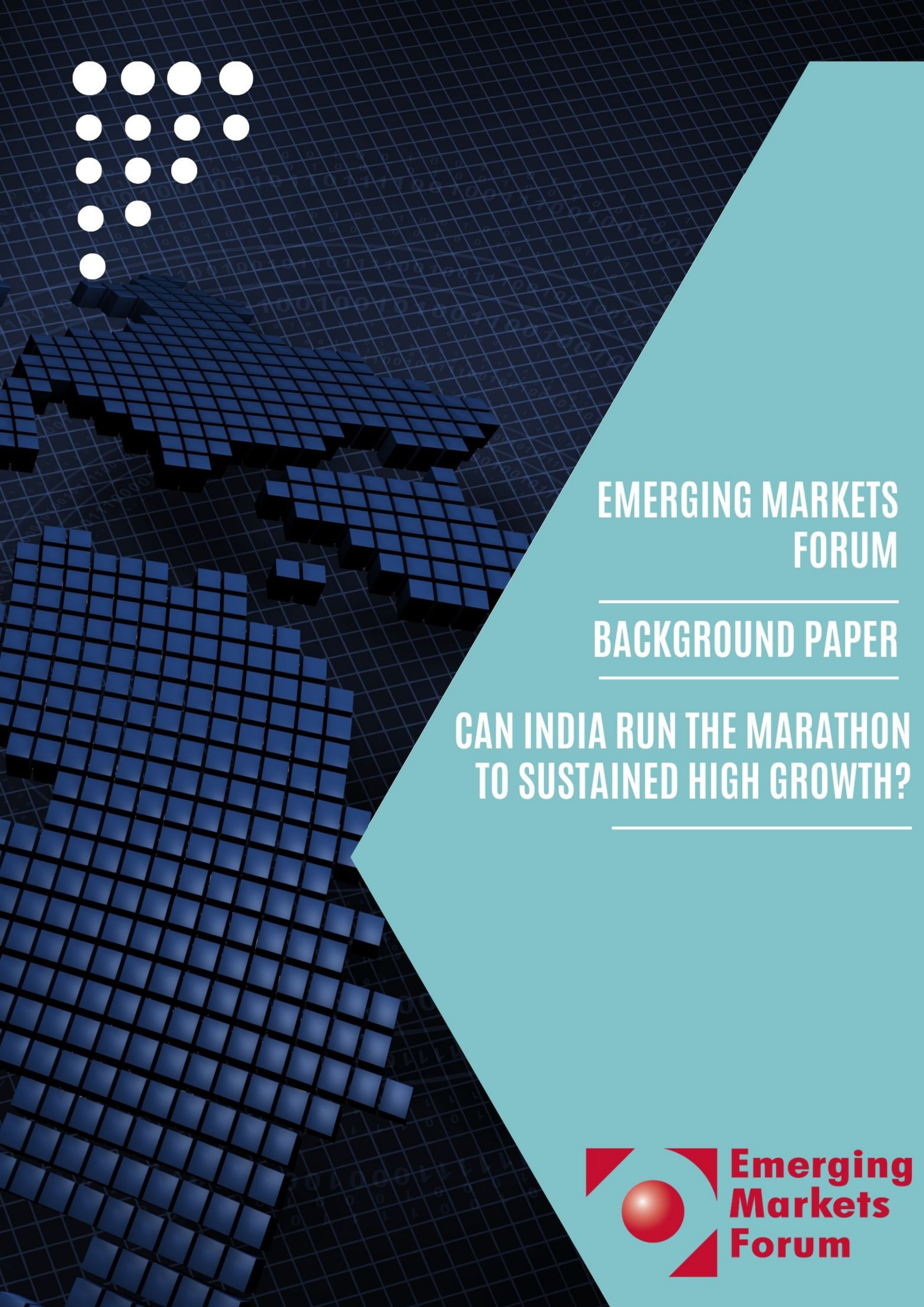


EMERGING MARKETS FORUM

BACKGROUND PAPER

CAN INDIA RUN THE MARATHON TO SUSTAINED HIGH GROWTH?

Emerging Markets Forum

Can India Run the Marathon to Sustained High Growth?

Centennial Asia Advisors, Revised 4 August 2024

Is India finally getting its moment in the sun? After living in the shadow of China for the past decade, the latter's economic woes and some hard-won gains from policy reforms by Delhi, the world's third-largest country is enjoying a good post-pandemic period with high growth and favourable shifts in the underlying economic fundamentals. The key question that will determine India's position in the world economy, and by extension the geopolitical arena, is whether the recent growth spurt can be sustained. Is the pattern of false starts of the past to be repeated – where a few years of rapid growth is followed by slower growth due to some internal or external difficulty? As we asked in our 2009 report, can India run a full marathon or is it only capable of being an occasional sprinter?

This chapter proceeds as follows:

- Section 1 presents long-run India's economic performance to argue that not being able to sustain robust growth has accumulated into large gaps vis-à-vis China and other now-middle-income economies. While some of the setbacks have been inflicted by external shocks, shortcomings in the domestic economy have reduced India's resilience to these shocks while also exerting headwinds. Crucially, while underperformance in global value chains limited the upside potential.

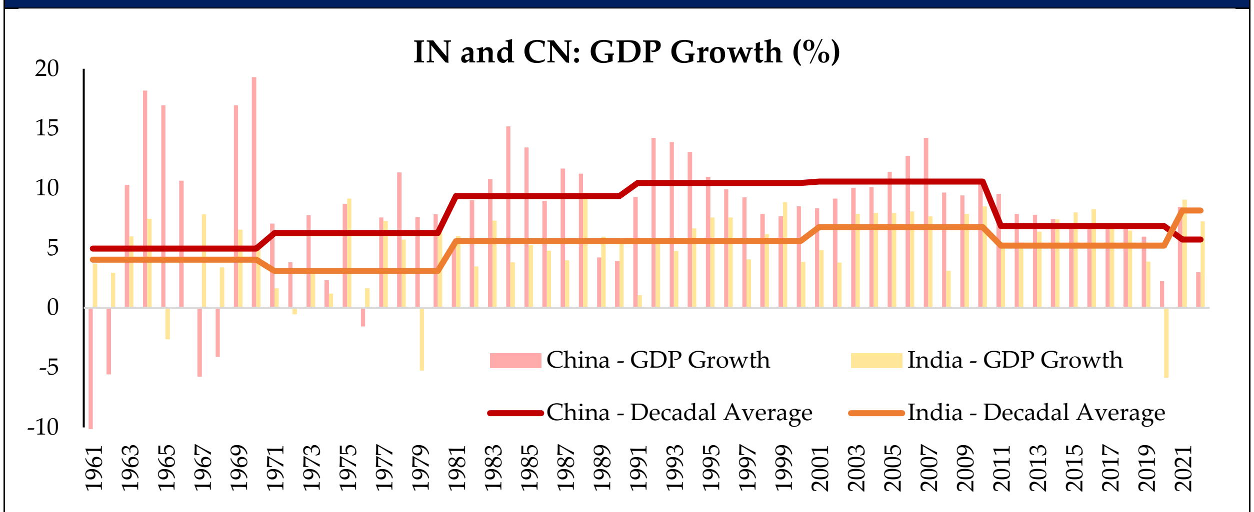
- Section 2 presents our near-term assessment of the Indian economy. We see the cumulative effects of reforms which have improved economic fundamentals translating into accelerated growth for the next decade. In essence, India is better-placed to unlock its economic potential and favourable fundamentals such as demographics thanks to improved infrastructure and a more business-friendly eco-system. Sounder macroeconomic management has reduced the chances of macro-financial shocks throwing the economy off-track. However, without further reforms, this growth may come with pockets of weakness, such as chronic weaknesses in the labour market and soaring inequality.

