Priorities for Economic Reforms

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I consider it a great privilege to be invited to deliver the 13th Jawaharlal Nehru Memorial Lecture instituted by IFFCO. It is conventional to begin memorial lectures by saying a few words about the man whose memory is being honoured. When that person is Pandit Jawaharlal Nehru, it becomes difficult to know where to begin or for that matter how to end. This is especially so for my generation. I was 4 years old at the time of independence and throughout the next seventeen years, which were my formative years in school and college, we all basked in comfort knowing that the Government was safe in the hands of a person who was the unchallenged leader of independent India and the living embodiment of the struggle for independence, which was still relatively recent. We also saw him as a tireless worker striving to build a modern, secular and economically strong India and a shining example of the highest standards of statesmanship. The fact that the world also saw him in these terms was an added source of pride and comfort and, if I may say so, probably also some complacency.

Jawaharlal Nehru's range of interests was so wide that no subject would be inappropriate for a lecture in his memory. However, placed as we are at the end of a decade of economic reforms and also on the eve of the millennium, which inevitably forces one to look ahead, I thought it would be appropriate to devote this lecture to the priorities for economic reforms as we enter the first decade of the new millennium.

1. Some Positive Features

A policy agenda for the future should be determined by looking at existing strengths and weaknesses and building on the strengths while correcting the weaknesses. It is natural that public discussion usually focuses on our weaknesses which therefore always look daunting. But to put matters in perspective, I would like to begin by acknowledging that we enter the new millennium with some important strengths. Let me just mention three :

- First, our growth performance is now much better than the frustratingly slow 3-5% to 4% growth which characterised the first three decades after independence. India's GDP grew at an average rate of 5.8% in the 1980s. It accelerated to around 6.5% in the Eighth Plan period (1992-93 to 1996-97) and this is expected to be maintained in the Ninth Plan period. This record suggests that the Indian economy is adjusting well to the new policies. It is not generally realised that if we focus on the 1980s and 1990s, India has been one of the ten fastest growing economies in the world!
- The educational deficiencies of our population have long been a drag on our growth potential. We have always taken pride in the quality of our highly skilled personnel, our scientists, our managers and more recently our software wizards. But the general level of education for the bulk of our population has long been extremely low. Adult literacy was only 18.3% in 1951 and only increased to 28.3% by I960 and 34.4% by 1971. This was undoubtedly one of the reasons for our persistently low growth in the early years. The most recent estimates by the NSS show that literacy had increased to 62% in 1996-97. This is still low, but it is now in the range which is consistent with achieving growth rates of 7 to 8%.

- Population growth, which for long remained stubbornly above 2 percent, at last appears to be declining. Kerala's justly celebrated achievements in this area have been matched by Tamil Nadu and it appears that Andhra Pradesh and Karnataka are not far behind. Birth rates are much higher in the northern States but even in these States they are declining. India's population in the next decade is expected to slow down to 1.5%.

These positive developments have important implications for our prospects in the next decade. If GDP growth can be pushed up from around 6.5% at present to say 7% at the start of the decade, and then to 8% by the end of the decade, it would give us an average growth of around 7.5% for the decade as a whole. With population growing at 1.5%, this means per capita income would grow at about 6 percent per year. Growth of this order is much higher than we have experienced in the past and can create many virtuous circles. If it is reasonably well distributed, it would guarantee a sharp reduction in the level of poverty by the end of the next decade. One can go further and say that unless we can achieve growth of this order, we cannot expect to see a significant improvement in the conditions of living of the mass of our people.

What are the policies we need to follow to achieve such growth and especially to make it broad-based ? Fortunately, a substantial consensus has now emerged in professional and even in political circles on economic policies. There is general agreement that the process of economic reforms must be strengthened and deepened and this is sometimes described as implementing "the second generation of reforms". I am not entirely comfortable with this description. It implies that we have successfully completed the first generation of reforms, and must now move on to the next hierarchical level. The reality is somewhat different. I would classify the reform agenda ahead of us into three categories.

- The first item on this agenda on which there is a great deal of agreement must be to restore fiscal discipline. This is actually a first generation reform, which we have not been able to carry out as planned.
- The second category consists of first generation reforms which are more or less on track, but are still to be completed because of our deliberate choice of gradualism as a reform strategy.
- The last category consists of what can be called genuine second generation reforms, which take the reform process to new areas not addressed thus far.

2. Fiscal Discipline

Let me begin with fiscal discipline, which is a first generation reform which got lost somewhere on the way. The seriousness of the fiscal problem facing the country is now so widely recognised that it is useful to put it in some perspective.

