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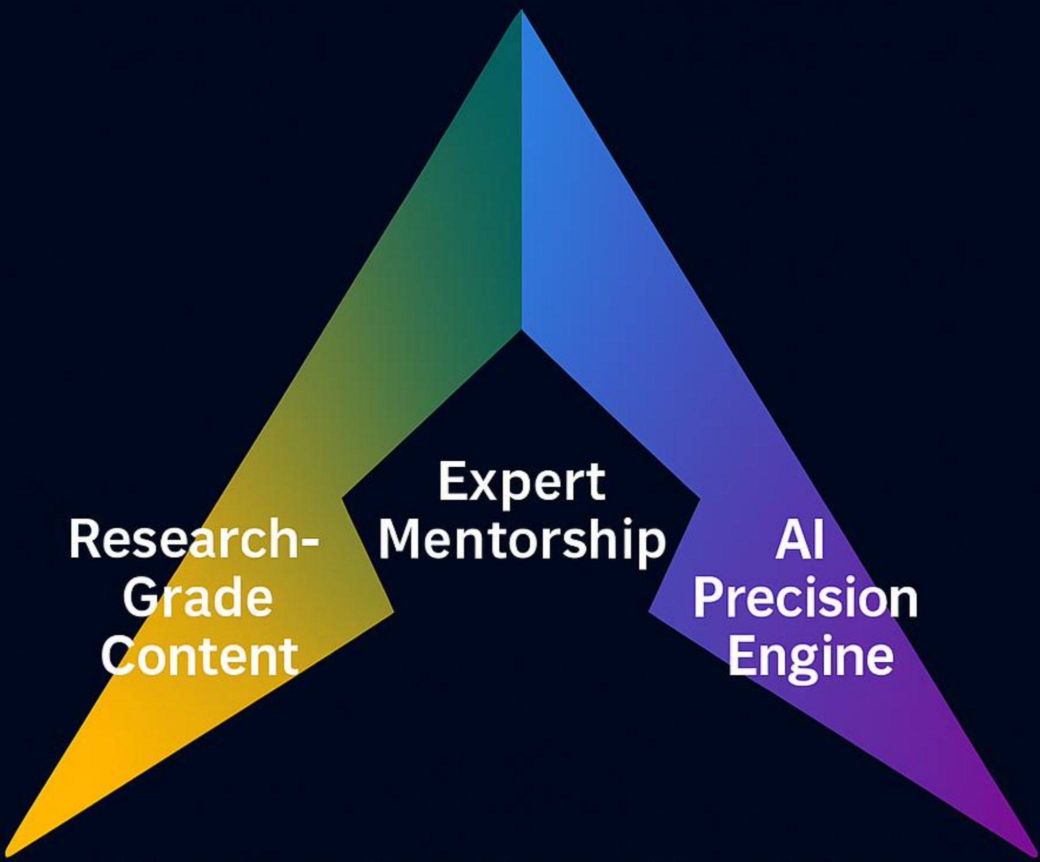

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Why This Book

The Economic Survey is the Government of India's most authoritative annual document on the state of the economy. Prepared by the Chief Economic Adviser and tabled in Parliament, it goes beyond statistics to explain the why and how behind economic trends, policy choices, and future challenges. For a UPSC aspirant, it is not just a source of data, but a window into the government's economic thinking.

This book is designed to help aspirants decode the Economic Survey strategically, rather than read it as a bulky, technical report. In the UPSC examination, the Survey plays a crucial role across GS Paper 3, Essay, and the Interview, providing authentic arguments, contemporary examples, and policy-backed viewpoints that distinguish a mature answer from a generic one.

The utility of the Economic Survey lies in:

- Strengthening conceptual clarity in core economic themes like growth, inflation, employment, fiscal policy, climate transition, and state capacity.
- Providing official language, keywords, and frameworks that can be directly used in Mains answers and Essays.
- Helping aspirants develop a balanced, analytical perspective, valued highly in the Personality Test.

This book simplifies the Survey by:

- Organising content theme-wise, aligned with the UPSC syllabus and PYQ trends.
- Converting dense analysis into exam-ready insights, arguments, and illustrations.

The recommended way to use this book is not rote memorisation, but selective assimilation—use it to enrich answers, sharpen essays, and build an informed worldview. When used alongside standard textbooks and current affairs, it can become a high-impact value addition, helping aspirants think like policymakers rather than mere examinees.

In essence, this book bridges the gap between the Economic Survey as a government document and the Economic Survey as a UPSC success tool.

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High Priority Topics

Moderately Important Topics

HIGH PRIORITY TOPICS

1. State of the Economy: India’s Growth Narrative

a. Introduction

At a time when the global economy remains fragile—fragmented by geopolitical tensions, supply chain disruptions and trade protectionism—India has emerged as the fastest-growing major economy in the world. According to the Economic Survey 2025–26, India recorded real Gross Domestic Product (GDP) growth of about 7.4 per cent in FY 2025–26, while its medium-term growth potential has been revised upward to nearly 7 per cent.

What distinguishes this phase is not merely the numerical strength of growth, but its quality, resilience and structural underpinnings. The Survey characterises the current phase as one of “pushing the growth frontier,” marking a decisive transition from post-pandemic recovery to a more durable and self-sustaining expansion path.

India’s Growth Snapshot:
From Recovery to Expansion

Dimension	Key Insight (Economic Survey 2025–26)
Global Context	Fragile world economy (geopolitics, protectionism)
India’s GDP Growth	7.4% (FY 2025–26)
Medium-Term Potential	~7% Sustainable Growth
Nature of Phase	“Pushing the Growth Frontier”
Growth Character	Quality, Resilience, Structural

b. From High Growth to High Potential

The Survey draws a clear analytical distinction between realised growth and potential growth.

i. Understanding the distinction

- Realised growth (7.4 per cent) reflects actual economic performance in FY 2025–26, based on First Advance Estimates.
- Potential growth (around 7 per cent) represents the economy’s sustainable medium-term capacity without generating inflationary pressures or macroeconomic instability.

The critical insight is that India’s recent performance is no longer driven by base effects or temporary fiscal stimulus. Instead, the economy has entered a phase of structurally higher growth.

ii. Structural drivers of higher potential

This transition is anchored in multiple reinforcing factors:

- Improved macroeconomic stability, reflected in moderated inflation, credible monetary policy and fiscal consolidation.
- Stronger balance sheets across banks and corporates, enabling credit expansion without systemic risk.
- Deep structural reforms, including the Goods and Services Tax (GST), labour market rationalisation and foreign direct investment (FDI) liberalisation, which have enhanced efficiency and formalisation.
- Sustained public capital expenditure, which has successfully crowded in private investment, reversing the long stagnation in capital formation.

As the Survey notes, these foundations position India to sustain growth in the near term while strengthening its medium-term growth frontier.

c. Domestic Demand as the Engine of Growth

A defining feature of India's current growth model is its overwhelming reliance on domestic demand, rather than external markets.

i. Composition of demand-led growth

- Private Final Consumption Expenditure (PFCE) reflects strong household demand, driven by services, urban consumption and a gradual recovery in rural spending.
- Gross Fixed Capital Formation (GFCF) captures rising investment in infrastructure, manufacturing capacity, housing and logistics.

The Survey emphasises that growth in FY 2025–26 has been primarily driven by these domestic components, with external demand playing only a supportive role.

ii. Policy significance of domestic-led growth

- Domestic demand-driven growth is inherently more resilient to global trade shocks and protectionist cycles.
- It enhances policy autonomy, reducing dependence on export-led deflationary strategies.
- It supports inclusiveness, as consumption growth indicates broader participation across income groups, while investment expands future productive capacity.

In a fragmented global economy, a consumption- and investment-led growth model enhances both stability and sustainability.

d. The Growth–Vulnerability Paradox

One of the most analytically significant contributions of the Economic Survey is its articulation of the growth–vulnerability paradox.

i. The paradox explained

Despite robust growth and improved macroeconomic fundamentals, India continues to experience:

- Periodic currency pressures, and
- Volatile capital flows.

Traditionally, strong growth, sound fiscal management and low external debt are associated with currency appreciation and stable capital inflows. India's recent experience departs from this conventional expectation.

ii. Structural global explanations

The Survey attributes this paradox to profound changes in the global financial and geopolitical landscape:

- Capital flows are increasingly shaped by geopolitics, tariff regimes and strategic alignments, not just economic efficiency.
- Technological concentration and artificial-intelligence-centric investments have redirected global capital towards a few advanced economies.
- Strategic power gaps now matter as much as growth performance in determining capital allocation.

As a result, India's strongest macroeconomic performance in decades has coincided with a global system that no longer consistently rewards macroeconomic success.

e. Nowcasting and the Evolution of Economic Policymaking

The Survey highlights the increasing relevance of nowcasting in modern economic governance.

i. Meaning and rationale

Nowcasting refers to estimating current or near-term economic activity using high-frequency indicators, rather than relying solely on lagged GDP data that are subject to repeated revisions.

ii. Indicators and policy relevance

- High-frequency data such as GST collections, e-way bills, industrial production, credit growth and services PMIs are used.
- The Economic Survey employs an in-house nowcasting framework to assess growth momentum during later quarters of FY 2025–26.

This approach enhances policy agility by enabling faster calibration, early identification of stress signals and evidence-based intervention in an uncertain global environment.

f. The Rupee and the Question of Undervaluation

Another striking observation of the Survey is that the Indian rupee is "punching below its weight."

i. Evidence of underperformance

Despite strong growth, controlled inflation, healthy banks, low external debt and comfortable foreign exchange reserves, the rupee depreciated by around 6.5 per cent during FY 2025–26.

ii. Factors behind the divergence

- A persistent goods trade deficit, driven by manufacturing and energy imports.
- Global capital shifting towards technology and AI-centric investments, particularly in the United States.
- Geopolitical fragmentation and tariff uncertainty, distorting capital flows.
- A mismatch between India's growing economic size and its strategic influence in the global order.

iii. Limited silver lining

The Survey also notes that:

- A relatively undervalued rupee offers temporary support to exporters.
- It partially offsets higher tariffs in developed markets.
- Stable crude oil prices have prevented imported inflation.

Thus, currency underperformance signals vulnerability, but also provides short-term competitiveness gains.

g. Synthesis: Beyond Growth Numbers

Taken together, the Economic Survey presents a nuanced assessment of India's growth trajectory. The economy is strong, domestically anchored and structurally resilient, yet it operates within a global order where economics alone no longer determines outcomes.

Growth success does not automatically translate into currency strength, stable capital flows or strategic leverage. Instead, economic performance is increasingly filtered through geopolitical, technological and strategic considerations.

Conclusion

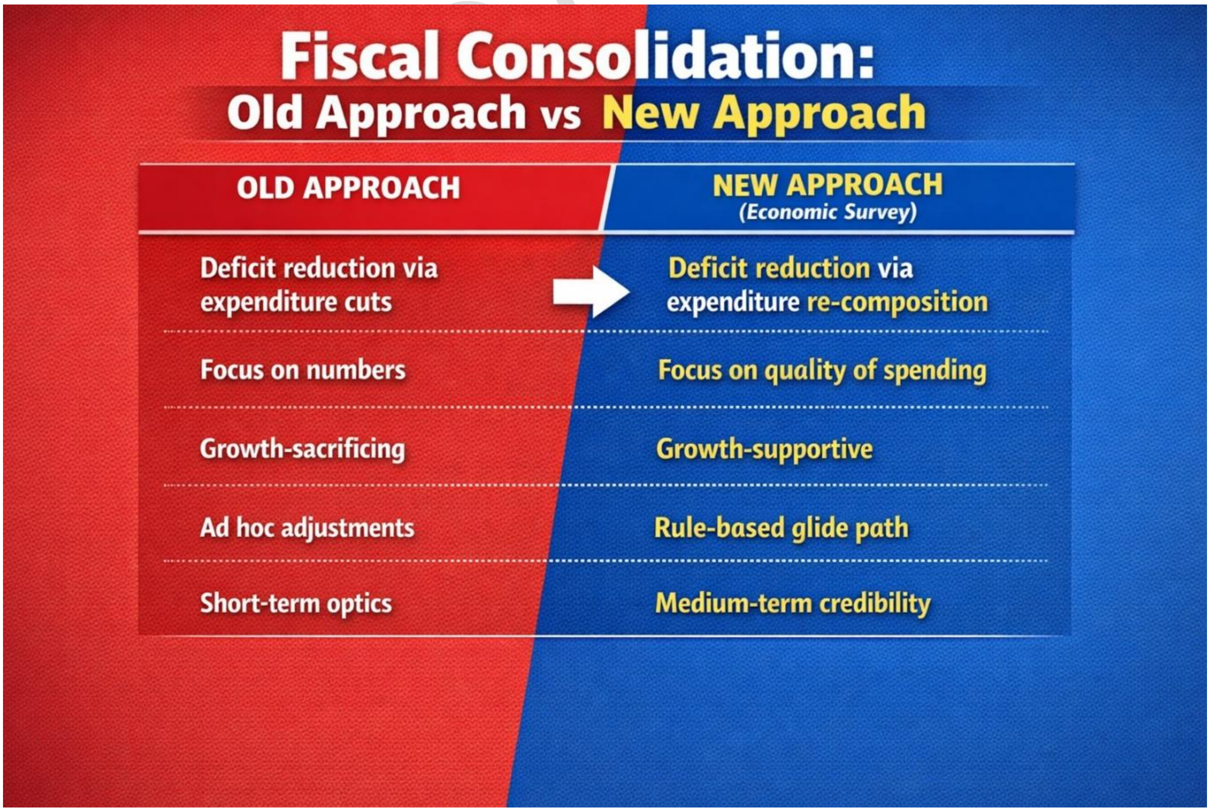
India's current growth phase marks a decisive transition from cyclical recovery to structural expansion, underpinned by domestic demand, revived investment and strengthened macroeconomic fundamentals. At the same time, the growth–vulnerability paradox and the rupee's underperformance underline the limits of economic strength in an increasingly geopoliticised global economy. As the Economic Survey suggests, the challenge ahead lies not merely in sustaining high growth, but in converting economic resilience into competitiveness, strategic capacity and durable global influence.

2. Fiscal Consolidation and Expenditure Quality

a. Introduction

Fiscal consolidation in India has entered a qualitatively distinct phase. Unlike earlier episodes of deficit reduction that relied predominantly on expenditure compression, the current approach combines credible deficit reduction with a conscious improvement in the quality of public spending. The Economic Survey 2025–26 emphasises that fiscal credibility today is determined not merely by the size of deficits or debt, but increasingly by how productively public resources are deployed.

This represents a decisive shift from numerical fiscal targets towards a composition-driven and growth-supportive consolidation strategy, aligning fiscal policy with the broader objective of pushing India's growth frontier.



b. Fiscal Consolidation Path: From Crisis Response to Credible Anchoring

Fiscal consolidation refers to the process of reducing fiscal deficits and public debt while preserving macroeconomic stability and growth momentum. India's recent fiscal journey reflects a calibrated transition from crisis-induced expansion to medium-term discipline.

i. Post-pandemic fiscal trajectory

- The fiscal deficit widened sharply to about 9.2 per cent of GDP in 2020–21, reflecting emergency pandemic spending and revenue collapse.
- With economic normalisation, the deficit declined to 6.9 per cent in 2021–22 and 6.4 per cent in 2022–23 during the recovery phase.
- By 2023–24, consolidation gained credibility, with the deficit falling to around 5.8 per cent.
- This trend continued in 2024–25, with the deficit declining further to about 5.1 per cent, supported by growth rather than expenditure cuts.
- The medium-term fiscal anchor targets a deficit of 4.4 per cent of GDP by 2025–26.

ii. What distinguishes the current consolidation

The Survey highlights that the Centre remains on track to achieve this target despite global uncertainty, geopolitical disruptions and welfare pressures. Unlike earlier episodes marked by ad hoc cuts and growth sacrifice, the present phase is characterised by:

- A rule-based glide path,
- Protection of capital expenditure, and
- Enhanced market credibility.

Accordingly, fiscal consolidation today is best understood as consolidation through composition rather than compression.

c. Reorienting Public Spending Towards Capital Expenditure

A central pillar of the current fiscal strategy is the deliberate shift from consumption-oriented revenue expenditure to asset-creating capital expenditure.

i. Revenue versus capital expenditure

- Revenue expenditure—such as salaries, subsidies and administrative spending—supports short-term consumption and has relatively low growth multipliers.
- Capital expenditure, by contrast, creates durable assets in infrastructure, transport, energy and digital systems, with multipliers often estimated between 2.5 to 3 times.

ii. Scale and impact of capital spending

The Economic Survey notes that central government capital expenditure has more than doubled since 2019–20. This sustained push has:

- Improved logistics and reduced transaction costs,
- Strengthened supply-side capacity, and
- Crowded in private investment after a prolonged period of capital formation stagnation.

Public investment has been channelled into transport infrastructure, logistics networks, digital public infrastructure and the energy transition, thereby supporting both current demand and future productive potential.

iii. Economic rationale

Capital expenditure expands supply capacity, improves efficiency and mitigates medium-term inflationary pressures. Consequently, fiscal policy is increasingly aligned with long-term growth objectives, making expenditure quality central to debates on infrastructure-led development and fiscal sustainability.

d. General Government Deficit and Cooperative Fiscal Discipline

While policy debates often focus on the Union government's deficit, the Survey stresses the importance of the general government deficit, which combines the fiscal positions of the Centre and the States.

i. Why the general government deficit matters

- State governments account for nearly 60 per cent of total public expenditure.
- The combined fiscal stance influences borrowing pressure, interest rates and macroeconomic stability.

Fiscal consolidation is therefore credible only when pursued symmetrically by both tiers of government.

ii. Improving State finances

The Survey observes that:

- Most States are adhering to Fiscal Responsibility and Budget Management (FRBM) limits, and
- Many States have simultaneously increased capital outlay.

As a result, the general government deficit is on a declining trajectory, reinforcing macroeconomic stability and market confidence.

This coordinated Centre–State effort highlights the role of cooperative federalism in sustaining fiscal discipline.

e. Unconditional Cash Transfers: A Cautious Critique

One of the most analytically significant sections of the Survey concerns the expansion of unconditional cash transfers.

i. Nature of unconditional transfers

These include universal income transfers, pre-election guarantees and open-ended welfare commitments that provide income support without productivity, asset-creation or outcome conditions.

ii. Fiscal and economic concerns

The Survey does not oppose welfare spending per se, but raises three structural concerns:

- Erosion of fiscal space, as rising revenue expenditure constrains investment in productive capital assets—especially at the State level.
- Weak and transitory multipliers, since consumption support does not generate durable productivity gains.
- Inter-generational equity risks, as borrowing to finance current consumption shifts the burden to future taxpayers.

iii. Policy implication

The Survey's position is not anti-welfare, but pro-quality welfare. It emphasises the need for cash transfers that are:

- Targeted,
- Time-bound, and
- Fiscally sustainable.