- Section 3 investigates caveats to this optimism caused by key structural defects that will constrain growth in the long term if not addressed. Wide gaps in human capital remain, whether it is underperformance in health-related metrics or deficits in education and skills that harm productivity and competitiveness. In particular, we fear that an unwillingness to more fully open up to international trade could stymie ambitions of exploiting the export space vacated by China. Whether the "software" of economic policymaking and governance can tackle these deficits remains an open question.

SECTION 1: INDIA'S POTENTIAL UNREALISED

There is a reason why India, for all its economic potential, has not broken out of the ranks of lower-income countries into middle and upper-middle-income status, as several other Asian economies have. While the economy is capable of delivering strong growth rates on a sporadic basis, it has often failed to sustain the momentum necessary to propel it towards higher income levels. What has been unfairly described as the "Hindu" rate of growth of 4% or less in the early post-independence period, did give way to much better growth of around 6% in the run-up to the 1991 crisis. Even then, decadal average growth never managed to exceed 7%. China, on the other hand, has managed to grow at around 10% for three consecutive decades, which is what ultimately enabled it to cement its position as the world's second-largest economy. That recent years have seen India outgrow China should not disguise the fact that the former had consistently underperformed for decades. Given India's lower starting point and the dynamics of economic convergence, it should have done much better.

Long-run growth in India has underperformed China for decades



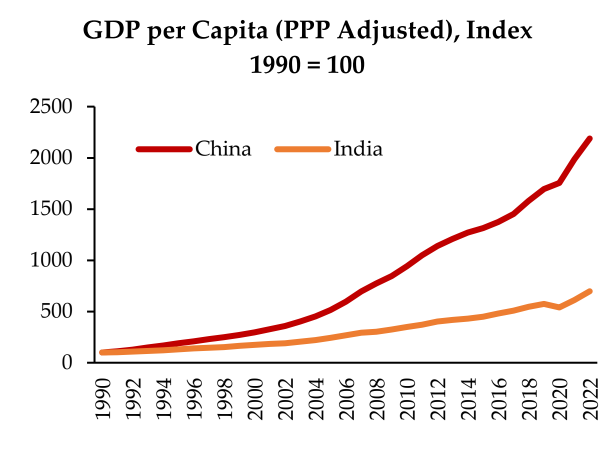
Source: Centennial Asia Advisors calculations based on World Bank Open Data

The result of this differential performance is stark. The two economies were at approximately equal levels of per capita income in 1990. Subsequently, however, China consistently managed to deliver stronger growth with only occasional setbacks which it quickly recovered from. In contrast, not only has India's average growth performance been worse than China's, but it has also been less consistent, with sharp swings in both directions. The result of this is that by 2022. Chinese per capita incomes had increased by over twenty-fold from 1990 while India only managed a six-fold increase.

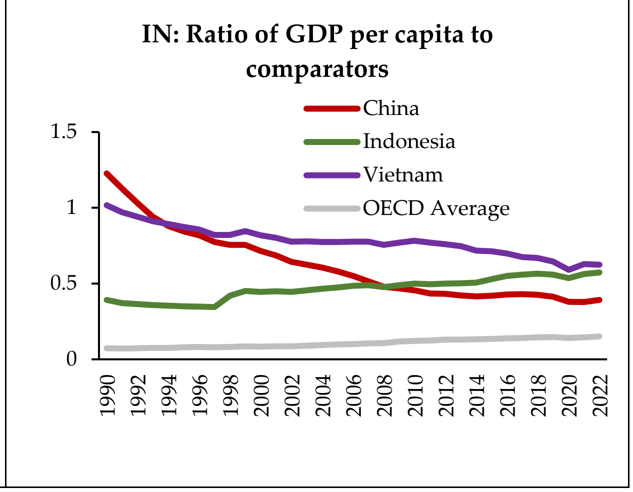
It is not just the comparison with China that is unfavourable. Vietnam which was similarly poor to India in 1990, also galloped ahead in the succeeding years and by 2022, per capita incomes in Vietnam were 75% higher than in India. On current trends, it will take India another seven decades to fully catch up with Indonesia, a country with its own share of development difficulties and crises. Meanwhile, the distance with today's high-income economies, proxied by the OECD average, remains wide.

The bottom line is that even as the economy has succeeded in dragging hundreds of millions out of hardcore poverty, Indians remain poor by international standards and proclamations of the creation of a new mass of "middle-class consumers" need to be qualified; the median Indian citizen only enjoys daily consumption of USD4.0 in purchasing power parity terms, making them poorer than global averages.[1]

India's growth pales in comparison with China…



…and convergence with other markets a mixed bag

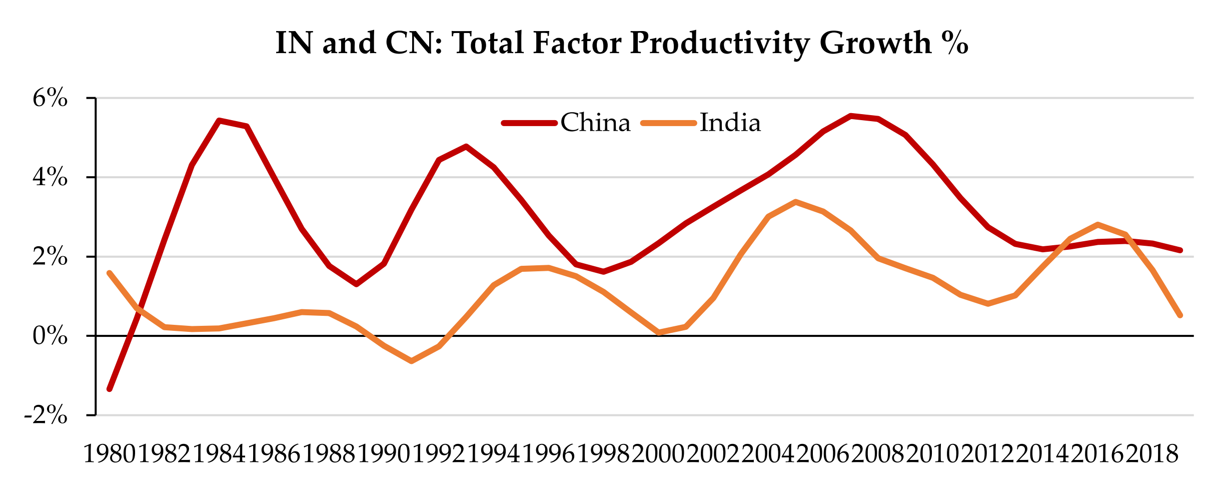


Source: Centennial Asia Advisors calculations based on World Bank Open Data

It must be recognized that much of India's overall growth has been delivered by its favourable population dynamics to date; the former has had much higher birth rates than China due to the latter's "one child" policy. But the fact that China has outgrown India despite the population differentials suggests that on per-capita incomes or productivity, India has a much longer way to go. In the past four decades, India's productivity growth has outperformed China in only 5 out of 40 years; the peaks in India's productivity growth cycle (such as in the aftermath of the 1991 reforms) are only slightly better than the lows that China faced, for instance during the Asian Financial Crisis. A sharp slowdown in the years preceding the pandemic is also observed, perhaps indicating that the gains from the measures in Prime Minister Modi's early term in office may be running out and that the economy may face new constraints that will need to be resolved.

[1] World Bank Poverty and Inequality Platform (2024) *Accessed via Our World in Data*

Decades-long gaps in productivity growth are a key reason for India's falling behind



Source: Centennial Asia Advisors calculations based on Penn World Table. Data are smoothed using the Hodrick-Prescott filter.

What explains India's underperformance in delivering strong growth and thus missing out, at least to date, on being an "Asian economic miracle"? Without attempting to produce a detailed account of India's economic history, several major themes explain why India has not caught up with the pace of other faster-growing Asian economies despite several favourable fundamentals.

