, 2023b).¹

The existence of a large population living in poverty strains India's state capacity and its industrialisation

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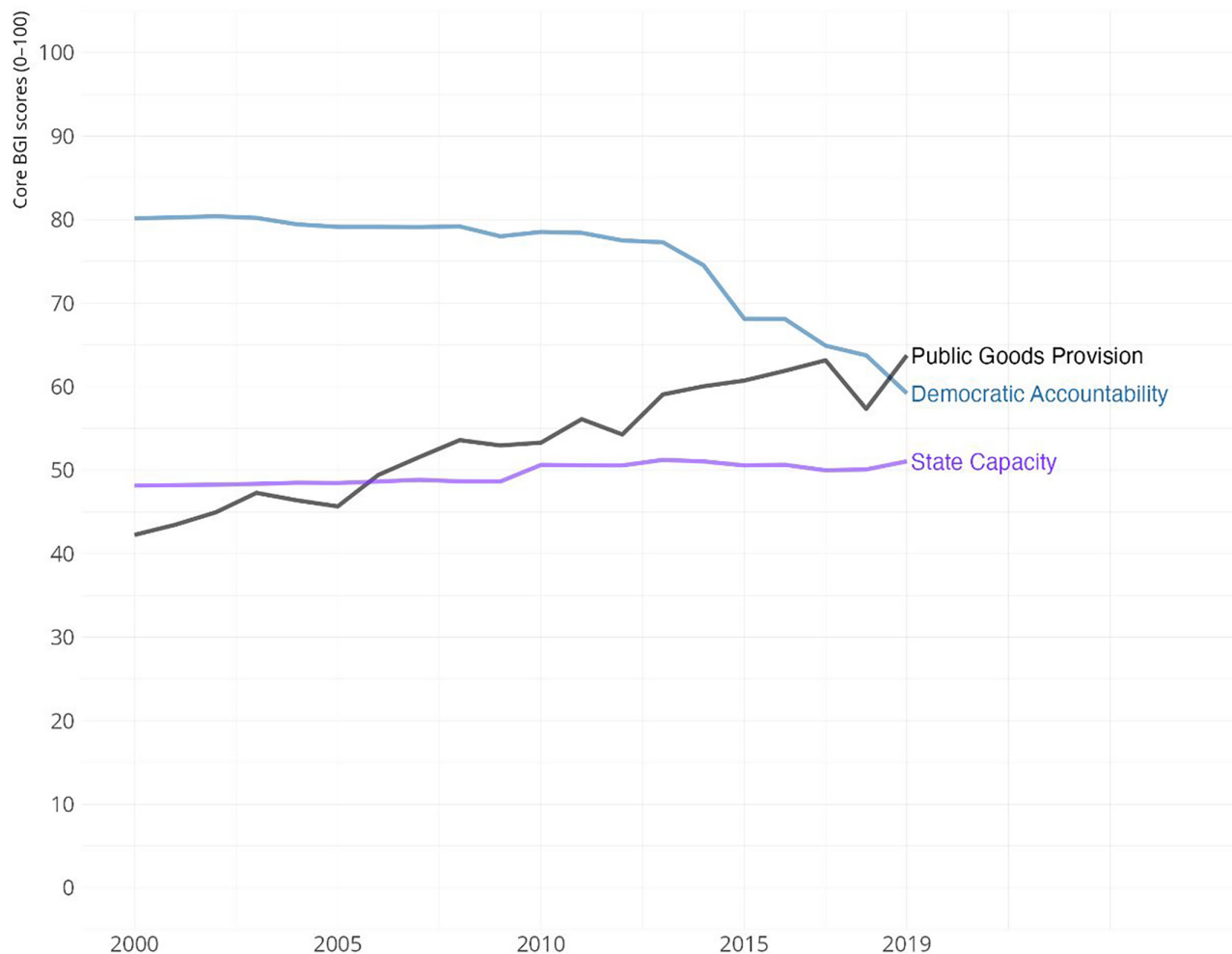


FIGURE 1 Overview of India's main indices. *Source:* Berggruen Governance Index 2022.

ambitions. In 2019, 595 million people in India, or some 40% of the country's population, were living on less than US\$3.65 a day, the poverty line for middle-income countries (World Bank, 2022, p. 42). Acute conflicts arise from increasing poor population and limited natural resources. Furthermore, India heavily relies on imported goods and resources, resulting in long-term trade deficits, fiscal deficits and external debt (Trading Economics, n.d.; IMF, n.d.; Knowledge at Wharton, 2019).