This framing is crucial for balancing social protection with long-term growth imperatives.

f. Redefining Fiscal Credibility Through Spending Quality

Traditionally, fiscal credibility was judged primarily by low deficits and manageable debt levels. The Economic Survey broadens this understanding.

i. Quality as a credibility signal

When borrowed resources are deployed in ways that raise potential GDP, markets perceive:

- Lower sovereign risk,
- Reduced borrowing costs, and
- Greater policy credibility.

ii. Market response to productive fiscal policy

The Survey points to:

- Declining sovereign bond spreads,
- Improved credit assessments, and
- A lower economy-wide cost of capital,

as evidence that markets increasingly reward productive fiscal strategies.

In essence, fiscal discipline today is judged not merely by restraint, but by intelligence in expenditure allocation. Markets reward not just discipline, but fiscal intelligence.

g. Synthesis: Consolidation, Composition and Credibility

India's contemporary fiscal strategy integrates multiple dimensions:

- A credible glide path from pandemic-era deficits ensures numerical discipline.
- Prioritisation of capital expenditure strengthens growth potential and supply-side capacity.
- Centre–State coordination reinforces macroeconomic stability across the federal structure.
- Restraint on unproductive revenue spending preserves fiscal space.

Together, these elements enhance fiscal credibility while supporting sustained economic expansion.

Conclusion

India's fiscal consolidation strategy reflects a decisive transition from narrow deficit targeting to qualitative fiscal management. By protecting capital expenditure, strengthening cooperative federalism and exercising caution over open-ended revenue commitments, the approach seeks to reconcile growth, stability and credibility. As the Economic Survey underscores, sustainable public finance in the coming decade will depend not merely on reducing deficits, but on ensuring that every rupee spent expands the economy's productive frontier.

3. Cost of Capital and Monetary Transmission in India

a. Introduction

Despite a prolonged phase of low and stable inflation and broadly accommodative monetary conditions, the cost of capital in India remains structurally high. The Economic Survey 2025–26 argues that this outcome does not reflect a failure of monetary policy transmission alone. Rather, it is the product of deeper structural, external and institutional constraints that shape borrowing costs in emerging economies.

Recognising this distinction is essential to understanding why price stability does not automatically translate into cheap credit in a developing economy with high growth aspirations such as India.

b. Why Capital Is Structurally Expensive in India

The cost of capital refers to the effective rate at which firms and governments can borrow, encompassing not only interest rates but also risk premia, transaction costs and uncertainty premiums.

i. Savings–investment imbalance

The Survey's core argument is that capital in India is expensive not because inflation is persistently high, but because underlying risk remains elevated and domestic savings are insufficient relative to investment needs.

- India is a labour-abundant but capital-scarce economy pursuing rapid development.
- Large investments are required for infrastructure expansion, manufacturing growth, urbanisation and the energy transition.
- Domestic savings alone cannot finance this scale of investment.

This structural savings–investment gap necessitates reliance on foreign savings, embedding external vulnerability into the financing process.

ii. Current account constraint

This vulnerability manifests in a persistent current account deficit (CAD), reflecting excess investment over savings.

- Structural goods trade deficits driven by energy imports and electronics outweigh services exports.
- Remittances provide support but remain cyclical and insufficient to fully offset merchandise imbalances.
- In early development phases, higher growth often widens the CAD, as imports rise faster than exports.

The Survey thus treats India's external imbalance as structural rather than purely cyclical, with direct implications for capital costs.

Low Inflation ≠ Cheap Capital

Common Assumption	Economic Survey's Argument
Low inflation → low interest rates	**Low inflation** is necessary but not sufficient
Monetary policy drives borrowing costs	Risk premia + external constraints dominate
Transmission failure is the cause	**Structural** features of EMEs matter

c. Foreign Savings and the Embedded Risk Premium

The Economic Survey places particular emphasis on the linkage between the current account deficit and the cost of capital.

i. Risk characteristics of foreign capital

- A CAD requires external financing, exposing the economy to global risk appetite.
- Capital flows are sensitive to global liquidity conditions, geopolitical developments and investor sentiment, often reacting more to external shocks than to domestic fundamentals.

As a result, foreign capital is never risk-neutral.

ii. Transmission into borrowing costs

Investors demand additional returns to compensate for:

- Exchange rate risk,
- Sudden capital reversals, and
- Geopolitical uncertainty.

These risk premia are embedded in sovereign yields and corporate borrowing costs, raising the overall cost of capital even during periods of low domestic inflation.

India's high growth ambitions, dependence on imported energy and import-intensive manufacturing expansion ensure that these risk premia remain persistent rather than transient.

d. Global Financial Conditions and Their Spillovers

The Survey situates India's experience within a rapidly evolving global financial environment.

i. Changing global capital flows

- Global liquidity has tightened.
- Capital has become increasingly concentrated in technology and artificial-intelligence ecosystems in advanced economies.
- Geopolitical fragmentation, tariff conflicts and sanctions regimes have intensified uncertainty.

ii. Implications for emerging economies

In this environment:

- Emerging markets must pay a structural premium to attract and retain capital.
- Strong domestic macroeconomic management does not guarantee lower borrowing costs.

Thus, the cost of capital is shaped as much by global conditions as by domestic policy choices, limiting the scope of monetary autonomy.

e. Banking System Health and Its Limits

Banks remain the primary channel of monetary transmission in India.

i. Improved banking fundamentals

The Survey notes that the legacy of stressed assets peaking after 2018 has been addressed through:

- The Insolvency and Bankruptcy Code,
- Recapitalisation of public sector banks, and
- Improved credit appraisal and governance.

As a result, banks today are better capitalised, carry fewer stressed assets, and can support robust credit growth.

ii. Why capital remains costly

Despite these improvements:

- Banks price loans based on risk-adjusted returns, not policy rates alone.
- External vulnerability, legal delays in contract enforcement and sector-specific stress continue to influence lending spreads.

A healthy banking system can improve transmission efficiency, but it cannot eliminate macro-structural risks embedded in the economy.

f. Why Monetary Transmission Remains Partial

Monetary transmission refers to the process by which changes in policy rates influence lending rates, investment decisions and economic activity.

i. Where transmission works

- The pass-through from policy rates to banks' funding costs has improved significantly.

ii. Where transmission weakens

However, the pass-through from funding costs to lending rates remains incomplete due to:

- Post-NPA risk aversion among banks,
- Informal sector opacity,
- Delays in contract enforcement, and
- Stress in MSMEs and infrastructure sectors.

Consequently, monetary easing does not translate uniformly into cheaper credit, particularly for smaller and riskier borrowers.

g. Why Low Inflation Does Not Guarantee Cheap Capital

A common analytical misconception is that low inflation automatically ensures low interest rates. The Survey explicitly challenges this assumption.

i. Inflation versus risk

- Inflation control is a necessary but not sufficient condition for cheap capital.
- Risk premia operate independently of inflation and reflect political uncertainty, external vulnerability and institutional quality.

ii. Exchange rate and twin-deficit concerns

- Expected currency depreciation raises borrowing costs even in low-inflation regimes.
- Large fiscal deficits combined with a current account deficit create twin-deficit concerns, elevating sovereign yields and corporate financing costs.

Thus, the ultimate determinant of capital costs is risk, not inflation alone.

h. Synthesis: Growth Ambitions, External Constraints and Policy Limits

The Economic Survey presents a clear analytical chain:

- High growth ambitions generate large investment demand.
- Investment exceeds domestic savings, leading to persistent current account deficits.
- External financing embeds global risk premia.
- Monetary policy operates within this structural framework, limiting its ability to deliver cheap capital independently.

Growth, therefore, creates both opportunity and constraint.

Conclusion

The Economic Survey makes a critical analytical contribution by distinguishing cyclical monetary influences from the structural determinants of capital costs. While low inflation, improved banking health and better monetary transmission have strengthened India's macroeconomic framework, capital remains expensive due to persistent current account deficits, dependence on foreign savings and elevated risk premia shaped by global financial conditions. Reducing the cost of capital, therefore, requires not only prudent monetary management, but sustained efforts to enhance export competitiveness, strengthen energy security, maintain fiscal discipline and build institutional credibility in an increasingly uncertain global order.

4. External Sector and the Manufacturing Imperative

a. Introduction

India's external sector has displayed notable resilience in an era marked by global fragmentation, protectionism and geopolitical uncertainty. This resilience has been driven largely by the sustained strength of services exports and steady remittance inflows, which have cushioned the balance of payments against repeated external shocks.

However, the Economic Survey 2025–26 issues a clear structural warning. For a large and fast-growing economy with rising import requirements, external stability, currency strength and strategic autonomy cannot be sustained by services alone. Manufacturing exports, the Survey argues, are not a discretionary policy choice but a macroeconomic and strategic necessity.

b. India's External Sector Structure: Services Strength and Manufacturing Weakness

India's current export structure is characterised by a sharp asymmetry between services and manufacturing.

i. Dominance of services exports

- Services exports—particularly information technology, business process management, financial services and professional services—have placed India among the leading global exporters in this domain.
- These exports benefit from India's human capital advantage, scalability through digital delivery and sustained global demand.
- They are relatively less dependent on physical logistics and infrastructure.

The Economic Survey observes that services trade shows low sensitivity to exchange rate movements, reflecting quality- and skill-based demand rather than price competitiveness.

ii. Structural weakness of manufacturing exports

In contrast:

- Manufacturing exports remain limited in scale and are often import-intensive.
- Merchandise trade continues to record a persistent deficit.
- Overall balance of payments stability is achieved only with the support of capital inflows.

iii. Core structural asymmetry

Despite their strength, services exports do not generate sufficient foreign exchange to offset:

- Energy imports,
- Electronics and machinery imports, and
- Intermediate inputs required for domestic manufacturing.

This asymmetry between services-led export earnings and goods-led import dependence lies at the heart of India's recurring currency vulnerability.

c. Manufacturing Exports and Currency Stability

One of the Survey's most critical insights is that currency stability depends on trade composition rather than growth performance alone.

i. Growth without trade balance correction

In a high-growth economy:

- Rising incomes and investment increase import demand.
- If goods exports do not expand proportionately, the merchandise trade deficit widens.
- This generates downward pressure on the currency, even when inflation is low and services exports are strong.

Thus, strong growth can coexist with currency stress.

ii. Why manufacturing exports matter

Manufacturing exports are uniquely positioned to correct this imbalance because they:

- Offer scale, generating export volumes services cannot easily replicate.
- Respond more effectively to price and cost competitiveness, allowing exchange rate adjustments to translate into export gains.
- Enable import substitution in critical sectors, reducing external dependence.
- Generate large-scale employment for semi-skilled labour.

A stable currency, therefore, requires an export basket capable of scaling with economic growth—a role manufacturing alone can fulfil.

iii. Limits of services in ensuring currency stability

Services exports, by contrast:

- Are skill-intensive and concentrated in limited sectors.

- Are less responsive to price signals.
- Provide stability but cannot structurally correct the trade balance in an economy of India's size.

d. The Limits of a Services-Led Growth Model

The Economic Survey does not reject services-led growth, but places clear boundaries on its long-term effectiveness.

i. Employment constraint

- Services contribute significantly to GDP but absorb a relatively small share of the labour force.
- Manufacturing remains essential for realising the demographic dividend and achieving inclusive growth through mass employment.

ii. External vulnerability

- Services demand is sensitive to immigration regimes, data localisation rules and regulatory changes in destination markets.
- Geopolitical tensions and technological restrictions can disproportionately affect cross-border services delivery.

iii. Strategic fragility

A services-dominated external profile does not ensure:

- Supply chain security,
- Industrial resilience, or
- Technological sovereignty.

The Survey therefore characterises services as a stabiliser of growth, not a strategic anchor of long-term resilience.

e. Trade Diversification as a Strategic Imperative

The global trade environment has undergone a structural transformation marked by geopolitical blocs, trade weaponisation, sanctions and supply chain reconfiguration.

i. Why diversification is unavoidable

In this environment, excessive dependence on:

- A few markets,
- A narrow product base, or
- Limited value-chain segments

has become a source of vulnerability rather than efficiency.

ii. Dimensions of diversification

The Economic Survey emphasises diversification across multiple dimensions:

- Markets – deeper engagement with the European Union, Africa and Latin America.
- Products – expansion into electronics, green technologies, chemicals and advanced manufacturing.
- Value chains – movement from assembly to design, innovation and branding.
- Partnerships – broader and deeper trade agreements beyond traditional allies.

In this context, trade diversification is not merely export promotion, but a tool of external resilience and policy autonomy.

f. Strategic Significance of the India–European Union Free Trade Agreement

Within the Survey's external sector framework, the proposed India–European Union Free Trade Agreement (FTA) assumes particular importance.

i. Why the European Union matters

- The EU is the world's largest integrated market.
- It has high purchasing power and demand for quality manufactured goods.
- It is a global leader in technology, standards and regulatory frameworks.

ii. Manufacturing transformation

Beyond tariff reduction, EU market access can:

- Incentivise scale, quality upgrading and compliance.
- Integrate Indian firms into global value chains.
- Support movement up the manufacturing ladder.

iii. Currency and strategic implications

- Higher manufacturing exports to the EU can reduce the merchandise trade deficit.
- This improves current account sustainability and supports currency stability.
- Geopolitically, as the EU seeks alternatives to China, India offers market size, democratic stability and strategic alignment.

In this sense, the India–EU FTA is as much about currency stability and strategic autonomy as it is about trade liberalisation.

g. Synthesis: Composition, Not Growth, as the Core Challenge

The Economic Survey presents a coherent synthesis:

- Services exports provide short-term stability.
- Manufacturing exports determine long-term sustainability.
- Trade diversification enhances resilience.
- Strategic partnerships such as the India–EU FTA provide leverage in a fragmented global order.

India's external sector challenge, therefore, lies not in the pace of growth, but in the composition of that growth.

Conclusion

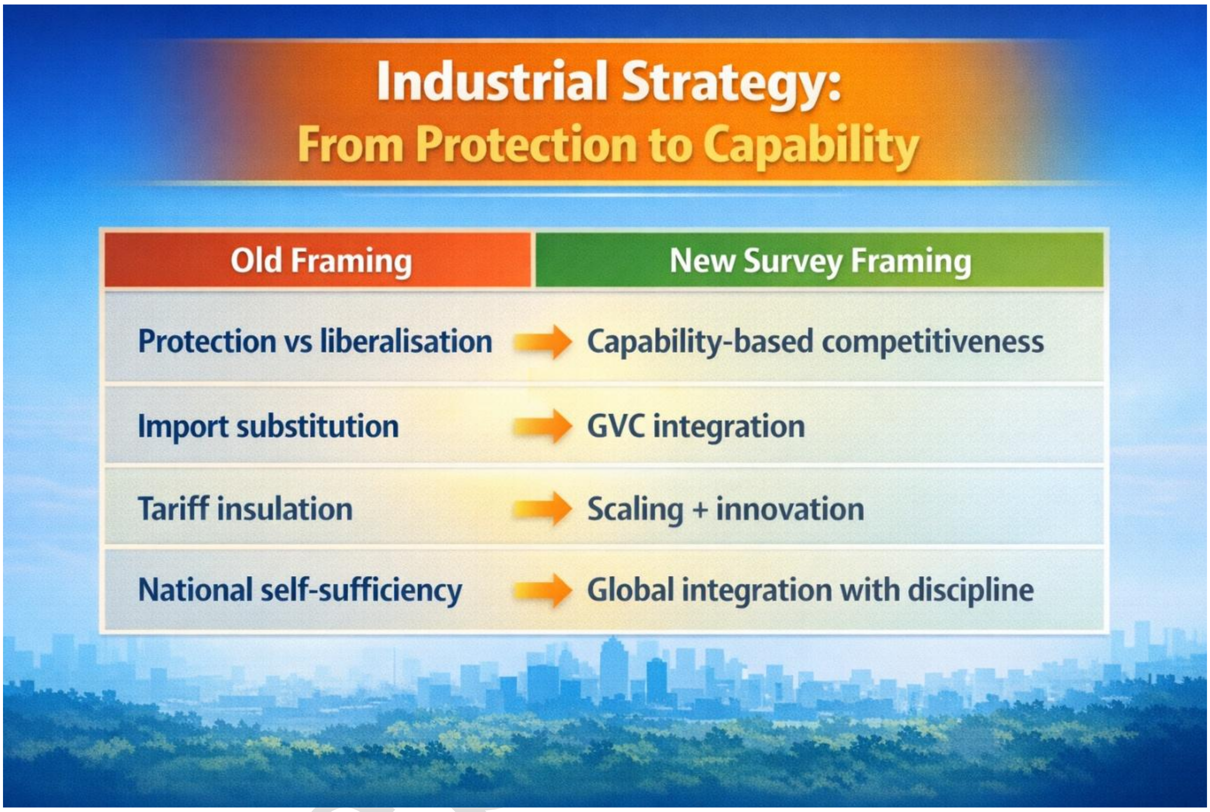
The Economic Survey underscores that while services exports have insulated India from global volatility, they cannot alone sustain currency stability, employment generation or strategic resilience. For a large, aspirational economy with rising import needs, manufacturing exports constitute the missing pillar of external sustainability. Trade diversification and strategic partnerships—particularly the India–European Union Free Trade Agreement—are thus not optional trade instruments, but essential macroeconomic and geopolitical imperatives. India's long-term external stability will ultimately depend on how effectively it converts high growth into globally competitive manufacturing capacity.

5. Industrial Strategy and Manufacturing Competitiveness

a. Introduction

India's renewed emphasis on manufacturing is unfolding in a global environment marked by supply-chain fragmentation, strategic trade realignments and intensifying technological rivalry. The Economic Survey 2025–26 argues that industrial success under these conditions cannot be achieved through indiscriminate protection or inward-looking import substitution. Instead, it requires an industrial strategy that is selective, disciplined and globally integrated.

Manufacturing competitiveness, therefore, must be built through deeper integration with global value chains, systematic scaling of micro, small and medium enterprises, and sustained innovation-led upgrading, rather than tariff-led insulation. This framing moves the debate away from protection versus liberalisation towards capability-based competitiveness.



b. Global Value Chains and the Logic of Manufacturing Integration

Global value chains (GVCs) refer to production networks in which different stages of value addition—design, component manufacturing, assembly and marketing—are distributed across countries according to comparative advantage. In this system, competitiveness flows not from national self-sufficiency, but from effective participation in cross-border production networks.

i. Why GVC participation matters for India

For India, integration with GVCs is critical because it:

- Provides access to large global markets,
- Facilitates technology transfer through learning-by-doing,
- Enhances export competitiveness, and
- Contributes to improving the trade balance over time.

The Economic Survey notes that manufacturing expansion in India is import-intensive in its early stages, making GVC participation a necessity rather than a weakness. Imported intermediates often embody advanced technology, quality standards and design capabilities that domestic firms initially lack.

ii. India's current limitations

Despite this logic:

- India's participation in electronics, precision machinery and advanced manufacturing value chains remains shallow.
- Dependence on imported intermediates remains high.
- Domestic value addition in several sectors is consequently low.

