The government of India needs to take some hard decisions in the upcoming Union budget for 2000/01. There are several reasons why it is important to do so right now. India's political system is more than ever in consensus about the basic direction of reforms. The current government enjoys a strong electoral mandate. This is the first year in office for this government, and is therefore, the most suitable time to undertake harsh measures.

A decade of opening of the economy has produced new dynamism, most dramatically in the information technology sector, but in others as well. GDP growth rates can be raised and sustained beyond 6 to 6.5 per cent should certain critical reforms be implemented soon.

To begin with, the process of fiscal consolidation needs to be pursued much more vigorously in the budget. We believe that India's overall government spending, currently around 33 per cent of GDP needs to be brought down substantially as a proportion of national product in order for India to achieve its reform goals of macroeconomic stability and long-term rapid growth. Large and persistent fiscal deficits in India are a serious cause for concern.

There are several risks with high fiscal deficits. First, budget deficits could once again spill over into macroeconomic instability, if the government resorts again to inflationary finance. Second, the budget deficits imperil national saving rates, thereby reducing overall aggregate investment, and jeopardising the sustainability of high growth. Most directly, low levels of public investment have rendered India's physical infrastructure incompatible with large increases in national product. Without an increase in the scale and rate of growth of infrastructure investment, growth rates in India are bound to remain moderate at best. Third, the continuing large budget deficits, even if they do not spill over into macroeconomic instability in the short run, will require higher taxes in the long term, to cover the heavy burden of internal debt. High tax rates will place India at a significant disadvantage relative to other fast-growing countries.

Expenditure reform in India is critical in view of the fact that India's government dis-saving and overall level of government spending remains high. There is probably little room to cut capital expenditures, in view of the fact that they have already been squeezed to a mere 3.3 per cent of GDP in 1998-99. It is also hard to imagine that rapid growth can be accomplished with public investment spending by government of less than the current rate relative to GDP.

Governmental action is needed in reducing expenditure under four major heads of current spending. With respect to internal public debt, there is one important mechanism that could substantially ameliorate the fiscal situation. Privatisation of public enterprises could raise significant funds as a per cent of GDP, which could be used to buy down the public debt. Not only would the stock of debt itself be reduced, but also the interest costs of servicing the debt would surely decline as the debt stock itself was brought under control.
Reduction in central government subsidies is another area of expenditure control. The key to subsidy reduction lies in phased increase in user charges in sectors, such as power, transport, irrigation, agriculture and education.

Reducing the size of the public administration could also cut government spending. One way to achieve a reasonable degree of success in this direction might be a freeze on new employment, matched by normal attrition through retirement and death.

The tax structure in India still remains very complicated with high rates of taxation with regard to both direct and indirect taxes. In the area of direct taxation, while rates of personal income tax are pretty much in line with those outside India, corporate tax rates are high. As regards excise duties, there has not been much progress in moving from the modified value added tax (MODVAT) to a full VAT. However, the transformation of existing Modvat into a full-fledged central VAT up to the manufacturing stage is far from complete. More importantly, import duties are still high and need to be brought down considerably.

In our view, the government needs to give greater attention to, and provide larger resources for, primary education and primary health. The economic and social returns from such an initiative would be huge. Evidence from across the world suggests that high levels of literacy have helped raise growth rates and reduced fertility rates over time.

We are of the view that India's growth strategy should focus heavily on exports. We find that India's export environment suffers from several institutional weaknesses. India's labour laws, noted unfavourably in the 1999 Global Competitiveness Report, make it very costly to fire workers in enterprises of more than 100 workers. Equally remarkably, India's legislation continues to restrict the entry of medium or large firms, or the growth of small firms into medium or large firms, in several areas of potential comparative advantage.

Such restrictions virtually assure China's dominance in these sectors compared with India. India's tax and tariff structures similarly remain anti-export biased. Finally, the regulatory attitude to foreign direct investors, who could be the fuel for India's export drive, continues to be ambivalent. The government promotes FDI on the one hand, but then maintains regulations against full foreign ownership, or insists on lengthy approval processes, on the other hand.

To sum up, action is needed on several fronts. Some of the key areas requiring further reform to attain and sustain higher rates of GDP growth are: greater openness of the economy; dereservation of items from the reservation list of the small scale sector; deregulation of India's private sector, including liberalisation of labour laws and exit policies; demonopolisation of infrastructure; and decentralisation of economic policymaking.

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