The institutional costs relating to labour laws, health care and social security of regulating and utilising this massive working age but unskilled population are seemingly insurmountable (Choudhury, 2022).² It is no surprise that most of India's poor work in informal sectors in a dispersed and unorganised manner (Crane, 2017). As a result, it is difficult to establish labour-intensive industries necessary for absorbing the large labour force and producing general and consumer goods and thereby boosting domestic consumption and attracting foreign investments. The problems arising from India's economic dualism are further complicated by difficulties relating

to land acquisition, another essential factor of production, due to landownership, caste hierarchy and patron–client relations in rural India (Bhattacharya et al., 2022).

In 2014, in an attempt to lead the country onto a path to become a labour-intensive manufacturing power like China, then newly elected Prime Minister Narendra Modi launched a Make in India initiative with the original goals of creating 100 million jobs and increasing the manufacturing share of GDP to 25% by 2022 (later postponed to 2025). Simultaneously, Modi's government implemented a large number of major public goods schemes to facilitate the process. However, the initiative was largely a failure because much of the foreign direct investment (FDI) attracted went into the service sector (Agarwal, 2022). In addition, rampant corruption, lack of jobs, massive unskilled labour³ and unequal distribution of key resources such as water continue to adversely affect India's governance (UNDP, 2020). This article takes a closer look at India's performance as measured by the Berggruen Governance Index (BGI)⁴ to shed light on the relationship between the formal–informal duality and India's developmental path by

looking at challenges manifested in public goods provision, state capacity and democratic accountability.

2 | PUBLIC GOODS PROVISION

As part of Modi's blueprint to steer the Indian economy to self-sufficiency, public goods provision is a crucial component in the government's efforts to achieve financial inclusion of India's masses primarily through the Direct Benefit Transfer (DBT) scheme. The scheme tries to involve Indians who are excluded from formal institutions in economic production, covering mostly people living below the poverty line under 312 different schemes from 53 ministries (Gupta, 2016). Overall, as shown in Figure 1, India has made substantial progress in providing public goods (increasing its BGI score from 42 in 2000 to 64 in 2019), particularly in the environmental sector (see Figure 2).

India has shown substantial improvement in two out of three indicators of environmental public goods: air quality and energy. One of the DBT schemes, the Pradhan Mantri Ujjwala Yojana (PMUY), has provided

free liquid petroleum gas connections to millions of households, reducing their reliance on traditional fuels like wood and coal (Ministry of Petroleum and Natural Gas, n.d.). This initiative has not only improved air quality but also decreased health risks associated with indoor air pollution. Furthermore, India has made noteworthy strides in improving access to electricity, achieving nearly 100% access by 2019 from 58.8% in 2000 (World Bank, n.d.-a).

In terms of economic public goods such as food security and employment, India has made moderate progress. India's Food Vulnerability Index (FVI) rank moved from 127 in 2000 up to 85 in 2013, but after a sharp drop to 143 in 2014, it rose back steadily to 116 in 2020, indicating a return towards improvement in food security (Notre Dame Global Adaptation Initiative, 2021). To protect these gains and provide assistance during the COVID-19 pandemic, the government launched programmes such as the National Food Security Act and the Pradhan Mantri Garib Kalyan Yojana (PMGKY). However, food insecurity remains a significant challenge, particularly in regions affected by droughts, floods and other natural disasters. The