In a fragmented global economy, the Survey underlines that competitiveness flows through value chains rather than national silos, and India's manufacturing strategy must be aligned with this reality.

c. MSME Scaling and the 'Missing Middle' Constraint

Micro, small and medium enterprises (MSMEs) form the backbone of India's manufacturing employment, yet they remain structurally constrained in scale, technology adoption and export orientation.

i. Nature of the "missing middle" problem

The Economic Survey diagnoses a persistent "missing middle", characterised by:

- A very large number of micro enterprises, and
- A thin layer of medium-sized firms.

High informality, limited access to formal finance and low productivity prevent many firms from growing beyond subsistence scale.

ii. Why scale matters

This structural imbalance has serious implications:

- Small firms tend to focus on domestic markets and operate with low efficiency.
- They struggle to meet global quality, compliance and delivery standards.
- Scaled enterprises, by contrast, are better positioned to integrate into GVCs, adopt advanced technologies and access formal finance.

iii. Policy implication

The Survey stresses that industrial policy must enable firms to grow beyond artificial size thresholds, rather than locking them into sub-optimal scales. Protection, where provided, should facilitate graduation into larger, more productive firms and encourage integration into global production networks.

d. The Risks of Over-Protection and Inverted Duty Structures

A key analytical warning in the Survey concerns the dangers of excessive and poorly designed protection.

i. Nature of protection-induced distortions

- High tariffs, permanent import barriers and indiscriminate quality control orders can raise domestic production costs.
- Inverted duty structures—where imported inputs are taxed more heavily than finished goods—further distort incentives.

ii. Economic consequences

Such distortions lead to:

- Erosion of export competitiveness,
- Skewed incentives in favour of inefficient firms, and
- Weakening of GVC participation as India becomes a high-cost production node.

The Survey cautions that indiscriminate quality controls and inverted duties often harm downstream industries more than they protect upstream producers.

e. The Discipline of "What Not to Protect"

One of the Survey's most significant conceptual contributions is its emphasis on disciplined industrial policy—clarity not only on what to support, but also on what not to protect.

i. Categories that should not be protected

- General-purpose inputs, as protection raises economy-wide costs.
- Industries that are already export-competitive, where protection reduces efficiency and innovation incentives.
- Labour-intensive sectors, which suffer employment losses when input costs rise.
- Poor-quality incumbents, whose protection entrenches inefficiency.

ii. Conditions for justified protection

The Survey proposes a strategic test:

- Domestic production must be technically feasible.
- Protection must be temporary and time-bound.
- Clear export or performance benchmarks must be specified.
- Measurable capability improvements must result.

In the absence of these conditions, protection becomes counterproductive and delays industrial upgrading.

f. Innovation and the Future of Manufacturing Competitiveness

The Survey situates manufacturing competitiveness firmly within the context of technological change.

i. Emerging determinants of industrial success

Automation, artificial intelligence, advanced materials and precision engineering increasingly define global manufacturing leadership.

ii. India's innovation gap

While India has demonstrated strengths in startups and IT services:

- Manufacturing research and development remains weak.
- Hardware-oriented deep technology ecosystems are underdeveloped.
- Patenting intensity in manufacturing sectors remains low.

iii. Strategic focus areas

The Survey advocates a focused push in:

- Electronics and semiconductors,
- Green technologies, and
- Defence manufacturing.

The strategic objective is to move from assembly to design, and from scale alone to technological sophistication. Future manufacturing competitiveness will depend less on tariffs and more on innovation, skills and technology absorption.

g. Synthesis: Towards a Coherent Industrial Strategy

Taken together, the Economic Survey outlines a coherent industrial framework:

- Global value chain integration provides scale and learning.
- MSME scaling addresses productivity and export constraints.
- Selective and disciplined protection avoids cost inflation and inefficiency.
- Innovation-led upgrading ensures long-term competitiveness.

These elements together form the basis of sustainable manufacturing growth in a fragmented global economy.

Conclusion

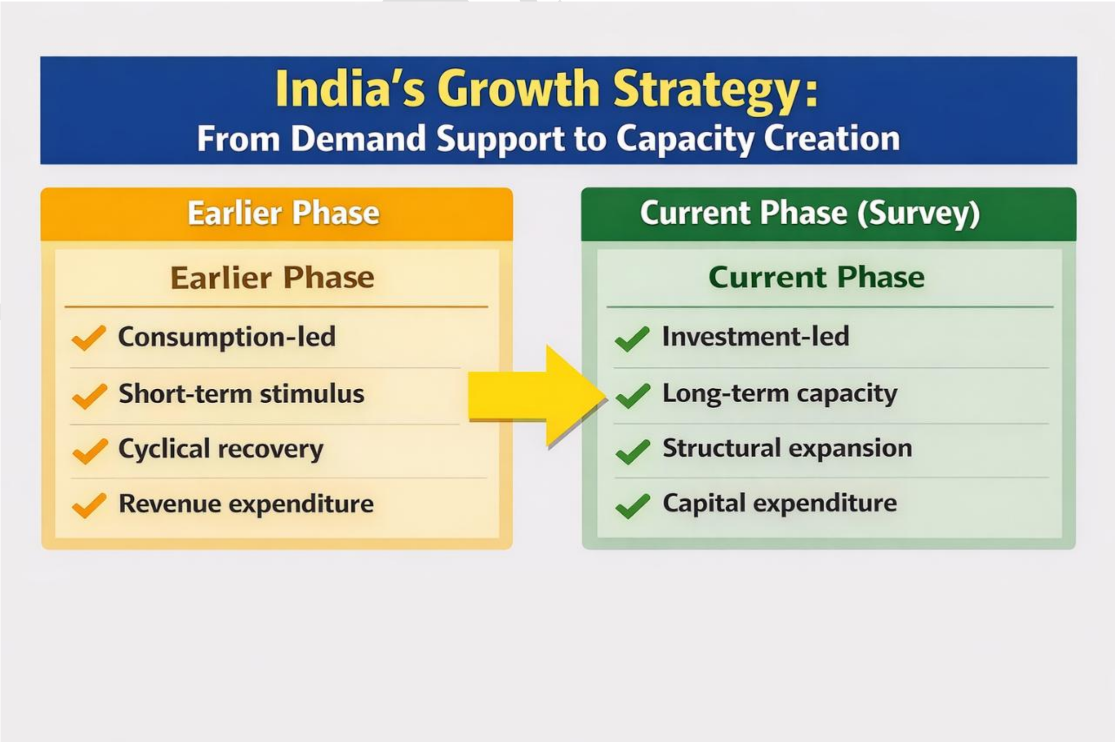
The Economic Survey advances a nuanced industrial vision that rejects both laissez-faire neglect and indiscriminate protectionism. It argues that manufacturing competitiveness must be built through global value chain integration, systematic scaling of enterprises, disciplined trade policy and sustained innovation. By clearly identifying what to protect and what not to protect, India can avoid the historical pitfalls of inward-looking industrialisation and position itself as a reliable, competitive and technologically capable manufacturing hub in an increasingly fragmented global order.

6. Investment and Infrastructure-Led Growth

a. Introduction

Investment-led growth has re-emerged as the central pillar of India's medium-term economic strategy. Moving beyond consumption-driven expansion and the constraints of export-dependent models, the Economic Survey 2025–26 underscores the transformative role of public capital expenditure in reviving private investment, raising productivity and expanding the economy's long-run growth potential.

When efficiently deployed, infrastructure investment—across both physical and digital domains—acts not merely as a facilitator of growth, but as the backbone of India's contemporary growth architecture. This marks a decisive shift from short-term demand support towards durable capacity creation.



b. Public Capital Expenditure and the Crowding-in of Private Investment

In macroeconomic theory, public investment can either crowd out or crowd in private investment.

i. Crowding-in as the dominant mechanism

- Crowding out occurs when public borrowing displaces private investment in an economy operating near full capacity.
- Crowding in occurs when public investment eases constraints, lowers costs and improves returns, thereby stimulating private investment.

The Economic Survey argues that India is currently experiencing a crowding-in effect. Public capital expenditure on infrastructure reduces logistics and transaction costs, enhances project viability and improves expected returns for private investors. As infrastructure gaps narrow, uncertainty declines and long-term private investment becomes more attractive.

ii. Enabling macroeconomic conditions

This mechanism has become effective due to a favourable macroeconomic environment:

- Inflation has remained relatively contained.
- Fiscal consolidation has followed a credible and transparent glide path.
- Banking sector balance sheets have strengthened following stress resolution.

Simultaneously, public capital expenditure has been protected and expanded even during fiscal consolidation, signalling policy commitment. The Survey emphasises that this credibility effect reduces uncertainty and anchors private investment expectations.

In this context, public capital expenditure functions less as a fiscal burden and more as a confidence anchor for private investment revival.

c. Revival of Public–Private Partnerships: From Risk Transfer to Risk Sharing

Public–Private Partnerships (PPPs) played a major role in India's infrastructure expansion during the 2000s, but subsequently faced serious setbacks.

i. Causes of earlier PPP stress

- Over-optimistic traffic and revenue projections,
- Regulatory uncertainty and delays, and
- Prolonged contractual disputes

resulted in stalled projects, stressed balance sheets and a breakdown of trust between the State and private investors.

ii. A rebalanced PPP framework

The Economic Survey notes that the revival of PPPs in the current phase rests on a more realistic and balanced risk framework.

- The State increasingly absorbs risks related to land acquisition and regulatory uncertainty.
- The private sector focuses on construction efficiency and operational performance.

This shift reflects a crucial insight: private investment responds not to the transfer of risk, but to the reduction of uncertainty.

iii. Improved contract design

Newer models such as the Hybrid Annuity Model and the use of Viability Gap Funding have enhanced project bankability and reduced financial stress. The Survey's underlying logic is that PPPs succeed when the State acts as a stabiliser of expectations rather than a mere risk-shifter.

In essence, the renewed PPP approach prioritises bankability over bravado.

d. Logistics and Connectivity as Foundations of Competitiveness

High logistics costs have long acted as a structural drag on India's competitiveness.

i. The logistics cost challenge

- Logistics costs in India remain around 13–14 per cent of GDP, significantly higher than major global peers.
- High costs contribute to uncompetitive exports, fragmented domestic markets and inflationary pressures.

ii. Infrastructure-led logistics reform

The Survey identifies logistics and connectivity investment as central to reducing the cost of growth itself. Key thrust areas include:

- Expansion of road and highway networks,
- Dedicated rail freight corridors,
- Modernisation of ports and inland waterways, and
- Development of multimodal logistics parks.

Improved connectivity accelerates goods movement, reduces inventory holding costs, enhances firm-level productivity and strengthens export competitiveness.

Crucially, the Survey frames logistics reform not merely as an infrastructure initiative, but as a market-integration and supply-side inflation control strategy.

e. Digital Infrastructure as the Backbone of Modern Growth

A distinctive feature of India's investment-led growth strategy is the central role accorded to digital infrastructure.

i. Components of digital infrastructure

Digital infrastructure spans:

- Connectivity layers such as broadband and 5G networks,
- Platforms including digital payments systems and tax networks,
- Data rails such as digital identity and payment architecture, and
- Service delivery systems ranging from e-governance to financial technology.

ii. Economic impact

The Economic Survey highlights several transformative effects:

- Reduced transaction costs through instant payments, paperless compliance and faster credit delivery.
- Accelerated formalisation of micro, small and medium enterprises, widening the tax base.
- Improved credit access through data-driven assessment.
- High scalability, combining large multiplier effects with low marginal costs.

The Survey's broader insight is that digital infrastructure functions as a general-purpose public good, amplifying returns on physical infrastructure investment. In this sense, digital infrastructure is not an adjunct to growth, but its nervous system.

f. Synthesis: Infrastructure as a Self-Reinforcing Growth Cycle

Taken together, the Economic Survey presents infrastructure-led growth as a self-reinforcing cycle:

- Public capital expenditure strengthens physical infrastructure.
- Improved infrastructure lowers costs and raises productivity.
- Lower costs crowd in private investment across sectors.

- Digital infrastructure multiplies and sustains these gains through efficiency, scalability and inclusion.

Through this interaction, infrastructure evolves from a supporting input into a strategic driver of growth.

Conclusion

India's investment-led growth strategy reflects a decisive shift from short-term demand management to long-term capacity building. By prioritising public capital expenditure, reviving Public–Private Partnerships through improved risk sharing, strengthening logistics and connectivity, and embedding digital infrastructure at the core of economic activity, the approach seeks to crowd in private investment and expand the economy's productive frontier. As the Economic Survey suggests, infrastructure today is not merely a facilitator of growth; it has become the strategy of growth itself.

7. Employment, Formalisation, and Human Capital

a. Introduction

India's employment challenge has evolved beyond the narrow question of job creation to encompass deeper concerns relating to the quality, formality, inclusiveness and long-term sustainability of work. The Economic Survey 2025–26 notes that recent years have witnessed improvements in key labour market indicators, including stabilising unemployment rates, rising labour force participation and visible signs of formalisation.

At the same time, structural constraints persist in the form of low female labour force participation, the rapid expansion of gig and platform-based work, and enduring skill–industry mismatches. Addressing these interconnected dimensions is essential for converting India's demographic advantage into durable and inclusive economic growth.

b. Employment Trends and the Process of Formalisation

The Survey observes that India's post-pandemic recovery has been accompanied by a gradual improvement in labour market conditions.

i. Improving employment indicators

- Unemployment rates have stabilised.
- Labour force participation has shown an upward trend.
- Indicators of formal employment have expanded.

More importantly, the policy focus has shifted from the number of jobs created to the nature and quality of employment.

ii. Meaning and pathways of formalisation

Formalisation refers to employment relationships that are registered, regulated and covered by institutional social security mechanisms. This includes:

- Enrolment under provident fund and health insurance systems,
- Integration of enterprises into the tax framework,
- Digital wage payments, and
- Compliance through online platforms.

The Survey highlights rising formalisation through increased payroll-based registrations, greater digital compliance via systems such as the GST network, and improved visibility of workers in official databases.

iii. Formalisation without firm formalisation

A key insight of the Survey is that formalisation is advancing even without a complete transition from informal enterprises to formal firms. Elements of formality are increasingly embedded within informal structures through digital payments, registration and regulatory integration.

Formalisation, therefore, is not a binary shift, but a gradual and layered process.

iv. Economic significance

From a macroeconomic perspective, formalisation:

- Enhances productivity,
- Expands access to social security,
- Improves credit availability through formal income recognition, and
- Strengthens fiscal capacity by widening the tax base.

Formalisation thus acts as a bridge between economic growth and social protection.

c. Female Labour Force Participation: A Structural Constraint

Despite recent gains, India's female labour force participation rate (FLFPR) remains structurally low compared to global averages and East Asian economies. The Economic Survey treats this not merely as a social issue, but as a core macroeconomic constraint.

i. Economic significance of female participation

Higher female participation would:

- Expand the effective labour supply,
- Enable fuller utilisation of the demographic dividend,
- Improve household welfare through income diversification, and
- Raise overall economic output.

Conversely, low participation represents a substantial loss of potential GDP.

ii. Structural barriers

The Survey identifies multiple constraints:

- A disproportionate burden of unpaid care work,
- Inadequate childcare infrastructure,
- Concerns related to safety, mobility and transport, and
- Limited availability of suitable non-farm employment, especially with the slowdown in labour-intensive manufacturing.

iii. Policy direction

The Survey emphasises:

- Expansion of employment opportunities in urban services,
- Promotion of digital and remote work,
- Alignment of skills with emerging sectors, and
- Investment in supportive infrastructure such as childcare facilities and safe transport.

The underlying message is that female labour participation is as much an issue of infrastructure and economic design as of social norms.

d. The Gig Economy and the Question of Regulation

The rapid expansion of the gig economy represents one of the most significant transformations in India's labour market.

i. Nature and drivers of gig work

Gig work is characterised by:

- Short-term contracts,
- Platform-mediated task allocation, and
- Flexible work arrangements.

Its growth has been driven by digital platforms, rising urban demand, low entry barriers and a preference for flexibility, particularly among younger workers.

ii. The regulatory dilemma

The expansion of gig work presents a policy trade-off:

- Insufficient regulation exposes workers to insecurity and lack of social protection.
- Excessive regulation risks undermining flexibility, raising compliance costs and discouraging job creation.

iii. Survey's balanced approach

The Economic Survey adopts a pragmatic position:

- Gig work is recognised as a distinct and enduring feature of modern labour markets.
- The focus is on extending social security coverage and benefit portability.
- Employer–worker relationships should be clarified without forcing gig work into traditional labour law frameworks.

The central challenge is not to eliminate flexibility, but to provide security without rigidity.

e. Skill–Industry Mismatch and the Quality of Human Capital

One of the most persistent structural challenges highlighted by the Survey is the mismatch between workforce skills and industry requirements.

i. Forms of skill mismatch

Skill mismatch manifests through:

- Qualifications that exceed or fall short of job requirements,
- Rapid skill obsolescence due to technological change, and
- Regional mismatches between labour supply and demand.

ii. India-specific challenges

In India, the problem is aggravated by:

- Weak alignment between education curricula and industry needs,
- Limited exposure to workplace practices,
- Rapid advances in automation and artificial intelligence, and
- High informality, which weakens incentives for firm-level training.

iii. Shift in labour market challenge

The Survey notes that India's employment challenge has shifted from job quantity to employability and job quality.

iv. Human capital strategy

Addressing this requires:

- Greater emphasis on vocational education and apprenticeships,
- Industry-linked skilling programmes, and
- Lifelong learning frameworks that enable continuous skill upgrading.

Human capital development must move away from front-loaded education towards continuous adaptation over the working life.

f. Synthesis: Employment, Formalisation and Human Capital as a Unified Transition

The Economic Survey presents India's employment transformation as an interconnected process:

- Rising formalisation improves job quality and social security coverage.
- Better-quality jobs and supportive infrastructure can raise female labour force participation.
- The gig economy expands opportunities but requires adaptive regulation.
- Continuous skill alignment ensures employability in a changing economic landscape.

Together, these elements shape the trajectory of sustainable and inclusive employment growth.

