

## **Ten Economic Policy Issues for India in the New Millennium**

### **1. How does one best approach India's fiscal mess?**

Q: India's debt and fiscal deficit parameters are the worst amongst major countries. The IMF has indeed compared these unfavourably with crisis ridden Latin American countries like Argentina and Brazil. However, unlike the eighties, these deficits have not spilt over into the external sector (external debt has stabilised in nominal terms, debt-service ratios have fallen sharply, and FE reserves are piling up), and do not seem to have had a markedly adverse macro-economic or crowding-out impact (growth rates are robust, and interest rates and inflation are at historic lows). The fear is that once private investment picks up both inflation and interest rates would be under pressure.

**2. Putting in place a policy mix that would ensure maximum private, including foreign, investment in the infrastructure. Major budgetary shifts towards primary education, health, social security and investment in physical Infrastructure, would largely address issues relating to poverty alleviation, population control, productivity and economic growth (raising growth rates from 5-6% to 8-9%) by crowding in private investment.**

Q: While the above reasoning may be theoretically correct, in a robust and keenly contested democracy such budgetary shifts are difficult, particularly in the short-term. India is paying a heavy price for continued under-investment in the infrastructure, physical as well as social. Since most of this investment would have to come from the State, already crippled by high debt and budget deficits, is it nevertheless desirable for government to borrow massively to upgrade the infrastructure in a time-bound manner? Joseph Stiglitz has recently cautioned us against being obsessed with fiscal deficits to the detriment of growth and demand. Poverty indices have declined gradually over the years, but India still has a major share of the World's poor, which acts as a drag on the

economy through low productivity. Poverty reduction also has a huge demand side upside, for it is well-known that the multiplier effect of putting more income into the hands of the poor is much higher than what it is in the hands of the more affluent.

### **3. Clarifying and reforming Centre-State financial relations with a view to enforcing fiscal responsibility. This would arguably require fiscal decentralization.**

Q: Since the federal government has greater responsibilities for resource mobilization, the States run big budget deficits, and there is little incentive for them to contain deficits and irresponsible expenditure. Unlike the US, the States are not required by law to avoid budget deficits. Similar legislation may be politically difficult in India, unless the Centre devolved more financial and tax-raising powers to the States. Is this nevertheless desirable, so that States are made responsible for both revenue mobilization and expenditure, with no devolution of funds from the federal government except in the form of incentives to promote certain policies?

### **4. Public sector downsizing, including privatization.**

Q: India has a large public sector, and though privatization has picked up momentum during the past year, it is nevertheless subject to bitter political debate. Concerns have been expressed that poor corporate governance, high industrial tariffs, inflexible labour policies and high transaction costs in the economy for industrial producers may have a negative fallout on efficiency gains from privatization and may, in the medium to the long-term, undermine or derail the privatisation process in India. Are such fears justified?

### **5. Trade policy reform**

Q: India's industrial tariffs are still way high by global standards, and these undoubtedly have costs in terms of welfare loss and allocative inefficiencies. They also prevent India from harnessing

international trade as an engine of growth in the manner it was used in East Asia and China. Prof. Jagdish Bhagwati has recommended that India move unilaterally towards a low-tariff regime, irrespective of the outcome of WTO negotiations. Govt. have announced their intention to lower these to 10% on raw-materials and 20% on finished products by 2004. Are these rates justified? Should they be even lower? Should there be a single (low) uniform rate of tariffs as a long-term goal? What should be the time frame for trade policy reform? How does one respond to a situation where nominal tariffs are low, but recourse is liberally taken to non-tariff barriers? Indian industry also feels that it would be unfair to expose it to global competition because its transaction costs are higher on account of a weak infrastructure, cross-subsidized administered prices and cost of capital, etc. How does one respond to such fears? Should India open up agriculture on a non-reciprocal basis? India has the potential to become an agricultural super-power on account of the vast arable area, and inherent competitiveness: Indian agriculture is globally competitive if subsidies are disregarded, but most countries subsidize their agriculture much more heavily.

