**Time for bold action**

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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. This Government enjoys a strong electoral mandate. This is its first year in office and is, therefore, the most suitable time to take harsh measures. A decade of opening of the economy has produced new dynamism, most dramatically in the information technology sector. GDP growth rates can be raised and sustained beyond 6 to 6.5 per cent if certain critical reforms are implemented soon.

As the fiscal deficit remains very high, the process of fiscal consolidation needs to be pursued much more vigorously in the Budget. Considering the excessive preemption of the community's savings by the Government, the potential for crowding out the requirements of the enterprise sector, the pressure on interest rates, and rising interest payments on Government debt, it is essential to reduce the fiscal deficit, mainly by lowering the revenue deficit. Correction of these deficits would, inter alia, require considerable refocussing and reduction of large hidden subsidies associated with underpricing in crucial areas, such as power, irrigation, urban transport, and higher education. Food and fertilizer subsidies are other major areas of expenditure control. Be that as it may, the process of fiscal consolidation needs to be accelerated through more qualitative adjustments to reduce Government dis-savings.

We believe that India's overall Government spending, currently around 33 per cent of the GDP, needs to be brought down substantially as a proportion of the national product for the country 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. This would happen, for example, if the Government meets increasingly onerous terms in financing the increasing stock of public debt on the open market, and therefore turns to the Reserve Bank for increased financing. Second, the budget deficits imperil national saving rates, thereby reducing overall aggregate investment, and jeopardising the sustainability of high growth. The effects of low investment rates on overall GDP growth are not hard to see. Most directly, low levels of public investment have rendered India's physical infrastructure incompatible with large increases in the national product. Without an increase in the scale and rate of growth of infrastructure investment, growth rates are bound to remain moderate. Third, the 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 disadvantage relative to other fast-growing countries.

Expenditure reform in India is critical as Government dis-saving and overall level of spending remains high. There is probably little room to cut capital expenditures as they have already been squeezed to a mere 3.3 per cent of the GDP in 1998-99. Of course, in the future, it should be the private sector rather than the Government which meets most of the enormous infrastructure
needs of a growing economy. Still it is hard to imagine that rapid growth can be accomplished with public investment spending by the Government of less than the current rate relative to the GDP.

Governmental action is needed in reducing expenditure under four major heads of current spending. With respect to internal public debt, one important mechanism could substantially ameliorate the situation. Privatisation of public enterprises could raise significant funds as a percentage of GDP, which could be used to buy down the public debt. Not only would the stock of debt itself be reduced, but the interest costs would also decline. The cash value of these enterprises vastly exceeds the value of profit flows that the state now collects on these assets. Public sector profits are dissipated in poor productivity, over manning, excessive salaries, soft budget constraints, and generally poor management. For this reason, sale of the enterprises to private sector buyers, if used to buy down the public debt, would yield annual saving in interest costs that far exceed the Government revenues that are claimed by virtue of state ownership of the assets. This is especially true given that many enterprises with significant positive market value are actually loss makers in current cash flow, under state management.

The Central Government currently has equity holdings in 240 enterprises, 27 banks, and two large insurance companies. Further spending cuts could come from liquidation of loss-making enterprises that have no positive net market value. Liquidation of these would imply a rise in domestic savings. Of course, saving would be higher if these enterprises have salvage value. To capture these savings, an exit policy to allow the Government to close down loss-making enterprises is needed.

Reduction in Central Government subsidies is another area of expenditure control. According to the Discussion Paper on Subsidies brought out by the Finance Ministry in 1997, the subsidies given by the Central and the State Government totalled Rs. 1,372 billions during 1994-95 constituting 14.4 per cent of the GDP - Rs. 430 billions of Central subsidies and Rs. 942 billions of State subsidies. The subsidies of the Centre and the States on non-merit goods and services (such as agriculture and allied activities, irrigation, power, industries, transport etc.) amounted to 10.7 per cent of the GDP. The average all-India current recovery rate for non-merit goods and services was placed at 10.3 per cent in 1994-95, with the rate for the Centre being slightly higher at 12.1 per cent compared to 9.3 for the States.

Reforms in the current subsidy regime should be undertaken with the objective of reducing the overall scale of subsidies. Moreover, the reforms should help make the subsidies transparent, and use them for well-defined objectives. Subsidies should focus on final goods and services to maximise their impact at the minimum cost. 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. Existing functions could easily be met through modest improvements in computerisation. Obviously, bolder - if less politically palatable - solutions could result in even larger savings.
While progress has been made in the area of tax reforms, the tax structure in India still remains very complicated with high rates 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. Under the Modvat scheme, credit of duty is allowed on inputs that are used either for producing excisable finished products or intermediate products. Over time, the ambit of Modvat has been extended to include more commodities/sectors. However, the transformation of existing Modvat into a full-fledged central VAT up to the manufacturing stage is far from being complete. More importantly, import duties are still high and need to be brought down considerably. While the country has come a long way from being a closed economy to a relatively open one, India still is a highly protected economy by current international standards.

