

AGENDA FOR REFORMS: FISCAL

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by

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Any views expressed in this paper are those of the author and should not be attributed to the organization for which he works.

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I. OVERVIEW

A. Introduction

1. Economic reforms started in a slow, fragmented and limited way in the eighties and gathered momentum and clear direction in the nineties. These reforms have by and large focussed on removing the economic distortions created by earlier policies such as physical controls on economic activity and excessively complicated taxes. As a result of these reforms India will likely have a trend growth rate of over 6.1% per annum over the last two decades of the 20th century. This will rank India as the eighth fastest growing economy (excluding small countries) in the world over these two decades.¹ Despite this India remains one of the poorest countries in the World. As per the last comprehensive survey in 1993-94, about 36% of the people are still below the poverty line. As per the international poverty line, about half the people are still poor. The fiscal problem, arising from an excess of unproductive expenditure, increases the vulnerability of the poor (and the economy as a whole) to adverse shocks. The performance of other Asian countries that were in a similar situation three to four decades ago shows that we can solve these problems of poverty in a decade, if we can summon up the will and determination to do so.

B. Goals and Objectives

2. As we enter a new millennium, low (per capita) income poses both a challenge and an opportunity. We must accelerate economic growth in the first two decades of the 21st century so as to eliminate poverty and under-employment. We must ensure human development and empowerment of the poor, by ensuring 100% literacy and universal primary education. The experience of other countries in Asia shows that it is possible to raise growth to 7%, to maintain it for two decades and thus generate full employment, and provide 100% literacy. Basic minimum services must be provided to all. To ensure environmental sustainability and quality of life population growth will have to be contained. And all this must be done in a manner that promotes peoples' participation and builds self-reliance and human dignity.
3. The state must refocus attention on some of its most basic responsibilities such as the provision of public goods (roads, police, courts, regulatory systems), primary education, 'public health' (water, sewage, & sanitation) & population control and stop degradation of common resources (water, forests). These responsibilities have been virtually lost sight of, squeezed

¹ Small countries are defined as those with a population less than 10 million and GDP less than US \$ 40 billion. Among the small countries for which data was available two grew faster than India.

between rising fiscal deficits and expanding role of the state in every area of economic activity and the inevitable rent seeking that followed. The only way the government can provide these basic services in the next decade is by ruthlessly shedding a host of activities that the private, co-operative and decentralised sectors are capable of undertaking given the right policy environment. It is of vital social and national interest to ensure 100% literacy and universal primary education within the next decade.

C. Means

4. Accomplishing all this requires both a completion of reforms started earlier and new reform initiatives, which encompass fundamental fiscal changes, reform of relatively untouched sectors and factor markets and institutional and legal areas. The fundamental driving force behind the social benefits that accrue from a market economy, is “competition”. One of the important tasks of reform has been and remains, to identify and remove all the bottlenecks to competition arising from past government policies, colonial era laws, outdated rules, and bureaucratic regulations & procedures. This must encompass not only the product market but also factor markets which are the source of productivity, technical change and sustained growth. In most parts of the economy de-control, de-bureaucratisation and correction of policy distortions is sufficient to generate competition.
5. There are three sectors in which this has to be supplemented with an independent and modern regulatory system. One is physical infrastructure, where some segments are still characterised by ‘natural monopoly’ and which requires regulatory structures to foster and mimic competition. The other is the financial sector (banking, finance and capital markets) characterised by fiduciary responsibilities. This sector requires a different type of regulation focusing on transparency, reduction of systemic risk and detection and punishment of fiduciary irresponsibility. The third is that part of the social sector characterised by information asymmetry and fundamental irreversibility (education & health).² Modern regulation is necessary to ensure that information on quality of service is made available to the public and fraud & cheating is minimised.
6. The fiscal situation deteriorated during the eighties and culminated in the BOP crises of 1991. Though the sharp deterioration that immediately preceded the crisis was reversed equally quickly, the fiscal deficit remains at a high level. Underlying this deficit is a quality of expenditure, which is not sustainable. Too much is spent on unproductive subsidies, goods and services and too little on basic public goods & human needs and maintenance of capital. In the long term such a high level of fiscal deficit is not sustainable. It must be brought down over the next decade to sustainable

² Wasted years & life-time effects and permanent damage to health respectively.

levels. If this is not done, the vulnerability of the economy to adverse shocks could increase, especially if the high fiscal deficit is coupled with a continuing deterioration in the quality of government expenditure. Higher growth could then be put into jeopardy. The fiscal problem must be tackled head on by the Central and State governments if high growth is to be achieved and sustained. This note lays out the agenda for Fiscal reform.

