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REPORT

INDIA'S ECONOMIC REFORMS

by
JAGDISH BHAGWATI
and
T.N. SRINIVASAN

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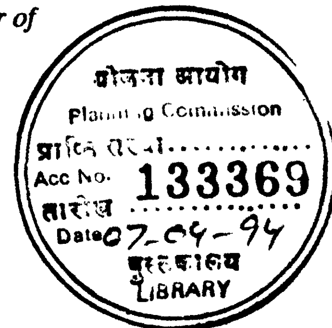

July 1993

PREFACE

Over the past two years, the Government of India has taken a number of initiatives aimed at basic economic restructuring and reform, with the objective of putting the Indian economy on a sustainable path of high growth. I had invited Professor Jagdish Bhagwati and Professor T.N. Srinivasan, two of our most outstanding and internationally recognised academicians, to study the reforms underway and to make recommendations for future action.

2. Professor Bhagwati and Professor Srinivasan have contributed extensively to the analysis of India's economic problems and maintained an abiding interest in Indian economic development. Their report, prepared in an honorary capacity, has been produced at short notice. I would like to take this opportunity to express my deep appreciation for their efforts, which truly constitute a labour of love.

3. The report is being published in the interest of public information and debate on our ongoing economic reforms. I have no doubt that it will contribute to a wider awareness of the urgent issues which need to be addressed as we proceed further.

(Manmohan Singh)
Finance Minister

New Delhi
July 12, 1993

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Useful suggestions were also made by Manmohan Agarwal, Isher Ahluwalia, Swami Aiyar, Abid Hussain, Deena Khatkhate, K. Sundaram, Suresh Tendulkar, Tarun Das, Vivek Dehejia and Fredie Mehta. We are particularly indebted to Arvind Panagariya for extremely useful suggestions on our discussion of trade reforms.

During a visit to New Delhi in December 1992, one of us (Bhagwati) also profited from several conversations with officials from the Ministries of Finance and Industry and the Planning Commission, and with many academic economists and economic journalists, and from a meeting with prominent industrialists arranged by the Confederation of Indian Industry. T.N. Srinivasan participated along with some economists from India in a Seminar on Agricultural Reforms in India at the World Bank. He benefited from the discussions at the seminar and with economists of the World Bank in analyzing some of the issues considered in Section IV E.

While the Report is intended for wide circulation and an audience that would include the Cabinet, the Members of Parliament and the general public, we felt it necessary at many places nonetheless to support our recommendations with extensive economic argumentation. We suggest therefore that the non-economist readers focus on the Executive Summary and also on Sections I and II, in particular, as they are both important to understand the rationale of our reforms and the need for next steps.

Finally, while we cover much ground, we confine ourselves to the broad areas of macroeconomic and microeconomic reforms. The fact, for example, that we do not address issues such as primary education and population control (on both of which and much else each of us has written since the 1970s, stimulated by our work at the Planning Commission on the Third Plan in the 1960s), this does not mean that we attach low priority to these questions. They just do not fit well into the economic architecture that our reforms seek to create and whose dimensions we wish to focus on. Doubtless, the Finance Minister's colleagues in charge of these other portfolios will pursue them with equal energy and steadfastness.

EXECUTIVE SUMMARY

1. The economic reforms initiated by the government in June 1991 have an excellent rationale. The "macroeconomic" situation, both external (the balance of payments) and internal (the fiscal deficit), was unsustainable. The economy's inefficiency had also left us behind in the race for development: our policy framework needed desperate overhaul. This overhaul would necessitate what economists call "microeconomic" or "structural" reforms. The macroeconomic problems, in turn, had been accentuated by, if not largely been a result of, the microeconomic inefficiencies.

2. Explaining the rationale for the reforms, and the principles of reform making as now understood by economists from worldwide experience (in Section II), the Report highlights the need for momentum, building on the reforms to date with a number of new steps which would complete the transition to the new policy framework which will promote greater efficiency, growth and therewith a surer and deeper attack on poverty alleviation. Indeed, in the absence of further new steps, the returns from the existing reforms may be meager, in terms of productivity and export increases in particular, encouraging the critics of the reforms to accuse the reformers plausibly about being in error when they argued for their necessity.

The Report proceeds to spell out these steps, which include actions to consolidate the important and bold reforms already undertaken to date and to correct for mistakes revealed by experience, and also to argue for several new measures which would complement and enhance greatly the efficiency of the measures already taken.

3. In the *Macroeconomic* area (Section III), two pertinent questions are discussed: (1) have we made the necessary cuts in the fiscal deficit in the best possible way; and (2) since we are borrowing externally, as part of our adjustment and otherwise, are we borrowing "too much"?

(1) The cutting of developmental expenditure appears to us to be a little beyond what appears prudent: growth later may be compromised by this, so the government needs to examine this question carefully. On the other hand, the Finance Minister has been accused of cutting "Social Expenditure", thus stabilising the economy at the expense of budgetary cuts in spending on the poor. This is not a valid criticism, however.

On raising revenue, to reduce the fiscal deficit, we think that the tax base needs to be widened and the tax structure also needs an overhaul. The Chelliah Committee's careful recommendations on reforming our tax system need to be accepted and implemented.

In addition, as privatisation proceeds, the proceeds from equity sales should be set aside to retire the substantial accumulated governmental debt instead of being used to reduce the current budget deficit. This would enable us to reduce quickly the burden of interest payments which afflict the budget, while also putting extra pressure on the government to push ahead with necessary fiscal reforms.

Finally, since the banking system is traditionally forced to finance at low cost nearly half of the government's fiscal deficit, financial reform which includes removal of this practice is an essential ingredient in making fiscal responsibility by the government more likely. So is a measure of independence for the Reserve Bank of India which cannot currently play the inflation-restraining role that the independent US Federal Reserve system and the German Bundesbank play. Otherwise, a replay of the 1980s experience with financial excess by the government will remain likely.

(2) On the question of external borrowing, we conclude that we have not borrowed too much. But our calculations suggest that we are close to the margin where, if the returns fall a little, the borrowing may begin to turn counterproductive. Our calculation therefore suggests the critical role of the reforms. If these reforms are completed with the new measures now necessary, then the returns to our investments will indeed rise. But if we hesitate and procrastinate over them, we could wind up having borrowed unwisely.

4. In the *microeconomic* area, we consider several sectors and problems. Among them, the following are important:

(1) *Industrial and Trade Licensing*: We recognise the sweeping nature of the reforms to date. But we draw attention to several problem areas where reforms are necessary to cement what happened so far: (i) the bureaucracy remains a problem despite extensive delicensing: (ii) state-level restrictions continue largely in place and need to be removed if delicensing is to amount to much; and (iii) the liberalisation of imports, and hence effective convertibility, still awaits substantial unification and reduction of the tariff rates and, besides, the imports of consumer goods remain very heavily proscribed. In all three areas, we propose specific steps to be taken, to strengthen the effectiveness of the existing reforms.

In addition, as we move towards freer imports, we will also need to make certain other changes, to establish the institutions that go with freer trade and

which we did not need when we were inward-looking and protectionist. In particular, we need to set up anti-dumping and market-disruption-related machinery to deal with "predatory" trade and with "import surges" respectively.

(2) *Direct Foreign Investment*: We applaud the changes made in our policy regarding direct foreign investment (DFI). But we stress that there is today much competition for DFI around the world and that ambivalence in policy, as in the continuing bureaucratic hurdles, will not help.

Also, in this context, a compromise in regard to the acceptance of intellectual property rules (however "unfair"), as demanded by the United States and in fact by other OECD countries, should be treated simply as a (minor) cost of attracting DFI. For, multinationals now treat the acceptance of such rules as an index of the seriousness of a country in attracting DFI.

Also, we suggest that exploring seriously the possibilities of joining one or more of the existing and emerging trade blocs is now a "must" for India. For, access to one of these blocs is a powerful incentive for multinationals to come in: this in fact is a main reason why President Salinas has been pushing for NAFTA, the free trade agreement with US and Canada.

(3) *Public Sector Enterprises*: We recommend, in light of the enormous weight of these inefficiently functioning enterprises in the economy, that the options of both increased competition (through free entry by the private sector, domestic and foreign; through appropriate changes in price policy, labour laws etc.; through creation of appropriate institutions such as the National Renewal Fund which will improve the profitability of private enterprises and thus put pressure on the public sector enterprises to improve theirs; and through removal of subsidies so that survival under competition depends only on shaping up) and privatisation become matters of urgent policy.

Equally, we suggest that, except for security-related reasons, public sector enterprises should no longer be started afresh except where the private sector is unable to enter and a social need is clearly established for such investment. Again, the policy of acquiring new "sick units" should be totally abolished.

In short, the lessons of unhappy experience with the public sector enterprises in all sorts of countries and with diverse social and cultural traditions suggest that it is extremely hard to make them function efficiently. So, our early optimism, based on a priori thinking, should yield to pragmatism: we cannot afford otherwise.

(4) *Financial Sector Reform*: The need for financial sector reform can

hardly be overemphasised. It is part of the new institutional setup that we must acquire as we escape from the old, inefficient policy framework. Scarce funds have to be channelled to the most efficient uses, and financial sector reforms are critical to that task.

The Bombay scam that became a hot potato has affected the pace of financial reform by creating the impression that it was a product of the limited financial reforms undertaken prior to it. But this is simply false. It is important to distinguish financial sector liberalisation and reforms that are desirable from those that represent undesirable deregulation of a sector that is particularly prone to panics, manias and scams everywhere (including in the UK where the prestigious Bank of England fell victim to the BCCI deceptions and in the US where imprudent deregulation created the S&L crisis).

It is important that, even as we build up the regulatory machinery so that it can perform adequately in the future (though, in the nature of the case, nothing will rule out scams altogether in this susceptible sector), we must push ahead with the demolition of the old and counterproductive rules. We endorse generally the Narsimhan Committee recommendations and their quicker implementation.

(5) *Agriculture*: Finally, in regard to the important sector, Agriculture, we make several recommendations.

In regard to foreign trade in agricultural products, we recommend that quantitative restrictions (QRs) and canalisation be abolished, replacing the QRs with tariffs.

Regarding the Public Distribution System (PDS), aimed at protecting the poor, we make several recommendations to improve its targeting of the poor, so that the cost resulting from extensive leakage to the nonpoor is minimised and more benefits reach the poor even if the subsidies are abolished (as they must) on the macroeconomic ground of reducing the fiscal deficit. The schemes we favour (such as Food Stamps) would also involve the abolition of the Food Corporation of India and its attendant costs.

We also recommend the removal soon of the three major subsidies on agricultural inputs: fertilisers, irrigation and electricity. We cite studies that show that the entire set of reforms, implemented in conjunction with the subsidy removal, is still likely to be favorable to agricultural incentives, as seems to be the case in many developing countries.

Finally, regarding agricultural credit, we argue that the policy of subsidising interest rates helps predominantly the nonpoor farmers and should be withdrawn. The problem for the poor farmers instead is access to credit. This requires the establishment of institutions such as the Bank in Bangladesh. All

this is part of the set of financial sector reforms awaiting the government's action.

5. Finally, if we are to move to an outward-oriented strategy, seeking to exploit trade and investment opportunities provided by the world economy, then we must take appropriate action to ensure that these opportunities are available to us maximally. Otherwise, we would be operating with one blade of the scissors and ignoring the other.

Towards this end, we recommend that India play a constructive role in making the Uruguay Round successful since the alternative is the strong asserting their might as with the Super 301 and Special 301 actions of the United States against other nations (including us) and the breakdown of the multilateral trade discipline that, despite its weakness, provides something like a rule of law benefiting us.

More important, we recommend that India now actively start exploring the options of joining in the free-trade blocs that are in place (EC and NAFTA) and which might emerge (in Asia). Else, it stands in danger of losing out to other countries, members of such blocs, in trade access and in attracting investment.

I. INTRODUCTION

A. India at Crossroads

India is at a crossroads. Intensive economic reforms were launched in June 1991 by the government of Prime Minister Rao and are in mid-course.

The reforms had long been seen to be necessary, though the "political will" to start and sustain these reforms had been lacking until recently. Indeed, steps towards reforms had been taken earlier. But this time, the effort is more sizable, is significant, and has been maintained so far.

It would have been tempting, in view of the recent unfortunate events in Ayodhya and the consequences that they may precipitate in terms of implicit and explicit realignments among the different political parties, to take the easy road and to neglect, even to jettison, the economic reforms for which the Rao government and India have received so much world attention and acclaim, financial support from bilateral sources and from multilateral institutions such as the IMF and the World Bank, and a measure of popular support within India itself.

But that would be a myopic and self-defeating option to choose. Firm leadership, wedded to staying the course, and in fact building visibly and significantly on the gains so far, is necessary if we are to make the transition from an inefficient to an efficient economy, producing satisfactory growth, and therewith a substantial impact on poverty. Successful reforms also offer the only prospect of escaping from the embarrassing dependence on foreign subventions that we have fallen into. True self-reliance, a cherished value, will be realized only when we learn to manage our economy successfully.

Prime Minister Nehru's vision of a strong, independent India, with a sound economy generating rapid growth and reduction of the poverty afflicting many among us, is within our grasp if only the economic reforms are sustained and intensified.

The Finance Minister's budget in February, taking the reforms further in many ways, including in particular the unification of the exchange rate so as to create a "fully" convertible rupee on the trade account, and the Prime Minister's forthright support of economic reforms and their intensification are therefore to be applauded.

The important questions before the government, and the country, now are the following:

(1) Are the reforms, as implemented so far, well-designed in terms of their rationale and relevance to the problems we face; and

(2) what are the next steps that the government must undertake, both in terms of more effective implementation of the reforms already attempted and of the further reforms to be made, in order to bring the reform process to successful completion?

In answering these questions, we will argue that the Indian reforms have generally avoided missteps, perhaps erring on the side of caution but maintaining a prudent but steady course. At the same time, it is important that the government now begin to tackle forthwith a new set of reforms, also discussed in the Report, that constitute logically the next step in the process. These can both cement the reforms already in place and help to earn greater social returns from the reform process. In fact, as we cannot emphasise too strongly, without many of these next steps, some of the key components of the reforms to date could unravel as critics note the limited returns to them and contradictions cause difficulties.[1]

B. Rationale for the Reforms

It is important to understand, and indeed this understanding must obtain at political and bureaucratic levels as well, why the present reforms are necessary. For, only then can the necessary support be adequately mobilised and sustained through the course of the reforms.

As is now well-understood, India faced a macroeconomic crisis that required immediate attention when Prime Minister Rao took office. This crisis had to be attended to forthwith. But, as in many South American countries in the 1980s, the macroeconomic crisis became also the occasion for undertaking substantial microeconomic (or what are sometimes called "structural") reforms that had been long overdue.[2]

In fact, these structural reforms were necessary because we had evidently failed to generate adequate rates of growth of income and of per capita income. Not merely did India's weak performance in this regard fall

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[1] In particular, in the absence of public sector reforms, freeing up the infrastructure bottlenecks, the supply responses to the borrowing and the freeing of trade could be so limited as to cause acute problems with servicing the debt and sustainmg these reforms.

[2] The microeconomic inefficiencies can be aruged to have contributed to the macroeconomic crises in important ways, though. On this question, see Jugdish Bhagwati's 1991 Radhakrishnan Lectures, to be published as *India in Transition: Freeing the Economy*, by Clarendon Press: Oxford, 1993; and especially Vijay Joshi and Ian Little, *India : Macroeconomics and Political Economy, 1964-1991*, Oxford University Press: 1993. We return to this question later, in section IV.

below her own expectations as defined in the First and Second Five-year Plans.[3] It also put India behind many other developing countries, and way behind the superperformers in the Far East.

Figure 1 underlines this forcefully. Using data for 21 "high income" and 88 developing countries since 1960, this chart shows up India's sorry performance.[4] In turn, it can be persuasively argued that the failure to grow also undercut our efforts to create more jobs and thus to pull up more people into gainful employment, thus undermining the main objective of alleviating our massive poverty.

Since our low growth performance cannot be attributed to failure to raise the necessary savings and investment, for we did pretty well (if not as well as the super-successful countries of the Far East) on that score, it reflected our failure to get adequate returns from these rising investments. In short, our policy framework was inefficient, in fact woefully inefficient. We had to contend with deep-seated "microeconomic" flaws.

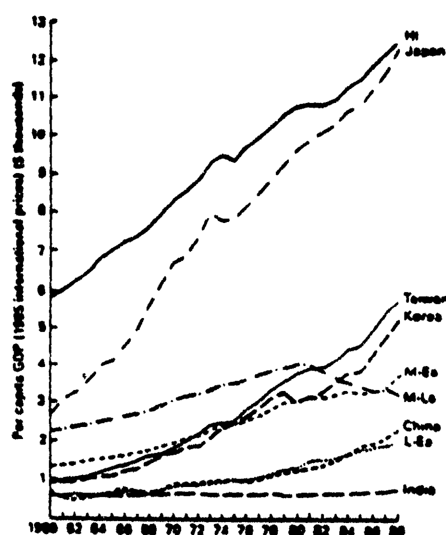

FIG. 1. A comparison of GDP per capita in India and other developing countries, 1960–88
Key.
HI High-income countries
M-EA Middle-income countries in East Asia
M-LA Middle-income countries in Latin America
L-EA Low-income countries in East Asia
Source: The World Bank.

3 The contrast between the actual outcomes and the plans and expectation embodied in the still-earlier and seminal work of the National Planning Committee of the Indian National Congress, constituted under the chairmanship of Pandit Nehru in 1938 is considered at length by T. N. Srinivasan in "Indian Economic Reforms : Background, Rationale, and Next Steps," Economic Growth Center, Yale University (mimeo), April 1993. This paper also illuminates how longstanding the beliefs are about the earlier developmental strategy which the reforms seek to abandon in light of experience, and hence also the passion with which some critics object to the reforms. We have drawn on this paper in writing several sections of this report.

4 The comparative growth rates are assessed more carefully in Bhagwati, *ibid.*

The macroeconomic crisis thus provided the opportunity and the necessity finally to address meaningfully the inefficiencies in our policy framework that had hurt our economic performance and to begin seriously the task of undertaking the necessary microeconomic or structural reforms as well. These reforms, necessitating an exhaustive restructuring of our policy framework, had become critically necessary.

Indeed, it is necessary to appreciate that we had become marginalised in the world economy. Not merely were our growth, and hence all else such as poverty alleviation, unsatisfactory, the multiplying success stories were to be found elsewhere. Increasingly, many of our economic policies were also seen as wittingly foolish, impossible to explain as sensible. Among these were our maze of senseless bureaucratic controls on production and investment. Perhaps the most compelling reason for reforms was then to clean the house and to restore India eventually to the position of respect in the world economy and polity that she enjoyed during the years of Prime Minister Nehru's stewardship.

C. The Report

The rest of this Report is therefore structured as follows.

In section II, in view of the importance of clarity concerning the nature and objectives of the sweeping reforms for a healthy public debate and in order to ensure the successful execution of the ongoing and future reforms, we address the broad principles concerning the design and implementation of policy reforms that the government needs to keep in mind.

Section III then addresses briefly the strictly macroeconomic questions raised by the reforms. These concern naturally the issues of fiscal stabilization, monetary restraint and currency convertibility. [In turn, of course, each of these has microeconomic implications. For example, the removal of subsidies to reduce the budget deficit will bear directly also on efficiency in agriculture and in public sector enterprises.]

