

The budget should be the operational policy document to signal

the decade of development

To climb a steep gradient

tele 27/12/01

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The government of India has proclaimed the new decade a decade of development, during which India will meet bold targets for economic growth and social development. Some of the key policy challenges in meeting these goals need to be discussed. We suggest that the Union budget for 2001-02 should be the operational policy document to lead India's decade of development. The main parts of the budget strategy should be reduced overall deficit to preserve macro stability and to enhance growth; a shift of budget spending towards social areas and away from subsidy areas, and away from areas where the private sector can substitute the public sector; and finally, focus on the two pillars of policy change — the social and the economic pillars.

The Central government must undertake a fundamental review and reorientation of fiscal policies to support the decade of development. There are three goals. First, the overall fiscal deficit must be reduced sharply. Second, the expenditures should be shifted from economic sectors like infrastructure where the private sector can carry the investment burden, to social sectors like health and education where increased public spending is vital. Third, social programmes should be redesigned to make a maximal impact per rupee spent. This can best be accomplished by replacing generalized subsidies, such as the public distribution system or free electricity for farmers, with targeted programmes such as school meals.

The Central government's current fiscal deficit is around five per cent of the gross domestic product, and this should be reduced to ensure macroeconomic stability, and to prevent an unmanageable buildup of public debt. At the same time, social spending should rise, including an increase for health and for education. Most of this should come from cuts in existing expenditures rather than from increases in taxation as a per cent of GDP. Current government spending is already around one-third of GDP, which is quite high by comparison with other developing countries in India's income range. If India were to increase expenditures further as a per cent of GDP, it would have a very difficult time raising the internal tax revenues to cover the spending programme.

The following prime areas of potential expenditure reduction over a three-year period can be identified. Among Central expenditures are disinvestment of public sector units (with revenues used to pay down the public debt). The net worth of Central

PSUs is estimated to be Rs 1,324 billion, a little over 6.5 per cent of GDP. The capital employed is around Rs 2,230 billion (estimated savings one per cent of GDP).

The second is closure of loss-making PSUs. Of a total number of 236 PSUs, there are 104 loss-making ones that account for roughly Rs 60 billion in annual losses to the Central exchequer (estimated savings three per cent of GDP)

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The third is reduced bureaucracy. A freeze on new employment matched by normal attrition through retirement and death. On an average, about 125,000 Central government employees are taken off the government payroll each year for these reasons. Implementation of such an approach over a period of four years could result in a reduction in the government employment by approximately 12.3 per cent, or a reduction of around half a million employees from the present total of about four million. On an average, the government could save about Rs 20 billion every year on reduced salaries, and the associated reduction in the operating expenses. Over a three-year period, this would imply savings of roughly 0.3 per cent of GDP.

Then, Central power sector undertakings' support to state electricity boards should be looked into. SEBs owe huge sums to the Central power sector undertakings, such as the National Thermal Power Corporation, National Hydro Power Corporation, Damodar Valley Corporation and so on. It is estimated that as of September 1998, the SEBs owed Rs 16,800 crore to these power sector undertakings (estimated savings 0.8 per cent of GDP).

Subsidies should be reduced, including that in the public distribution system and transport (estimated savings 0.5 per cent of GDP). Infrastructure investments can be reduced too by being taken over by private sector projects. Annual infrastructure investment for India is placed at around Rs 650 billion, which is roughly 3.2 per cent of GDP. We figure that a little less than half

of this amount can be reduced (1.3 per cent of GDP at the Centre) in investments over three years if the private sector were to take on large scale investments in the infrastructure sector (estimated savings 1.3 per cent of GDP).

Another area of reduction is interest payments. This additional budgetary saving is a result of a reduction in real interest rates that will come from the overall package of contractionary fiscal measures suggested above. Interest payments were placed at Rs 88,000 crore in 1999/00 or 4.6 per cent of GDP (estimated savings 1.0 per cent of GDP).

The estimated expenditure saving that could be achieved by each of these items total to approximately 5.2 per cent of GDP over three years. Of course, these are approximate.

It may seem politically impossible to proceed with such bold cuts, but it should be remembered that these cuts would be combined with substantial increases in public and private spending. Public spending would rise in health and education, including some highly visible and politically popular programmes such as school meals and increased availability of primary health facilities. Private spending in infrastructure would also be politically popular, as it will mean the much faster diffusion of new technologies to rural areas.

Investments in health and education will have direct and beneficial effects on economic growth, by fostering a healthier, better educated, and therefore more

productive labour force. But social investments are not enough. Social investments must be combined with a large improvement in the business environment in India in order to promote a more rapid rate of economic growth.