In 1991, when the economic reforms began, we faced an exceptionally severe crisis and the Central Government's fiscal deficit - which had reached 8.3% of GDP in the preceding year - was seen as a root cause of the crisis. This gave a sense of urgency to the need for fiscal correction and we were able to reduce the deficit to around 6% of GDP in the very first year. It was recognised at the time that even this was too high and further reduction was needed to release resources into the economy and reduce interest rates, both very necessary to stimulate private investment. The medium term objective, outlined in a discussion paper circulated by the Finance Ministry in 1993, was to reduce the fiscal deficit to around 3% by 1996-97. Unfortunately this target was never achieved. The actual deficit was 5.2% in 1996-97, it deteriorated to 6% in 1997-98, and has remained at about that level subsequently. The result has been that interest rates remain very high.

Meanwhile, the fiscal position of the States, including the so called better administered States, has deteriorated significantly. Unlike the Centre, the States are not allowed to borrow freely and this puts an automatic limit on their fiscal deficit. However, this only means that their fiscal weaknesses are reflected in an

uncontrolled growth in non-Plan expenditure, and mounting losses on the supply of various economic services. The scale of the problem can be judged by the fact that the losses of all the State Electricity Boards amounted to about Rs.11,000 crores in 1997-98. The losses on account of irrigation are about Rs.2000 crores even if we count only the maintenance cost of the systems. If interest on capital invested in irrigation is included, the losses would be much higher. Losses in the State Road Transport Corporations are about Rs.1000 crores.

With such large losses it is not surprising that the States are unable to meet their targets for Plan expenditure. In the Eighth Plan period (1992-93 to 1996-97) Plan expenditure by the States in real terms was 20% lower than targeted. The position has worsened in the Ninth Plan because of the impact of the Fifth Pay Commission. Besides, what is shown as Plan expenditure in the States Budgets exaggerates the actual extent of new development projects. This is because Plan projects which have been almost completed continue to be shown as ongoing projects, which enables the salary and running costs of these projects, which should normally be covered by the non-Plan budget, to be financed from the Plan budget. In effect, therefore, a large portion of Plan expenditure is not financing new development projects but only covering salaries and rising costs of old projects. The situation in some States is such that they find it difficult to meet salary payments.

The consequences of not correcting this situation are self-evident. The high deficit will perpetuate the present high interest rates which hurt investments in the economy and indeed hurt the small producers the most. The low level of Plan expenditure will jeopardise much needed public investment in critical areas and jeopardise our growth objective. I am not saying that growth depends only on Plan expenditure, or that all Plan expenditure is sacrosanct. Most of the investment needed to achieve our targeted 7 to 8 percent growth can and should come from the private sector, and there are many areas where Plan expenditure can be effectively replaced by private investment. However, the ratio of Plan expenditure of the Centre and States combined was 11.3% of GDP in 1990-91 and has declined to a little over 9% today. This has squeezed investment in many areas which are critical for accelerating growth to 7-8 percent.

This resource squeeze has direct implications for our ability to accelerate growth in agriculture. Faster agricultural growth and broad based rural development is central to our strategy for reducing poverty. To achieve this, we have to expand investment in irrigation, land development, soil and moisture conservation, agricultural research, development of agricultural marketing facilities, and finally expansion and maintenance of rural and district roads to improve rural connectivity. These basic investments in rural infrastructure can only be undertaken by the public sector but unfortunately the level of these expenditures has probably declined in real terms because of the severe fiscal problems of the States.

Much larger investments are also needed in health and education, especially in rural areas, to bring our social development indicators up to respectable levels comparable with other developing countries. This again has to come from public sector. In other infrastructure areas such as power generation and distribution, ports, airports, telecommunications and national highways, the private sector can play a much larger role than it has in the past, and this must be encouraged. However even in these areas, public investment will continue to be extremely important in the

foreseeable future and we have large gaps to fill.

The fiscal objective for the next decade must therefore have two dimensions. We must reduce the fiscal deficit to release resources for private investment but we must simultaneously increase public investment in critical areas. This suggests that the scale of fiscal effort needed is very large. The combined fiscal deficit of the Centre and the States was around 8.5% of GDP in 1998-99- The Finance Minister has already said that we should try to reduce the Centre's fiscal deficit (as recently redefined) to around 2 percent over the next three years. This would suggest that the combined fiscal deficit of the Centre and the States should be reduced to say 4.5% over a three year period. Simultaneously, we should aim to increase total Plan expenditure of the Centre and the States taken together by say 1.5% of GDP from the present level. The total fiscal improvement required to achieve these twin objectives is around 5.5% of GDP over a three year period i.e. around 1.8 percentage points per year.