We conclude that the stabilization policy is on track, but that certain correctives are in order. In particular, the reduction of the fiscal deficit through cutting developmental (capital and human) spending creates the possibility of adverse long-run consequences for efficiency and short-run consequences for equity that the government is aware of but needs to address more adequately. In regard to convertibility, the trade account convertibility that was achieved to date had been qualified by the absence of a unified exchange rate and, more important, by the continued trade restrictions in the form of high tariffs on most goods and severe quantitative restrictions (QR) on imports of

consumer goods. Steps towards the eventual completion of effective convertibility by steadily removing these two qualifications needed to be taken. The February 1993 budget has already unified the exchange rate for most current account transactions and made modest cuts in tariffs. The introduction of substantial uniformity in tariffs and further phased reductions in their level are now required. And liberalizing consumer goods imports must also now be on the agenda.

Section IV considers, in more depth, the microeconomic reforms that constitute the core of the changed policy framework that will take the economy into a more efficient mode. Since the rationale for many of the reforms (such as the dismantling of the Kafkaesque licensing system) is now widely appreciated, we focus instead on the key issues that now require attending: among them the further liberalization of the import regime, further reform of the direct foreign investment (DFI) policy, the question of privatisation, and reforms in our critical Agricultural sector.

Section V considers broader questions of foreign economic policy on which we must begin to focus immediately if the transition to the New Economic Policy is to be successful. In particular, we consider, in view of India's transition to an outward-oriented economic strategy in regard to trade and foreign investment, the need to consider, among other issues, how India is to fit into the growing trend towards regional blocs in world trade and what we should begin doing about it.

Section VI concludes the Report.

II. DESIGNING AND IMPLEMENTING REFORMS: PRINCIPLES

At the outset, some issues concerning the design and implementation of reforms may be discussed. There is now a growing literature in economics on these questions, reflecting both theoretical analysis and empirical examination of the reform efforts in several developing countries. Its insights need to be adapted to the Indian situation and some key lessons learnt and applied.

A. Common Misunderstandings

Since the reforms are both sweeping and often "liberal" in the sense of removing several harmful constraints (on domestic production and investment, on foreign trade and on foreign investment) and permitting a far greater role for market forces in guiding the economy than hitherto, it is natural that they should create serious misunderstandings, and hence roadblocks to the reforms, unless they are properly understood and, in turn, explained to the populace by the political leadership at every opportunity. There are four specific misunderstandings that are fairly common today and need to be cleared up.

1. "We are turning to laissez-faire"

Occasionally, one hears that the Rao government is turning away from "planning" to "laissez-faire".

It is indeed true that the proposed reforms are, in key respects, aimed at allowing a greater play for markets where bureaucrats and politicians were wholly dominant in decision making. In short, the reforms are intended to remove the government from areas of economic decision-making where our own and more extensive international *experience* (not *ideology*) has shown in the postwar period that governments harm, rather than help, the developmental process.

In short, governments tend to do certain things badly and must be kept away from them. But their role continues to be important in other areas, especially in poor countries. The reforms are thus aimed at taking the government out of some areas and concentrating its energies on others. They aim to refocus policy intervention, not to eliminate it. The reforms are about "appropriate intervention", not about laissez faire.

This is not to say that we are not having to challenge vested interests and defunct ideas on how to manage (or, shall we say, mismanage) the economy. Thus, the extensive framework of detailed licensing and control of production, investment and trade will have to be virtually abandoned. The efficiency of our many public sector enterprises has to become a primary question, necessitating a revision of the earlier hands-off approach to them. We cannot continue treating this sector as a sacred cow, revered and worshipped but often decrepit

and destitute. Extensive privatisation and other changes aimed at efficiency will lead eventually to a lower (even terminated) governmental presence and role in those enterprises that survive the reforms as productive units in the economy.

None of this adds upto laissez-faire, i.e. the injunction to let governments do nothing. Even the reform process will require imaginative governmental design and management! And, at the end of the reform process, the government will be heavily involved in the economy: through fiscal and monetary management, in education, in public health, in trade management abroad at the GATT and in bilateral negotiations to assure market access, in science and technology policy, in financial sector regulation, in advancing environmental protection, and indeed in much else that cannot be left entirely to the market place.

Indeed, even if laissez-faire were the objective of some academic reformers, one need not fear that it will arrive. Governments get elected to do things. To expect that they will oblige by self-destructing as per an agenda of laissez-faire is to be utopian, at best, and silly, at worst.

2. **"We are abandoning poverty alleviation for growth"**

If the Rao government then needs to educate the public that we are not abandoning the government's role in the economy but simply refocusing it to make it far more effective, the need to emphasize that we are not abandoning poverty alleviation in favour of efficiency and growth is equally great. For, quite correctly, those who stand for laissez-faire and those who do not share the view that the elimination of poverty has to be our principal task are not likely to have many followers in India.

The problem in Indian debate arises from the tendency of many to think that the economic reforms, since they favour efficiency and growth, must be against poverty alleviation. This is however an "anti-growth" misunderstanding, pitting growth against poverty, that reflects in turn three different misconceptions.

(a) "*The removal of poverty requires anti-poverty programs, not growth*": This view is wrong on two counts. Growth will generally create jobs, pulling people up into gainful employment and hence out of poverty. It is an "indirect" anti-poverty strategy and was, in fact, embraced as such from the beginning of our postwar developmental efforts. The failure to achieve satisfactory growth, *not* the emphasis on it, lies at the heart of our failure to make a more effective dent on poverty.

not

Next, even our ability to finance governmental support of "direct" anti-poverty programs will be crippled if growth yields to stagnation. Low growth means growing inability to raise the revenues without which governmental

programmes cannot be financed. This is partly the reason why, around the industrial world, the low growth rates of the 1970s and 1980s have led to growing strains on the budget and to attempts at pruning the welfare state.

(b) "*The planners in India until the 1980s treated growth as their target and neglected poverty in consequence*": The anti-growth sentiment has also flourished in India because of the ready assumption that, until the 1970s, the Indian leaders and planners were unmindful of poverty alleviation as their objective and enamored instead of growth in itself. Now that efficiency and growth have become an important motive for economic reforms, it is thought that we are regressing back to the old ways.

But there is no basis in reality for these views. From the beginning, growth was regarded as a way of impacting on poverty, rather than as an end in itself.[5]

The pronouncements of Prime Minister Nehru, the contents of the earliest Five-year Plans and the strong stress from the 1960s by our planners on "minimum levels of living" are evidence of our clarity on these questions, and of the obfuscations by those who allege that poverty was not our earliest concern and objective and of their self-serving claims that they somehow redefined our objectives away from growth towards poverty-alleviation in the 1980s.

(c) "*Growth is a conservative 'trickle-down' strategy*": In turn, these critics have alleged that growth amounts to a passive, conservative "trickle-down" strategy. This too misses the point. In our context of immense poverty, growth represents an activist, radical "pull-up" strategy for removing poverty. And that is exactly how we thought of it when we were planning our assault on poverty from the early 1950s.[6]

The issue before us then is not the artificial one of growth *versus* poverty. Rather, it is one of how, given whatever resources we deviate to growth, we get the maximum payoff in growth and in job creation. In short, how do we redesign the policy framework that has worked so inefficiently and produced such disappointing results? That is precisely where the economic reforms come center stage.

3. "We are yielding to foreign pressure"

The fact that the reforms were part of the conditionality that came with multilateral assistance has also created the impression that they are a result of foreign pressure. In turn, there is the notion that the ideas and policies being imposed on us are foreign and also that they are ill-designed, in consequence, for us.

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[5] This is manifest also from the deliberations of the 1938 Nehru Committee, referred to in Srinivasan, *ibid*.

[6] This is not to say, of course, that those among the poor who are weakly connected with the growth process because of their social or economic circumstances would not be left poor despite growth. Our planners equally recognized the need for special measures to assist these groups.

Indeed, it is true that, without the crisis being on us, the initial adoption of the reforms may have continued to be postponed. Our earlier efforts at initiating and sustaining them had been hesitant and limited, at best. Conditionality played a role, for sure, in strengthening our will to embark on the reforms. But the seriousness and the sweep of the reforms, and the Rao government's explicit embrace of them as against the earlier "reforms by stealth", demonstrated that the driving force behind the reforms was equally, even overwhelmingly, our own conviction that we had lost precious time and that the reforms were finally our only option.

The complaint that the ideas being implemented are extraneous does not reflect the reality either. These reforms in our, and indeed in many other developing countries' policies, were being advocated from the early 1960s and the proponents, the pioneers, included Indian economists.[7] It is ironic, in fact, that these ideas, rejected at the time by our authorities and by many of our economists as well, have now been adopted worldwide but have come to be adopted by us only at the end of this revolutionary change. Indeed, these ideas have been recycled back to us, in many cases, by the staff of the multilateral institutions who learnt them from our own pioneering economists. The claim that the ideas are foreign and hence ill-suited to us is therefore incorrect. In any event it is surely odd and indeed counterproductive to accept or reject ideas based on where they are coming from!

4. "We are turning back on all we did earlier"

There is also an understandable feeling that the reforms imply that everything we did earlier, from Prime Minister Nehru's time, was a failure.

In the critical areas where the reforms are concentrated, this is indeed largely true. In some cases, the mistake was not in the original policy but rather in not abandoning it as circumstances changed or became clearer. This is the case with our import-substitution policy which was premised on export pessimism which was widely shared in the 1950s. But as it became evident in the 1960s that this export pessimism was unwarranted, in view of the rapid growth of world trade and the fact that the Far Eastern economies, in particular, had used export opportunities arising from that growth to great advantage, we should have turned more confidently to similar outward-orientation. But we did not, even though these changed circumstances were evident and had been noted by some of our economists at the time.

Then again, the policy of expanding the public sector through increasing investment in successive Plans reflected, at least in part, the early assumptions that the public sector enterprises would be efficient and that they would also generate financial surpluses for the government and help therefore to increase

[7] Cf. Bhagwati, *ibid.* 1993, for further details.

national savings and investment. Already by late 1960s, these assumptions were being seen as unrealistic; and economists began to see that there were serious incentive problems that led to these outcomes almost everywhere, no matter what the political and social situation in a country. But we have been among the last countries to draw this lesson and act on it.

The reforms naturally focus on the areas where we have failed, either from the beginning or because of lethargy in changing course as necessary. But this does not mean that we have failed everywhere. Chief among our achievements is our success at managing democracy -- an achievement that has scarcely been rivaled by another developing country in the postwar period. Within the economic sphere too, we have some success stories, in agriculture for instance.[8]

When the reforms are taken to the public by the government, it may well be sensible then to present the successes as well as the failures which the reforms address. Then again, the presentation of the reforms as necessary since policies that "made sense earlier" are "inappropriate now" may be politically more prudent than to claim, as is truthful, that many of these policies were simply wrong.

B. The Need for Clear and Repeated Affirmation of Reforms

The government needs therefore to educate the public continually about the foregoing misunderstandings, and every important Minister of the cabinet and every available occasion must be exploited to do this and thus to put the rationale and importance of the reforms before the public. If this is not done, the reforms are likely to lose support as misunderstandings multiply and acquire cogency simply because no coherent rationale and defense of the reforms is available.

To some extent, the slowdown and aborting of the reforms under Prime Minister Rajiv Gandhi could be attributed to this failure of articulation: the efficiency-oriented reforms were often misinterpreted as "yuppie" yearnings out of tune with India's poverty needs when, in fact, they could have been explained as truly anti-poverty measures which would improve our ability to pull more of the poor into gainful employment.

This would also enhance the credibility of the reforms. Without sustained and repeated affirmation in the public domain of the reforms, the past history of reform efforts will continually provoke doubts about the government's determination to stay the course.

[8] While agriculture has been generally successful in India with the average growth rates being 2.5% and 3.1% per annum in 1965-80 and 1981-1990 respectively, performance has been better in other countries, e.g. Kenya, Pakistan, Indonesia. Our success rather has been in the dramatic increase in the output of wheat since the adoption of the green-revolution technology in the mid-60s.

The credibility of reforms is necessary because, without it, firms and other decision-makers will not take the decisions that would make the reforms successful. For instance, if it is assumed that the government will revert to licensing and exchange controls on trade, investment in export promotion will be inhibited and a central objective of the delicensing reforms will have been frustrated. To take another example, the continuation of the FERA and COFEPASA machinery and controls on direct foreign investment (DFI) cannot but fail to make the removal of many restrictions to attract DFI less than credible to foreign investors: this machinery, and the numerous difficulties and roadblocks still in place, mix the signals badly (whereas China, for example, which is attracting dramatic amounts of DFI, sends very clear and credible signals indeed by contrast).[9]

C. **The Need for Momentum**

It is important also to have the reform process building momentum rather than losing steam. There are several reasons why cascading reforms are likely to be more successful.

(i) A blitzkrieg of reforming measures represents a moving target for opponents, making it more difficult to concentrate criticism than when the target is static.

(ii) Often there will be economic complementarities in the reform process. Thus, industrial delicensing is more effective if the current account has convertibility. But the latter is trickier to implement. So, you begin with the former and pursue the latter in a more measured way, as is indeed the case with our reforms.

(iii) If the momentum builds steadily, the credibility of the reforms also gains in the process and so does their prospect of success.

The Rao government has indeed maintained a momentum in the reforms, with changes coming in a steady torrent over a wide range of areas and at every opportunity as in the February 1993 budget. But the time has now come, as we propose below, for a further shift of gears. This is necessary, not merely because it is logical to build on what has been done so far (as we argue in the next subsection) but also because the Ayodhya tragedy and its aftermath created initially some skepticism abroad in regard to the government's ability to pursue reforms further.[10]

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[9] The issue of credibility in ensuring the success of economic reforms has now been studied extensively and is recognized as a key component of successful reforms. See, for instance, the excellent discussion of the issue in Dani Rodrik, "Promises, Promises: Credible Policy Reform Via Signalling", *Economic Journal*, vol. 99 (1989), pp. 756-772.

[10] This skepticism related, in the foreign press, both to the added strain on the budget from increased expenditures on law and order and to the possible need of the Rao government to bring the leftwing political parties on board against the BJP.

D. The Need for Comprehensiveness

A broad sweep in the scope of the reforms is also advisable. This is partly because, as we just argued, complementarities increase the efficacy of one reform if another is also undertaken.

But it is also a result of the fact that reforms entail pain because of the adjustments that they impose, forcing at minimum a change in one's way of doing business. If the reforms are extensive, more people are likely to be involved in the pain, thus making it a "shared sacrifice" in the national interest and moderating opposition from any one group in particular.

E. The Speed of Reforms

Perhaps the hardest question to answer relates to the optimal speed of reforms. Opinion seems to divide typically into two camps: those who are impatient to go faster and those who cannot go fast enough.

From the economic point of view, the problem is quite complex. It is also true that the effective speed at which reforms may be implemented is, in any event, beyond the economist's control since some reforms will simply take their own time to get down on the ground. For example, one may want to immediately privatise all public enterprises; but finding buyers may take a long time.

Then again, political factors must be taken into account in implementing reforms. If reforms are undertaken without attempting to build up a reasonable measure of political support, the whole experiment may backfire.

Thus, for instance, the Rao government, already beset by charges of a "sellout", would have been probably unwise to privatise the public enterprises right away: it might have helped cement leftwing opposition to the rest of the reforms. Nor would it likely have made political sense to embark immediately upon an exit policy aimed at relocating the labour force away from inefficient plants and firms: without adequate economic and political preparation to do this, the government may well have precipitated major political opposition of a kind which a fragile government might succumb to.

Thus, it is hard to double guess the government's speed of reforms. It might conceivably have moved faster in some areas. But the fact remains that it did move decisively on many fronts and has not seriously backtracked on any of its major reforms. One *can* say, however, that the time is now ripe for added reforms.

F. The Need for Institutional Change

This is particularly so because the reforms that we have undertaken so far, especially in industrial and foreign-trade delicensing, amount to a radical change in the functioning of the economy that requires substantial,

complementary institutional changes if they are to be truly effective. And these institutional changes are the ones that need now to be undertaken with vigour.

An analogy with the former Soviet Union should illustrate well what we have in mind. The Soviet Union was afflicted with even more sweeping controls over production, trade and investment, with an overwhelming role for central planning and virtual absence of private ownership of the means of production when reforms were begun under President Gorbachev. The intention was to shift to a market economy. But the institutions to support such a market economy were often wholly absent. Thus, for instance, when Party control over food procurement disintegrated with *glasnost*, it became increasingly difficult to procure food at low prices for distribution at subsidized prices in the state-owned city shops: the farms simply sold the food at higher prices in the rural areas and the city shops soon had empty shelves. The problem was that fiscal policy instruments had not been put in place when the old "command" system had collapsed[11]. Then again, the response of production and investment to price signals was inhibited in the absence of private ownership of productive capacity in most sectors: this contributed to chaos as the command system collapsed but the institutional requirements of a functioning market system were still not in place.

Our reforms do not pose stark problems of the Soviet variety since we have already had a functioning market economy. But the heavy hand of extensive licensing did mean that we had no significant role earlier for an efficient financial sector (which would help allocate investible resources among alternative claimants) since investments were decided upon by the government, or for an efficient labour market with adequate possibilities for labour reallocation because both firms and labour were, for the most part, effectively protected against the rigours of the marketplace in the shape of competition and possible bankruptcy.

Thus, as we are now effectively entering a delicensed system, it becomes necessary to adapt our institutions forthwith to include financial and labour-market reforms, in particular. The energetic pursuit of these reforms, difficult as they appear, must now be on the government's agenda.

G. Meeting Expectations

Finally, the art of designing and implementing economic reforms must also extend to the task of holding expectations from reforms within manageable bounds while the reforms take root.

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[11] For a fuller analysis of the Soviet experience, see Padma Desai, *Perestroika in Perspective*, Princeton University Press: Princeton, Updated Paperback Edition, 1990, page 154.

What we said so far related to the substance of the reforms and to the task of ensuring that their credibility was maintained for economic decisionmaking to respond so as to make the reforms successful. This would ensure that expectations concerning sustained support for the economic reforms and their momentum would be satisfied.

But expectations about their success, in terms of results, also need to be taken care of. Else, support for them would begin to wear thin. This is, of course, a corollary to the concern of our earlier planners: that the "revolution of rising expectations" would be hard to meet and therefore might lead to a corrosion of the developmental programmes.

The problem has been a difficult one for the Rao government, of course. Partly, this is because the macroeconomic need to stabilise the economy inevitably reins in the economy and dampens the growth of output that the microeconomic reforms would generate. Thus, in an ultimate irony, while the macroeconomic crisis made the microeconomic reforms politically possible, it makes their success slower and hence more difficult.[12]

Partly, the difficulty comes also from the fact that the results often will not be large immediately.[13] There are time lags. Besides, the efficiency of some measures already taken will improve only as others are taken now, as explained earlier. Even in countries like Mexico, where the last decade has witnessed major reforms, the effect on the growth rate has been much less than dramatic, though the high inflation has been brought under control and the economy now seems poised for a major takeoff.

But it is clear that the payoff will be a function of the sweep and depth of the reforms: a proposition that is demonstrated well by China's rapid growth under its substantial economic reforms. The government must therefore proceed, for this reason as well as the others outlined earlier, to build rapidly on the reforms so far.

So much for the general principles of economic reform, many already implicitly underlying the strategic decisions undertaken by the Rao government to date but nonetheless necessary to appreciate if the reform process is to stay on course and if general support for it is to be maintained in the country. We turn now briefly to the macroeconomic reforms (Section III) and, at greater length, to the microeconomic reforms that await further action (Section IV).

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[12] At the same time, of course, microeconomic reforms without macro-economic stability are unlikely to be productive and unlikely therefore to take bold.