Internally, much of India's post-independence history up until the 1990s was characterised by the now-infamous "license-permit-quota raj", most notoriously represented by the Industries (Development and Regulation) Act 1951. Under this system, a vast swathe of economic sectors saw firms face significant barriers to entry and expansion; then-prime minister Indira Gandhi reportedly quipped that it took a whopping 420 days for a business license application.[2] Regulations such as the Monopolies and Restrictive Trade Practices Act placed penalties on firms that grew beyond a certain size. Other deficiencies in the business climate such as access to reliable power supply, labour regulations, and credit constraints have led to the economy being characterized by a "long tail" of small, informal, family-run firms that do not make the transition to being larger firms that can enjoy economies of scale and become sources of significant labour and capital demand in their own right.[3]

Even as the 1991 reforms unwound some of the worst aspects of the post-British "raj", doing business in India is highly challenging for domestic aspirants and foreign investors. Onerous land and labour regulations, as well as regulatory fragmentation across states, have contributed to sluggish growth in new business creation and a high degree of informality, while aversion to foreign investments meant that India missed out on participating in global value chains that other Asian markets have done with great success.

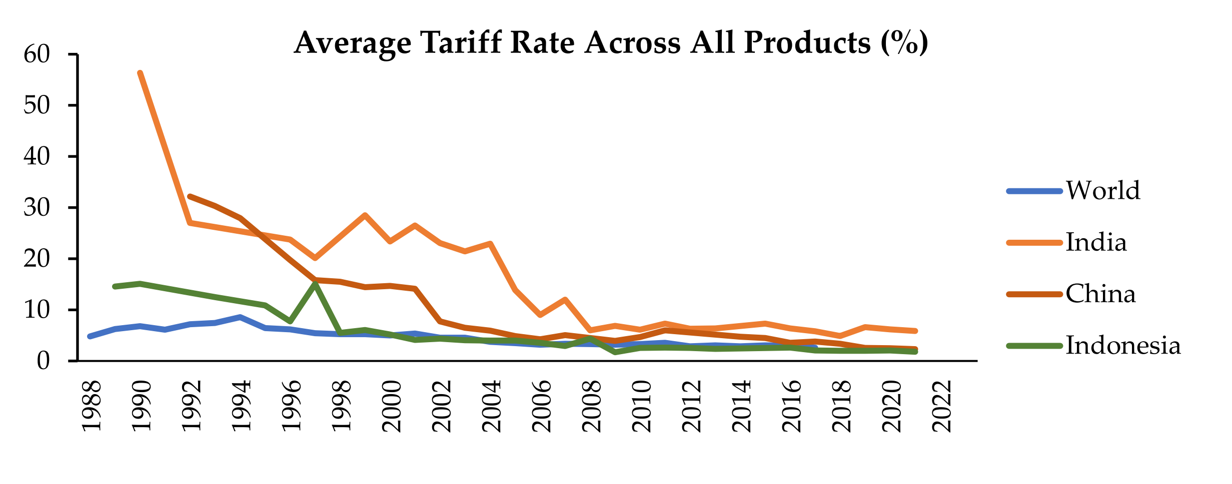
[2] Mahindra (2010) *After the Raj, it was the Licence Raj*

[3] Raj and Sen (2016) *Moving out of the bottom of the economy? Constraints to firm transition in the Indian informal manufacturing sector*

If domestic economic dynamism was constrained by regulatory burden, their access to external markets was also hampered by the government's restrictive stance on international trade. Indian exporters and importers were subject to stringent permit requirements, high tariffs for intermediate and finished goods, and an overvalued exchange rate. The emphasis on self-sufficiency and reliance led to *de facto* autarky for most of its early development stage; the economy was virtually self-sufficient in manufactured and consumer goods, but this came at an enormous cost to allocative efficiency.

As a result of this, the opportunity to tap into global value chains and richer export markets was severely curtailed, with the playing field largely left to others, including China. This led to a severe underutilization of its labour endowment that persists even today; despite holding over 20% of labour among non-highly-industrialized economies, its share of labour-intensive, low-skilled manufacturing exports was only approximately 5%.[4] The lack of trade orientation meant that even as global firms were seeking a low labour-cost base for their manufacturing investments, India decisively lost this contest to China, which was a key driver in the widening gap between the two large economies.

Sky-high tariff rates in the pre-liberalization period



Source: World Bank Open Data

Many of the other difficulties plaguing India are, to some extent, consequences of the two adverse developments above. A lack of a high-value-added manufacturing segment is largely the consequence of not enjoying the spillover effects associated with quality foreign direct investments. India's infamous infrastructure woes were in large part caused by the regulatory fragmentation and land and labour law rigidities that made even public sector capital infrastructure a difficult task. Public services in the key areas of education and health were also

[4] Subramanian and Chatterjee (2020) *India's Inward (Re)Turn: Is it Warranted? Will it Work?*

subject to the differing quality of governance across India's states, with the large states of Uttar Pradesh and Bihar, among others, drawing the short straw compared to others.[5]

[5] Kapur (2020) *Why Does the Indian State both Fail and Succeed?*

SECTION 2: INDIA IS ABOUT TO START ANOTHER SPRINT BUT CAN IT LAST?

Against the picture of chronic underperformance of past decades, recent years have seen a more optimistic narrative being articulated. Post-pandemic growth has been world-leading. Even as the rest of the world struggled with dealing with post-pandemic scarring, inflationary shocks from the Russo-Ukrainian war, and the consequent monetary tightening, India managed to deliver high growth rates of 7% or more in the three fiscal years after the pandemic. As China faces its own headwinds, India may now find itself positioned as a key driver of global growth. We argue that there are good reasons to believe that India is about to embark on another burst of high growth for around a decade as the previous limiting factors to growth are loosened thanks to prior policy reforms, as well as the dividend from favourable economic fundamentals.

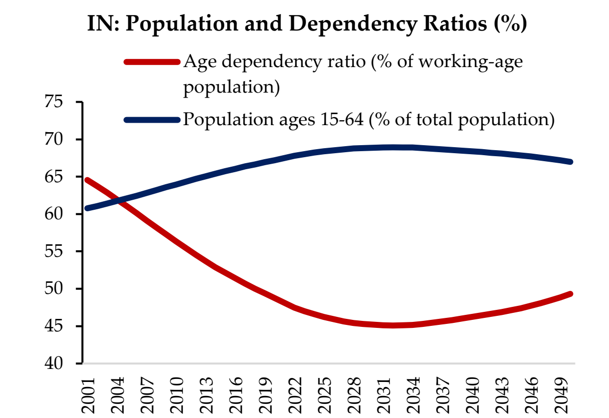
The combination of the upcoming demographic dividend and an enhancement of bottom-up economic capabilities via improved infrastructure, expanded access to basic necessities, and the accumulated dividends from prior reforms will likely provide India with a good run of growth until they are exhausted.

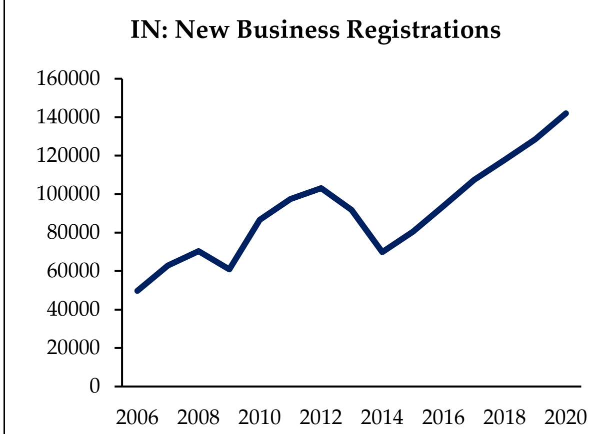
Among the chief tailwinds is that India is at its demographic prime. High birth rates in previous years mean that its working-age population continues to expand even as China faces "Japanified" demographic dynamics, compromising its position as the world's factory. Even today, growth rates are still close to replacement levels, although we must note that India's demographic transition has occurred at a lower level of income compared to other Asian economies except for China. With that said, the working-age population is expected to reach a turning point at around 2035, which would, at least quantitatively, mark the exhaustion of the demographic dividend.