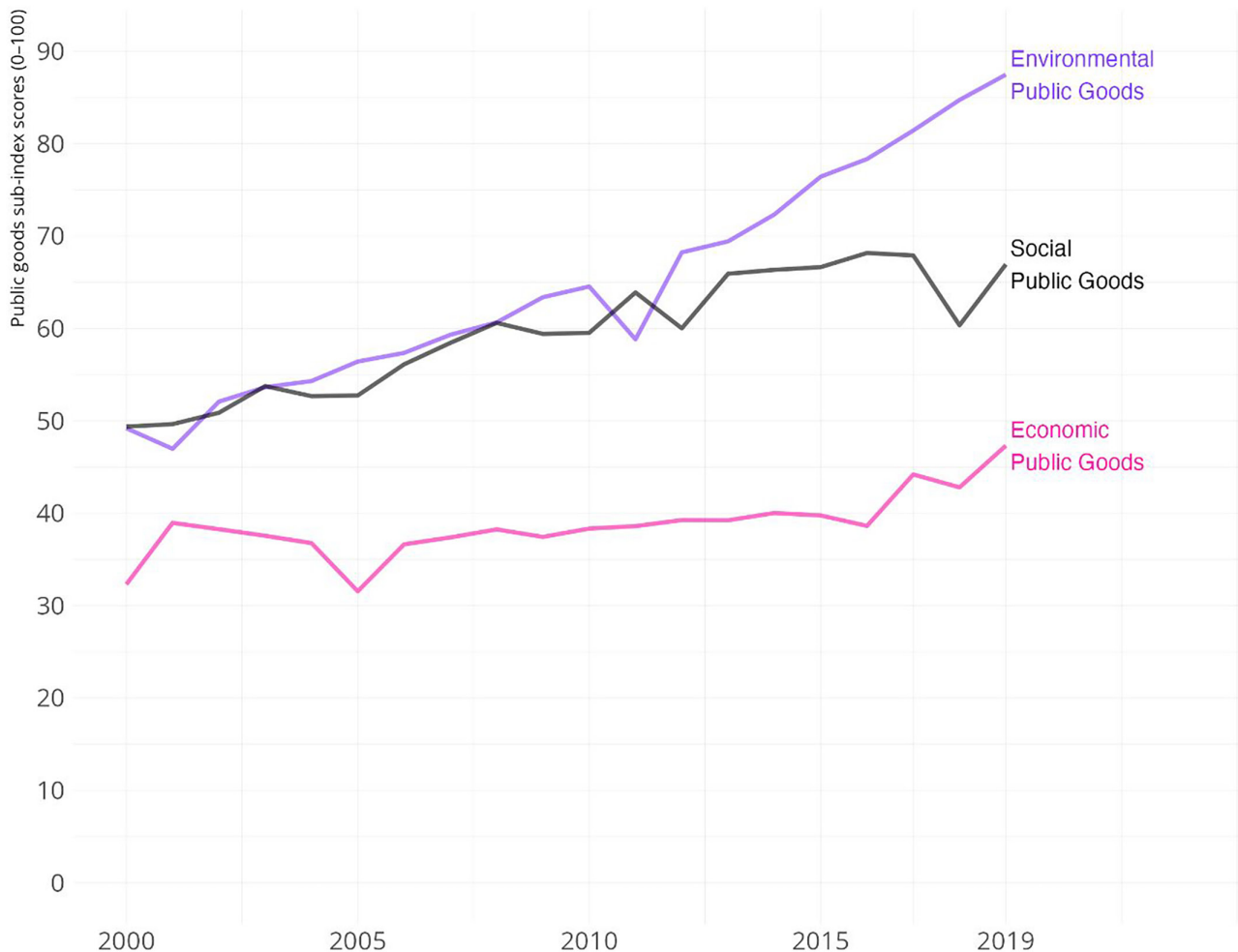


FIGURE 2 Public goods provision in India, by subindices, 2000–2019. *Source:* Berggruen Governance Index 2022.

country's Economic Complexity Index (ECI) has also improved, moving from a rank of 46th in 2000 to 41st in 2019, under initiatives like Startup India and Digital India introduced to promote innovation and entrepreneurship.

India's progress in social public goods has been increasing most slowly among the three BGI subindices, nevertheless rising from 49 in 2000 to 67 in 2019. Several important policies such as National Health Policy passed in 2002 and the Rights to Education Act (RTE) were initiated to improve access to health care and increase net primary school enrolment rates. Indeed, India's primary school enrolment rate has remained above 94% since 2000. Additionally, rural India remained a crucial focus for improving education and health care. Government initiatives like the National Rural Education Mission (NREM) and National Rural Health Mission (NRHM) of 2005 both aimed to enhance access to quality education and affordable health care in rural areas. Over the last two decades, gaps between rural and urban areas have narrowed, although huge disparities still exist (Mohan & Kumar, 2019).

