

Economic Survey of India, 2007

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Introduction

Since the mid-1980s successive reforms have progressively moved the Indian economy towards a market-based system. State intervention and control over economic activity has been reduced significantly and the role of private-sector entrepreneurship increased. To varying degrees, liberalisation has touched on most aspects of economic policy including industrial policy, fiscal policy, financial market regulation, and trade and foreign investment.

Overall, reform has had a major beneficial impact on the economy

Annual growth in GDP per capita has accelerated from just 1¼ per cent in the three decades after Independence to 7½ per cent currently, a rate of growth that will double average income in a decade. Potential output growth is currently estimated to be 8½ per cent annually and India is now the third largest economy in the world. Increased economic growth has helped reduce poverty, which has begun to fall in absolute terms.

Liberalised areas have grown rapidly

In service sectors where government regulation has been eased significantly or is less burdensome – such as communications, insurance, asset management and information technology – output has grown rapidly, with exports of information technology enabled services particularly strong. In those infrastructure sectors which have been opened to competition, such as telecoms and civil aviation, the private sector has proven to be extremely effective and growth has been phenomenal. At the state level, economic performance is much better in states with a relatively liberal regulatory environment than in the relatively more restrictive states.

This policy brief presents the assessment and recommendations of the 2007 OECD Economic Survey of India. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, held a special seminar to discuss this survey with the participation of the Indian government. The starting point for the Survey was a draft prepared by the Economics Department of the OECD which was then modified following the discussions in the seminar, and issued under the responsibility of the Secretary-General.

Further reforms are needed in a number of areas

In labour markets, employment growth has been concentrated in firms that operate in sectors not covered by India’s highly restrictive labour laws. In the formal sector, where these labour laws apply, employment has been falling and firms are becoming more capital intensive despite abundant low-cost labour. Labour market reform is essential to achieve a broader-based development and provide sufficient and higher productivity jobs for the growing labour force. In product markets, inefficient government procedures, particularly in some of the states, acts as a barrier to entrepreneurship and need to be improved. Public companies are generally less productive than private firms and the privatisation programme should be revitalised. A number of barriers to competition in financial markets and some of the infrastructure sectors, which are other constraints on growth, also need to be addressed. The indirect tax system needs to be simplified to create a true national market, while for direct taxes, the taxable base should be broadened and rates lowered. Public expenditure should be re-oriented towards infrastructure investment by reducing subsidies. Furthermore, social policies should be improved to better reach the poor and – given the importance of human capital – the education system also needs to be made more efficient.

Reform must continue if government is to achieve its growth targets

The Government’s target of reaching GDP growth of 10% in 2011 is achievable if reforms continue. In addition, if the relatively restrictive states improve their regulatory frameworks towards that of the better-run states, growth will be more inclusive and income gaps across states will narrow. The impressive response of the Indian economy to past reforms should give policymakers confidence that further liberalisation will deliver additional growth dividends and foster the process of pulling millions of people out of poverty. ■

Figure 1.
GROWTH OF POTENTIAL INDIAN GDP PER CAPITA OVER THE LONGER TERM
 % per annum



Source: OECD estimates.

Why has recent growth been so rapid?

Over the past two decades, India has moved away from its former *dirigiste* model and become a market-based economy. This process started in the mid-1980s and gathered substantial momentum at the beginning of the 1990s. Direct tax rates were significantly reduced, pervasive government licensing of industrial activity was almost eliminated, and restrictions on investment by large companies were eased. Furthermore, financial markets were reformed, with banks restored to health, entry barriers lowered, equity markets transformed and new supervisory bodies introduced. The process of reform has continued in this decade with a further opening of the economy to competition. The number of industries reserved for very small firms has been significantly reduced, and foreign suppliers have been encouraged to enter the market by a progressive lowering of tariffs to an average of 10% in 2007. The rules governing foreign direct investment have been markedly eased, notably in the manufacturing sector. Last but not least, fiscal discipline has been improved by the passage of fiscal responsibility laws for the central government and all but three of the 28 state governments.