Conclusion

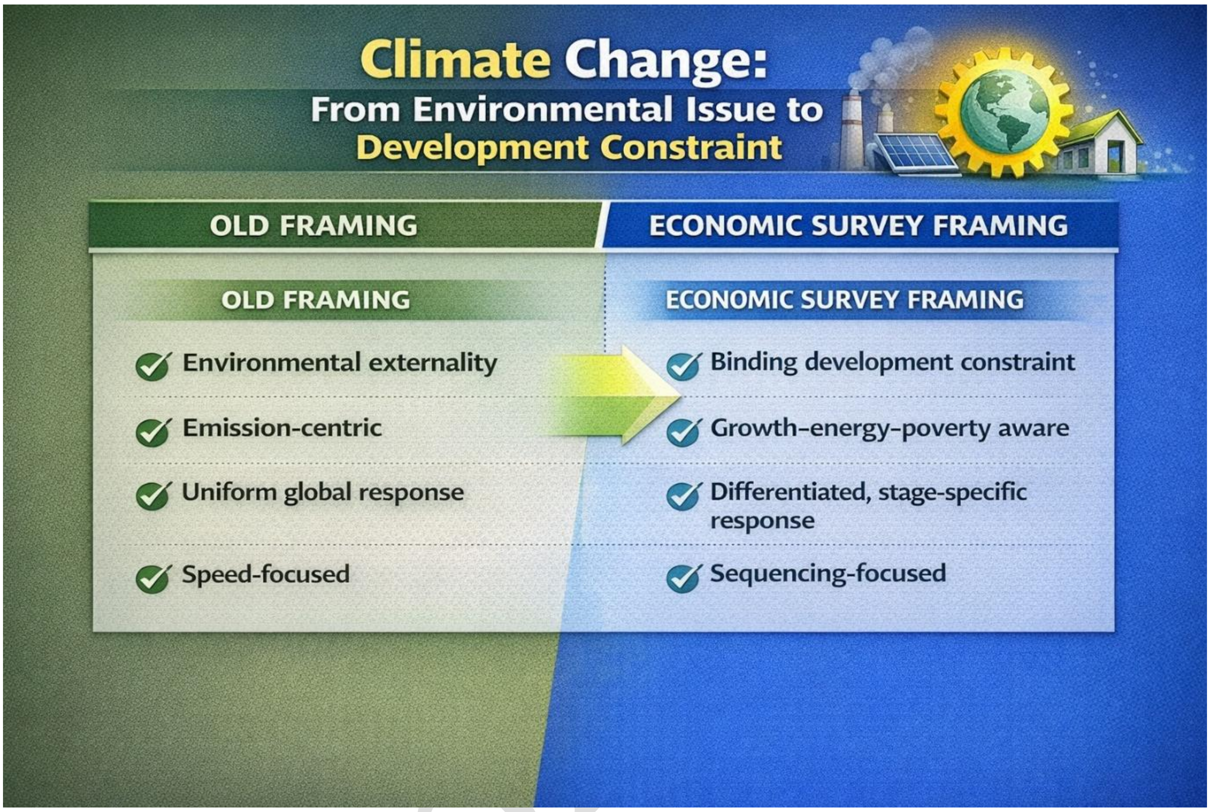
India's evolving employment landscape mirrors the broader transformation of its economy—from informality to formalisation, from a focus on job quantity to job quality, and from static education models to dynamic human capital development. While rising formal employment and digital labour platforms have expanded opportunities, enduring challenges such as low female labour force participation and persistent skill mismatches continue to constrain inclusive growth. As the Economic Survey suggests, the future of India's labour market will depend not merely on creating jobs, but on nurturing capable workers, adaptable institutions and forms of work that are both secure and flexible.

8. Climate Change as a Development Constraint

a. Introduction

Climate change has moved decisively beyond the domain of environmental protection to emerge as a binding constraint on economic development. For India—a lower-middle-income economy with large energy needs, persistent developmental gaps, and high climate vulnerability—the core question is no longer whether climate action is required. The real challenge lies in designing a climate response that does not undermine growth, poverty alleviation, and energy security.

The Economic Survey conceptualises this challenge through the idea of a development-compatible climate transition, anchored in realism, careful sequencing, and the principle of global equity. Climate policy, in this view, must align with India's developmental stage rather than impose premature constraints that risk slowing economic transformation.



b. Adaptation versus Mitigation: India's Core Climate Priority

A clear conceptual distinction between mitigation and adaptation is essential to understanding India's climate strategy.

i. Conceptual distinction

Mitigation focuses on reducing greenhouse gas emissions and delivers long-term global benefits, while adaptation aims to reduce vulnerability to climate impacts and generates immediate, local gains. Renewable energy expansion and electric mobility are mitigation measures, whereas flood control systems, heat action plans, and climate-resilient agriculture constitute adaptation.

ii. Why adaptation is existential for India

India's climate reality strongly favours an adaptation-first approach. Although the country accounts for only around four per cent of global cumulative emissions, it bears a disproportionate share of climate impacts—recurrent heatwaves, floods, cyclones, and growing water stress. The Economic Survey therefore makes an unambiguous assertion: for India, adaptation is not optional but existential.

This priority flows from three interlinked factors:

- Persistent development deficits in housing, urban infrastructure, healthcare, and agricultural resilience.
- High exposure to climate risks, driven by a large agrarian workforce, dense coastal settlements, and widespread informal urbanisation.
- Immediate welfare gains from adaptation through reduced mortality, livelihood protection, and lower disaster-related economic losses.

Adaptation, in this sense, is best understood as development by another name, directly reinforcing human security and economic stability.

c. Climate Finance: The Missing Pillar of Transition

The transition to a low-carbon and climate-resilient economy is inherently capital-intensive. Significant investments are required for renewable energy, electricity grids, storage systems, and large-scale adaptation infrastructure. The Economic Survey recognises that India cannot finance this transition independently without risking slower growth or heightened debt stress.

i. Structural weaknesses in global climate finance

The global climate finance architecture remains deeply inadequate. The long-standing commitment by developed countries to mobilise one hundred billion dollars annually has been repeatedly under-delivered. Concessional finance is scarce, risk-sharing mechanisms remain weak, and access to finance for adaptation is particularly poor.

The Survey offers a sharp critique, noting that global climate finance is:

- Fragmented, spread across multiple poorly coordinated instruments.
- Mitigation-biased, neglecting adaptation needs of vulnerable economies.
- Misaligned with the fiscal and developmental realities of developing countries.

ii. India's calibrated position

India's position, articulated with diplomatic precision, is that climate finance must be predictable, affordable, and accessible. Crucially, it cannot rely solely on loans. Grants, risk guarantees, and genuine technology transfer are indispensable if climate action is to remain development-compatible.

Without adequate climate finance, the pursuit of net-zero risks becoming a poverty trap rather than a pathway to sustainability.

d. Carbon Markets: Promise and Pitfalls

Carbon markets aim to reduce the cost of mitigation by allowing emission reductions to be traded through carbon credits. These markets function either as compliance mechanisms under regulatory frameworks or as voluntary platforms.

i. Potential benefits for India

For India, carbon markets appear attractive due to:

- Cost-efficient mitigation pathways
- Sectoral flexibility
- Potential financial inflows
- Incentives for technological innovation

ii. Structural and ethical concerns

The Economic Survey, however, adopts a cautious stance. It highlights persistent concerns regarding:

- Market integrity, including double counting of emission reductions
- Low-quality credits and verification challenges
- Distributional risks, with benefits accruing disproportionately to larger actors
- Policy complacency, if markets substitute for regulatory action

Most importantly, the Survey warns against over-reliance on markets, emphasising that carbon markets can only complement, not replace, strong public policy.

e. Green Growth and Energy Security: Resolving the Apparent Tension

A central analytical challenge in India's climate discourse is balancing green growth with energy security. While clean energy and low emissions are long-term imperatives, reliable and affordable energy remains an immediate necessity for growth and industrialisation.

India's energy reality complicates this balance. Coal continues to play a significant role, oil imports strain external accounts, and renewable energy—despite rapid expansion—remains intermittent, storage-dependent, and capital-intensive.

The Economic Survey offers a critical insight: energy security is not the opposite of a green transition but a precondition for its success.

India's strategy therefore seeks a calibrated balance through:

- Rapid renewable capacity expansion
- Diversification of domestic energy sources
- Investments in grid stability and storage
- Avoidance of a premature exit from fossil fuels

The Survey cautions that a disorderly transition can be as damaging as climate inaction itself.

f. Sequencing the Net-Zero Transition: The Defining Insight

Sequencing refers to the ordering of climate actions in line with income levels, technological readiness, and development priorities. Poor sequencing can raise energy costs, slow growth, exacerbate inequality, and provoke political backlash through job losses and industrial slowdown.

i. Phased transition pathway

Implicitly, the Economic Survey outlines a phased pathway for India:

- Growth and universal energy access
- Efficiency improvements and adaptation
- Large-scale clean energy deployment
- Deep decarbonisation, culminating eventually in net-zero emissions

ii. Equity as the underlying principle

This approach is inseparable from the principle of global equity. Developed countries industrialised early and account for the bulk of historical emissions, while developing countries are still building basic economic capacity. In this context, net-zero represents the destination, but sequencing defines the journey.

g. Synthesis: Climate Philosophy of the Economic Survey

The Economic Survey presents an integrated climate philosophy that reconciles environmental responsibility with developmental realism. Adaptation is accorded first priority, supported by credible climate finance, a balanced energy transition, and a carefully sequenced pathway towards net-zero.

Rather than denying climate responsibility, India's approach reflects differentiated realism, grounded in economic structures, social needs, and historical equity.

Conclusion

The Economic Survey reframes climate change not as a binary trade-off between growth and sustainability, but as a complex challenge shaped by timing, financing, and institutional capacity. For India, a development-compatible climate transition must prioritise adaptation, secure energy needs, mobilise credible climate finance, and sequence mitigation in line with technological and economic readiness.

In a world marked by unequal responsibilities and capabilities, climate ambition divorced from development realism risks becoming neither just nor sustainable.

9. Artificial Intelligence as a General-Purpose Technology

a. Introduction

Artificial Intelligence (AI) represents the next major general-purpose technological transformation, comparable in its systemic impact to electricity or the internet. Its significance lies not merely in automation, but in its ability to reshape productivity, competitiveness, and state capacity across sectors simultaneously.

For India, the central issue is not whether to adopt AI, but how to integrate it within a development context marked by capital scarcity, labour abundance, and institutional diversity. The Economic Survey frames AI as a productivity multiplier rather than an end in itself, while cautioning that its long-term impact will depend critically on access to computational resources, data governance frameworks, talent depth, and policy quality.

b. Artificial Intelligence as a Growth and Productivity Multiplier

Artificial intelligence differs from earlier waves of technological change because it automates and augments cognitive tasks, not merely physical labour. By improving decision-making quality, reducing informational asymmetries, and enabling rapid optimisation, AI functions as a general-purpose accelerator of productivity rather than a sector-specific innovation.

i. Channels of productivity enhancement

The productivity impact of AI unfolds cumulatively:

- Process automation and augmentation of human judgement
- Improved decision quality and predictive capacity
- Lower operational costs alongside higher output quality
- Diffusion of firm-level gains into economy-wide growth acceleration

ii. Sectoral relevance in India

In the Indian context, these channels operate across multiple sectors:

- Manufacturing – predictive maintenance and real-time quality control

- Agriculture – precision farming and weather-based advisories
- Services – enhanced coding productivity, analytics, and customer support
- Governance – improved targeting, fraud detection, and service delivery

AI thus raises productivity not by replacing effort alone, but by augmenting human judgement.

iii. Structural relevance for India

AI's importance is amplified by India's structural constraints. Capital scarcity, uneven skill distribution, and a large informal sector limit the reach of traditional productivity-enhancing investments. AI offers a leapfrogging opportunity by lowering coordination costs, improving scale efficiency, and strengthening state capacity without proportionate increases in physical capital.

c. Compute, Data and Talent: The Binding Constraints

While the potential of artificial intelligence is substantial, the Economic Survey emphasises that its diffusion is constrained by three binding bottlenecks—compute, data, and talent. This realism distinguishes the Survey from unqualified techno-optimism.

i. Compute as a new factor of production

Compute has emerged as a decisive factor of production in the AI era. Advanced models require:

- High-performance chips
- Large-scale data centres
- Reliable power and cooling infrastructure

India faces structural limitations due to limited domestic semiconductor manufacturing, heavy reliance on imported hardware, and the energy-intensive nature of compute infrastructure. As the Survey implicitly highlights, AI capability is increasingly determined by access to compute rather than algorithms alone.

ii. Data availability versus data usability

Data constitutes the second major constraint. Although India enjoys a natural advantage in population scale and diversity of use cases, this does not automatically translate into productive AI deployment.

Key challenges include:

- Fragmented and siloed datasets
- Unresolved data privacy and consent concerns
- Lack of interoperable public data platforms

Data abundance without governance and standardisation limits effective model training and deployment.

iii. Talent depth and capability asymmetry

The third constraint lies in talent. While India has a large IT workforce and a vibrant startup ecosystem, it remains thin in:

- Frontier AI research
- Semiconductor and hardware design
- Deep-tech and foundational model development

This raises the risk that India may become a large user of AI technologies while remaining a limited shaper of their direction and standards.

d. Artificial Intelligence Governance and Safety

The Economic Survey places strong emphasis on governance, recognising that AI systems generate significant risks alongside benefits. These risks include algorithmic bias, hallucinations and misinformation, job displacement, and excessive concentration of economic and informational power.

i. Governance dilemma

India's governance challenge lies in navigating between two extremes:

- Over-regulation, which can stifle innovation and entrench incumbents
- Under-regulation, which risks misuse, public harm, and erosion of trust

The Survey implicitly advocates a middle path based on risk-sensitive regulation, context-specific safeguards, and adaptive rather than static rules. AI governance must be enabling by default and restrictive by exception.

ii. Core governance principles

Key principles highlighted include:

- Transparency in system design
- Accountability for outcomes
- Human oversight in high-stakes applications
- Explainability where AI affects rights, welfare, or access to essential services

e. India's Development-Oriented Artificial Intelligence Path

The most distinctive contribution of the Economic Survey lies in its articulation of a development-specific AI strategy. It explicitly recognises that India cannot replicate the trajectories of advanced economies.

The United States follows a market-driven, capital-abundant model dominated by large technology firms, while the European Union prioritises rights-based regulation within institution-rich societies. India, by contrast, is capital-scarce, labour-abundant, and development-constrained.

i. Productivity-first deployment

At the core of India's approach is a productivity-first rather than replacement-first mindset. AI must augment workers, improve service delivery, and close state capacity gaps rather than merely displacing labour.

ii. Integration with public digital infrastructure

A second pillar lies in integrating AI with public digital infrastructure:

- Digital identity systems
- Payment platforms
- Health, agriculture, and welfare databases

When layered over these platforms, AI multiplies their developmental returns.

iii. Applied relevance over frontier dominance

The Survey implicitly favours applied AI over an exclusive focus on frontier model development. Priority use cases include healthcare diagnostics, agricultural advisories, and educational tools, where marginal productivity and welfare gains are highest.

iv. Inclusivity and relevance

Inclusivity forms the final pillar. Multilingual models, low-compute solutions, and edge AI applications tailored for rural and resource-constrained settings are essential to avoid deepening digital divides. India's challenge is not to build the largest models, but the most relevant ones.

f. Artificial Intelligence, Employment and the Productivity–Jobs Balance

Concerns over job displacement occupy a central place in the AI debate. The Economic Survey adopts a balanced position, recognising that AI will displace certain tasks, create new roles, and reshape skill demand.

The decisive variable is not the technology itself, but economic adaptability.

i. Conditional employment outcomes

- In flexible labour markets with strong skilling systems, AI acts as a productivity enhancer
- In rigid systems, it risks becoming labour-replacing

ii. Policy focus areas

Policy responses must therefore prioritise:

- Continuous and modular skilling
- Task-level transitions rather than occupation-level shocks
- Social protection mechanisms to support adjustment phases

g. Synthesis: Artificial Intelligence as an Institutional Force Multiplier

The Economic Survey conceptualises artificial intelligence not as a silver bullet, but as an institutional force multiplier. Its contribution to productivity, growth, and state capacity is conditional on complementary investments in compute, data, talent, and governance.

Without these institutional supports, AI risks remaining an enclave technology with limited economy-wide impact.

Conclusion

The Economic Survey places artificial intelligence at the frontier of India's productivity challenge, highlighting both its transformative promise and its structural constraints. While AI can accelerate growth, enhance state capacity, and improve service delivery, its ultimate impact will depend on how effectively India addresses compute, data, and talent bottlenecks while crafting governance frameworks that balance innovation with trust.

A development-oriented AI strategy—grounded in inclusion, applicability, and institutional complementarity—offers India the opportunity not merely to adopt artificial intelligence, but to deploy it in service of broad-based and sustainable growth.

10. From Economic Strength to Strategic Power

a. Introduction

In an era marked by geopolitical fragmentation, weaponisation of supply chains, and intensifying technological rivalry, the Economic Survey advances a decisive argument: economic strength alone is no longer sufficient. It must be converted into strategic resilience if nations are to protect growth, autonomy, and policy space.

For India, the challenge is to move beyond an inward-looking mindset of import substitution, pass through a phase of strategic resilience, and ultimately achieve strategic indispensability. This transformation, the Survey argues, hinges fundamentally on state capacity. In doing so, it reframes the role of the State—not as a minimalist regulator or an overbearing controller, but as an entrepreneurial, enabling, and strategically intelligent actor.

b. From Import Substitution to Strategic Indispensability

The conceptual core lies in distinguishing three stages of economic strategy: import substitution, strategic resilience, and strategic indispensability.

i. Import substitution: limits of defensive self-reliance

Import substitution represents the older paradigm, centred on domestic production of previously imported goods through protective barriers. While this approach may reduce external dependence in a narrow sense, the Survey is clear about its structural limitations.

Persistent protection tends to generate:

- Cost inefficiencies and weak competitiveness
- Technological stagnation and limited innovation
- Fiscal strain from sustained support
- Isolation from global production and knowledge networks

As a result, import substitution often produces illusory self-reliance, failing to build underlying capabilities.

ii. Strategic resilience: intelligent integration with safeguards

Strategic resilience marks a more advanced and pragmatic stage. It refers to the ability of an economy to absorb shocks, withstand disruptions, and resist coercion without systemic breakdown.

Crucially, resilience does not imply insulation from global markets. Instead, it rests on:

- Diversified supply chains
- Domestic capability in critical sectors
- Redundancy where risks are high
- Strategic buffers in energy, food, and finance

India's emphasis on energy security, digital public infrastructure, and defence manufacturing reflects this approach. As the Survey underlines, strategic resilience is fundamentally about risk management, not economic isolation.

iii. Strategic indispensability: from defence to influence

The final and most sophisticated stage is strategic indispensability. At this level, a country becomes so integral to global systems that others depend on it for their own stability and growth.

Unlike resilience, which is defensive, indispensability is proactive. It creates mutual dependence, allowing a country to shape outcomes rather than merely absorb shocks. India's potential role in semiconductor ecosystems, pharmaceutical supply chains, and digital public goods illustrates this aspiration.

True strategic autonomy, the Survey emphasises, arises not from isolation but from indispensability.

c. The Entrepreneurial State: Enabling, Not Controlling

The Economic Survey advances the idea of the entrepreneurial State, carefully distinguishing it from both the licence-permit raj of the past and from state monopolisation or crony capitalism.

An entrepreneurial State is one that:

- Creates markets rather than merely regulating them
- Reduces uncertainty and crowds in private investment
- Takes early-stage risks where private capital hesitates
- Builds platforms instead of directly producing goods
- Withdraws once markets mature

Investments in infrastructure, digital public infrastructure, and research and development ecosystems exemplify this approach.