Overall, while India made improvements in public goods provision, challenges persist. Inadequate physical infrastructure, a complex regulatory environment and a lack of skilled labour continue to hinder progress in various sectors. More importantly, the country's economic public goods provision is limited to the formal industry and service sectors, with those working in the informal sector still lacking job security and social benefits (Reserve Bank of India, 2015). Modi's scheme to improve public goods provision and thereby the ease of doing business has not benefited the Indian poor. India lost 24 million manufacturing jobs between 2017 and 2020, and more people are out of work now than in 2011 (Sahay, 2023). Although coverage of India's health care and education has increased, the quality is debatable, with wide geographic variations.

Challenges arise sometimes not only because of lack of infrastructure or human resources, oftentimes it is also due to social factors like caste and religion. A vast majority of Dalits, which are the lowest stratum of the castes and constitute 25% of India's total population, still depend on the goodwill of the upper caste community for access to water and other essential resources (Sur, 2020). Moreover, social norms continue to hinder progress in reducing gender-based violence, including domestic violence, sexual assault and harassment, which impact women's empowerment and participation in public life.

3 | STATE CAPACITY

India's performance in state capacity has remained steady, and the score stagnates at 50, as shown in Figure 1. India is in the process of moving from a low-capacity state characterised by non-transparency, high

centralisation and upward vertical accountability to a high-capacity state that is decentralised, information-based and responsible to citizens instead of superiors (Kapur et al., 2017).

As shown in Figure 3, India's coordination capacity has remained below or at 60 over the observation period. While India's population increased from 846 million to 1.2 billion between 1991 and 2011, total public sector employment actually decreased from 19.1 to 17.9 million. The acute talent crunch in terms of endemic vacancies and personnel shortages has become the most basic reality of India's public institutions (Ibid., p. 11). Understaffing, together with over-bureaucratisation, has contributed to the poor governmental infrastructure, reflected in aspects like continued difficulties of doing business in India (which, despite deliberate government efforts to improve, still ranks 63 in ease of doing business and 136 in starting a business) (World Bank, n.d.-b).

Although India improved its transparency and accountability mechanisms through initiatives like the Right to Information Act (RTI) of 2005 that empowered citizens to seek information from government bodies, there are some alarming trends. Ministerial decision-making is highly fragmented, and power within ministries is highly centralised. Fragmentation complicates both policy formulation and implementation, and the minister's excessive power and responsibility crowds out dissenting voices. This weak coordination mechanism is a hindrance as India moves to address challenges like climate change that require creativity and cooperation.

India's fiscal capacity improved from 22 in 2000 to 32 in 2019, although this is still a low absolute figure. A first peak was achieved in 2006 after India had implemented measures such as tariff reductions to promote international trade, which led to higher trade tax revenues, particularly customs and excise duties. India's total tax-to-GDP ratio also rose during the same period (PIB, 2022). In July 2017, after nearly two decades of planning and negotiation, the nationwide Goods and Services Tax (GST) replaced the patchwork of value-added, sales and excise taxes levied by 29 states and the federal government. Since then, a second upward trend is observed that is a result of increasing direct and indirect tax revenues. This is further fuelled by the BJP's initiative apparently intended to tackle widespread tax evasion. About 90% of all transactions in India take place in cash, and few people and businesses pay income tax. In 2016, the Modi government demonetised 86% of banknotes, making them worthless, with the originally stated goal of addressing tax avoidance and corruption by surfacing untaxed cash (Price, 2022).

India's delivery capacity has not changed in the last two decades. Corruption, a key component affecting delivery capacity, has remained a persistent challenge