Not only are the numbers favourable, but on-the-ground economic attitudes are also favourable – a "mental revolution" that will boost economic dynamism. Attitudes towards entrepreneurism, for instance, are positive when compared with regional averages[6], and the boom in the non-formal education sector such as online learning and executive education suggests that the demand for new skills is robust despite the weakness of the formal education system. Whether it is the high-profile technology "unicorns" that are emerging in India's dynamic cities, or small-medium businesses that serve local communities, business creation in India has been on the up in recent years. A large population, most of them hungry for success, is thus creating a large pool of entrepreneurs and consumers, underpinning the near-term potential of India's economy.

[6] Global Entrepreneurship Monitor (2023) *Entrepreneurship in India*

Demographic dividend for another decade…	…which contributes to new business activity



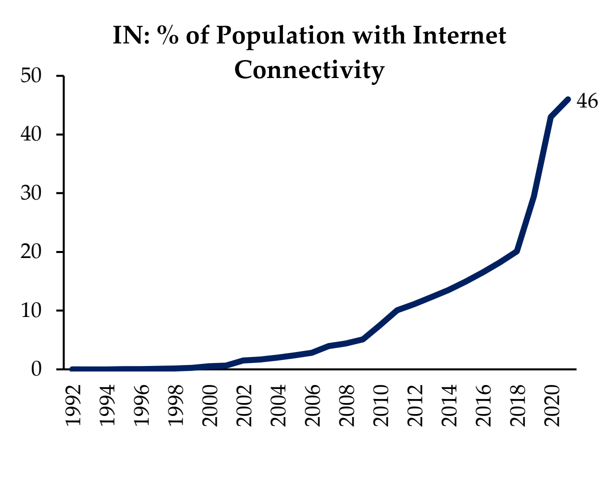
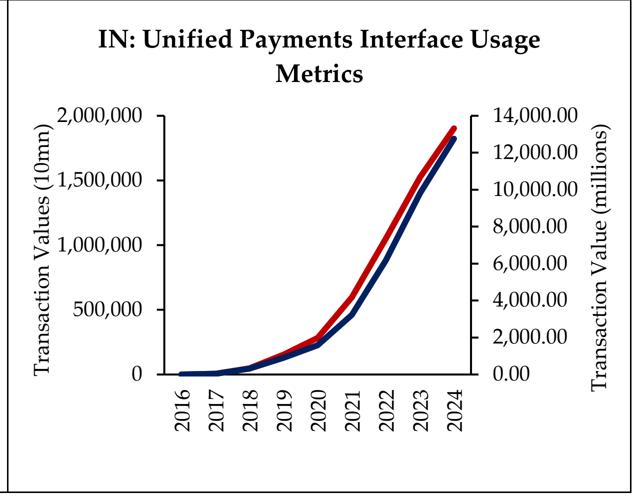


Source: Centennial Asia Advisors calculations based on UN Population Prospects, World Bank Open Data

Supporting the expansion of business activity has been improvements in previously-poor infrastructure. The Modi government's infrastructure policy has been, to put it simply, "build, build, build". As a result, many aspects of infrastructure have seen massive expansions; the number of airports doubled between 2014 and 2023, while electrified rail almost tripled in the same period. This is set to continue in the short term; central government capital expenditures have seen strong double-digit growth since 2019, and together with private sector partnerships, are expected to deliver further infrastructure gains in the coming years, with the Mumbai-Ahmedabad High-Speed Rail and a second airport for New Delhi being only two of the highest profile developments. The impact of these developments in terms of reducing the costs of transporting goods and people and opening up new markets such as domestic and international tourism, should not be understated.

It is not just physical infrastructure that has made massive strides; equally, if not more exciting, is the "digital boom" of internet and data-related infrastructure. From the bottom-up has been a rapid expansion in internet access, and other related services such as bank accounts, important requirements in accessing the digital economy. From the top down, the government has facilitated the development of an impressive digital public infrastructure ecosystem including payment systems (most notably, the Unified Payments System), unique identity (Aadhaar), and others. These have had widespread benefits in terms of transforming the structure of the economy; previously informal businesses were registered onto national tax and business registries, which in turn enabled access to formal-economy services that were previously denied to them. There have also been benefits to the effectiveness of public policy: while the United States government struggled to manage the distribution of its massive pandemic-era financial aid, this digital infrastructure made the task trivial for New Delhi.[7]

[7] Alonso et. al. (2023) *Stacking up the Benefits: Lessons from India's Digital Journey*

Expanded internet access enabling new economic activity…	**…bolstered by a world-class digital infrastructure including the ubiquitous Unified Payments Interface**
	

Source: World Bank Open Data, National Payments Corporation of India

Another positive aspect of the past decade has been the fulfilment of a wide range of basic needs for socioeconomically disadvantaged segments of the population. The Modi government's "New Welfarism" strategy involved the subsidized provision by the government of basic goods, services, and utilities to households. Whether it was bank accounts, toilets, or even basic water and power supply, the government has rolled out ambitious initiatives that aimed to ensure that these basic amenities are made available to India's massive population.[8] While there has been steady progress in preceding years, the decade since 2014 saw the rate of expansion accelerate, with the gains in rural India being particularly noteworthy.[9] An emphasis on women and certain marginalized communities is also discernible and, while coming with important caveats, laudable.

These have not just translated into improved access to these goods and services in and of themselves but also contributed to tangible gains in quality of life that many readers would take for granted. For instance, the expansion of toilet access has helped reduce the rate of open defecation from 33% in 2014 to 11% in 2022; this was a whopping 73% at the beginning of the millennium. Maternal mortality has also gone down from 384 deaths per 100,000 live births in 2000 to 103 in 2022; while progress was steadily made in the two decades, the "last mile" declines were in part thanks to a maternity care package programme introduced in 2016.[10] While we caveat that gains have not been made everywhere, most notably in stunting, this should not detract from the achievements that have saved tens of thousands of lives and delivered quality-of-life improvements at scale.

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[8] Sinha (2024) *Integrated Welfare Empowerment in India's New Welfarism Paradigm*
[9] Anand, Dimble, and Subramanian (2020) *New Welfarism of India's Right*
[10] Bhatia et. al. (2021) *Pro-poor policies and improvements in maternal health outcomes in India*

The long-run benefits of the combination of these policies should not be dismissed even if one has reservations about their immediate impact. Improved health outcomes on basic dimensions via improved sanitation and nutrition are not only welcome in their own right, but they also benefit children's ability to receive and absorb education via reduced absenteeism, not to mention better early-stage brain development due to reduced exposure to adverse health conditions.[11] If sustained, this may be key to unlocking the full potential of India's massive population both as productive workers and consumers with earning power in the future economy.

Even as the fundamentals have shifted in a positive direction, there have also been welcome improvements in economic management that are likely to improve the stability and resilience of the Indian economy. As we have previously elaborated, India has historically been subject to stop-go cycles of growth, with internal displacements or external shocks amplified due to defects in the economic policy framework. With admirable progress being made in remedying the defects in the institutional and policy framework in India, clearing the runway of road bumps that may retard a potential takeoff.

The admirable growth and resilience in the post-pandemic years showcase some of these achievements. Consider inflation, which has previously been a sore point for India given the lack of a well-developed monetary policy framework and volatile price pressures. Even in comparison with previous inflationary episodes, the 2022 inflationary shocks have been managed fairly well by the Reserve Bank of India ("RBI"); the newfound credibility in the new regime allowed inflation expectations to be better anchored, reducing the persistence of inflationary shocks and lowered averaged policy rates given the more favourable growth-inflation trade-offs under inflation targeting.[12]

Furthermore, the macro-financial difficulties that resulted in the "Twin Balance Sheet" crisis that spanned, roughly speaking, 2008-2018 have been, to a large extent, resolved after some admittedly hard-fought reforms. Aggressive lending and lacklustre supervision and risk management by banks saw a significant deterioration in asset quality, and this was before the Asset Quality Review of 2015 brought to the surface the even deeper extent of the problems in banks' balance sheets.[13] A series of measures by the government and central bank have meant that some of the prior excesses have been managed, allowing the financial sector to remain supportive of growth even as interest rates were hiked to handle the inflationary shocks of 2022-23.