This model is especially relevant for India. As a capital-scarce economy facing long-gestation investments, high uncertainty, and strategic technologies with unclear short-term returns, India cannot rely on private capital alone to bear first-mover risks. The entrepreneurial State, therefore, does not replace markets; it makes them possible.

d. Deregulation as an Expression of State Capacity

One of the most analytically striking arguments concerns deregulation. Conventional wisdom often equates stronger state capacity with more regulation. The Economic Survey deliberately reverses this logic.

Excessive regulation often reflects:

- Administrative overload
- Proliferation of procedural controls
- Opportunities for rent-seeking
- Weak enforcement capacity

In contrast, effective deregulation is a marker of high state capacity. It allows the State to focus on outcomes rather than procedures, improves rule clarity, and strengthens credibility.

A weak State compensates for limited enforcement by multiplying rules. A strong State governs through trust, transparency, and credible enforcement. Deregulation, therefore, should be understood not as state retreat, but as state confidence.

e. State Capacity as the Binding Constraint

At its deepest analytical level, the Survey identifies state capacity as India's binding constraint. State capacity refers to the ability to:

- Design sound policies

- Implement them effectively
- Enforce rules consistently
- Adapt institutions based on feedback

It encompasses administrative competence, legal enforcement, data systems, inter-agency coordination, and public trust.

The Survey's central claim is stark: India's challenges arise not from lack of ideas, resources, or intent, but from limitations in execution capacity. Infrastructure outcomes are constrained by project execution, welfare programmes by targeting and leakage, regulation by weak enforcement, and industrial policy by coordination failures.

Without adequate state capacity:

- Higher spending yields diminishing returns
- Additional regulation becomes counterproductive
- New schemes underperform regardless of intent

f. Role of the Private Sector and Citizens

The Economic Survey explicitly rejects both excessive state dominance and passive corporate dependence. Strategic outcomes require competitive markets, innovation, risk-taking, and global integration by the private sector.

Equally important is the role of citizens, often underappreciated in discussions of state capacity. Compliance reduces enforcement burdens, trust lowers transaction costs, participation improves policy feedback, and accountability strengthens institutions.

State capacity, in this sense, is co-produced by the State and society, not generated by institutions in isolation.

g. Synthesis: Economic Governance as Strategy

The Economic Survey weaves these strands into a coherent strategic framework. State capacity enables an entrepreneurial State, which supports smart deregulation and private sector dynamism. Together, these foundations build strategic resilience and, over time, strategic indispensability.

Economic governance, in this vision, is not routine administration but an instrument of national strategy.

Conclusion

The Economic Survey presents a compelling vision of India's strategic future. Strategic autonomy, it argues, will not be secured through protectionism or inward withdrawal, but through resilience, indispensability, and institutional strength. At the centre of this transition lies state capacity—the ability to govern effectively, deregulate intelligently, and partner productively with markets and citizens.

As global uncertainty deepens, India's true comparative advantage will rest not merely in scale or growth rates, but in its capacity to translate ambition into execution and resilience into strategic relevance.

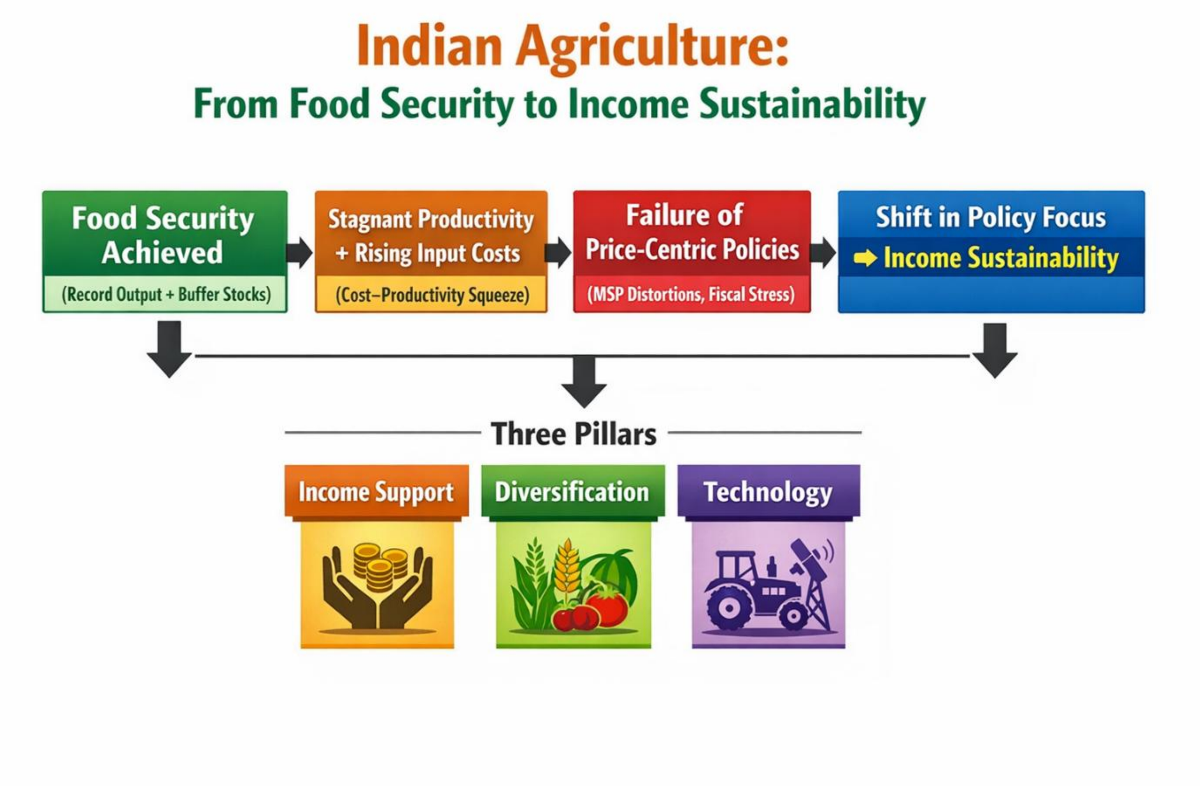
MODERATELY IMPORATANT TOPICS

1. From Food Security to Income Sustainability

a. Introduction

Indian agriculture today no longer suffers from a food security deficit. The country produces record quantities of foodgrains and maintains substantial buffer stocks. Yet, beneath this apparent success lies a deeper and more persistent crisis: the sustainability of farm incomes.

The core problem is not inadequate production, but a widening mismatch between stagnant productivity and rapidly rising input costs. As a result, traditional policy instruments centred on prices and procurement are proving increasingly ineffective. This structural reality necessitates a fundamental shift in policy thinking. The challenge before Indian agriculture is no longer how to produce more of the same crops, but how to enable farmers to earn more from the land they cultivate.



b. Stagnant Productivity and Rising Input Costs: The Core Structural Contradiction

Indian agriculture is trapped in a persistent cost–productivity squeeze. While the cost of cultivation continues to rise sharply, yield growth has slowed or plateaued across major crops. The result is stagnating or declining net farm incomes even in years of good production.

i. Structural causes of productivity stagnation

The plateau in productivity reflects multiple long-term structural factors:

- Exhaustion of Green Revolution gains, which were largely one-time improvements driven by irrigation, fertilisers, and high-yielding varieties
- Fragmentation of landholdings, with average operational holdings falling below economic viability, limiting scale efficiencies and mechanisation
- Degradation of natural capital, including soil fatigue, groundwater depletion, and declining total factor productivity

These trends raise costs without generating commensurate yield gains.

ii. Drivers of rising input costs

Input costs continue to rise due to deep-rooted structural pressures:

- Increased dependence on hybrid and proprietary seeds
- Fertiliser prices linked to volatile global energy markets
- Rising labour costs due to rural wage growth and migration
- Higher irrigation expenses caused by falling groundwater tables
- Continued reliance on informal credit, raising borrowing costs

Even when output prices rise nominally, real farm incomes often decline because cost escalation outpaces productivity growth.

iii. Broader economic implications

This contradiction explains the persistence of farmer distress despite record foodgrain output. At the macro level, it fuels subsidy dependence, accelerates environmental degradation, and pushes rural youth out of agriculture without adequate non-farm alternatives. What appears to be a price problem is, in reality, a productivity-led income crisis.

c. From Price Support to Income Support: A Necessary Shift

Price-based agricultural policies are premised on the assumption that higher output prices will translate into higher farmer incomes. Over time, this logic has weakened.

i. Structural limitations of price support

Price support mechanisms suffer from three core limitations:

- Production distortions, encouraging monoculture and overproduction of low-value crops
- Uneven distribution of benefits, favouring surplus regions while excluding small and rainfed farmers
- Rising fiscal and ecological costs, particularly through water-intensive procurement-driven cropping systems

Higher administered prices often generate market gluts and fiscal stress without delivering durable income gains.

ii. Conceptual superiority of income support

Income support offers a more coherent alternative. By decoupling income security from output decisions, it provides a predictable income floor while allowing market signals to guide cropping choices. This neutrality encourages diversification, reduces risk aversion, and avoids many distortions associated with price guarantees.

Income support shifts the policy focus from dictating what farmers should grow to ensuring that farming households can maintain a dignified livelihood.

iii. Limits of income support

However, income support is not a substitute for productivity growth. It does not automatically raise yields and must be complemented by reforms in technology, market access, and risk management. It should therefore be viewed as a transition instrument, enabling deeper structural change rather than as an end goal.

d. Crop Diversification: The Economic Logic of Income Growth

Crop diversification has shifted from a desirable option to an economic necessity. Multiple forces make diversification unavoidable:

- Low value per hectare in staple crops

- Rising climate variability and production risk
- Changing dietary demand towards high-value foods
- Ecological stress from water- and input-intensive farming

i. Value-based income versus volume-based income

The economic rationale for diversification is clear. Staple crops generate volume-based income, while diversified farming systems generate value-based income. Horticulture and allied activities offer higher returns per hectare, faster cash cycles, and stronger linkage to expanding markets.

Diversification also acts as a risk-hedging mechanism, spreading income across crops, seasons, and market segments, while aligning production with India's evolving consumption structure.

ii. Structural barriers to diversification

Farmers' reluctance to diversify reflects rational responses to risk, not informational failure. Key constraints include:

- High price volatility in non-staple crops
- Inadequate storage, processing, and cold-chain infrastructure
- Uncertain market access and weak value chains
- Credit and insurance systems designed around cereals

Diversification therefore requires systemic support, not advisory persuasion alone.

e. Technology as the Bridge to Income Transition

Technology forms the central link between low productivity and sustainable income growth by reducing uncertainty and improving efficiency.

i. Irrigation efficiency as risk management

The focus of irrigation policy has shifted from expanding coverage to improving efficiency. Efficient water use stabilises yields, enables multiple cropping, supports diversification, and reduces climate risk. Irrigation now functions as a risk-management tool as much as a yield enhancer.

ii. Mechanisation in a smallholder context

Mechanisation should be understood as enhancing labour productivity rather than replacing labour. It reduces drudgery, improves timeliness of operations, and offsets rising wage costs. Custom hiring centres and shared-access models are essential for reconciling mechanisation with fragmented landholdings.

iii. Digital agriculture and precision decision-making

Digital agriculture marks a transition from guesswork to precision:

- Weather data improves crop planning
- Advisory platforms optimise input use
- Market information enhances price discovery
- Digital credit and insurance reduce risk exposure

By improving access to information, digital tools transform farmers from passive price takers into informed economic decision-makers.

Crucially, technology lowers uncertainty—the single largest barrier to diversification. With technological support, diversification becomes a calculated choice rather than a gamble.

Conclusion

Indian agriculture is undergoing an inevitable structural transition from a production-maximisation model to an income-sustainability model. Stagnant productivity combined with rising input costs has exposed the limits of price-centric policies, making income support, diversification, and technology adoption central to future strategy.

The real policy challenge lies not in choosing between price and income support, but in sequencing reforms so that income security enables farmers to adopt technology, diversify intelligently, and gradually escape the low-productivity trap.

The future of Indian agriculture lies not in growing more, but in earning better.

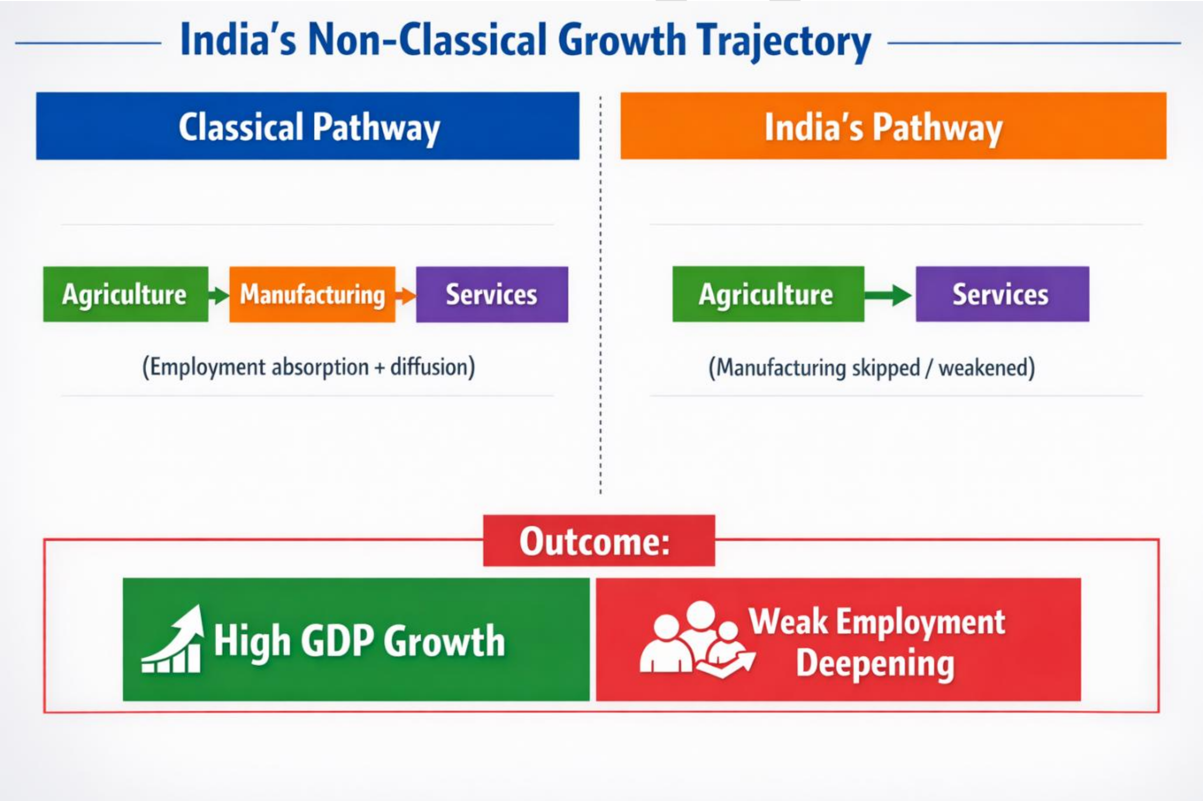
2. The Centrality of Services in India's Growth Story

a. Introduction

India's growth trajectory has diverged sharply from the classical development pathway followed by most industrialised economies. Instead of moving sequentially from agriculture to manufacturing and then to services, India has transitioned directly from agriculture into services.

As a result, the services sector has emerged as the primary engine of economic growth, a stabiliser of the external sector, and the leading contributor to productivity gains. This atypical pathway has enabled high aggregate growth and rapid global integration. At the same time, it has exposed deep structural limits, particularly when contrasted with manufacturing's traditional role in employment absorption and broad-based structural transformation.

The outcome is a dual growth paradox: robust GDP growth accompanied by weak and uneven employment deepening.



b. Services as the Principal Driver of Growth

The dominance of services in India's growth process rests on a set of structural advantages that manufacturing has struggled to replicate.

i. Structural advantages of services

Services leverage India's human capital more effectively, particularly its large pool of skilled and semi-skilled labour. Unlike manufacturing, services:

- Face fewer land acquisition constraints
- Require lower upfront physical infrastructure
- Are less dependent on complex logistics
- Are often digitally tradable, enabling global market access

These characteristics allow services to scale rapidly with relatively modest capital investment.

ii. Macroeconomic implications

As a result, services contribute disproportionately to:

- Gross domestic product growth
- Export earnings
- Aggregate productivity gains

In contrast, manufacturing faces high entry barriers in the form of capital intensity, regulatory friction, and supply-chain complexity. This asymmetry explains why India has been able to globalise economically without industrialising first.

However, while this model has made growth less resource-intensive, it has also reduced employment elasticity, creating a structural tension between output growth and job creation.

c. Global Capability Centres: The Flagship of Services-Led Growth

Global Capability Centres (GCCs) represent the most visible and sophisticated manifestation of India's services-driven growth.

i. Functional upgrading within global value chains

GCCs signify far more than traditional outsourcing. They reflect India's functional upgrading within global value chains, marked by a shift from back-office tasks to:

- Core business processes
- Research and development
- Analytics and design
- Strategic and managerial functions

Through these centres, India has embedded itself in high-value segments of the global knowledge economy.

ii. Structural advantages over manufacturing

The rapid expansion of GCCs is explained by their structural advantages relative to manufacturing plants:

- Lower capital intensity
- Minimal regulatory friction
- High locational flexibility
- Faster establishment timelines

Multinational firms can establish offices far more easily than factories.

iii. Emerging asymmetries

However, this success also deepens structural asymmetries:

- Employment is highly skill-selective
- Growth is spatially concentrated in urban enclaves
- Backward linkages with the domestic economy remain weak

While manufacturing diffuses growth through supplier networks and ancillary industries, GCC-led growth remains concentrated socially and geographically.

d. Limits of Services-Led Growth

The central analytical concern lies in the limits of services-led growth, particularly with respect to employment, the external sector, and structural transformation.

i. Employment intensity constraint

Services generate fewer jobs per unit of output than manufacturing. High productivity, automation-friendly processes, and skill-biased demand constrain their ability to absorb semi-skilled and low-skilled labour. At scale, this produces tendencies of jobless growth.

Manufacturing differs fundamentally by:

- Absorbing labour exiting agriculture
- Providing laddered skill progression
- Generating strong employment multipliers through supply chains

Without manufacturing, services alone cannot resolve India's demographic employment challenge.

ii. External sector imbalance

A second limitation emerges in the external sector. Strong services exports attract capital inflows and exert upward pressure on the currency. While this reflects economic success, it can erode the competitiveness of merchandise exports by raising relative prices.

This imbalance is structural rather than policy-driven. Manufacturing exports provide a counterweight by:

- Diversifying export composition
- Stabilising export volumes
- Buffering currency volatility

An external sector anchored solely in services remains vulnerable to exchange-rate dynamics and demand shocks.

iii. Incomplete structural transformation

The third limitation concerns incomplete structural transformation. In the classical pathway, manufacturing acts as a bridge between agriculture and services. India's shortcut has left this bridge underdeveloped.

