Economic Reforms: the Next Wave

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It is a matter of great honour to me that I have been asked to give this fifth Lalit Doshi Memorial Lecture. I feel somewhat inadequate in giving this lecture as I look at the very eminent predecessors I have had, including the Chairman, Mr. Deepak Parekh. I am sure that this is a result not of an objective search but more the result of Bharat Doshi's affection and friendship for me.

I cannot claim to have known Shri Lalit Doshi very well. My interaction with him was essentially during the late 1980s when he was Joint Secretary in the Ministry of Chemicals & Petrochemicals. Lateral entries into the government like myself always find life somewhat uncomfortable in the midst of the close knit exclusive club called the Indian Administrative Service. Lalit was among those IAS officers whose dedication to overall development of the country and openness of mind was such that he welcomed outside economists like myself and made us feel comfortable within the government. No doubt this also resulted from his own achievements and interests in economics which induced him to have a broader view of the role of government in economic development. As we worked on the New Industrial Policy in early 1990, he was among those people who contributed to the confidence required to undertake the massive de-regulation of Indian industry that took place in 1991, after the initial false start in July 1990 under the then National Front government. Subsequent to the economic reforms in 1991 he was also among the senior state government officers who responded enthusiastically to the new policy regime both as Managing Director of SICOM and Secretary (Industries). From the brief association that I had with him it was always inspiring to see as dedicated and competent an officer like him serving the government.

It is in this context that I have chosen the theme of today's lecture on "Economic Reforms: The Next Wave". A great deal of change has taken place in the 1990s but much more change has to take place in the first decade of the new millennium if India is to achieve its rightful place in the world's economy. According to one reliable calculation, 300 years ago around 1700, India, China and Europe had roughly equal weights of about a quarter in the world's economy. Our share fell from this level to less than 4 per cent over the next 250 years characterised by the British colonial regime. It is only since independence that we have recovered from this long decline and begun to increase our share in the world's economy. However, in the last 20 years China has forged far ahead so that from a position of rough equivalence they are now more than double our weight in the world's economy. The task for the next wave of reforms is to accelerate our economic growth further that we then attain a sustainable path of long term growth and development so that we can hold our heads high before people of our generation move on.

Achieving Social Justice: The Need for Higher Economic Growth

Table 1: We have come a long way since Independence

	Poverty (Percent)	Literacy (Percent)	Life Expectancy (years)	Power Capacity (mw)
1951	45	17	32	1,362
1961	45	31	45	4,653
1971	52	38	50	14,709
1981	43	44	55	30,214
1991	35	52	60	85,000

But there is still far to go.

We have come a long way since independence (see Table 1). 1947 marked a major departure from almost a thousand years of political, economic and social subjugation. The country was then literally in darkness. Compared with 90,000 MW of installed power generation capacity today the total installed capacity in 1947 was 1362 MW. Life expectancy at birth was 32 and female literacy was less than 8 per cent. It is perhaps appropriate to characterise the second millennium of the Christian calendar as India's dark millennium. Interestingly what are characterised as Europe's dark ages were among the more prosperous periods of Indian history! It was during the first Christian millennium when we had illustrious dynasties such as those of the Kanishka, the golden period of the Guptas, of Harsh Vardhan, the Pallavas, the Chandelas and the Cholas. It was right at the beginning of the second millennium, 1001 A.D., that Mahmud of Ghazni made his first foray into India; and within 200 years, by 1192, Delhi fell to Mohammad Ghori. We are now at the dawn of the third millennium and we must collectively ensure that we do not repeat the existence of the last 1000 years.

Although most of us would justifiably feel disappointed at the progress made by India since independence, we must recognise the positive achievements that have been indeed been accomplished. After a century or more of zero economic growth, the first three decades of the post independence period laid the foundations for sustained economic growth of a kind not seen in recorded economic history. But this growth at less than 1.5 per cent annual growth in per capita incomes was undoubtedly inadequate to make any dent in poverty. Benefits from this growth were simply not palpable. However, the foundations for modern economic growth were well laid and we saw significant acceleration in the 1980s and 1990s. The higher annual growth of per capita income of about 3.5 per cent achieved in the 1980s become palpable and major poverty ratios fell significantly (see Table 2).

Table 2: GROWTH OF THE INDIAN ECONOMY

ANNUAL GROWTH RATE (% PER YEAR)

YEARS	GNP	Per Capita
1950-1980	3.5	1.3
1980-1990	5.5	3.5
1990-2000	6.5	4.8
2000-2010	7.5	6.0

As stated by a senior political leader "economic growth without social justice is inhuman but social justice without economic growth is impossible". The progress achieved in the 1980s I think taught us the lesson that a key objective of economic policy must be acceleration of economic growth. No distribution can take place when there is nothing to distribute.

The 1990s started with a full scale fiscal and balance of payment crisis. This disaster was turned into an opportunity and a wide ranging economic reforms process was put in motion to enable the next round of even higher sustained growth. For a brief period these reforms did seem to have put the country on a higher growth path of more than 5.5 per cent annual per capita income growth. However, not only did this peter out quickly, so did the reforms process. Thus there is a clear need to rekindle the zeal for a renewed wave of economic reforms to set in motion a process which then leads the country to once again attain the growth path which we thought we had achieved in the mid 1990s. This next wave of reforms must lay the foundations of economic policy for the new millennium and we may term them as "Reforms for the Indian millennium"!

Our worst failure during last 50 years has been in human development: poverty levels remain high; almost 60 per cent of our girls and women remain illiterate; and about two fifths of our children still do not reach even the fifth grade in school. Here again, there are new rays of hope: the spread of literacy seems to have accelerated and a dramatic reduction of poverty is also within sight. We are perhaps the first generation in Indian history who can actually aspire to seeing India without significant poverty. Hence in the forthcoming 50th year of our Republic we must quickly resolve to place the acceleration of economic growth at the top of our agenda.