This improvement has to be achieved partly by the Centre and partly by the States. I will not go into the issue of what should be the exact balance between the two. The important point to note is that a fiscal correction of 5-5 percentage points of GDP over the next three years is an extremely difficult task in any situation. It cannot be achieved by acting on one or two instruments. Action will be needed on several fronts. Let me mention some:

i) ***Improving tax administration to raise larger revenues***

Anyone who has studied the Indian tax system both at the Central and the State level is struck by the fact that the system is archaic with complex and cumbersome procedures, a multiplicity of rates, numerous exemptions and large areas of discretion, all of which lends itself to evasion by tax payers and harassment by tax authorities. The system also lends itself to corruption at all levels, which explains the relatively low levels of tax realisation. Experience of other countries shows that a tax reform which brings about a system change could generate additional revenues of 3% of GDP in a relatively short period without necessarily increasing tax rates. Half the fiscal adjustment needed could therefore come from effective implementation of tax reform. This can be done if we can translate general statements about "improving tax administration" and "widening the tax" into specific proposals for removal of exemptions, simplifying the system by reducing the number of rates and also modernising procedures. Hopefully, the new Tax Reforms Committee, referred to in the President's Address can quickly come up with specific recommendations in this regard.

ii) ***Reducing subsidies***

Almost everyone is willing to endorse general statements about reducing subsidies, but agreement vanishes as soon as one focuses on specific proposals. And yet the total volume of direct and indirect subsidies in our system has risen to unsustainable levels. The major direct subsidies in the Central Government are the subsidy on fertilizer, food and sugar and these amount to Rs.24,000 crores according to the Budget Estimates for 1999-2000 though they may turn out to be higher. In addition, there are large implicit subsidies such as massive undercharging for higher education and for hospital services, undercharging for railway passengers, undercharging for postal services, etc. The subsidy on kerosene is Rs.8000 crores and on LPG around Rs.4000 crores. These subsidies are not technically borne by the Budget, but are covered by overcharging for other petroleum products such as petrol and aviation turbine fuel. However, this clearly represents a loss of potential resources since the cross subsidy element built into the high price of some petroleum products could otherwise be mopped up in the form of tax revenue. These subsidies are not specifically targeted at the poor but actually accrue to relatively higher income groups,

or at best to the average consumer. However, the subsidy burden effectively prevents the government from spending on programmes which would stimulate broad based growth which would have a large beneficial effect which is probably better distributed. The State sector too is burdened by massive subsidies which could be reduced. Electric power is supplied to farmers at 10 to 20% of the cost of production in most States and free in some. Household consumers of electricity are also undercharged as is water for irrigation, passenger bus services and, of course, higher education.

I must emphasise that what is needed is not complete elimination of all these subsidies, but only a substantial reduction combined with better targeting. This will release resources which will enable us to finance some of the critical expenditures which need to be increased to meet our development objectives.

iii) ***Downsizing of government***

This is another area where we can save some resources. Government departments, including the Railways and Posts, have long been overmanned. There are also too many government departments. A liberalised economy needs far fewer Ministries and Departments than a controlled and regulated economy and some steps have to be taken in this direction. The Fifth Pay Commission, an expert body, had estimated that a 30% reduction in government staff should be achieved over time. Proposals to downsize government are sometimes resisted because it is perceived that unemployment is a serious problem and government employment helps to meet demands for jobs. However redirecting resources from paying for surplus manpower in order to build much needed economic and social infrastructure will create many more jobs in the rest of the economy. We have to recognise that the purpose of government is to provide essential services efficiently, and not to create employment.

iv) ***Bolder Privatisation***

Many developing countries have been able to bring about a substantial improvement in their fiscal position by undertaking major privatisation of public sector enterprises. This option is also open to us and should be aggressively followed not only by the Centre, which has begun the process, but also by the States. I will say more on this subject later in this lecture.

v) ***Reprioritize Plan Schemes***

Finally, it is necessary to re-prioritize Plan expenditure to eliminate schemes which are of doubtful value. Detailed post evaluation studies show that many of our Plan schemes, though well intentioned, simply do not achieve their stated objectives, or do so only to a limited degree making the schemes cost-ineffective. This is due to a combination of poor design of the schemes and inadequate administrative capability. Unfortunately, such schemes continue to remain in operation, absorbing resources which could be deployed in other areas. The administrative agencies responsible for these schemes become strong vested interest for their continuation and criticism of the effectiveness of the scheme only leads to demands to "strengthen" the schemes through better administration and monitoring, which usually means more staff and more resources. A thorough re-examination of all Plan schemes, with a drastic elimination of schemes which are demonstrated to be ineffective, would release resources which would enable the more important and more cost-effective schemes to be fully funded. Strict application of such tests of effectiveness in a framework of formal zero based budgeting would automatically ensure better design of schemes and also appropriate mid-course restructuring, to ensure that they remain funded.

