



GROWTH OF INCOME AND INEQUALITIES IN INDIA

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INTRODUCTION

In the recent past, the best economic performance of the Indian economy was achieved during the year. It is important to note some relevant parameter values during the year because they have been actually achieved by the nation in not too distant past and, therefore, can easily be achieved again. It represents the lower boundaries on the potential existing in the economy. In 2010-11, we came very close to achieving several of those parameter values, which indicates the feasibility and practicality of such a potential existing in the economy at present.

In 2007-08, the Indian economy clocked the growth of 9.3 per cent in real GDP at factor cost, exports growth of 29 per cent in dollar terms, inflation rates of 4.7 per cent (Wholesale Prices) & 6.2 per cent (consumer prices), foreign exchange reserves of \$310 billion equivalent, average exchange rate of Rs. 40.3 per dollar, current account deficit of only 1.3 per cent of GDP, combined fiscal deficit of 4 per cent of GDP, combined revenue deficit of 0.2 per cent of GDP and primary surplus of 0.9 per cent of GDP. Thus, the year 2007-08 was outstanding in all relevant performance parameters except consumer inflation. This was made possible primarily because domestic savings rate and domestic investment rate reached their respective peaks at 36.8 per cent and 38.1 per cent of GDP. The Incremental Capital Output Ratio (ICOR) reflecting the efficiency of converting capital formation into growth of output was around 4.1. The performance of the economy slipped on all these parameters sharply after the year 2007-08. International developments in terms of financial & confidence crisis of 2008, increase in commodity prices including oil prices, Euro zone sovereign debt crisis, etc. led almost all developed economies into severe recession and most of the developing economies to a

significant slowdown. Both fiscal and monetary boosts were provided all over with a significant collaborative effort to emerge out of such a slump. Indian economy could fast recover and emerged out of the slowdown initially in terms of regaining the growth momentum, but failed to reign in the inflation, twin deficits on fiscal & current account, steep depreciation of the currency and loss in foreign exchange reserves. Public sector savings fell sharply from 5 per cent of GDP in 2007-08 to 1.3 per cent in 2011-12. Savings of the private corporate sector also fell from 9.4 per cent of GDP in 2007-08 to 7.2 per cent in 2011-12. As a result, overall savings rate in the economy fell by 6 percentage

points to 30.8 per cent of GDP in 2011-12. Investment rate also fell from 38.1 per cent of GDP in 2007- 08 to 35 per cent in 2011-12 and the growth of real GDP came down to 6.2 per cent in 2011-12. ICOR increased to 5.6 indicating substantial deterioration in the efficiency of capital resources that can occur only if the investments remain under or unutilized. The government's failure to take several decisions of critical importance and urgency to ensure proper utilization of natural resources and capital investments in areas of strategic importance such as infrastructure provision, raw material supplies, taxation, providing environmental clearances, giving timely approvals for projects with huge investments, etc. resulted in sharply reducing capital efficiency and consequently increasing the ICOR in the system. From the economy's potential assessment angle, all these factors are of temporary nature and can get reversed very fast. If the central government starts performing by taking quick decisions and clearing the pending cases of approvals, it may not only provide good incentives for additional investments from the private corporate sector but also lead to improvements in utilization rates of existing projects. All this can result in reducing the ICOR back to the level achieved in 2007-08. Similarly, the central government can reign in the fiscal discipline soon to ensure a rise in the public sector saving back to the level of 2007-08.

Thus, achieving the domestic savings rate of 36.8 per cent in near future is very likely. Then, attaining the investment rate of 38 per cent is also quite feasible. However, the future potential of India is far more attractive, because India is among the few economies currently in the world enjoying the demographic dividend. The proportion of population in the employable age group of 20 years to 65 years is on the rise in the country and is likely to continue rising till about 2027-28 as per the UN projections. Thereafter it may stabilize for a while and then start falling. To attain the current level of the ratio, it may take another 15-20 years because the life expectancy in the country is also likely to rise in the meantime, but the further rise would be