7. The institutions of governance and market, too often taken for granted in the economic context, are basic to equitable & efficient growth and for sustaining such growth at high levels. The quality of institutions of governance needs to be improved dramatically. This requires a fresh and unbiased review of their roles and functions, a much greater focus on a few vital functions, abandonment of numerous objectives & tasks accumulated over the decades and a thorough modernisation of management systems, procedures and technology. In some cases old institutions (such as Panchayats and Co-operatives) have to be strengthened and given new roles. The States must decentralise powers and functions to the local level so as to improve targeting and productivity of expenditures.

II. COMPLETED REFORM

A. TAX DISTORTIONS

8. In the context of the overall tax system, import & export duties and taxation of inputs into production are recognised by tax experts as the most distorting forms of taxation. In other words such taxes reduce the efficiency and productivity of the economy by diverting resources and effort away from value addition and growth. A reduction in import duties and the extension of MODVAT credit on taxes paid on inputs have therefore been important measures for improving the efficiency of the tax system. Similarly the wide dispersion of rates of customs duties and excise taxes increased litigation, rent seeking and corruption. It was only after the mid-eighties, when the differentiation of rates reached absurd heights (e.g. excise duties on cloth varied by count, denier and dimension) that the reduction in the number of rates started. Considerable progress was made in the nineties with the rates on most products, particularly intermediate and capital goods, being reduced to three. Only a few intermediate goods such as polyester still have a separate higher rate. With the reduction in the peak rate the number of basic customs duty rates have also come down to about 5.
9. In the direct tax area, efforts have been directed to simplify the tax system, reduce the maximum tax rate and broaden the tax base. The maximum marginal personal income tax rate, which had risen to almost 100% in the mid-eighties was brought down to 56% by 1991 and 30% by

1997-98. The corporate tax rate, which ranged between 51.75% to 57.5% for different types of companies in 1991 was unified and brought down to 35%. The reduction in average marginal rates, the attempted simplification and administrative improvements, have resulted in a broadening of the base of direct taxes and a rise in the direct tax to GDP ratio.

10. Though import duties for exporters were rationalised during the eighties there was no such move regarding general import duties. By 1990 import duties were 300% or more for several items and above 200% for many items. Peak rates were progressively reduced during the nineties to reach 40% in 1999-2000.³ As a consequence the import weighted average tariff rate for all commodities declined from 87% in 1990 to 30% in 1998-99. Average collection rate of customs duties (including CVD) declined from 47% in 1990-91 to 27% in 1997-98.

B. CAPITAL MARKET

11. Controls on pricing of primary issues were removed and the Controller of Capital issues abolished, and the Securities and Exchange Board of India (SEBI) was given statutory powers in the early nineties. SEBI has laid down rules and regulations covering primary and secondary markets and the operation of market intermediaries and participants. These include disclosure and other requirements for primary issues and take-overs, insider trading, management of mutual funds and stock exchanges, and transparency & other obligations on brokers and investment bankers.
12. The systems, procedures and technology of trading have been modernised. On line electronic trading was introduced by the National Stock exchange, and has been replicated in the Bombay Stock Exchange. Payment and settlement systems have been modernised through the setting up of clearing corporations. Prudential regulations have been strengthened. A National Securities Depository has been set up, enabling the securities of a substantial number of Companies (198) to be de-materialised. The entry of foreign institutional investors (FIIs) into the market has accelerated introduction of modern systems, procedures and attitudes into the capital market. Demand for equity research and for transparent corporate accounts has gone up.

III. FINISHING INCOMPLETE REFORM

13. Elimination of Controls & licensing and the revenue deficit are the two major unfinished items of first phase of reform. Both these are multifaceted and multi-dimensional items, which concern many ministries and

³ The additional duty (CVD) as the counterpart of domestic excise taxes and the Special additional duty (SAD) as the counterpart of state sales taxes are **not** protective duties.

departments. It is therefore essential that all concerned ministries or departments draw up a time schedule for completion of the unfinished reforms. States should also be requested to draw up such a schedule, which could perhaps be monitored by the Planning Commission (in co-operation with concerned departments). Some of the specific items needing attention are indicated below.