Implementing reforms along these lines is obviously not a simple matter. Each of these proposals viewed in isolation is bound to generate controversy. But then, a fiscal

correction of 5.5 percent of GDP cannot be achieved without such effort. Unfortunately our present system, with its tradition of secrecy about the Budget, makes it very difficult to confront these choices. Difficult decisions cannot be taken if they have to be kept secret from everyone except a very small group, and then suddenly unveiled on the last day of February to be subjected to instant analysis by TV experts! It will be necessary to prepare the ground by actively debating the available options, and more importantly, identifying the implications of not pursuing them.

The need for taking these difficult decisions would become much clearer if we were to adopt the practice followed in some countries of presenting budgets with projections for subsequent years also. This would present a comprehensive picture of the scale of effort needed if we want to get to where we want in the next three years. In this framework the effort needed today can be reduced only if we explicitly plan for a much larger effort tomorrow.

Whatever we do, we can be sure of one thing. If we do not make a move on most, if not all, of the issues I have listed, we will not see significant progress on the fiscal front. This in turn will mean a continuing erosion of public investment in critical areas, continuation of high interest rates limiting the flow of funds for private investment, and an international rating which remains below investment grade. It is unlikely that we can achieve 7 to 8% growth in such circumstances.

3. Completing First Generation Reforms

Having emphasised the overwhelming importance of fiscal correction, let me now turn to my second category which consists of reforms which have proceeded more or less in the gradualist manner originally envisaged, but which need to be completed, or in some cases modified to reflect new developments.

i) ***Industrial Deregulation***

Liberalisation of industrial licensing and opening up industry to foreign investment was an important part of first generation reforms. This element has progressed fairly well as far as Central Government controls are concerned. Investors still face many problems in implementing projects, but these are largely at the State level, which is a second generation area. However there are some areas of industrial deregulation where further action is needed.

The sugar industry is one such area. Sugar is an extremely important agro-based industry and the second largest industrial employer in the country after cotton textiles. If liberalisation is beneficial to industry it should be beneficial to sugar also. Yet this industry remains subject to extensive control associated with the existing dual price system. State advised prices to be paid to farmers are often unconnected with market conditions, a portion of the production has to be surrendered as levy sugar at an unremunerative price, the so called free market sugar is also subject to release control, and the industry complains of a non-level playing field against imports which do not suffer from the levy. There is a strong case for decontrolling sugar and opening up this area to market competition. If it is felt necessary to retain sugar in the PDS, this should be done by purchase of sugar at market prices with a separate subsidy from the budget. However, I would argue that the sugar subsidy is very poorly targeted and benefits mainly urban middle income consumers. There is a very strong case for removing sugar from the PDS.

Coal is another area where industrial de-regulation should be extended. This is a critical energy source, where private investment is not allowed at present except for captive mining. If we have opened up petroleum to the private sector, there is no reason why coal should not be opened up also. The additional coal production needed to meet the country's energy demands in the next decade is so large that it simply

cannot be met by the nationalised coal industry. Failure to increase coal production will only make us more dependent on oil where we are already heavily dependent on imported supplies. The need to allow private investment in this sector is therefore urgent. Private investment will add a competitive spur to the industry, and also bring in new technology which is important in view of the fact that environmental considerations are likely to impose restrictions of various kinds on coal and coal quality. Since coal mining is a difficult area where environmental clearances are bound to take time and the development of a mine also takes several years, we need to act now if we want additional production in six to seven years time!

Another area of industrial policy which needs to be addressed relates to the policy of reservation of certain products for the small scale sector. Many experts have argued that reservation is not the best way of helping small scale industry and their arguments are persuasive. In fact, it is not generally realised that the sectors which are reserved for SSIs have grown more slowly than the unreserved SSI sector. Nevertheless, I recognise that this is a sensitive issue on which it will take time to build a consensus. However, there is a strong case for immediately de-reserving certain areas which have a strong export potential such as garments, toys, and leather footwear. Let me just illustrate the point by looking at two items 'which in India are reserved for SSI production. In 1997, whereas India's exports of toys and sporting goods were US$ 70 million China's exports were US$ 8 billion. In other words, China exported 120 times the amount India did! The story in footwear is nearly the same. We exported about US$ 350 million whereas China exported US$ 8 billion, or about twenty two times our level. Continuing with small scale reservation in these areas is preventing us from developing a dynamic export sector which we desperately need, and which would generate high quality employment. We complain about lack of market access for our exports, but the fact is that in critical areas where we have a strong comparative advantage our own policies have prevented us from penetrating world markets.