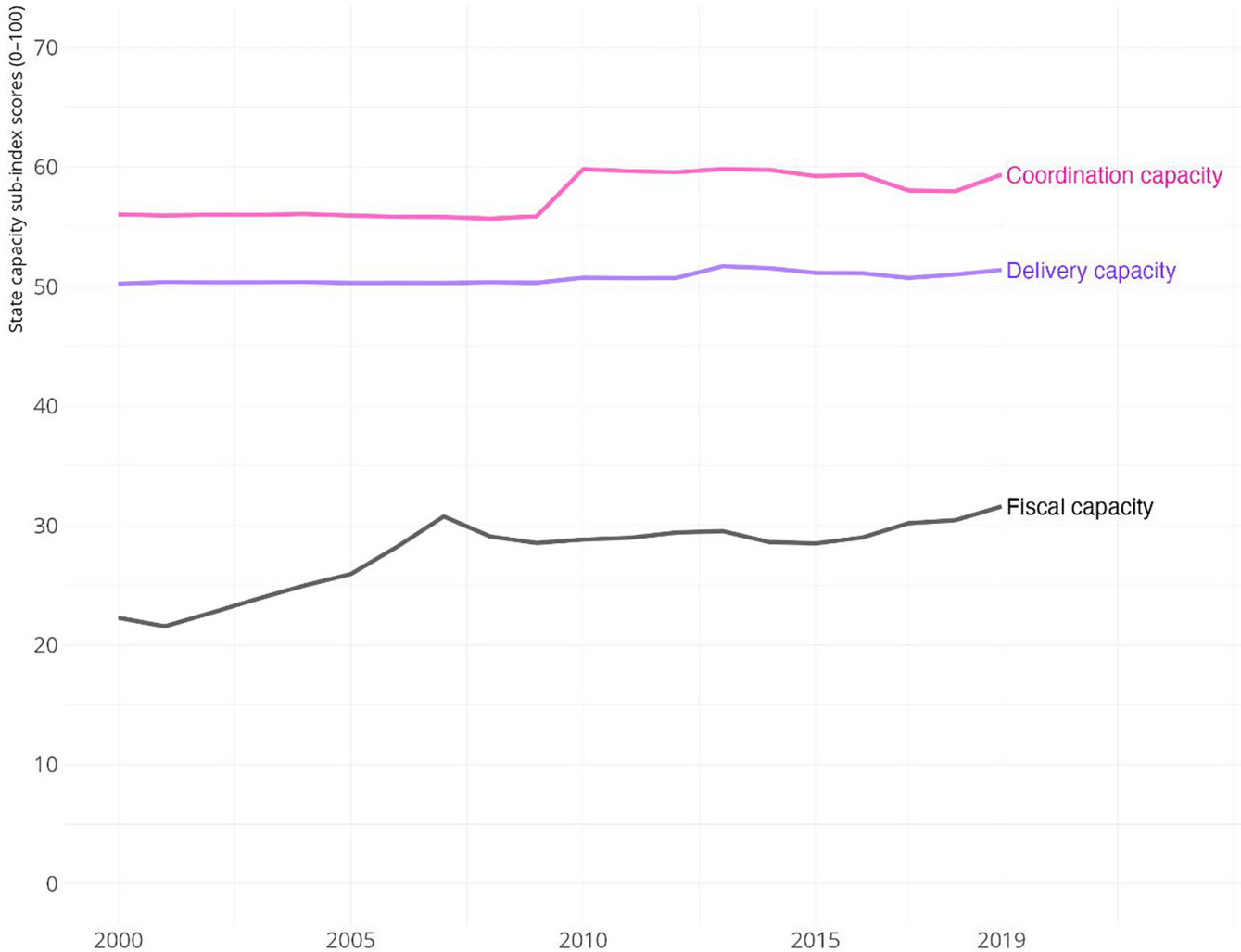


FIGURE 3 State capacity in India, by subindices, 2000–2019. *Source:* Berggruen Governance Index 2022.

in India, and efforts to combat it have faced hurdles such as delays in legal processes, bureaucratic red tape and limited resources for effective enforcement. Although India has long-established institutions like the Central Vigilance Commission (CVC) and the Central Bureau of Investigation (CBI) to investigate and prevent corruption, it remains an endemic problem and pervades all levels of governance (Rahman, 2022).