**6. Resolving the 'Agrarian Question' by quickly getting large numbers off agriculture, or alternatively evolving a new model of sustainable petty production.**

Q: In both China and India the share of agriculture in the national income has fallen sharply consequent on sustained high growth in manufacturing and services. The proportion of people dependent on agricultural incomes has fallen very little, however, leading to sharp diminishing of per capita rural incomes. With a generalized shift from food crops to more profitable commodity production, agricultural incomes have become increasingly volatile. Agriculture in these highly populous countries is largely based on petty production, whose capacity to absorb such price volatility is limited. Existing models of development, based on the European and American models, are based on a large-scale shift of people out of agriculture, which is subject to diminishing returns. Such a large-scale shift does not seem to be happening in China and India. The State is also unable to pump in huge

subsidies to support agriculture at anywhere the levels prevalent in Europe and America. The agricultural sector in India has therefore entered a prolonged crisis which could be a huge brake on growth and development and lead to social unrest.

### **7. Putting in place a viable social security system before the population ages.**

Q. It would be difficult to get a political consensus on a more flexible labour policy without introduction of a comprehensive social security system and a flexible pension system (on the lines of the US 401K which can migrate from one employer to another). Most functioning and stable democracies have such systems and it would become increasingly difficult to fund such schemes once the population ages.

### **8. Opening up of the domestic financial sector, and a calibrated movement towards opening up the capital account in the external sector.**

Q. Despite considerable liberalisation over the last decade, India's financial sector is still dominated by publicly owned entities, and the capital account is not freely convertible. This has perhaps ensured that fiscal deficits have not spilt over into the external sector, and that India has avoided currency crises of the Latin American and East Asian variety. However, this has also perhaps raised the cost of capital in India: the household sector is by far the biggest net saver, and the greater portion of their savings are in financial assets. A good portion of these (one third of bank credit, plus another 10% for food procurement) are drafted by government for priority sector lending, and banks have consequently charged higher interest rates for commercial lending to ensure returns to capital. Is it time for government to let go controlling interest in public sector banks? Would this result in even greater strain on the fisc, because priority sector lending may have to be shifted to the budget through either direct lending or through off-budget guarantee mechanisms? To the extent that Government has to recapitalise the NPAs of Banks, this pressure on the fisc exists even now. Also, with FE reserves rising rapidly, is it time to move

towards a rupee that is fully convertible on the capital account?

**9. India's industrial growth rates post liberalisation have been disappointing and lower than what they were in the eighties on average. The spurt in growth post-liberalisation has been services led, with greater linkages to the global economy than to domestic industry.**

Q: Indian industry is not very competitive globally, and the prospects for higher growth rates as industrial tariffs fall further are grim. Infrastructural weaknesses, high cost of capital, inflexible labour policies, a clogged and inefficient judicial process resulting in effectively weak creditor-rights, cross-subsidised administered prices in coal, power, transportation etc. result in high transaction costs for Indian industry. Labour policy reform is necessary to ensure flexibility in exit and entry, as extant labour policy is a major impediment to industrial investment and competitiveness. India has inherent advantages in the services sector, but can this sector remain sustainable and take on the load of both the industrial and agricultural sectors that are lagging?

**10. Improving governance and reducing corruption and transaction costs.**

Q: India has a serious problem with corruption, red-tape and governance which hampers the delivery mechanism of social sector schemes and tends to scare off investment. Even the new regulatory institutions, supposedly at arms-length from government, are constrained by the overall environment of poor governance, and have not been able to stem financial and Corporate scams. India has tried, and is continuing, to reduce what Prof. Jagdish Bhagwati has described as 'Directly Unproductive Profit Seeking' (DUPS) economic activity through the liberalisation process by making most economic decisions automatic and rule-bound rather than discretionary. Foreign investment, for instance, is now largely automatic. However, to the extent that tax collection, regulation and social sector delivery would still have to be done by the State, transaction costs prevailing in the economy continue to be unacceptably high. It has been argued that e-governance is perhaps the best way to address this issue. Any fresh ideas on how this issue is best handled?