These reforms have had a major beneficial impact on the economy. By 2006, the average share of imports and exports in GDP had risen to 24%, up from 6% in 1985. Inflows of foreign direct investment increased to 2% of GDP from less than 0.1% of GDP in 1990, with outflows of foreign direct investment picking up substantially at the end of 2006. The combined fiscal deficit of central and state governments has been reduced from 10% of GDP in 2002 to just over 6% of GDP by 2006, with the ratio of debt to GDP falling from 82% in 2004 to 75% by March 2007. There has been a massive increase in output, with the potential growth rate of the economy estimated to be around 8½ per cent per year in 2006. GDP per capita is now rising by 7½ per cent annually, a rate that leads to its doubling in a decade. This contrasts to annual growth of GDP per capita of just 1¼ per cent in the three decades from 1950 to 1980. Faster growth has resulted in India becoming the third largest economy in the world (after the United States and China and just ahead of Japan) in 2006, when measured at purchasing power parities, accounting for nearly 7% of world GDP. Moreover, with increased openness and rapid growth in exports of merchandise and IT-related services, its share in world trade in goods and services had risen to slightly over one per cent in 2005, when measured at market exchange rates.

The current expansion, which started in 2003, has not led to an imbalance between supply and demand, despite annual GDP growth reaching 9% in 2006. The non-agricultural GDP deflator, a broad measure of prices, has shown little tendency to accelerate and increased by less than 5% year on year in 2006. Some measures of inflation have moved above the authorities' goal of keeping the annual inflation rate in the range of 5-5½ per cent, reflecting sharp increases for food in other commodity prices. However, the monetary authorities are acting to ensure that such increases do not become entrenched and announced, in April 2007, that monetary policy will aim at achieving an inflation rate of 4-4½ per cent per year over the medium term. In this respect, they are being helped by the appreciation of the currency. The current account balance has moved into a deficit, but only similar in relation to GDP to that of the second half of the 1990s and, moreover, is being financed by foreign direct investment. Such a benign outcome has been helped by increased domestic saving including the recent fiscal consolidation. ■

What reforms are needed to raise growth and lower poverty?

The fiscal reforms enacted in 2004 have permitted a significant reduction in the extent to which the government pre-empted national savings to finance consumption. The fiscal deficit, which has been reduced substantially, is on track to meet the legislated target of a combined central and state government fiscal deficit of 6% of GDP by fiscal year 2008. Already, the reduction in government dis-saving contributed almost half of the increase in the net national saving rate between 2001 and 2005, which has now reached almost 22% of GDP, with the gross saving rate being some ten percentage points higher at 32%. Faster economic growth will require that a greater share of output be devoted to investment for both business expansion and infrastructure. This implies the need to raise savings further by continuing the fiscal consolidation strategy. At the same time, it is necessary to improve the quality of spending.

Increased growth since the mid-1980s has helped to substantially reduce the national poverty rate to 22% of the population in 2004, with the speed of poverty reduction appearing to increase between 1999 and 2004. Moreover, in this period, the absolute number of people living below the poverty line fell for the first time since independence. To meet one of its Millennium Development Goals, of halving poverty by 2015, the government is aiming to achieve an even higher medium-term economic annual growth rate of 10%. With additional structural reforms, this goal is achievable. In addition, growth needs to become more inclusive by increasing the prosperity of poorer states, whose economies have expanded at a slower pace than those of the richer states in the past decade, and so reducing their difficulties in lowering poverty. The analysis of this report suggests that the differences in economic performance across states are associated with the extent to which states have introduced market-oriented reforms. Thus, further reforms on these lines, complemented with measures to improve infrastructure, education and basic services, would increase the potential for growth outside of agriculture and thus boost better-paid employment, which is a key to sharing the fruits of growth and lowering poverty. ■

Which markets need further reform?