[13] Exceptions will typically arise, however, when the initial inefficiency in a sector being reformed is very high and the reform removes that inefficiency directly, as happened with the effects of Chinese decollectivisation of communes.

III. MACROECONOMIC REFORMS

A. The Macroeconomic Crisis

The Indian macroeconomic crisis was precipitated mainly by the growth of the public spending through the 1980s that increased the budget deficit as a proportion of our GNP, although external shocks played a fortuitous contributory role.[14]

The state of our public finances had indeed reached crisis proportions by the end of the 1980s. The public debt-to-GNP ratio increased through the 1980s, going up to almost 60% at the end of the decade, implying a doubling of the ratio at the end of the previous decade (see Figure 2). As is now wellknown, the proximate reasons for this situation were the failure of the public sector to generate investible resources and the explosive growth of governmental current spending that saw the budget deficit as a proportion of GDP rise from 6.4 to 9% during the 1980s.[15]

The question must be addressed:[16] did the microeconomic inefficiencies have anything to do with this, or was "profligacy" the true, final and sole cause of the macroeconomic crisis? Evidently, it was the former.

Of course, the failure of the public sector enterprises to generate profits (and hence their contribution to the macro crisis) is a microeconomic efficiency failure. But, in turn, because these enterprises have dominated the provision of infrastructure and critical intermediates, their inefficiency has led to downstream inefficiencies in a multiplier fashion. Then again, the restrictive trade and industrial licensing framework, for instance, led to serious loss of efficiency by reducing the scale of output, eliminating effective competition, creating bottlenecks, and in myriad other ways. The result was to reduce the returns from our investments and our growth rate. In turn, surely the revenues raised from the economy, for any given tax rates, were adversely affected, the political ability to raise tax rates in a situation of slowly-growing incomes was impaired, and the necessity to undertake budgetary expenditures to support the

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[14] An analysis of our public finances, and their contribution to the crisis that engulfed India, can be found in Joshi and Little, 1993, *op. cit.*, and Bhagwati, 1993, *op. cit.* The barest essentials are treated here.

[15] More detail on the budget deficit is provide dbelow where we discuss the stabilization effort since 1991

[16] The reason to address this question is that some leftwing criticism of the new reforms tends to assert that microeconomic inefficiencies are being exaggerated and liberalisation is being smuggled in under the misperception that the old micro policies caused a crisis. Cf. Deepak Nayyar, "Indian Economy at the Crossroads: Illusions and Realities:, *Economic and Political Weekly*, April 10, 1993 and the forceful critique of it by Manu Shroff, "Indian Economy at the Crossroads", *Economic and Political Weekly* May 8, 1993

creation of public-sector jobs and for consumption were also increased--all factors contributing to the budget deficit crisis.

The two OPEC shocks of 1973 and 1979 hurt, but did not have a sustained impact on the budget deficit. The external shock administered by the loss of remittances and the expenditures incurred to rescue workers in the aftermath of the invasion of Kuwait in August 1990 certainly accentuated the fiscal crisis at the end. But the crisis was certainly "home-made".[17]

The rise in foreign borrowing was a major component of the fiscal crisis, reflecting in turn the excess of domestic expenditure over income.[18] Thus, as evident from Figure 2, the external public-sector debt (and not just the domestic public-sector debt) increased greatly as a proportion of GNP during the 1980s, rising to 21% by 1987-88. This increase in external indebtedness meant that debt service as a proportion of exports increased more than threefold to 32% in 1986-87 from 1980-81.

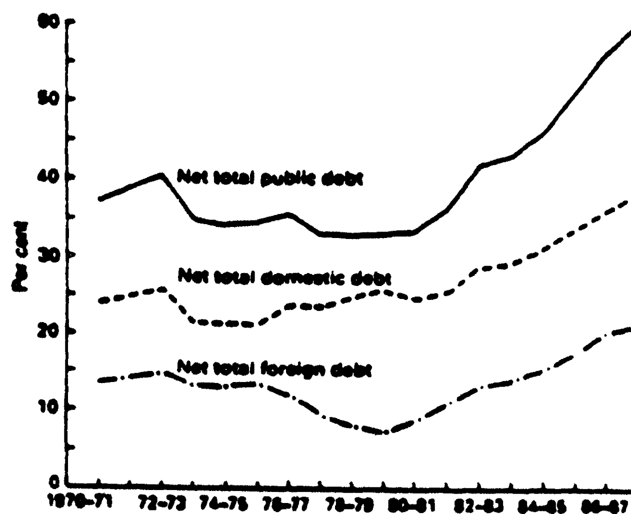

FIG. 2. India's net public debt to GNP ratios, 1970–87
Source: W. Buiter and U. Patel, 'Debt, Deficits, and Inflation: An Application to the Public Finances of India', *Journal of Public Economics*, 47 (1992), 171–205.

[17] Cf. Willem Buiter and Urjit Patel, "Debt, Deficits and Inflation: An Application to the Public Finances of India", *Journal of Public Economics*, 47 (1992), pp. 171-205; and also Bhagwati, 1993, *ibid.* and Joshi and Little, *ibid.*

[18] One can legitimately ask whether the inflow of foreign capital was "exogenous" and "primary", leading to an "accommodating" *ex post* current-account deficit and excess of domestic investment over savings, just as the Reagan administration claimed that the US payments deficit reflected capital inflow that came in because of confidence in the US rather than was driven by excess spending, primarily fuelled by the budget deficit. Our view is that, while our long-term foreign aid inflows are properly considered to be exogenous in this sense, the foreign borrowings in the 1980s, as by the public sectors noted in the next, were in the main reflective of the governmental excessive spending we focus on below. Even the NRI loans, attracted by offering generous returns that exceeded the rates in capital markets, can be viewed as reflecting the increasing inability of the government to balance the budget and hence to dampen the resulting pressures on inflation and on the balance of payments.

In fact, reserves plummeted to less than ten days of imports by the beginning of 1991, prompting borrowing from the IMF in January of loans worth $1.8 billion and then again, as reserves fell perilously low again and the prospect of NRI-deposit withdrawal and of overnight-borrowing recall a worrisome reality, in October 1991.

The macro imbalance, fuelled by the budget deficit and financed by the external borrowings and the decumulation of reserves, was accompanied by accelerated inflation to double-digit levels. Evidently, a stabilization programme, reversing the growth in the budget deficit and tightening monetary policy, was called for. This, the reforms initiated by the Rao government sought to do.

The Fiscal Deficit And Remedial Action

The key question then is not whether the stabilisation was called for: there was no option. Rather, it is: has the stabilisation been carried out in an appropriate fashion? We answer this question now, concluding that some correctives are in order. In particular, we draw attention to the following areas of concern and remedial action:

*the reductions in developmental expenditure appear to be taking the brunt of the successful effort to cut the budget deficit: this could create difficulties down the road;

*there is scope for further cuts in nondevelopmental expenditure, especially in regard to the emoluments and size of the bureaucracy, and subsidies to public sector enterprises (whose reform we discuss separately below) and to agriculture (also discussed separately in Section IV below);

*there is need to raise more revenue by expanding the tax base, while the reforms recommended by the Chelliah Committee are considered for adoption; and

*a sound management of monetary policy in the interest of financial stability requires that the financial sector reforms (which we discuss separately below) be implemented at greater speed.

(a) Developmental Expenditure

The reduction of the budget deficit, the principal proximate cause of the macroeconomic crisis, was inevitable. But the difficult problem is to decide whether the government chose the best way of reducing that deficit. In short, two major questions arise: has the government raised revenues or relied entirely on cutting expenditure; and have the cuts in expenditure been too unmindful of

the need to take the longer view on developmental expenditure and the need to soften the impact on the poor? We begin by considering the question of developmental expenditure.

That the reduction in the budget deficit has been brought about partly by a reduction in developmental expenditure cannot be denied. For example, while the overall developmental revenue expenditure of the Center is budgeted to remain virtually unchanged in 1992-93 in nominal terms at Rs. 207 billion (compared to the revised estimate of Rs.214 billion in 1991-92), non-developmental expenditure is budgeted to rise from Rs. 472 billion in 1991-92 to Rs.538 billion in 1992-93 --- an overwhelming part of the increase, roughly Rs.48 billion, being the rise in interest payments on domestic and external debt.[19] [The consolidated budget data for 1992-93 for state governments were not available to us as of the date of finishing this Report; but it is unlikely that they would show any offset to the above categorisation by revealing that their developmental expenditure had increased substantially.]

At the same time, the Center's developmental expenditure on capital account has also registered only a negligible increase in nominal terms: from the revised estimates of Rs.57 billion in 1991-92 to Rs. 63 billion in 1992-93. It is highly probable therefore that the overall governmental expenditure in real terms during the course of our stabilisation has been significantly at the expense of developmental expenditure in the revenue and capital accounts. Three comments are in order.

First, the developmental expenditure links directly to the long-term health of the economy. The reduction of developmental expenditure is likely to reduce the growth rate and therefore to come to haunt us in the shape of further pressures to resume excess spending through the budget as in the 1980s.

We are aware that, simply because expenditures are classified as developmental, they are not so, whereas nondevelopmental expenditures may have productivity and growth effects. Also, cuts in developmental expenditure may be offset by improved efficiency: but this will not happen unless major reforms, especially in the public enterprises, are undertaken with due speed.

Second, therefore, the reliance on (real) cuts in developmental spending holds danger that must be moderated by reforms in the public sector. These reforms will have to include (as we propose below) opening the reserved areas fully to private sector and far more liberally to foreign investment, an energetic demolition of any obstacles in this goal (e.g. price policy restrictions, labour laws that are antagonistic to efficiency and can be altered without sacrificing

[19] We consider below the question of addressing the interest cost of the debt (a problem afflicting many countries, including the United States, currently), in the context of the question as to how to use the proceeds from selling equity in the public enterprises that are being privatised.

internationally sanctioned rights), a speedier policy on privatisation of a large number of the existing public enterprises, and a decision to hold back from creating new public sector enterprises in except when security considerations dictate otherwise.

Third, the cuts in (real) developmental expenditures by the government may well affect adversely the private investment expenditures in the economy, creating deflationary impulses in addition to those that the government had intended. Because crucial infrastructure activities are in the public sector, and private investment finds its returns dependent on the availability of these infrastructure inputs (such as power), private investment has traditionally been crowded in, rather than out, by public investment in these infrastructure sectors.[20] Thus, the government must make every effort to ensure that, despite predictable political pressures, the reductions in developmental expenditure are brutally selective, sparing areas where the infrastructure bottlenecks are currently quite severe.[21]

(b) Cutting Non-developmental Expenditure

Cuts in nondevelopmental expenditure are difficult to make. But there are areas where they are necessary, not merely in themselves but also because of their effects in improving productivity in the economy. These desirable cuts relate to subsidies of various kinds, chiefly in two areas: budgetary support to loss-making public sector enterprises and subsidies to agricultural inputs (fertilisers, irrigation and electricity) and to outputs (through the Public Distribution System).[22] We consider these reforms in the wider context of reforms in the Public Sector Enterprises and in Agriculture, in separate sections of the Report below.

The question of Social Expenditures, or "safety nets" to be more precise, especially with a view to protecting the poor from the effects of stabilisation, is also a compelling one. The Finance Minister has been criticised for ignoring this aspect of the stabilisation issue, with talking about it but ignoring it in his actions, and even with complying more with the concerns of the IMF and the World Bank regarding the efficiency aspects of stabilisation rather than their equity exhortations.[23] This criticism is however exaggerated, at best.

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[20] This was demonstrated in T.N.Srinivasan and N.S.S. Narayana, "Economic Performance since the Third Plan", *Economic and Political Weekly*, Annual Number, 1977.

[21] Of course, if such spending is highly unproductive in any particular segment of the public sector, then that consideration should override what we argue above, in favour of a high-priority shift to the private sector through privatisation and other policies encouraging private entry.

[22] We might stress here itself that the cuts in the PDS can be made as part of a sweeping reform of the system so that it is much better targetted to the poor whom we seek to support. This is spelled out at length in our treatment of the PDS and its reforms below.

[23] See, in particular, Sanjaya Baru, "New Economic Policy: Efficiency, Equity and Fiscal Stabilisation", *Economic and Political Weekly*, April 10 1993: "Having chanted the 'safety net' mantra, Singh's letter [to the IMF] proceeds to focus the entire attention on the programme of action on fiscal, trade and tax reform." (page 715).

The aggregate expenditure on what are generally considered "social sectors" (defined as Agriculture and Cooperation, Food, Health, Education, Women and Child Development, Rural Development etc.) did go up from 15.4% of total government expenditure to 15.7% between 1991-92 and 1992-93, with the nominal expenditures by the central government in Health and on Women and Child Development showing growth rates of as much as roughly 40 and 21 % respectively.[24] Admittedly, the total expenditures are small in any event. But then is not the Finance Minister right that it is the lack of efficiency and growth that has driven us into a situation where our capacity to increase such expenditures dramatically has been sapped, and that the stabilisation, once it takes root, and only the completion of the reforms (which must include an expeditious implementation of many of the new steps we recommend in this Report) will put us back into a situation where we can undertake these necessary increases in expenditure. Talk is cheap; and one's social conscience can be readily stroked by such talk. What counts, as the Finance Minister has made amply clear, is the ability to deliver on such talk. Talking about poverty is not to alleviate it.

(c) Raising Revenue

The Indian tax system is in need of reform. The fiscal base is narrow and the structure of taxes is inefficient. The government is well aware of these problems, having commissioned and now secured the Chelliah Committee report on Tax Reforms. We need only to endorse the generally excellent set of proposals made by the Chelliah Committee, except to state that, in the Sections below on Agriculture and on Consumer Goods Import Liberalisation, we make further, somewhat bolder suggestions (which, however, are in consonance with the spirit of what the Chelliah Committee recommends).

(d) Public Sector: Proceeds from Privatisation

We consider public sector enterprise reform below. But we address here the question raised by the use of the sales proceeds from the limited sales of equity so far. These have been treated as revenue receipts to reduce the current budget deficit. Is this a wise decision or, as has been suggested by some economists, should we use these proceeds to retire our considerable debt?[25]

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[24] In this context, the establishment of the National Renewal Fund also needs to be cited as an institutional innovation designed to ease the adjustment problems of the workers as stabilisation and microeconomic restructuring prompt the laying off of workers from enterprises that must close or retrench. We might also remind ourselves that, as Professor P.C.Mahalanobis noted long ago ("The Asian Drama: An Indian View", *Sankhya*, Series B, Vol.31, 1969), the welfare benefits extended to organised-sector urban workers under our labour laws accrue to a very small fraction of the work force and could operate both to introduce inequality and to inhibit growth that would benefit those not covered by these labour laws. His remarks on the absence of a link in India between productivity and wage as well as the excessive fringe benefits enjoyed by civil servants continue to be relevant. His proposal for a Labour Reserve Service is worth considering.

[25] This alternative has been suggested most forcefully by the economist Deena Khatkhate.

In principle, whether these sales proceeds are used to reduce the current budget deficit or to retire debt would not be a meaningful question if only the overall simultaneous choice of the two objectives were made in the light of the fact that these sales proceeds were available to the government: otherwise, we would be guilty of the fallacy of misplaced concreteness. The issue, however, is a very real one: for, it is being asserted that the government is avoiding such a principled choice and is in fact taking the easy way out of not raising revenues or cutting expenditures or both by pretending that these sales proceeds are revenue. If this is true, and we suspect that this may be true or might become true as sales proceeds continue to accrue from further privatisation, then a rule that allocates these proceeds to debt retirement might be a good idea. Consider then the following.

Thus, the Center's internal rupee debt as a proportion of GDP has increased from 35.6 % in 1980-81 to 53.3% in 1990-91. It has declined somewhat as a result of greater control over the fiscal deficit by the Finance Minister, of course, to 52.1% in 1991-92. The large size of the debt has meant that interest payments (net of dividends and profits from public sector enterprises) as a proportion of total central governmental expenditure have increased between 1980-81 and 1991-92 from 5.4% to 14.8%.[26]

A good rule to go by, therefore, would be to follow the Mexican example and to assign the proceeds from equity sales in public enterprises exclusively to retiring the accumulated debt. This would enable us to reduce quickly the burden of interest payments which afflict the budget, while also putting pressure on the government to push ahead with necessary fiscal reforms in regard to both taxation and expenditures.

(e) Financial Sector Reform: Banking

We should also stress here that nearly half of the gross fiscal deficit of the central government in 1990-91 was financed by the banking system (including the Reserve Bank of India). Through instruments such as the mandatory cash reserve ratio and statutory liquidity ratio, the government has traditionally forced the commercial banks to hold a larger share of relatively low-yielding government liabilities in their asset portfolio than they would otherwise hold.

It has also been suggested that the participation of some banks m the recent stock market scandal was a reflection of their urgent need to earn a high return from the free part of their loanable funds since their profitability was seriously affected by having to finance relatively unprofitable government liabilities. This may well be so, though it is hard to imagine that the results

[26] We need however to keep in mind the fact that a significant proportion of the internal public debt is held by nationalised banks.

would have been much different even otherwise once the chance to make quick if illegal profits, under what was perceived to be inadequate regulatory discipline, was seen by the offending parties.

In any event, the facts that important financial intermediaries such as the major commercial banks and the Life Insurance Corporation (a monopoly) are in the public sector, and that the Reserve Bank of India does not have the autonomy of either the Federal Reserve of the United States or the Bundesbank of Germany, have meant that the central government has faced little external discipline to trim its fiscal sails for fear of being unable to finance its deficits at any inflationary cost.

This means that the reform of the financial sector, including of the Reserve Bank of India, must be treated as an integral part of the fiscal reforms aimed at reducing the likelihood of the 1980s indiscipline resurrecting itself, and hence as central to the general reform of the public sector's working in India.

B. Are We Borrowing Too Much?

We now turn to the question occasionally raised by critics of the reform process: are we borrowing too much?

(1) At the outset, we must dismiss the criticism of borrowing undertaken when we would otherwise have been forced to default in 1991. The decision not to default was clearly wise: a default would have damaged our creditworthiness and forced us into yet more of the policies that had produced the crisis in the first place. For instance, more autarkic policies would have emerged as foreign exchange credits dried up and NRI investments began to drain out with loss of confidence resulting from tne default. In the longrun, of course, creditworthiness often returns as memory fades and new opportunities are seen by foreign investors, as in the 19th Century and has happened in Latin America now despite the widespread defaults in the 1980s. But this too has required the turn by these Latin American countries to serious reforms. The reforms that were to accompany the lending to us could be then seen as necessary also to maintaining our longrun creditworthiness, to enable us to continue borrowing from the international capital markets for accelerated growth.

(2) Then again, we may think of borrowing in order to smooth consumption over time. This may, for instance, be because of random shocks (such as variations in the monsoon or term-of-trade fluctuations) leading to fluctuations in income. Such consumption smoothing would then lead to borrowing today, when income has fallen, in anticipation of increased income tomorrow. Such borrowing does occur for us from time to time, as for other countries, often from the IMF.

(3) The critical question for us, however, does not relate to such borrowing. Rather, it concerns whether our overall indebtedness has risen too much altogether, whether we are in the position of the Latin American countries in the mid-1980s, with an intolerable external debt burden that would kill their economic growth for nearly a decade, or whether our borrowing is prudent as was South Korea's in the 1980s.

To consider this question, first examine the facts. According to the *Economic Survey 1992-93*, the total external debt (excluding defence-related debt but including NRI deposits) is estimated currently around $72.67 billion. The ruble debt amounts to about $9 billion.

