

**CHALLENGES & POLICY RESPONSE:**  
**MACRO POLICY FRAMEWORK FOR**  
**DEVELOPMENT**

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# 1 POLICY & PERSPECTIVE

## 1.1 Introduction

The old paradigm of Indian development is that of a “Mai-Bap Sarkar,” based on the assumption that the active involvement of the State is essential for economic development and poverty removal. Over the decades this was used to justify intervention in and entry of the State into every sphere of economic activity. Under the guise of noble purpose the government had gradually usurped the space occupied by the private sector, co-operatives, individuals and social groups. This spread of Leviathan has been accompanied by a gradual but pervasive deterioration of governance. It has also distorted the attitudes and operations of business, workers and farmers. Though this deterioration started with specific areas of government operations and specific regions of the country, by now encompasses the entire country, every State and every field of activity in which government is involved. In some States and in regions of other States Government failure has now reached a point at which government has become non-functional: It cannot even fulfil the basic role, the provision of ‘Public goods’ that it has played for centuries leave alone the grandiose development role envisaged for it in the (old) development paradigm of the second half of the 20<sup>th</sup> century.

There is therefore the need for a new approach at the beginning of the 21<sup>st</sup> century, that recognises that ‘government failure’ is a much more important problem than ‘market failure.’ ‘Privatisation’ of government services by its employees and government’s monopoly of power are the real problems today. The new paradigm must be based on a clear and non-ideological recognition of the strengths and the weakness of the State and the People. A democratic society has enormous potential for entrepreneurship, innovation and creative development. The people, their diverse forms of activity and association such as companies, co-operatives, societies, trusts and other NGOs must be allowed and encouraged to play their due role. The State must focus on what only it can do best and shed all activities that the people can do as well or better. The heavy hand of government in the form of incentive distorting laws, rules, regulations, procedures and red tape, have also corrupted industry & business and other organised interest groups. These must be removed so as to release the energy of the people. The State should confine itself to managing the economy so as to accelerate *employment* and income growth in a self sustaining manner, ensure that all citizens receive their *entitlements* of basic public goods and services and *empower* the poor so that they have equal rights (and responsibilities) with the better of citizens. Rights cannot be divorced from responsibilities without serious adverse consequences.

## 1.2 Goals and Objectives

India, a highly populated country, is characterised by “hidden” or “disguised” unemployment. Woefully poor people cannot afford to be unemployed. They therefore end up doing low productivity jobs in Agriculture or informal service sector. The problem of poverty is closely linked to this problem of disguised unemployment. At least for able-bodied adults they are two sides of the same coin and the elimination of “surplus labour” is almost synonymous with the elimination of poverty. Productive *employment* generates income that allows workers to buy private goods.

All citizens, including the poor, are also *entitled* to an equitable share of basic public resources. The most important are Public Goods & Services that by definition cannot be bought separately by and/or sold separately to individuals. They have to be supplied publicly by the government. The classic public goods are (local) roads, police & public security, judiciary and national defence. Public health services are perhaps equally if not more important to the poor. These include control of communicable diseases, clean drinking water, sanitation & sewerage.

*Entitlements* also include a basic level of social security for the old, disabled and infirm, for children and those who are unable to get any work. A 21<sup>st</sup> century society cannot let its citizens starve or suffer from chronic hunger and government must provide food to the destitute.

A 21<sup>st</sup> century democracy must in fact go further and *empower* the poor who cannot afford to pay for their education. Government must ensure that all its citizens are literate and all children attain some basic level of education, which we currently define as primary/elementary level. Education not only empowers the public but also ensures that the employed can do the productive jobs that open up and helps to sustain economic growth over the long term.

Access to information is an important element of empowerment. The poor and their well wishers must have the right to information about expenditures that are routinely justified in their name. The Internet and Internet telephony can play a role in breaking the rural areas' informational isolation. Excessive taxation, in the form of revenue sharing and charges for surplus (free) spectrum, hinder such a development.

The basic goals of economic development have remained unchanged for decades though their expression may have varied over time. We can restate them in the context of 21<sup>st</sup> century democratic society & economy, as,

- Eliminate Poverty
  - Over the next 15 years or so. Under the current definition that is similar to the 2001, \$1 a day definition of the World Bank. The poverty line can be raised (doubled) at that time.
  - Poverty is closely linked with, “under-employment” or “disguised un-employment” and therefore to “higher productivity” jobs (rather than to make-work jobs)
- Human Development
  - 100% literacy & primary education. On attainment, the goal-post can be shifted to, ‘universal secondary education.’
- Public Goods
  - Basic public goods of reasonable quality and adequate quantity.
  - Democratic access to public goods & services is a right of the Public
- Empowerment of the Poor
  - All citizens must get basic human rights
- They must also fulfil their civic responsibility, for instance public cleanliness (not spitting, throwing trash).
- The concrete objectives that must be fulfilled for achieving these goals include,
  - High growth between 7% and 7.5% for the next two decades.
  - Efficient, self-sustaining labour intensive growth.
    - This focus must continue as long as there is ‘surplus labour’ or ‘disguised employment.’
    - To be self-sustaining, these jobs must be ‘productive’ & ‘value creating’ in contrast to make work government employment.
- Supply of basic public goods & services.

- o Basic, un-glamorous items like clean drinking water, roads, sanitation, sewerage & waste processing/disposal, communicable disease control, personal safety & security, rule of law.
- Government must also deal with positive (e.g. literacy) & negative externalities.
  - o Population stabilisation & environmental sustainability. Population takes a heavy toll on environmental resources (quality of water, air, forests, natural vegetation).
  - o Pollution of water sources by industrial effluents & sewage in scenic areas and future availability of water.
  - o Population growth & reduced financial resources for public good provision.

Achievement of these objectives requires a new economic policy framework.

### **1.3 Policy Reform**

Any new approach must correct the incentives for productivity and create disincentives for corruption. It has long been said that Democracy is the worst form of government except all the others. The greatest advantage of a market economy is that it is based on the most realistic assumption that every individual will act in his/her best interest. Economic theory also tells us that under certain conditions market competition produces results that are the most efficient. As the obverse of monopoly it is a useful goal even when the ideal is not attainable. It has therefore come to be widely accepted over the last two decades that market incentives are the most sustainable incentives for business, workers and farmers and that market competition is the best handmaiden of the social purpose. The best antidote to exploitation by corrupt businessmen & bureaucrats, lazy organised sector workers and shoddy products and services is competition.

Laws, particularly economic laws (including contract law), do not merely define what a citizen/resident can or cannot do. They create a system of incentives and disincentives for economic agents and those charged with implementing the law. Most economic laws have had consequences that the originators had no inkling off. The common result of the myriad such laws are to create incentives for rent seeking, rent creation, bribery and corruption. The rules & procedures for public institutions, such as universities, research institutions, and hospitals, are equally oppressive.

Recent studies have demonstrated the (static) costs imposed on producers by the bureaucratic red tape and harassment that results from oppressive rules and procedures. The dynamic costs, in terms of discouragement of creative, innovative & knowledgeable people from entering business, though much harder to measure may be more devastating in the long run. It is necessary to systematically audit all economic laws from the incentive perspective and modernise them keeping in mind the results that they have produced. Laws, rules and procedures must be modified to minimise the time & money cost of compliance to relatively honest economic agents.

## **2 GROWTH MACROECONOMICS**

### **2.1 Growth**

The growth rate of the economy, which averaged 5.8% per annum during the eighties as well as the nineties has declined in the 2000s. The average growth rate of the economy during the ninth plan has fallen to 5.5% per annum. Consequently the average growth rate for the 22-year period 1980-1 to 2001-2 has declined marginally to 5.7% per annum. The highest growth in GDP at factor cost achieved for any contiguous five-year period was 6.8% during 1994-5 to 1998-9. During the nineties there were four 5-year periods in which growth averaged 6.5% or more. These were the 5-year periods centred on 1994-5, 1995-6, 1996-7 and 1997-8. The only other period that comes close in terms of growth achievement was during the eighties when growth averaged 6.2% during 1986-87 to 1990-91 (centred on 1988-9) and was 6% in the five years centred on 1998-7. Historical experience therefore suggests that deep and wide-ranging reforms can step up the growth rate by 1% point from the historical average to around 6.8% per annum. Going beyond this will require much more than has ever been achieved in India. It will require us to look at and learn from the experience of a handful of countries that have achieved growth rates higher than 7.5% for any length of time and of China & S Korea that have exceeded 8%.

The growth rate of the economy did not accelerate permanently during the nineties despite deeper and wider reforms, because of two (perhaps three) reasons. Firstly there is a continuing decline in the quality of governance since the seventies and this trend has continued during the nineties and the 2000s. The fiscal deficit is only the quantifiable and visible symbol of the deterioration, much of which continues below the surface. The average pace of reforms during the nineties was, in hindsight, just enough to counter the negative influence on growth arising from deteriorating quality of governance. The growth spurt(s) imparted by the economic reforms during the mid-eighties and the first half of the nineties did take the economy to a higher growth level for a some years (6 to 8 years), but the pace of reforms was not fast enough to maintain the higher growth in the face of the higher dead weight losses imposed by the trend deterioration in governance systems. This negative trend in governance continues during the new century.

In addition the bursting of the Asian growth bubble and the consequent lowering of the projected growth trend of these and other emerging economies, has left substantial excess capacity in industries with large economies of scale. Given the lower growth trajectory and policy rigidities in these countries, the potential excess supply will take some time to be purged from the system. The greater competitive pressures unleashed by the bursting of the bubble will therefore continue for some time. This combined with the cyclical decline in the World/US economy has perhaps reduced our growth rate even further in the short-medium term (5-6 years from 1998-9). Countering these negatives will therefore require urgent attention to governance issues and acceleration in the pace of reforms.

#### **2.1.1 Poverty & unemployment**

Economic growth is commonly measured by the growth of Gross Domestic Product (GDP). Given the level of population growth the difference between the two is the growth in per capita GDP or the average growth of income of the population. If the income distribution remains unaltered this also implies that the average income of

all income categories has grown by the same percent. If we examine the consumption distribution based on the NSS surveys, we find that it has remained more or less the same during the last two decades, despite annual fluctuations arising from variations in rainfall/agricultural production. This in turn implies that over a reasonable period of time, say 10 years or two Plans, growth benefits every one including the poor. Thus we would generally expect higher growth to lead to faster poverty reduction, though the same growth rate can produce different reductions in the proportion of poor depending on the proportion of people at the poverty line at any given time-- which depends on where the poverty line is on the consumption/income distribution. The higher the growth rate and the longer it is sustained the faster would be the elimination of poverty.

Economic growth also determines the resources (tax revenues) available to the State to under take supply of public goods & services and to provide some 'societal minimum' level of social security/welfare to the citizens. By their nature these have to be provided by the State based on the tax revenues garnered from citizens. Growth is therefore also necessary to accomplish the societies objectives on these two fronts.

India, like other high population Asian economies in earlier decades, is characterised by a substantial amount of 'hidden' or 'disguised' unemployment. There is a substantial amount of 'surplus' or 'underemployed' labour in the informal sectors engaged in low productivity work. The poor cannot afford to be unemployed so they will find something to do that generates some income, even if its marginal productivity is below the minimum wage in the organised or semi-formal sector. The problem of poverty removal is therefore equivalent to the generation of sufficient higher productivity jobs to remove underemployment. This in turn requires self-sustaining labour intensive growth. The strength of the link between GDP growth and employment is however critically dependent on economic policies and how they influence the incentive to employ workers and the labour/capital intensity to adopt. Policies that raise the direct or indirect cost of labour to the organised sector will slow down the generation of high productivity jobs in this sector and the overall growth of productive employment. For instance the contract labour act discourages the outsourcing of services and will therefore slow the generation of organised services and the growth of higher productive jobs in the service sector.

Literacy and primary education of all children (and access to secondary education), the future workers of the economy, will by the same token improve the quality of labour. Job training and skill development similarly raise the quality of the existing labour force, raise the productivity of work and leads to higher wages and income growth. Both these also encourage faster creation of higher productivity jobs that generally requires better-educated workers.

Employment data for the nineties indicates that the rate of growth of (explicitly measured) employment has slowed. It should be noted, however, that this has less importance to the poor who suffer from disguised unemployment, and more to the non-poor or middle class. One aspect is that the proportion of adults (defined for employment purposes as over 15 years old) in schools and/or colleges has increased, thus reducing the proportion of population seeking work. The other aspect is that organised industry, both public and private, suffers to different degrees from over-manning and that the nineties were a period of adjustment in which some of these unproductive jobs were eliminated. Most importantly policy reforms to remove the distortions in labour, SSI & other sectors that would increase the pace of organised sector employment generation (higher productivity jobs) have been slow.



### 2.1.2 Catch-up & Usable Technology

Our per capita income puts us in the category of Low-income countries of the world. The gap between our average income and that of the High-income countries shows how poor our citizens are relative to theirs. Fifty years after independence this gap and the high poverty that is one of its aspects, is embarrassing. It need not however lead us to despair. The per capita income gap also measures the gap between the productivity of our workers relative to that of workers in the developed countries. The gap thus also shows the huge potential for development, productivity growth and catch-up. It shows that if we get our policies and institutions right the economy can grow at a much faster rate than high-income countries and even middle-income ones.

One mistake that was commonly made by the communist and socialist countries in the previous century was to focus only on the simplest outward manifestations of this productivity gap. As the productivity gap is invariably associated with a capital gap (differences in per capita capital stock), so it was thought that increasing the capital stock in the poor country would close the productivity gap. From this a simple but wrong deduction was made, that economic development would follow if the saving rate was raised and this saving was invested in machinery, equipment & construction. A slightly sophisticated version of the latter was to believe that imported or new capital also has technology embodied in it and once industrial plants using the latest equipment were built the technology gap would be closed and the country would be become developed/rich. Though all these have some element of truth they made two mistakes: One that association is not causation; for instance higher savings rate may not lead to increased investment, or higher investment may not lead to higher productivity (inefficiency, wastage). Second, they missed the most critical element of the technology gap, the gap in knowledge.

Technology is not just machines & equipment and the ability to keep them working. Much more important is the knowledge inside the heads of people, the education, skills and training that allows them do new things. It is also new methods of organisation, management and marketing. It is the ability of the economy to respond changes/shocks by adapting and developing what exists. The most important difference between the Indian and Korean economy today is not that the latter has a much higher capital stock and a lot of modern equipment but its 'human capital,' that gives the economy the ability to adapt to all kinds of shocks.