(ii) ***Opening the economy to trade***

Opening up the economy to foreign trade was another important part of the reform agenda and the reforms in this area are now more than half complete. The Government has announced that all QRs will be removed by the year 2003 and this is being done in a phased manner. The time frame of the transition has been made quite clear and has been well accepted by Indian industry. However, we do not have an equally clear time frame for tariff reduction. The government has given a broad indication that tariff rates will be reduced to bring them in line with East Asian countries in about three years time. It would be desirable to give Indian industry[7] a clearer idea of what is intended. Industry is also rightly concerned that tariff reduction should not create tariff anomalies in which tariffs on inputs remain high while tariffs on outputs are reduced.

The time has come for us to quantify our intentions more clearly. We could for example indicate that the average tariff level, which is around 30% at present, will be reduced to say 15% over a three year period. This would imply an annual reduction of approximately 5% per year on average, which could be easily absorbed by Indian industry. We should also clearly identify the major tariff anomalies and lay down a phased programme for their elimination. Our anti-dumping mechanisms and procedures should also be strengthened in parallel to reassure industry that they will not be subjected to unfair competition.

There are some who fear that Indian industry will not be able to survive foreign competition if tariffs are reduced further. Personally, I think this is a mistaken view. Indian industry has been able to adjust to large tariff reductions in the past few years

and there is no reason to believe that the process cannot be pushed further, especially since the market determined exchange rate will ensure that any excessive pressure of imports will produce an offsetting depreciation which will help domestic industry, while also helping exports. Reduced tariffs on inputs will obviously help domestic industry to become more competitive.

iii) ***Disinvestment and Privatisation***

Disinvestment is another first generation area where the reforms are poised to be carried to the next higher level. The reforms began with "disinvestment" which would still leave the government with a majority stake in PSUs. The United Front Government indicated a willingness to reduce the government's stake to a minority in the non-core and non-strategic area. The present government has gone further still, with a clear declaration that we will go clown to 26% in the generality of cases. Disinvestment proposals involving a change in management are currently being processed for Modern Foods and Balco, and for the introduction of a strategic partner in IPCL.

Nevertheless, uncertainties remain in the public mind about the extent to which the government should go. Many people believe that while sale and transfer of management is acceptable for weak PSUs, we should not give up majority control in the so-called "navaratnas". Others believe that the revenues from disinvestment should be used to strengthen other public sector units. As far as the issue of majority ownership is concerned, the fact is that we cannot achieve the desired fiscal correction if we do not off-load a majority stake in the equity of many of the navaratnas. The public must therefore be persuaded that such disinvestment or privatisation is desirable and will help to pay for the creation of socially more useful assets such as schools and hospitals and other forms of rural infrastructure. Nor should we assume that the revenues from disinvestment will necessarily be ploughed back into other PSUs. We have to consider what is the best use for these resources and if hospitals and schools and roads are more important, that is surely what we should build.

The fiscal problem facing us suggests that we should try to achieve disinvestment levels exceeding, if possible, the Rs. 10,000 crores budgeted for 1999-2000, though I recognise that even this level has never been reached in any single year. A business as usual approach to disinvestment will not do. We should move away from annual planning of disinvestment and indicate the scale of effort needed over the next three years. On this basis we should clearly identify the companies and also the extent of disinvestment in those companies which is needed to achieve our target. The Government has indicated that it is considering a new mechanism for implementing disinvestment including the setting up of a separate unit. This is a very welcome development. The key to its success will be our willingness to take the PSU to be privatised out of the administrative control of the administrative Ministry and transfer it to the new unit. The Ministry's views will of course be taken into account but the critical decisions on the pace and manner of disinvestment and privatisation should be with the new unit.