The Next Wave: From Announcement to Process

Most reforms that have so far been put in place can be characterised as reforms by announcement. The industrial policy reforms, trade policy reforms, tax reforms were all reforms which can be accomplished by government announcement without much need for initiating process change. In other areas such as public sector reforms, privatisation, financial sector reforms, labour reforms, and the like, these have all been stymied since they require an initiation of process change and cannot be accomplished by mere announcement. These reforms cannot be accomplished by means of administrative or even parliamentary announcement. They require legislative changes, persuasion, administrative reforms, and changes in the mindset of all the main actors in the economic process. In my view urgent action in each of these difficult areas constitute the next wave of reforms.

Thus "The Next Wave" will require much greater commitment on the part of whichever government is in power and the achievement of greater consensus than has been achieved in the past. They can not be done by stealth. Moreover it will require a great deal of process change across different sectors and different segments of the population with stakes in economic growth. It will also involve much greater involvement and consensus of state governments.

That the initiation of these reforms is a must is indicated by the consequences that can be foreseen to result from economic growth of more than 7 to 8 per cent per year. Population growth has already declined from about 2.2 per cent per year for the 1970s and 1980s to about 1.7 per cent now. It is likely that this can decline further to less than 1.5 per cent in the next decade. Thus the achievement of 7.5 per cent GDP growth would result in more than 6 per cent annual per capita income growth which would then replicate the experience of the East Asian countries of the last two decades. Once such growth gathers force we can look forward to sustained GDP growth of even 8.5% towards the latter part of the next decade, leading to more than 7 per cent per capita income growth which implies doubling of per capita income every 10 years. With such growth we can expect poverty to decline to as low a level as 10% within the next 10 years. At the other end the growth of the middle and upper income class will proceed apace creating a market which will be larger than all other markets after China. This then is the task for economic policy for the next decade. Even then, to place the matter in context, our per capita income in 2010 will be at a level roughly equivalent to what Thailand was in 1985, that is we will still be 25 years behind a country like Thailand.

What then is Required?

Improvement in economic growth needs a higher investment rate, augmentation of labour capability, as well as the achievement of higher productivity all around. The improvement in productivity would itself result from greater efficiency in investment and through improvement in the quality of our vast human resources.

The reforms in the 1990s have set in motion a positive process by which private corporate sector investment has been rising on a sustained basis. But its efficiency and further increases depend crucially on greater and more efficient public investment. According to my understanding, apart from the ill effects of the East Asian financial crisis and some inappropriate monetary and exchange rate policies since 1995, the key reason for a slow down in economic growth has been the significant fall in public investment levels that have occurred (see Table 3).

Table 3: Declining Public Investment

	Gross Capital Formation (Percent of GDP)		
	Total	**Private Corporate Sector**	**Public Sector**
1980-85	**21.9**	**4.3**	**10.2**
1985-90	**23.7**	**4.5**	**10.5**
1990-95	**23.7**	**6.0**	**9.1**
1995-98	**24.0**	**8.3**	**7.0**

The instrument for improving investment efficiency is the provision of a greater degree of competition in all areas of the economy. However certain investments such as those in social and physical infrastructure can only be made by the public sector or in cooperation with private sector. Efficiency of private sector investment requires availability of public services such as good education and health services for the majority of the population, minimum levels of nutrition for all citizens of the country, transportation infrastructure and the like. It is entirely appropriate that all goods, which are not public goods, should be increasingly provided by the private sector, or a commercialised public sector. However, private sector investment would itself be crowded in by greater and more efficient public investment. But such increases in public investment can only be achieved if the government is able to reduce or eliminate unnecessary subsidies and then re-allocate expenditure directly to those needs, which cannot be provided by the private sector.

As I will demonstrate, the key problem that is currently inhibiting sustained and higher economic growth is the very serious nature of the fisc at both central and state levels. It is my view that unless there is urgent and drastic action to improve quality of the Indian fisc higher economic growth will by stymied. The increase in private corporate sector investment will not sustain itself unless fiscal health is restored. But this involves a great degree of process change to which I now refer.

Restoring Fiscal Health

High growth in the 1980s was bought by a sustained increase in public investment. However, this investment was financed by increasing degrees of public borrowing, both external and domestic, rather than an increase in tax or other revenues. The consequences of such sustained high fiscal deficits are there for all to see. The excess external borrowing contributed to the 1991 BOP crisis. Continuous excessive domestic borrowing has led to a continuing increase in debt service payments, which are now becoming unsustainable. The current cost of borrowing by the government is now in the region of 10 to 12 per cent. Detailed calculations on the returns to public sector investments suggests that the average return at present, excluding petroleum companies, is not different from zero at both the central and state levels. This is then the index of inefficiency in the allocation of investible resources available with the government at present. Continued high fiscal deficits have resulted in high and increasing interest payments both at the central and state levels, accompanied by continued reduction in resources available for plan expenditures, low expenditure on social sectors, and higher and higher borrowing requirements.

This proces is unsustainable. The consequence of excessive public borrowing goes beyond the public sector- the private sector is even more adversely affected. Excess public borrowing results in high interest rates, crowding out of private investment, and inhibits financial sector reforms. Thus an improvement in public sector functioning is a key requirement for full achievement of higher growth in the economy and for finding resources necessary for higher investment in social services. An examination of the expenditure pattern of the central government shows that interest payments now amount to more than 70 per cent of central tax revenues and about 50 per cent of total current revenues (see Table 4).

Table 4: Worsening Fiscal Situation
(Percent)

	Revenue Deficit/ Fiscal Deficit	Interest Payment/ Revenue	Interest Payment/ Tax Revenue
1980-85	17	23	30
1985-90	32	30	40
1990-95	48	44	59
1995-98	50	47	64

Wages and salaries form only about 12 per cent of Non Plan expenditure. We can fire all central government staff outside the defence services and we will still have a high fiscal deficit! Subsidies, pensions and defence expenditure a count for the rest. Revenue deficit accounts for more than half of the fiscal deficit. We are now borrowing for current expenditures which generate no returns. This situation will continue unless debt service payments can be reduced.