In terms of absolute size of the debt, India is certainly among the major borrowers. However the debt/GNP ratio is under 30% and the debt-service/exports (of goods and services) ratio is also around 30%. [The corresponding ratios for low-income countries other than India and China were 82.6% and 24.9% respectively in 1990.] The *average* interest rate on India's external public debt was 8%, the proportion of debt with variable interest rates was 17.5%, the *average* maturity was 25 years and the *average* grace period of 8 years in 1990. Thus the average interest rate was not very high and the maturity period was fairly long.

In assessing whether India has borrowed too much, what matters evidently are not the average interest rates and the average maturities but the interest rates and maturities of the loans at the *margin*. One might suggest that borrowing from NRI's represents the marginal loans. And interest on such deposits is substantially higher than the average rate of 8% and the maturities are much shorter. However, one might argue that NRI deposits are essentially short-term loans and the relevant margin is India's longer-term borrowing from the external private capital market. Once again, the rates of interest on such loans are higher than the average rate of 8%, and the maturities are much shorter than the average maturity of 25 years.

These represent the cost side of the ledger.[27] As for the benefit side, the return to the borrowing may be viewed, broadly speaking, as the marginal return to the economy. This does not mean, of course, that there is a direct connection between external loans and investment. Indeed such loans could finance activities other than investment. Still, indirectly by releasing resources which otherwise would have to be diverted from investment to such activities, loans may be considered to add to investment. Again, the marginal return to

[27] We should adjust further for any terms-of-trade losses that would arise from amortisation and interest payments in foreign exchange. But so would benefits change from the terms-of-trade gain from the loan inflow. We ignore this complication, whose empirical importance we doubt anyway, in the argument in the text.

investment (in terms of value added) may be equated to the ratio of increment to GDP brought about by the investment.[28]

If so, consider that India has been investing around 25% of GDP, while the rate of growth of GDP sustained by this investment appears, on average through the 1980s, to be roughly 5%. This suggests a return in terms of *gross value added* of 20% to the investment. Using a *net* investment rate of about 16% of NDP and a NDP growth rate of about 5%, the return in terms of *net value added* is about 30%. It is arguable whether the return should be calculated using net or gross concepts of investment and domestic product. Sidestepping this issue, we may use the rates of return derived by using the two concepts as suggesting a range within which the true return lies. Thus, assuming a share of capital in value added of about 40%, the realized *real* rate of return to investment would range between 8 to 12%. If we assume then that the nominal interest rate on marginal loans is of the order of 12%, the real interest rate would be about 7%, assuming a world inflation rate of 5%.

Thus the realized rate of return to investment in the Indian economy is somewhat above (but not very much above) the interest cost. Of course, if the rate of growth could be increased substantially through better policies (or if the share of capital is much higher than 40%), then the realized rates of return would go up substantially. If, in addition, the real interest rate on marginal loans were less than 7%, then the margin of benefits over costs of external loans would be much more comfortable.

Since the real option at our command is not to lower the rates at which loans will be available to us but rather to improve our efficiency and increase the rate of return to our borrowing and investment(though, successful reforms would certainly improve our credit rating and hence indirectly lower the cost of borrowing), we can hardly overemphasise the need to get on expeditiously with the reform process if we are going to repeat the South Korean experience rather than get into a Latin American quandry (though, the borrowing in Latin America was so recklessly large that we cannot properly put our current borrowing into that class even if our reforms go slower than they prudently should).

It is of the utmost importance, therefore, for the next steps in economic reforms to be taken forthwith. Especially, the substantial delicensing of trade and industry and the virtual restoration of current account convertibility have led to the possible creation of appropriate market incentives in the economy. But much needs to be done, as we argue below, to make this an effective reality:

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[28] Of course, the margin for the borrowing could be different from this measure if the borrowing for instance was wholly wasteful or was accompanied by improved efficieny in the economy. In the former case the return to the borrowing would be lower, in the latter case, higher, than our estimate. See our discussion below.

state-level restrictions are still in place, and there is much bureaucratic machinery in place with consequent delays and transaction costs that damage the economy despite much delicensing. Then again, with public enterprises still intact, the provision of infrastructure facilities continues to be inefficient: efficient operation still awaits forceful remedies such as privatisation.

These and other reforms still awaiting implementation must be swiftly undertaken or else the supply response to the incentives sought to be provided by the reforms to date, and the returns to the borrowings we have made, will be disappointingly low. This would tend to make the borrowings even counterproductive and would certainly threaten the reform effort with failure and reversal.

Hence, we urge that the microeconomic reforms, where new steps must be taken boldly and in ways that we define in the next section, be implemented as a matter of urgency.

IV. MICROECONOMIC REFORMS

The reforms to date have been mainly aimed at eliminating the chief constituent dimensions of the earlier, unproductive policy framework.

In particular, the licensing system that governed industrial and trade decisions has been largely dismantled. The opening of the economy wider to trade has been accompanied by a favourable shift in the attitude and a major shift in the policy towards direct foreign investment (DFI). These reforms are considered below.

At the same time, the reforms have much further to go in other critical areas, chiefly the privatisation of the large public sector, the institution of a flexible labour hire-and-fire policy and the freeing (simultaneously with the necessary social regulation) of the financial sector.

Before we address each of these areas of reform in some depth, we think that two points need renewed emphasis:

First, we are transiting from one *system* to another. The reforms in place and the reforms in prospect dovetail into one another: each without the others produces far less benefits than when all are in place together.

Second, it is important that the reforms in prospect be undertaken now under our own steam rather than having them materialise as part of a *de facto* or *de jure* conditionality package from the IMF as we seek tc borrow more money. Conditionality is important when there are powerful anti-reform forces inside the aid-recipient country that need to be and also can be effectively countervailed. When the reform process is broadly accepted, as it seems to be by now in India, reliance on conditionality to usher in the next stage of reforms is both unnecessary and also carries obvious and gratuitous political risk. We would urge therefore that the measures for the next set of reforms, discussed below, are resolved upon *before* we formally borrow afresh from the IMF rather than after (as a set of conditionalities attached to the borrowing).

A. Industrial and Trade Licensing Reforms

The dismantling of industrial and of trade licensing, which crippled efficiency in our industry, has been attended to with despatch by the government so far. The two sets of controls were mutually reinforcing. Equally, the removal of one without removing the other would have been generally infructuous: e.g. if raw material imports were allocated pro rata to

capacity, and not allowed to be resold, then the more efficient producers could not expand production and drive out the less efficient ones even if industrial licensing preventing production expansion (and hence such competition) were abolished.

In the same way, the reform that has led to the rupee's trade account convertibility is also critical. If exchange controls continue while import controls are eliminated, the former can create the same restraints as the latter. For, imports can be as readily prevented by exchange controls as by import controls. Thus, the removal of industrial and trade licensing must be seen in conjunction with the restoration of the rupee's (trade account) convertibility as having jointly resulted in a freeing of India's economy.

Yet, important qualifications must be attended to forthwith if these reforms are to be truly effective. In particular, four important problems need to be addressed: (1) the bureaucracy should not become an obstacle to the intended reforms; (2) the State-level restrictions on economic decision-making, once the center-level restrictions are largely removed, should not become the new, effective constraints now; (3) the remaining controls, in particular the virtually blanket restraints on consumer goods imports, must be tackled; and (4) institutional changes must be made to support the general freeing of imports that we are moving to.

1. The Bureaucratic Problem

The dismantling of licensing by the government may be meaningless if the bureaucrats, down the line, continue to act as if controls are still in place. We have found numerous instances of bureaucratic inertia, at best, and obstructionism, at worst, which strongly suggests that the government needs to confront this issue frontally. Old habits die hard; and they linger on longer if they are also lucrative to stick to.

In regard to the licensing system, both domestic and in foreign trade and investment, it is necessary to systematically alert the bureaucracy to the new changes and to instruct it firmly (with prospect of penalties under due process of law) to prevent continuing roadblocks to production and investment decisions. In those instances where the bureaucracy no longer has a role in the new policy framework, the best policy would be to apply to it the "exit policy" that must now be embraced as part of the additional, new steps towards economic reforms that have to be taken by the government.

In this regard, it is also important that there be continual interaction, in an *institutionalised form*, between industry and the government so that efficient channels are established for rapid communication to the government of

implementation roadblocks as the bureaucracy copes with the new changes that are aimed at greatly restricting its role. This also requires a change in the old, inherited style of operation where the government was in an adversarial role to industry[29]. That attitude, and the institutional structure, have to be changed quickly and comprehensively to make industry a creative and respectable partner both in implementing the reforms and in playing a central role in India's economic development. This is, in fact, the trend everywhere, including in the United States and in Great Britain where the adversarial attitudes to business and industry were long fashionable but have now lost ground.

Such institutional changes would also accelerate reform in new areas where residual controls and restrictions remain but have no good justification. Thus, for instance, in a most useful and revealing *Report on Administrative Reforms* produced by the Confederation of Indian Industry's National Task Force on Administrative Reforms, there are excellent suggestions for streamlining the clearance procedures that still remain for industrial undertakings.

It turns out, for instance, that there are 13 agencies which must be approached even today for clearance. Many of these permissions are, of course, necessary: some relate to pollution control, others to town planning and other reasonable requirements that have counterparts in most countries. The problem, however, is that because we do not have Single Window Clearance, each of the 13 clearances takes its own time. Besides, there is no effective time constraint on each agency's decision. Since time is money, it would surely make sense (as the CII Task Force recommends) to have Single Window Clearance by a designated authority which, in turn, ensures that the required 13 clearances are obtained within, say, 1.5 months. In Singapore, the Task Force notes, the Government grants clearance in less than two weeks.

2. State-level Restrictions

The delicensing is also at the central level and numerous restrictions continue at the state level. This again poses the question: since virtually any industrial plant must be physically located in a state, how can effective delicensing be achieved if state-level restrictions continue in place?

Of course, once central licensing is removed, states can no longer use political clout to have industries allocated by the licensing authorities to them. The allocation of industries among the states now comes about through competition among states. In consequence, states will now have an incentive to

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[29] This is not to deny that, under the licensing system, influential and large business groups had a preferential access to licensing authorities.

offer relief from the tyranny of their own restrictions to industrialists seeking to find the most favourable location of their industry. We have been informed by industrialists that this is already beginning to happen. If so, the inefficient state-level restrictions will begin to disappear simply because the central licensing-cum-statewise-allocation system has been dismantled[30].

But this only represents a slow scenario and besides it works for large firms rather than for small firms without political access. There is thus room for accelerating the process through initiative by the central government to educate the state governments into simultaneous dismantling of state-level restrictions.

Equally, the central government should consider introducing "conditionality" in its allocation of revenues to the states: the level of such allocations could be made a function, not merely of "needs", but also of "rewards" for pursuit of designated policies such as delicensing that complement rather than frustrate the nation's economic reforms. This would be an extension of the principle that the Finance Commission and the Planning Commission already uses in rewarding the states for their resource mobilisation efforts. While this can only be a "medium-run" political process, it should be initiated at the earliest as its importance is undeniable.

3. Liberalising Imports

Imports have been largely liberalised, compared to pre-1991. But tariffs are still high and non-uniform and, in particular, a major qualification to the liberalization of the trade sector continues to be the extensive restrictions on consumer goods imports. Thus, the 1991 non-food consumer goods imports (at 1980-81 prices) were $650 million, of which $280 million were for personal baggage, $220 million for audio and visual equipment, $110 million for textiles and garments, and $40 million for sports goods, the total amounting to about 2.5% of the total imports. By contrast, in many developing countries with more liberal trade policies, the ratio of such imports to total imports ranges between 5 and 15 %.

We believe that the hesitation in liberalizing consumer good imports is a hangover from earlier, fallacious modes of reasoning and that policy needs to be changed in this regard. We proceed to argue for such liberalization first by describing the current situation regarding import tariffs and quantitative restrictions on imports generally and on consumer goods imports in particular, second by arguing at length why the arguments usually marshalled against

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[30] State-level competition that takes the form of competitive relaxation of desirable regulations would however be deplorable. To avoid that, we also would need to coordinate and harmonise such desirable regulation, as is done in the European Community for instance.

consumer goods import liberalization are wrong, third by considering the way in which such reform should be undertaken.[31]

(a) The Current Situation Regarding All Imports: QRs and Tariffs

The restraint on imports, once exchange controls are eased,is essentially defined by either quantitative restrictions (QRs) or by tariffs.

Currently, the imports of capital goods and of intermediates are mostly freed from exchange controls: in particular, the imports of capital goods worth up to Rs.2 crores were fully liberalised by last year, whereas the imports of intermediates have been liberalised (except for a few exceptions carried on the Negative List mentioned below) through the new ability to import them freely even if one is not an Actual User (though, foreign exchange for all imports can only be bought from authorised dealers which include the large commercial banks).

By contrast, the imports of consumer goods are severely constrained by QRs, coming principally under the socalled Negative List under our Import Policy. In essence, as the conventional usage goes, the list is Positive, in the sense that the Policy document specifies that, except for a few items altogether prohibited and a few others which are exempted, the imports of any consumer goods would require an import license.

Thus, on average, consumer goods imports are constrained by QRs whereas capital goods and intermediate good imports can be regarded as being constrained by tariffs.

Tariffs therefore have a predominantly revenue-generating effect, rather than a resource-allocational effect, in the consumer goods sector whereas they also have a significant resource-allocational effect in the capital and intermediate goods sectors. But if (as we argue below) consumer goods imports are liberalised as part of our next set of reforms, through the removal or enlargement of QRs, the consumer goods tariffs would become the binding, effective constraint on them as well. In that case, it becomes important to examine what the *tariff structure* is, since the resource-allocational effects of trade policy will then be determined by the tariff policy: and reform in tariffs, both in their structure and level, would acquire yet greater importance and urgency.

(i) *The Tariff Structure:* The tariff structure currently has a bias against consumer goods as does the QR policy structure, but in a much diminished

[31] We also recommend in subsection 4 some critical, accommodating institutional changes to go with the import liberalization of all goods.

fashion. Thus, if one looks at the available data, consumer goods have the highest range of duties whereas capital goods have the least.

But the range of duties can be misleading. The highest rates may apply to a few imports whereas the lowest rates may apply to many more. At minimum, we should look at the average duty rates calculated as a simple average. Preferably, we should look at import-weighted averages (though, even that has the problem that high duty rates lead to low imports and hence we would understate the restrictiveness of duties by using import weights). If we then look at the averages of the duties levied, what do we find?

Drawing on the Chelliah Committee's calculations, we can broadly infer that, in 1990, the consumer goods imports carried import duties that were at least as high as those on capital goods whereas the manufactured intermediate goods imports were taxed at lower rates. This is evident from Table 1 which shows that, in 1989-90, the import-weighted average duties on manufactured consumer goods were almost the same as on manufactured capital goods and lower than on intermediate manufactures. But if the nonmanufactured intermediates, which must be the main component of the other groups such as Agricultural Products and Mineral Products are taken into account, the average duty on intermediates must surely lie below that of the consumer and capital goods imports. However, other estimates suggest that by the end of 1992, consumer goods did have the highest import-weighted average duty at 86%, with 69% for intermediates in general, and capital goods at below 55%. This trend towards reducing the capital goods tariffs and thus leaving consumer goods with the highest tariffs was continued in the 1993 budget.

For instance, the Finance Minister brought the duty on project imports and general machinery imports down yet further to 35%. Import duty in projects in priority sectors such as coal-mining and petroleum refining were brought down yet further to 25%, and in power projects to 20%. On machine tools, duties had varied between 60 and 110% but were reduced now to three rates: 40, 60 and 80%. Some of the duty reductions were extended simultaneously to intermediates used in the production of such capital goods in India so as to prevent adverse effects on their production from higher duties on their inputs than on their outputs. On the average, therefore, the consumer goods imports wound up carrying broadly higher rates than capital goods and intermediate imports.

Economists also distinguish between "nominal" protection, i.e. protection by item or commodity, and "effective" protection, i.e. protection to a process of production or to "value added" in an activity. The latter, effective rate of protection (ERP) is a better index of resource-allocational pulls created by the tariff structure and hence also to the actual such effects provided, of course,

that these effects are allowed to operate and are not frustrated by an industrial licensing system that restricts and guides investments.

In general, one can argue that lower rates on capital goods and intermediates than on final goods would imply that the ERPs would be even higher than the nominal tariffs. Since the average official tariff rates on consumer and capital goods are roughly similar (see Table1) and on intermediates are mildly below for manufactures and significantly below for other goods such as metals and agro-products, the net effect of the nominal tariff structure would appear to be to yield ERPs that should mildly exceed the nominal tariffs in most cases. The Chelliah Committee's calculations confirm this outcome (see Table 2) for nearly all major groups of imports.[32]

Table 1 : Average Tariff Rates for Broad Commodity Groups

Group	Weight (import based)	1989-90	
		simple average	Import Weighted average
Agricultural prod.	0.03	99	46
Coal, crude oil, and natural gas	0.16	82	54
Other mineral prod.	0.03	98	20
Manufactured prod.	0.78	123	98
Of which-			
Consumer goods	0.87	138	89
Intermediate goods	0.47	125	103
Capital goods	0.24	94	91
Aggregate	1.00	121	87

Source : Chelliah Committee's *Interim Report, op. cit.*, Table 8.2

Other aspects of the tariff structure also need to be noted before we discuss the question of liberalization of consumer goods and of the general trade policy reform within which that liberalization must be set:

(ii) *Revenue Collection*: The duty rates, discussed above, are not the same as the effective duty rates implied by actual revenue collections. This is

[32] The earliest calculations of ERPs for India were made By Dr. V.R.Panchamukhi and can be found in Jagdish Bhagwati and Padma Desai, *India*, Oxford University Press, 1970. The usual calculations distinguish between ERPs based on QRs when these are the effective constraints on imports and those based on tariffs as in the Chelliah Committee Report.

Table 2 : Nominal and Effective Rates of Protection Based on Simple Averages and Import-Weighted Averages in 1989-90 According to Major Groups.

Major Groups	Simple averages NRP	NRP	Import-weighted avg. NRP	NRP
Agro-based				
Mean	134	161	131	160
Standard dev.	26	65	49	91
Weighted avg.*	134	160	133	160
Chemicals				
Mean	117	120	115	131
Standard dev.	49	79	18	74
Weighted avg.*	105	101	104	114
Metals				
Mean	131	143	123	136
Standard dev.	16	32	26	50
Weighted avg.*	128	132	126	136
Machinery				
Mean	103	87	98	84
Standard dev.	25	42	29	47
Weighted avg.*	100	82	97	82
Manufacturing				
Mean	119	125	109	115
Standard dev.	33	63	50	88
Weighted avg.*	121	130	113	113

Note : * Value-added weights.
Source : Chelliah Committee's *Interim Report, op. cit.*, page 184, Table IV. 2.

because there are many exemptions from the duty rates, depending frequently on the user (e.g. drawbacks are granted to exporters)[33], and because the high tariff rates as in India lead to significant self-serving reclassification of imports, with suitable incentives provided to the customs authorities by the

[33] The discrepancy arises because the calculations of the (legal) duty cannot usually be adjusted effectively for the exemptions available and therefore, in practice, are always largely unaccounted for

importers, such that these exemptions become applicable, pulling the average duty collected within a class of imports down to the below-mean levels.[34]

In India, as elsewhere, therefore, there is a discrepancy between the official duty rates and the collection rates. Thus, the Chelliah Committee has estimated that: " In 1980-81, the import-weighted average rate of nominal tariff (with quantifiable exemptions) was 38 per cent. In 1989-90, it rose to 87 per cent. The collection rate of duty increased in this period from about 20 per cent to about 44 per cent." [35]

An added point needs to be made. It is most likely that, as evidenced in other countries, this discrepancy between the legal duty and that implied by the revenues collected, rises with the duty charged. In short, the exemptions tend to increase de jure and also to be increasingly exploited de facto, the greater the incentive to do so that is provided by higher duties. As for the actual revenues collected, they tend to fall additionally because of increased evasion through smuggling and through underinvoicing, both of which mean that the duty fails to apply to the true level of imports.