The best illustration of the knowledge gap between India and the more developed/ richer countries is the differential in agricultural productivity. If we compare agriculture production statistics the per hectare agriculture production of many crops in India is one-third to two-third that of the emerging economy with the highest productivity. Surprisingly this is not because they have a higher proportion of land under irrigation. On the contrary comparative irrigation statistics show that India has one of the highest proportion of irrigated land, though this statistics does not account for the quality of irrigation, the state of repair of canal irrigation systems and the institutional arrangement for distribution of canal water. The explanation lies in the gap in knowledge of all those engaged in farming, irrigation, R&D, extension, input supply and output purchase. In the rural areas access to information and the ability (education) to translate this knowledge into usable form is the key constraint. Even though many institutions exist on paper to transfer this knowledge the incentives to transfer relevant information have been distorted by bad policies and institutional / organisational failures. One example of this is that despite 50 years of major and minor irrigation efforts in the States, it took the voluntary efforts of non-governmental

organisations in the nineties to show the importance of water harvesting and watershed development in rural development & growth.

Un-organised industry and services share some of the problems of access to information and ability to translate these into usable knowledge. These would however be wiped out in due course if artificial policy created differences between small informal and large organised sectors were removed. Policy distortions play a much larger role in discouraging movement towards the technology frontier. Restrictions on international trade, FDI, technology purchase, travel and hiring/immigration of skilled non-citizens hindered the flow of information into the country till 1991. Most of these distortions have been corrected since then, but some critical ones remain and should be removed. Domestic policy distortions that make it difficult or impossible for firms to restructure, amalgamate and exploit the economies of scale & scope condemn industry and services to inferior technology and low productivity. Exist restrictions that keep inefficient firms in the industry from dying act as a drag on the best most productive firms, reduce the average productivity of the industry well below the most productive firms and thus widen the productivity gap between us and the higher income countries. Public Sector management and oversight systems that discourage risk taking and provide the greatest incentive for sycophancy create a productivity gap that can only be eliminated by privatisation. Entry restrictions (SSI, Contract labour act) and tax bias in favour of small un-organised firms also have the effect of widening the productivity gap artificially.

## **2.2 Investment: Productive & Profitable**

Even though higher saving may not lead to higher investment, an increase in 'productive' & 'profitable' investment, almost always leads to higher savings, as it raises the growth of per capita income. This does not mean that saving is unimportant, quite the contrary public dis-saving can be extremely damaging to national growth as it can erode national wealth. What it does mean is that even though both saving and investment are needed to sustain growth, aggregate investment is a much more critical driver of growth than aggregate savings. The adjectives, "productive & profitable" are central to this conclusion. Forced investment of the kind seen in the USSR in the last few decades of its existence, eventually drove the economy into the ground. Investment must be productive and earn an economic return. This need not always be in the form of private profits. A high social return, such as from local & inter city roads is acceptable even if it yields low profits, but not if it generates losses because of leakages, corruption and gross inefficiency. The latter are deadweight losses that will reduce growth not raise it. In an era when governance has been deteriorating for decades, this is a critical caveat.

Private investment must earn a rate of return that exceeds the cost of capital. As the starting point of any entrepreneur's calculation is current profitability of production, policies and procedures that reduce current profitability are not conducive to investment. By its very nature, however, returns to investment accrue over a long period in the future. Thus expectations about the future are central to private investment. The role of 'animal spirits' has always been critical in stepping up investment and sustaining it at high levels. Investors must have faith in the stability of the system the predictability of government actions, the rationality of economic policies and the conduciveness of the general environment for investment. This also means that sometimes socio-political factors can play as important a role as economic aspects. For instance in our democratic system, criticism of govt policies by its own party members, supporters and associates can have a more devastating effect on

investor confidence than criticism by opposition parties, whose role it is to question government policies.

The economic policy framework and the efficiency of government & market institutions are key drivers and sustainers of high investment. In a sense much policy reform has to be directed at removing distortions and costs imposed by bad policy and institutions gone to seed. The degree of success in doing this will determine the private investment rate and the growth rate that can be achieved. Economies that were most successful in directing their policies, institutions and government structures towards the common endeavour of raising productive & profitable private investment and socially efficient investment in the production of public goods and services were able to raise their growth rate to the highest level. In addition those countries that were able to adapt these policies and institutions to changing circumstances were able to sustain these growth rates for the longest period (decades).

In the transition from a heavily controlled economy with an overwhelming role for government investment to a competitive market economy, public investment has to be carefully re-adjusted. Unfortunately, under the pressures of fiscal crisis, public investment has sometimes been driven by short-term considerations rather than by a rational process of re-adjustment and phasing out. For instance, in the absence of comprehensive reform in the power sector, the expectations of increased private investment have been completely belied. Thus the public sector will continue to have an important role in power sector investment till such time as the sector is reformed comprehensively. Further, in the absence of critical reform even public investment cannot be maintained indefinitely.

### 2.2.1 Distortions & Incentives

Any policy intervention that is not intended to correct a market failure creates distortions. It is now universally accepted that controls on production, distribution, trade and investment create such distortions. In the past our approach was often to counter the negative effect of one distortion by another distortion. For instance, where investment licensing created artificial monopolies and raised the costs of production, price controls were imposed to 'protect' the consumer and total assets of business houses were monitored and controlled. Similarly when controls, licensing and discriminatory treatment make an industry uncompetitive (e.g. organised textiles) this is sought to 'corrected' by tax incentives. As the public knows, 'two wrongs cannot make a right.' The entire structure of controls must be dismantled if all such distortions are to be removed and the economy made competitive. The remaining controls on agriculture, industry, mining and services must be removed during the 10<sup>th</sup> plan.

These arguments are equally applicable to physical and social infrastructure, though decontrol has to be complemented by setting up of modern regulatory systems. In the former, 'natural monopoly' segments, if any, have to be regulated, while in the latter, regulatory systems are needed for education and health services.

Incentives, fiscal & others are prima facie the obverse of controls. The first issue is to distinguish between efficient tax policy and 'incentives'. The refund of indirect taxes (excise, sales tax, import duties etc.) paid on inputs used for export production is an essential element of a destination based indirect tax system, it is not an 'incentive' given to exporters. On the other hand zero tax on income from exports is truly an incentive. There is little evidence that, in general, tax incentives are effective in achieving their objective, and none that the resulting benefits outweigh the costs. The case is perhaps strongest in the case of exports and FDI in exportable

goods, but even here the results are mixed. The general conclusion is that ‘incentives’ can act as a signal of the government’s interest and support and thus impart the initial push. Sustained investment depends on more fundamental competitiveness factors.

Such incentives also have the effect of attracting rent seekers and subsequently rent creators. Eventually, political patronage and monopoly rents are likely to speak louder than hard earned competitive profits. The negative effects of such ‘incentives’ therefore soon begin to outweigh the limited positive effects. For these reasons any such incentives should be selective and limited.

Protection, by creating temporary monopoly, can also attract investment. This does not, however, meet the criteria of ‘productive’ and ‘profitable’ investment that was posited earlier. In this case the profits are arising only because of a hidden subsidy financed by an implicit tax on user industries and/or consumers (through a rise in the prices paid by them). The viability and sustainability of any such investment is suspect. Investment that comes up merely because of such created monopoly and implicit subsidies, does not create value or wealth for the nation as a whole, but merely transfers wealth from one set of people to another. Arguments of national security and self-sufficiency that are often used in such cases must be weighed very carefully to weed out self-serving rent seekers.

Finally, ‘make-work investment,’ for instance government financed investment in building roads that every one knows will be washed out in the next monsoon is neither ‘productive’ nor ‘profitable.’ It will not therefore have any positive effect on economic growth. After fifty years of building such roads, we must realise that it is better to build 10 Kms. of pucca road instead of 40 Kms. of kucha roads costing 1/4<sup>th</sup> per km. Even when pucca roads (e.g. those connecting villages to State roads) are not profitable to a private investor (being a public good), they are ‘productive’ for society and therefore ‘socially profitable.’

## **2.3 COMPETITIVENESS**

There are four board sources of competitive disadvantage in India relative to other low-income competitor countries like China. All four have their origin in either outdated policies or poor governance. These are non-tradable infrastructure services like power and transport, bureaucracy and red tape, controls & incentives against exploiting scale economies and complex & inflexible economic laws relating to labour, land & buildings.

### **2.3.1 Infrastructure**

Inadequate and poor quality of infrastructure is the most visible source of competitive dis-advantage. The problem has its origin in the bundling of the policy, regulatory and production functions within the same laws, rules and government organisations. Though the unbundling and separation of these functions is a necessary condition for improvement it is no longer sufficient. As is now well recognised, the regulatory functions must be separated and assigned to independent professional regulators with sufficient autonomy assured through a transparent selection procedure. Government infrastructure monopoly must be dismantled by unbundling the ‘natural monopoly’ segments from the competitive and contestable segments and allowing free entry and competition into the latter. For competition to be effective in the contestable segments, the ‘natural monopoly’ company or companies must operate on the ‘public carrier’ principle with access and fair and transparent pricing of network services assured by the regulator. Transparency also

requires that any implicit cross-tax subsidy be made explicit. Without these three elements, unbundling and competition cannot work.

Though all public infrastructure services are a source of competitive disadvantage to varying degrees, power and railways are the greatest burden on the economy today. If the complex and highly distorting system of implicit cross-tax subsidies is made explicit it will likely show that industry and services are, with limited exceptions, paying more than the (efficiency) cost of these services. The varying availability and quality of power poses additional costs (safety equipment, back up generation) and creates competitive disadvantage. Low user-charges are an important issue only for the agriculture sector and consumers. In the case of power, a solution of the problem of T&D losses (so called) is critical to any sustainable and viable long run solution.

## 2.3.2 Governance

### 2.3.2.1 Control Burden: Red Tape

All international comparative surveys suggest that bureaucracy is particularly oppressive in India and its heavy hand ties industry in red tape that is costly and time consuming to free oneself off. This red tape has a differential impact on the small-scale sector because its fixed cost nature imposes higher per unit costs on those with low volumes. Recent domestic studies suggest that it varies from State to state and may affect different sectors to different degrees. It is also found to fall quite heavily on imports in terms of time delays and costs. Though the direct effect of such bureaucratic cost on imports may be equivalent to an additional protective tariff, it can have a strong negative effect on labour intensive exports. Several such exports like textiles & electronics, are also critically dependent on imported inputs, and time delays and costs can make them uncompetitive. This control burden is like a dead-weight loss imposed on the economy that reduces the competitiveness of the economy adversely affecting investment and growth.

### 2.3.2.2 Institutional reform: Red Carpet

The institutions of government are in dire need of reforms. Institutional reform is also the most difficult aspect of reform. Without such reforms, it will not be possible to raise growth above 7%, and 8% growth will remain a chimera. The knowledge gap of the economic bureaucracy is most acute in recognising the critical importance of productive & profitable investment. It would not be too much of an exaggeration to say that most if not all operational departments of the government (at all levels) view businessmen as exploiters who should either be shown their place by getting them for violating one of the many rules under their jurisdiction or be forced to share the fruits of their 'presumed to be' ill gotten gains. It is ironic that controls, licensing and extortionary tax rates (100% on income from certain assets during the mid-seventies) provided incentives for both business and the bureaucracy to become corrupt, created artificial monopolies and reduced or nullified the benefits of market competition.

De-control and de-licensing must be followed by a thorough review and overhaul of the rules and regulations, if the full benefits of competition are to be derived by the people. We have to be wary only of monopolies and regulatory capture and of protection and subsidies provided by the state to favoured businessmen. The institutions of government must understand that under *genuine competition*, profits are the result of entrepreneurship, innovation and hard work and

are therefore well deserved. That production and investment under competition benefits all of us as they create productive jobs and national wealth. *Promotion of 'productive' & 'profitable' investment must be made the primary objective of all economic institutions* and they must be judged by the amount of private investment and growth in production, supply & employment that takes place under their charge. For institutions overseeing the supply of social services, measurement of output & its quality is essential. This is particularly important for sectors such as education where for-profit institutions are not allowed by law, or sectors in which market pricing is not possible, it is not uncommon to measure only the inputs (e.g. number of class rooms or schools) or hypothetical inputs (no of teachers appointed, rather than those that actually show up in class) or inadequate measures of output (gross enrolment). This can be quite misleading, for instance children will rapidly drop out of schools where teachers do not show up to teach leaving gross enrolment and teacher role numbers unchanged. Gross enrolment or teachers on the books or salaries paid provide inadequate information if students drop out soon after enrolling as teachers do not show up to teach. It is essential to devise and use measures of quality-adjusted output for such sectors. For instance, the production/supply of education services has to be measured in terms of the number of children educated to measurable standards.

### **2.3.2.3 Feudalism & Banditry**

With measured T&D losses over 50% in Delhi, no agriculture to speak of, 'Transmission & Distribution' has to be an all time euphemism for what some have called 'Theft and Dacoity' loses. One former Power minister in the central government, who had also been a leader of the DESU union in his youth, used the term "T&D mafia" to describe the system. Though the situation may be the most glaringly obvious in the Capital it is perhaps not much better in many States. This is not merely a problem of power reform but of a creeping failure of governance and the rule of law, over the past three decades. A permanent solution to the power problem is not possible without dealing firmly with this governance problem.

The deterioration of governance also imposes dead-weight losses on the economy and is a source of increasing competitive disadvantage. This can be seen in starkest form in the relatively poorer states and the relatively backward regions of non-poor States. In such pockets the failure of governance is manifested in the inability to protect the life and property of citizens. The political economy literature identifies 'Feudal' and 'Bandit' States as two types of pre-modern States. Efficient competitive markets cannot exist under feudalism or 'bandit-raj' conditions. By the same token it is perhaps naïve to expect governments that have failed to provide even basic law and order, to carry out economic development in these areas. Alternative institutional arrangements have to be devised in such situations rather than pouring more money into failed governmental institutions. The State governments' efforts must be focussed on restoring the rule of law and eliminating feudal conditions and pockets of banditry. This can have a positive impact on the investment environment in the entire State, even if the problem was limited to a few areas.

### **2.3.3 Economies of Scale and Scope**

Small industry reservation and capacity licensing of large industry though falling at opposite ends of the spectrum of capital intensity, shared one deceptively simple idea. That government had the knowledge, ability and the motivation to determine both the private and the socially efficient scale of production for each and every possible industry. Technological change, economic developments and shocks

and the increased complexity of the economy, not to speak of government failure, have long since put paid to this conceit. Yet SSI reservations continue. Even where licensing has been abolished, the harmful consequences of these policies in terms of numerous unviable small capacity plants will take some time to unravel. The process of moving to plants of globally competitive scale can be expedited if SSI reservation is abolished, modern bankruptcy laws, rules & procedures introduced into the Companies Act, mergers and acquisitions facilitated and unviable plants allowed to shed labour.