4 | DEMOCRATIC ACCOUNTABILITY

India's democratic government is modelled after the British Westminster system, with a president as head of state, a prime minister leading the executive, a two-chamber parliament consisting of the Rajya Sabha and Lok Sabha (the upper house and lower house of the Indian Parliament) and a supreme court overseeing the judiciary. The constitution guarantees rights such as equality before the law and freedoms of speech and assembly (Price, 2022). From 1989 to 2014, India

witnessed 25 years of coalition governments led by various parties, including the Indian National Congress. The 2009–2014 Congress-led coalition faced criticism for representing an elitist English-speaking class without a clear vision for India. In 2014, Narendra Modi, known for his efficient governance in the state of Gujarat and Hindu nationalist beliefs, became prime minister. His party, the BJP, secured a majority in the elections and expanded its support base primarily in the most populous and generally poorer Hindi-speaking states.

Often referred to as the world's largest democracy, India's performance in democratic accountability now stands in question. As shown in Figure 4, India's scores on all three BGI subindices have dropped substantially since 2014 under Modi's Hindu nationalist government, especially societal accountability. The 2014 general election represents a shift back towards principles of majoritarian nationalism where a majority enjoys more rights than the minorities (Jaffrelot, 2021). Despite the BJP's dominant electoral victory, 37 parties claim representation in the Lok Sabha, while the Rajya Sabha remains deeply divided. The fragmentation of