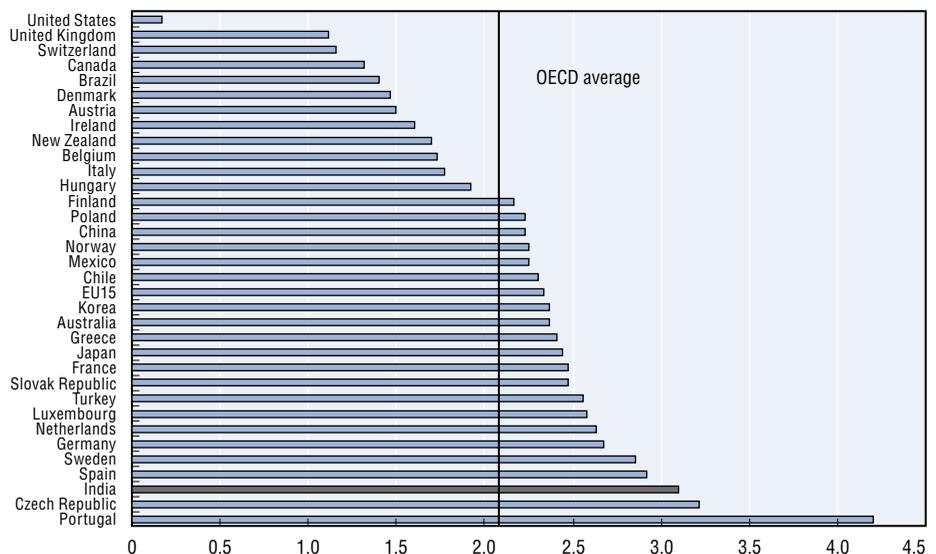
The next round of reforms needs to focus on a number of key areas that have the potential to further boost economic growth, while ensuring that the expansion becomes more inclusive. Recent reforms have made a number of sectors of the economy more dynamic, especially in the service sector. However, there are still a number of barriers to growth in product, labour and financial markets, and the provision of infrastructure, where reform is needed both at the central and state levels. While the optimal policy would be to remove these bottlenecks across the country, the creation of Special Economic Zones that aim to reduce a number of these barriers locally might demonstrate the benefits of such reforms and so act as a catalyst for more generalised change, but care needs to be taken as to the extent of tax concessions that are granted. Furthermore, taxation policies need to be reformed in order to create a truly national market and improve incentives and release resources for reducing bottlenecks in infrastructure, which are a key constraint on growth. In addition, education needs to be delivered more efficiently so as to improve human capital formation. There are undoubtedly further challenges facing the economy, but this report focuses on these areas which are the key to boosting growth further.

Are labour market reforms needed?

Economic growth could be made more inclusive by achieving faster growth in regular employment, as opposed to casual and self-employment. Although regular employment has risen, it still represents only 15% of total employment and its growth has been almost exclusively in the smaller, least productive enterprises. Employment in firms with more than ten employees accounts for only around 3¼ per cent of total employment (one-quarter of regular employment) and has been falling. Indeed, India has a much smaller proportion of employment in enterprises with ten or more employees than any OECD country. The number of workers has also fallen in the manufacturing sector where the share of labour income in value-added is low compared to other countries and capital-intensity is relatively high. Such developments indicate that India is not fully exploiting its comparative advantage as a labour-abundant economy.

The level of employment protection needs to be reformed in order to increase employment, particularly in larger companies, which are the only ones covered by this legislation, and to remove barriers which hinder firms from exploiting economies of scale. New indicators presented in this Survey show that laws governing regular employment contracts in India are stricter than those in Brazil, Chile, China and all but two OECD countries. A major, but by no means the only, reason for this stringency is the requirement to obtain government permission to lay off just one worker from manufacturing plants with more than 100 workers (but not from establishments in the service sector). On the other hand, the extent of protection for people working on temporary or fixed-term contracts and for smaller firms, all areas where regular employment is increasing, is similar to the OECD average. Moreover, indicators of labour regulations at the state level suggest that states that have introduced reforms have more fluid labour markets. Some reduction in the stringency of employment protection laws is needed and could be balanced by an increase in the extent of accrual-based severance payments. At the

Figure 2.
AN INTERNATIONAL COMPARISON OF EMPLOYMENT PROTECTION LEGISLATION
Regular employment (restrictions on indefinite contracts)



Source: India: OECD computation; OECD (2007), *Going for Growth*; OECD (2006b), *Economic Survey of Brazil*; China: OECD estimate.