Economies of Scope is a wider concept encompassing purchase, logistics, finance, marketing and organisation and management functions. At its simplest level it refers to similar items produced in two different plants but using common inputs or marketing channels (such as two different chemicals or fibres). At the other end of complexity it refers to synergies between completely different industries such as communication, computers/IT and entertainment as encapsulated in the term 'convergence.' Rules and policies can still keep such economies of scope from being fully exploited.

#### 2.3.4 Comparative Advantage to Disadvantage

With a large population human resources are potentially our greatest asset. Theory also suggests that with so much hidden or disguised unemployment and low per capita income the Indian economy has a comparative advantage in labour intensive manufacturing. Yet extreme laws, inflexible rules and regulations and biased procedures, seem to have turned this advantage into a disadvantage; Large industry wants to minimise the use of organised labour, which is viewed as a permanent millstone around its neck, and prefers to set up capital intensive even while complaining about the higher cost of capital in India. Small industry coming under the purview of these laws, with much less access to capital markets and credit, having less options in this regard and thus cannot do without labour, tries to keep it off its rolls wherever possible and to roll it over otherwise. Thus the laws and procedures now provide a strong incentive for using casual labour, a result that is almost the opposite of that intended. They continue to protect organised sector workers hired decades ago, but at the cost of faster generation of more productive jobs during the last two decades.

### 2.4 Savings

Though jobs growth and economic growth depend on productive investment, independent of its source, in the long run the wealth of a nation's people depends on the Savings of it is people. Our private savings rates, corporate and households taken together, are among the highest in the world and comparable to those in East & S.E. Asia. Our public saving rates are, however, pathetic compared to these countries and among the worst in the world. This shows that we need not be excessively worried about the thriftiness of our people, it is the profligacy of our government that should be our main concern.

#### 2.4.1 Private Saving

Private Savings as conventionally measured, include (besides corporate savings) the financial saving of households their investment in housing and the physical investment by household enterprises/ business. Studies have generally found that household saving as measured are very insensitive to the interest rate (real after tax interest rate). Though tax incentives for particular saving instrument may induce

greater flow of saving into those instruments, they do not affect total saving. The best way to encourage household savings is to provide a sound and safe financial system that is transparent and provides a choice of financial instruments of different maturities and degree of risk, in which the real interest rate on risk free debt of short maturity is positive i.e. the interest rate exceeds the rate of inflation (as measured by general consumer price index). A positive environment for investment and income growth will then ensure that sufficient private savings are forthcoming.

When household savings are redefined to include investment in durable assets such as cars and major consumer durables, the picture changes somewhat. Savings in such assets have to be defined net of consumer debt incurred for their purchase (investment). The existence of consumer credit makes it possible for consumers to save part of the cost of the item and take credit for the rest. Such saving therefore is much more responsive to the rate of interest (on consumer credit). Studies generally find that household savings re-defined to include such investment in consumer durables is much more responsive to changes in the real interest rate. This does not however justify tax incentives as in conventional terms most people would view this as an incentive for purchase of consumer durables.

#### 2.4.2 Public Saving Rate

The public sector's saving rate has declined from about 2.4% of GDP in the seventh plan, to 1.6% of GDP in the eighth plan to an abysmal -0.8% in the ninth plan. Thus between the last two plans it has dropped by 2.4% points of GDP. We must stop this haemorrhaging of national wealth by the government and aim to raise the public saving rate back to the levels prevailing in the 7<sup>th</sup> or 8<sup>th</sup> plan. A planning commission working paper has shown that the rise in the fiscal deficit during the eighties crowded out private investment by raising the interest rate and reducing the credit available to the private sector. Because of the opening of the capital account during the nineties the ability of the private sector to access foreign capital (through ECB, FII and FDI) has increased. With the opening of the economy to international capital flows the gap between domestic and international rates has narrowed during the nineties. A rise in the government saving rate would help in lowering the domestic interest rate and closing the gap further.

#### 2.4.3 Govt Debt

Though public dis-saving is a relatively recent phenomenon, starting from the second year of the ninth plan, government has been accumulating debt for decades. This is because the cost of borrowing exceeded the returns from the investment financed by it. The fiscal deficit of the Central and State governments is a measure of the net accumulation of debt (at historical cost) by the government during the year. The central government debt rose during the eighties to reach a peak of 53 % of GDP in 1991-92. It declined during the next five years to reach a low of 46.6% of GDP in 1996-97. It has been on a clear up trend since 1997-98 and has reached 55.1 % of GDP in 2000-1 as per revised estimates. The total debt of the government (Centre & States) has followed a similar pattern and stood at 65.3% as per revised estimates.

A large government debt reduces the government's ability to use fiscal policy as an instrument against negative demand shocks and hangs as a Democles sword over the financial system. One cross-country study has shown that fiscal policy becomes ineffective if a country's debt exceeds a level of around 60% of GDP. Sale of government assets and the use of proceeds to reduce government debt below what



it would otherwise be, helps reduce this threat over the financial system. If the fiscal deficit, without taking account of privatisation proceeds, is reduced to zero then all privatisation proceeds automatically go towards retirement of existing debt.

## **2.5 Money And Finance**

A modern and efficient financial system is necessary not only to provide a conducive environment for private saving, but also to ensure that these are channelled into the most productive investment opportunities. Regulatory systems must be improved to come up to international best practice and regulations continuously updated to meet new regulatory challenges. Competition must be enhanced to improve efficiency while the regulatory system ensures prudential behaviour. New financial instruments and new institutions must be encouraged to expand the range of business (e.g. small women entrepreneurs in villages) that can access credit from the financial system. In doing this it must be remembered that the organised banking system with large fixed costs is not the most cost effective way of reaching the small informal business sector.

### **2.5.1 Govt. Oligopoly**

About 80% of banking system assets are owned by government owned banks and financial institutions. This is the highest proportion of government ownership in the world. Even though notionally there are numerous separate nationalised banks, the institutional structure of the government, the RBI and the banks makes them act as an oligopoly. The full benefits of competition will only accrue to savers and investors if this oligopoly is dismantled and an absolute majority of the government owned banking system privatised. In the meanwhile it is essential to allow government to reduce its share holding in these banks to 33%.

### **2.5.2 Regulatory System**

As the financial system gets more sophisticated the regulatory system must respond by increasing the sophistication of their regulations. For instance as financial participants become adept at using hedge products, regulations must be put in place to ensure that these are carried out in an open and transparent manner and not to disguise accounting losses. The skills and training of the regulatory staff must therefore be continuously updated.

### **2.5.3 Monetary Policy Rigidity**

Monetary and exchange rate policy are two instruments in the hands of the Central bank/Government to manage the external and internal balance. If the exchange rate is fixed for political reasons then the exchange rate must handle even the entire burden of external management. On the other hand a flexible exchange rate that largely takes care of external changes allows interest policy to respond to fluctuations in domestic demand. Interest rate policy needs to be managed in such a way that the real interest rate fluctuates in response to the demand for credit arising from the fluctuations in domestic aggregate demand. Thus nominal rates must respond both to changes in inflation and to changes in aggregate demand.

The short-term interest rates of the Central bank such as the 'Bank rate' and the 'Repo rate' determine the rates in the inter-bank call money market. The overnight call money rates in turn are the fulcrum on which the term structure of interest rates rests. Thus the RBI's overnight nominal repo rates are kept unchanged despite a fall in the inflation rate the real interest rates in the economy will rise. Similarly if the RBI repo rate is unresponsive to changes in the demand for credit, the real interest rate will not be able to play the role of automatic stabiliser for the economy.

## 3 FISCAL REFORM

### 3.1 FISCAL TRENDS: Centre & States

#### 3.1.1 Fiscal Deficit: Combined

The Gross fiscal deficit of the Government (Centre & States combined) as ratio to GDP has been on an upward trend over the last two decades (figure 3). The Primary deficit to GDP ratio in contrast is on a clear downtrend for the decades taken together. The reason for the divergent trend in these two ratios is that **interest paid on the debt has risen as a proportion of GDP almost linearly over the two decades, rising by 2.3% of GDP between 1980-1 & 1990-1 and by 1.5% of GDP between 1990-1 and 2000-1**. The rising trend in this ratio is only marginally higher than the trend in the average interest rate on the current (i.e. exchange rate adjusted) value of the debt (10% steeper slope). The main reason for this discrepancy was the rise in the (adjusted) debt-GDP ratio during 1980-81 to 1991-2 and the phase out of financial repression since then. With the move to a market determined interest rate on government debt, the implicit tax on savers to subsidise government borrowing from the banking system has gradually been eliminated.

Both the gross fiscal deficit and the gross primary deficit follow the same general pattern, with three sub-periods discernible in the evolution of the fiscal deficit: The early eighties (till 1986-7), the ten-year period from 1987-8 to 1996-7, and the period since then. The first and second sub-periods are characterised by clear up trend and down trend respectively. In both of them, the line connecting the peaks and the line connecting the troughs have the same slope as the trend line (i.e. either positive or negative). The first sub-period originated in the second oil shock of 1979-80, which was accentuated by a poor monsoon. Even though some effort was made to control the situation subsequently these did not prove durable. In the second sub-period the primary deficit was brought down from 6.4% of GDP to 1.3% of GDP, with the fiscal deficit falling from 9.8% to 6.4%. The third period shows an up-trend over the five years till 2001-2, with the fiscal deficit reaching 9.6% of GDP in 1999-2000 marginally higher than the previous peak of 9.4% in 1990-91 but lower than the absolute peak of 9.8% of GDP in 1986-7. The fiscal situation seems to have stabilised in the last two years, and the deficit is estimated to come down to 8.1% in 2001-02. The third sub-period of rising deficits had its origin in the pay-commission that set off an explosion of wage & salary increases for government employees.

#### 3.1.2 Expenditures

The Expenditures of the Centre and States (combined) show the same pattern. Total expenditures as a proportion of GDP rose during the first sub-period to reach a peak 32% in 1986-87, falling thereafter to reach a trough of 25.2% of GDP in 1996-97. They have been on an up trend since then and reached 19.8% of GDP in 2001-2 (BE). Both major components of expenditures, namely non-interest revenue expenditures and capital expenditure follow the same pattern. **Revenue expenditures, excluding interest payments appear, however to have peaked at 19.3% of GDP in 2000-1 a proportion that is higher than the previous peak of 19.2% of GDP in 1986-7**

(and 1997-8). Though Capital expenditures follow the same pattern the fall in their ratio between 1986-7 and 1996-7 is much sharper than rise till 1986-87 or the fall since 1996-7. Consequently capital expenditures at 4.5% of GDP in 2001-02 (BE) are a little more than half the 8.1% of GDP in 1980-81.

In contrast to capital expenditures, interest payments at 6.3% of GDP in 2001-02 (BE) are three times the 2.1% of GDP in 1980-81. Thus the (4.2% of GDP) increase in interest payments can be said to have crowded-out capital expenditures to the extent of 3.6% of GDP and contributed 0.6% of GDP to the 1.4% of GDP increase in the fiscal deficit over this period.

Explicit budgetary subsidies such as those on food and fertiliser constitute a small fraction of the hidden or implicit subsidies.

### 3.1.3 Revenues

Though the Revenue receipts of the Centre and the States (combined) follow the same general pattern, there is a double peak of 20.1% of GDP in 1986-87 and 1989-90 and the trough (13.3% of GDP) is displaced by two years to 1998-99. The fall in revenues during 1998-99 though a noticeably sharp 1% of GDP is less than the 1.5% of GDP decline in revenues during 1990-91. The subsequent recovery has been equally sharp, with the total revenue budgeted to be 19.8% of GDP in 2001-2, a little lower than the previous peak of 20.1% of GDP in 1986-87. The 1986-7 peak was partly due to unusually high non-tax revenues of 4.4% of GDP, from which they declined to 3.1% of GDP in 1998-99. In 2001-2 non-tax revenues are budgeted to be 3.8% of GDP, which is the same level as prevailed in the early nineties.

Tax revenues of the Center and States combined were on an up trend during the early eighties and peaked at 16% of GDP in 1987-88. They fell continuously since then to reach a low of 13.3% of GDP in 1998-99. Tax revenues in 2001-2 are budgeted to exceed the pre-crises highs and to reach the previous peak of 16% of GDP. The declining pattern of tax revenues is due entirely to indirect tax revenues, which declined from a peak of 13.6% of GDP in 1987-88 to a low of 10.0% of GDP in 1998-99. They have recovered since then to reach a budgeted 11.6% of GDP in 2001-2 a percentage that is lower than in 1992-93. The decline in indirect tax revenues is clearly due to the reduction in customs revenues and the failure of domestic indirect tax revenues to compensate for this decline. Income tax revenues, which were 2.5% of GDP in 1980-81 were also 2.5% of GDP in 1990-91. They fluctuated between 2.4% and 2.7% of GDP during this period. Since then they have been on a clear up trend reaching 4.4% of GDP in 2001-2 (BE). This up trend is clearly due to income tax reforms that have reduced tax rates and attempted to simplify the system and expand the base.

### 3.1.4 Sustainability

In conclusion the fiscal deficit has gone through three phases and is now almost back to where it was at its peak. The reduction in the Primary deficit has been offset by the rise in interest payments. The primary deficit has declined largely because of the decline capital expenditures. Both non-Interest revenue expenditure and tax revenues are now at almost the same level as at their earlier peaks. The former can therefore be viewed as the main cause of the current adverse fiscal situation.

The sustainability of the fiscal deficit is conventionally defined in terms of the inter-temporal trend in the Debt-GDP ratio. The total debt of the central and state governments as per the budget documents of the government, adjusted for exchange

rate changes, was on a clearly rising trend during the eighties. It rose from a trough of 47.2% of GDP in 1981-82 to a peak of 72.0% of GDP in 1991-92, the increase in the latter year being due to revaluation of external debt because of the devaluation. This debt was on a declining trend till 1996-97, when it reached 63.8% of GDP before resuming its upward trend to reach 72.9% of GDP in 2001-2(RE/BE), exceeding the previous peak in 1991-92. Thus, except for the high growth years of 1994-95 to 1996-97 the combined fiscal deficit of the government was on an un-sustainable path.

A sufficient condition for sustainability is that, (a) the rate of growth of the economy exceed the real interest rate, and (b) the primary deficit be eliminated. The growth rate of GDP has generally exceeded the real interest rate on government borrowing, except in 2000-01 when it fell to 4%. The primary deficit has however exceeded 2% of GDP, except during the high growth years when it was reduced to 1.3% of GDP. It has slipped badly since 1996-97, tripling by 1999-2000 to 3.9% of GDP. The primary deficit of the centre and the states must be eliminated over the tenth plan period and the growth rate of the economy raised above the average of the ninth plan to put government debt-GDP ratio on a visibly declining trend.