Studies of other developing countries' duty collections show conclusively what we can guess at from our own anecdotal evidence, that the revenues do not rise proportionately to the duty rates. Thus, a fine study of the problem by the economists Pritchet and Sethi calculates that[36] : "The mean collected rate in Pakistan for items with an 60% tariff is 40%. For items with an 80% tariff the collected rate increases only to 51% and then is roughly the same 52% and 54% for items with official rates of 100 and 125 percent. In Kenya, the mean collection rate decreases from 43% at 60% official to 31% at 80% and 36% at 100%." Their estimated equation regressing the collection rate on the official rate of duty shows that: "An increase of ten percentage points of the official rates produces an increase of only 3.3 percentage points in the collected rate for Pakistan, 4.9 percentage points for for Kenya and roughly 4.7 % for Jamaica."

Since our average tariff rate is very high, and this is yet more so for consumer goods imports, it is important to remember therefore that the impact of substantial liberalisation of consumer goods imports along with the rest of our imports, via tariff reductions, will not necessarily have large adverse effects on our revenue position. With QRs liberalised and tariffs coming down from what would be highly-restrictive levels, we may expect the volume response to

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[34] On the other hand, the collection of revenues, as distinct from the discrepancy between the official duty and the duty implied by the collections, will also be affected by high-tariffs-induced underinvoicing of imports and by outright smuggling outside of the customs and trade-accounting framework.

[35] Ch. Chelliah Committee Interim Report on Tax Reforms, GOI, December 1991, page 94.

[36] Lance Pritchett and Geeta Sethi, "Tariff Rates, Tariff Revenue and Tariff Reform: Some New Facts", mimeographed, Research Division, IBRD, Washington D C , August 10, 1992.

liberalisation to be large. Further steps by the government to reduce the average tariff level are therefore not to be feared because of their revenue implications.

(iii) *The Tariff Structure: Multiplicity of Rates:* Yet another aspect of the tariff structure must be considered since it is in necessity of bold reform as much as the liberalisation of consumer goods imports. The tariff structure is characterised by a multiplicity of rates. There are currently more than 20 ad valorem tariff rates and numerous specific tariffs as well.

In theory, non-uniform tariff rates can be justified on several grounds, including distributional objectives that cannot be met in more efficient ways and on efficiency grounds such as when different commodities enjoy different degrees of market power in world markets. In reality, there is little correspondence between such reasons and the actual policy choices as revealed in the tariffs in place.[37] The multiplicity of rates also implies that protectionist lobbies find it easier to lobby for tariffs whereas, if uniformity was adopted as a policy, it would become relatively unprofitable to lobby for one's tariff because of two reasons: the government could always argue that a specific demand for higher tariff could not be met because it would involve raising all other tariffs which the government cannot do; and the lobby's advantage from getting the higher rate, thanks to its own lobbying (which costs money), would be reduced since other tariffs, including of its inputs, would rise equally.[38]

The recommendations of the Chelliah Committee now, and of the Alexander Committee and the Long Term Fiscal Policy document earlier in the mid-1980s, to simplify the tariff structure are therefore both sensible and in need of implementation at the earliest. However, they do not go far enough, in accepting the notions that "universal intermediates [should] be subject to a duty rate less than that for raw materials and other intermediate goods", that these, in turn, should have a rate "lower than that for capital goods", that "non-essential" consumer goods should carry the "highest duty rate", in the end there being a five-tier duty structure.[39]

We see little logic for these distinctions that would permit differential rates by broad groups so defined. For instance, reducing the input duties while maintaining the output duties on "nonessential" consumer goods would only increase the effective protection for such consumer goods, drawing resources towards their production, especially when industrial licensing has been

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[37] Of course, when ERPs are calculated, the analyst finds a substantial degree of dispersion among these tariff rates (see Table 4). Total uniformity of tariffs would eliminate this phenomenon, of course.

[38] The economists Arvind Panagariya and Dani Rodrik have recently explored a number of such arguments for adopting a policy of uniform tariffs.

[39] *Cf.* Chelliah Committee Report, *op.cit.* (p.94), citing the Long Term Fiscal Policy document of 1985, with apparent approval.

effectively removed as a regulating device. It is more sensible, if the consumption of certain luxuries is to be curtailed, that this be done by taxing them, regardless of whether they are imported or home-produced, rather than by taxing only their imports and therewith creating an added incentive to produce them at home.

While the 1993 budget took several commendable steps towards reducing the rate structure, several were necessarily *ad hoc*, reflecting the production needs of domestic industry. It is time to look at the entire tariff structure in totality and to bring substantial uniformity into it, now that the Finance Minister has already made the idea of tariff rate simplification familiar to the public.

(b) Why Consumer Goods Ought also to be Liberalised?

The question of liberalisation of consumer goods imports (consistent, of course, with taxes on the consumption of luxuries and of "bads" through what are popularly called "sin taxes") is a particularly difficult one in India for several reasons. These reasons consist of misconceptions, fears, and lack of appreciation of the positive benefits to be derived from such liberalisation. Since they define politically powerful objections to completion of the trade policy reforms by extending the reforms to consumer goods, and they should evidently be confronted and contained, we consider these reasons now in some depth, warning the reader that the added space devoted by us in consequence to liberalisation of consumer goods imports, relative to the space allotted to other elements of reform, is no indication of the relative urgency and importance of these different reforms.

(i) *Misconceptions:* The misconceptions are longstanding on the Indian scene. Two are particularly potent:

First, a common fallacy is that the removal of consumer goods import restrictions will lower the savings rate. But, in general, the effect will be to shift the consumption to other types of consumer goods, domestically-produced tradeables and nontraded goods.

Second, it is feared that consumer goods imports will increase the availability of luxuries. But this is wrong on several counts:

* "Luxuries" are a nebulous concept under whose rubric lie goods that reflect the cultural mores prevalent at any point of time in a society. Yet, the concept has been used in practice in India by bureaucrats in charge of licensing to categorise goods which, for one reason or another (whether their own preferences and prejudice), they would like to exclude from the consumption basket. Thus, in the 1950s and 1960s, cosmetics, refrigerators, airconditioners,

cars and consumer electronics fell into this category. Today, with the growth of the middle class to over 100 million ,it is hard to think of "luxuries" in the same way; most of these goods are now part of widespread consumption.

* Again, we must admit that some of these goods also have productive aspects. Electronic goods such as personal computers for instance are useable for fun and games, but are also clearly producer goods in the home. Our conventional tendency during nearly four decades of planning to look wholly upon such goods as "nonessential" or "luxuries" disregards the dual (consumption and investment) aspects of many such goods today, falsely forcing us into restrictive policies that can be harmful to productivity and to a growth-oriented modernisation of the economy.

* Moreover, if "luxury" imports of traded goods are curbed, and there are import-competing products available from domestic production, then the effect of such import curbs will be largely to substitute domestically produced "luxuries" for imported ones: e.g. Marutis replacing Hondas and Volkswagens. The objective of restraining luxury consumption will not have been served by such an import policy.[40] The correct policy to restrain consumption of any good or "bad" (e.g. heroin) is to tax it, regardless of whether the item is imported or domestically produced.

* If the demand shifts from restricted imports of luxuries to nontradeables, the results are likely to be deleterious in our context. Suppose, as is likely, that demand shifts to expenditures on housing, a nontradeable. This is likely to be conspicuous consumption, perhaps making the task of managing the politics of inequality more unmanageable. Moreover, an increase in demand for nontradeables such as housing will raise their prices, because the elasticity of supply is likely to be much lower than that of world tradeables, both feeding inflationary wage demands and also impacting adversely on the real incomes of the middle class.

(ii) *Fears:* Then, there are fears that the liberalization of consumer goods imports will harm the economy by reducing the governmental revenues, and by creating a balance of payments crisis.

(i) We have already indicated above that the fear of a substantial loss of revenue from such liberalization is exaggerated and that the problem is manageable. To recapitulate more cogently , a change in the trade policy to liberalise consumer goods imports would mean liberalising the QRs which are currently the real restraint on such imports. This itself would, at the current high tariff rates, would generate added revenue, not diminish it.

[40] If it is thought that such domestic production "saves foreign exchange", that is still another fallacy Resources used in such domestic production could be used to produce for exports, or to produce nontradeables which then absorb domestic expenditure and hence reduce the demand for imports, for instance

But any added liberalization which effectively requires tariff cuts will also likely meet with a significant response for reasons suggested above. In fact, it seems very reasonable to argue that revenues may even rise in view of the extremely high tariffs now. Thus, in Figure 3 , which is the socalled Laffer curve, the horizontal axis measures the average tariff rate and the vertical axis measures revenues collected. When the tariff rates are prohibitive, nothing gets imported, and there is no revenue. When the rates are zero, no revenue gets raised either. So, the curve meets the horizontal axis at the origin and at the high tariff that eliminates imports. In between, it rises and must fall. Assuming only a single peak, we can then plausibly assume that we are to the right of this peak and will therefore increase tariff revenues by liberalising consumer goods imports with QR expansions and tariff reductions.

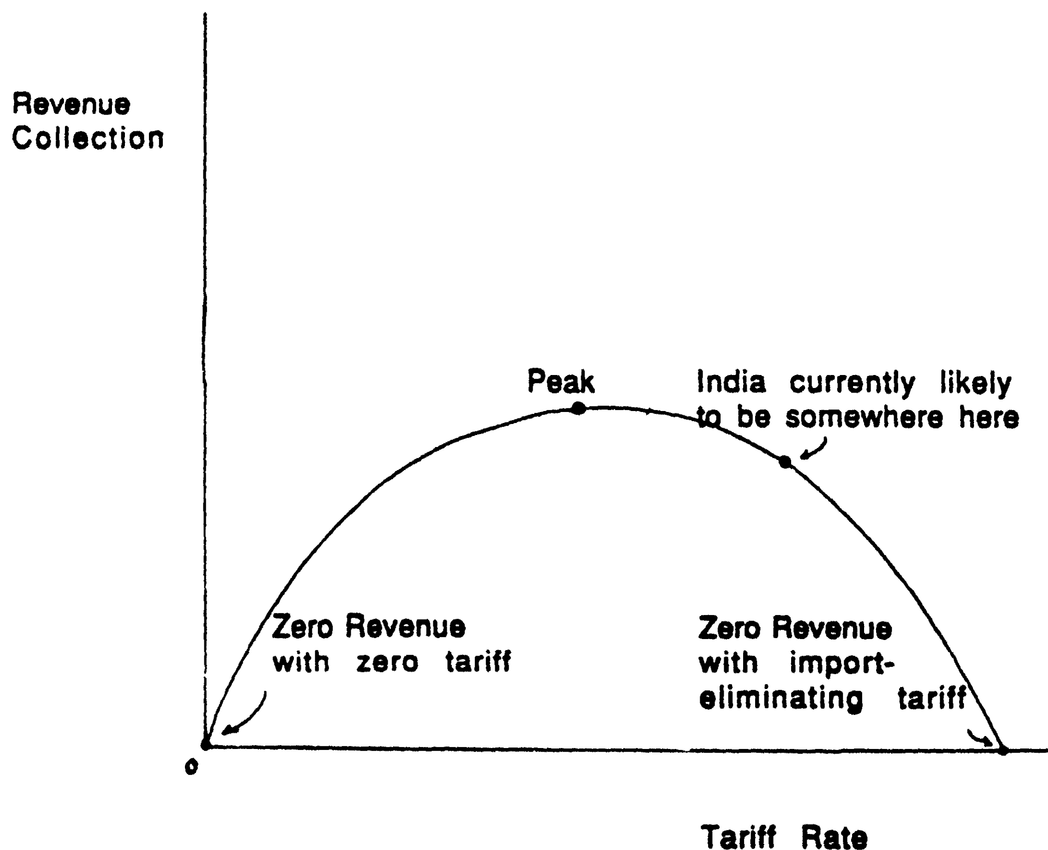

Figure 3: Tariff Rates and Revenue Collection

(ii) There is also the "macroeconomic" worry that liberalising consumer goods imports (and indeed other imports too) will create a balance of payments crisis because imports will then increase greatly owing to speculation, on the self-fulfilling assumption that the import liberalisation cannot be sustained and will be reversed. But there is little reason to believe that a balance of payments crisis should develop, given the prudence with which the government has proceeded in fact to reduce the budget deficit and to exercise monetary restraint. The substantial reduction in the real exchange rate since the reforms started has also made less credible the scenario that significant further depreciation will take place in the shortrun, a scenario which can (if credible) precipitate outflows and a crisis.

(iii) *Positive Arguments*: We should also stress several "positive" arguments which make the liberalisation of consumer goods imports desirable:

* The protection of consumer goods production is as harmful, from an efficiency viewpoint, as the protection of any other kind of production: it diverts resources to inefficient production. It would be desirable for any particular production only if economists could convincingly argue that there are uncompensated, beneficial spillover effects that this particular production generates, and these too more significantly than other production from which resources will be diverted. It is hard to imagine that case being successfully made for the bulk of consumer goods production as a class.

* Then there is the usual loss to consumers from the higher prices of consumer goods that protection implies. Modern economic theory shows how this loss arises also in the form of reduced variety of goods that are available in the economy.

* The lack of such quality and variety in imports also, in turn, leads to the loss of quality upgrading that international competition provides and which is necessary eventually for successful and sustained export of manufactures.

(c) How Consumer Goods Imports Should be Liberalised?

Essentially, since both QRs and tariffs are involved, and since QRs are generally the effective restraint on imports of consumer goods, the liberalisation of these imports must first involve the moderation or removal of the QRs and, second, as soon as tariffs begin to bite, the progressive reduction of the generally high tariffs as well.

The liberalisation of consumer goods therefore can proceed in alternative ways that involve different ways of dismantling QRs and of lowering tariff barriers, and different sequences in which these two may be

combined. The important issue relates however to the choice of the methods by which QRs will be dismantled. The experience of other countries that have liberalised imports in the past suggests several ways in which QRs on consumer goods imports could be liberalised in India now :

(i) *Outright Abolition of QRs:* As in Greece (1953-55) and in Chile which abolished QRs within a year, we could simply "light a bonfire" of the QRs on consumer goods imports. This is certainly an idea worth considering since the existing tariffs are so high that our import-competing consumer goods industries will remain well protected anyway, with the impact of the QR abolition limited in consequence.

The further and truly difficult bite would come rather when we begin lowering the tariffs thereafter: this tariff reduction can be gradual, in a pre-announced step-by-step programme. In addition, the depreciation of the real exchange rate has already made our tradeable goods internationally more competitive than prior to the reforms, and so has the reduction of the duties introduced in the last budget on imports of intermediates and capital goods.

If we put institutional machinery in place then (as proposed in subsection 4 below) to handle market-disruption complaints and to adopt temporary "safeguards", as do many countries (e.g. Section 201 of the US trade law), we should have no problem with the adoption of such a policy. And we could substitute, in case of goods whose consumption we badly want to restrain, consumption taxes that do not discriminate against imports in favour of domestic production.

We would therefore recommend this option of outright abolition of the QRs on consumer goods imports, with the institutional safeguards and policy changes indicated, for the government to adopt at the earliest. But if gradualist solutions are desired from excessive caution, whether political or economic, then other solutions can be considered.

(ii) *Radial Expansion of QRs:* Imports could, for instance, be expanded , from an initial quantity established in case of altogether-prohibited imports as a small fraction of existing domestic production if any, at a certain rate annually. This method, which has the advantage of simplicity but has little economic rationale, was adopted by the European Community. As recorded by the economist Wendy Tackacs, the EC having aggregated all the bilateral QRs of the members into a total QR, for a commodity, the total quota was increased by no less than 10%, and quotas for items without any existing imports, the initial 1959 quota were set so as not to fall below 3% of domestic EC production at the time.

If such a scheme were adopted in preference to the scheme for outright

abolition of QRs, the expanding QRs would have to be allocated to importers. Since they carry a premium which will continue in many cases, and for some time, the question will arise: who should get the benefit of obtaining the QR licenses? The obvious answer is: auction off the QRs so that the government earns the premium, this amounting of course to added revenue for the government at a time of macroeconomic pressure to reduce the budget deficit.

(iii) *Selective Reform:* On the other hand, the expansion of quotas, or even their abolition, could be done selectively by sectors or groups of commodities, as was done in South Korea between 1978 and 1988 by expanding the coverage of items on the automatic list of approval steadily from 53.8 % to 95.2%.

It is hard to imagine, however, that this is a desirable method since a great deal of hassle and political bargaining would go into the choice of the sectors whose head would go on the block earlier rather than later.

(iv) *Tariffication:* In lieu of a simple abolition of QRs, a more cautious policy that is used sometimes is to seek to convert them into equivalent tariffs. This has, for instance, been suggested for Japanese rice quotas at the Uruguay Round of multilateral trade negotiations. It is also the method used variously by many liberalising countries: e.g. Israel, Ghana, the Philippines and Spain. Tariffication does not, of course, reduce the protection that the earlier QRs provided: the protection might, in some cases, even increase though that is not intended.[41] The only advantage is that the tariffication makes the protective effect more transparent and that, insofar as the implied tariffs are usually excessively high, this transparency assists the cause of those who want to reduce the protection being provided.

If this course of action is followed, the QRs would indeed be abolished outright out they would be replaced by added tariffs which then define a higher set of tariffs from which to begin the task of reducing tariffs. This may lead to problems with the GATT where some of our tariffs are bound. But there is little doubt that if QRs, which are the effective constraint, were being converted to tariffs, no Contracting Party at the GATT is likely to act perversely and to object to our tariffication.

In practice, there are numerous variations on how QRs might be mitigated or removed. The only serious alternative which might be considered appealing is to build on current practice by using the fact that the government has already eased up a little on consumer goods imports by introducing in October 1992 the Special Import Licenses, SILs, which permit a small single-

[41] This may be because of shifts in supply and demand that would have reduced the protective effect of the replaced QR.

digit fraction of the export earnings by certain classes of exporters to be used to import consumer goods on the Positive List of restricted consumer goods imports. Since these imports fetch premia, though the premia have not always been large because of the high tariffs that must be paid, these schemes (like many Export Bonus Voucher and Exchange Retention schemes of yesteryear and even now in other developing countries) utilise the scarcity premium on consumer goods imports to subsidise exports. This tie-up between what are, for the erroneous reasons analysed above, considered to be undesirable imports and the desirable objective of promoting exports may ease the politics of liberalising consumer goods imports by steadily increasing the fraction of foreign earnings to be so utilised and by increasing also the number of consumer goods eligible for such imports. But this is a small gain in our view.

A cleaner and deeper surgical strike on consumer goods import restrictions would be our preference. It would also imply that the "bias against exports" that such restrictions inevitably provide would be reduced simultaneously (continuing then only insofar as tariffs provide them), though the expansion-of-the-SILs approach would provide an added export incentive. But such an added incentive would, in the nature of the case, be unstable, varying with the premium and the rates of retention provided. We doubt that this would provide the sustained incentive to make the investment and marketing decisions to enter foreign markets on a longrun basis.