The manner of the disinvestment, i.e. whether it should involve retail sale to broad based investors or an outright sale to a single buyer, or the induction of a strategic partner will of course vary depending on the enterprise, and the rationale of the specific choice can be made transparent. We should also explain to the public that there is no reason to be alarmed because we are reducing government equity to a minority stake. Our objective should be to ensure that the navaratnas are strengthened as corporate entities, and not that they do not slip out of government control. In fact, a strong case can be made that ending government control over

these enterprises is essential if they are to have the commercial autonomy and flexibility they need to survive in competitive markets. No one seriously believes that the presence of the government as an owner adds any value to the company from a commercial point of view. This is as true of Maruti as it is for SAIL or IOC.

iv) ***Financial Sector Reforms***

The financial sector is another area where first generation reforms are well underway but the process needs to be accelerated. The Reserve Bank of India has made commendable progress in upgrading prudential and regulatory standards in our banking system to meet the international standards laid down by the Basle Committee. This is an area where all developing countries will be under much greater international scrutiny in future given the increased concern about financial sector weaknesses in the aftermath of the East Asian crisis. Fortunately, although we still have some way to go, the gaps that remain are easily bridged.

However, the next step is in some ways more difficult : how to make sure that our banks, especially the public sector banks, can meet the new prudential standards and compete effectively against foreign banks and private sector banks while doing so. Competition in the banking system will be intensified by technological change, especially the introduction of information technology. The more dynamic banks which take to the new technology will be able to increase their market share without having an extensive branch network. The public sector banks, whose great strength has been their branch network, must be ready to meet this challenge. They will need autonomy and flexibility to restructure in many ways. They will need flexibility in recruiting and promoting personnel, the ability to negotiate wage agreements which reflect productivity and profitability in individual banks and flexibility to redeploy staff and deal with excess staff through voluntary retirement. They will also need flexibility to close loss making branches.

These are difficult issues on which the first reaction of many of the interest groups involved, and even of the general public, may be negative. However we need to develop greater understanding on the part of these groups of the necessity for making these changes in the interest of the banking system itself together with assurances that these changes can be achieved without too much disruption. Some of these problems have to be faced in the near future as the difficult problem of the three weak banks identified by the Verma Committee is addressed.

An important positive development in the financial sector is that the opening of the insurance sector to private investment now appears imminent. Legislation has been introduced in Parliament and hopefully it will be passed soon. This will enable new private sector entrants to come into this sector sometime in the year 2000. A strong and competitive insurance industry will strengthen long-term contractual savings, improve service quality to customers, and also serve as a vehicle channelling long term finance, which is relatively scarce at present, to the capital market. This is of course absolutely essential to finance infrastructure. Even so, we have to remember that it will take 5 to 6 years for the new entrants to reach any credible size. Substantial flows of finance from new insurance companies to infrastructure can therefore only be expected in the second half of the decade. This only underscores the urgency of beginning the process as soon as possible.

vi) ***Private Financing of Infrastructure***

Private investment in infrastructure is another critical area which was part of first generation reforms but where a major push is needed to carry the reforms forward. Achieving rapid growth in today's more open and competitive environment requires a much higher level of international competitiveness. This in turn requires a very high

quality of infrastructure. Unfortunately, our infrastructure whether we look at roads, power, ports or telecommunications is clearly inadequate. There are severe shortages in quantity and equally serious deficiencies in quality. Public investment will continue to have an important role in all these areas, but the scale of the need is such that it must be supplemented by private investment. Private investment is especially helpful in the effort to improve quality.

The power sector and telecommunications were opened up to private investment as part of first generation reforms and this was extended to ports, airports and roads. The results so far have been mixed. The good news - and there is some - is that it has been possible to attract investment in all these sectors. About 9000 MW of power capacity has come up, or is under construction, in the private sector. There has also been substantial private investment in cellular phones and other value added segments of telecommunications. Significant private investment has come in ports and the first joint sector airport was recently commissioned in Cochin. Sceptics who say that nothing has happened are clearly misinformed. However, the results achieved thus far are less than was expected and there have been serious implementation problems in all these areas for different reasons.

In the power sector the financial condition of the State Electricity Boards makes it difficult for private power generators to raise the necessary financing as long as the SEBs are seen to be unreliable paymasters because of unviable tariffs and large transmission and distribution losses, much of which is just due to theft and corruption at the distribution end. In retrospect, it would have been better to start the power sector reforms with reforming tariffs and privatising distribution to improve the financial viability of the sector. In telecom there have been other sorts of problems, first because of the inability of new private investors to meet their obligations regarding license fees, and then because of continuing disputes on the jurisdiction and the powers of the regulatory authority.