### **3.2 Centre & States**

Interest payments of both the Central Government and the State governments have contributed to the rise in combined payments. The behaviour of the primary deficit of the Centre and the States is quite different. The primary deficit of the Central government has been on a broad down trend since its peak of 5.5% in 1986-87 and was budgeted to reach its lowest point of 0.2% of GDP in 2001-2(be). In contrast, the primary deficit of the States has resumed its upward journey after falling from 2.3% of GDP in 1984-85 to 0.6% of GDP in 1993-94 and reached its highest level of 2.4% of GDP in 1999-2000. The underlying cause of this divergent behaviour is explained by the growth of the non-interest portion of revenue expenditures and non-developmental expenditures. In the case of the former the combined pattern is largely driven by the central government non-interest revenue expenditures, while the 2000-1 RE of 8.8% of GDP is 1.3% point lower than the peak of 10.1% in 1986-87. The States non-interest revenue expenditure has fluctuated since 1987-88 and at 11.8% of GDP in 2000-01(RE) was higher than the previous peak of 11.5% of GDP in 1991-92. In the case of non-interest non-development expenditures States ratio to GDP has been on an up trend through since 1980-81 (except for a marginal decline in the high growth years 1995-96 & 1996-97). In contrast the corresponding central government expenditures were on a downtrend from 1982-83 to 1994-95 since when they have reversed direction. As a result of these divergent trends the net effect is a rise in non-development, non-interest expenditures (combined) rose from 1981-2 to 1986-87 fell till 1992-93, and after some turbulence have been rising since 1997-98.

Conversion of the primary deficit into a surplus therefore requires a reduction of the revenue and non-developmental expenditures of the States, some reallocation of these (revenue & non-developmental) expenditure by the central government to capital expenditure and an increase in the efficiency and productivity of both the Central and State governments. The efficiency of the domestic indirect tax system also needs to be improved through more effective reform of the CENVAT and State sales & excise taxes.

### **3.3 Quality of Expenditure**

Fiscal sustainability has two other aspects. One is the quality of government expenditure and the other the efficiency of the tax system. We first address the former. One of the most important implications of the fiscal problem in India is that the government has no money to spend on essentials. The basic problem is therefore of identifying and eliminating wasteful and unproductive expenditures so that the fiscal deficit can be eliminated and more money spent on essential government functions.

#### **3.3.1 Interest Payments**

Interest payments are a major item of expenditure, with 40% of total Central & State government tax revenue spent on interest payments to others. They thus “crowd out” other potentially more productive items of government expenditure. Interest on accumulated debt is the embodiment, as it were, of past sins. That is borrowing to finance past government expenditure. In the past few decades such expenditures consisted of both government consumption (or revenue expenditure) and unproductive investment (or capital expenditure). Thus concern about interest payments is implicitly a concern about the volume and/or quality of expenditures in the past. Some of these past government consumption and unproductive government investments are rightly viewed as crowding out present government expenditures.

One implication is that to the extent that this debt was incurred in financing investment or capital it should be allocated and assigned to these investments and the concerned organizations (e.g. PSUs, PSBs, DPEs or administrative departments). A substantial part of the indirect subsidies are the cost to the government of servicing the debt assigned to each of these organizations (organized by sub-sectors & budget heads instead of by organisations). The rest is the depreciation of these assets and deterioration of their quality because of lack of replacement investment. The net value of these organizations to the government is therefore the gross value of assets or equity owned by the government in each organization minus the debt incurred by government in setting them up.

Studies comparing the rate of return in public sector units with similar units in the private sector show a large gap between the two. The Dis-investment department has compared the interest that can be earned on the money earned by strategic sale of PSUs in the last few years with the dividends the same companies have been paying to the government in the 3-5 years prior to their sale. The former comes out to be about 10 times the latter. This is a rough and ready measure of the national wealth that will be created or unlocked by strategic sale of PSUs. The major policy implication is that, privatisation of public sector units producing “private goods & services” and use of the proceeds to repay the debt is the best way to cap and reverse the trend in the interest-GDP ratio.

#### **3.3.2 Allocation: Public Goods**

The next question that arises is what are these “essential” government expenditures that have a higher claim on government revenues? One important category consists of Public Goods & Services. Public goods are characterized by an element of non-excludability (e.g. defence, police) or very high transaction costs for pricing (e.g. local roads) so that they cannot be charged for on an individual basis. They (public goods & services) are almost by definition items that must be paid for out of tax revenues.

The second essential area of government expenditure is on subsidies for those goods and services that have large externalities. In principle all private (non-public) goods & services can be assigned to three categories: Those with high, medium and low or no externalities. Elementary education, rural water supply, adult literacy, rural secondary education and development of markets in remote, hilly & backward areas have high externalities. It is convenient to refer to goods and services with a large element of positive externality as 'Quasi-public goods.' These goods can in principle be supplied privately and charged privately, but either need to be supplied publicly (e.g. public drinking water tap or toilet) or deserve a subsidy ('merit' good). This subsidy may vary with the area (e.g. rural-urban) because of lumpiness relative to demand or by income of purchaser because of varying social benefit (eg. literacy or primary education).

'Public' and Quasi-public' goods include,

- i) Roads [excluding major, high density highways] & Water ways [river navigability, drainage systems, flood control]
- ii) Legal System [laws, courts, judges]
- iii) Public security system [police, prosecutors, jails]
- iv) Public Health systems [Communicable diseases, epidemic monitoring & control, Public drinking water, sewerage & sanitation systems]
- v) R&D on socially beneficial areas, including tropical diseases, agriculture (e.g. appropriate crops & rotation patterns for different agro-climatic regions), pollution.
- vi) Public Education [rights, responsibilities, civic & democratic virtues, public morality, productive knowledge (e.g. agricultural extension), preventive health & population restraint, pollution abatement, water conservation]
- vii) Environment & Pollution, forests, parks.

There are also basic social welfare functions like ensuring that no citizen starves or is chronically hungry and the provision of basic social security to children, old, aged, infirm and disabled that along with the above are basic entitlements of the people. Government must ensure that all citizens are provide with these 'entitlements.'

Central and state governments have spread their limited resources too thinly over too many areas and items of expenditure. As a result many of these essentials have suffered from a lack of resources and attention, and the availability and quality of these public goods has deteriorated dramatically. The time taken in court cases is legendary. Recent brake-down of law and order that have attracted media attention are only the 'tip of the iceberg,' of the gradual but inexorable deterioration in the ability and motivation of the police force and those who rule over them to do job of protecting the life & limbs of citizens and their property. As pointed out in the approach paper to the tenth plan governance has deteriorated progressively over the decades. Though the deterioration is worst in the poorest states, the better off states including the richest union territory have not been immune from this deterioration. In this era of severe fiscal problems it is essential for government to go, "**Back to Basics**" and refocus its attention on public goods & services.

### 3.3.2.1 Subsidy

Expenditure on *subsidies* by the centre in the terminal year of the Ninth Plan was Rs.30523 crores, which is 12.6% of the total revenue expenditure by the Centre. Subsidies have grown in size and have now become financially unsustainable. Some of the subsidies e.g. the fertilizer subsidy, are really subsidies to cover the high cost of the fertilizer industry. According to a recent study<sup>1</sup> the share of budgetary subsidies going to the farmers has been on the average about 66.5% over the period 1981-82 to 1999-2000 and rest was the share of the industry. In a number of years, the share of fertilizer subsidy for the farmers was less than 50% (for example 1983-84, 1985-87 and 1999-00). On the issue of inefficiency of urea plants, the study had worked out the viability of different plants at different international urea prices. According to them, at a price of \$90/MT almost the whole of urea industry (almost 98%) would be rendered economically unviable. Even at \$160MT almost 50% would become unviable.

The Fertilizer Retention Price System distorts investment and production decisions and creates an inefficient production system. The RPS ensures that subject to some capacity utilization norms, the production units are ensured a return of 12% on capital employed. The difference between the retention price plus freight and dealers' margin and price charged by the farmer accounts for the subsidy on urea. The fertilizer subsidy has three adverse consequences. First, it protects inefficiency in the production units because production units are assured of a substantial return on capital even if they compromised on some of the norms. Secondly, excess use of subsidised fertilizer has created an imbalance between N, P and K, whereas excess use of water for irrigation has produced water logging in many areas. The two factors put together is increasing the salinity levels of fertile lands. Third, these are provided universally to all farmers and the incidence of their benefit is in proportion to their use, which would favour rich farmers with better paying capacity.

Another explicit subsidy is the food subsidy. A major portion of the food subsidy goes to meet the procurement and operational costs of the Food Corporation of India. FCI's operational cost for wheat increased from 42% of procurement price in 1991-92 to more than 68% by 1996-97. In the case of rice, the FCI's operational costs were 116% of the procurement price in 1991-92 and they increased to more than 133% by 1998-99.<sup>2</sup>

The achievement of the "Back to Basics" approach will require phasing out of all budgetary provisions for expenditure on 'private' goods. In concrete terms, we have to,

- a) Phase out of budgetary subsidies on goods & services with low or no externality such as Industry, power, shipping, road transport, other transport, coal & lignite. The phase-out schedule must however give sufficient time for, developing a clear, transparent and positive framework for private, production & supply, an independent regulatory framework for natural monopoly segments and time for consumers to adjust to higher cost-based prices (excluding X-inefficiency costs of monopoly & corruption).
- b) Align the degree of subsidy with the ordering of the degree of externality.

Thus for instance, the degree of externality in education is the highest for literacy and primary education and lowest for higher education. The degree of subsidy should accordingly be the highest for the former and should decline as we move up the education ladder.

Similarly the portion of subsidy that is a subsidy to fertiliser producers has no externality and should be phased out the fastest. A large subsidy can even have negative externalities because excessive use of fertiliser pollutes water sources and can harm the soil. Further, the retention price system is the most inefficient way of providing a subsidy to either farmers or fertiliser producers. A more efficient system is to provide either a subsidy per unit of fertiliser supplied to farmers (farmer subsidy) or a subsidy per unit of production (fertiliser producer subsidy) or a combination of the two.

- c) Target desirable subsidies on the poor, by eliminating subsidies going to the upper half of the population.

The rise in the MSP for wheat to a point at which stocks have been raised way above buffer stock norms has converted this subsidy from a food subsidy to a surplus (wheat) farmer subsidy. Even those with access to the PDS buy a portion of their grain from the market. A lower MSP would have resulted in more grain in the market, lower prices for market purchase by the poor and a better targeted PDS subsidy.

The imperfect coverage of PDS also precludes the really needy like the migrant labour, tribals, and the homeless from the merits of food subsidy. Similarly the subsidies on irrigation, power, fertilizer, diesel, credit do not improve income distribution in rural areas rather they benefit the landed gentry rather than the small and marginal farmers. It is therefore essential that these subsidies are reduced and part of the money saved is channeled into more productive expenditures that have a better and more lasting impact on the incomes of the poor.

As most public services will continue to be produced or supplied by government to a large extent for quite some time, it is essential to improve the efficiency of production in terms of cost & quality.

### **3.3.2.2 User Charges**

Most subsidies in India are not given explicitly through the budget but are implicit in the control of prices below the cost of production and supply. According to latest estimates<sup>3</sup>, cross-subsidisation in the power sector has increased from Rs.1296 crore in 1991 to Rs.10120 crore in 1998-99 (RE). This constituted 37% of the subsidy provided to the agriculture and domestic sector in 1998-99 as compared to 22.9% in 1990-91. The railways which was a surplus sector in 1996-97 with an estimated surplus of Rs.4624 crore became a subsidy sector in 1998-99, the estimated subsidy being Rs.4021 crore. The average recovery rate in the case of centre is shown to be 13.98%, if railways is excluded. In the case of PSUs the recoveries are mainly in the form of dividends and interest. If surplus sectors like petroleum and communications are excluded, the total subsidies for the PSUs (centre) amount to Rs.10979 crore of which, the economic services account for the bulk. In the economic services, the main public sector subsidisation is seen in four sectors, viz; energy, industry and minerals, transport and agriculture and allied activities. The recovery rates are generally higher in these cases as compared to direct departmental expenditures. For public enterprises in the social services, the recovery rate is 23.70% and for the economic services, it is slightly higher at 28.03%. On the other hand the state public sector has drawn an



implicit subsidy amounting to about Rs.10000 crore with an overall recovery rate as low as 1.64%.

A price controlled below the cost of production and supply represents a tax-subsidy combination that distorts both consumption and production. The low consumer price encourages excessive use by those who can get the controlled material. At the same time producers have no incentive to invest in creation of new capacity, as returns at the controlled price are insufficient to cover the cost of new investment. As there is no incentive to invest in O&M the quality of production from existing systems also deteriorates. As demand grows over time the gap between supply and demand increases, and a black market premium inevitably emerges that is shared by the employees and owners of the good or service. If the government is the owner of the production unit(s), expansion of capacity can and does occur if and only if the government subsidises the cost of capital in some way (indirect subsidy through equity or loans or non-payment of dues to other government organisations). Corruption inevitably flowers with employees or management or both trying to extract the implicit rents in supply of a controlled commodity in short supply. State Electricity Boards are an example of the frightening extent to which this process can lead- one former SEB union leader who subsequently become power minister rightly called the SEB a Mafia organisation.

Where the controlled price varies by buyer it is a cross-tax subsidy. Most government monopolies are subject to this form of price control. Electricity pricing is the most notorious example of cross-tax subsidy, with the railway service pricing not far behind.

In these cases, as the implicit subsidy on some sub-groups rises with the cost of production, prices being held constant (e.g. electricity for farmers or rail fares for lower class passengers) prices may rise to exceed the cost of production for another sub-group. Instead of receiving a subsidy, the latter sub-groups are actually paying an additional tax. Thus honest industrial and commercial buyers of electricity in many States are being unfairly charged a tax that in some cases can reach 500% (because of fixed charges that have to be paid even if electricity use is low). Similarly general freight rates are now higher than the market can bear, so that the railways are progressively losing profitable freight traffic to the roadways.

The user charges for all categories of buyers must be equated to the cost of supply to each category. Where the gap is large it can be closed gradually through a mix of price rises and explicit budgetary subsidies. Subsidies on all 'private goods and service,' can and must be phased out gradually over a period of three to five years.

Many social services produced and supplied by the government such as higher education and training, hospital services and urban services (water, sewage, sanitation) have both a private and a 'quasi public good character.' Thus higher education (and hospitalisation) is a private good/service in that it can and should be charged for as the returns to such education from increased future income cover the cost of acquisition. On the other hand meritorious students from poor families must be provided access to higher education as this is in the interest of the economy as well as of social stability and democracy. The solution is a combination of higher user charges that fully cover operational costs and part of the capital cost, government guaranteed student loans and means-cum-merit scholarships that ensure that even the poorest have access to higher education and the nations brains are developed and put to the best possible use.