Beyond QR-removal to Tariff Reduction: Once the QRs are virtually removed, and tariffs become the relevant restraints, the government needs to proceed quickly to simplification of the tariff structure and to step-by-step reduction of the tariff level as well. We can proceed simultaneously to binding the tariffs at the GATT and making significant tariff concessions at the Uruguay Round itself this year so as to take credit for such tariff changes in the game of reciprocal concessions and thereby earning some concessions in return for doing what is good for us anyway.[42]

4. Institutional Changes to Accompany Trade Liberalisation

As we liberalise trade policy , freeing imports of all types of goods, making international competition an increasing reality on the Indian scene, we also need to make institutional changes to accompany and support the new regime.

(a) *Anti-dumping*: While antidumping institutions and practices are are nowadays being misused for protectionist purposes in the EC and in the United States, the underlying notion that predation needs to be avoided for free trade to

[42] We have already dealt earlier with the problem of the effect of tariff cuts on revenue collection and discounted it.

assure mutual gain for the trading nations is not without merit. As we enter freer trade, we must therefore create the necessary antidumping procedures and institutions to implement them.

But we should also learn from the grossly abusive practices of the United States and of the EC to devise procedures which will truly assure fair trade instead of being captured by protectionists for their own use. In doing this, we must remember of course that it is difficult for the government to set standards which others do not care to observe. But we must remember that our protection hurts us as it hurts others, and that the use of antidumping actions fairly is as much in our interest as in that of our trading rivals.

Since, however, it is difficult to adhere to higher standards than others do when our industry complains, it is important that we also work energetically, joining forces with other developing countries such as Singapore and Hong Kong and with Japan, to oppose the weakening of the antidumping discipline at the Uruguay Round that is sought currently by countries capitulating to their protectionist lobbies.

(b) *"Safeguard" Actions*: Like other countries with freer trade, we will also have to handle the market-disruption problems that can arise when imports are freed from restraints. Procedures and institutions again will have to be put in place, taking international experience into account, so that complaints concerning injury from "import surges" (as they are called in the new context of negotiations for the North American Free Trade Area where the US fears market disruption to its industries from rapidly expanding Mexican exports) are investigated and determined upon, and relief offered in a way that does not lead to interminable or discriminatory protection.

Towards these ends, we will need to re-examine and redefine the role of institutions such as the Tariff Commission whose role was earlier circumscribed to merely calculating the protection needed to protect an industry from competition rather than judging whether such protection was justified in light of some objective criteria!

[43] In these and other ways, including GATT negotiations and law, we need considerably more expertise than we possess simply because we have not engaged forcefully in trade to date and the reforms make this neglect a shortfall that we must urgently repair. The immediate expansion of teaching and research programmes in international trade law where we can train lawyers, bureaucrats and economists who become experts on whom the government can draw as we transit to more integration into the world economy, is now of the utmost importance.

[44] For an early analysis of this uncritical role played by the Tariff Commission, not because of its own fault but because of a faulty conception of its role by the government, see Padma Desai, *Tariff Protection in India 1947 1965*, Hindustan Publishing Corporation: New Delhi, 1970

B. Direct Foreign Investment

The question of direct foreign investment (DFI) is related to the question of trade and industrial policy, reforms in one suggesting and even requiring reforms in the other.

Thus, for instance, inward oriented trade policies lead to DFI which is aimed at the domestic market whereas outward oriented trade policies encourage DFI which seeks global markets. The former then leads to inefficiencies which are similar to those that afflict domestic investments: small scale, lack of effective competition, and bias against exports, whereas the latter leads to efficiencies which are similar to those that accrue to the domestic investments and firms in these economies. Thus, as we have been forced to do in the past, under inward oriented trade policies the DFI policy is geared to *forcing* the foreign firms to export as a *precondition* for investing in India, since the incentives work against producing in India for export markets. Once the bias against exports is eliminated, we then do not need to produce these artificial inducements to offset the adverse anti-export disincentives of our own making. Thus, these "export performance requirements" which have contributed to the relative unattractiveness of India as a host country for DFI can be eliminated now that we are turning rapidly to an outward oriented set of trade and industrial policies.[45]

Indeed, the outward orientation of our trade and industrial policies, belated as it is, should also help us to attract more DFI since DFI is not merely less productive in an inward oriented policy framework but also because the flows of DFI are likely to be limited when only aimed at the domestic market and hence coterminus with the size and growth of that market. On the other hand, outward oriented economies attracting DFI aimed at global markets have the world for their market.[46]

Our DFI policy, embodied in the FERA Act of 1975 but in making before that time, was itself dictated by the view, widely prevalent at the time, that regarded DFI as capable of malign impact on the economy. Indeed, policy inclined to the view that this possibility was also probable and that extensive regulation was the only way to tame DFI into a benign influx. This was part of

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[45] Since the conclusion of the Uruguay Round is likely to include proscription of such requirements as part of the agreement on Trade-related Investment Measures (TRIMs), as does the December 1991 "Dunkel Draft", our logical abandonment of such a policy, in view of our reforms, would also be timely. It is also not prudent to expend our limited bargaining power at the Round on fighting such a proscription which has little adverse effect on us in view of our trade reforms and also because few other developing countries are likely to join us in such an effort.

[46] For evidence on this hypothesis about the relationship between outward and inward oriented trade policies and the magnitude of DFI inflows, see V.N. Balasubramanyam, "EP, IS and Foreign Direct Investment in LDCs", in A.D. Koekkoek and C.B.M. Mennes (Eds.), *International Trade and Global Development: Essays in Honour of Jagdish Bhagwati*, Routledge: London, 1991.

the general revisionism which argued with the conventional view that the world economy, and integration into it, would be to mutual advantage of the developing and the developed countries. It argued forcefully instead that the interaction could be malign, the effect being to create predation, not gain, for the weaker countries of the South. If unchecked and unregulated, DFI would inhibit the growth of domestic entrepreneurship; it would stifle the growth of domestic technology; it would create balance of payments difficulties, contributing to the natural proclivity of DFI to result in a loss of political and economic independence.

Needless to say, specific instances can be cited that would illustrate each of these concerns. Indeed, flagrant use of political muscle by foreign multinationals in their host countries was manifest in the overthrow of President Allende in Chile and in the downfall of Mr. Lumumba in the Belgian Congo (though, the factors that led to these political events were quite complex and domestic disaffection produced by unsustainable policies cannot be underestimated).

But several observations must be made. First, the accumulation of evidence in the postwar period shows that the malign-impact scenarios have not proven to be the dominant experience with DFI in the developing countries. DFI has been mainly associated, for instance, with substantial technology diffusion, with dissemination of better management practices, with increased competition that has stimulated local firms into producing higher-quality products that facilitate entry into export markets, and with substantial contributions of its own to the host country's export performance.[47] Where DFI has failed to achieve these beneficial effects in a substantial way is precisely where the policy framework has tended to restrict and regulate with a view to inhibiting these effects from arising.

Second, for India itself, our longstanding policy of inhibiting DFI has been associated with a general decline in the technological capability of our industry on average[48], though that failure is attributable to the whole complex of policies that must include also the licensing framework that, by severely restricting the ability to diversify output and to invest, made the entrepreneurial absorption (and invention) of new technology a relatively unremunerative activity. Indeed, studies of the technological backwardness of the former Soviet

[47] See, for instance, the various writings of Magnus Blomstrom of the Stockholm School of Economics and Robert Lipsey of the National Bureau of Economic Research, and other evidence cited in Veena Mishra's fine contribution on DFI to *Policy Options for Economic Reform*, Indian Merchants' Chamber and Indira Gandhi Institute for Development Research, IMC IGIDR Series, Vol. 1, April 1992, Bombay.

[48] We deliberately say "on the average" because, as with the former Soviet Union, specific technical objectives can always be achieved, and have been in India, when resources are concentrated on a well-defined target. That fact is compatible with the failure of the system to produce technical capability and innovativeness over a wider spectrum of activity owing to policy- created disincentives.

Union, now abundantly in evidence, had long argued that similar restrictions on production and investment, endemic to the communist scene but reproduced ingeniously in ours by the policy framework we now seek to discard, had inevitably led to this astonishingly bad outcome.[49]

Third, while we are moving in that direction through successive measures of liberalisation, it is important to clear away the debris left by the old-fashioned thinking (endemic in trade policy as well, as we have just seen) that somehow consumer goods are not an appropriate area for DFI inflows. Producing consumer goods efficiently "saves foreign exchange" as much as producing other goods that are equally efficiently produced. The successful export performance in manufactures by Japan and other Far Eastern economies was led at the outset by light consumer goods whose production had not been hampered by restrictions on absorption of technology, on production levels, on investment and on product diversification. It is noteworthy that Toyota and Hindustan Motors started production of cars in the same year, and witness the contrast today! Is there any doubt that, allowed to expand freely and with export disincentives absent, the Birlas could not have done what the Toyodas did? To have restrictions on DFI in consumer goods per se, no matter what they are, is to commit the fallacy of characterising commodities as "good" or "bad", depending only on their role as consumer or other goods. We recommend therefore that these ways of restricting DFI be done away with.

This policy decision would be compatible with giving *positive* incentives for DFI in areas where, for say security or other demonstrated reasons for prioritising the investment, we seek immediate DFI which would otherwise not be forthcoming.

Fourth, since attracting DFI has now become a policy adopted worldwide, by the developing countries of Latin America, the "newly exporting countries" (NECs) of Asia, the former Soviet Union, Eastern Europe and China --- not to mention the same game being played by the EC and the United States as well vis-a-vis each other ---, the restrictions on the sectors where DFI can flow in India, especially ones that have no rationale, are likely to hurt our competitive efforts at getting the DFI flows up. More than ever before, the competition for DFI has become a very difficult one today.

Fifth, it is in this light also that we ought to consider modifying our opposition to the proposed intellectual property rules at the GATT under the Uruguay Round. Yes, the theoretical classroom case on our side is strong. But the reality is that such protection has now become identified in the multinational circles and lobbies with whether a developing country is serious about attracting foreign investment. Mexico, recognising this reality, has thrown in

[49] Cf. Joseph Berliner, *The Innovation Decision in Soviet Industry*, MIT Press:Cambridge, Mass., 1976.

the sponge, accepting extremely stringent intellectual property protection rules so as to win US consent on the NAFTA accord and therewith to attract DFI. Making a shrewd cost-benefit calculation, we need to do more or less the same, linking this explicitly to policy statements and public relations efforts to advertise our determination to attract DFI.

Sixth, the continuation in place of FERA and COFEPASA, with the machinery for control and many controls still present, remains a standing reminder to foreign investors of the ambivalence that continues in regard to DFI in India. If these cannot be removed, with the exception of regulations that simply require attendance to our necessary legislation regarding environment, for instance, (legislation which most nations have or ought to), the least we can do is to minimise the bureuacratic hurdles by reducing the large number of permissions and clearances to bestill sought to a quick-acting, single-stop clearance system.

Seventh, as we discuss in detail in Section V, we need to examine forthwith the options before us in light of the ongoing regionalisation of the world economy, so as to access (through Association agreements or membership) the trade blocs already formed and likely to form. Such access gives the developing countries which enjoy it the ability to divert DFI away from developing countries that do not have such access. We cannot afford to sit idly by while this happens.

C. **Public Sector Enterprises: Privatisation and Competition**

Among the major reforms still awaiting a forceful solution is the reform of India's immense, and immensely inefficient, sector comprising enterprises engaged in "productive" activity. It would be tedious to repeat here the wellknown facts concerning these enterprises. We concentrate therefore on the remedies.

The problem has arisen in two different ways:

* Under SICA, the government has traditionally acquired several "sick" units, thus avoiding the bankruptcy of failing enterprises and ironically extending to private enterprises the disincentives that operate on public enterprises!

* For public enterprises started as such, the inefficiencies and the losses met by subsidies have been the major problems.

In principle, the former policy can simply be stopped and the bankruptcy laws, duly reformed, can be applied to any new enterprises that are failing the market test so that no new enterprises are taken on as sick units. [In practice, whether this can be credibly done depends on whether the government

is seen to have the determination to withstand political pressures to take over such units so as to protect the jobs of their workers. This credibility will increase with the establishment of the new institutions such as the National Renewal Fund which ease the exit of workers from failing units.]

We should also insist, in light of the experience we have had with the working of the public sector enterprises in the last four decades, on fully renouncing the creation of any new public sector enterprises in areas where the private sector will invest and where "security" considerations do not require governmental ownership It is not enough to "dereserve" the sectors held exclusively for the public sector (reduced from 17 to 8 in 1991, with the possibility of case-by-case exceptions); instead, the presumption now should be universally in favour of the private sector.

When it comes to enterprises already under governmental ownership and care, there are of course several options which the government has already been considering and, in some cases, even adopting. The central policy in this regard was laid down well in the Industrial Policy Statement of 24th July 1991 where a number of different approaches were distinguished. While the government has pursued several of them, and we believe that governmental policy so as to achieve management efficiency in the public sector enterprises is finally on track and should be steadily acquiring the necessary momentum, we consider here the broad dimensions of different policy options and their desirability.

1. Privatisation

Two main approaches need to be distinguished: sale of fractional equity in the public sector enterprise to private parties, while retaining controlling ownership and management in the pubic sector; and true privatisation that transfers control and management to the private sector (though some governmental equity holding, without managerial intervention, may continue).

(a) A main thrust of the early privatisation efforts was to disinvest in public enterprise shares. But, instead of considering the matter to be one of genuine conversion of the public sector enterprises to private sector ownership and management, as should have been the objective of policy, the programme offered only fractions of total equity in the chosen enterprises to the private sector.

Unless there was a "signalling" effect that further and fuller privatisation was in the works and therefore the management had better shape up or be prepared to ship out --- a signal we suspect, was not being conveyed ---

the programme offered only a marginal stake in public sector enterprises to the private sector without any efficiency implications.

The best defense that one might make of this policy was that the government may have been moving cautiously in the matter of genuine fullscale privatisation because of the complexity of the matter in view of the fact that the public sector had become a sacred cow in the political arena and partly perhaps because it wanted to gain some experience with disinvestment on a limited scale before moving full speed ahead in a more substantive way. It is perhaps more likely that the government found virtue in the fact that the sales proceeds could be used as revenues targetted at reducing the budget deficit as required by both necessity and by broad conditionality. In that case, the policy raised the further question (discussed in Section III.1.(d)) as to whether such use of the sales proceeds may not have meant that the necessary effort at raising revenue or cutting expenditure was not compromised.

As is wellknown, the policy involving disinvestment upto only 25% of equity in 30 profitmaking enterprises was made in three successive sales: December 1991, February 1992 and October 1992.[50] The method used in the first two sales was to offer "packets" containing shares of the enterprises for sale only to financial institutions, banks and mutual funds, in a bidding process with reservation prices, and with the restriction that the bundles could not be unbundled and the shares traded individually until 3-6 months. In the third sale, there were important changes: packets were absent and the auctions were open to bids by private individuals. In short, the process of disinvestment was already being changed in a more efficient direction, in light of both experience and criticism.

The realization of proceeds from these sales exceeded anticipations in the first two sales, however, while falling under in the third (despite the unbundling and the opening of the bidding process to private parties). The question that created controversy therefore is whether the procedures chosen to disinvest led to underpricing of the sales price of the equity and hence to an unintended transfer of wealth to the buyers. Drawing on British experience, studied by the economists Vickers and Yarrow [51], adapting their methods of analysis to the Indian situation as necessary, and analysing the behaviour of share prices when traded alongside the methods of the sales used by the government, the economist Rajendra Vaidya has concluded that the listing of shares prior to sale and the underwriting of shares are two ways in which the underpricing of the equity being sold can be avoided. Doubtless, these lessons have been drawn by the government as well now.

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[50] The economics of this disinvestment has been studied insightfully at our request by Rajendra Vaidya, "Disinvestment of Public Enterprise Shares", Indira Gandhi Institute for Development Research, Bombay, 1992, mimeo.

[51] J. Vickers and G. Yarrow, *Privatization: An Economic Analysis*, MIT Press Cambridge, Mass., 1988

(ii) But the main option, from the viewpoint of efficient management, has to be privatisation that transfers control and management to the erstwhile public sector enterprises. Sale of fractional equity to the private sector in enterprises that continue to be essentially owned and managed by the public sector cannot address the efficiency question meaningfully. The government is moving, quite properly, in this direction with the active exploration currently of the restructuring of Hindustan Machine Tools Limited, Bharat Bhari Udyog Nigam Limited, and Bharat Yantra Nigam Limited, preliminary to promoting their eventual privatisation. We endorse these moves and only make three observations.

First, the idea of restructuring before privatisation is desirable simply because it would, by exploiting any efficiencies that can be implemented, improve the proceeds that the government can secure from privatisation. On the other hand, the best restructuring may materialise from the actions of the private investors who would have the incentive to restructure in order to improve the returns from the enterprises they have bought.[52]

Second, the restructuring that would be truly useful prior to privatisation has to be the change of labour laws and the creation of institutions to ease the adjustment problems of labour when retrenched, the freeing of restrictions on price policy and of other restraints on efficient functioning, and the like. These changes would enhance the ability of the private investors to make improvements in management and efficiency, which would enable them to earn more in the marketplace and hence to offer better terms to the government for the enterprises they are buying. These changes would have a beneficial impact on the working of not merely the public sector enterprises to be privatised but indeed for all economic activity in every sector.

We therefore support the establishment of the National Renewal Fund, though it has limited funds, as it will ease somewhat the adjustment problems associated with retrenching labour as restructuring proceeds in the public sector (as also for retraining, placement services etc. for labour being displaced in the organised sector). We urge however that we learn from the experience of the developed countries such as the United States where the Adjustment Assistance schemes (introduced in the context of trade liberalisation) effectively turned into instruments for financially supporting labour and enabling it to stay on in sectors that ought to be winding down when the true objective was to get the labour to retrain and get out more quickly from these sectors.

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[52] An excellent treatment of the question as to when privatisation should be preceded by restructuring is provided by Paul Seabright, "Infrastructure and Industrial Policy in South Asia Achieving the Transition to a New Regulatory Environment", The World Bank, June 1, 1993; see especially Box D.

Third, the sale of lossmaking enterprises without any attempts at possible restructuring could lead to their being taken over at prices that reflect a decision by the private investor simply to dismantle them for what they are worth in their component assets, provided that this is politically and legally feasible. In that case, however, there could be serious adjustment problems for infrastructure-supplying sectors: the closure of an inefficient airline when others more efficient are not in a position to fill the gap in the service, for instance, may lead to immediate dislocations that could be quite damaging to the privatisation effort.

2. Competition

From this perspective, it is important to understand that the introduction of effective competition for the existing public sector enterprises would be valuable in itself so that, where it is particularly successful in turning a public sector enterprise into a highly-efficient undertaking, it may even justify a decision at times not to privatise (since the essential aim of the reforms must be to improve the efficiency of operation and management, not a shift to private sector ownership per se). But in other cases also, as the privatisation proceeds, the introduction of efficiency-prompting competition can only help the government realise better returns from the privatisation if the enterprises are in better operational shape.

The Indian public already knows what the effect of allowing the introduction of private airlines, however modest, has been on the Indian Airlines: the sheer ability to compare the two sectors has put some pressure on the IAC, though much more awaits being done. Similarly, the effect of letting in CNN and BBC, for example, and destroying the erstwhile monopoly of Doordarshan has permitted the viewers to vote with their feet, or rather with their remote controls, and is forcing changes in the latter.

The dismantling of industrial licensing, the ability of the private sector to invest in areas reserved for the public sector: these policies have changed. But the government needs to ensure that these changes are truly effective instead of becoming frustrated by continuing administrative obstacles (as noted by us earlier in this Report in regard to industrial delicensing, for example). Furthermore, the entry of the private sector requires also that the ability to deter entry be carefully examined: thus for example, in power generation, access to the electricity grid has to be effective for entry to occur. Then again, price controls may render profitable operation impossible, deterring entry into a sector that is technically open to entry now.