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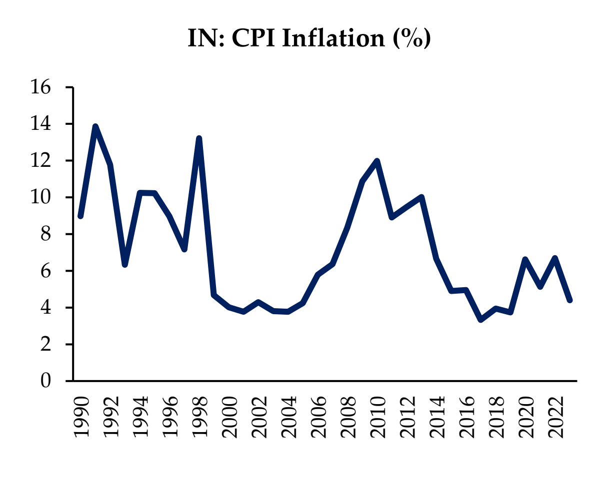
[11] Orgill-Meyer and Pattanayak (2020) *Improved sanitation increases long-term cognitive test scores*

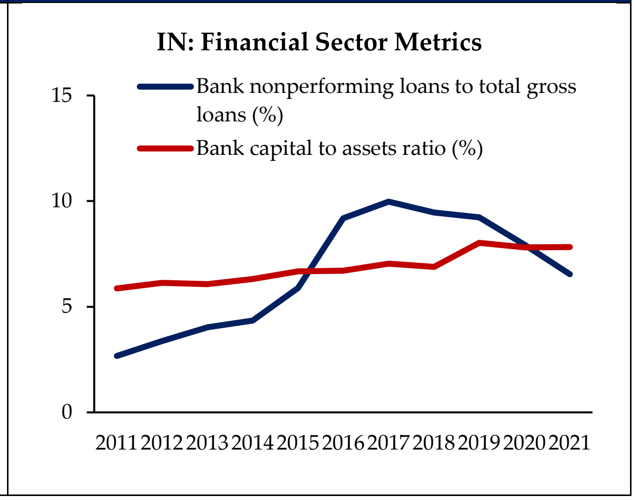
[12] Eichengreen, Gupta, and Choudhary (2021) *Inflation Targeting in India: An Interim Assessment*.

[13] Raju (2018) *Non-Performing Assets of Banks in India*

High and volatile inflation is a thing of the past



Hard-won reforms improved financial system stability



Source: Centennial Asia Advisors calculations based on World Bank Open Data

We should recognize that the respectable performance of recent years is not down to pure luck; to a large extent, they represent the fruits of prior, at times difficult, economic reforms that successive governments, including but not limited to the Modi-led administrations, have pursued. For instance, fiscal policy has been bolstered by the 2017 introduction of the Goods and Services Tax, which despite its earlier implementation difficulties, was a game-changer both in terms of improving the central government's revenue collection, as well as better integrating India's domestic market across states. The year-to-year conduct of fiscal policy has also been more prudent, with the shift away from large-scale handouts towards public infrastructure striking us as broadly appropriate for long-run growth objectives.

In the financial sector, a series of policy actions by the RBI[14] was also key to improving the soundness of the financial system. Even if they did come with short-term costs such as a spike in non-performing loans and tighter credit conditions, the financial sector was ultimately put on a sounder footing. One may quibble about the pace of the progress or unresolved difficulties, but the fact remains that headline measures of financial stability have improved and weathered the stresses of the post-pandemic period admirably well, as acknowledged by the International Monetary Fund ("IMF").[15] The Insolvency and Bankruptcy Code (2016) was also one among several high-profile measures at consolidating previously fragmented regulations and helped impose market discipline on previously errant firms and banks.

Continuing our runner's analogy, India currently stands as an athlete in prime age and has done some of the preparatory work such as a training regime and appropriate diet which place it in good stead to undertake the next run. These preparations, however, are not complete and even in the short term, we see several pockets of weaknesses despite the positive headline growth.

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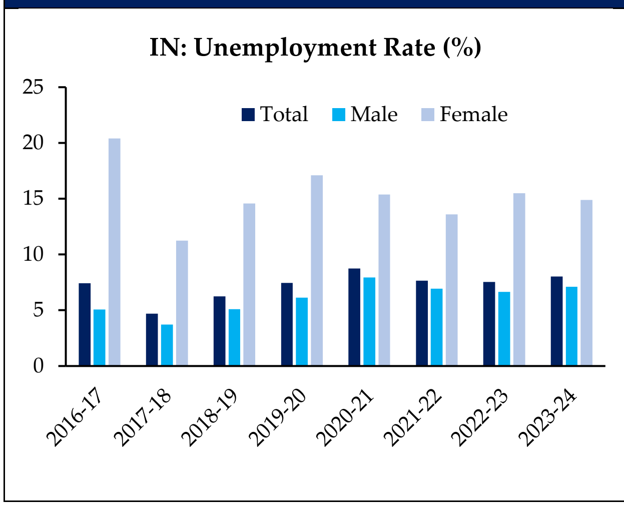
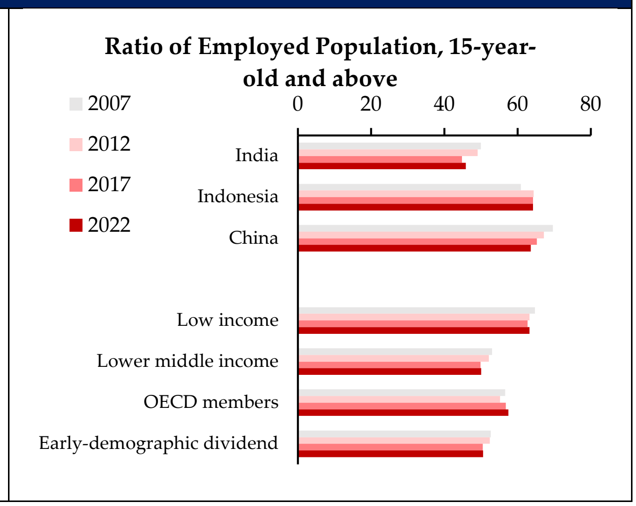
[14] Economic Survey of India (2017) *The Festering Twin Balance Sheet Problem*
[15] IMF (2023) *Article IV Consultation with India*

The major concern that we have is the "jobless" nature of growth; high growth has, at least to date, not translated into positive outcomes for the population seeking gainful and productive employment. An early sign of this is the chronic weakness in the labour market; the fact that official unemployment statistics are notoriously unreliable is symptomatic of this. Independent estimates pin the unemployment rate at around 7-8% in recent years, worse than a decade ago. The problem is even more severe for the up-and-coming youth segment of India's labour market; some estimates suggest that four out of ten youths face some degree of unemployment or underemployment.[16] International comparisons are also unfavourable, with the employment ratio lower than lower-middle-income economies averages.