History has shown that export-led growth is a crucial component of overall economic growth. Without rapid export growth, there cannot be rapid growth of imports. But imports are necessary for India to obtain the modern technologies that have been developed abroad. Thus rapid export growth is a *sine qua non* for rapid economic growth.

Rapid export growth can only be achieved in areas of Indian comparative advantage. These include labour-inten-

sive manufacturing sectors such as apparel and textiles, automotive components, footwear and leather goods, jewellery, processed foods, and electronics assembly. They also include high-technology areas in information technology and biotechnology (like pharmaceuticals) that rely on India's tremendous scientific and engineering capacity.

India has achieved some success in export led-growth, but much less than many other Asian countries, notably China. China's exports grew from around \$20 billion per year in 1980 to around \$200 billion in 2000, roughly increasing tenfold. India's exports, by contrast, grew from around \$17 billion in 1980 to around \$35 billion in 2000, or roughly doubling.

India has the resource base, it has the entrepreneurship, it has the access to the sea coast, a vast labour force, and it has everything that coastal China has had except the interest of government. India has underemphasised the role of industrial facilities, underemphasised the role of infrastructure, of land area, of effective port facilities that are needed to be able to compete with China. But this is an area where one could find tens

of millions of jobs over the next few years in real, significant foreign exchange earning private sector activity. This would require a change of attitude, a real promotion of these sectors both at the Central and state government levels.

There are several barriers to more rapid export growth. Fortunately, most of these barriers can be overcome by regulatory changes and private investments rather than public money. Some of the crucial steps needed for a faster growth of exports include reform of labour laws to ensure the right of enter-

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prises to hire and fire workers for economic causes, subject to the normal rule of law (for example, prevention of arbitrary dismissals in retribution for union activity). Also, improvement of infrastructure, mainly ports, telecommunications, airports, power, and roads. Then, elimination of remaining administrative barriers to foreign direct investment in export oriented sectors (for example, elimination of need for government approvals).

Moreover, there should be much more active use of special economic zones and export processing zones as incentive schemes for export-oriented enterprises. States and private enterprises should be free to establish export processing zones according to general legislation. Last, remaining reservations for small-scale enterprises should be eliminated, especially in export oriented sectors but also generally in the economy.

India's infrastructure is notoriously

bad. The road networks are insufficient and of very poor quality. Ports are completely inadequate, so that most exports must be transshipped through Singapore or Sri Lanka, rather than shipped directly from Indian ports. Airports are insufficient and the airspace is reserved for just a few carriers. Telecommunications are notoriously poor in quality and coverage. Electricity supplies are irregular, scarce, and of low quality. Water supplies are scarce in many areas, and insufficient for key industries as well as household use.

And in general, neither the government at the Centre or the state levels can afford to upgrade these infrastructure systems out of budgetary funds. Many of these sectors already impose huge fiscal costs as government provides overt and hidden subsidies to these key sectors.

Fortunately, India could enjoy a major — indeed fundamental — improvement in infrastructure quality without major budgetary increases. The key is regulatory change, involving two main steps. First, regulatory and oversight responsibilities for almost all infrastructure should be devolved to the state level. This includes areas now under Central control, such as major ports and airports and telecommunications. The states have a much better idea of their specific infrastructure needs than do the Central bureaucracies.

Second, infrastructure should be provided mainly by privately financed projects without state guarantees. The entire cable TV industry in India has grown up without government subsidy, precisely because it was not regulated. Other key areas — telecommunications, internet, water, power — would similarly expand dramatically if private investors could enter and compete.

Each sector requires its own reforms. Reforms in telecommunications have begun, especially with the end of the Videsh Sanchar Nigam Limited monopoly by 2002 and the intention to disinvest a major part of the government's holding in the state company. Still, the regulations on local telephony and internet services are blocking a substantial growth of such services throughout the country. Again, barriers to building new airports and to licensing new aviation companies has stymied the development of an efficient and low-priced network of domestic and international flights.

The government of India should therefore take the following steps in infrastructure. First, devolve major regulatory responsibilities to the states in the following areas of infrastructure: ports, airports, power, telecommunications (international long-distance, domestic long-distance, local, data transmission, wireless), internet service, water and sanitation. The individual states should have the powers to liberalize these sectors, permit entry of private firms, and admit foreign investors.

Second, the Centre and the states should set goals for specific areas of infrastructure, including universal village access by 2010 to telephony, electric power, internet connectivity, and roads to major towns and cities, and finally, open each infrastructure sector to private sector competition, including rights of entry in service provision, by both foreign and domestic providers.