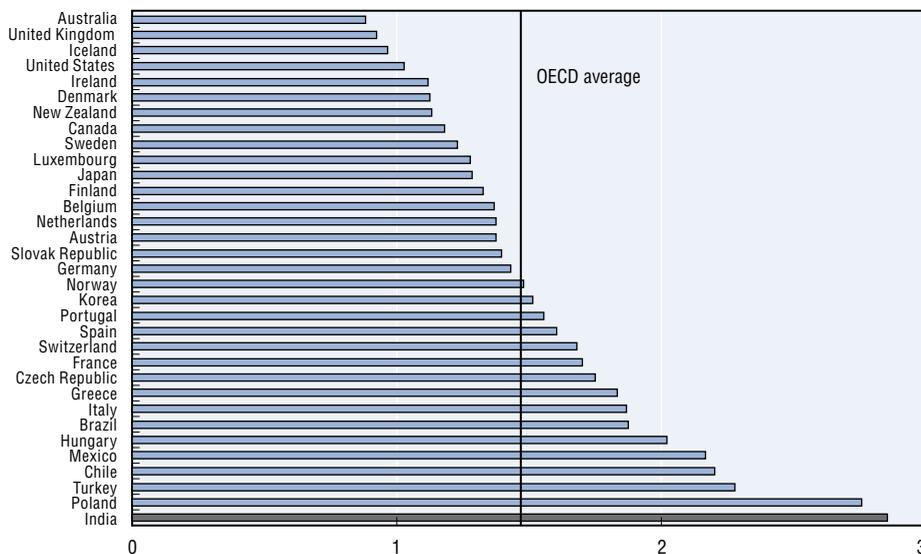
same time, a consolidation of the 46 central and around 200 state labour laws should be considered. These reforms would remove an important barrier to the expansion of smaller companies and would increase employment, productivity, real wages and the number of social benefit recipients, as well as facilitating the movement of labour out of agriculture to more productive areas.

How should competitive forces be strengthened?

Improving the business environment is essential for boosting the growth potential of the economy. Excessive regulation of markets is a barrier to the diffusion of technology and lowers the speed with which labour productivity catches up to the level of the best performing economies. According to new indicators presented in this Survey, there are a number of areas where reforms have already lowered regulatory barriers to international best practice. Nonetheless, overall, regulation is more restrictive than in Brazil, Chile and all OECD countries. Moreover, there are wide differences in the extent of regulation across states, which affect their respective economic performance.

There are a number of areas where barriers to competition need to be reduced. Innovation and responsiveness to changing market demands require the ability to create new firms quickly. All levels of government should lower the barriers to entrepreneurship by re-engineering procedures to reduce administrative burdens on new and existing firms and reduce the extent of inspections, as well as the number of returns. A specific unit should be charged with undertaking regulatory impact analyses of existing and proposed laws. Reservation of specific product areas for small-scale enterprises should be ended in line with the government’s timetable. It is important to ensure that there is a competitive environment for existing firms to operate in, including in those manufacturing industries which are still highly concentrated. There is an urgent need for the new Competition Commission to become a fully functioning agency capable of enforcing the competition law introduced in 2003. Finally, it is also a difficult and lengthy process to restructure or close insolvent or bankrupt companies. A modern bankruptcy law is needed which should also reduce the role of the courts.

Figure 3.
PRODUCT MARKET REGULATIONS: AN INTERNATIONAL COMPARISON
 The indicator score runs from 0-6, representing the least to most restrictive



Source: OECD calculations.

Competition can also be increased through a further opening to the world economy. Recent tariff cuts need to be continued and to go beyond the government's target of alignment with average ASEAN tariffs by 2010. The dispersion of tariffs rates is also high in India, a relic of past activist industrial policies. Reducing the dispersion of tariff rates (or, in the end, moving to one uniform tariff rate) would further increase efficiency. Barriers to foreign direct investment (FDI) have been lowered in the manufacturing sector, which has led to a marked increase in investment inflows. But restrictions still exist in a number of service areas and reducing these would benefit the Indian economy. For example, removing the cap on FDI in the insurance sector would allow a welcome expansion of the industries capital base. Lifting the ban on FDI in retail trading would help to improve productivity, supply chain management, reduce the exceptionally high rate of waste of agricultural produce and so lower retail prices and raise producer prices.

Should more enterprises be privatised?