The key objective of fiscal reform has to be a reduction in debt service payments. This has to be achieved by a progressive reduction in public debt and through higher revenues. The possibility of achieving higher revenues through increase rates of taxes is both undesirable and infeasible, except through buoyancy and expansion of the tax base. The main instruments for achieving this reform are (i) widespread and bold imposition of user charges on all non merit goods and (ii) widespread and bold privatisation.

Importance of User Charges

A good deal of public sector investment is in the provision of infrastructure services. The pattern and organisation of the provision of such infrastructure service has been done in such a way that the public has got used to not paying the economic charges for these services. This includes key services such as power, water supply, irrigation, and transport among others. The Finance Ministry has calculated that hidden subsidies on non merit goods amount to as much as 10.7 per cent of GDP. In the case of the power sector alone the losses resulting from lower than economic pricing to the agriculture and domestic sectors amount to almost Rs. 25,000 crore a year.

Consequently public investments made in the past fifty years have imposed an increasing burden on the budget rather than providing returns in the form of non tax revenues through dividend payments made to the government. The public has got used to not pay adequately for these services for two reasons. It is perceived that the services are provided by the government and therefore do not have to be paid for. Second, with quality of service being poor, the public is loath to pay higher charges. This is a vicious circle which needs to be broken. The imposition of higher user charges has to be accompanied by improvements in the quality of service.

It is only if government receives returns from the investments it makes, which are financed from borrowing, can fiscal health be restored. The argument for not charging appropriate user charges has essentially been on the basis of the inability of the poor to pay for such services. This argument has little basis, in fact since most such services are essentially consumed by the better off sections of the society. At least 60 per cent of rural house holds and about 20 per cent of urban households do not have a power connection; only 60 per cent of urban households have taps within their homes, even fewer have in-house latrines. **We therefore need a major campaign to bring up the levy of user charges to economic levels so that the infrastructure entities both public and (potentially) private, are able to get adequate returns to their investments.** In my view this is the most important feature of the economic reforms necessary for the achievement of higher growth. The fiscal health of both the central and state governments would then improve dramatically. Moreover, we would then be able to invest appropriately in the provision of such infrastructure services which are essential both for economic growth and for social justice. But this reform cannot be done by announcement. It needs research, public awareness, public education and persuasion. The central government must lead this campaign and forge understanding and consensus with state governments, who must in turn do the same with local bodies. Both a carrot and stick approach will have to be followed. At the same time acceptability of higher charges for such services will not be feasible unless there is greater efficiency in the delivery of these services. This requires widespread reform in the public sector.

I notice from the manifestoes of both the leading political formations that almost everything has been promised in their economic agenda. However, there is no mention of the importance of user charges, let alone any commitment to imposing them.

Increase in user charges will only benefit the budget in the future. This will involve great process change and will take some time to yield fruit. The government must examine each infrastructure sector closely and programme the gradual imposition of economic pricing in each sector. Some regulatory authorities have already been formed and will be expected to lead this process. They must be strengthened professionally, made financially autonomous and allowed to function independently. The campaign must be time bound: we cannot afford more than five years to reach appropriate levels of user charges.

In the interim, resources have to be found for retiring public debt. These resources must come from privatisation.

Privatisation

The retirement of public debt requires generation of a large volume of capital resources. The main source for such resources can be the proceeds from a programme of bold and widespread privatisation at both the central and state levels. Time is now ripe for shedding old shibboleths and proclaiming a clear position on privatisation of all but strategic public sector enterprises. Such a programme must be distinguished from the disinvestment programme which has been sporadic, half hearted and poorly administered. I believe that this has mostly been due to lack of clarity in the objectives of disinvestment.

Jawarhahlal Nehru's idea of the public sector was very different from the way it has evolved through the years. Nehru's conception for the public sector was for attaining the commanding heights of the economy and not its commanding depths. Private sector enterprises were then seen to be inefficient and public sector enterprises were expected to induce a greater degree of efficiency in the economy. The assumption was that the efficient public sector would be instrumental in the generation of large surpluses. The record has been the opposite. However, we must recognise that public sector enterprises do dominate key sectors of the economy in the infrastructure and heavy industry areas. It is all the more necessary for the economy that these enterprises become more efficient.

Sustained industrial growth in the future therefore requires that these enterprises grow much faster than they have in the past, attain higher technology levels and become more competitive. The government must look at itself as a successful venture capitalist. What a venture capitalist does is to invest in a risky new enterprise; he pulls out once it succeeds thereby making profits in the bargain and then goes on to invest in other new enterprises. Thus the government should tell itself that it has indeed succeeded in creating a credible industrial base in the country but which now needs to be privatised so that it can grow further. In the bargain, the government can recoup its investment and use it to enable it to now concentrate on other areas which require its attention.

The achievement of higher investment and consequent higher growth in both public and private sector companies will require a more widespread pattern of share holding. The government does not have the resources to invest in the magnitude required to enable the existing public enterprises to grow faster. With the opening of trade, the dereservation of areas reserved earlier for public enterprises, and the liberal introduction of foreign investment, public sector enterprises are now faced with intense competition of the kind which they have not faced before. The restrictions implied by government ownership are inconsistent with the kind of freedom required for flexible operation in a free and competitive framework. We must now explicitly accept that the kind of freedom envisaged for successful enterprises is practically not feasible within our framework as long as government share holding remains greater than 50 per cent, and the enterprise is classified a public sector enterprise.

We must adopt a new approach to public sector enterprises which recognises that privatising them would be the best way of making sure that the core of Indian industry grows, remains competitive and is enabled to compete internationally. These are the enterprises which may have the potential of becoming Indian multinationals in the future. They are indeed the industrial enterprises in the country which have potentially the highest technological competence and which can indeed hold their own against the new competition but to do this they must be freed from the shackles of government controls.