14. There are number of reforms, which have been mentioned and talked about but have not yet been undertaken seriously, and others which have elements similar to those in the earlier phase, but nevertheless represent a significant departure or advance over earlier reforms. They are therefore both a prelude to and part of the second phase reforms, just as the reforms of the eighties were for the first phase.

A. SUBSIDIES

15. The fiscal problem first raised its head during the eighties, though there were some premonition in the seventies in the form of negative savings by government. Both revenue and fiscal deficits rose during the eighties. By the end of the eighties the fiscal deficit had become serious enough to become a major underlying cause of the BOP crisis which followed. It is therefore an old problem with a large unfinished agenda. The revenue deficit represents borrowing to finance revenue expenditures. There has been widespread agreement for at least a decade, if not longer, that this is not a desirable situation and must be corrected. At the same time there is wide consensus that those below the poverty line, and particularly the poorest of them must be helped in some way which is more efficient and less subject to leakage. To achieve this objective it is necessary to eliminate wasteful expenditures and target subsidies more carefully.
16. Any subsidy on a good or service distorts the consumption and production of that good or service. Thus for instance a power subsidy results in wasteful consumption of power and distorts the entire structure of production and investment in power. This is why most subsidies are classed as non-merit subsidies. As the discussion paper on subsidies indicated, such non-merit subsidies (including indirect or implicit subsidies) for Centre & States were estimated at about 11 % of GDP in 1994-95. It is therefore essential that these subsidies are reduced and part of the money saved is channelled into more productive expenditures that have a better and more lasting impact on the incomes of the poor. Some of the important pending reforms in the area of subsidies and user charges are as follows.

1 Fertiliser Retention Price System

17. Some academics have estimated that (depending on the international price) between half and two-thirds of the Urea subsidy goes to the fertiliser

industry. This cannot be justified in the name of farmers. The retention price system distorts investment and production decisions and creates an inefficient production system. Dismantling of the retention price system and price de-control are essential for initiating cost efficiency and a search for innovative ways of meeting the fertiliser requirements of farmers at the lowest possible cost. Moving to a de-controlled system in which the farmer gets fertiliser at international prices could accomplish this objective.⁴

18. To achieve this goal Urea imports should be put on OGL with zero import duties. The maximum (minimum) retention price would be simultaneously lowered (raised) by appropriate amounts to reach world levels within 3 to 5 years. A reduction and elimination of the fertiliser subsidy would make it possible to provide sufficient allocation to irrigation and watershed development schemes that particularly benefit small and marginal farmers.

2 Public Distribution System

19. The public distribution system (PDS) has grown in an incremental and piecemeal fashion over the years, under the pressure of circumstances. It is appropriate to re-examine its objectives and re-direct it towards these objectives. In an open economy with free access to the productive capacity of the world economy, the primary purpose of a PDS is to supplement the incomes of the poor. For the urban middle class, it can at most provide a temporary buffer against the occasional sharp change in food prices. With this in view the following changes in the PDS should be considered:

- It is essential to improve the targeting of PDS to those who need it most, namely those below the poverty line. A start can be made by removing actual & potential (indicators: property owners/permanent tenants, motor vehicles, telephones, electricity usage, foreign travel) income tax payers from PDS.
- Sugar is neither nutritious nor is it health enhancing and should therefore be removed from the PDS. The poor will be effectively compensated if this is coupled with complete de-control of sugar so that poor consumers get the benefit of competitive prices.
- Much of the food subsidy is channelled to the FCI. It also monopolises the food credit. FCI like all monopolies is subject to wastage and inefficiency. The benefits of competition can be harnessed in the service of the poor by converting FCI into an agency for planning and project management, while permitting free entry into procurement, storage and distribution. States would be free to set up public or joint venture companies if they find it commercially viable. Private entry would also be encouraged under transparent accounting norms & rules for

⁴ The 'Hanumantha Rao committee' report also supported de-control of fertilisers.

determination of carrying charges. The current massive excess stocks provide an ideal opportunity for major reform.