necessarily slower as we achieve higher levels. Since the dependency ratio would be falling in the country till 2027-28, domestic savings rate is most likely to rise further to reach the levels already reached in south-east Asia of 40-42 percent of GDP. If the efficiency of capital resources is maintained with the ICOR staying at 4.1, this in itself would generate an annual growth rate of 10 per cent of real GDP. This is purely domestically funded growth potential. We expect that such a high growth momentum is most likely to attract huge foreign investment in search of better returns and dynamic markets. Similarly our companies would reach out to foreign destinations to expand their markets. If we assume a net inflow of only 2 per cent points, it would push our annual growth potential upward to 10.5 per cent over a fairly long period unto 2050. Population growth rate is likely to slow down considerably and would be about annual 1 per cent on average. Then the per capita real GDP is likely to grow at around 9 per cent annually.

Increase in Income

Income per capita has been increasing steadily in almost every country. Many factors contribute to people having a higher income such as education, globalisation and favorable political circumstances such as economic freedom and peace. Increase in income also tends to lead to people choosing to work less hours. Developed countries (defined as countries with a “developed economy”) have higher incomes as opposed to developing countries tending to have lower incomes.

In economics, “factor income” is the return accruing for a person, or a nation, derived from the “factors of production”: rental income, wages generated by labor, the interest created by capital, and profits from entrepreneurial ventures.¹⁵¹

From labor services, as well as ownership of land and capital.^(Citation needed)

In consumer theory 'income' is another name for the “budget constraint,” an amount Y to be spent on different goods x and y in quantities x and y at prices P_x and P_y . The basic equation for this is

$$Y = P_x \cdot x + P_y \cdot y$$

This equation implies two things. First buying one more unit of good x implies buying P_x/P_y less units of good y . So, P_x/P_y is the *relative* price of a unit of x as to the number of units given up in y . Second, if the price of x falls for a fixed Y , then its relative price falls. The usual hypothesis is that the quantity demanded of x would increase at the lower price, the law of

demand. The generalization to more than two goods consists of modelling y as a composite good.

The theoretical generalization to more than one period is a multi-period wealth and income constraint. For example, the same person can gain more productive skills or acquire more productive income-earning assets to earn a higher income. In the multi-period case, something might also happen to the economy beyond the control of the individual to reduce (or increase) the flow of income. Changing measured income and its relation to consumption over time might be modeled accordingly, such as in the permanent income hypothesis.

Defining Social Capital

Economists have traditionally focused on natural capital, physical capital and human capital as key determinants of economic growth and a vast body of theoretical and empirical literature in growth economics has examined these relationships. But the focus on these three types of capital often overlooks a critical aspect in the process of economic growth in that they do not explain how economic actors interact. More recently, it has been suggested by some economists and political scientists that the missing link in the growth process is 'social capital'. But what exactly is social capital

Social capital, in essence, is the institutions, relationships, attitudes and values governing interactions amongst people and contributing to economic and social development. It has been defined as 'the net works, norms, relationships, values and informal sanctions that shape the quantity and co-operative quality of a society's social interactions' Defined this way, social capital includes shared values and rules for social conduct including trust and civic responsibility. Its increasing prominence in economics discourse parallels the rise of the 'informal institutions' literature in related fields such as development economics. Social capital may also be important in that it influences the social and political environment that in turn shapes norms such as those with respect to government, the rule of law, and civil and political liberties.

Concepts of Income Inequality

Income Equality: Measures the distribution of income across households or individuals in an economy. This is usually measured using the Gini Coefficient of Inequality ranging from zero to 1. 0 indicates complete equality and 1 indicates complete inequality. Two conceptions of inequality:

Household Income Distribution: This is the distribution of income across households within the economy. It can be further decomposed into:

- a) Primary Income Distribution: The distribution of the household incomes consisting of the different factor incomes in each household **before** taxes and subsidies, as determined by markets and market institutions
- b) Secondary Income Distribution: The distribution of household incomes **after** deduction of taxes and inclusion of transfer payments
- c) Tertiary Income Distribution: The distribution of household incomes when imputed benefits from **public expenditure** are added to household incomes **after** taxes and subsidies. **Functional Income Distribution:** This is the distribution of income between different factors of production such as land, labour and capital. It is typically measured as the share of wages or profits in national income.