Bold privatisation cannot be done in a business as usual manner. I would suggest the examination of the German model wherein all the East German public sector enterprises were transferred to a public trust called the Treuhandanstalt. The trust was empowered to sell all the public enterprises entrusted to it. It was given a time frame to achieve this purpose. It was given an appropriate budget and also empowered to negotiate with prospective buyers appropriate conditions for the sale. Such conditions could include restrictions on disposition of the labour force in these enterprises. Whereas it may neither be desirable nor feasible to take the German model lock, stock and barrel, I would strongly suggest that this model may be examined and something akin to it to put in place in India. Similarly steps should be taken by all state governments.

The proceeds from the sale of these public sector assets should be exclusively utilised to retire existing public debt and contribute to the National Renewal Fund which is dealt with later in the discussion on industrial restructuring. The proceeds from the sales must not be used to defray current expenditure.

Apart from reservations on privatisation itself the main perceived constraint inhibiting privatisation is the issue of labour. This is particularly important for loss making and bankrupt enterprises. This issue must also be addressed upfront and mechanisms designed to initiate process change, which realistically addresses the concerns of labour. Workers' legitimate needs have to be met. Older workers must have access to voluntary retirement packages, whereas younger workers must receive assistance in retraining and redeployment with access to temporary needs for unemployment benefits.

Privatisation will bring back to public coffers the fruits from past public investments. How do we ensure that future public investments provide adequate return to the government so that it can retain fiscal health on a sustainable basis? I believe that the whole system of public investment through the plan process needs reexamination. The existing process induces lack of accountability at every level. The decisions to invest are too remote from the point of investment. The central government acts a giant financial intermediary, borrows resources from the public and the allocates them on the basis of certain conventions and formulise to state governments and other entities. State governments in turn pass on these resources to state government organisations. The receipt of such resources is not dependent on performance and their ability to pay back appropriate returns for the funds received. This system is no longer sustainable and needs a new approach.

A New Approach to Public Investment

All public investment activity must be guided by the fact that, in the absence of a positive balance of current revenue, public investments are from resources borrowed by the government from the market. Thus they are not free resources and must be allocated in such a way that they generate appropriate returns. Whereas it is not possible to obtain clear returns that are identifiable from investments in public goods, it is possible to obtain returns from other investments through user charges. In such cases, as far as possible, investment should be made through accountable entities which can themselves see the connection between investments and economic returns and act accordingly. So far, the government, particularly the central government, has been acting as a giant financial intermediary, borrowing funds from the market and then on-lending them to other entities such as state governments, development authorities, public sector enterprises and the like. But in this system there is little accountability. There are effectively no sanctions against lower entities, which do not pay back the loans that have been entered into earlier. Similarly, poor performance in the past does not endanger the possibility of obtaining new resources. In fact, effectively, the advance of new loans helps in servicing the older loans.

It would therefore be preferable to reduce the role of the government as a financial intermediary. For those activities which are in the nature of public goods, it would be better to provide outright grants, and for others, particular in the area of infrastructure, budgetary funds should be used to provide equity to enterprises, which would than help such entities to crowd in other resources, either as additional equity or debt.

The implications of such an approach are as follows:

(i) **Direct Borrowing by States and Local Governments: State Government and Municipal Bonds**

State governments, state government corporations, urban development authorities, municipal bodies, etc. should all be allowed to borrow freely in the market. Their ability to borrow would then depend on their ability to get appropriate credit ratings, and this would force them to be accountable and credit worthy. For this system to succeed, higher level governments will have to eschew the temptation to either guarantee state government or local authority bonds ex-ante, or to bail them out when in difficulty expost. No political system makes this easy to practice and similar difficulties will exist in India. Paradoxically, the deteriorating fiscal situation of both central and state governments in India will itself limit the ability to undertake bailouts.

This is a major change and its implementation will require not only great process change but also a constitutional amendment.

(ii) **Budgetary Allocations as Equity and "Embedded Subsidies"**

In view of the severe constraint on public resources, the available resources must be used to help in raising other resources as far as possible. In principle, this can be done by using public resources as "equity like" resources. Different sectors exhibit different degrees of commercial viability. For example, it may be expected that sectors such as power and telecom can be fully viable on a commercial basis: they should be able to service both debt and equity resources on a fully commercial basis. However other sectors such as urban water supply and sewerage may not exhibit commercial rates of return for some time. In such sectors the government can provide equity like resources on a concessional basis with stipulations on rates of return expected being less than commercial. **Such arrangements would enable project entities to raise other equity and debt resources on a fully commercial basis,** thus enabling greater investment than would otherwise be possible. By way of illustration, say in a water project, if the government provides equity resources with no dividend expectation for 15 years, on the basis of a 2:1 debt equity ratio, and debt can be raised commercially at, say, 15 percent, the project is then "commercially" viable, and credit rated as such, at a 10 per cent overall rate of return. User charges can then be set at affordable rates. Such a procedure can be used in many sectors and projects to effectively use public resources to leverage other resources toward those areas of investment, which are regarded as preferred areas of investment for social and physical infrastructure.

This procedure can also be effective in providing much greater autonomy to public sector entities: the public scrutiny process of resource allocation would then apply only to the equity allocations, and not to the debt raised by these entities. Within the stipulated dividend expectations, public sector entities would then be much freer to take their own decisions.

Such a change in the approach to public investment will imply considerable re-thinking on the role of the Planning Commission. It will not need to spread as much time in plan allocations as it does now. It will need to transform itself into resuming its role as a strategic thinker for the government.