Chronic weakness in Indian labour markets suggests "jobless growth" is still a problem





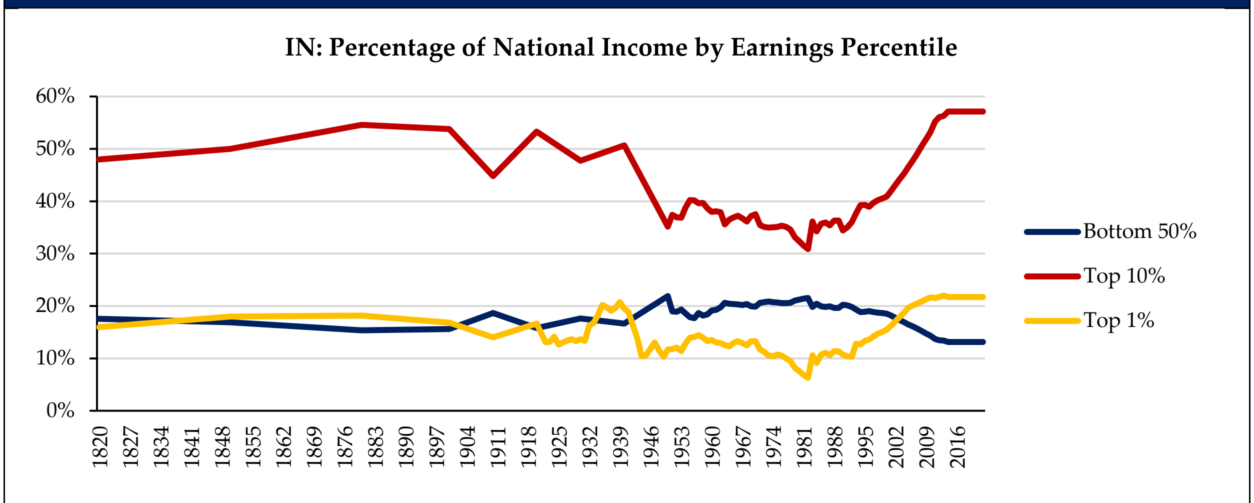
Source: Centre for Monitoring the Indian Economy, International Labour Organization

There are thus consequences whether it is for India's potential as an economic hub, or the welfare of the average Indian citizen. From a business perspective, the difficulty in securing staff with the necessary skills has already been reported as a key impediment to expansion – this will only become more serious as the economy attempts to move upwards into higher-valued manufacturing and services. Meanwhile, the burden of supporting a sicker population could very well turn a demographic dividend into a demographic nightmare; not only is the productive potential of the labour force compromised, but the state would also have to bear the fiscal burden of the additional healthcare expenditures associated with poorer health outcomes. Even if "New Welfarism" helped pluck some of the low-hanging fruit in this regard, the root-and-branch reforms to education and health that do not deliver immediate benefits but are crucial for long-run human capital development cannot be ducked forever.

[16] Azim Premji University (2023) *State of Working India*; CMIE (2024) *Economic Outlook Database*

The uneven transmission of the fruits of growth is apparent when considering other indicators. Income inequality, for instance, has experienced a dramatic increase in the past decades; estimates suggest that levels of inequality are now back to levels previously experienced during the days of British colonial rule, in addition to being among the highest in the world. For instance, the income share of the top 10% of earners is approaching 60% of total income, above the colonial-era peak of around 55% in the late 1800s. Correspondingly, the income share of the bottom half of society has been squeezed since the turn of the millennium, with the latest estimates suggesting that they collectively account for only 13% of total income. Similar dynamics are also observed when considering wealth inequality.

Back to the future? Inequality has exceeded colonial-era highs in recent years



Source: World Inequality Database

What does this mean for the average Indian? Arguably, not very much; as we mentioned earlier estimates of median daily consumption (which we take as a more reliable measure of household welfare), have only grown by 25% in the decade since 2014, despite real per capita GDP growing by 50% in the same period. The situation is even more dire for those at the bottom of the income distribution; daily consumption for this segment of society has seen only marginal growth over the decade since 2014, with the urban poor seeing virtually no gains in spending power.[17]

Summing up, even if India does grow at an admirable pace in the near future as we expect it to, we should not be blind to the possibility that the fruits of such growth may not be distributed widely among the country's massive population. The experience of the past decade has already shown that the gains have largely accrued to the urban upper class that have managed to benefit the most from the administration's pro-business reforms. For most of the rest, however, poverty, poor job prospects, and ill health remain a widespread reality. As we will explain in the next section, this underperformance in ensuring the fruits of growth are enjoyed by the average Indian is a source of trouble for the economy to sustain its momentum.

[17] Our World in Data (2024) *Poverty Data Explorer*

SECTION 3: TO FUTUREPROOF INDIAN GROWTH, MORE REFORMS ARE NEEDED

The achievements of the past decade are poised to trigger a period of high growth for around a decade or so. However, such reforms alone cannot be relied on to power the Indian economy beyond that period. After the dividends from these shifts are exhausted, the economy will soon face the next set of binding constraints that will, if not resolved, lead to a loss of economic momentum. The task is not trivial; India needs to maintain decades of high growth performance if it is to firmly join the ranks of today's developed economies.

The World Development Report 2024[18] argues for a a sequenced, three-pronged approach to help nations such as India escape the middle income trap. This involves promoting investment in the first phase, then encouraging the infusion of new technology from around the world in the second and, finally creting the conditions for innovation in the economy.

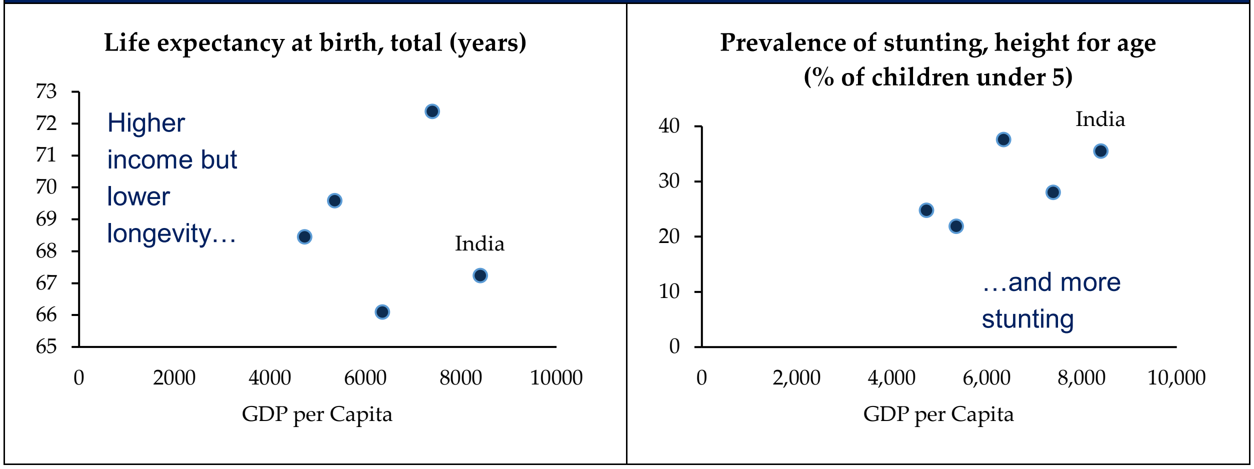
India will, therefore, need a next generation of reforms to achieve this. In our view, this will be best done through updates in the "software" of economic policy which could loosen the next set of constraints before limit growth. **Looking at today's high-income markets, three key ingredients strike us as essential for economic success, namely well-developed human capital, openness to international trade, and high-quality institutions and governance.** These are the gaps that India has not decisively closed. If India is to continue growing after the demographic dividend and other low-hanging fruit run out, policymakers can no longer duck the deep-rooted reforms necessary to remedy these gaps.