“Inequality in India has grown faster in the last 10-12 years than any other time in our history since the colonial era/,” P Sainath, senior journalist and Rural Affairs Editor at *The Hindu*, says. The evidence is especially stark in such areas as health. In 2003, a national newspaper reported the deaths due to malnutrition-related causes, of over 9,000 children below the age of 6. This was in 15 largely adivasi-populated districts of Maharashtra, just a few kilometres from super-specialty private hospitals in Mumbai.

All over the country people are dying of diseases that should not kill them. For instance, 199 per 1,00,000 people in India still die of tuberculosis every year (UNDP). And it is not specialised care they need, but basic preventive care. “Specialised care is highly overrated. It is possible to care intensively without Intensive Care Units,” Dr Subhash Daga, head of the paediatric ward at Cama & Alkesh Hospital, Mumbai, says. With low-cost technology and standardised protocols of treatment interventions, Dr Daga has nursed around 450 malnourished and anaemic children back to health in the last four years. This health turnaround costs the exchequer Rs 250 per child for 15 days of treatment. Dr Daga believes it is possible to replicate such low-cost treatment of diseases in rural areas.

Instead, the Government of India reduced its expenditure on the children's nutrition programme from Rs 79.2 million to Rs 77.7 million in the 2003 budget (Ramachandran, P. 'Unhealthy Policy', *Frontline*, March 15, 2002). Government expenditure on health as a

percentage of Gross Domestic Product (GDP) declined from 1.3 in 1990, to 0.6% in 2002. This is well below the 5% of GDP recommended by the World Health Organisation. While the budgetary allocation in the health sector by the central government over the last decade has been stagnant, in the states it has declined from 7% to 5.5% (Draft National Health Policy, 2001).

The *Human Development Report 2002* (UNDP), drawing on data collected from 1995-2000 states that in India less than 50% of the population has access to essential drugs, only 31 % has adequate sanitation facilities, 47% of children below the age of 5 are underweight, and only 42% of births are attended to by skilled health staff. In short, public health care expenditure does not match peoples' health demands.

According to other recent estimates, there are only 4.48 hospitals, 6.16 dispensaries and 308 beds for every 100,000 of India's urban population. In rural areas, the situation is worse, with 0.77 hospitals, 1.37 dispensaries, 3.2 Public Health Centres and just 44 beds for every 100,000 people. In 1997, an estimated 68% of the hospitals, 56% of dispensaries, 37% beds and 75% of allopathic doctors were in the private sector (Ravi Duggal, 2002; 'Right to Health' (Mimeo), CEHAT, Mumbai).

The push for increased participation of private sector entities in health care services is evident, for example, in Andhra Pradesh. The state government in recent years has boosted the private sector in health, promoted corporate hospitals and pioneered the 'user-fee' system in government hospitals. This systematic dismantling of the public health system has turned poor people to private hospitals at significantly higher cost.

Dr Padma Prakash, women's rights and health activist, says, "People are forced to go to private hospitals because there are no beds available in public ones." She berates the lack of preventive care for undernourished and overworked people and the decreasing focus on preventive health care.

Relevance to the Inequality

Income inequality can be analyzed along two dimensions - household income distribution and functional income distribution. While the former studies the distribution of income across households within the economy, the latter studies the distribution of income between different factors of production such as land, labour and capital. The Gini coefficient - the most commonly used measure of income inequality- captures personal (household) inequalities, usually based on secondary income distribution (post taxes and transfer payments). Yet, it is clear that even from

the limited perspective of household incomes, it is the tertiary income distributions that are more relevant to developing countries like India. More importantly, measures of personal inequality fail to capture the manner in which such incomes are generated in the production process, and the resulting functional inequality.

Daudia and Garcia Penalosa (2007), for instance, have proved that personal income distribution is dependent on factor income distribution and the relationship is statistically significant. Thus, an increase in the share of labour will result in a lower Gini Index of personal incomes. Other compelling arguments to understand functional income distributions have rested on the notion of understanding the micro foundations of macro-level national income accounts data, social justice and fairness considerations, as also to provide a better understanding of inequalities in personal income distribution.