Public-sector ownership in industry is still extensive in India. In the so-called organised sector of the economy, state-owned enterprises produce 38% of business-sector value-added. There is a large tail of loss-making public enterprises, particularly at the state level and, on average, the productivity and profitability of publicly-owned firms have been lower than in the private sector. Privatisation would thus appear to offer considerable possibilities for improving productivity. However, the privatisation programme has stalled and, in any case, has involved mainly selling minority stakes, rather than transferring control. Government firms represent a small share of output in manufacturing, construction and non-financial services. Given the potentially competitive nature of these industries, government ownership should be reduced. Privatising firms in sectors where the government share of output is larger (banking, insurance, coal and electricity) would also be desirable but may need to be phased in (see below). In the meantime, public companies should be controlled by a government investment agency, rather than by a sponsoring ministry, so as to separate the ownership and policy-making functions.

How should the financial sector be changed?

The financial sector has one of the highest shares of public ownership in the economy and needs to be liberalised further. Successful reforms have already restored the health of the public banks, most of which now have minority private shareholders, and have created new regulators. The functions of the Reserve Bank of India (RBI) as the owner of some public banks and manager of government debt are being reduced but, consideration should be also given to whether the supervision of the banking sector should remain inside the RBI. Despite progressive deregulation, banks can still allocate only 41% of their assets completely freely, notwithstanding long-standing recommendations by government committees that this ratio should be increased. Private-sector services (and new banks in particular) have been successful in India and so progressive privatisation of the public banks would most likely improve the efficiency of the sector, especially if they were given greater freedom to allocate assets and restrictions on foreign direct investment in the sector were removed. As capital would be better allocated, the efficiency of the whole economy would be improved. Equity markets have been transformed as the result of private-sector initiative and new regulatory agencies, and have become competitive with leading world markets. However,

a much broader range of exchange-traded derivative instruments needs to be allowed in order to improve the market for bonds. In this regard, opening markets to all participants would help. A more principle-based approach to capital market regulation might help speed up the introduction of new instruments and, as in product markets, supervisory bodies should be subject to periodic regulatory impact reviews. ■

Can infrastructure bottlenecks be lessened?

In some of the former fully government-owned infrastructure sectors, such as telecommunications and domestic civil aviation, the opening to the private sector has produced exemplary results. In both sectors, new private entrants now have market shares of over three-quarters. Since the easing of regulatory constraints in 2004, the telecommunications network has become the third largest in the world. In both sectors, choice has expanded and prices have fallen. Even so, more needs to be done to promote competition in the fixed-line market, given the possibilities offered by broadband technology.

Electricity is one sector where public enterprises are still dominant and demand consistently outstrips supply, representing a major constraint on growth, particularly in electricity-intensive sectors such as manufacturing. On the basis of current plans, electricity generating capacity will rise by 6% annually over the period 2007 to 2012, double the rate of the past five years and the second largest absolute increase in capacity in the world. However, this is still well below the likely growth rate of GDP. The under-investment in this sector is caused by low profitability. In 2000, as much as 40% of electricity was not paid for due to poor management of distribution enterprises and a failure to eradicate theft. Revenues were further limited by a legacy of political constraints on pricing policy at the state level, such as extensive cross-subsidisation in favour of farmers and households at the cost of industrial and commercial firms. In 2003, the government introduced a new policy framework that addresses distribution problems, mandates a more competitive electricity market with more private-sector involvement and progressively lowers the extent of cross-subsidies. In addition, there is a programme that gives financial incentives to states that meet specific milestones in the reform process. In states where implementation of the new framework is more advanced, some progress has been made, but still only a few areas have an uninterrupted electricity supply. Overall, there has been only a modest increase in the proportion of electricity that is paid for since the programme started. The government should encourage speedier implementation of reforms, consider reducing transfers to states that do not advance sufficiently rapidly and rewarding those that find ways to reduce losses, and increase private participation in the sector to a greater extent than in existing electricity reform programmes. The development of the electricity sector is also influenced by the coal sector, which is controlled by two public enterprises whose output is allocated to users by an inter-ministerial committee, with prices set on cost-plus basis. The government should auction coal mining concessions to the private sector and allow coal to be allocated by the market mechanism.