The result is:

- Persistence of informality
- A dual economy with high-productivity service enclaves
- Large pools of low-productivity mass employment

Services modernise national income faster than they modernise employment structures.

e. Why Services Cannot Substitute Manufacturing

The relationship between services and manufacturing is fundamentally one of complementarity, not substitution.

Services excel at:

- Driving rapid growth
- Facilitating innovation
- Enabling global integration

Manufacturing, though slower to scale, performs essential anchoring functions by:

- Absorbing labour at scale
- Diffusing growth across regions
- Stabilising the external sector

India's strategic challenge therefore lies not in choosing between services and manufacturing, but in correcting the sequencing imbalance created by premature service dominance. Services amplify growth, but manufacturing anchors it.

Conclusion

India's services sector has been an exceptional growth accelerator, enabling rapid global integration without a manufacturing-first phase. Global Capability Centres epitomise this success, embedding India within the global knowledge economy.

Yet, services-led growth reveals inherent structural limits in employment generation, external sector resilience, and inclusive transformation. Sustainable and inclusive growth will therefore require not a retreat from services, but a deliberate rebalancing, in which manufacturing complements services by absorbing labour, stabilising trade, and spreading growth beyond urban enclaves.

Services may power India's growth engine, but manufacturing must provide its chassis.

3. Urbanisation as a Binding Constraint in India's Growth Story

a. Introduction

India is urbanising rapidly, but the institutions that govern cities are not evolving at a commensurate pace. People, firms, and capital are concentrating in urban spaces faster than infrastructure provision, municipal capacity, and governance systems can respond. This structural mismatch has transformed cities from engines of growth into bottlenecks that impose costs through congestion, informality, weak service delivery, poor investment climate, and rising inequality.

This governance deficit has clear macroeconomic implications. As the urban share of population and the urban contribution to gross domestic product continue to rise, the quality of urban governance will increasingly determine whether urbanisation yields a productivity dividend or becomes a drag on growth. Urban governance, therefore, is not a peripheral administrative concern but a binding constraint on India's development trajectory.

b. Informal Urbanisation: The Dominant Indian Reality

The defining feature of India's urban transition is informality. Informal urbanisation refers to the expansion of cities outside formal planning, land titling, and service delivery frameworks. Settlements emerge without mapped layouts or trunk infrastructure, employment expands in low-productivity informal enterprises, and peripheral census towns grow rapidly while being governed under rural institutional arrangements. Migrants are absorbed economically into cities, but not institutionally.

i. Structural drivers of informality

This pattern is not a matter of preference but an institutional outcome shaped by both demand and supply forces:

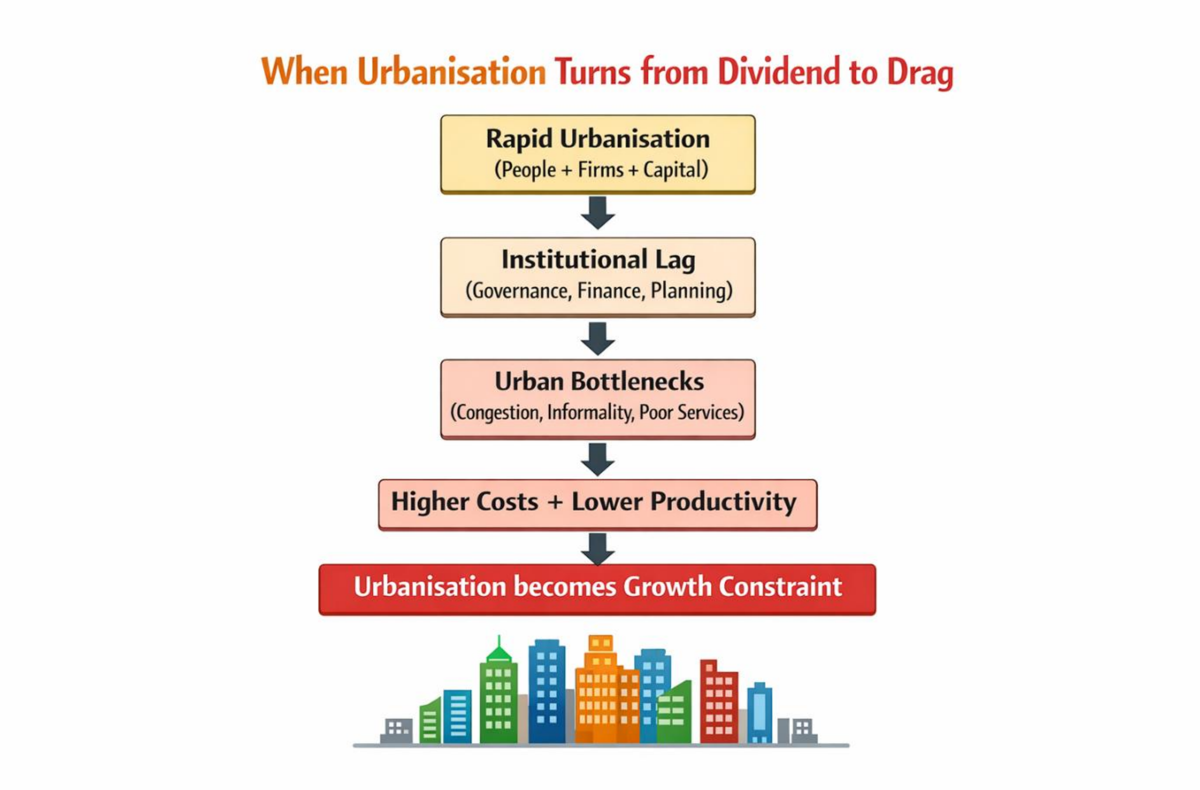
- Demand-side pressures, including rural distress, demographic momentum, and aspiration-driven migration
- Supply-side failures, marked by inadequate availability of formal housing and serviced land
- Distorted land markets, weak titling systems, and high compliance costs
- Static master plans, unable to accommodate the dynamic and incremental nature of urban growth

Under these conditions, informality becomes the default mode of urban expansion.

ii. Informality as a governance failure

Informality becomes a governance problem when it locks cities into a low-productivity equilibrium. Settlements lacking formal status receive inadequate water, sanitation, and waste services, resulting in health burdens and productivity losses. Over time, these conditions entrench urban poverty and raise the fiscal cost of retrofitting infrastructure.

Informality, therefore, is not merely illegal housing; it is the emergence of a parallel urban economy created by institutional gaps in planning and service delivery.



c. Weak Municipal Finances: The Fiscal Root of the Deficit

At the core of India's urban governance challenge lies a fiscal contradiction. Municipalities are tasked with delivering complex city-level outcomes while operating with revenue structures closer to those of rural local bodies. Urban local governments remain heavily dependent on intergovernmental transfers and possess limited own-source revenue capacity.

i. Structural weaknesses in municipal revenue

Municipal finances are constrained by several persistent weaknesses:

- Property taxation failures, including under-coverage, undervaluation, and weak enforcement
- Inadequate user charges for water, sanitation, and solid waste services, leaving operations underfunded
- Underutilisation of land value capture instruments, despite rising urban land values

These constraints undermine financial autonomy and service sustainability.

ii. Transfer dependence and credit constraints

Heavy reliance on transfers further weakens municipal capacity. Intergovernmental transfers are often unpredictable, delayed, or tied to rigid conditions, while state-level controls limit local fiscal discretion. Weak accounting systems, poor balance sheets, and volatile cash flows reduce municipal creditworthiness, restricting access to long-term borrowing and private capital.

iii. Reform imperatives

The direction of reform is increasingly clear:

- Strengthening property tax systems through improved mapping, valuation, billing, and enforcement
- Rationalising user charges to ensure cost recovery and service sustainability
- Revitalising State Finance Commissions to deepen urban fiscal federalism

The growing emphasis on municipal reforms within national urban missions reflects an acknowledgement that infrastructure outcomes cannot be separated from fiscal capacity.

d. The Planning–Execution Gap: The “Paper City” Syndrome

A persistent feature of Indian urban governance is the disconnect between ambitious plans and lived outcomes. Cities often exhibit comprehensive plans without executable projects, projects without maintenance systems, and accountability frameworks without corresponding capacity. As a result, cities appear robust on paper but fragile in practice.

i. Capacity and coordination failures

Several factors explain this gap:

- Acute capacity deficits within urban planning institutions
- Shortages of trained technical and managerial personnel
- Fragmented governance structures involving multiple agencies—municipal bodies, development authorities, parastatals, and state departments

This diffusion of authority results in the absence of a single accountable entity for city-wide outcomes.

ii. Distorted incentives and weak systems

Incentive structures further skew priorities. Capital expenditure is politically visible and therefore prioritised, while maintenance and service quality receive limited attention. Weak outcome metrics encourage asset creation over service delivery. Data gaps, poor asset registers, procurement inefficiencies, and weak monitoring systems contribute to delays, cost overruns, and underperformance.

India’s urban deficit, therefore, is not merely an infrastructure gap but an institutional throughput gap, reflecting the inability to convert plans into sustained service outcomes.

e. Urban Governance as a Growth Constraint

Cities are central to productivity growth through agglomeration economies, efficient matching of workers and firms, and innovation spillovers. When governance is weak, these advantages are reversed and cities impose a tax on growth.

Key channels through which weak urban governance constrains growth include:

- Congestion costs, leading to lost work hours, logistical delays, and higher transaction costs
- Public health externalities, as weak water, sanitation, and waste services increase disease burdens
- Investment deterrence, due to informality in land and enterprises
- Low-productivity traps, as firms remain small to avoid regulatory complexity
- Fiscal fragility, limiting the ability to build stable infrastructure pipelines or leverage private capital

When weak municipal finances, limited capacity, and poor execution interact, urbanisation ceases to be a dividend and becomes a structural constraint on economic expansion.

Conclusion

India's urban challenge does not arise because people are moving to cities, but because institutions are failing to move with them. Informal urbanisation, weak municipal finances, and a persistent planning–execution gap together constitute a governance deficit that depresses productivity, raises business costs, and deepens inequality.

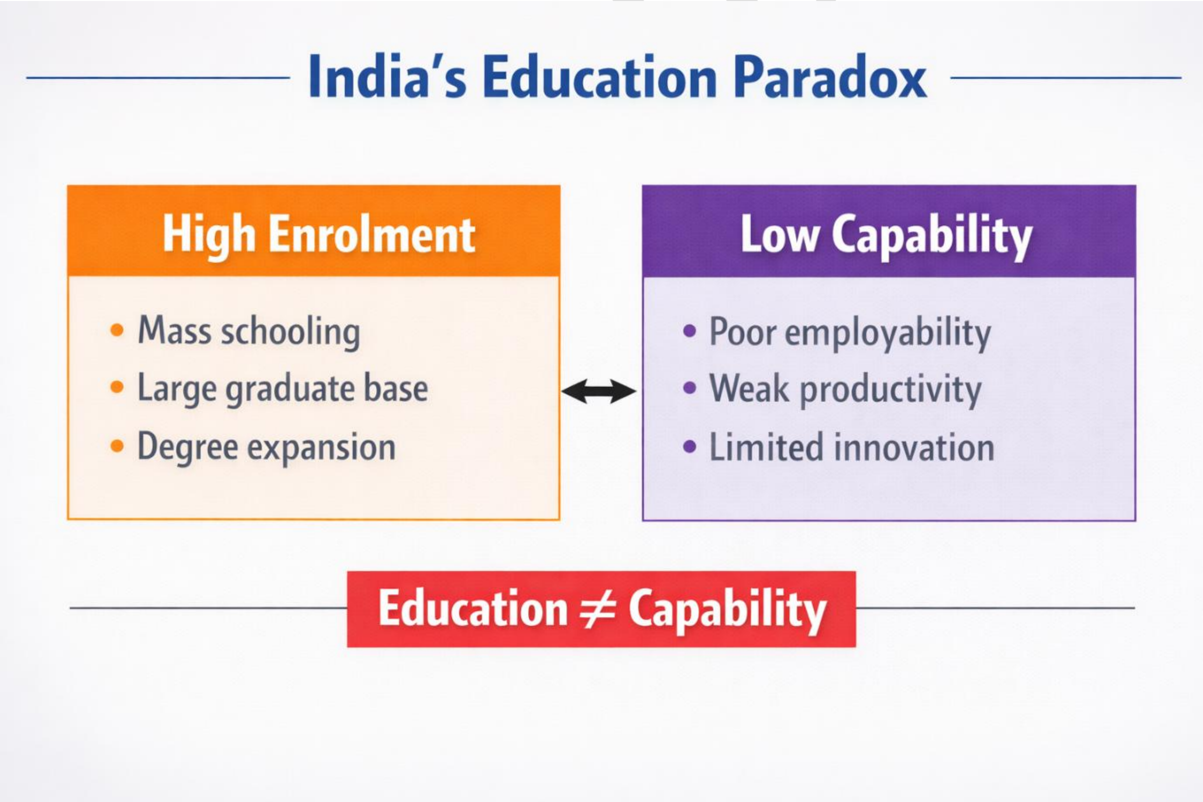
As urban areas become central to India's development ambitions, strengthening municipal capacity and fiscal autonomy must be viewed not as welfare-oriented interventions, but as core macroeconomic growth reforms. The success of India's urban future will ultimately depend on whether governance can catch up with urbanisation itself.

4. The Quiet Crisis: Education without Capability

a. Introduction

India today exhibits a profound paradox. It has one of the largest formally educated populations in the world, yet continues to struggle with low employability, weak labour productivity, and limited innovation capacity. The central problem no longer lies in access to education, but in what education delivers in terms of cognitive skills, adaptability, and economic capability.

As a result, education outcomes have emerged as a binding constraint on growth, state capacity, and social mobility. Education is no longer merely a social sector concern; it has become a core macroeconomic and governance challenge. The quality of human capital produced by the education system will increasingly determine whether India's demographic profile becomes a dividend or a drag.



b. Enrolment Expansion and the Learning Outcomes Gap

Over the past two decades, India has achieved significant success in expanding access to schooling and higher education. Enrolment rates have risen sharply, attendance has improved, and formal educational participation is now near-universal at the school level. However, this quantitative expansion has not translated proportionately into improved learning outcomes.

Once access reaches saturation, further gains from enrolment expansion diminish rapidly. At this stage, outcomes depend primarily on instructional quality, curriculum relevance, and institutional effectiveness. India has largely solved the problem of schooling, but not the problem of learning.

i. Foundational learning deficits

Weak learning outcomes are rooted in early-stage deficits:

- Poor foundational literacy and numeracy
- Students progressing through grades without mastering basic competencies
- Accumulation of learning gaps over time, creating a pipeline problem

Higher education institutions inherit students with weak foundations, limiting the effectiveness of advanced instruction.

ii. Pedagogy and assessment failures

Pedagogical practices reinforce these deficits:

- Rote-based and examination-centric instruction
- Limited emphasis on conceptual understanding and problem-solving
- Evaluation systems that reward recall rather than reasoning

This narrows learning outcomes and discourages critical thinking.

iii. Teacher capacity and governance gaps

Teacher quality and incentives play a decisive role. Variations in teacher capability, limited continuous professional development, and weak performance-linked accountability undermine classroom effectiveness. From a governance perspective, this represents a service delivery failure, not merely a resource shortage.

c. The Skill–Education Mismatch and the Employability Gap

A direct consequence of weak learning outcomes is the growing mismatch between educational attainment and workplace skills. This skill–education mismatch arises when formal qualifications fail to translate into job-ready capabilities. Degrees increasingly signal completion rather than competence.

i. Manifestations of the mismatch

The mismatch is reflected in:

- Graduate unemployment and underemployment
- Employer dissatisfaction with job readiness
- Expansion of low-productivity service employment despite rising education levels

ii. Curriculum–economy disconnect

At the root lies a disconnect between curricula and economic realities:

- Slow curricular updates in rapidly changing economic contexts
- Weak industry–education feedback mechanisms
- Institutional inertia relative to labour market transformation

Educational systems move more slowly than economic structures, producing outdated skill profiles.

iii. Credential inflation and weak signalling

Credential inflation compounds the problem. Degrees become minimum entry filters even as skill differentiation remains weak. Over-qualification coexists with low productivity, eroding the signalling value of education. Degrees increasingly signal persistence and compliance rather than proficiency.

iv. Absence of experiential learning

Limited exposure to real-world problem-solving intensifies the mismatch:

- Weak internship and apprenticeship ecosystems
- Minimal workplace-based learning
- Employers bearing the burden of skill formation

Young entrants face barriers to labour market entry as firms prefer experienced workers.

This mismatch affects both manufacturing and services. Modern services demand cognitive, communication, and digital skills, while manufacturing requires technical competence and process discipline. Weak education quality undermines both, but is particularly damaging for labour-intensive manufacturing and productivity upgrading.

d. Human Capital Quality versus Human Capital Quantity

India's demographic advantage does not rest on population size or enrolment ratios, but on productive capability per worker. Economic growth depends on both workforce size and productivity per worker. While India has expanded educational access, productivity remains constrained by weak human capital quality.

i. Components of human capital quality

Human capital quality encompasses:

- Foundational skills enabling future learning
- Cognitive abilities such as reasoning and problem-solving
- Adaptability and capacity for lifelong reskilling
- Health and nutrition affecting physical and cognitive performance
- Soft skills including communication, teamwork, and reliability

Human capital is therefore measured not in years of schooling, but in years of effective learning.

ii. Economic consequences of low-quality human capital

Low-quality human capital traps the economy in a low-productivity equilibrium:

- Firms adopt low-skill, low-technology production models
- Innovation remains shallow and incremental
- Wage growth stagnates
- Structural transformation slows

Workers struggle to transition from agriculture to manufacturing or from low-end to high-value services.

iii. Governance and state capacity implications

The implications extend beyond markets to governance. State capacity depends on the availability of skilled teachers, engineers, healthcare workers, administrators, and technical professionals. Weak education outcomes erode institutional effectiveness, creating a feedback loop in which governance failures further weaken human capital formation.

e. Education Outcomes as a Macro Growth Constraint

From a macroeconomic perspective, poor learning outcomes initiate a cumulative chain reaction:

- Weak learning → inadequate skill formation
- Low skills → reduced labour productivity
- Low productivity → constrained industrial upgrading
- Limited upgrading → slow expansion of high-value services

This dynamic explains why high headline growth does not consistently generate quality employment, why formal sector job creation remains limited, and why informality persists despite educational expansion.

Education quality ultimately determines whether demographic change becomes a dividend or a drag.

Conclusion

India's education challenge has decisively shifted from access to outcomes, and from quantity to quality. While enrolment expansion has created a necessary foundation, persistent learning deficits and skill mismatches now threaten to dilute the country's demographic potential.

Human capital quality—defined by cognitive capability, adaptability, and productivity—has emerged as a central determinant of economic growth, employment generation, and governance effectiveness. Unless education systems are reoriented toward measurable learning outcomes and economic relevance, India risks becoming a society that is formally educated yet functionally under-skilled.