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THE UNION Government needs to give greater attention to, and provide larger resources for, primary education and primary health. It has to do more to raise literacy levels and provide greater access to basic health services. It has a particularly critical role in spreading literacy and access to primary health care so that all can participate in a meaningful manner and benefit fully from India's economic transformation. Much higher levels of literacy could be achieved through creative use of Information Technology (IT), better school attendance and other policies with a clear focus on inclusion of girls and other traditionally-disadvantaged groups. 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 economic growth rates and reduce fertility rates. Public health campaigns are also required to combat major infectious diseases, especially the incipient AIDS epidemic.

Rather than providing across-the-board subsidies on food which tend to get dissipated in corruption, administrative costs, and lower prices for the wealthy, in part these programmes could be targeted at school children, by guaranteeing one nutritious meal a day for every child in every school throughout the country. Schemes such as mid-day meals should be expanded. However, the current scheme does not envisage any re-targeting of subsidies as we suggest. Not only would this help to target the aid to needy households, but would also provide a vital economic incentive for poor parents to send their children to school.

Expenditure on educating girls is perhaps one of the most productive. It helps bring down both fertility and infant mortality rates. The impact on the former is seen to be significant and similar in most Indian States. Besides, higher female literacy would be instrumental in raising the status of women in society. The Central Government needs to provide enhanced transfer payments to the States to help support primary health and education. This may be done on a matching-grant basis, so that State Governments are given an incentive to increase their own effort in these areas. In addition, some part of the privatisation revenues could be earmarked for primary health and education. Briefly put, a reorientation is required in the Government's social policy - with high priority for human resource development.

India's growth strategy should focus heavily on exports. Export-led growth in services is one of the most interesting developments, and export-led growth in manufactures, the more traditional textiles and apparel, in electronics and other labour-intensive operations remains an area where India could do a lot more. 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 staff in enterprises of more than 100 workers. The result is that formal-sector firms (those that are registered and pay their taxes) are loath to take on new employees, and the vast majority of employment is informal, in small, tax-evading, inefficient enterprises. Equally remarkably, legislation continues to restrict the entry of medium or large firms, or the growth of small units into medium or large enterprises, in several areas of comparative
advantage. Thus, garments, toys, shoes and leather products continue to be reserved largely for small-scale producers.

India's tax and tariff structures also remain anti-export biased. The high overall tariff rates, especially on intermediate products used by exporters, impose a heavy indirect levy on export competitiveness. Further, the Union Budget for 1998-99 had imposed an additional non-modvatable levy of 8 per cent on imports, later reduced to 4 per cent. There are duty drawback systems to reduce this anti-export bias, but such programmes are administratively burdensome and often too costly to use effectively. Finally, the regulatory attitude to foreign direct investors, who could fuel 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.

The development of industrial parks for exports should be intensified. Private developers need the freedom to acquire urban and semi-urban land to develop infrastructure in support of exports. The Government must take measures to reduce export costs, including private-sector provision of port services; zero tariff ratings on capital and intermediate goods imports used for export (based on an effective duty exemption scheme); enhanced export-oriented infrastructure especially roads to the airports, reliable power supply, and telecommunications facilities to support export zones. As suggested by the Abid Hussain Committee, the reservation of labour-intensive activity for the small-scale sector should be scrapped.

In addition to labour-intensive manufacturing exports, India has a clear and growing capacity in service-sector exports based on information technology. Here, as in labour-intensive exports, Government policy could do much more to spur export growth. On the plus side has been the Government's long-term commitment to the IIT's. More recently has been the Government's support for Software Technology Parks (STPs), in Chennai, Bangalore, Pune, and other cities, which are the IT-industry equivalent of the EPZs in manufacturing industries. There are serious negatives, however. The continuing state monopoly of VSNL in international telephony hikes the costs of telephone and IT services and affects India's international competitiveness in the IT sector. India's telephone density is abysmally low, at around 1.3 per hundred in 1995, compared with around 62.6 per hundred in the United States. Charges for domestic long distance and international telephone calls in India are among the highest in the world, largely due to lack of competition. Physical infrastructure for data transmission (e.g. optic fibre cables) remains underdeveloped despite some recent progress.

India is becoming one of the most important players in the IT sector which is the fastest growing foreign exchange earner. The Government could do more for this industry, not through direct subsidies necessarily but actually through liberalisation, facilitating lower-priced telecommunication services by allowing new entry of major international players who would lay down a tremendous optic fibre network in India and increase the bandwidth available for businesses. The Government should find resources to support basic science and R&D in this sector because India has world-class engineers and scientists who could keep it in the forefront of this new technology.
To sum up, action is needed on several fronts to attain and sustain higher rates of GDP growth. These are: greater openness of the economy; dereservation of items from the small scale sector; deregulation of the private sector including liberalisation of labour laws and exit policies; de-monopolisation of infrastructure; and decentralisation of policy-making.

Fiscal deficit remains high. Ominously, the ratio of internal public debt to GDP has continued to rise, and the debt service burden has grown even faster because of rising interest rates. Evidently, expenditure reform has lagged behind tax reform. The expenditure-GDP ratio needs to be brought down considerably. The composition of Government spending is skewed towards unproductive, current expenditures and away from basic infrastructure as well as vitally-needed human resource development, especially in the areas of primary health and education.

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