Enhancing Economic Efficiency: Financial Sector Reforms

One of the key consequences of poor fiscal health of the country and excessive government borrowing is the brake it puts on financial sector reform. Enhanced overall competitiveness of the economy depends on the efficiency of the financial sector. As stated earlier, acceleration in economic growth will depend both on achieving higher investment levels in the public and private sectors but also on achieving higher investment efficiency. With the opening of trade and foreign investment, competitiveness of Indian enterprises depends on what prices it pays for its key inputs-capital, labour and the raw materials it uses. Labour costs are already low in India, but labour efficiency needs to be enhanced through capacity building. Trade reforms are bringing the costs of all traded inputs nearer world prices. Thus it is in the remaining area of capital that greater action has to be taken.

It is noteworthy that both the manifestos of the lading political formations are silent on the issue of financial sector reforms - an area which I believe is key to the future of the Indian economy.

Excessive government borrowing requirements have impeded financial sector reforms since the government has to maintain adequate controls on the sources of savings to finance itself. First, the high government borrowings result in higher interest rates than would otherwise exist. This imposes high costs on the whole economy. Second, the government has to maintain a high SLR on banks to ensure that there is adequate subscription to Treasury issues. This reduces liquidity for lending for other needs. Third, most financial institutions, including insurance, provident and pension funds, and small savings are kept under government ownership so that government financial requirements are fulfilled. Indeed, all small savings are used to finance central and state government borrowing requirements. As in other areas, public sector ownership has resulted in inefficiency and overmanning in banks and other financial sector institutions. The need of the day is greater competition and contestability to induce greater efficiency in the financial sector which then enhances competitiveness in all real sectors of the economy.

The government began a programme for introducing new private sector players in banking in 1992. The process of disinvestment in some of the nationalised banks, particularly the State Bank of India has also begun. Meanwhile many reforms have taken place in the banking sector particularly in relation to interest rate deregulation, reduction in reserve ratios, and the introduction of prudential guidelines, all of which are designed to strengthen our banking system and to improve its quality and competitiveness. Much of this was done in response to the Narasimham Committee recommendations on financial sector reforms. Now the second Narsimham Committee recommendations are also available.

However, with all of these very significant developments the financial sector remains largely in the hands of the government. Consequently there is still inadequate competition and progress towards the banks'competitiveness remains slow. The private banks are still small in weight and are therefore not able to apply the kind of competitive pressure needed for enhancement of efficiency in the banking system. In fact with the margins available in the nationalised banking system, the private banks are quite happy to be price takers and thereby be extremely profitable. They have the benefit of being small and of using the newest technologies available.

Competition in the banking sector will only be observed if the weight of the bank participants outside the nationalised sector increases. It is therefore worth considering a bold programme of successive privatisation which quickly leads to one, two three or more nationalised banks to reach levels of disinvestment above 50 per cent so that they become independent of the Government and at least half of the financial sector is in private hands. This should be done in such a manner that they are widely held and not controlled by any particular industrial group. We would than be able to see the emergence of true competition leading to greater specialisation between banks and other of higher levels of efficiency both in the private and pubic sector.

There is one other consequence of opening the financial sector to more institutional participants of the varieties that I have described. The efficient working of the capital market depends on the existence of many different view points among its participants. Not everyone should have the same view at the same time. If most institutions have one owner as is currently the case, that is the government, healthy development of the capital market becomes difficult. Thus a side benefit of this diversification of ownership among financial institutions is a more healthy development of the capital market. This also has a bearing on the future of corporate governance in the country. As the current dominant promoters of companies, the government in the public sector and the industrial families in the private sector lose their dominant shares, appropriate corporate governance will need other influential voices in their board rooms. In countries which have gone further on this road most companies are widely held but it is the institutional investors who have the capability of monitoring the performance of companies well. We can expect the same progression to take place here. But the monitoring function would be difficult to perform unless diversification of ownership takes place among institutional investors. The broadening of the financial sector in the terms I have described will therefore also contribute to the emerging scene of corporate governance in the country.

Opening Insurance, Provident and Pension Funds

Infrastructure investment requires long term funds. What kind of investors have such long term funds. It is essentially insurance funds, pension funds, provident funds and the like which have funds that can be invested in long term securities. It is for this reason that it is essential that we open up our insurance sector, the pension and provident fund sector to new participants. Understanding of this issue needs a digression on Indian market demographics.

Very significant economic and demographic changes are being observed across the country and which are likely to intensify over the next 10 years and beyond. First, we have witnessed rapid urbanization over the last two decades or more. The urbanization level is likely to be around 30 per cent by the year 2000-01 comprising about 300 million people. We already have more than 300 cities with more than one hundred thousand population and 23 cities with more than 1 million population. As the pressure on housing increases and as people become more mobile with increasing urbanization we are also observing pressures appearing on the social front and the breakdown of the joint family system. Second, although we have not done as well as many other countries in health, the life expectancy in India has increased from about less than 32 at the time of independence to about 62 now. At medium and higher income levels people are surviving up to higher and higher ages into the eighties and even their nineties. With this increase in longevity and pressures on housing it is becoming more difficult for parents to stay with and be looked after by their children. Thus there is an increasing demand for social security instruments which provide adequate resources for people in their old age so that they can continue to live reasonable comfortably and with dignity even after their working lives are ended. These demands will only intensify in the future. At present, it is only in the organised sector that there are provident funds and pension funds arrangements. Life insurance is provided only by the Life Insurance Corporation of India. Although the LIC has done a very creditable job of extending its reach all across the country, the coverage of life insurance in India compared to other countries would suggest that much more can be done. What is therefore absolutely critical at this time is the opening up of this sector to many more participants so that our citizens have many more options than are currently available for their contractual saving.

It is in view of these two aspects of the major economic, social and demographic changes that are in store for us over the next 10 years that it is of the utmost urgency that we open up the financial sector to new institutional players, particularly insurance, pension and provident funds. We would then complete the virtuous circle of high economic growth, high savings, high investment high infrastructure investment, high economic growth. The opening up of insurance and other segments of the financial sector is something that is crucial for providing a social safety net for all our citizens while at the same time providing a mechanism for the funding of the infrastructure entities that I have mentioned earlier. It is mainly institutional investors who can be expected to have the capability of assessing the credit quality of the different infrastructure entities, be they private companies, public sector companies, state governments or local governments.