The future of India's growth will be written not in classrooms filled, but in capabilities created.

5. Health System Resilience

a. Conceptual Foundations of Health System Resilience

i. Big Picture Context: Why Resilience Matters

India's health system is conventionally assessed through capacity indicators such as the number of hospitals, hospital beds, doctors, and medical colleges. These indicators capture visible expansion but fail to reflect the system's ability to handle repeated and systemic shocks. Recent experiences—including pandemics, heatwaves, air pollution episodes, and the accelerating burden of non-communicable diseases—have revealed deeper structural fragilities.

India's health system demonstrates a reasonable ability to treat illness once it occurs, yet a limited capacity to prevent disease before onset. This asymmetry has critical implications for long-term sustainability.

ii. Defining health system resilience

Health system resilience refers to the capacity of the system to:

- Prevent avoidable health shocks
- Absorb and respond effectively to crises
- Maintain essential health services during periods of stress
- Protect long-term human productivity and welfare

Under this framework, health transcends the welfare lens and functions as core economic infrastructure, comparable to transport, energy, or education, because it underpins the productive potential of the population.

b. Preventive versus Curative Care: The Structural Imbalance

i. Nature of the Imbalance

India's health architecture remains heavily skewed towards curative, episodic, and hospital-centred care, while preventive and public health functions remain institutionally weaker. The prevailing model follows a reactive sequence—disease occurrence is followed by treatment and recovery, subject to affordability.

A resilient system, by contrast, operates upstream. It focuses on early risk identification, disease prevention, timely detection, and low-cost primary care before complications emerge.

ii. Why Preventive Care Remains Systemically Weak

Political economy bias

Curative care is visible, tangible, and politically creditable. Hospitals, advanced equipment, and specialist services produce immediate and demonstrable outputs. Preventive care, however, succeeds precisely when adverse outcomes do not occur. Its benefits are long-gestation, diffuse, and difficult to attribute to a single intervention, making it politically undervalued.

Fragmented public health functions

Effective prevention requires coordination across urban planning, sanitation, nutrition, environmental regulation, and behavioural change. Governance structures remain siloed, with weak institutional mechanisms for cross-sectoral convergence, diluting population-level impact.

Inadequate response to epidemiological transition

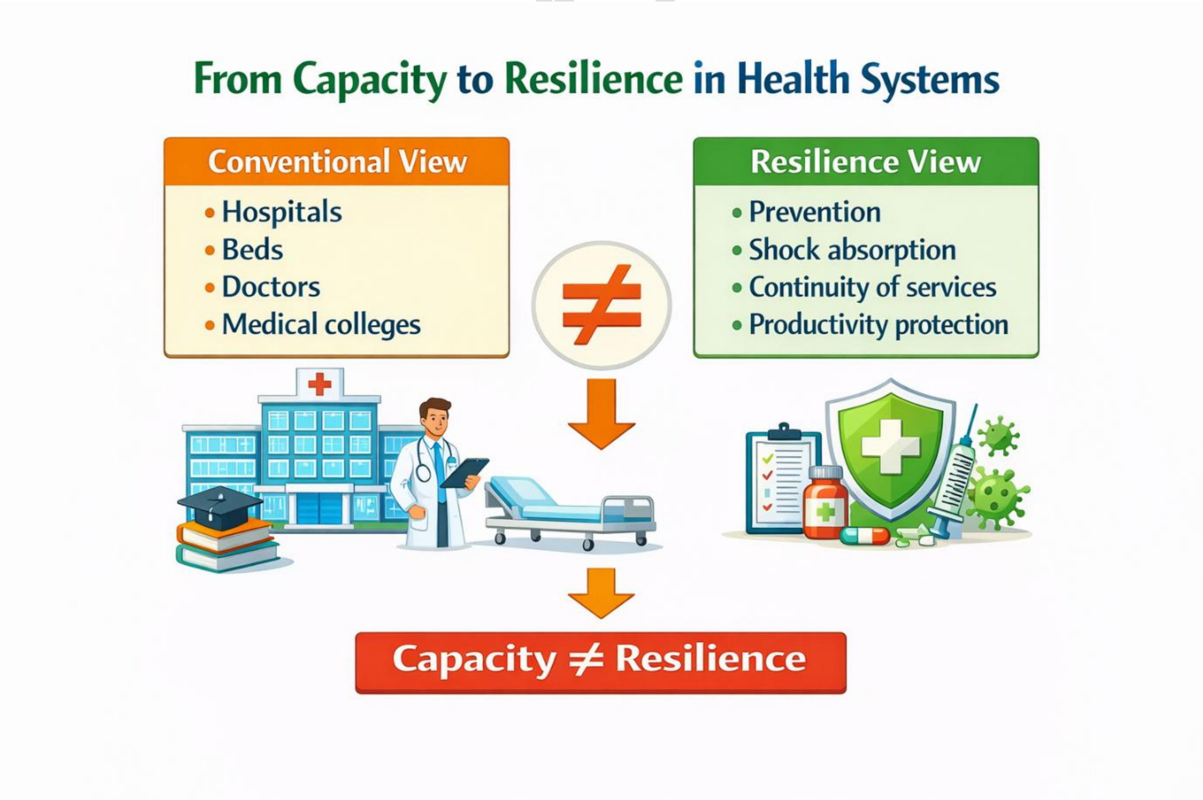
India faces a dual burden: persistent communicable diseases alongside a rapid rise in non-communicable diseases such as diabetes, cardiovascular disorders, and chronic respiratory illnesses. These conditions are highly prevention-sensitive, yet institutional priorities remain treatment-heavy, reinforcing downstream costs.

iii. Consequences of the Imbalance

The cumulative outcomes of this structural skew include:

- Rising out-of-pocket health expenditure
- Late-stage disease detection
- Chronic overburdening of tertiary hospitals
- Limited shock-absorbing capacity during health emergencies

A system oriented primarily towards cure may excel at firefighting but remains structurally ill-equipped for fire prevention.



c. Public Health Spending: Efficiency over Quantum

i. Why Efficiency Matters More Than Absolute Spending

Health system resilience depends less on the absolute size of expenditure and more on how resources are allocated, delivered, and monitored. Comparable spending levels can yield vastly different outcomes depending on alignment with disease burden, effectiveness of delivery mechanisms, and linkage between spending and outcomes.

Health resilience is therefore a function of spending quality rather than spending quantity alone.

ii. Key Efficiency Challenges in India's Health Spending

Input-focused budgeting

Health budgets emphasise infrastructure creation, personnel hiring, and procurement, with limited linkage to outcomes such as disease reduction or service quality. Capacity creation does not automatically translate into population health gains.

Weak prioritisation of primary care

Disproportionate allocation towards tertiary hospitals and urban centres leaves primary and preventive care under-strategised. Preventable conditions are thus treated at higher cost levels, undermining fiscal efficiency and equity.

Human resource productivity gaps

Skill deployment often mismatches local health needs, continuous training remains limited, and workforce distribution is uneven. Underutilisation in some regions and overload in others reduce system-wide effectiveness.

Data and accountability deficits

Weak disease surveillance, inadequate monitoring of service quality, and poor feedback loops prevent timely course correction. Without outcome-linked spending, health budgets risk becoming accounting exercises rather than resilience investments.

d. Health as a Productivity Investment

i. Moving Beyond the Welfare Paradigm

Health exerts a direct influence on labour productivity, learning outcomes, workforce participation, and macroeconomic stability. Economic output depends on workforce size, working hours, and productivity per hour—all of which are shaped by population health.

ii. Channels Linking Health and Productivity

Labour supply and participation effects

Reduced disease burden lowers absenteeism, extends working lives, and improves participation rates, especially among women.

Human capital formation

Early-life health affects cognitive development and learning capacity, while adult health shapes endurance, decision-making quality, and efficiency at work.

Household financial stability

Preventive health care lowers catastrophic health expenditure, stabilising consumption and savings, strengthening intergenerational mobility, and reducing poverty traps.

Macroeconomic resilience

Epidemics and chronic disease burdens impose large macroeconomic costs, behaving like negative productivity shocks that constrain long-term growth.

e. Health System Resilience as an Expression of State Capacity

i. Governance Foundations of Resilience

A resilient health system reflects broader state capacity. It requires:

- Long-term planning
- Inter-departmental coordination
- Fiscal prioritisation
- Trained human resources
- Data-driven decision-making

These are fundamentally governance functions rather than purely medical concerns.

ii. Integrated Causal Flow of Weak Resilience

A curative-heavy system weakens prevention and early detection, raising disease burden and treatment costs. This leads to productivity losses and household stress, ultimately undermining health system resilience and long-term growth prospects. Over time, these failures spill into labour markets, income distribution, and institutional credibility.

Conclusion

Health system resilience in India depends less on expanding curative capacity and more on correcting the structural imbalance between prevention and treatment. Persistent underinvestment in public health, early detection, and outcome-oriented spending predictably generates higher costs, weaker shock absorption, and sustained productivity losses.

Reframing health as a productive investment rather than a consumption expense shifts the analytical focus from hospital counts to human capability. In the long run, resilient health systems do more than save lives—they sustain economic growth, strengthen governance, and expand national potential. A nation's productivity is ultimately bounded by the health of its people.

6. Poverty, Inequality and Social Protection

a. Reframing Poverty in Contemporary India

India's contemporary poverty discourse has moved decisively beyond the narrow question of how many people fall below an income threshold. The more salient concerns now revolve around the nature of deprivation, the durability of exits from poverty, and the extent to which public spending translates into sustained capability gains rather than short-term relief.

Simultaneously, rising inequality and binding fiscal constraints compel difficult choices in the design of social protection systems. Policymakers must balance:

- Targeted versus universal approaches
- Relief-oriented measures versus long-term investments
- Fiscal prudence versus social justice

Poverty, therefore, is no longer examined merely as an outcome but as a dynamic condition shaped by vulnerability, inequality, and institutional effectiveness.

b. Multidimensional Poverty Reduction: A Trend-Based Perspective

i. Limits of Income-Centric Poverty Measures

Traditional income-based measures capture purchasing power and consumption capacity but inadequately reflect deprivation in critical dimensions such as health, education, living conditions, and access to basic services. Income alone does not fully represent human well-being or resilience to shocks.

This limitation has led to the adoption of multidimensional poverty frameworks, which conceptualise poverty as a denial of essential human capabilities rather than merely low income.

ii. Key Trend Insight in India

Over the past decade, India has experienced a substantial decline in multidimensional poverty. Improvements have been particularly visible in:

- Access to basic services
- Educational participation
- Health-related indicators

Crucially, recent poverty reduction has been driven increasingly by public provisioning of essential goods and services rather than income growth alone. Deprivation removal, rather than income expansion, has played the dominant role in shaping recent outcomes.

iii. Structural Drivers of the Trend

Expansion of public goods

Improved access to housing, sanitation, electricity, and drinking water has reduced non-income poverty even where income growth has been modest. These interventions directly enhance living standards and human development outcomes without relying solely on market-mediated gains.

Risk mitigation and stabilisation mechanisms

Social protection instruments cushioning households against health shocks, employment volatility, and climate-related disruptions have reduced poverty re-entry. Unlike earlier decades, where transient shocks frequently reversed gains, the contemporary framework emphasises stability and resilience.

Persistent Unevenness in Poverty Reduction

Despite aggregate progress, poverty reduction remains uneven due to:

- Regional disparities across states
- Under-captured urban informal poverty
- Variations in public service quality

India's poverty challenge has thus shifted from mass destitution to questions of vulnerability, service quality, and uneven capability formation.

c. Inequality as a Structural Development Constraint

i. Poverty Reduction without Equality

Poverty and inequality need not move together. Absolute poverty can decline even as relative inequality rises. This divergence generates social tensions, complicates political economy dynamics, and poses risks to the sustainability of growth.

Rising inequality weakens the social foundations of development even when headline poverty indicators improve.

ii. Channels through Which Inequality Operates

Opportunity inequality

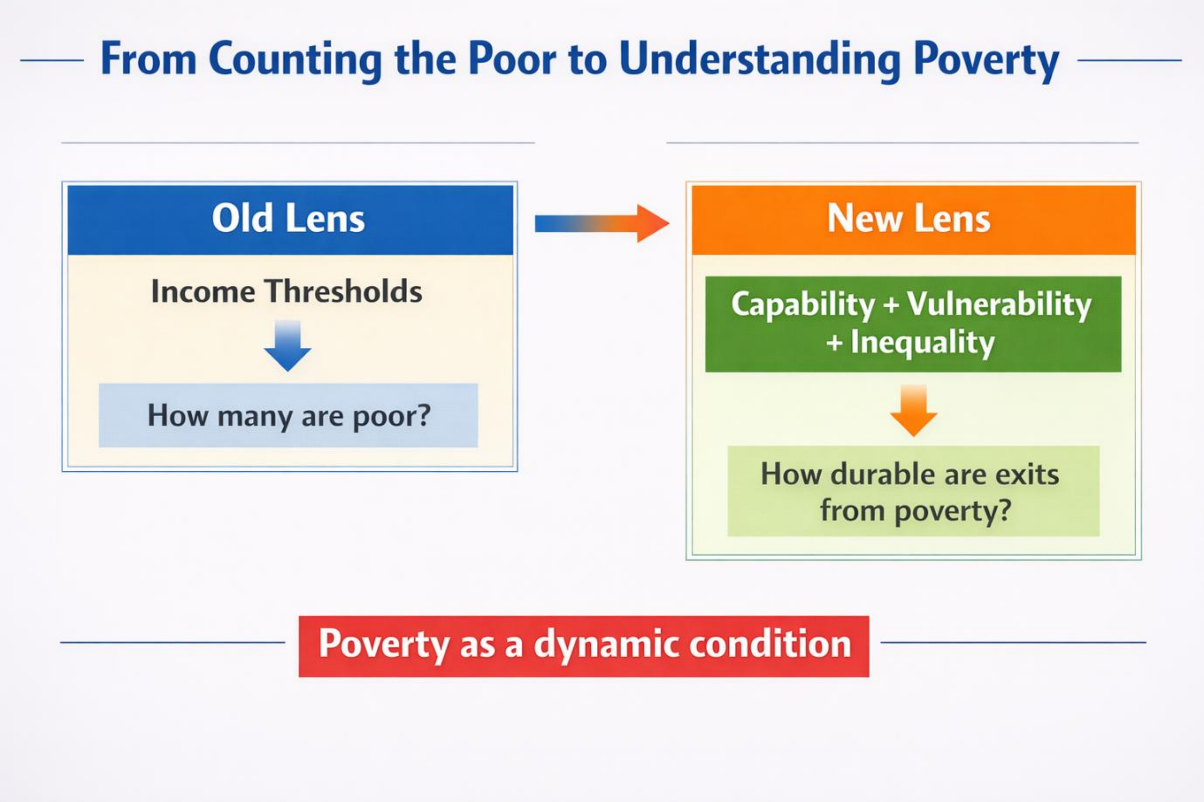
Unequal access to quality education, healthcare, and urban economic opportunities entrenches intergenerational mobility barriers. Outcomes increasingly depend on initial endowments rather than individual effort.

Spatial and occupational inequality

Economic growth has concentrated in select regions, urban centres, and skill-intensive sectors. Rural areas and informal workers lag behind, reinforcing regional and occupational divides. Inequality increasingly reflects location and access rather than productivity alone.

Implications for Social Protection Design

Rising inequality complicates welfare architecture. Universal expansion strains fiscal capacity, while targeted approaches risk exclusion errors and administrative failures. Political pressures often push systems towards broader coverage, intensifying tensions between fiscal sustainability and social inclusion.



d. Targeted Welfare versus Universalism

i. Logic and Limits of Targeting

Targeted welfare aims to concentrate resources on the most vulnerable, minimise fiscal costs, and maximise impact per unit of expenditure. In fiscally constrained settings, targeting offers efficiency and poverty focus.

However, persistent challenges include:

- Identification errors
- Administrative complexity
- Exclusion of eligible beneficiaries

Greater precision often increases implementation burdens and governance risks.

ii. Logic and Limits of Universalism

Universal approaches seek to eliminate exclusion, reduce stigma, and foster social solidarity through predictable entitlements. Administrative simplicity and political durability are key strengths.

Yet universalism entails:

- High fiscal costs
- Leakage to non-poor households

- Opportunity costs that may crowd out critical public investment

iii. The Emerging Middle Path

Policy thinking increasingly transcends this binary. A pragmatic hybrid approach includes:

- Universal access to basic services
- Targeted income or vulnerability-based support
- Life-cycle-based social protection
- Automatic stabilisers during economic or health shocks

The core policy question is not whether to choose universalism or targeting, but which welfare components should be universalised and which should remain targeted.

e. Efficiency of Social Spending

i. Why Efficiency Has Become Central

With rising social demands and limited fiscal space, the effectiveness of social expenditure has become as important as its scale. The critical concern is whether spending enables durable exits from poverty and sustained capability formation.

ii. Dimensions of Social Spending Efficiency

Allocation efficiency

Resources must address structural causes of deprivation rather than providing temporary relief. Poor allocation leads to symptom management without lasting upliftment.

Delivery efficiency

Leakages, delays, and administrative costs weaken impact. Accurate identification, timely transfers, and predictable service delivery significantly improve outcomes.

Outcome efficiency

The weakest yet most crucial link lies in monitoring whether spending translates into capability creation. When evaluation focuses on expenditure rather than outcomes, social spending risks becoming fiscally expensive compassion rather than transformative investment.

iii. Risks of Inefficiency

Inefficient social spending can:

- Crowd out capital expenditure
- Reduce long-term growth potential
- Weaken public trust
- Foster dependency traps

Over time, this undermines both economic resilience and institutional legitimacy.

Conclusion

India's poverty challenge has evolved from a problem of survival to one centred on capability, vulnerability, and inequality. The decline in multidimensional poverty reflects meaningful progress driven increasingly by public provisioning rather than income growth alone. Yet persistent inequality and fiscal constraints complicate the design of social protection systems.