Government hospitals must gradually raise user charges while ensuring that the poor are assured access to its services at lower cost. Besides the current systems of free outpatient services for the poor, alternative channels such as subsidised health insurance for the poor must also be developed. Government must remove the legal and procedural impediments to the development of health insurance and health maintenance organisations.

In the case of urban water and sewage services, the private and public good aspects can be dealt with more easily by providing the poor with sufficient free public water taps, public toilets and bathing facilities while charging market price for water and sewer connection to private housing. A small amount of subsidy for private connections can also be justified in small urban and semi-urban areas where economies of scale cannot be fully exploited and this raises the market price of supply. The same services in rural areas would have to be subsidised to a larger extent.

### 3.3.3 Efficiency & Productivity

Even if there is a need for government subsidy, it does not follow that the good or service must be produced and/or supplied by the government. Government should only produce and supply such a good or service if its efficiency is higher than that of the private (individual, co-operative or corporate) sector and non-profit organisations (NPOs).

There are inherent problems in government production and supply of private goods & services. The CAG & other government auditing procedures are not conducive to commercial production and supply, particularly in a highly complex economy subject to myriad risks and shocks. The principle agent problem means that public employees and their overlords have a strong incentive to first create rents & then appropriate these rents for themselves. As a result corruption has gradually become endemic and there is much evidence that government production is less efficient than private. The only profitable government entities are *either* ones who appropriate natural resource rents (the difference between world price and the full cost of extraction), which appear as profits under normal accounting procedures, *or* government created monopolies (created by banning private production or investment for decades) with no private benchmarks for comparison.

The production, supply & maintenance of most of the subsidized services produced by the government can and should be progressively opened to the non-profit organisations, co-operatives and private providers. The first step would be to develop a supportive policy framework for private entry. A modern regulatory framework must also be created for social sectors where quality is difficult to judge before purchase but is critical to the future of individuals.

Even if steps are taken to involve non-government organisations in production and supply of quasi-public goods a large number and quantity of goods and services will still be produced by the government. It is therefore essential to improve the efficiency of and quality of these goods & services. There are many detailed issues involved in improving the efficiency of government programs. From a broad (macro) perspective, this requires improvement in two areas: Modernisation of Management and institutional reform to improve public accountability.

A complete and thorough modernization of the systems and procedures for production, supply and procurement of goods & services is needed. Perhaps not more than 25% of government projects use PERT/CPM a technique of project management, a technique that was developed in World War II and taught in US engineering

colleges since the sixties. Only a few progressive organisations like NTPC use these techniques. Modern inventory control is a subject that started being discussed decades ago, but is apparently still not in use in government organisations with the largest inventory of equipment and spare parts. Mean while the world has moved on to logistics and then to supply chain management.

### 3.3.4 Institutional Reform

The key to public accountability of government agencies supplying goods & services and government servants and political masters overseeing them is the citizens' right to information. A "Right to Information Act" must be enacted to return this right to the public. The poor in whose name all expenditures are justified must have the right to know all the facts relating to expenditures made/justified in their name. The information needed to be made publicly available includes the names of those who have authorized or spent the money, the purpose for which the money was spent, the names of the companies or individuals who received this money and what they have produced/done for receiving this money.

Decentralisation and devolution is an essential element of accountability. In decentralising government functions we must follow the principle of subsidiarity. That is, each government function must be performed at the lowest level at which it is feasible to perform. Thus primary schools must be run by and controlled by the local Panchayats and secondary schools at the next higher level.

Issue specific user groups must be empowered to share with Panchayati raj & other government institutions the responsibility for monitoring public activity at the village and local level. For instance, all parents of school age children in the village (or set of villages) must be part of a user group for monitoring the activities of the village primary school, its teacher and the government supplies allocated to it. Similar user groups should be set up for all local public goods and services provided by the government.

### 3.3.5 Public-Private Partnership

The government has to be responsible for funding the supply of public goods, Quasi-public goods and required welfare services. It need not, however, produce and supply all these itself. Incremental supply of existing services as well as the provision of new services or in new areas can increasingly come from non-government sources. Non-government sources can include private commercial and non-profit organisations as well as other forms of production such as co-operatives. A pragmatic, no-ideological approach should be followed so that the best private producer is harnessed to the task at hand. For instance, many urban services can be supplied by private companies, while it may be easier to use non-profit organisations to supply social services like primary education in rural areas.

In the case of existing facilities either long-term management contracts, long term lease of facility or outright sale can be used where appropriate. In the case of new facility innovative mechanism like Public-Private partnership can also be tried, where a producer invests in new facilities as part of a bidding process in which he commits to supply certain services based on a transparent pricing formula. Such a system allows fund strapped governments to leverage investment in pure public goods like roads, jails, court & police stations.

### **3.4 Tax Reform**

An efficient tax structure is the third leg of fiscal sustainability. Reduction of the revenue deficit also requires a rise in tax GDP ratio on a sustained and sustainable basis. This is only possible if the overall tax system is efficient and equitable. As taxes affect every facet of economic activity, they also have considerable power to misdirect economic activity into socially unproductive channels. In the past, use of the tax system for micro-management has often detracted from the primary goal of raising revenue in an efficient and equitable manner. It is therefore necessary to take an integrated view of the tax system.

#### **3.4.1 Direct Tax**

Though the marginal income tax rate of 30% on personal income is quite reasonable, it applies at relatively low levels of income. A rationalisation of the income tax brackets would require stretching out the income brackets. Strictly speaking income is defined as a change in net wealth and all income must be taxed at a uniform effective rate. Strict application requires that gifts are treated as income in the hands of the receiver, and that wealth tax is abolished. Further, receipts of insurance benefits to compensate for loss does not constitute change in net wealth, and should not be included in taxable income. The same principle applies to insurance or other compensation for expenditures on health.

Rationalisation of deductions and exemptions must be based on certain principles. If we adopt full income taxation, all saving exemptions should be eliminated and effective rates reduced by stretching out the brackets, to ensure initial revenue neutrality. Over time such a system will lead to increased compliance and broadening of the base. To the extent that we deviate from an income type towards a consumption type tax the most efficient way is to have a single, comprehensive net saving deduction directed toward (long term) retirement saving. Charitable deductions can also be justified as a means of using private charity to provide a social safety net.

The peak rate of corporate tax should be brought down to 30% to equate it with the personal income tax rate. Exemptions and deductions must generally be based on the principle of externalities or public good. Any developmental incentives must be time bound and directed at the source of the problem. For instance the absence of a long-term debt market argues for providing an incentive to savers for investment in such debt.

#### **3.4.2 National Market**

If viewed from a national perspective the domestic indirect tax system is highly fragmented. This in turn fragments what should be a relatively large domestic market. An integrated and sound domestic tax system will allow domestic companies to make full use of the large market to exploit economies of scale and scope. This will strengthen the competitiveness of the economy and eventually benefit all States.

An ideal indirect structure for the country would in our view consist of two sets of indirect taxes (a constitutional amendment would be needed for this purpose): A single uniform rate National VAT on all goods and services (except for a limited number of pre-specified exemptions) and State sales taxes on a dozen specified goods with a pre-specified upper limit on the sales tax rate for each of these goods. The Central government would have the responsibility of setting the national VAT rate in

consultation with the States and for administering it with the help of the States as needed. Preliminary calculations suggest that a VAT of 15% may be sufficient to ensure revenue neutrality with respect to existing Central & State indirect taxes. The proceeds from this tax would be shared between the Central government and the States in the proportion necessary to ensure that there is no diminution of the States' indirect tax revenues. To ensure that the indirect system is equitable, and to support positive externalities, the following goods and services would be exempt from the VAT: Food, including processed (cereals, pulses, vegetables, fruits, milk & products and possibly sugar), Drugs, Medical Equipment & medical services (Diagnostic; Disability compensating or Disease preventing/curing), Environment friendly fuels (Cooking gas, kerosene), Educational services and Knowledge services (Educational material, R&D, Testing, Consultancy). There would also be a sales volume exemption of Rs. 1 or 2 lakh (say) based solely on the need for minimising compliance & administrative costs. All other exemptions should be abolished. Administration of the system for transactions up to some limit (Rs. 10/20 lakh say) could perhaps be decentralised to the States.

In addition, the State government would have the right to levy sales taxes on a limited set of final, finished consumer goods (to ensure that there is no cascading & no taxation of intermediate goods). The maximum total tax on any good or service should not exceed 50%. This means that with a VAT rate of 15%, the sales tax must not exceed 35% (upper limit/maximum). Such a high rate could however be applied only to de-merit goods such as tobacco products (cigarettes, cigars, chewing tobacco) and hard liquor. Fuels with negative environmental externality, such as petrol & diesel, could be subject to a maximum sales tax of 25%. The same maximum rate could also apply to cars and low ( $\leq 5\%$ ) alcohol beverages like beer & wine. A few other items such as Air travel, Air Conditioners, Motor cycles/scooters & home entertainment products (excluding radio & TV), Entertainment services like cinema, Hotels & Restaurants service, could be subject to a maximum sales tax of 15% (i.e. 0% to 15%). Across the world, Sales taxes are normally levied at the point of sale to the consumer. Because of evasion & related problems, we follow the practice of "first point sales tax," where the tax is collected at the point of sale by the producer. Strictly speaking this is better termed as an excise tax. However, as long as cascading and multiple taxation are avoided and all States follow the same method, either method can be adopted.

Both the national VAT and the State Sales taxes would apply to imported consumer goods & services in the same way as they do to domestically produced ones. Imported goods would enter the VAT chain at the point of entry into the country and from there on be treated exactly as if they had been produced in India. The final point of sale collection (of sales tax) has the merit that each State can collect its own sales tax on imported goods. If the first point Sales tax (excise) methodology is adopted then an excise/sales/SAD tax will also have to be collected (on the specified set of goods) at the customs point on behalf of the States. This creates undue complexity if the States have different rates of tax on the same good.

Natural resource rents

The proposed National VAT and related sales tax structure will require an amendment to the constitution. Given the nature of the change this will have to be preceded by extensive discussion between the Centre and the States. Development of a consensus, the formulation and completion of this process and its implementation could take a decade, if not more. It is therefore useful to set a more pragmatic target for the Tenth Plan that is not only desirable in itself, but can also act as a half-way

house to the ultimate goal. A Dual VAT structure that, (a) replicates for the Centre the structure envisioned for the National VAT, but without violating (in spirit) the existing constitutional powers of the Centre and the States, and (b) transforms the existing State taxes into a system that includes as many of the features of VAT as possible. This may however require some constitutional modifications to close the loopholes in the VAT chain.

### 3.4.3 Central

#### 3.4.3.1 CENVAT

The most important element of Dual VAT is a Central VAT that approximates as closely as constitutionally possible the National VAT outlined earlier. The main features of such a CENVAT can be summarised as follows:

To be called a [central] VAT, the excise tax must become comprehensive and universal, so that every producer pays excise duty on his total output of goods. Excise paid on all excised or excisable inputs used in the production or marketing of the good whether they are "consumable," "design and drawings", or anything else must be deductible from excise paid on the final output. Extension of the system to the wholesale level would facilitate a continuous chain of deduction or set-off. An constitutional change or agreement with the States that allows the central government to bring wholesale trade into the CENVAT net, while promising to return to them the revenues from value added at the wholesale stage would be desirable.

The key to a comprehensive VAT type system is a single general or basic ad-valorem rate, which is eligible for VAT deduction. The base rate has been set at 16%. This rate falls in the band in which most countries' VAT rates lie. **Most of** these countries do not, however, have separate state sales taxes. Our state sales taxes are mostly in the range of 8% to 12%, with a few rates (e.g. cars, petrol) as high as 20%. If sales and other domestic taxes were incorporated our domestic indirect tax rates would be among the highest in the world.

When the MODVAT system was extended during the nineties, there was a conscious decision to go for a consumption type VAT by providing for full expensing of the excise paid on capital goods rather than set up a system of annual depreciation related deductions. The spreading of the excise deduction on capital goods over two years (i.e. an implicit straight line depreciation over two years) in the 2000-1 budget complicates the system and reduces the potential benefits from drastic simplification of the administrative system & procedures. It also raises the effective excise tax on capital goods by about 3%. The high tax rate on polyester violates the uniform basic rate principle. The high excise rates on carbonated beverages also violate the spirit of the CENVAT.

An equitable indirect tax system requires lower effective indirect tax rates for basic human necessities. Food is a very important part of the consumption basket of the poor. With such a large proportion of the population poor and an equal proportion (APL) living under the threat of poverty, food products must be exempted from the CENVAT to ensure that it is equitable. Ill health is an important cause of people moving from above the poverty line (APL) to below the poverty line (BPL). In principle, therefore medicine/drugs and medical equipment (i.e. disease & injury related) should be fully exempt. The current system of exemptions for life saving drugs, life saving equipment and special gadgets and equipment for the handicapped

could be universalised to cover all scheduled drugs, and drugs & medical equipment required to prevent or treat disease and disability.

This is also consistent with the renewed thrust for Knowledge Based industries (like bio-technology) and Agriculture. The new system of deemed credits for agriculture (proposed below) would allow us to retain the basic CENVAT rate on processed food, while reducing the currently high effective rate on value added by food processing companies. When poverty (as per current definition) is eliminated and the country reaches middle-income levels in the next decade (2010 to 2020) these exemptions can gradually be phased out.

Lower tax rates can also be justified on selected goods on environmental grounds. Thus natural & biological fertilisers & pest-retarding agents could be exempted from CENVAT, as they act as substitutes for artificial fertilisers & pesticides, which are polluting water sources. Production & supply of Biogas and solar energy should also be completely exempt. There should also be a lower rate of tax on clean fuels such as LNG and LPG, as these fuels are substitutes for polluting kerosene and fuel wood.

A balancing of revenue and equity considerations also suggests a *few higher rates for demerit goods* like tobacco products (cigarettes, cigars, chewing tobacco or mixed in pan masala) and for *final, finished, luxury consumer durable goods* like cars. These should be in the form of a 'special excise', which is not eligible for VAT credit. Special excise rates of 5% (4%), 15% (14%) and 20% (19%) would be appropriate if the base CENVAT rate is 15% (16%).

Special excise can also be imposed on grounds of environmental pollution. Thus polluting fuels like Motor Spirit and Diesel as well as selected dyes & chemicals that damage water sources could have special excise taxes on top of the general rate of 15% (16%). The special excise should not exceed 25% (24%) so that the total does not exceed 40%.