I do not propose to go into these issues in detail. I would only say that we must recognise that attracting private investment into regulated infrastructure sectors is much more complex than we had realised. Private investors in infrastructure are subject to price regulation and also have to deal with other large public sector organisations in a monopoly situation. Price regulation can cause problems if the tariffs are not sufficiently remunerative, or if they are perceived to be unfair by the public. Dealing with public sector organisations in a monopoly situation poses its own problems. Private telecommunication companies have to deal with the public telecommunication system for interconnection. Private ports have to deal with the Railways to get rail connectivity. It is necessary to provide an environment in which private investors can have reasonable certainty about the rules of the game and which is also seen to be fair to consumers and the public. This calls for strong and credible regulatory agencies which can ensure fairness in fixing regulated tariffs and also provide assurance of fair treatment for private investors.

We need to review our policies and benchmark them against best international practice. This may require changes in many areas to bring our policies in line with best practice. In telecommunications, the government has announced that it will amend the law to strengthen the Telecom Regulatory Authority of India (TRAI). This is a very important decision which should be speedily implemented on the basis of experience elsewhere. We should also look at the other regulatory authorities in the system - the CERC, the SERC, the TAMP etc. - to see whether similar strengthening is needed.

3. Second Generation Reforms

Let me now turn briefly to what I would call the real second generation reforms, i.e.

reforms that have not formed part of the explicit reform agenda thus far, but now need to be brought to the top of the agenda for the next decade.

i) ***Extending Reforms to the States***

First, there is the issue of extending the reforms process to the State Governments. There has been much discussion and public debate about reforms in the Central Government but the need for parallel reforms at State government level has not received enough attention. And yet, most of the areas where the common man interfaces with the government agencies lie in the State government area. Health, education, agricultural extension and agriculture related services, irrigation, power distribution, rural, state and district roads, municipal services in urban areas are all areas where the quality of government output directly affects the lives of the people. All these areas are in the purview of State Governments.

Some State Governments have recognised the need for reforms in particular sectors e.g. in the power sector, and this is indeed a welcome development. The number of such States is still small, but hopefully it will expand. The key to success in this area, as in many others, is the willingness to introduce reasonable user charges which make the sector financially viable. This is true for power and also for many other services. If States can take significant steps in this area, it would take care of some of the most critical constraints in the next stage of development.

Many of the developmental problems in the State sector are a reflection of the fiscal crisis facing State governments and corrective action in this area, along the lines mentioned earlier, would help resolve these difficulties. However, resources are not the only problem. Additional resources will not improve education if the system tolerates teachers who do not teach, or even attend school. It is a sad fact that efficiency levels in our governmental system have deteriorated greatly in many parts of the country. This is partly due to the fiscal crisis itself because underfunding leads to loss of élan and morale. However it is also in large part a reflection of a deterioration in governance standards which has led to a decline in accountability and performance. One should of course beware of generalisation. Some States perform much better than others. Individuals can always make a huge difference everywhere. However the system as a whole is becoming dysfunctional. Administrative reforms designed to improve performance and increase accountability are therefore essential if resources are to be translated into effective developmental work. The specific solutions needed will vary from State to State. I share the view of many people that greater involvement by the people at the ground level will on the whole improve the responsiveness and efficiency of the system.

State Governments also need to undertake liberalisation of their controls and procedures. The number of separate permissions needed to set up a small business in most States ranges between thirty and forty, and each one of these becomes an occasion for harassment and corruption. What is worse, these burdens fall especially heavily on small businesses increasing transactions costs for them enormously. A serious effort to reduce the rigours of "inspector raj" at the State level would be a major boon to small business and would encourage investment. States would achieve much more by way of attracting investment if they tried to compete with each other in providing an investor friendly environment and in providing superior infrastructure than in the usual effort to offer sales tax incentives.

ii) ***Labour Legislation***

An area that has not been touched by the reforms thus far, but which must now be addressed urgently, relates to reforms in the labour markets and especially labour laws. Economists have long known that India's labour laws deny firms the flexibility

they need to operate successfully in highly competitive markets. Enterprises do not have the flexibility to retrench labour or to close down a particular unit in the company in response to changing market conditions without getting prior government permission. The labour laws also specify the "service rules" which govern employment and which cannot be changed very easily. This can make it difficult even to redeploy workers to different activities when needed.

The intention behind these laws was to protect employment. However in trying to protect existing employment they actually discourage growth of new employment. This was less of a problem in earlier years, when the economy was closed and even domestic competition was limited, and the additional costs could simply be passed on to consumers in the form of higher prices. This is no longer possible in an open economy, especially one subject to strong competition from imports. Indian industry needs flexibility to deal with the new and much more competitive situation. They need flexibility to downsize when needed and also to restructure and reorganise businesses through sale acquisition and merger. The present labour laws are a serious impediment to this process. The resulting inflexibility discourages businesses from expanding freely, and also prevents restructuring which would improve efficiency and create a basis for future expansion of employment.