Enhancing Private Sector Competitiveness: Industrial Restructuring

I would now like to turn to the areas of industry and trade. The achievement of higher economic growth requires the attainment of higher efficiency and that in turn comes through greater competition. The New Industrial Policy of 1991 introduced new competition by abolishing industrial licensing in almost all industrial sectors abolishing restrictions on MRTP companies, terminating the Phased Manufacturing Programmes, substantially freeing foreign direct investment and import of foreign technology, and freeing areas reserved for the public sector. This policy reform removed almost all restrictions on new entry. Over the years the trade regime has been substantially modified so that most restrictions on the import of industrial goods have been removed. It is only in the area of consumer goods that import restrictions still have to be removed. At the same time the tariff structure has been brought down considerably thereby reducing the protection available to Indian industry. Whereas a great deal has been done we must now establish a new credible time table for competing this unfinished agenda. A new time table for tariff reduction must be announced a la Chelliah. The remaining trade liberalisation must be accelerated and both foreign investment and technology imports must be freed further. These measures are necessary to help pushing Indian industry to become internationally competitive.

Despite these fresh winds of competition on the whole it must be said that our industry has coped extremely well after having being sheltered in a close and protected economy for more than 40 years. A great deal of re-engineering has taken place, new challenges have been imparted on a rapid pace, and quality is being upgraded all around. Indian industry has shown that it is indeed ready to compete. This restructuring now needs to be accelerated but is being inhibited by rigidities in both the capital and labour markets.

Industrial Restructuring

The impact of 1991 reforms on Indian industry was cushioned by the large devaluation of the rupee which took place simultaneously at that time but that cushion is now no longer available so that competitiveness now will have to be achieved through higher productivity which requires both greater investment in technology and in training. Furthermore much greater flexibility is required for industrial restructuring. This implies the institution of more rapid bankruptcy procedures, easier reallocation of capital, and flexibility in labour use. With the likelihood that trade liberalisation and tariff reduction will continue there will be continued pressure on Indian industry in the years to come. I therefore believe that we will need much more industrial restructuring in the next five years than we have had in the last five.

Consequently it is important that the government puts in place a mechanism by which some of the unsuspecting losers in this restructuring do not suffer. If it does not do this then those affected in such a fashion would make sure that this restructuring does not take place. For healthy sustainable industrial growth we must understand that continued industrial restructuring is essential for better investment allocation and efficiency. We will indeed see mergers and acquisitions, take-overs, reorganisations and the like to a much greater degree than in the past. We would also see much higher likelihood of closures, partial or full, in the coming years.

I would therefore suggest that putting in place a social security mechanism for workers displaced due to industrial restructuring is a must. Thus the National Renewal Fund or some similar mechanism must be resuscitated so that resources are available to help the labour displaced from restructuring. The whole procedure for restructuring, closure and bankruptcy must be simplified and this involves significant judicial reform as well. It is only if the labour affected by restructuring can be adequately compensated both through monetary competition and therefore an active programme of re-training and re-deployment would it become much easier to undertake quick restructuring processes including rapid closure resulting from bankruptcy. In order to make this process a self sustaining one, action must be initiated urgently to set up a self funding insurance fund for employment which can then eventually replace the National Renewal Fund.

One specific need of industrial restructuring that I would like to stress is for the regeneration of industrial distressed areas of long standing such as Ahmedabad, parts of Mumbai, other cities such as Kanpur, Indore and Calcutta. As may be expected, industrial distress is indeed concentrated in the oldest industrial areas of a country. Re-generation of these cities requires the unlocking of number of rigidities, which have constrained the freeing up of assets long rendered unproductive. The Urban Land Ceiling Act, the tardy process of bankruptcy in our courts the lack of social security for workers have all inhibited the productive re-generation of cities which were once the most vibrant and productive in the country.

Enhancing Private Sector Competitiveness: Dereservation of Small Scale Industries

What then are the remaining areas that require attention? First, the one sector that has continued to remain protected through trade restrictions is that of consumer goods. The difficulty is that whereas these trade restrictions remain in force, all these industries have been delicensed. Relative to other industries this sector therefore receives excessive effective protection. It is then to be expected that new industrial investment, both foreign and domestic, would flow to this sector in preference to other sectors. This is a situation which is tailor-made for the establishment of excess capacities. That would indeed seem to be the case. We can observe excessive new entry in many areas such as automobiles, consumer electronics, white goods and others. On the positive side, because of this excess entry prices have not risen as much as they might have been expected to in the absence of import competition. The entry of foreign direct investment and new foreign technology has also led to an all around quality upgradation in this sector. The establishment of these new capacities and the upgradation of technology along with new foreign investment in these areas suggest that the time is more than ripe for the removal of the trade restrictions on the import of consumer goods.

What will be the consequences of such an action? First, Indian consumers would gain by the availability of even greater choice than is available now. Second, price rises would be further constrained by international prices with the opening up of trade. Third, foreign investment of the tariff jumping variety would disappear. We would then not observe investment in clearly uneconomic size plants attempting to produce 5000 or 10,000 cars, for example. Investments would be made only in substantial manufacturing capacities which are likely to be internationally competitive. In other words the allocation of investible resources in the industrial sector would become much more efficient leading to higher growth.