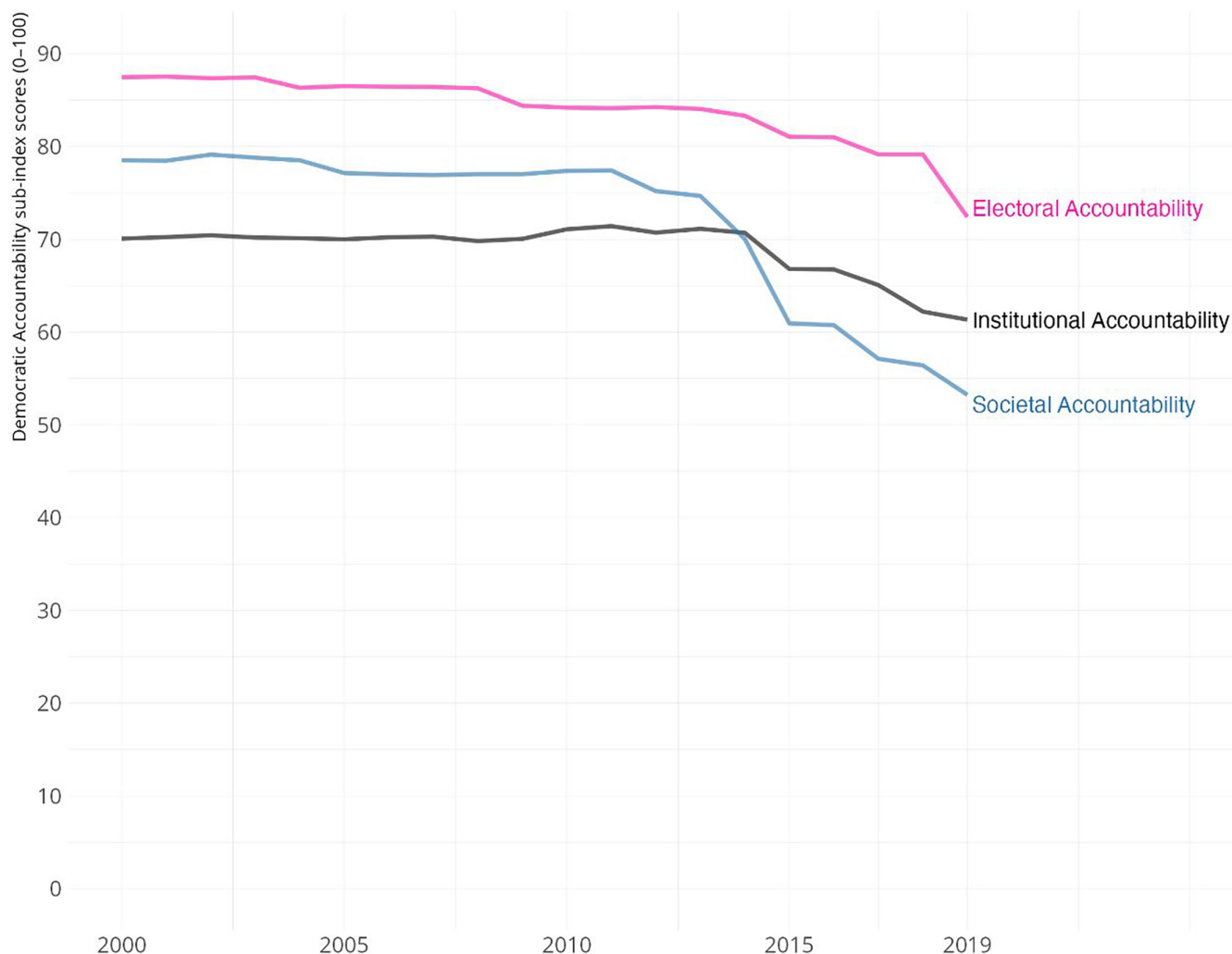


FIGURE 4 Democratic accountability in India, by subindices, 2000–2019. *Source:* Berggruen Governance Index 2022.

political power will continue to adversely affect the functioning of Parliament, resulting in a greater number of disruptions and fewer sittings, undermining the critical deliberative role of a parliament in any democracy (Madhavan, 2017). In 2020, India was declared an ‘electoral autocracy’ by the Varieties of Democracy Institute (V-Dem, 2020).

More importantly, due to the populist appeal of Modi's government, Indian society has come under the influence of a divisive ideology that separates ‘pure people (nationalist)’ and ‘corrupt citizens (anti-nationalist)’. The polarising effect of this ‘us versus them’ discourse has led to a significant decline in societal accountability. Independent institutions and media have been used and manipulated for political propaganda and unleashing campaigns to marginalise Muslims and other groups that contest the idea of a Hindu Nation (Rashtra). According to Reporters Without Borders (n.d.), India ranks 142nd out of 180 countries in terms of press freedom in 2020. Media self-censorship has become a norm due to the fear of harassment and violence against journalists. The Indian government has also made several

efforts to censor the media, especially during times of political unrest. For instance, in 2019, the government imposed restrictions on the media coverage of the Kashmir conflict.

India's institutional accountability has also been largely undermined. A decline of checks and balances resulting from a weakened parliament and judiciary is observed. For example, the judiciary has rescued unfairly treated Muslims in the past, but the Supreme Court has now stopped confronting the government, likely because of ideological affinities or the blackmailing of justices by the executive (Jaffrelot, 2021, p. 456). In addition, India's judicial system presently has a backlog of more than 31 million cases. Government estimates suggest that as many as 10% of all cases have been pending for a decade or more (Kapur et al., 2017). This backlog has clearly limited the effective exercise of judicial oversight.

Furthermore, electoral accountability has declined remarkably. The selection of bureaucrats in charge of key institutions of the state apparatus like the Election Commission of India (ECI), the Lokpal, the Central

Information Commission and the Central Bureau of Investigation tend to be biased towards those who do not take a stand against rulers (Jaffrelot, 2021, p. 457). In Modi's election campaigns in 2014 and 2019, a distorted political system was evident, where incumbents maximised their chance of winning through far stronger financial means. This distortion is made possible through electoral bonds,⁵ control over media outlets and weakening of the ECI.

5 | FUTURE CHALLENGES

Across the three main BGI indices, India faces many common underlying challenges, including political, religious and social polarisation, a large informal sector, poor infrastructure and corruption. However, one of India's most significant challenges is its inability to achieve sustained economic development to meet its developmental needs, particularly when compared to China. Modi's Make in India pro-business initiative may have improved the ease of doing business, but it falls short of being a comprehensive industrial policy. Major programmes like demonetisation and the Goods and Services Tax do not effectively contribute to building or enhancing India's manufacturing capacity. Consequently, India seems to be pursuing a path of further economic opening up rather than China's state-led development.