The provisions relating to contract labour also need to be amended. They make it difficult for establishments to contract out services which have to be performed on the premises - e.g. gardening, cleaning, security and cafeteria. Greater flexibility in this area would lead to a profusion of smaller businesses providing services to existing firms which are otherwise unwilling to increase their own labour force. It would contribute to total employment generation and even to enterprise development.

The time has come to amend our labour laws to bring them in line with practices in other countries. It should be kept in mind that the existing laws apply only to the organised sector labour force, which constitutes only 8% of the total labour force. Ninety-two percent of the labour population derive no benefit from these laws. In fact these laws actually discourage the growth of high quality employment in the organised sector and to that extent are against the interest of those who are seeking employment.

iii) ***<u>The functioning of the legal system</u>***

My final candidate for second generation reforms is the legal system. If we want to integrate with the world and to benefit from large inflows of foreign investment we need a well functioning legal system in which contractual rights and obligations can be effectively enforced. The legal system must be one in which the laws are clear and transparent, procedures are speedy, the judiciary is independent of politics and outcomes are perceived to be fair. I have no doubt that we score very well on independence of the judiciary and fairness, but not on clarity or the speed of procedures.

I must confess that I am not professionally competent to pronounce on legal infirmities but I would like to mention some commonly perceived problems.

- First, there is no doubt that we have a plethora of outdated laws, many of which need to be scrapped.
- Second, the laws that are not outdated are often drafted in a manner that is open to multiple interpretations and the resulting lack of clarity has been the subject of a surprising amount of unnecessary legislation. Bibek Debroy in a recent study has highlighted some particularly absurd examples arising out of lack of clarity in the excise law. In 1959 the Supreme Court had to pronounce whether charcoal is coal. On several other occasions it has had to pronounce on whether betel

leaf, chillies, lemons and green ginger are vegetables because if they were, they would be free of tax. My favourite example is the one in 1985 when the Supreme Court had to decide on the vegetable status of coconut – it led to a split decision!

- Third, our legal procedures are enormously time consuming. They seem to be designed to help those seeking postponements. If justice delayed is justice denied there is not much justice in our system.
- Finally, the Government itself has a voracious appetite for litigation and routinely appeals all decisions against it, even decisions by its own appellate bodies! An important motivating factor behind such appeals is the perception that failure to appeal may impugn the integrity of the relevant administrative authority.

The end result of all this is that our courts are clogged with cases and litigation takes an enormously long time. Interestingly it is ordinary citizens and small businesses that are hurt most by these problems. Large corporations, with a battery of lawyers, are much less vulnerable. Drastic change in this area is clearly desperately needed.

Ladies and gentlemen, I am conscious that there are many important issues of policy which I have not touched upon. One cannot be comprehensive and still observe the normal time constraints of a lecture. My objective was only to outline the broad agenda of reform that we must address in the coming years. As you can see the agenda is fairly large and some of it quite difficult. I would only say that if we can make significant progress in most of the areas I have mentioned, we would be well set to achieve 7 to 8 percent growth over the next decade, and what is more a growth which will be distributionally balanced and will dramatically reduce poverty.

Dr. Montek Singh Ahluwalia - *A Profile*

Dr. Montek Singh Ahluwalia, presently Member, Planning Commission, is a renowned economist of international repute.

Born on November 24, 1943, Dr. Montek Singh Ahluwalia had a brilliant academic record with a B.A. (Hons.) degree in Economics from Delhi University and a Master's degree and M. Phil both from Oxford University.

Starting his professional career as an economist (1968-71) in the World Bank, Washington he served World Bank in the capacities of Deputy Division Chief of Public Finance Division (1971-72) and later on as Chief of Income Distribution Division, Development Research Centre (1972-79).

Dr. Montek Singh Ahluwalia came back to India and joined as Economic Adviser, Ministry of Finance, Government of India (1979-85). After that there was no looking back to him and he continued to assume the important positions including Additional Secretary to Prime Minister (1985-88), Special Secretary to the Prime Minister (1988-90), Commerce Secretary (1990-9D, Secretary Department of Economic Affairs, Ministry of Finance (1991-93) and Finance Secretary, Ministry of Finance (1993-98), before he occupied the present position as Member, Planning Commission in August, 1998.

Dr. Montek Singh Ahluwalia has a number of articles to his credit published in both Indian as well as international professional journals. He presented many papers in National and international Seminars and various other forums covering various subjects including Indian Economy, Finance, New Economic Policy and Globalisation and its impact, to mention a few.