It must be noted here that in terms of exports the most likely areas where Indian exports can be expected to increase is indeed in the area of light consumer goods. At the NCAER my colleague Dr. Rajesh Chaddha has studied in great depth the pattern of export development in East and South East Asian countries. He has observed the unmistakable existence of what has come to be known as the flying geese paradigm. Almost all the successful East Asian exporting countries have started with labour intensive relatively low technology products such as textiles, clothing, shoes, toys, sporting goods and the like. They have then graduated up to somewhat higher technology consumer goods and than later to even higher technology and capital intensive sectors such as those of capital goods and petro chemicals. Over the same period, our own export pattern has remained stationary at the level of labour intensive low technology products such as clothing, textiles, shoes, other leather goods, and the like. Even in these areas the growth could have been much higher than has been the case. It is only if we could introduce greater competition, higher technology and quality in our consumer goods sector that we could expect to see substantial growth in exports of consumer goods which is essential for our trading future. Other studies done at the National Council of Applied Economic Research comparing domestic prices of many of these consumer goods with international prices suggest that we could indeed be very competitive in international markets if adequate quality upgradation can take place.

I have mentioned some of the sectors in which newly exporting nations usually specialise in. You would observe that most of these sectors happen to be reserved for small scale industries in India. This is the second area where we need substantial reform in our policies. So far our policy platform for small scale industries has been one of protection as it has been in other areas. To a certain extent, we can claim success for these policies in the past. Many new entrepreneurs would not have been able to enter the industrial sector without the protection available to small scale industries. However we have now reached the stage where the existing policies are hindering the growth of small scale industries rather than helping them.

First, as I have already mentioned, the areas where we can expect the highest growth in exports happen to be reserved for small scale industries. It is undeniably true that a good deal of success has been achieved by our garment exporters and others in the past. They are now increasingly constrained in their growth because of uneconomic sizes of operation. These exports have relied on the advantages based on low wages and on the quotas available in developed countries because of the multi fibre agreement. Unit value realisation in many of these exports is very low compared to other countries. The attainment of both higher volume growth and of higher unit value realisation will require both larger scales of operation and higher quality. It is therefore essential to loosen constraints in these sectors so that they can grow freely in volume, utilise better machinery, graduate upto higher technology levels, and have better international marketing. What has been observed in other countries in Asia is that the production of such consumer goods may be through final assembly operations which are large in scale but where a great deal of out sourcing to small enterprises is undertaken to preserve their competitiveness. Consequently the freeing of restrictions on the size of small scale industries dereservation is likely to lead to the growth of many more small scale enterprises then is currently the case along with much higher growth in employment.

Second, the changes in trade policy that have already taken place in the last five years have led to the free import of more than 600 items in the small scale reservation list. We are therefore in the anomalous situation where we can import more than 600 items which can be manufactured by large enterprises abroad but which large Indian enterprises are prohibited from producing. This is clearly one area where Indian industry has not been placed on a level playing field.

Third, the trend in the framework of international trade is such that the remaining trade restrictions on consumer goods are likely to be lifted within the next 5-6 years. Thus the writing is on the wall that all the items currently reserved for small scale industries would be importable within the next 5 to 6 years. **Consequently it is of the utmost importance that, as the Abid Hussain Committee on Small Scale Enterprises has recommended, the existing restrictions must be removed forthwith in the interest of small scale industries.** Such a measure would give them time to expand in size and upgrade technologically to compete with imports and in export markets when the MFA is lifted.

I would expect that such an action would lead to a new spurt both in industrial growth and in export growth. I should hasten to add that mere dereservation would not be enough. Such de-regulation of small scale industries must be accompanied by targeted action to provide both technology and financial assistance to the small scale industrial sector. It is clear that at present the Indian banking system is not fully equipped to promote small scale enterprises around the country. The Abid Hussain Committee has recommended a number of actions in this regard also. The key issue is that banking institutions must be enabled to improve their credit assessment capabilities with regard to small scale enterprises so that they can distinguish adequately between good and bad credit quality. The cost of such credit assessment can be reduced by a better recognition of clusters of like small scale industries which exist around the country. Special assistance must be given to those industries which are in the reserved list to enable them to expand and upgrade technology. This will need significant government funding to supplement banking resources.

Agriculture Reforms

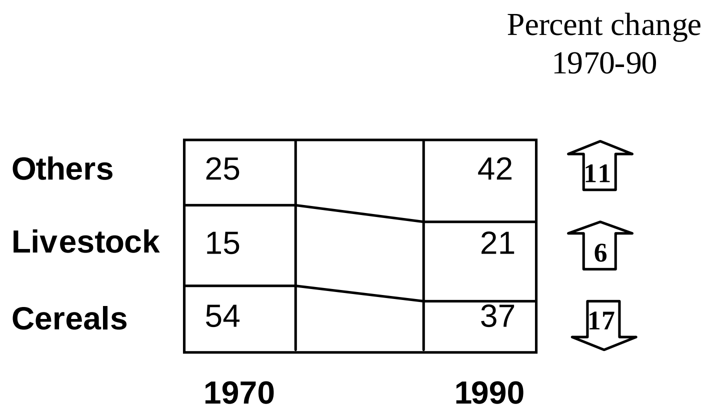
As with the rest of the economy the agriculture sector also exhibited a picture of stagnation at the time of independence. In the first flush of planning particularly during the second and third five year plans industry was given a much higher importance. Consequently growth in agricultural g.d.p. was only about 1.9 per cent per year between 1950 and the mid 1960s. The drought of 1965 to 1967 and the associated difficulties in importing food at that time gave a jolt to the Indian government and ever since food security, equated with food self-sufficiency, has been given the highest priority in economic policy making. The results have been gratifying and much higher growth was achieved from the late 1960s until the mid 1990s of the order of about 3.7 to 3.9 per cent per year. The preoccupation with food security and its equation with food self sufficiency led to restrictive trade policies controlling both import and export of agriculture goods. This policy combined with that of high protection to industry resulted in declining terms of trade to agriculture until early 1990s. The farmer has been effectively taxed by the existence of lower than world prices in most agriculture products. The very negative consequence of such policies has been the necessity for providing input subsidies to partially compensate for the adverse terms of trade being meted out to agriculture. All aggregate measure of support (AMS) calculations suggest that the input subsidies have not come anywhere near to adequately compensating the farmer for the losses suggested from adverse terms of trade. The economic reforms of the 1990s have partially corrected this situation through the drastic reduction of industrial protection but this also resulted in significant increases in agriculture support prices leading to increasing subsidies. As a result public investment in agriculture seems to have declined. But the improvement in terms of trade has also resulted in significant increase in private investment.