The government also needs to make clear that the existing public sector enterprises will not automatically be subsidised out of their losses into

continuing operation.[53] The combination of such a clear policy of what economists now call "hard budget constraints" with truly effective dismantling of barriers to private entry would mean a pincer-movement type of attack on public sector inefficiency: the entry of better-managed and efficient private competition would put pressure on the public sector enterprises and that pressure would then translate, in the presence of hard budget constraints, into the option to perform or to fail into bankruptcy.

While the government, thanks to the macroeconomic measures which we have reviewed, is currently wedded to dismantling subsidies and will introduce a measure of hard budget constraints, we suspect that the continued easing of the macroeconomic crisis could lead to a weakening of the political ability to stay the course. Hence, our preference is to go ahead with privatisation plans, preparing to shed most of the public sector enterprises from the custody of the government even as we implement speedily the institutional changes (such as the National Renewal Fund) that would make competition an increasing reality in much of the public sector.

We also suspect that, since many public sector enterprises impinge directly on the consumers, the demand for privatisation and for competition regardless is currently ahead of the supply, and that the hesitation of the government to proceed more expeditiously with the task reflects excessive caution. We know that the demand for serious reforms in delicensing was undercut because the elites who made policy were insulated from the effects of bad policy by being able to jump ahead of the queue. But, this is not always true for infrastructure-supplying public sector enterprises that impinge on all. Thus, when IAC service breaks down, it affects indiscriminately. Power failure also affects all (though the rich can take defensive action through their own mini-scale and expensive generators whose multiplication is an indictment of our policy to date). Thus, we suspect that the outrage over the failure of power, airlines, telephones and communications to function with efficiency has grown ,especially as the possibility of alternatives has become a reality thanks to the reforms to date. The worldwide movement towards privatisation also reflects similar experience, and is based on pragmatic experience rather than on an ideological preference for the private sector.

3. Infrastructure

While we have argued for reform of the public sector enterprises, partly because of their importance in supplying the infrastructure without which the response to the reforms to date will be inadequate, infrastructure is supplied by

[53] This again can be done more credibly if the National Renewal Fund, and even a limited unemployment insurance scheme, are successfully established.

the government in other ways as well (e.g. through Departmental undertakings). Thus, the total public sector spending on infrastructure in the Eighth Plan (on power, transport, telecommunications, and urban water and sewage provision) accounted for roughly a third of the total public sector outlays.

We would then be remiss if we ignored this critical area that requires attention from the government. However, the problems that attend the sectors in infrastructure are complex and difficult because of several reasons. For instance, they produce output that is often not traded internationally.[54] So, opening of the market to international competition to introduce efficiency is not policy that is available. Then again, these sectors are often characterised by scale economies, network externalities, long gestation lags in investment, and public-goods aspects in their output, raising familiar but policywise difficult problems.

Hence, an agenda for improvement of efficiency, and for increase in the supply (given the serious current shortages), needs to be developed for each sector, keeping its special characteristics in view. This goes beyond the terms of our reference. We therefore confine ourselves mainly to drawing the government's attention to a few salient issues that the available studies have highlighted.[55]

(a) In the *transport* sector, railways and airlines (until recently, as already noted) have been state monopolies, the former organised as a departmental enterprise and the latter as a public sector corporation. In road transport, however, goods transport is almost entirely private while a mix of public and private operations exists for passenger transport.

In *road* transport, then, indicators such as the number of employees or the profits per vehicle are cited to suggest that the state transport agencies are overstaffed relative to the private firms. But this may be an overstatement of the problem since the private firms are exempt from some of the labour laws that state agencies must conform to, while they also have profit-related incentives to evade the labour laws they are subject to whereas the state agencies have no profitmaking to worry about!

We suspect that the real problem with the efficiency of the road system lies in its role vis-a-vis the competing rail system: for, freight can be often carried by either. In particular, railway passenger fares and freight rates are *administered* prices; and studies suggest that cross-subsidisation of passenger

[54] Power, of course, can be traded across borders but, in our case, is not traded. Then again, there is already some international competition for the market for international travel, though much more will prevail if the Uruguay Round talks succeed and concessions begin to be made to liberalise the service sectors

[55] In particular, we consider the transport sector, including road, rail and airlines.

fares at the expense of freight rates is significant. At the same time, railways are required to favour the movement of freight by other public sector agencies (e.g. the Food Corporation of India) over the movement of private freight when it comes to allocating scarce wagons. It is certainly likely that the phenomenal growth of private movement of freight over long distances in lorries reflects to a great extent the cost, uncertainties and other impediments associated with private freight movement on the railways.

Again, we only have a system of motor vehicle taxes, and no tolls are levied on the use of the highway system. As a result, there is no link between the revenue from these taxes and the cost of investment and maintenance of the highway network.

What is clearly necessary in the road-surface transport sector is an integrated analysis which would provide a systematic basis for determining the rate structure, the tax structure, and the level as also the modal and spatial distribution of highways and rail tracks.

In regard to the *airlines*, we have already indicated that competition through the encouragement of new entry by private, domestic, and foreign, airlines would shape up the IAC.[56] At the same time, we see no reason why the IAC should not be privatised in the foreseeable future, even as the competition is intensified so as to improve its efficiency.

(b) *Power generation* is an area that has already been opened up for for private investors, domestic and foreign. However, until the issues relating to the administered prices of fuels (such as coal and natural gas) and to controls on prices charged to various users of electricity are resolved, the response is likely to be limited.

Then again, efficient *telecommunications* remain a major problem on the Indian scene. This sector is also being opened up to more private entry. But the issues relating to pricing, and to the regulatory regime we will work with, will have to be quickly resolved if new investments are to be attracted and the working of the old ones induced to become more efficient.

China and Latin America are moving ahead with major foreign investors to modernise their telecommunications. If we fall seriously behind, we will be handicapped in our competition for the world's markets for sure.

D. Financial Sector Reform

The role of financial sector reforms is equally well understood by the

[56] The entry of foreign carriers can be part of the concessions we make at the Uruguay Round, earning reciprocal concessions in other sectors. Reciprocal concessions for Air India and other prospective new carriers down the road may also be put in place now, though our ability to profit from them would depend on our ability to come up with competitive airlines once we shift to a more competitive framework at home.

government presently. In essence, this is part of the new institutional setup that is necessary once the old system of licensed and controlled allocation of investible resources among different activities is abandoned. The essential questions should relate, not to whether we should have these reforms (a question we have answered in the affirmative since the excellent 1991 Narsimhan Committee Report), but to how rapidly to proceed on the different dimensions of the necessary reforms.

Some general observations may be made. First, the financial scandal that burst on the Indian scene nearly a year ago, understandably slowed down the pace of financial reforms. Quite aside from underlining the need to improve the regulatory regime, many thought that the liberalization in the financial sector was responsible for the scandal. In reality, this was not so. Nothing that happened could not, in principle, have occurred a few years ago when we were still in the old regime. If anything, the old regime had meant that the ability to earn decent profits was seriously compromised by measures such as the forced purchase of low-yielding governmental liabilities and this may have made banks hungry to earn profits even by cutting corners (as noted by us earlier). While the government did argue this, it carried less weight than it should, simply because it was in the dock and politics is often the art of pressing an advantage even when objective analysis shows otherwise. Nonetheless, it is necessary to understand that the scandal was not a product of the financial sector reforms that were beginning to be made.

Second, there is nothing exceptional in the fact that the financial sector will show occasional excesses that even the best regulatory regime may fail to detect. The BCCI scandal, which was far greater than our homemade variety, escaped some of the best regulatory agencies in the world, deceiving the formidable Bank of England and the US authorities. Perhaps some sectors are more prone to abuse than others. The financial sector presents the greatest opportunities for skulduggery, leading to the rise of major criminal figures and scandals; the industrial sector throws up fewer robber barons; and the agricultural sector usually presents the fewest opportunities for ill-gotten wealth.[57]

Third, therefore, governments typically tend to swing from excessive regulation, often moved by such excesses and scandals, to excessive deregulation which then, because of the excesses it encourages, leads back to excessive regulation. These cycles exist in all regulatory activity, to some extent, but are exaggerated in the financial sector everywhere.

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[57] Governmental intervention such as the price support programmes for agriculture in the United States and the European Community do create opportunities for malfeasance as well, but the the magnitudes involved are way below what can happen in the financial sector.

Fourth, the government also needs then to distinguish between desirable and undesirable regulation. The financial liberalization that the government is embarking on is deregulation of the right kind: removing the features that have seriously reduced the efficiency of the financial sector and which must be eliminated to make the financial sector play the role it must now in the new regime. Deregulation of the wrong kind was the one that removed the restraints on the US banks' activities that led to the enormous S&L crisis (as was in fact predicted by several economists at the time that the restraints were being removed).

The government must therefore proceed expeditiously with financial sector reforms, to facilitate an efficient flow of resources into our industry and trade, and also (as noted above) to establish the instrumentalities that constrain the government's ability under the old regime to finance inflationary financing by commercial banks and by a compliant central bank.

The creation of an efficient mechanism to ensure the flow of resources into the industries and activities that are most promising by the market test requires action on several fronts that the Narasimham Committee ably laid out.[58] In particular, the Committee wanted interest rates to be freely determined by market forces, and to reduce the role of the government in the allocation of credit by (i) reducing the socalled priority sector lending from 40% to 10% of total bank loans within a period of three years, and eventually down to zero %; and (ii) reducing the Statutory Liquidity Requirement from 38.5% to 25% of the bank deposits and reducing also the "cash reserve" requirement that similarly taxes the banks in favour of the government. In addition, the Committee urged the reduction of entry barriers on private and foreign banks so as to improve efficiency through competition, and it proposed also financial opening to the world by permitting private capital inflows.

We endorse these proposals (while recognizing the wellknown problems of moral hazard and adverse selection in letting interest rates be market-determined). If anything, there needs to be faster progress on proposals such as reducing priority sector lending and, during the transition to such lending to government being eliminated, raising the cost of such credit in any event to normal commercial rates (as has been done by several developing embarking on financial reforms).[59]

The government is aware, but we might reiterate, that rapid financial sector liberalization in the matter of allowing private (nonequity) capital inflows, in pursuit of higher real interest rates resulting from the freeing up of

[58] We have profited from the excellent treatment of the subject by Pradeep Agarwal, "Financial Reforms", in *Policy Reforms for Economic Reform*, IMC IGIDR, 1992, op.cit.

[59] For more detailed suggestions, see Agarwal, ibid

interest rates, created severe problems in some developing countries. Thus, in Chile, Argentina, Uruguay and the Philippines, the freeing up of the interest rates led to extremely high real interest rates, exceeding at times 25% in real terms, thanks to destabilising demands on bank credit from several sources with pent-up demands that had been frustrated before the financial liberalization.[60] At the same time, of course, there is much evidence of artificially low real interest rates leading also to adverse effects on economic growth. The answer therefore seems to be to ensure that there is close monitoring of the interest rates and of bank lending as also reasonable limits on deposit insurance so as to ensure that speculative borrowing is not financed by banks (as the US banks did, given that their deposits were guaranteed without effective limits by the Federal Deposit Insurance Corporation, contributing to the creation of the S&L crisis).[61]

In view of the limited nature of our experience with many of these matters, given the old regime, it is important that the government draw extensively on both academic and practical expertise in the area of financial liberalization. The (necessary) regulatory structure that we finally put in place, including the guidelines under which, say, SEBI will operate, will also require expert processing of ideas and information about other countries' experience which we should freely draw upon. This should be standard practice in any case; but it is all the more important when we start from an institutional setup where such expertise has not developed in India because it had no place. [62]

E. Agriculture

We have decided to treat reforms in Agriculture separately, even though the specific measures we recommend belong to areas such as Foreign Trade and Macroeconomic Reforms (e.g. the proposals to curtail drastically the input subsidies and to reform the Public Distribution System), largely with a view to emphasising that this sector remains critical to the overall health of the

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[60] In the Chilean case, with the freeing of capital inflows, banks borrowed from abroad and lent at home at high interest rates with little consideration for potential default. When extensive defaults occurred, the government was forced by external lenders (using financial and political muscle) into accepting responsibility for these private debts even though the loans had not been guaranteed by the government!

[61] In this regard, we should also stress that a careful policy reassessment is necessary in the matter of the treatment of "nonperforming" loans in the bank portfolios. A significant part of these nonperforming loans is attributable to the government's policy on priority lending (which we discussed earlier) without adequate scrutiny (at loan "melas", for instance), and to the fact that the waiving repayments (the socalled loan "mafis") encourages imprudent borrowing.

[62] We emphasise the obvious here, but it is necessary to do so. For instance, the nonnegligible undervaluation of the equity sold under the first two rounds of sale in 1991 and 1992 could have been avoided, as we noted in the text, if the experience of the UK had been properly taken into account. Then again, the SEBI guidelines applying to investment and merchant banking services required for corporate issues of longterm securities in India could be improved and specific market mechanisms can be suggested which would be more effective than these guidelines. Cf. Sankar De and Sushil Khanna, "Merchant Banking under SEBI Guidelines: A Study of Regulations in Developing Capital Markets", Indian Institute of Management, Calcutta, April 1993, mimeo.

economy and both efficiency and equity considerations demand that the reform effort be focused squarely on it as much as on other important areas such as the reform of the public sector enterprises. In particular, we urge the government to address the following areas with concrete policy reforms:

* Foreign trade in agricultural outputs and inputs
* Public distribution system (PDS) with respect to foodgrains, edible oils and sugar
* Subsidisation (explicit and implicit) of agricultural inputs: fertilisers, irrigation and electricity
* Agricultural credit

1. Foreign Trade in Agricultural Goods

Foreign trade in most agricultural goods is currently subject to QRs or canalisation or other restrictions such as minimum price requirements, and has not been covered by the trade liberalization measures of 1991 and 1992 to date. The effect of the traditional trade policy in regard to agricultural goods is evident from the fact that, until recently , the border prices of rice and wheat were about twice the domestic price whereas the domestic edible oil prices were more than twice the world market prices, these price disparities between domestic and world prices reflecting export and import restraints.

At the same time, inputs into agriculture, such as fertilizers, irrigation water and electricity are heavily subsidised (and agricultural income is still not subject to income tax). If the total effect of all implicit and explicit taxes and subsidies, including the protective effect for manufactures (relative to agriculture broadly speaking) that the overvaluation of the rupee implied until recently, were calculated, we would find that the effect has been to bias the government-provided incentives against agriculture. Hence, a broadbased sweeping set of reforms would favour, rather than harm, agriculture on the average.[63] Within agriculture, of course, some items (e.g. rice and cotton) are deprotected by the full set of current policy measures while others (e.g. oilseeds and sugracane) receive high protection.

We see no reason for this continued reliance on QRs and on canalisation of agricultural goods to continue under the new regime of liberal trade that the economic reforms plan to implement. It is now time to abolish canalisation altogether and also to convert the QRs into equivalent export and import tariffs,

[63] This conclusion is based on estimates made by the World Bank economists, Gulati and Purcell. The broad conclusion is also paralleled by the experience of many developing countries, as studied by a team of economists led by Anne Krueger of Duke University, at the World Bank.

next turning to a phased, preannounced set of reductions of these tariffs down to much lower levels. [Where there is reason to maintain higher tariffs, as in the few cases when India has a sizeable influence in the long run on prices in the world markets (e.g. tea, basmati rice and jute), this could be done consistently with the general reform we advocate in shape of removal of the QRs and the canalisation process.]

2. The Public Distribution System

We now turn to the pressing question of reform of the Public Distribution System which has distributional-equity objectives. This system requires immediate reform because, as currently constituted, it is inefficient in targetting the poor effectively, so that it has soaked up largescale governmental revenues (adding to the problem of the budget deficit) while producing limited results.The macroeconomic necessity to rein in subsidies and to protect the poor effectively during the necessary macroeconomic adjustment doubly requires therefore that the reform of the PDS be undertaken as an urgent task.

The PDS supplies specified quantities of rice, wheat, coarse cereals, edible oils, kerosene and sugar at prices below ruling retail market prices to holders of ration cards through the Fair Price shops. Although the PDS initially covered (except in Kerala) only urban areas, at present rural areas also are covered.

The supplies of cereals and sugar for the PDS are obtained through domestic purchases and imports by the Food Corporation of India (FCI), a central government enterprise, and by state governments. Edible oils are imported by the canalising agencies, viz. the State Trading Corporation of India (STC) and Hindustan Vegetables Oils Corporation Limited. Since kerosene is a petroleum product, it is handled by the state monopoly, Indian Oil Corporation. If edible oil imports are freely permitted, the domestic price is likely to fall; in any event, a good case does not exist for subsidising edible oil prices below import price levels.

The domestic purchases are made at "procurement" prices from wholesale traders in wheat and from rice millers. A specified proportion (the so-called 'levy') of sugar output is bought from sugar mills at the levy price below the open market price at which the rest of the sugar output is sold. The FCI and other relevant state government agencies thus purchase, transport and store the commodities included in the PDS. In the triennium ending in 1988-99, about 16.5% of domestic wheat output and 13.2% of rice output were procured

on the average.[64] The pressure for increasing procurement prices year after year has proved politically irresistible: in 1992-93 they were raised by over 15% in the case of rice, wheat and coarse cereals.

The direct budgetary cost of PDS (i.e. the difference between the revenues from sales and the cost of purchase, transport, storage and establishment) has been growing. In 1990-91, the central government alone spent Rs. 25 billion (or 3.5% of its total revenue expenditure of Rs. 735 billion) on food subsidies. However one should not view these subsidies exclusively as consumer subsidies, or as representing the total economic cost (over the prices paid by consumers) of the operation of the PDS, for two reasons.

First, the cost of the inefficiency of FCI (its excessive staffing, inefficiencies in its purchase, storage and transport operations) is reflected in the budgetary subsidy. According to one estimate, FCI overhead and storage costs have recently risen at annual rates exceeding 20% and together accounted for half of the total food subsidy in 1990. Second, there are non-bugetary costs such as the cost of the preference given to FCI relative to private traders in the transportation of agricultural commodities by the railways, concessions in the interest rate charged to FCI by the banking system for credit, etc.

Ostensibly, the PDS is meant to be part of a 'safety net' for the poor. According to estimates by the economist Subbarao, however, while 50% of India's poor live in Bihar, Madhya Pradesh, Rajasthan and Uttar Pradesh, they received only 10% of PDS supplies in 1990. Minhas has also estimated that more than a third of rice and wheat, 40% of edible oil and as much as 73% of sugar sold through the PDS in rural areas were bought by the richest 40%. In urban areas, however, the poorest 40% managed to buy about the same proportion of wheat, edible oil and sugar and about 50% of the rice sold through PDS. Thus the PDS did reach the poorest 40% (at least in the country as a whole) while at the same time supplying the non-poor the same commodities at prices below those ruling in the market. PDS is thus poorly targeted to the poor: the leakage to the non poor is really very high.[65]

Apart from poor targeting, the PDS also suffers from leakage of supplies to the open market. Some estimates put such leakages at a third of the rice, wheat and sugar offtake from the PDS and over half of edible oil. Presumably these leakages are effected through sales by fair-price shopkeepers to bogus

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[64] Besides the procurement of foodstuffs for the PDS, the government buys raw cotton and natural rubber as well under its price support programme.