Nevertheless, challenges persist for further advancements in economic liberalisation. India has been a leading reformer in liberalising its FDI policy in many sectors over the past two decades, and caps on foreign participation have been raised since 2014. The opening was most ambitious in the air, real estate and retail distribution sectors. In 2017, the Foreign Investment Promotion Board was abolished, and the government approval system was simplified and decentralised. However, opening itself completely to the global financial markets carries inherent risks for India across all three indices. While liberalisation is said to bring benefits like increased capital flows, technology transfer and job creation, it can also exacerbate income inequalities and contribute to social polarisation (PwC, n.d.).⁶

In addition, India faces acute demographic problems that influence its economic development. Firstly, approximately 60% of India's population is of working age, and this proportion is projected to reach 65% by 2031 (Raghavan, 2023). However, if the Indian government fails to create jobs at a comparable rate, it will likely lead to significant social problems for a country that adds 10 million people of working age each year. Secondly, India's deeply segmented education system hampers the country from harnessing its demographic dividend. Despite having the largest pool of English-speaking graduates with a science, technology, engineering and

mathematics (STEM) background, India also has the world's largest illiterate population, with nearly half of its women being illiterate (EY India, n.d.). The caste system, gender discrimination and extreme poverty all hinder labour mobility.

Fundamentally, India's potential for development is hindered by the duality of informal and formal sectors. On the one hand, to create a pro-business environment and attract investments in manufacturing sectors, India needs to formalise its economic institutions. However, high institutional costs are likely to push India further into a low-growth trap. India currently lacks both the fiscal capacity and the ability to mobilise the masses like China did during Mao's era to make up for capital needed for building infrastructure, a necessary aspect of its economy. On the other hand, formalising India's informal economy would lead to increased labour and resource costs, making it difficult for the country to mitigate volatility in an era of financial globalisation. Even wider income gaps can also give rise to regional and religious conflicts.

India possesses immense potential for development, and its dualistic institutional structure should not be viewed solely as a hindrance to reform. It is crucial to acknowledge that while this structure presents challenges, it also serves as a vital social stabiliser as India seeks to go global. With an increasing population and limited resources, India can only make progress by minimising social costs and fostering the growth of labour-intensive industries on its own terms.

ACKNOWLEDGEMENTS

Thanks to Arjun Appadurai (Bard College) and JP Singh (George Mason University) for valuable feedback on an earlier version of this article. Open Access funding enabled and organized by Projekt DEAL.


CONFLICT OF INTEREST STATEMENT

There are no conflicts of interest.

DATA AVAILABILITY STATEMENT

The data that support the findings of this study are openly available at <https://governance.luskin.ucla.edu/datasets/>.

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ENDNOTES

¹ As of 2018, agriculture, industry and services each account for 17.1, 29.1 and 53.9% of India's GDP. While India's national income in service sectors as share of GDP has risen relatively quickly since 2000, the incomes of agriculture and industry as share of GDP have been slowly declining.

² These costs include cumbersome land-acquisition laws; complicated and highly restrictive labour laws across states; a logistics cost that is 14% of the GDP, as compared with less than 10% in developed nations.

- ³ According to the United Nations' Human Development Report 2020, which covered the 2015–19 period, only 21.2% of India's workforce had formal skills training. This put the country at 129th among 162 surveyed nations.
- ⁴ The Berggruen Governance Index is a collaborative project between the UCLA Luskin School of Public Affairs and the Berggruen Institute examining, as of 2022, the performance of 134 countries in key areas over a 20-year period to advance understanding of why some countries are governed more effectively and enjoy a higher quality of life than others. See 'Introducing the Berggruen Governance Index: I. Conceptual and Methodological Framework' and 'Introducing the Berggruen Governance Index, II. Initial Results 2000–2019', both by Anheier, Lang and Knudsen, in this special issue. The full dataset is available for download in various formats at <https://governance.luskin.ucla.edu/datasets/>. A data exploration tool offers readers a variety of ways to examine the data; available at <https://governance.luskin.ucla.edu/index/>.
- ⁵ Electoral bonds, introduced by the BJP-led NDA (National Democratic Alliance) government in 2018, were aimed at promoting transparency in political party funding. However, they have faced criticism from some who argue that their implementation primarily aims to limit funding for opposition parties, thus undermining their efficacy.
- ⁶ A more volatile exchange rate can significantly affect India's economy. In 2022, India experienced a 7.3% GDP growth based on PPP, while in nominal terms, the growth was 3.4%. This significant gap reflects the substantial proportion of unskilled labour in India's total workforce and a significant number of individuals with low incomes.

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How to cite this article: Yang, Y. (2023) India: Developmental challenges faced by a dual economy. *Global Policy*, 14(Suppl. 4), 104–112. Available from: <https://doi.org/10.1111/1758-5899.13272>