While policy makers have been mainly concerned with supporting foodgrain production the consumption pattern of the population has been changing very significantly to reduce considerably the importance of food grains in their diets. The share of cereals in food expenditure has declined very considerable in both rural and urban areas continuously. In urban areas cereals constituted about 36 per cent of food expenditure in the early 1970s. This had declined to about 26 per cent by the late 1980s. Similarly in rural areas the proportion of food expenditure on cereals fell from about 54 per cent in the early 1970s to 37 per cent in the late 1980s (See Table 5 & 6).

Table 5: …Food habits are changing in India - in urban...
Changing food expenditure, urban India

Percent	1970	1990	Percent change 1970-90
Others	34	36	↑ 2
Veg/fruits	10	13	↑ 3
Livestock	20	25	↑ 5
Cereals	36	26	↓ 10

Table: 6…and rural India
Changing food expenditure, rural India



We are therefore observing that even though the per capita availability in foodgrains is not much more than it was 30 years ago, the foodgrain surplus is continuing to accumulate. What has happened is that the availability of consumption of foods such as vegetables, milk, fish and poultry has been increasing very fast. According to one estimate the availability of potatoes has increased by a factor of about 12, of milk by about 7, and of meat by about 10 over the past 30 years or so. Whereas the evidence on this very significant change is quite obvious from the standard statistical sources, the pre-occupation of policy makers with foodgrain production continues unabated.

A new approach to agriculture policy is therefore required and needs much greater study than both economists and policy makers have so far given it. In the first instance, in view of the relatively high level of food security that has now been achieved the climate is now ripe for bold policy reforms in the external sector through the removal of export and import controls on agriculture trade. This will no doubt mean a corresponding policy adjustment on provision of food to the poor through the public distribution system which must be made much more targeted than as heretofore been the case. Such a trade reform would correct the very distorted incentive structure that exists today and will enhance farmer incomes on the whole. We can also expect agriculture exports to increase substantially but to reap the full benefit of such external reforms we will need to negotiate aggressively in the WTO millennium round to obtain a better deal for our agriculture exports than might exist today. I am aware that such a drastic change in trade policy cannot be done overnight. As in the other areas we must however, achieve clarity in our objectives and then pursue a phased but time bond policy reform process.

The correction in the incentive structure for agriculture will also make it feasible to reduce the various subsidies particularly in power and fertilisers to eventually eliminate them. This will provide a very significant fiscal dividend to the country enabling higher public investment where it is required. The government already has available with it the report of the Hanumantha Rao Committee on Fertilier Policy Reform. The Committee has given a very balanced view on how this complex policy change can be accomplished. It is imperative that a clear view is taken on the recommendations of this Committee and a credible reform process we put in place in the fertilizer sector.

The agriculture sector policy continues to suffer from a large number of other domestic market controls. Movement of agriculture products is still not free across the country. Various products such as sugar, rice and molasses also suffer from the imposition of levies designed to procure these products at lower than market prices. Different controls are imposed by the central and state Governments. A comprehensive cataloging must be done on such restrictive laws and controls and all those which do not serve the farmers interest must be abolished. Connected with some of these controls are also small scale reservation in industries like agricultural implements, edible oil processing and other areas of food processing. As with all other small scale industry reservations these also must be abolished.

Finally explicit attention must be given to be very significant changes taking place in the agriculture sector which are beginning to forge a much closure connection between the primary producers, intermediate food processing and eventual marketing of value added products. As noted earlier, with the share of unprocessed foods falling, the real growth area in the agriculture sector is in value added foods of all varieties such as meat, poultry, fish, vegetables fruits and the like. For this transformation to take place successfully specific attention has to be given to the provision of rural infrastructure particularly that of roads which must connect all villages in the country. If there are no roads, produce can neither be taken to these unconnected villages for marketing nor can the farmers' produce be taken to the market. Other investments are required to make possible the transfer of agriculture products to where they are processed and eventually to where they are marketed. Heavy investments are required in establishing cold chains across the country. At present these investments are also handicapped by existence of various restrictive laws which inhibit such investments.

Indian agriculture is at a stage where it can grow faster than it has earlier but it requires a drastic change in production from simple foodgrains to higher value added products. This then is the challenge for a new wave of reforms in the agriculture sector.

Conclusions

You will notice that I have not talked about reforms and initiatives in the areas of infrastructure health, education, nutrition and other social sectors. This is not because I belittle their importance. Indeed, as I have mentioned right at the beginning, it is these areas which have suffered from the worst policy failures since independence. However, I believe that there is no hope of making any progress in these areas unless fiscal health is restored at both state and central government levels. It is on these issues therefore that I have laid much greater stress.

Let me conclude by reimphasising that so far we have carried out successfully most of the easier components of economic reforms that needed implementation. There is now a widespread view that there is broad political consensus on economic reforms and that they will be carried forward regardless of which political formation comes into power. My view is slightly different. There is broad political consensus on slow and economic reforms. The requirement of the next wave is for a bolder initiative into all the difficult areas that I have outlined. The most serious area is, as I have mentioned, that of the fiscal state of the country. The restoration of fiscal health and acceleration in infrastructure investment cannot take place without a national campaign for the imposition of user charges for all infrastructure services which are not regarded as public goods. I am convinced that if we tackle some of these basic problems then, on the basis of underlying market demographics, there is no reason why we cannot achieve growth rates of 8 per cent and above which will enable us to banish poverty within the life times of my generation. This is what Lalit worked towards right through his life and would surely have contributed to its achievement had he lived his full life.