[65] Also see a recent study by Kirit Parikh, "Who gets how much from PDS: How effectively does it reach the poor", Indira Gandhi Institute for Development Research, Bombay, undated. Parikh, using the data collected by the 42nd round of the NSS, reaches the same conclusion: in particular, that "the cost-effectiveness of reaching the poorest 20% of the households through PDS cereals is very small. For every rupee spent less than 20 paise reach the poor in all states, excepting in Kerala where 26 paise reach the poor".

ration card holders. The shopkeepers earn the difference between the open market price and the sale price to card holders. Thus the leakage is an unintended transfer to the shopkeepers.

These problems of the PDS have of course been clearly recognized by the government. Indeed the Economic Survey 1992-93 points out that:

> The PDS supplies no doubt have contained the vigour of inflation but part of their impact has been offset by monetisation of budgetary deficit to meet food subsidies. Maintaining supplies to PDS involves continuation of food procurement, grant of subsidies, and reintroduction and perpetuation of some controls. But several weaknesses have emerged in the distribution system which have diluted the essence of the system to benefit the vulnerable sections.The financial liabilities of the state governments in maintaining this system have increased. Leakage and black marketing in PDS supplies have also reduced the full impact of PDS in containing inflation. [paragraph 4.51]

In reforming the PDS system, however, different alternatives may be considered. First, consider alternative ways of targetting the poor more effectively.

(i) Better targetting of the poor may be achieved through a means test. It is often argued however that a cheaply administered, reliable means test is administratively infeasible in the Indian context. Possibly this is so; but we doubt that this option has been effectively explored.

(ii) Better targetting may also be achieved by entrusting the task of identifying the poor to the local bodies (at the block or village level), with possibly social actions groups coopted into the task, through some centrally-defined transparent procedure. Kerala has had some success with this approach and it would be worth exploring it thoroughly to see if it can be transplanted effectively elsewhere in India.

(iii) Yet another approach would be through commodity-based targetting. For example, a PDS confined to the distribution only of coarse cereals is most likely to be used only by the poor. The case for supplying sugar and vegetable oil through the PDS is extremely weak anyway. As such, even if the PDS is not confined to coarse cereals, sugar and edible oils should be excluded from it altogether.

Next, consider the design of the PDS more generally. Is the chosen method of distribution, assuming even efficient targetting, the least-cost way of achieving the objective of supporting the consumption of the poor? We do not think so.

(i) *Food Stamps*: Thus, we could move to a system of food stamps which enables the holders of these stamps to pay for part of the cost of their purchase (from the open market) of commodities covered by this alternative PDS.

If the issue of the food stamps could not be effectively targetted at the poor and if the use of stamps could not be effectively confined to the purchase of PDS food commodities, such a scheme in effect becomes an undifferentiated income subsidy. At the other extreme, full effectiveness in targetting and purchases would provide the poor, and only the poor, with additional income to buy essential PDS food commodities.

In either case, with the poor buying from the market, the government would not be involved in the purchase, transport and storage of commodities. Thus the FCI could be dismantled.

The Sri Lankan experience with food stamps might be worth examining in this context. If there is significant inflation in food prices, as was the case in Sri Lanka, food stamps of fixed nominal face value would obviously fetch less food and amount to less of a real income subsidy. But with flexibility in the design of the scheme (for example, one could consider indexing the value of the stamps by the prices of coarse grains or other such commodities bought only by the poor), such problems could be effectively tackled.

A move to food stamps away from the present PDS seems to us therefore to be an attractive policy option for the government to embrace as part of the continuing reforms.

(ii) *Bids*: If the changeover to a food stamp system is somehow deemed infeasible, it is still desirable to do away with the inefficient FCI by letting the private sector supply the quantity of grains needed for the PDS, at the place and time needed, by calling for bids. By making the entire process of the call, receipt, opening and acceptance of bids as transparent and open as possible, abuses of the system could be minimized.

Admittedly neither the food stamp system nor the bid system takes into account the possible implicit taxation involved in the purchase of grain at procurement prices for the PDS. If the very operation of the PDS, by effectively removing the poor from the open market and leaving only those with an inelastic demand in it, does not raise the open market prices sufficiently above procurement prices so that the weighted average of procurement and open market price is below the open market price that would have prevailed in the absence of a PDS, this taxation could be significant. But in recent years, with effective lobbying by farm interests, the procurement prices have not deviated much from the open market prices. As such, the cost of operating the PDS has not been reduced by such implicit taxation of producers.

3. Subsidies on Agricultural Inputs

There is also an excellent case for removing the existing subsidies on the three major agricultural inputs: fertilizers, irrigation water and electricity.[66] This is necessary because they add to the budget deficit in a big way and they must distort the choice of technology in agricultural production as well. If, further, these subsidies are removed in tandem with the changes in the import regime that are discussed earlier, it is also likely that agriculture, on the average, will benefit from the reforms instead of being harmed incentivewise.

(a) Fertilizers

In 1990-91, fertilizer subsidies amounted to as much as Rs. 44 billion as compared to the total revenue expenditure of Rs. 735 billion. Although, on the average, the issue price of fertilizers has been increased by 30 percent since August 1991, there is still room for further increases since, even with this increase, the considerable gap between domestic and import parity price has not been closed. There is much evidence that the marginal returns on fertilizer use would be attractive to farmers even with an increase in fertilizer price to import parity levels.

(b) Irrigation

The situation with respect to irrigation charges is also abysmal. In 1989-90, even without providing for capital costs, current expenditure on the irrigation system exceeded revenues from the water charges by over Rs. 23 billion, the revenues as a proportion of current expenditures amounting only to 7.5% in 1988-89. Since the current irrigation charges as a proportion of marginal returns from irrigation are almost negligible for most crops, it follows that raising them would not significantly reduce the net returns from cultivation of irrigated crops at the outset, while it would raise revenues significantly.

There are also many serious problems with the planning and implementation of irrigation investments and with the operation, maintenance and management of irrigation capacity once created. Irrigation departments are widely understood to be overstaffed, inefficient and uninterested in recovering irrigation costs since they have no access to the use of irrigation revenues. A number of studies have already identified many of these problems and have made recommendations for their correction. Since irrigation is the responsibility of state governments and since their capacity (administrative and political) to reform the irrigation system management is limited, not much can be expected in the short to medium run by way of major reforms. But the center

[66] It should not be inferred that it is the agriculturists who are being subsidised. Indeed, fertulizer subsidies reflect in part the high cost of fertilizers produced by some of the more inefficient domestic producers. Irrigation and electricity subsidies also reflect at least in part the overstaffing and other inefficiencies of state irrigation departments and electricity boards

needs to push for these reforms in all possible ways, while insisting at least on having irrigation charges raised immediately.

(c) **Electricity**

Agricultural use of electricity has grown rapidly from less than 5% of total consumption in 1960-61 to about 20% in 1990-91. In the 1980s the average annual rate of growth was about 15%. Estimates by World Bank economists suggest that both farmers and other consumers have been heavily subsidized at a price that is less than half the long-term marginal cost of supply. Moreover, only two-thirds of the amounts billed are recovered.

Thus, electricity generation (other than self-generation by the railways and by some industries and the limited output of private utilities) and distribution are the responsibilities of State Electricity Boards (SEB's). The Economic Survey of 1991-92 projected the commercial losses of all SEB's to be Rs. 48.5 billion. Although the supplying of power to widely-scattered irrigation pumps is costly, it is supplied free of charge in some states such as Tamil Nadu or at a very low price in almost all others. Thus the losses in sales to agriculturists account for a significant proportion of the total losses of SEB's (which, of course, reflect other factors such as inefficiency in operation and in the maintenance of generation and transmission facilities).

Power generation has now been opened for domestic and foreign investors. Yet, as long as the price which private producers will receive is controlled by the state, it is likely that the response by private investors will be disappointing. Indeed, the price guarantees reportedly demanded by foreign investors who have shown an interest in power generation testifies to this. This can be calamitous for the success of the entire reform effort since power is clearly an important bottleneck right now. Therefore, the entire gamut of issues relating to power generation and distribution such as the scale of investment in generation and transmission, the composition of the generating capacity in terms of thermal, hydro and nuclear, the choice of fuel for thermal plants (i.e. coal, lignite, fuel oil and natural gas), and above all the extent of state involvement in the energy sector as a whole and particularly in the generation, transmission and pricing of electricity also need now to be thoroughly reviewed.

New institutional arrangements should also be examined. For example, scale economies in generation are apparently not significant in some new technologies. In the absence of significant scale economies and externalities in generation and distribution (which require public ownership or preferably public regulation), these activities could be privatized, while long-distance transmission through an interstate grid in which network externalities are important could be in the public sector or alternatively be operated as a

regulated private monopoly. The grid would then purchase power from private generators and sell to private distributors.

4. Agricultural Credit

We finally turn to the question of agricultural credit. The major, declared objective of agricultural credit policy has been to enable farmers, especially small and marginal farmers, to adopt modern technology and improved agricultural practices. However, "Despite a substantial increase in the overall agricultural credit, the problem of mounting overdues has slowed credit expansion. Overdues have been around 40-42 percent during the last 3-4 years." (*Economic Survey* 1991-92).

While the decennial rural debt surveys of the Reserve Bank of India suggest that the share of institutional credit in total rural credit has increased substantially from 20% in 1951 to over 80% in 1981, there are reasons to believe that these data overstate the increase and that informal credit continues to be very significant in rural areas. At the same time, there are substantial regional variations in institutional credit use. The World Bank estimates that in the mid-1980s an average of only 27% of India's farmers used cooperative credit, varying from 9% in West Bengal to 90% in Punjab. Besides, only 4% of the farmers used credit from commercial banks and two-thirds of term credit went to the large farms.

Thus it is an open question whether the objectives of the agricultural credit policy are being achieved. The World Bank estimates that farmers cultivating over 5 acres receive an interest rate subsidy on term loans of about Rs. 1 billion per annum. If one realistically assumed that their annual overdues would never be cleared, they in effect received a further subsidy of over Rs. 2 billion.

Given then the scale of the problem, the situation calls for a corrective policy. It must be understood that the credit subsidies are of little value to the poor farmers since most of them do not get access to credit in the first place; access to credit is really the problem faced by the poor (a problem that can be attacked along the lines suggested by the Grameen Bank in Bangledesh). The reform of the agriculture credit system, as we have now inherited it, should in fact be regarded as an important part of the financial sector reforms whose urgency we discussed earlier in this Report.

V. LOOKING AHEAD: TRADING CHOICES

If we make a successful transition from an essentially inward-looking posture to an outward-oriented economy, exploiting foreign trade and investment opportunities fully, we have to examine how we can position ourselves so that these opportunities are maximally available to us. Else, we will be working with one blade of the scissors, ignoring the other.

This requires that we now begin to appraise the trends in the world trading system realistically and formulate policies that will prepare us to exploit these trends to our best advantage.

A. Supporting the GATT and Closing the Uruguay Round

The ability to exploit the trading opportunity in the world economy requires that our access to world markets is secure. While world markets can absorb our increasing exports, if these markets are kept open, it is not certain that they will be left open as effectively as when the trading nations agree to binding rules and disciplines. This discipline is provided by the GATT (the General Agreement on Tariffs and Trade) in Geneva.

If the GATT is wounded and weakened by the failure to conclude the seven-year old multilateral trade negotiations, then the effect will be to pull the world yet more towards unilateral actions by the economically stronger trading nations. A telling example is provided by the United States in its use of Section 301 policies aimed at unilaterally imposing its own demands on other trading nations through threats to otherwise close its own markets. Such a demand was indeed made on us on 25 May 1989, when the US invoked Super 301 provisions of its 1988 Trade Act to indict us for trading practices defined as unfair by the US unilaterally and not constituting a violation by us of any treaty-defined obligations. The Clinton administration currently intends to revive the now-lapsed Super 301 legislation. This will certainly be aimed at Japan; but, as in 1989, it can be expected to be aimed at other countries.

Since the US has asymmetric economic power, the result will certainly be to create unilateral demands on us and others. This cannot but lead to disruption of our trade access from time to time. If the US revives Super 301, then the EC can also be expected to follow suit. In Japan also, there is increasing concern about this use of aggressive unilateralism and therefore a segment of opinion suggests that Japan acquire a similar legal instrument to respond to US actions. This too can have prospective spillover onto other nations.

It is therefore in our interest to support the emerging efforts by the United States and the EC to close the Uruguay Round of multilateral trade negotiations,

since a strengthened GATT means a greater worldwide, multilateral discipline that could contain the outbreak of unilateralism by the stronger trading nations. Multilateralism is the best defense of the weak.

Since there will be efforts by the US to exempt the use of 301 actions from any GATT discipline, as a part of the last-minute demands before closing the Round, India should actively join the world community in refusing to concede such demands, while being flexible on many other matters. Else, a central benefit to us of multilateral discipline in the world trading system will have been nullified.

India's ability to play a significant role in the Uruguay Round negotiations at this stage is strictly limited, of course. But our views today, precisely because of our changed image thanks to the reforms and also greater flexibility at the trade talks, are listened to with greater respect and attention than during the 1980s. Our role in the final lap of the Uruguay Round negotiations must be reckoned therefore to be non-negligible, especially if we back agendas that are clearly to strengthen, rather than weaken, the GATT system.

B. Regionalism: India's Options

The wounding of the GATT through protracted and continuing negotiations of the Uruguay Round has accentuated the existing trend towards the formation of regional blocs. The failure of the EC (European Community) to respond to the US demands to start multilateral trade negotiations in 1982 was a principal factor in turning US trade policy towards the US-Canada free trade agreement. That, in turn, triggered the further extension of the regional arrangement to include Mexico under the now-impending North-American Free Trade Area (NAFTA).

This tendency to build FTAs is now creating its own momentum. With the earlier Bush decision to extend the NAFTA to South America, as part of the Enterprise for the Americas Initiative, and President Clinton's increasingly likely endorsement of such an initiative, there is now strong likelihood that a regional Americaswide NAFTA will materialise and therefore that there will be some momentum for a defensive response in Asia, with Japan at the center of such a free trading area.

If this happens, as is increasingly likely, then the world trading system may soon be fragmented into four "blocs": the (enlarged) EC, the NAFTA extending into South America and becoming an "Americas" bloc, an Asian bloc, and the "bloc" of marginalised nonmember nations that are not part of any of the former three blocs.

If India is left out of membership in any of these trading blocs, and becomes a member of the fourth "bloc" of marginalised nonmembers, she will

be deprived of the maximal trading and (inward) foreign investment opportunity that she can otherwise enjoy. For, access to one of these large blocs can be a powerful way of attracting foreign investment which will go where the markets are. Indeed, the Mexican President Salinas's decision to seek to join NAFTA with the US and Canada was prompted largely by a desire to attract foreign investment in this way.

Our diplomacy should therefore now be geared immediately to seeking membership in one or more of these blocs. As of now, only the EC exists and NAFTA (embracing Mexico) is nearly born. Nothing precludes membership or quasi-membership in both.

(i) We should forthwith begin therefore formal approaches to the EC to explore an Association agreement such as the many that the EC has already signed with foreign nations, including in Africa. More cannot be expected because full membership is regionally constrained to Europeans. Our special relationship with Great Britain and generally excellent relations with France, Germany, the Netherlands and other European nations, as also the growing attractiveness of India as a market and as a sourcing country for foreign firms, should also predispose the EC towards a favourable response.

(ii) Equally, we should explore the possibility of a free trade agreement with NAFTA. Towards this end, we could exploit our Commonwealth relationship with Canada, encouraging it to seek our membership just as the US (not Canada) sought successfully to bring in Mexico (and Canada went along). It may not be too ambitious to get the Canadian government to play an initiating role in seeking new members for NAFTA, drawing upon Canada's external alliances and political affiliations (such as the Commonwealth), instead of relying only on the US for choice of new NAFTA members.

This does not preclude our simultaneously approaching the US itself for NAFTA membership. The nearly-million strong Indian community in the US provides the possibility of mobilization by us of political force that can get attention in Washington D.C.. This also requires that our objectives be totally clear and firm and that India be represented in Washington by an energetic and visionary Mission that acts so as to mobilize this political potential for the economic objectives, just as Mexico has done effectively with its more numerous nationals in the US in creating support for NAFTA in the US Congress. This also implies that voting rights of the Indians in the US become critical: unlike any other democracy, the US legislates primarily to benefit those who voice their concerns rather than for generalized benefits that accrue to all even if demanded by a few. In turn, this means that India should now go full speed ahead with permitting dual citizenship, enabling many in the US (and elsewhere) to gain voting rights that they can get only if they renounce Indian citizenship.

(iii) The possibility that we should explore with the greatest energy, however, is with Asia. At the moment, there is no Asian bloc, and many in the West think that one may not materialise. On the other hand, it is hard to imagine anyone taking seriously the formation of the US-Canada free trade area over a decade ago, and its extension to Mexico would have been regarded as altogether utopian. The speed with which old assumptions are shifted by new possibilities and realities is truly dazzling.

As it happens, the sense that the world trading system is being already "carved up" into blocs by the EC and the United States is already leading Malaysia to sponsor such an Asian bloc. The anti-American rhetoric in which such a proposal tends to emanate from Malaysia handicaps the acceptance of the idea by Japan. For, Japan has naturally no desire to make the Asian bloc an offensive rather than a defensive move: Japan cannot afford to, and sensibly will not wish to, alienate the United States.

But the sentiment for an Asian bloc is now stronger and growing. India must become an active proponent of the idea, seeking membership as and when the idea materialises. This will need patient diplomacy since the current position is that India is not perceived as a "natural" member of such an Asian bloc and our membership even of the APEC, which is only a looser body of Asian and Pacific nations for economic cooperation, is still pending.

We will need to woo the ASEAN nations which were earlier turned off by our pro-Soviet positions on Vietnam, and we will also need to work actively on Japan itself, using both economic and political carrots to do so. Essential to our success will be commitment to an Asian identity (which need not exclude multiple affiliations and identities). Without this commitment, our membership may run into difficulty just as Britain's less-than-total enthusiasm for entry into the EC contributed to repeated French vetoes on the British application for membership.

Only by getting ready diplomatically for exploring these policy options, and pursuing them urgently, can we expect to safeguard our economic interests in the evolving economy. Our thinking and polices have to be reshaped to suit the rapidly changing world economic world economic scene.

The active exploration of these trading possibilities and choices would also make more credible our commitment to the reforms initiated since 1991, both at home and abroad. In turn, that would benefit the reform process itself, creating a virtuous circle where reforms lead to intimate engagement into the evolving trade regimes and that engagement in turn encourages foreign investment and interest in India's economy and reinforces the success of the reforms in providing benefits.

VI. CONCLUDING REMARKS

In conclusion, while the Rao government must be congratulated for boldness of the reforms to date, the time has now come to consolidate the reforms attempted already and to extend them boldly in several new directions.

In this report, we have argued why it is now necessary to take these further steps, we have highlighted the key areas in which these new steps must be taken, and we have spelled out these steps as well.

In essence, the productivity of the reforms to date depends critically on initiating and completing quickly the added reforms: they hang together in an integral way. Without the new steps, such as public sector privatisation and the breaking of important infrastructure bottlenecks for example, export performance and domestic productivity cannot respond significantly to the extensive delicensing and trade account convertibility that have been steadfastly implemented, thus putting these reforms at risk by preventing them from leading to significant results. For, the critics will point to the reforms in place and charge that the proponents had exaggerated their necessity.

The entire set of reforms, old and the new we propose, represents the creation of a sweeping, new institutional framework. With it, however, we will only rejoin the rest of the world in how we run our economy.

The full dividends from the reforms will come only when the transition is largely complete. The next, major steps we propose are what will complete the transition. The government has no time to lose.