All imports would also be subject to an identical deductible VAT and non-deductible special excise as on domestically produced goods. The 'Additional Duty' can be renamed CENVAT to make it WTO compatible. The customs department should keep a separate account for this CVD/CENVAT so that it can be distinguished from protective customs duty and accounted for in the CENVAT accounts. *Exports* would be zero-rated and entitled to a refund on CENVAT paid (as they are today).

### **3.4.3.2 Service Tax**

Central Service tax reform and extension must be designed to integrate it with the CENVAT by the end of the 10<sup>th</sup> Plan, keeping in mind the ultimate objective of a National VAT. The central service tax should therefore be integrated into the CENVAT by the end of the 10<sup>th</sup> plan. Then all services, particularly modern production services such as transport, communication and financial services, under the tax authority of the centre would also be subject to the same basic CENVAT rate. Similarly the tax paid on any services used as input (e.g. "telephone" or "insurance") into the production of excisable services or goods would be deductible (set-off). Any comprehensive Service Tax law must keep these objectives in view.

The second essential feature of the service tax law is that a service must be treated identically no matter who the producer is. Thus education services should be exempt independent of whether they are provided by the government, the co-operative or corporate sector. Thirdly, just as administrative convenience requires that low

volume producers be exempted from excise, low volume producers/sellers of services should also be exempt. There seems to be no cogent reason for setting different limits for goods & services. Fourth, as the Service tax administration is a completely new one, it must be built on the best and highest standards of modern tax administration to be found across the globe. In other words it must be technology (e.g. web filing & computerised checking) & data intensive and analytical (accounts, economic flows) rather than manpower intensive and physically intrusive. It can thus serve as precursor for a modern VAT administration.

Personal services like hair cuts and other pure consumer services can be delegated to the States in return for the Centre having complete authority over all services that are input into production, distribution and marketing. The States would have the right to levy and collect the former, subject to a pre-defined maximum that is consistent with the future integration of these services into the National VAT.

#### 3.4.4 State

The initial focus on harmonisation of State sales tax rates came from the fact that a National VAT must have a uniform basic rate. The objective was to move the States' sales tax systems to a MODVAT type of system and to simultaneously reduce the disparity in rates between the States. It appears that the first objective has been lost sight of in the effort to harmonise rates. In fact even the latter objective seems to be getting distorted by the fiscal crises to one of raising the rates. It is necessary to return to the original objective keeping firmly in view the objective of moving to a National VAT by 2010.

#### 3.4.5 Municipal & Local

Fiscal decentralisation is an important element of overall decentralisation. Just as certain taxes are assigned to the Central and State governments, taxes coming under the purview of the States should be assigned to lower levels of government within the State. Thus for instance land and property taxes should be assigned to the lowest levels of government, namely Panchayats and Nagarpalikas. There should also be a system of transfer of funds from the State governments to lower levels of government based on principles of tax potential and equitable sharing of taxes.



## 4 BALANCE OF PAYMENTS

### 4.1 BOP Management

External sector reforms have been the most successful of all the reforms that were undertaken in the nineties. These reforms have confounded the fears of critics and sceptics that imports would go through the roof and current account deficits would balloon. The results confirm that a well-regulated market-based foreign trade and payments system would be more efficient and equally stable. Both the trade and invisibles account are now much more resilient than they were in the eighties. Capital inflows are now much more diversified and therefore much less risky for the country. Both FDI and portfolio flows increased rapidly through the mid-nineties. The strengthening of the Balance of Payments as a result of the external sector reforms was reflected in the overall balance and the real exchange rate. There was an annual average reserve accumulation of 1.1% of GDP in the post crisis period compared to the annual draw down of 0.2% of GDP during the pre-crisis decade. The real effective exchange rate showed no depreciation on average during the post crisis period after depreciating by an average of 2% per annum during the eighties.

Contrary to the perception of many outside observers the Indian economy has become more open relative to other emerging economies. India's ranking with respect to trade, FDI and portfolio flows has improved noticeably over the eighties. Only in the case of tariffs is there is no relative improvement, probably because India was a complete outlier. There is however still a very long way to go to attain a ranking in trade and FDI that is commensurate with the size of the economy. Trade as well as FDI remain very low when measured as ratio to GDP and ranked accordingly. China's success in trade and FDI is not only a challenge but also a message of hope; that India too can make a quantum jump by greater opening of the economy and ensuring that domestic economic policies are conducive to the exploitation of the growth potential of trade and FDI.

The opening of the economy to international trade has successfully raised the share of trade in GDP. Goods and services trade has increased from an average of 15.1% of GDP during the eighties to an average of 24.8% of GDP in the nine years (1992-3 to 2000-1) after the crisis. Similarly merchandise trade, which had averaged 12.6% of GDP in the decade of the eighties, has increased significantly to an average of 20.1% of GDP in the post crises period. The change on the import side has been less than on the export side. Exports (imports) increased from 4.7% (7.9%) of GDP in the decade before the crisis to 8.5% (11.6) in the nine years succeeding it (i.e. post crisis period). As a consequence the proportion of imports financed by exports has increased from 0.59 in the pre-crisis period to 0.74 in the post-crisis period.<sup>5</sup>

Manufactured exports responded well to the trade reforms. Manufactured exports increased from an average of 60.7% of total exports in the eighties to an average of 76.1% of total exports after the crisis. As result the ratio of manufactured exports to GDP more than doubled from a pre-crisis average of 2.8% to a post-crisis average of 6.3%. Its share of total exports also increased from 60.7% to 76.1% between the two periods. The importance of manufactured exports to domestic manufacturers has correspondingly increased. This is best captured by the ratio of manufactured exports to GDP from registered manufacturing, which has also more than doubled from a pre-crisis average of 6.4% to a post-crisis one of 13.2%. Thus

even with the many domestic controls and policy distortions still hampering manufacturing in India this has sector has demonstrated its comparative advantage vis-à-vis other tradable sectors.

Elasticity pessimists in India have generally been very concerned about the effect of opening of the economy on the manufacturing sector (“de-industrialisation”). That these fears have proved unjustified can be seen from the value of net imports of manufactured products (Import-export). This has fallen dramatically from a pre-crisis average of 8.9% of GDP to a post-crisis average of 2.5% of GDP. In fact exports of manufactures exceeded imports of manufactures (i.e. a net surplus) during each of the four years from 1991-2 to 1994-5. This shows that manufacturing trade was highly responsive to the exchange rate devaluation of July 1991 as predicted in 1991.

Though trade and capital account liberalisation has been successful, the country has perhaps not moved as far or as fast as it could have without taking undue risk. The Asian crisis and the economic sanctions share some of the blame as they revived the primal fears of the sceptics, which were gradually being laid to rest. Too often, however, has this spectre been used to avoid or slow down sector external reform. The 1990s experience shows that external liberalisation will pay further dividends probably in the form of higher growth.

One result of the success of the capital flow liberalisation was the unprecedented surge in equity capital inflows between October 1993 and November 1994. A macro-management strategy for dealing with this “Dutch Disease” problem was developed, that was quite different from the standard ‘Washington-consensus’ view prevailing at that time. Smaller surges in capital inflows have occurred since then and are likely to so again, putting pressure on the exchange rate to appreciate and thus threatening exports and import competing industry. These would have to be managed accordingly, based on our earlier experience.

The strength of the external account rests substantially on the flexibility of the “managed float” in responding to changes in demand-supply conditions in the exchange market. Difficulties and temporary weakness have emerged and will arise in the future *if and only if* considerations other than market supply-demand determine the management of the floating exchange rate.

#### 4.1.1 Exchange Rate Policy

The changes in exports and imports have, paradoxically occurred despite the fact that the Real Effective Exchange rate averaged the same in the post crisis period as in the pre-crisis decade. This is however quite misleading as the real effective exchange rate depreciated by an average of 1.9% per annum in the nineties, because of a depreciation of 15.1% in 1991-92 and 11.1% in 1992-93 (tables 1 & 2). The real depreciation rate was therefore only 0.1% per annum slower than in the eighties and 0.2% per annum slower than in the seventies. As a result India’s share in world exports continued to increase from 0.52% in 1990 to 0.67% 2000. Because of gradual lifting of QRs and reduction in customs tariffs this increase was higher than in the previous decade.

The issue of temporary fluctuations and anticipated temporary shocks and how to deal with them has arisen in the context of the borrowing through India Millennium Deposits in 2000-1. Consumption-smoothing arguments suggest that short-term borrowing or temporary draw down of reserves would be justified if an adverse shock to imports, exports or an item of the capital account is temporary. The alternative is to let the exchange rate depreciate when the adverse shock hits and then appreciate after the shock has reversed itself. Medium-term borrowing is, however,

inappropriate to meet a short-term shock. If the external fluctuation is of uncertain duration, the policy choice between external borrowing and allowing the currency to depreciate is much more stark. In the case of a shock that could last more than a year, the exchange rate should be allowed to depreciate sufficiently to improve the trade balance and make the financing unnecessary. The lesson of the 1990-91 BOP crisis is that external borrowing through government owned financial institutions is a palliative, which ultimately weakens (rather than strengthening) the external balance.

The main lesson of the nineties is that liberalisation of the current and capital account increases the flexibility and resilience of the Balance of payments. This applies to trade, invisibles, equity capital, medium-long term debt flows and the exchange market. A corollary lesson is that even though the balance of trade may not be the cause of BOP problems (excess demand for foreign currency) an exchange rate depreciation by improving the balance of trade and the invisibles account can help minimise the probability of a crisis. Analysis has confirmed that in India the exchange rate is a powerful instrument of adjustment in the current account deficit. It also confirms that equity outflows are very unlikely to be major cause of BOP problems (unlike short term debt). Fiscal profligacy, which was a fundamental cause of the BOP crisis of 1990-1 remains a source of weakness, but its impact on the external account has become indirect and circuitous with implementation of external sector reforms. It operates much more through the general expectations about economic (growth) prospects and the risk premium demanded by foreign (and domestic) investors and lenders. Thus its negative effects are likely to be focussed on the domestic rather than the external account. In other words, the negative long-term effects of fiscal profligacy are more likely to be felt in future on the growth rate of the economy and the (health of the) domestic financial sector.

## **4.2 Trade Competitiveness**

Despite high export growth the trade account, the trade deficit has not changed significantly in the post-crisis period. It averaged 3.1% of GDP in the post-crisis period, compared to 3.2% in the eighties and 3.0% in the second half of the eighties. The trade balance was in fact stronger than is apparent from the bare numbers, as the post crisis imports include a substantial proportion of gold imports that earlier were not captured in the import numbers (smuggled). The break-up of the USSR also disrupted established trade patterns and new markets had to be found to replace those lost in the USSR & E. Europe. Further despite the Asian crisis in late 1997-98, the trade balance improved in 1998-99.

The trade deficit after falling sharply in 1990-1994 (2.1% of GDP) has increased even more sharply in 1995-1999 average 3.6% of GDP. This is higher than in 1980-1984 (3.5%). It touched 4% of GDP in 1999-2000 but fell back to 3% in 2000-1. The increase in the import GDP ratio over the nineties is driven by the increase in manufactured imports. The net imports of manufactured goods, which become negative (i.e. net exports) have risen in the 2<sup>nd</sup> half of the nineties. They still remain well below that in the 1<sup>st</sup> half of the eighties. There are a number of reasons for these developments. The euphoria that preceded the Asian crisis created large capacities in many (un differentiated) products in Asia that has been putting downward pressure on global prices of manufactured goods. This combined with the slower pace of real depreciation (0.8% per annum) during the 2<sup>nd</sup> half of the nineties compared to the 1<sup>st</sup> half (2.9% per annum), to eliminate any remaining “water under the tariff.” Indian manufacturing is therefore subject to competitive pressure for the

first time. The solution is to increase competitive efficiency further through faster tariff reductions combined with greater freedom to exchange markets to depreciate.

An important factor is the slow speed of fundamental domestic reform such as in the power and railway sectors that has raised the effective cost (direct cost, rationing, quality) of these two vital non-tradable goods. This means that the real exchange rate as measured by the ratio of the virtual cost of non-tradable goods to prices of tradable goods has probably risen faster than the tariff adjusted real exchange rate. When the real cost of other domestic distortions such as labour inflexibility is added, this denotes a loss in competitiveness of Indian producers of import substitutes that has not been fully compensated by firm specific productivity improvements. As long as the overall balance of payments is in equilibrium the solution lies in domestic reform rather than in faster exchange rate depreciation. This recommendation does not however apply when the economy is subjected to external shocks such as the Asian crisis or the lagged effect of external economic sanctions. In this situation the exchange rate must be allowed to adjust in preference to seeking special financing through government owned financial institutions.

Capital goods imports that were the likely driver of the increase in growth during the eighties have not risen as fast during the nineties. Imports of capital goods as a percent of manufactured imports have also fallen after rising to a peak of 33% during 1993-4 to 1996-97, though they were still in the 2<sup>nd</sup> half of the nineties a higher proportion of manufactured imports than in the 1<sup>st</sup> half of the eighties. This rise is partly due to the decline in FDI from 1997-98 onwards and partly to the decline in domestic investment (GDI) over the same period. The ratio of capital goods imports (\$) to domestic production of capital goods (IIP), which rose during the FDI and GDI boom of 1993-4 to 1996-97, has since fallen. This is a precursor of lower productivity growth in future. Elimination of remaining controls on domestic investment & production (SSI reservation, outsourcing (CLA), drugs, sugar, petroleum, fertiliser, coal, rail transport), regulatory & other reforms in infrastructure and elimination of remaining restrictions on FDI can help revival of both GDI and FDI.

#### 4.2.1 China Competition

During the tenth plan, one of the potential risks is that arising from China's export thrust into India. This has two components. One arises from labour intensive exports (considered subsequently) and the other from dumping by State owned enterprises (SOEs). With China's system of implicit and explicit subsidies to SOEs through State owned Banks (SOBs) quite obscure, there is a strong potential threat from subsidised exports by SOEs. A study quoted by Dr Sylvia Oestry<sup>6</sup> shows that India, other S. Asia and Indonesia are going to be the biggest losers from China's entry into the WTO. She also says that bringing "Transparency" in China's domestic policies with respect to International trade may take a very long time as even in the case of Japan it has taken over 100 years. Remedies under the WTO may be severely limited if China's accession agreement does not make "transparency" with respect to such subsidies a central focus of accession.

China's per capita income is about double that of India's. This means that on average the real wage in China must be about twice that in India. Yet China's labour intensive exports have flooded the world markets, while the same exports from India have a miniscule share of the market sometimes even less than that of countries, which are a tenth to a hundredth of its size. That this is not due solely to the all round technological, management & marketing support provided by FDI (by overseas

Chinese & others) is shown by the fact that these same products are now entering India and seriously challenging domestic producers even in the domestic market. The most important reason is that China's labour is much more productive than Indian labour as it is not debilitated by rigid & ossified, labour laws and procedures. There is no doubt in any one's mind in China that only hard working and productive workers can expect to get and hold their jobs.