Chief among these defects is India's difficulties in developing its human capital, whether it is in education, skills, or health. Take health for example. Despite progress in some dimensions such as improving maternal health and access to sanitation, other health outcomes have not seen commensurate gains in line with India's growth. Stunting, for example, remains an acute problem, in part driven by the practice of concentrating resources on eldest sons at the expense of other children but also shortcomings in the public health system.[19] Meanwhile, India's struggles with air pollution, a result of weak regulation, have led to it bearing a disproportionate burden in terms of air pollution-related deaths.[20]

These factors, among others, have led to the average Indian enjoying a lifespan that is lower than most of their poorer neighbours, while the country also underperforms in various healthcare outcomes. As alluded to earlier, poorer health outcomes have economic consequences, such as reduced worker productivity or a negative impact on educational attainment. It is not a stretch to argue that the chronic labour market weakness is in part due to the ill health of the population hampering business efforts to recruit and train the staff that they need.[21]

[18] World Development Report 2024 © 2024 International Bank for Reconstruction and Development / The World Bank.
[19] Jayachandran and Pande (2017) *Why are Indian Children So Short? The Role of Birth Order and Son Preference*
[20] Institute for Health Metrics and Evaluation (2024) *State of Global Air Report*
[21] Reddy and James (2024) The impact of health on labour outcomes among middle-aged and elderly: Insights from India

Despite being richer than its neighbours, health outcomes in India remain lacklustre



Source: World Bank Open Data. Other dots represent Pakistan, Bangladesh, and Nepal.

The other aspect of human capital, that is education, is also lacking. Even without the benefit of internationally comparable PISA scores after India's withdrawal in 2009, a wide body of evidence suggests that educational outcomes remain abysmal for a significant proportion of the population; a national learning assessment suggests that less than half of rural secondary and undergraduate students can solve simple division problems and that less than a quarter of students reached benchmark levels of literacy and numeracy for their grade[22]. Despite the renown of India's elite education segment as characterised by the Indian Institutes of Technology and Management, it remains the case that access to quality education remains far from equitable or widespread. This is even before considering the still-persistent socio-cultural cleavages such as by caste or religious groups.[23]

While some of these weaknesses are understandable given India's status as a developing economy, there is also a nexus to policy in that education and health have not received emphasis from the Indian government. From a budgetary perspective, neither the health nor education sectors have been major beneficiaries of the capital spending spree that New Delhi embarked on in the past five years. For health, general government health spending as a percentage of GDP remains at around 1%, less than half of emerging Asian averages, and this is manifest in various input-based indicators such as hospital beds or physicians per capita, which are also far below developing-economy averages, let alone recommended levels from global organizations. The education sector fares better in terms of monetary inputs, with government spending on education on an uptrend in the past decade. But this has not been translated into improved inputs on the ground; pupil-teacher ratios remain high at a national level, with a ratio of 26 students to 1 teacher at a primary level, around 10 students higher than developing-country averages.[24]

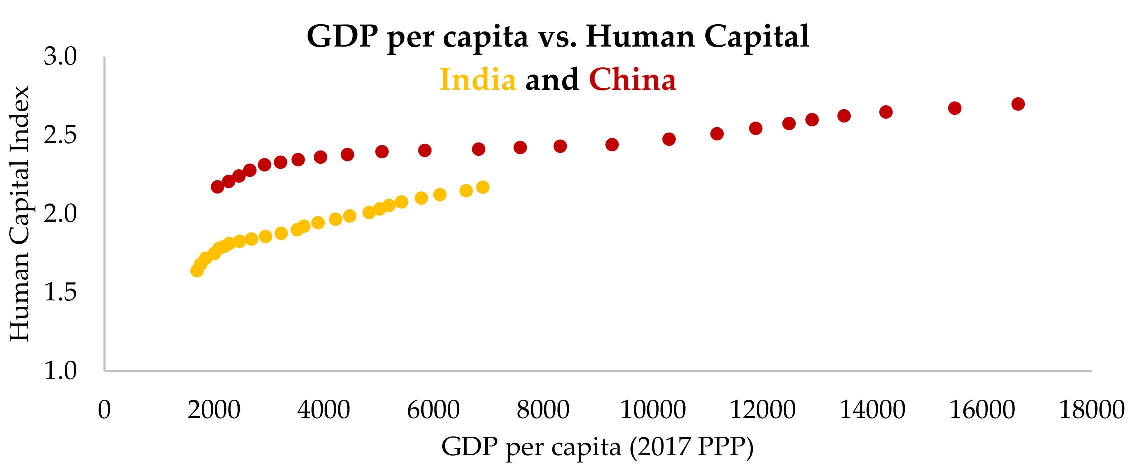
[22] Annual Status of Education Report (2022)
[23] Thorat and Khan (2023) *Why Inter-caste Inequality in Educational Attainment Still Persists? Wealth and Caste Discrimination Matters*
[24] Rajya Sabha parliamentary question on teacher-student ratio (2024)

To some extent, this is the result of the "New Welfarism" strategy pursued by the Modi administration, with its emphasis on tangible essential goods rather than public goods as traditionally defined. Even if the provision of these essentials such as toilets, power supply, and financial services are of substantial economic benefit to the population, they cannot substitute for the long-run boost to human capital that can only be delivered by an accessible and high-quality healthcare and educational provision. This is especially true if India is to transition away from a low-cost labour hub towards one that can leverage more sophisticated economic activity, whether it is in high-tech manufacturing or the business and technological services sector. A healthy and well-educated workforce is essential for future-proofing the Indian economy and resolving some of the chronic weaknesses in the labour market that are already apparent.

From a macroeconomic perspective, it is hard to see how India can emulate other high-growth markets without also matching them in terms of human capital. The figure below plots. For China and India, the trajectories between 1990 and 2019 of per-capita incomes and a measure of human capital by the Penn World Tables, which captures both years of skilling and estimated returns to education. Even at the starting point where both countries were at similar income levels, China started with much stronger human capital than India.

In the succeeding decades, not only has China surged ahead in terms of its income levels, but it also managed to pull ahead of India in terms of human capital, most notably via investments in educational and research capacity. At all equivalent stages of development vis-à-vis India, China enjoyed higher levels of human capital that enabled it to climb up global value chains and away from low-value manufacturing that powered its earlier stages of growth. Without discounting India's progress, its human capital today is where China's was in 1990. It is thus questionable whether India can emulate the Chinese success story when it lacks a key ingredient.

Human capital gaps persist and cast doubts on "China path" to growth

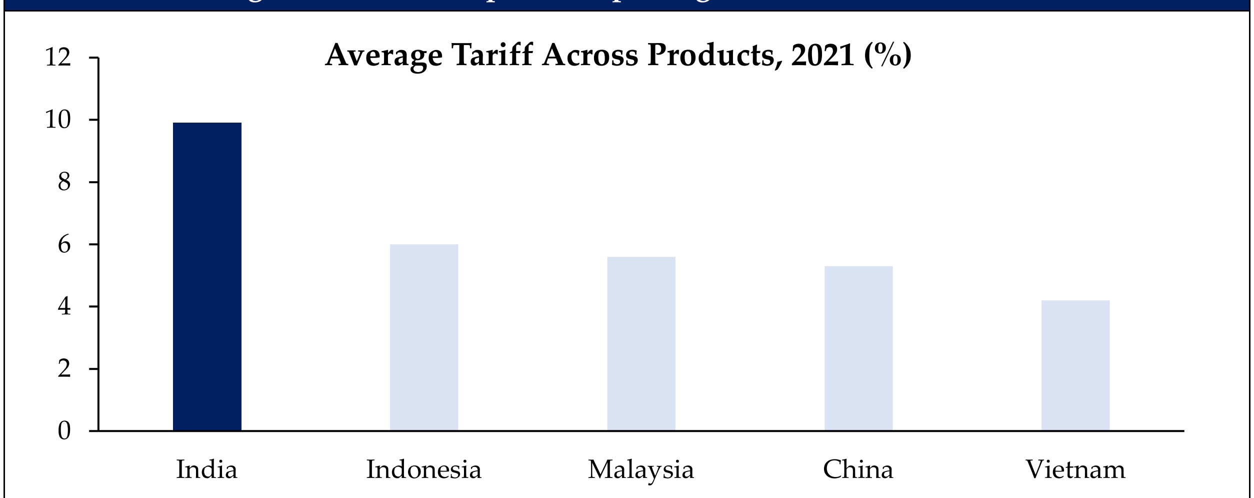


Source: Centennial Asia Advisors calculations based on World Bank Open Data

Another difficulty is India's relative lack of openness to international trade and investments. Even if the days of triple-digit tariff rates are long gone, it remains the case that tariffs on imported goods remain far above global averages and other emerging market economies. Policy attitudes towards trade policy also remain a mixed bag; while the government has made much about its "Made in India, Made for the World" mantra, the reality is that the burdens imposed by heavy-handed import tariffs and other restrictions are a *de facto* export tax that penalizes the competitiveness of India's exports vis-à-vis rival exporters. The past decade has seen tariff hikes in key product categories, including apparel, textile, and other low-skill manufactured goods. Little wonder that it is Bangladesh that is winning in this space.[25] Partially compensating for this is a globally-competitive services export sector, but the forgone opportunities in merchandise trade strike us as leaving money on the table.