Table 1
Per Cent of House Hold Drawing Income from various sources

Cultivation	Wage Work	Business	Other	Rural	Urbant	Total	Medion Income
✓	✓	✓	✓	1, 14	0. 26	0. 89	35, 755
✓	✓	✓		2. 78	0. 61	2. 16	32, 938
✓	✓		✓	8. 69	1. 12	6. 52	25, 507
✓	✓			23. 55	3. 83	17. 89	23, 536
✓		✓	✓	1.4 0	51 1	15	54, 850
✓		✓		3. 9	1. 28	3. 15	36, 000
✓			✓	5. 48	0. 56	4. 07	31, 265
✓				11. 27	1.03	8. 33	20, 964
	✓	✓	✓	0.81	1. 61	1.04	47, 400
	✓	✓		2. 43	5. 98	3. 45	40, 900
	✓		✓	6. 33	12. 1	7. 98	33,600 .
	✓			24. 23	48. 46	31. 18	27, 000
✓		✓	✓	0. 99	3. 71	1. 77	52, 000
		✓		3. 39	14. 1	6. 47	40, 000
				1.98	4. 15	2.6	18, 000
Negative or no income				1. 61	0. 69	1.35	-985
Grand Total				100	100	100	

Notes: Wage work includes agricultural and non-agricultural wage, and salaried work. Other sources include pensions, family transfers, and income from governmental programmes.

Source: IHDS (2010), p. 17

Inequalities in India

Inequalities in India have been measured using Gini coefficients for per capita consumption expenditure at the all-India, as well as state-level (Table 1). The data for 1973-74 to 2009-10 indicates that there hasn't been much decrease in inequality in terms of consumption expenditure. However, even this has to be interpreted with caution, since consumption inequalities usually underestimate the extent of inequalities. It is household income (rather than consumption) inequalities, which could provide better indicators of the extent of inequality. The India Human Development Survey (IHDS), 2010 has estimated income distribution across households in India. The results, not surprisingly, demonstrate a greater income inequality than that captured by Gini coefficients of consumption. Thus, the Gini index for consumption inequality is about 0.38 for India, while the Gini Index based on income is about 0.52. The

Global and Domestic Drivers of Factor Inequalities

The drivers of factor inequalities can be characterized broadly into two categories- exogenous (attributed to globalization) and endogenous (resulting from domestic policies). The degrees of trade openness, financial market liberalization (capital openness) and technical change have been identified as the broad exogenous drivers of factor inequalities. Additionally, monetary, exchange rate and fiscal policies act as the endogenous drivers of such inequalities through affecting growth, investment and employment adversely (UNDP, 2013). We use the export + import (trade) figures as a percentage of real GDP as a measure of Trade openness. Financial liberalization is measured through the volume of net portfolio flows into India, while Technical change is measured through the capital-labour (K/L) ratios. Figure 1 depicts the relationship between trade openness and labour shares, while Figure 2 depicts the relationship between financial openness and labour shares. As seen, while India became more open to both trade and capital flows, labour shares deteriorated. Next, we needed to derive an estimate of technical change. We used the approach used by Feenstra et al. (2013) (quoted in Inklaar&Timmer, 2013) to estimate labour input as the product of the number of workers in the economy 'E' times their average human capital 'he'. The resultant 'L' captures the trends in labour inputs used in the standard Cobb-Douglas production function. We combined this L with 'K' -the capital input in order to calculate the capital/ labour ratio in the Indian economy. The results in Table 3 indicate that the capital labour ratio in India has risen by about 2.37 times since 1991. At the same time, the share of labour compensation in GDP (at current national prices) has actually