It is perhaps not possible to address the entire gamut of labour laws, rules & procedures at one go, critical changes need to be identified. Changes have already been proposed in the Industrial Disputes Act and associated procedures so as to impart greater flexibility. The "Contract Labour act," as interpreted by the courts is more like a social security act and unlike any contract labour legislation in the world. The courts have recently re-interpreted the act to impart some flexibility in outsourcing services. Modernisation of this act, however, is still imperative so as to support specialisation and encourage the creation of jobs. Though this will not solve the problem of inability to fire irresponsible and uncaring workers (a serious competitive disadvantage vis-à-vis China & Indonesia) it will give a strong signal of hope to both industry and unskilled youth.

The second important reason for China's success and its strong competitive challenge in India is that it has never had SSI reservation. China's producers of labour intensive products have therefore been able to fully exploit economies of scale and scope in production, procurement, distribution and marketing. It is therefore no surprise that the greatest threat from Chinese exports is to SSI reserved products in India. If political constraints do not allow complete de-reservation in one go, we must urgently de-reserve labour intensive importable and exportable goods if we are to meet the challenge of Chinese competition. An immediate start must be made by de-reserving the previously identified exportable goods (toys, shoes, leather goods) and raising the asset limit to 3/5 crore on the set of goods already identified as having higher scale economies than the current asset limit.

### **4.3 Import Tariffs**

Given the past statements of all finance ministers during the nineties on bringing India's customs tariff rates to East Asian levels it is also useful to look at the tariff rates of these countries. After Cambodia, Thailand had the highest average tariff of 17.1%, followed by Vietnam (15.1%), Indonesia (10.9%), Philippines (10.1%), Taiwan (8.8%), S. Korea (8.7%), Malaysia (7.1%) and Singapore & Hong Kong (0%). All our South Asian neighbours such as Sri Lanka (20%), Bangladesh (22.2%) and Nepal (17.7%) as well as our northern neighbour China (16.8%) had lower average tariffs than us. This creates additional problems of import diversion and smuggling. The fact that India has some form of free trade arrangement with several of its neighbours means that it becomes profitable to import many items into these countries and then export them to India. Any objective assessment would suggest that Indian industry can surely compete with industry in these countries and there can be no rationale for an average rate higher than that of Nepal. Bringing down India's import tariffs below those prevailing in Nepal will reduce the incentive to use Nepal as a conduit for tariff jumping.<sup>7</sup>

Reform of the import duty structure within the existing commitment to bring the peak duty rate on "basic" customs duties to 20% creates certain constraints on rationalisation of the entire structure and elimination of anomalies by 2004-5. It is necessary to eliminate end-use and other exemptions that have been accumulated in an ad-hoc manner over the past several decades. Besides reducing complexity,

litigation and incentives for evasion & corruption, this has the additional benefit of facilitating the elimination of anomalies.

Even if our peak rate is brought down to 20% by 2004-5, we will still have some way to go to reach the tariff levels of East Asia as they stand today. In the meanwhile most ASEAN rates are to be reduced to the 0%-5% under the ASEAN free trade (AFTA) agreement. This will reduce the average rates of Thailand, Indonesia and Malaysia even further below ours. Similarly China has made commitments to reduce tariff rates over the next 3 to 5 years. The average tariff rates of the large OECD countries are clustered round 5%, with Canada at 4.6%, USA 4.8%, Australia 5%, Japan 5.2% and EU 5.6%. Switzerland (0%), Norway (3.3%), New Zealand (3.8%) have lower average rates. It is therefore imperative, to go beyond the existing commitments, and bring peak rates to E. Asian levels during the 10<sup>th</sup> Plan and to Developed country levels during the 11<sup>th</sup> plan.

An argument is often made that industry needs higher tariff protection, because of the relatively *high cost of infrastructure services and bureaucratic red tape* in India vis-à-vis other countries. High cost of non-tradable goods like infrastructure services relative to competitor countries is an economically valid argument for having a more depreciated exchange rate. In other words the higher protection should come through exchange rate depreciation rather than through higher tariffs; the former helps producers of exports and import competing products, while the latter helps only import competing producers. ***A high tariff protection leads to a high cost economy and erodes the competitiveness of the economy.*** If non-tradable costs in any country with a freely floating currency are rising faster than those in other countries, the exchange rate will (ipso facto) automatically depreciate relative to these countries. In an economy with a managed float, the exchange rate must be allowed to depreciate if the non-tradable costs increase. Such an exchange rate adjustment restores macro-economic and external balance. It does not however, remove the deadweight burden on the economy, which reduces the per capita income of the economy besides adversely affecting investment and growth (i.e. future per capita income).

This issue should not be confused with the problem of exchange rate management when there are large capital movement. This problem has to be dealt with as indicated above, whatever the level of non-tradable costs or the changes in non-tradable costs.

It should be noted that to the extent that different sectors are differentially affected by infrastructure costs and/or bureaucratic harassment costs, their relative competitiveness would be affected. This does not, however, provide an argument for greater protection of those industries that are most infrastructure-dependent or are subject to the greatest dead weight loss from bureaucratic interference. If infrastructure cannot be improved or bureaucratic costs reduced, there is no gain to the economy from promoting and protecting such industries more than others. Such protection will merely increase the dead-weight loss to the economy as a whole. The only sustainable solution is to improve infrastructure availability & quality and reduce harassment through policy and institutional reform. This will reduce the dead weight burden on those specific industries as well as the economy as whole, thus improving current & future (through higher investment & growth) per capita income.

With a varying structure of taxes it is necessary to look beyond the nominal tariff structure to the effective protection rate (EPR), as the higher the EPR the greater the room for inefficiency. The EPR therefore measures the degree of inefficiency that the domestic producer can have in value addition as a percent of the global efficiency norm of value addition in the production of this item. In the above example the

producer can be 40% more inefficient than the globally efficient producer. An analysis of the variation of the effective protection rate with a peak rate of duty of 20%, input tariffs ranging between 0% and 20% and different input ratios, yields several insights. Firstly, if all inputs used by the producer have an import duty of 20% then the effective protection rate is also 20% no matter what the proportion of value added. This result also implies that a uniform rate of import duty/tariff of 20% ensures an effective protection of 20% for all. Similarly *a single uniform rate of basic customs duty of 10% as proposed by us will ensure that all producers of all goods have an effective protection of 10%*. Second, the effective protection rate is inversely related to the proportion of value added by the producer and the average tariff rate on inputs used by the producer. For all goods at the peak rate of duty (20%) the effective protection rate ranges from 20% to 400%. Even if the average input duty is only 5% points less than the output duty (i.e. 15%) the effective protection can be higher than 100%. A two-tier duty structure with consumer goods at 20% can result in some having an EPR of 200%. *Thus with a varying rate of import duty on inputs, the effective protection rate can be quite arbitrary and random.*

Third, the producers who add the least value tend to get the highest protection. This can be illustrated by considering a case in which all raw material and intermediate goods have customs duty rate of 10% while most consumer goods have a customs duty rate of 20%. For this latter set of goods the effective protection increases from 21% if the value added ratio is 0.9 to an EPR of 30% if the value added ratio is 0.5 to 110% if the value added ratio is 0.1. In other words ***the higher the use of imported/importable inputs the higher the level of effective protection.***

The broad operational approach to customs duty reform adopted during the 1990s remains valid. This consists of reducing peak rates, removing exemptions and simplifying the system. We however need a clear vision of where we will be at the end of the decade along, so that economic agents (companies, business and farmers) can plan new investments rationally with better understanding of the policy environment. The country should move, to internationally competitive rates of customs duty protection by the end of the current decade. This will give sufficient time for industry and agriculture to adjust to these changes, and for government to ensure that domestic controls and bureaucratic constraints are eliminated.

Customs duty reforms can be carried out in two phases, with the basic “peak” rate of import duty reduced to 10% by the end of the tenth plan and to 5% by the end of the eleventh plan. More important, with the “peak” rate down to a reasonable level, virtually all exemptions can be eliminated by 10<sup>th</sup> Plan end so that 10% becomes the “standard” customs duty rate. At that point more than 9/10<sup>th</sup> of importable goods would be subject to a uniform basic customs duty of 10%. The “maximum” tariff rate would however be higher. During the second phase the “peak” rate would be reduced from 10% to 5% and the “maximum” rate brought down to the “peak” rate of 5%. At this time there would be a single uniform basic custom duty rate of 5% on all goods.

The basic rate of duty on many agricultural goods and on cars is currently higher than the “peak” rate of 30%. These highly protected items with above-peak tariff rates consist of either agricultural materials or automobiles. It may be difficult to bring all these down to 10% by the end of the 10<sup>th</sup> Plan. The high rate exceptions should, however, be limited to a maximum of 1/10<sup>th</sup> of the tariff lines (at the 4 or higher digit level). The basic customs duty on these above-peak items should generally not exceed 20% in 2006-7. In extreme cases (e.g. hard liquor) not exceeding 1/100<sup>th</sup> of the tariff lines (at the 4 digit level), the basic customs duty can

temporarily exceed 20% but should not exceed 30% in 2006-7. Thus 30% must become the “maximum” customs duty rate by the end of the 10<sup>th</sup> Plan.

Virtually all end-use exemptions as well as all temporary exemptions (considered below) would be abolished when the 10% peak rate is achieved. There is already a commitment to reduce the peak customs duty to 20% by 2004-5 (as proposed by the Finance Minister in the 2001-2 budget and reiterated in the 2002-3 budget). The phased reduction in the “peak” rate of basic customs duty should continue thereafter to 15% in the next year and to 10% by the end of the tenth plan. The minimum duty on exempt items earlier subject to a 5% duty would be raised to 10% by the end of the tenth plan. ***At this point all anomalies would be removed with the exception of those arising from international agreements and higher temporary protection of agricultural raw materials.***

A single uniform rate of basic (protective) customs duty on all imports has many attractive features:

- a. It ensures that the nominal protection for all imports is the same thus eliminating all classification problems and disputes, resulting in substantial saving in administrative and legal costs.
- b. It makes it much easier to administer the duty free import regime for exporters. As a single rate applies to all imports only a total value of imports needs to be specified in any advance license, making actual import 100% flexible. Similarly any draw back or refund calculation only needs the value of imports used in export production.
- c. Most imports can in principle be on self-declaration basis and customs staff can focus their time and energy on checking smuggling (through mis-declaration of quantity or concealment of item) and chronic misstatement of price.
- d. If the uniform rate is reasonably low the incentive for smuggling will be minimised and make the administrative problem of checking it, manageable.
- e. With a single, uniform nominal duty the effective protection rate is also identically equal to this rate. The rate of effective protection is therefore neutral and equal for all value added by domestic producers. This will increase the efficiency and competitiveness of the entire economy.
- f. Uniform effective protection on all producer goods is more equitable in that it removes the discrimination against other producers. Higher protection for one set of producers inevitably results in lower protection for some other producer.
- g. In the case of final finished consumer goods, there is much greater economic justification for a single uniform basic customs duty equal to that on producer goods (with AD/CVD = domestic taxes on consumer goods), than there is for a single uniform rate VAT or CENVAT (applying equally to domestically produced and imported goods).
- h. A low uniform rate duty will have the additional benefit of reducing our weighted average tariff rates below those prevailing in neighbouring countries. Our economic interests will then become much more closely aligned with theirs. Indian industry and agriculture will have much less to fear from special free trade arrangements with our neighbours than is the case today.
- i. A low uniform duty that is close to the average for ASEAN countries will enhance India’s case for closer economic integration with ASEAN. We can then take the lead in the formation of an Asian Common Market, instead of being treated as a highly protected pariah economy.



- j. Such a regime will eliminate the continuous lobbying that now takes place, and the special benefits to large industry & powerful interest groups and losses to the small and unorganised, that inevitably result from such lobbying.

#### **4.4 Current Account**

The invisibles account improved significantly in the post crisis period with inflows rising from the average of 1.4% of GDP in the eighties to 2.0% of GDP in the pre-crisis period. Thus these invisible flows are back to the high levels seen in the first half of the eighties (i.e. five years). That some of this improvement is due to the reform of gold policy can be seen from the big jump in remittances through official channels. Private transfers, which had averaged 1.1% of GDP in the pre-crisis period, have more than doubled to 2.5% of GDP in the post-crisis period. The investment & other income outflows after rising to a peak of 1.4% of GDP in 1991-2 and 1992-3 declined progressively to 0.8% of GDP by 2000-1. As indicated above, in the earlier years external debt was the driving factor while in the latter years FDI and portfolio flows have also started playing a role.

Contrary to popular perception *non-factor services, which include software exports, have not played a role in this improvement. This is primarily because software exports have offset declines in other non-factor services.* The sharp increase in software exports is reflected in miscellaneous receipts (not net) from 0.6% of GDP in the eighties and 1<sup>st</sup> half of the nineties to 1.3% of GDP in the 2<sup>nd</sup> half of the nineties. The improvement on this account has however been offset by a deterioration in net travel receipts. This points to the need for addressing the basic problems that bedevil foreign tourists coming to India, like lack of hygiene & health (tourist sites and hotels), information (about tourist sites, places & cities) and common curtesy (from immigration counters to local transport to tourist sites) & entertainment at tourist destinations.

The most critical areas of infrastructure reform from the tourism perspective is transport. The quality and efficiency of airports and domestic airlines can be improved through increased competition. Domestic airlines must be allowed to enter into joint ventures with foreign airlines and the foreign equity proportion raised at least to the level of Telecom. Airport services can be unbundled so that government can focus on improvement in air traffic control & landing equipment and security & safety procedures. The rest can then be left to the private sector. Railway transport can also play a part in tourism earning if the metro railway stations are privatised and turned into clean commercial hubs and the supply of passenger rail services opened up to private entry and competition (with no price control).

There was also a minimal effect of the Asian crisis on invisibles with a decline of 0.2% of GDP in the invisible surplus in 1998-99 and a strong bounce up the next year. The improvement in invisibles earning has ensured that there was little criticism of the current account liberalisation.

As a result of the strengthening of the invisibles account, the current account deficit averaged 1.1% of GDP in the post-crisis period. There is no evidence of deterioration in the current account over the decade, with the CAD being marginally lower in the 2<sup>nd</sup> half (1.2%) of the nineties compared to the 1<sup>st</sup> half (1.3%). The CAD is lower than the pre-crisis average of 1.8% of GDP, the 1.5% average of the 1<sup>st</sup> half of the eighties. The position was even better (0.5%) in 2000-1. The external reforms have therefore been successful in putting the current account balance on a sustainable path.