At a policy level, attitudes have tended to be sceptical of global trade, with the belief that its large domestic market allows the economy to forgo overseas markets. The country has not signed a single free trade agreement from 2014 until 2023 and shows no inclination to join major trade partnerships such as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership or the Regional Comprehensive Economic Partnership, the latter of which has almost universal coverage of the major Asia Pacific markets. Trade negotiations with major economic blocs such as the European Union and the Association of Southeast Asian Nations have also been a victim of hesitation by policymakers in New Delhi. Utilization of trade agreements that are signed remains low, suggesting that the claims that India does not benefit from free trade are self-fulfilling prophecies.[26]

Tariffs are still high relative to competitor exporting markets



Source: Centennial Asia Advisors calculations based on World Bank Open Data

[25] Subramanian and Chatterjee (2020) *India's Inward (Re)Turn: Is it Warranted? Will it Work?*
[26] Pandey and Unnikrishnan (2023) *Free Trade Agreements (FTAs) by India: Review and Implications for Future*

While the government has made strides in liberalizing foreign investment rules, the remaining restrictions and grey areas are still barriers to the entry and expansion of international investors seeking to do business in India. Furthermore, tariffs on imports of primary and intermediate goods and low participation in bilateral and multilateral trade arrangements mean that investors seeking to invest in India as part of a global value chain will have to think twice about whether the advantages of lower land and labour costs are worth the barriers to trade and limited market access. If New Delhi does not realize that global trade and investments are two sides of the same coin, it may well miss the opportunities provided by the current wave of supply chain relocations both to attract foreign investments, as well as expand its presence in global export markets. Ultimately, the economy risks foregoing the benefits of economic diversification and sophistication that exposure to global markets has shown time and time again to deliver.

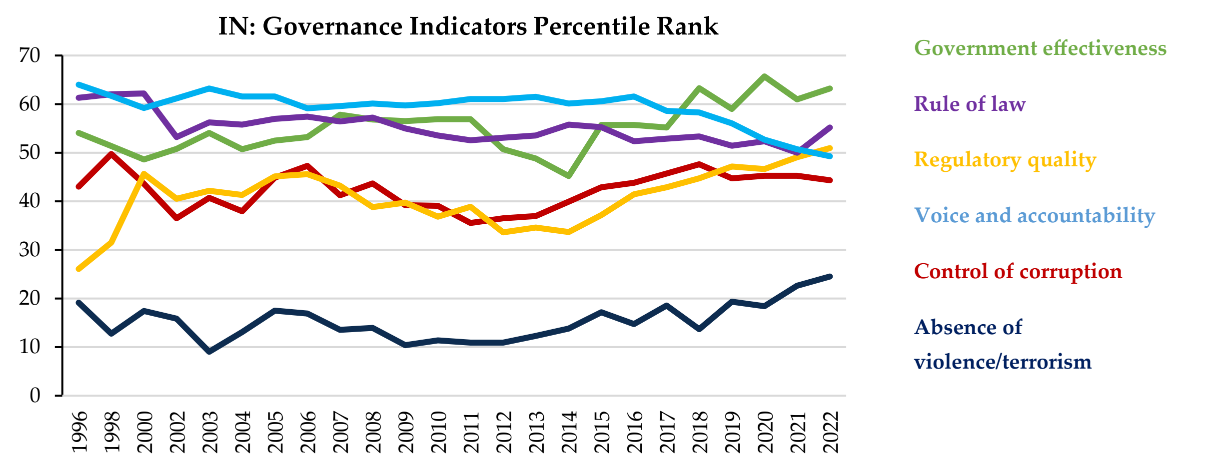
These are but two of a longer list of other areas that may become hindrances to further economic success, a list which includes still-arcane regulation and bureaucracy, difficulties in factor markets of land and labour, not to mention other aspects of multidimensional poverty and socioeconomic cleavages; the list is simply too long to enumerate in full. What will be key moving forward is whether the quality of Indian institutions, policymaking, and governance is capable of delivering the reforms necessary for the country to fulfil its economic potential after decades of false starts and missed opportunities.

At best, the record of the prior decade has been mixed. On the positive side, there has been an improvement in government effectiveness and business friendliness, with slashing red tape a key priority of the government in its efforts to improve economic competitiveness and attract investments, which has shown up in improved performance in indicators such as the Worldwide Governance Indicators and the OECD's investment restrictiveness index. A streamlining of overlapping bureaucratic agencies and processes has not only improved the business climate, but also enabled the government to undertake some of its large-scale achievements such as the rollout of the Goods and Services Tax, or the establishment of world-leading digital public infrastructure.[27]

However, the political trends have pointed to increased centralization of power in the national government, at the expense of checks and balances and separation of powers. The ability of the legislature and the judiciary to constrain the executive has been subject to pressure due to attacks by the BJP and its affiliated organizations against what they deem as bastions of the old Congress-linked elite The suppression of civil society and an independent press has also eroded another source of checks and balance and civic participation in policymaking. While elections have largely remained free, it is doubtful that they are fair given the perceived politically motivated crackdowns against opposition parties.[28]

[27] Bajpaee (2024) *Modi's India has become less liberal but better governed*
[28] Bertelsmann Stiftung (2024) *BTI 2024 Country Report - India*

Progress in improving dimensions of governance a mixed bag



Source: Worldwide Governance Indicators

Setting aside the (legitimate) concerns about democratic deterioration, there are also economic consequences; an over-dominant executive is prone to making domestic policy errors due to the weaker mechanisms for transmitting feedback and consultation. Episodes such as the demonetization of 2016 and the mismanagement of the pandemic were, to some extent, a result of this centralization. The degradation of transparency is also apparent in questions over the integrity of official economic data[29] as occurred in the withdrawal of the 2019 edition of the Household Consumer Expenditure Survey after leaked findings suggested a fall in household consumption, a finding that would have been a political embarrassment that undermined the government narrative of a booming economy.

Ultimately, sound governance is key to maintaining the confidence of domestic and international businesses to continue investing, while also ensuring that policymaking remains focused on the long-run public interest rather than the myopic electoral benefit of whichever party is in power. In a more volatile and uncertain environment, having an effective government that is subject to appropriate checks and balances, as well as accountability to the public, is key to ensuring that public policy can adapt to short-term shocks and structural shifts, whether they be technological change, climate pressures, or geopolitical tensions.

India is thus at a crucial turning point in its history. If it can put in place the right policies and institutions while growth is still healthy in the near future, the economy could well replicate, even if at a less dizzying pace, the "economic miracle" that propelled China and other Asian economies into middle-to-higher income status, with massive implications for improving the lot of one-sixth of humanity. The consequences are not just confined within India's borders; the rest of the world will also stand to gain from a richer India. It is ultimately up to the Indian people, from Uttar Pradesh to Tamil Nadu, to ensure that this comes to pass.

[29] Subramanian (2019) *India's GDP Mis-estimation: Likelihood, Magnitudes, Mechanisms, and Implications*

The Emerging Markets Forum was created by the Centennial Group as a not-for-profit initiative to bring together high-level government and corporate leaders from around the world to engage in dialogue on the key economic, financial and social issues facing emerging market countries.

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