A significant start has been made in involving the private sector in the provision of transport infrastructure. By end-2006, the outstanding value of public-private partnerships (PPPs) had risen to an amount equivalent to 3½ per cent of GDP, with most contracts having been awarded in the previous two years. The government encourages private involvement in

the construction and operation of ports and airports. Here there is a need to change the tariff-setting process in a way that encourages productivity improvements, moving away from a cost-plus basis system of price determination. Private involvement in the road sector is increasing, enabling a marked improvement in the quality of the national network; this will include an 18 000 kilometre-long national network of tolled dual-carriageway roads by end-2009. States are also improving their networks. The government has introduced model PPP concessions, which are awarded on the basis of competitive bids for subsidies, or payments if the concession is estimated to be commercially viable. Early experience with private involvement in these areas is generally positive, but outcomes under contracts need careful monitoring. A significant implementation problem has been the need to obtain cabinet approval for road contracts that are sufficiently large to attract private-sector interest. Greater authority should be delegated to the Highways Authority to speed up the process. ■

Do public finances need change?

Despite increased use of PPPs in infrastructure provision, greater government investment outlays are needed and could be funded by a re-organisation of public spending. At the same time, there is a need to reduce outlays on subsidies, which are much higher than in a number of emerging economies (such as Brazil and China). Moreover, electricity, food and petroleum subsidies do not reach the poorest groups in society because of poor administration and corruption. Indeed, the government estimates that to transfer one rupee to the poor by way of food and fuel subsidies it is necessary to spend almost four rupees. The government should reduce outlays on subsidies by better targeting them to reach poor people, as well as lowering support to companies, including loss-making public enterprises. In this way more funds could be made available for much needed infrastructure investment.

Reform of direct taxation also has the potential to further improve growth. Despite large cuts in direct tax rates, which have strengthened the economy, the share of direct tax revenues in GDP has risen. Nonetheless, the tax system still bears some traces of past interventionism, through extensive loopholes and exemptions which introduce distortions and complexity, facilitating tax evasion. They are most noticeable in the areas of saving, agriculture and corporate taxation. The treatment of some forms of savings is so favourable that they are often exempted from taxation at the time of initial savings, during the period when invested funds earn returns, and finally when investments are liquidated – a level of generosity that has rarely been found in the OECD area. Agricultural incomes are not subject to income tax and numerous exemptions exist in the corporate tax system. Indeed, these are so prevalent that corporate tax collections are only half of the theoretical yield. The government should consider reducing exemptions and loopholes in all these areas, creating room for cuts in statutory rates, thereby moving towards equalisation of effective tax rates across sectors and activities.

Significant reform of indirect taxation has also been undertaken, including the introduction of a destination-based, state-level VAT on goods in 2005. However, as taxes still represent a barrier to trade between states, further reform is needed to achieve a true internal market for goods and services. At present, there are a series of indirect taxes at the central and state levels that need to be integrated into a single tax that is neutral, both as to the sector and location of production, and minimises the possibilities for fraud.

At present, the major barrier to inter-state trade is the Central Sales Tax and this is being phased out. When this process is completed, controls could be abolished on nearly all state borders as they would not be needed for this purpose. The government is committed to the introduction of a nation-wide goods and services tax by 2010 that would meet these objectives, but its final form has yet to be determined. Experience with VAT systems in Europe shows that careful design is necessary to simultaneously reduce trade barriers and contain fraud. The government should consider two options: either, moving to a national VAT with central revenue collection and redistribution of the tax yield to the states through a formula, or, introducing a two-tier system that would allow both a central VAT and a state VAT. The first option would not exempt interstate exports while the second option would for the state VAT (as is currently the case) but not for the federal VAT. Such a system would maintain the audit chain in interstate trade (through the federal VAT), thereby facilitating tax enforcement. With this option states could retain a degree of fiscal sovereignty and could also set different tax rates. The second option would require close co-operation between state fiscal authorities to limit fraud. However, if this system were to also include a central rebatable VAT surcharge on cross-border trade, then fraud could be minimised.