## **4.5 Capital Account**

The capital account of the balance of payments has also shown corresponding improvement. Capital inflows (excluding “other capital”) increased from an average of 1.6% of GDP in the pre-crisis decade to an average of 2.2% of GDP in the post-crisis period. Even more significant than the overall increase was the increase in foreign investment inflows from negligible in the eighties to an average of 1.1% of GDP in the post-crisis period. The contribution of External assistance (and rupee debt) declined by 0.2% of GDP (each). The contribution of External Commercial Borrowing increased by 0.1% of GDP while that of NRI deposits remained unchanged. Thus the objective of raising the equity-debt ratio of external liabilities has been achieved

### **4.5.1 FDI**

FDI responded extremely quickly to the new policy announcement in July 1991, recovering to \$129 mi in 1991-2 itself and then more than doubling to \$315 million the next year. It continued to grow fairly rapidly to reach \$3.56 billion by 1997-98. Between 1990-91 and 1997-98 FDI grew at a compound annual rate of 67% (simple average of 73% for 1991-92 to 1997-98). This rapid growth was followed by the Asian crisis and economic sanctions, resulting in a decline of about 30% in 1998-99 and 13% in 1999-2000. Though much of the decline in 1998-99 was part of the over all decline in FDI flows to emerging markets because of changed risk perceptions, India did not share in the recovery of flows in 1999-2000. Despite positive growth in 2000-1 India’s share in FDI to emerging markets, remained below the peak reached in 1997-98. It seems to have recovered some lost ground in 2001-2.

During 1990-1 to 2000-1 about half of the foreign investment inflow was FDI and the other half portfolio (FII & GDR). This suggests that the opening of the equity market has been relatively more successful than the opening of FDI. This is not due to FDI policy alone. In the manufacturing sector where 100% automatic FDI is allowed in all areas open to large domestic industry there is only one specific restriction that applies to FDI but not domestic investment. This is the requirement that an existing foreign direct investor must obtain a no objection from the Indian JV partner before starting a new independent unit. This restriction has no relevance to green field investors and those without a domestic JV partner, but may have slowed the growth of existing FDI. The more important problem in the case of FDI in the manufacturing sector is domestic policy constraints such as SSI reservation and labour policy, rules & procedures that make China a more attractive destination than India. This discourages both Foreign and Indian companies from investing in a slew of labour intensive exportable sectors.

In the case of Infrastructure, foreign equity limits exist in two major sectors, Aviation and Telecom. The 49% limit in Telecom has clearly had a negative affect on FDI inflows into this sector and should be removed. The ban on foreign airlines in domestic aviation has been a more important factor in aviation and needs to be removed forthwith. A generic problem affecting many infrastructure sectors has been one of regulatory capture (and potential capture-creating regulatory risk) by Public sector monopolies abetted by their supervisory ministries. This problem has taken an excruciatingly long time to sort out thus slowing investment in infrastructure. A modern independent regulatory system in all infrastructure sectors would help to accelerate both foreign (FDI) and domestic investment.

In the case of the power sector the most fundamental problem is the “T&D Mafia,” that has a vested interest in maximising power theft by consumers. This

problem has to be addressed through a special police task force that arrests the corrupt employees and sequesters their ill-gotten gains. Some amendments may also be required in the, “The Prevention of Corruption Act” to make it possible to freeze the financial returns from investment of stolen power by employees. A break up of the “T&D mafia” will also make it easier to solve the secondary problem of raising user costs to economic levels. It will also make it possible to attract private entry into the power sector within a competitive generation industry and well regulated distribution & transmission sub-sectors. In the meanwhile greater transparency in the implicit tax-subsidy arrangements and their replacement by an explicit tax-subsidy regime will make it possible for private generators to operate outside the strangle hold of the SEBs.

In non-infrastructure services, particularly in some service sectors that have attracted large investments in other countries, domestic reforms as well as liberalisation of FDI has been painfully slow. The entire policy framework for private entry into real estate, housing and retail trade (particularly grocery super markets) needs to be reformed to attract both domestic and foreign investment.

#### 4.5.2 Convertibility

The Asian crisis has come and gone. The period in which forecasts of its negative effects were continuously revised upwards was followed by constant downward revision of these effects. The current consensus is that, even though the initial severity of the crisis was surprising (given that it occurred in economies thought to be “miracles”) the recovery was as quick as in other previous crisis. As in the case of our own BOP crisis of 1991 the “Asian crisis” was due to a mix of underlying Structural Problems, increasing Macro-economic Imbalances and Triggering Factors or Events. In a few countries like S. Korea recovery has been as fast as (or faster than) in India, while in others like Indonesia it is likely to be much slower. The speed of recovery has depended on the vigour with which some of the critical structural and macro problems have been tackled. Both the problems and the solutions are by now reasonably well understood. It is therefore time to put aside some of the irrational fears unleashed by the “Asian Crisis” and resume the process of moving towards capital account convertibility. As has been our practice so far, this should be done with “all deliberate speed,” that is at a speed which is reasonably fast but does not involve excessive risks.

Though the Asian crisis has come and gone, the processes of separating the right lessons from the wrong ones, is not complete in India. More important, the lessons for the crisis countries may differ in important respects from those for India. We had already learned several lessons from our own crisis of 1991 and the Latin American crisis of the previous decade. Among these was, to decrease the ratio of short term to total debt as the former was dangerously high before the crisis and a strong effort was necessary to attract Direct Foreign Investment so as to decrease the external debt-equity ratio of the country. The fixed overvalued exchange rate is also recognised as a major cause of the sharp rise in the current account deficit and the 1991 crisis. Opening of the current account during 1993 and 1994 was therefore accompanied by a flexible exchange rate policy. Post-crisis it was also recognised that the regulatory system for banks as well as stock markets had to be modernised and strengthened. Efforts in this direction started in 1992 and have continued steadily (though not very fast in some sub-sectors) since then.

The Asian crisis did reinforce (and make widely known) the importance of flexible exchange rates and Banking de-control & regulatory reform. It is now more widely recognised that the banking regulations have to be brought up to international standards. There were, also, a few more specific lessons, which are of relevance to our move toward capital account convertibility. In each of the affected Asian countries the crisis lasted about a year and recovery has taken place in two to three years after onset. Even in Indonesia the basic crisis lasted for about the same time and continuing uncertainty is largely due to political violence and constitutional upheavals. This pattern of crisis and recovery is very similar to the Mexican crisis of 1994. Fixed exchange rates and excessive external short-term borrowing (defined as less than one year) were the two most common macroeconomic culprits. The obverse of this proposition is that external loans with residual maturity of over one year did not add at all to the crisis, as the crisis was over within a year. Portfolio flows proved to be somewhat more volatile than expected, partly because of the fixed exchange rate; nominal exchange rate had not been allowed to appreciate in the preceding period of large inflows. As expected, however, stock market declines from panic sale of foreign portfolio equity proved to be self-correcting. The problem of declining stock prices and capital flight was limited to less than a year, as net inflows re-started as soon as the bottom had been reached. Further there is a strong suspicion that as in the Tequila crisis, capital flight originated from domestic investors and not foreign ones. Conversely FDI again proved to be much more stable with reductions in net inflows but no net outflow even during the crisis year.

Overall lessons, namely the need for flexible exchange rates, flexible interest rates, competitive stock markets and open forward markets are both helpful in avoiding crisis and in ending them rapidly. Keeping these lessons in mind we need to move forward on convertibility.

Formally we became convertible on the current account in 1994. There is a need to eliminate the gap between the theoretical position and the reality. All import controls (QRs) imposed on protection grounds were eliminated by April 1<sup>st</sup> 2001. The lifting or easing of exchange controls has however been very limited. Use & purchase of foreign exchange by individuals to import goods and services into India should be made virtually free by April 1 2003. This can be effectively achieved by allowing individuals to use international credit cards or bank cheques (FE denominated accounts) for purchasing goods & services up to a value of \$100,000 per annum. This limit could be phased in over time by raising it first to \$50,000 per annum (per resident) and then to \$100,000. The credit card records would be available to RBI (as well as to the Income Tax department) and any violation of the provision would attract penalties under FEMA.

A significant step towards capital account convertibility could be made, by simultaneously allowing individuals, businesses and Corporations to make capital transfers abroad, including for opening current accounts. This would be up to a limit of US \$100,000 per annum per resident, to be phased in the same manner as the limit for purchases. Within this limit employees of Indian companies could also invest in the ESOPs of foreign companies. The resident entity would however be required to keep a record of all such transactions and the assets so purchased, for showing to RBI or other designated authority when required to do so. In fact there could be a single overall limit of \$100,000 that includes both current and capital account transfers. Companies may also be required to list their foreign exchange assets & liabilities in their published accounts.

This policy would introduce virtually complete convertibility for 99% of our population, without giving rise to a significant increase in either capital outflows or import of goods and services. That is for those operating with tax paid income and assets. Capital account convertibility has already effectively exists and has existed for decades for those operating with so called ‘black money.’

#### 4.5.3 ECB

As our analysis of the Asian crisis showed there is little risk to the country in external borrowing of maturity above one year. The only thing to be watched carefully is the amount of loans with residual maturity of less than one year. The two together should be kept well within the foreign exchange reserves. It therefore follows that ECB policy can be significantly liberalised without excessive risk. At present ECB of maturity greater than 10 years is outside the ECB limits (i.e. de-controlled). We should plan for complete de-control of ECB and FCCB of maturity greater than one year before the end of the tenth plan. These should be phased in starting with immediate de-control of ECB of average maturity greater than 5 years and above, followed by, de-control of ECB (and FCCB) of average maturity of three years or more by resident companies.

## 5 CONCLUSION

The State and its functionaries have accumulated excessive power to the point that it has corrupted them not just financially but in spirit. Paradoxically the system's power to do useful work has been undermined, while its ability to do harm has multiplied. Countervailing power must be created to check the power to misuse and to strengthen the ability of the system to do good. Power must be returned to the people from whom it has been usurped and the State and its functionaries made accountable to the people. This will only happen if the State sheds all activities that the people and its institutions, both economic and social, can do, and the State becomes a facilitator instead of a controller. Only then will the State focus on and accomplish what it alone is able to but has neglected to do.

Over the next decade (or at most two), the people must re-establish their democratic power by forcing the Central and State Governments to undertake the following reforms:

- Review Laws, Rules, Regulations and Procedures to remove distortions and harmful incentives (e.g. red tape, corruption).
  - Remove distortions that provide a disincentive to hire labour in the organised sector and encourage capital intensive, non-labour using techniques of production and supply.
- Promote economic freedom and competition in the supply of all goods and services by removing controls on private/non-governmental economic activity and introducing modern professional regulatory mechanisms where needed.
  - Regulatory systems are needed for 'natural monopolies,' fiduciary financial institutions, education (school and college) and health (food, drugs, surgery).
- Privatised Public sector units (PSUs) producing 'private' goods & services. Corporatise, un-bundle and privatise all departmental public enterprises (except those producing nuclear, aero-space or defence systems).
- Privatised Public Sector Banks and Financial Institutions and move from government oligopoly to genuine competition.
- De-centralise the supply of 'Public & Quasi-public goods and services' to the lowest possible level of government and empower each level with the appropriate tax and expenditure power based on the principle of 'subsidiarity'.
  - Nagarpalikas and Panchayati Raj institutions must have the power to tax local land and property (within specified bands) and to control the supply of local public services.
- Introduce a Right to Information act that gives the unfettered right to people/poor (& NGOs representing them) to all information relating to the expenditures made in their name and ostensibly for their benefit. **Empower** user groups to ensure accountability of expenditures and provision of service to these users.
- Government must ensure all its citizens (particularly the poor, rural residents & those living in urban slums) the following basic **entitlements**:
  - Drinking water of acceptable quality for all by 2010. Pollution of drinking water sources should be eliminated and drinking water quality reach global standards by 2020. Basic life needs for water must be provided free to the poor and lower middle class. Beyond this water must be available on demand in urban areas at economic cost without rationing.

- Water harvesting, watershed development, tanks, wells for conserving water for personal, agricultural or other uses in all rural areas. Revival & maintenance of water & drainage channels to ensure water availability to rural areas.
- Modern sewerage, sanitation waste collection and disposal facilities in all urban and semi urban agglomerations and appropriate systems for all villages. Emerging economy standards by 2010 and global standards by 2020.
- Epidemic and infectious disease control of global quality (to both urban and rural areas). Public health education for all (basic health, hygiene and nutrition) to minimise infection and maximise nutritional value of food expenditure.
- Permanent Road connectivity to all villages.
- Free and compulsory Primary education for all by 2010, followed by universalisation of secondary education by 2020.

Though government has the responsibility to provide the funds needed for provision of these entitlements it need not produce everything itself. Wherever more efficient non-governmental delivery mechanisms are available they should be used.

- Reform the Police system by setting up operationally autonomous Police Commission in each State to run the police system. A Public oversight committee, with representatives of government and prominent citizens, would also be set up to ensure that the police do not misuse their authority and obey the law that they are charged to uphold. The monitoring/oversight committee should have the authority to ensure that any policeman that misuses his position or violates the law is given exemplary punishment.
- Set up a National Legal commission to provide similar (permanent) oversight over the legal system and the neutrality and probity of judges at different levels.
- Introduce a law to debar those against whom criminal charges have been framed in a court of law from holding or standing for election to a public office, till such time as the person has been acquitted. Set up a special tribunal for expeditiously try all such cases in which the person wishes to stand for public office or is holding public office at the time of notification of the new law.
- Ensure access of the rural areas to information on crops, non-agriculture and related activities through telecom connectivity (internet, internet telephone) at competitive cost. This requires immediate access of the private sector to monopoly networks like the telegraph system, elimination of explicit or hidden taxes (e.g. revenue share) on rural telecom provision, and modernisation of agricultural R&D and extension systems (autonomy, management, accountability) and encouragement and support to non-governmental initiatives (NPO, private, co-operative) to supply information in rural areas.
- Replace the myriads of anti-poverty, food/nutrition and income support programs for the poor by a *smart card system* that entitles the poor to a consolidated income supplement based on all relevant family parameters (income, health, age, gender) and identification & authentication systems. These parameters would be updated periodically and monitored by aggregating and cross-checking with NSS and other surveys.

## NOTES

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<sup>1</sup> Gulati and Sundarajan (2000)

<sup>2</sup> NIPFP, October 2001.

<sup>3</sup> *ibid*

<sup>5</sup> Working Paper Series, Paper No. 4/2001-PC, Planning Commission, December 2001.

<sup>6</sup> Distinguished Research Fellow, Center for International Studies, Toronto.

<sup>7</sup> Working Paper Series, Paper No 4/2002-PC, Planning Commission, April 2002.