diminished from 0.65 to 0.485. Table 3 also depicts the rise in Total Factor Productivity at constant national prices from 0.77 to 1.07 (base 2005 = 1). We can infer thus, that much of the gains in total factor productivity would have accrued to the owners of capital rather than labour. Thus, as India became increasingly integrated with the rest of the world, in terms of flow of goods, services and capital, as also benefitted from technical innovations, the impact on relative labour shares seemed to deteriorate in the period 1991-2011. Even so, the available data fails to point out the relative inequalities among skilled and unskilled wage labour - intra-factor inequalities - in the Indian context. The broad trends seem to match global experience pertaining to the impact of openness and technical change on labour shares. In fact, as the Trade and Development Report (UNCTAD) 2013 demonstrates, while labour income shares as a percentage of GDP fell almost globally over the period 1995-2013, India fared lowest among its regional peers in this regard. Such low and declining labour income shares have had an impact on private consumption expenditure and through it, on the India growth story.

How do domestic factors affect factor income inequalities? A shift in emphasis took place post 1980s in the aftermath of the debt crises, from Keynesian macro-stability towards greater fiscal balance and price stability. Such a shift in emphasis has proved to be the new driver for growing inequalities. Thus, contractionary monetary policies, with their adverse impact on interest rates, investment and growth, led to the surge in unemployment. Financial liberalization had an impact on the Real Effective Exchange Rate (REER), which surged, leading to greater imports, thereby affecting domestic production and employment adversely. Similarly, fiscal balance was sought to be achieved through expenditure cuts on items such as infrastructure, as also education and health, all of which affected the income earning potential of the poor and opportunities for social mobility (UNDP, 2013). Thus, national policies that seek to achieve price stability and fiscal balance may have the unintended consequence of reducing labour shares in GDP. India, especially in the aftermath of the global financial crisis post 2010, has pursued tight monetary and fiscal policies aimed at consolidation. Such policies have had a limited (if at all) impact on achieving their stated goals, viz. maintaining price stability and reducing fiscal deficits. These have however, been at the cost of growth and employment, reflected in the growing factor inequalities in the form of declining labour shares. However, such national policies should aim precisely to counter the effects of external shocks, which act as the global drivers of factor inequalities.

Policy Implications

It is time to examine the vexatious issue of inequalities through a different lens-view, namely of labour compensation and labour shares in national income. Policy considerations should focus on the tricky question of how to handle such inequalities and the government's role in the same. Government regulations to protect the share of labour, as in India's antiquated labour laws, would not work, leading either to greater unemployment (in the form of more contractual labour) or increased automation. A system of progressive taxation of capital would not work as well, leading only to greater tax evasion. On the one hand, we prescribe social nudges by the government in the form of tax breaks / rebates for firms which use variants of profit-sharing wage arrangements. These would not only help in reducing inequality, but also ensure better macroeconomic outcomes through generating regular private consumption and maintaining aggregate demand. On the other hand, government macro policies may need to shift attention from growth and inflation towards employment and skill generation to mitigate the deleterious impact of globalization (especially financial globalization) and technical change on relative factor shares. Cash transfers, especially targeted at the rural wage earners may help in reducing the functional inequalities in India. To sum up, a combination of measures aimed at reducing functional rather than personal inequalities may have a longer term impact on reducing inequalities.

Conclusion

This is a mind-boggling scenario where the per capita real income would be doubling every 8 years. The availability of goods and services would be increasing at an unprecedented rate and so would be the consumption of people. With such a high speed of expansion in the consumption basket, the consumption pattern would be changing drastically and rapidly. The basket would be highly diversified and ever changing. Rate of product obsolescence and depreciation would be very high. Preserving goods would not be found viable and feasible. Recycling of products and resources could become a formal business but affording it within the household could be almost ruled out. Service sector, entertainment, information, communication, research and development are the fields most likely to come to prominence. In short, the first fifty years of the current century are likely to be quite opposite to the first fifty years of the last century in India.

In such a dynamic and fast pace of economic growth, entrepreneurship and diversity of consumption would require considerable resources devoted to research and development. This would require qualitatively a much superior human resource development strategy. For a business enterprise, to survive and maintain one's relative position, rapid growth in labour productivity, technological improvements and emphasis on exclusive products would be the key. Emphasis and reliance on the private sector participation is likely to address most of these concerns as a part of their self-interest.

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