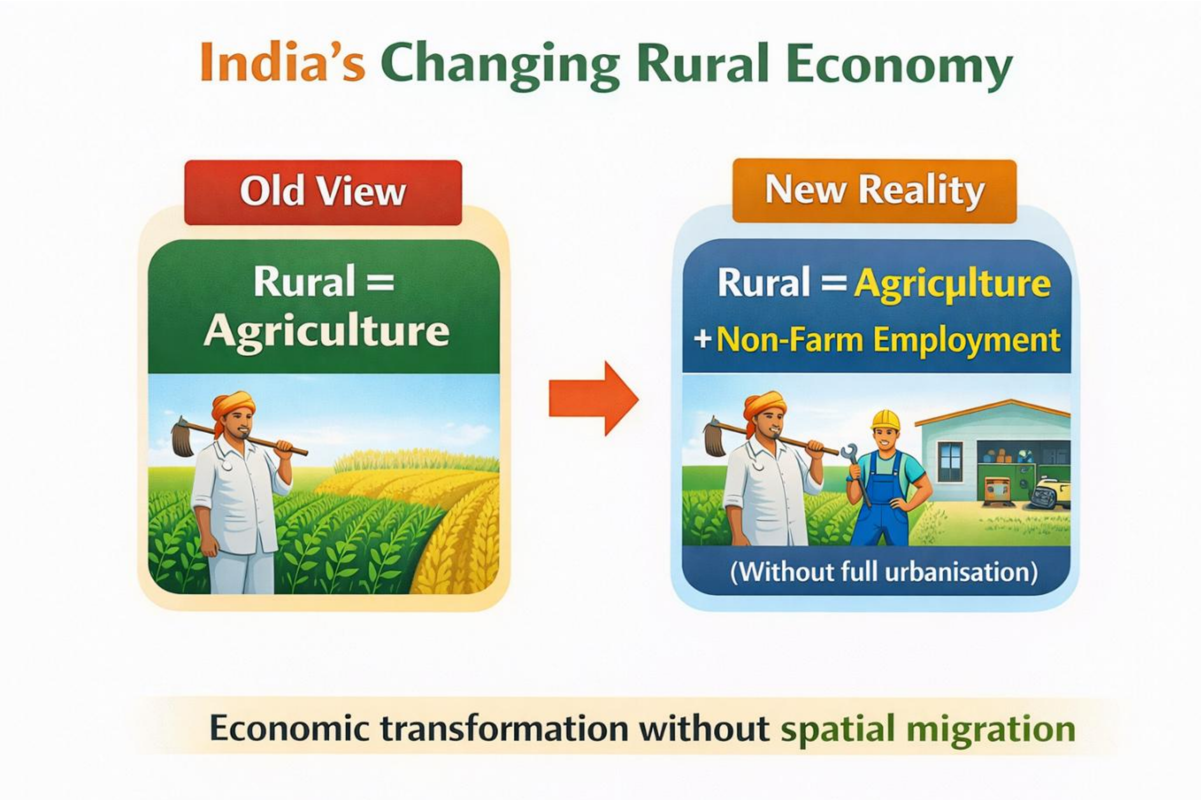
The debate between targeted welfare and universalism cannot be resolved ideologically; it must be addressed pragmatically through efficiency, outcome orientation, and sensitivity to vulnerability. In the coming decade, India's success will depend less on how much it spends on social protection and more on how effectively that spending translates into lasting human capability and social mobility. The true test of social protection lies not in relief delivered, but in poverty permanently escaped.

7. Rural Economy and Non-Farm Employment

a. Changing Contours of the Rural Economy

India's rural economy can no longer be understood as synonymous with agriculture alone. A gradual yet consequential transformation is underway, marked by diversification of rural livelihoods at a pace faster than changes in rural land use. Increasingly, income sources are non-farm in nature, while residence and social life remain rural.

This produces a distinctive economic reality in which employment structures, consumption patterns, and growth dynamics are reshaped without a corresponding spatial shift to cities. Rural India is thus undergoing economic transformation without full urbanisation.



b. Shift from Farm to Non-Farm Employment

i. The Emerging Employment Structure

Historically, rural India was closely equated with agriculture and farm-based employment. Contemporary rural labour markets, however, exhibit a more complex composition in which agriculture coexists with an expanding range of non-farm activities, including:

- Construction
- Small-scale manufacturing
- Trade and transport
- Services and public works
- Informal and self-employed occupations

India's labour transition is thus occurring largely within rural spaces, rather than through large-scale rural-to-urban migration.

ii. Why Farm Employment Is Shrinking Despite the Persistence of Agriculture

Productivity–labour mismatch in agriculture

While agricultural output continues, productivity growth remains limited, and additional labour generates diminishing marginal returns. This sustains high levels of disguised unemployment, pushing surplus labour out of farming without a corresponding decline in agricultural activity.

Demographic pressure and land fragmentation

Growth in the working-age population has exceeded agriculture's capacity to absorb new entrants. Fragmenting landholdings and rising mechanisation have further reduced agriculture's role as an employment absorber.

Income aspiration and risk considerations

Agricultural incomes are volatile and often inadequate, whereas non-farm work offers more regular cash flows and diversification of risk. Exit from farming is driven less by urban pull factors and more by push factors arising from farm stagnation.

iii. Nature of Rural Non-Farm Employment

Rural non-farm employment remains predominantly informal and low to medium in productivity. Much of it is seasonal and closely linked to construction and basic services. As a result, employment diversification has advanced faster than productivity transformation, producing a partial and uneven structural shift.

c. Rural Consumption Trends as an Indicator of Change

i. Why Consumption Provides a Clearer Lens

In rural India, income data is fragmented and employment patterns fluctuate seasonally. Consumption trends offer a more stable indicator of economic change, capturing both realised income and expectations of future stability.

ii. Shifts in Consumption Behaviour

A notable shift has occurred from subsistence-oriented spending towards discretionary consumption. Key trends include:

- Declining share of food expenditure
- Rising spending on education and healthcare
- Increased expenditure on mobility and consumer durables

Rural consumption is thus transitioning from survival-oriented patterns to aspiration-driven choices.

Role of non-farm income in stabilising consumption

Regular wages from construction, services, and informal enterprises reduce seasonal income volatility and smooth consumption across years. This improves household creditworthiness and deepens market participation.

Persistent heterogeneity across regions

Villages with better physical and digital connectivity experience faster income diversification and consumption upgrading, while remote regions remain agriculture-dependent and shock-prone. Rural India comprises multiple economies at different stages of transition.

d. Structural Rural Transformation: India's Distinctive Path

i. Beyond Sectoral Shifts

Structural transformation involves changes in employment sectors as well as shifts in income sources, productivity, consumption patterns, and exposure to risk. In India, these dimensions have evolved in ways that diverge from conventional trajectories.

ii. A Non-Linear Transition

Classical development models envisage a transition from agriculture to manufacturing and then to services, typically accompanied by urbanisation. India's experience differs:

- Shift from agriculture to rural non-farm services and construction
- Partial and uneven urbanisation
- Persistence of informality and low productivity

India is effectively urbanising economically before it urbanises geographically, resulting in slower productivity gains and blurred rural–urban boundaries.

iii. Drivers of Rural Non-Farm Expansion

Improved connectivity

Expansion of roads, transport networks, and digital access has enabled commuting, market integration, and non-farm activity growth.

Construction-led labour absorption

Infrastructure expansion and housing demand have made construction a major absorber of rural labour.

Education, skills, and agriculture-adjacent linkages

Basic education enables participation in services and trade. Many non-farm activities remain linked to agriculture through input supply, processing, logistics, and marketing, making rural non-farm growth agriculture-adjacent rather than independent.

e. Challenges in the Ongoing Transition

i. Productivity and Informality Constraints

The dominance of low-productivity informal employment limits income growth and resilience. Without skill upgrading and productivity enhancement, non-farm work risks replicating disguised unemployment outside agriculture.

ii. Gendered Exclusion

Women face constraints related to mobility, safety, access to skills, and social norms. As a result, participation in non-farm employment remains limited, risking a male-biased transition.

iii. Vulnerability to Shocks

Non-farm incomes remain sensitive to economic cycles and climate shocks. Construction and informal services are particularly vulnerable to downturns, making rural livelihoods fragile.

f. Policy Direction: A Structural Perspective

Policy must move beyond viewing rural areas solely as agricultural spaces and instead recognise them as integrated economic regions. Key priorities include:

- Improving physical and digital connectivity
- Deepening skill formation and training
- Enabling small-scale manufacturing and service clusters
- Strengthening access to credit and markets
- Enhancing resilience against economic and climatic shocks

The objective is not merely employment diversification, but productivity-led rural transformation.

Conclusion

India's rural economy is undergoing a gradual yet significant transformation, characterised by a steady shift from farm to non-farm employment and diversification of consumption patterns. This transition reflects both economic necessity and rising aspirations, as rural households seek stability beyond agriculture.

However, the predominance of low-productivity and informal non-farm jobs underscores the incomplete nature of this shift. Sustainable rural growth requires moving beyond labour exit from farming towards productivity enhancement, skill development, and resilience-building within rural non-farm livelihoods. The future of rural India lies not in abandoning agriculture, but in transcending its limits as an employment absorber.

8. State Finances and Sub-National Fiscal Risks

a. Sub-National Finances and Macroeconomic Stability

India's fiscal stability can no longer be assessed solely through the prism of Union government finances. States account for a substantial share of public expenditure, capital investment, borrowing, and delivery of essential services. Consequently, fiscal weaknesses at the sub-national level possess the capacity to undermine macroeconomic stability, compress growth-oriented public investment, and generate persistent fiscal stress.

The principal vulnerability does not lie in headline fiscal deficit figures, but in hidden, recurring, and poorly disclosed liabilities that accumulate outside formal budgets. These liabilities postpone adjustment while deepening long-term risks.

b. Off-Budget Borrowings: The Hidden Source of Fiscal Stress

i. Nature of Off-Budget Borrowings

Off-budget borrowings refer to debt raised outside the consolidated State budget, typically through:

- State-owned public sector undertakings
- Special purpose vehicles
- Borrowings backed by explicit or implicit State guarantees

While these liabilities do not immediately appear in fiscal deficit calculations, the responsibility for servicing and repayment ultimately rests with the State exchequer.

ii. Why States Rely on Off-Budget Routes

Fiscal rule-induced incentives

Borrowing limits under fiscal responsibility legislation incentivise shifting liabilities outside budget frameworks to remain formally compliant.

Political pressure and expenditure rigidities

Pressure to sustain welfare spending without commensurate revenue buoyancy encourages postponement of fiscal adjustment through off-budget mechanisms.

Infrastructure and subsidy commitments without fiscal space

Large infrastructure projects and subsidy obligations are often undertaken without adequate budgetary provision, leading to deferred recognition of liabilities.

In effect, fiscal compliance is achieved on paper, while fiscal stress is deferred into the future.

iii. Why Off-Budget Borrowing Poses Systemic Risks

Erosion of transparency and accountability

Understatement of true debt and deficit levels weakens legislative oversight and market scrutiny, reducing the credibility of fiscal accounts.

Future budget rigidity and crowding out

As liabilities mature, debt servicing crowds out discretionary spending, particularly capital expenditure and social sector allocations.

Weakening of general government credibility

Financial markets assess consolidated public finances. Hidden State liabilities can raise borrowing costs economy-wide.

The core issue, therefore, is not the absence of fiscal rules, but their observance in form rather than in spirit.

c. Power Sector Liabilities: A Chronic Structural Vulnerability

i. Why the Power Sector Matters for State Finances

Electricity distribution remains predominantly under State control, making the power sector a central source of fiscal risk. Persistent losses in distribution companies translate into mounting arrears, guaranteed borrowings, and periodic debt absorption by State governments. Consequently, the power sector represents the largest contributor to contingent liabilities at the sub-national level.

ii. Structural Sources of Recurring Stress

Political pricing and under-compensated subsidies

Electricity tariffs often fail to reflect cost structures, while subsidies announced by governments are inadequately or belatedly compensated, creating persistent revenue gaps.

Operational inefficiencies

High transmission and distribution losses, weak billing, and poor collection erode financial viability.

Regulatory and governance failures

Delays in tariff revisions and accumulation of regulatory assets postpone necessary corrections.

Power sector losses are therefore not merely operational deficiencies, but fiscal liabilities concealed within enterprise balance sheets.

iii. Fiscal Implications for States

Over time, liabilities migrate from distribution companies to State budgets through:

- Guarantees
- Debt restructuring
- Direct debt takeovers

This produces a recurring cycle of losses, borrowings, guarantees, and budgetary absorption, constraining States' ability to invest in infrastructure, health, education, and other development priorities. Power sector stress is thus structural rather than episodic.

d. Centre–State Fiscal Coordination: A Structural Challenge

i. Why Coordination Is Indispensable

India operates under a rules-based fiscal framework, yet aggregate fiscal outcomes depend on the combined behaviour of Union and State governments. Weak coordination between the two tiers dilutes the effectiveness of fiscal discipline.

Uniform borrowing limits, while administratively convenient, fail to reflect differences in revenue capacity, expenditure needs, and legacy liabilities across States. When borrowing space tightens without improved transparency, States are pushed towards off-budget routes.

ii. Spillover Risks in a Federal System

Fiscal stress in one State can elevate perceived sovereign risk and raise borrowing costs even for fiscally prudent States. In a federal economy, fiscal indiscipline at one tier inevitably transmits risks to the entire system.

iii. Towards Incentive-Compatible Coordination

Effective coordination requires:

- Transparent disclosure of liabilities
- Comprehensive reporting of guarantees
- Conditional additional borrowing linked to structural reforms, particularly in the power sector

Such an approach aligns State incentives with macro-fiscal stability without eroding federal autonomy.

e. Growth Implications of Sub-National Fiscal Stress

State-level fiscal stress constrains growth through multiple channels:

- Rising interest burdens and subsidy commitments crowd out capital expenditure
- Deterioration in public service quality in health, education, power, and transport
- Weakened investor confidence and reduced private investment
- Higher borrowing costs and limited counter-cyclical fiscal capacity

Weak State finances thus transform fiscal policy from a growth enabler into a binding growth constraint.

Conclusion

Sub-national fiscal risks in India stem less from headline deficit figures and more from opacity, recurring contingent liabilities, and coordination gaps within the federal fiscal framework. Off-budget borrowings undermine transparency, power sector inefficiencies generate repeated fiscal shocks, and weak Centre–State coordination erodes general government credibility.

Addressing these challenges requires more than tighter fiscal rules. It demands enhanced disclosure, incentive-compatible coordination, and structural correction of loss-making sectors. Sustainable growth in a federal economy ultimately depends as much on fiscally resilient States as on a disciplined Centre. In a system of shared sovereignty, fiscal stability is only as strong as its weakest State balance sheet.

9. Digitalisation and Formalisation

a. Introduction

India's growth challenge extends beyond expanding aggregate output to the deeper task of bringing economic activity into visible, rule-based, and scalable systems. A large informal sector constrains productivity, weakens tax capacity, limits worker protection, and reduces the effectiveness of public policy.

In this context, digitalisation has emerged as a powerful lever to reduce informality, improve compliance, enhance productivity, and strengthen state capacity. However, the transition from informality to formality is not frictionless. When pushed without enabling conditions, digital formalisation can impose disproportionate costs on small firms and vulnerable workers. Digitalisation may enable formalisation, but formalisation remains a transition rather than a switch.

b. Formalisation through GST and Digital Payments

i. Goods and Services Tax as a Formalisation Catalyst

The Goods and Services Tax has restructured India's indirect tax system by creating a nationwide value-added tax chain. By linking input tax credit eligibility to invoice reporting, GST embeds incentives for firms to disclose transactions and integrate into transparent supply chains.

Formalisation is thus achieved not primarily through coercive enforcement, but through alignment of compliance with business advantage. Firms that remain outside the system face competitive disadvantages in organised value chains, encouraging voluntary disclosure.

ii. Digital Payments and Transaction Traceability

The rapid expansion of digital payments has reinforced formalisation by reducing dependence on cash and generating verifiable transaction trails.

Firm- and household-level effects

Digital transactions create a financial footprint that facilitates access to formal credit, insurance, and financial services.

System-level governance gains

Enhanced traceability reduces under-reporting and improves the accuracy of economic data. Digital payments convert economic activity into information, and information into governability.

Formalisation as a Layered Process

Digitalisation-induced formalisation is rarely binary. Firms may:

- Register under GST while remaining labour-informal
- Adopt digital payments but operate with thin margins
- Enter tax systems without full financial or regulatory integration

Such partial outcomes reflect layered and incremental formalisation, not policy failure. They underscore the gradual nature of the transition from informality to full economic integration.

c. Productivity and Compliance Gains from Digital Formalisation

i. Firm-Level Productivity Effects

Digitalisation improves productivity by:

- Lowering transaction and coordination costs
- Improving inventory and supply-chain management
- Enabling scale without proportional increases in overheads

Formal firms gain improved access to markets, organised value chains, technology adoption, and better managerial practices. Productivity gains arise not from compliance alone, but from the efficiencies unlocked by formality.

ii. Compliance Gains for the State

From a public finance perspective, digital formalisation broadens the tax base without increasing tax rates.

Lower enforcement costs

Real-time data flows improve monitoring and reduce reliance on intrusive enforcement.

Stronger fiscal and policy capacity

Improved compliance enhances fiscal credibility, policy targeting, and macroeconomic management. Digital compliance thus lowers the cost of governance while raising its effectiveness.

iii. Wider Spillover Benefits

Beyond productivity and revenue, digital formalisation contributes to:

- Improved labour standards within formal enterprises
- Deeper financial inclusion
- Better data availability for evidence-based policymaking

Over time, these spillovers reinforce inclusive and sustainable growth.

d. Limits of Forced or Premature Formalisation

i. Cost Pressures on Small and Micro Enterprises

Formalisation imposes compliance costs such as record-keeping, technology adoption, and regulatory adherence. For small and micro enterprises with thin margins and limited managerial capacity, these costs can threaten survival.

Premature formalisation may therefore induce firm exit or push activity further underground rather than facilitate upgrading.

ii. Productivity Heterogeneity within Informality

Not all informal enterprises are positioned to benefit from formalisation. Many operate at very low productivity levels where the gains from market access and compliance do not offset costs. For such units, informality functions as a survival strategy, not deliberate evasion.

Uniform formalisation policies risk misdiagnosing structural constraints.

iii. Labour Market Implications

Abrupt compliance pressures can alter employment behaviour:

- Reduced hiring
- Increased casualisation
- Labour displacement or substitution

Displaced workers may re-enter informality elsewhere, resulting in relocation rather than reduction of informal employment.

iv. Risk of a Compliance-Led Slowdown

When formalisation outpaces improvements in skills, credit access, and market depth, it can temporarily depress output, discourage entrepreneurship, and increase fragility among small producers. Sequencing failures thus risk converting structural reform into a short-term growth constraint.

e. Balancing Digitalisation and Formalisation

Sustainable outcomes emerge when formalisation is:

- Incentive-based rather than enforcement-driven
- Supported by simplified, low-cost compliance
- Sequenced alongside productivity, skill, and credit expansion

Experience suggests that formalisation follows productivity growth; it cannot substitute for it. One-size-fits-all compliance regimes undermine both efficiency and inclusion.

Conclusion

Digitalisation has become one of India's most potent instruments for improving compliance, enhancing productivity, and strengthening state capacity. Reforms such as GST and the expansion of digital payments have increased transaction visibility and reduced governance costs, benefiting both firms and the state.

Yet formalisation is not an end in itself. When pursued without regard to firm capabilities, productivity heterogeneity, and adjustment costs, premature formalisation can weaken small enterprises and merely reallocate informality. The central challenge lies in sequencing—using digitalisation to enable formalisation rather than impose it. In India's development trajectory, digitalisation must function as a bridge to formality, not a cliff.

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