In a country as large and diverse as India, a good system of revenue sharing across the country is essential. Without it, differences in government spending across states would be extremely large. Amongst the 20 largest states, incomes in the three richest states are three and a half times higher than in the three poorest states, which have a combined population of over 300 million people. Although the system of tax-sharing and inter-governmental transfers markedly reduces spending inequalities, it has become very complex and involves a degree of central control over state investment outlays that may be excessive. The government should simplify the transfer system, improve its administration and make it more transparent. It should further increase incentives towards fiscal discipline, in particular by replacing the obligation for states to borrow from the National Small Saving Fund, and thereby increasing their use of the capital market.

A major drawback of India's fiscal federalism is that the local level of government remains underdeveloped. This is a particularly important inefficiency in a country where three-quarters of the population lives in states with over 50 million inhabitants. Local authorities raise little tax revenue themselves and their autonomy to set rates is very limited. Key local activities have been retained in state-run boards and authorities, which have been generally inefficient in meeting the rising demand for local services. Such shortfalls hit the poorer parts of the population particularly hard and contribute to the relatively low rate of urbanisation in India, which restrains gains from agglomeration economies. Improving local public service provision is essential and requires an increase in the revenue base of local bodies, increasing tax-sharing with state governments and raising their autonomy, accountability and administrative abilities. ■

How can the education system be improved?

There is an urgent need to improve education in India. Public expenditure on primary and secondary education is somewhat lower than in other emerging economies, but substantial private outlays result in overall spending being similar to that in developed OECD countries. Nonetheless, despite recent gains, the level of literacy is low and children receive on average only ten

years of education, three years less than in many emerging countries. There are also marked differences in educational attainment across gender and social backgrounds. Here, it might be possible to draw on the positive experiences in countries such as Mexico and Brazil of giving the poor cash grants that are linked to the continued education of their children, hence helping to reduce poverty through the accumulation of human capital. Such a policy would, though, require a strong local administration to implement the programme. Poor educational performance also affects labour market outcomes, with illiterate people finding it difficult to obtain regular employment. The government is attempting to implement free and compulsory education for children between the ages of 6 and 14, and has banned the employment of children under the age of 14. However, higher enrolment is just a first step to better outcomes. More needs to be done to raise the quality of education, including providing stronger incentives for teachers to work and improving both the attendance and completion rates of students and teachers' training. Education reforms at the state-level and in OECD countries suggest that decentralisation helps to raise efficiency and should be encouraged. Private-sector schools are expanding and typically cost less than public schools as a result of more market-based teacher salaries and better attendance of teachers. The government should experiment with vouchers which might allow further growth in private education.

In contrast to spending on primary and secondary education, outlays on tertiary education are low even after accounting for private spending. Total outlays are 0.8% of GDP, almost half the level in a large number of other emerging and developed countries. Moreover, a smaller proportion of younger age groups graduates from higher education than in many emerging countries. This shortfall appears to occur because of low private expenditure – even if it is high relative to that in continental European countries. Given the limited room for increased public spending and the high private return to tertiary education, one option would be to allow public universities to expand by charging higher fees and to permit more, appropriately regulated, private universities (including from abroad) to enter the market. One way to encourage higher private outlays would be to significantly expand the provision of loans with repayment contingent on income, so that all students are able to finance their studies, independent of their family background. The current loan programme is too small, overly complex and reaches only 2-3% of students.

Market-oriented reforms – which started in the mid-1980s and were followed by more fundamental reforms since the early 1990s and renewed in the 2000s – have lifted the Indian economy on to a significantly higher growth path, helping to reduce poverty. This success should encourage policymakers to continue with this strategy by, in particular: further reducing restrictions in labour and product markets; improving infrastructure, human capital formation and general public services; and further reducing tax distortions. Speeding up such reforms would help the government to achieve its objective of further raising India's sustainable growth path and at the same time make growth more inclusive. ■

For further information

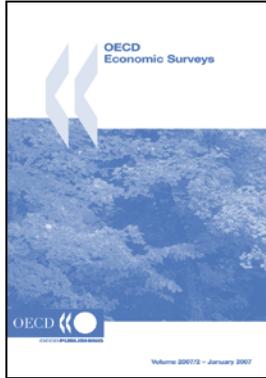
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