B. USER CHARGES & Investment Financing

20. Many public monopoly services have been priced either on the principle of 'what the traffic will bear,' or on the assumption that the government will underwrite whatever losses are incurred. This approach is a recipe for disaster, as already exists in the power sector in terms of low & highly variable availability and equipment destroying quality. It is essential to move to cost based pricing of infrastructure services to generate sufficient resources for quality production. It is also critical for generating finances for the investment needed to reach and sustain an economic growth rate of 7% to 8%. Higher infrastructure growth is in the long term interests of the common man both as a consumer and as worker. Among the specific areas that have to be addressed are the following:

- For commercial services like Telecom, a cross tax-subsidy mechanism can be used to fulfil minimal social objectives (like universal service obligation). Pricing international calls above cost and basic connectivity below cost and equalising the difference through a fund is one way of doing this. Another is to cordon off commercially non-viable areas (e.g. Northeast, Kashmir) and have a subsidy auction.
- In the case of basic rural infrastructure and basic social services (like roads, water, education and pollution reduction) a rise in user charges will have to be coupled with explicit (earmarked) budgetary subsidies.
- In higher education fees should be gradually raised to cover all operational costs. Fees could be raised to half or more of fixed costs for those skills that have high market demand (e.g. management, software). Means cum merit scholarships must be provided to ensure equal access to higher education. Subsidies should be focussed on research & development and research students in science & technology.

1 Petroleum APM

21. The administered price mechanism is to be dismantled by 2002. This process should be accelerated so that this important manufacturing sector can start seeing the benefits of competition.

22. Neighbouring countries, some much poorer than us have LPG prices much higher than in India. Our urban middle class, who is the main beneficiary of this subsidy, can certainly afford to pay the prices paid by consumers in Bangladesh or Nepal. LPG prices can be raised to international levels by eliminating the LPG subsidy. This must be coupled with de-control of prices, distribution and international trade to ensure competitive supply to consumers.

23. The higher the per unit subsidy, the greater the chance of Kerosene being siphoned off before it gets to the beneficiary. The subsidy has to be kept moderate if it is to have some chance of reaching deserving beneficiaries. Taking the subsidy directly into the budget can do this.

C. Budgetary Reform

24. The budget systems and operations need to be modernised and updated to take account of developments over the last 50 years. Government consumption expenditures must be clearly separated from government Investment. The concept of Revenue and Capital expenditure approximately captures these concepts but may need to be updated. Expenditure to rejuvenate, maintain or upgrade assets is as much investment expenditure as new investment. Plan and non-plan expenditure will need to be integrated to correspond to these concepts.
25. Zero-based budgeting was tried once and has been re-introduced in the last budget. The basic concept is sound and a renewed effort must be made to implement it. A system of quarterly budgeting and surrender of unused funds could be introduced. Greater budgetary autonomy and flexibility can be given to subsidiary organisations along with greater accountability. Computerised & standardised accounting systems can facilitate better management information systems, benchmarking and interdepartmental comparisons of financial efficiency.

D. TAX REFORMS

26. Reduction of the revenue deficit also requires a rise in tax GDP ratio on a sustained and sustainable basis. This is only possible if the overall tax system is efficient and equitable. As taxes affect every facet of economic activity, they also have considerable power to misdirect economic activity into socially unproductive channels. In the past, use of the tax system for micro-management has often detracted from the primary goal of raising revenue in an efficient and equitable manner. It is therefore necessary to take an integrated view of the tax system.
27. The reduction in customs revenue has been only partly offset by an increase in revenues from direct taxes. Though direct revenue must continue to rise as a proportion of GDP, excise taxes must also share the burden of raising the tax GDP ratio.

1 Central Value Added Tax

28. The move from a traditional excise tax to a Value Added Tax has taken almost two decades. Over 100 countries have already switched over to a VAT. Given the constitutional division of responsibilities, the central government can at least move over to, what may be termed a Central Value Added Tax (CENVAT). This will have under its purview all goods and

services which come under the authority of the central government. The essential features of such a tax are the following:

- It must be comprehensive and universal, so that every producer pays CENVAT duty on his total output of goods and services, and so does every importer.⁵ Wholesalers (large) would act as pass through agents (to complete the VAT chain).
- CENVAT paid on all inputs used in the production or marketing of the good or service whether they are "consumables" or services must be deductible from CENVAT paid on the final output.
- There would be a single basic CENVAT rate applicable to all manufactured intermediate goods, capital goods and the bulk of consumer goods & services. A rate of 15% will probably ensure revenue neutrality.
- To ensure that the CENVAT is progressive, all food products (except those explicitly & unambiguously linked to entertainment), drugs, pharmaceuticals and medical equipment would be exempted from the CENVAT. Administrative complications argue against expanding this list to minor items such as schoolbooks. There would be no end use exemption or other product exemptions from the 15% CENVAT.
- In addition there would be **special excise duties (SEDs)** on a carefully selected set of final finished consumer goods, which would not be eligible for CENVAT credit/deduction. De-merit goods such as tobacco products & pan masala could have a 25% special excise (i.e. total = 40%). Special excise on large and small motor cars (with dividing line at engine capacity 1.7 litre) would be 25% and 20% respectively. Multi-utility vehicles (for 7-12 people), air-conditioners, cosmetics (not hygiene items like 'toilet preparations'), motor spirit & HSD could have a special excise (pollution charge) of 15%. Cars for physically handicapped, scooters, motor cycles, arms & ammunition could have a special excise of 10%.
- CENVAT and the SED would be applicable to imports. Exports would be zero rated and entitled to a refund on CENVAT paid.
- There would be a standard CENVAT exemption (value limit) for small producers or suppliers based on administrative considerations as is common across the world. It should not be dependent on individual (SSI) notifications and exceptions (Khadi).
- A drastic simplification of the forms, filing and checking procedures supported by a transformation of the monitoring, administration and collection machinery.

⁵ Though it may be called CVD or Additional customs duty.

2 Customs Duty

29. Customs duty rates remain among the highest in the world. Most developing countries have customs duty rates in the range of 5% to 20%, while developed countries have even lower rates. Only S. Asian duty rates have been much higher. Pakistan has, however, recently brought down its peak rate to 35%, the level that already prevailed in Bangladesh. Sri Lanka has also recently brought down its peak rate from 35% to 30% and intends to reduce it further in the next few years. Reduction of our peak rate by 5% points a year would bring the overwhelming majority of basic customs duty rates to between 10% & 20% by 2003.⁶
30. Given the limited administrative capacity of less developed countries and their need for revenues, somewhat higher rates of customs duties have historically been justified in low-income countries. The most efficient revenue maximising tariff is a uniform customs duty. This is a useful ideal against which the protective elements of duty can be judged. A uniform import duty on all manufactured goods (including processed mineral & agricultural items) is a practical goal, as it would greatly simplify the whole process of import and export. Primary (unprocessed agricultural & mineral) products (including mineral oils) could have somewhat lower (uniform) rate. We can target a 10% duty on all manufactured goods and 5% on all primary products by 2005. Given a flexible exchange rate, macro-economic adjustments will ensure that the actual import increase is much less than the threat of imports and any increase in imports is accompanied by higher growth of exports and GDP.

3 Personal Income Tax

31. Though the marginal income tax rate of 30% on personal income is quite reasonable, it applies at relatively low levels of income. A rationalisation of the income tax brackets would require stretching out the income brackets. Strictly speaking income is defined as a change in net wealth and all income must be taxed at a uniform effective rate. Strict application requires that gifts are treated as income in the hands of the receiver, and that wealth tax is abolished. Further, receipts of insurance benefits to compensate for loss does not constitute change in net wealth, and should not be included in taxable income. The same principle applies to insurance or other compensation for expenditures on health.
32. Rationalisation of deductions and exemptions must be based on certain principles. To the extent that we deviate from an income type towards a consumption type tax the most efficient way is to have a single, comprehensive net saving deduction directed toward retirement saving.

⁶ The customs duty on soft (hard) liquor can be set equal to twice (thrice) the peak rate.

Charitable deductions can also be justified as a means of using private charity to provide a social safety net.

4 Corporate Tax

33. The peak rate of corporate tax should be brought down to 30% to equate it with the personal income tax rate. Exemptions and deductions must generally be based on the principle of externalities or public good. Any developmental incentives must be time bound and directed at the source of the problem. For instance the absence of a long-term debt market argues for providing an incentive to savers for investment in such debt.

E. CAPITAL & DEBT MARKET

34. Considerable strides have been made in the development and improvement of the equity market. The debt market has however developed more slowly. Among the reasons are the absence of a well-developed yield curve on government securities and the absence of a competitive insurance market. These are important for reducing the cost of government borrowing.

1 Government Securities

35. Rigidities in the government securities market need to be removed by making it as easy to buy and sell government securities and Treasury Bills, as it is to buy and sell stocks. Removal of stamp duty on trading in dematerialised debt is an important step in this direction. Issue of government debt through electronic exchanges, trading through terminals connected to such exchanges, standardisation & de-control of repo transactions and permission for short sales & 'when issued' trading, would increase the width and depth of the government securities & T-bills market. Quick entry of private insurance companies would also help accelerate this process.

2 Repo, Reverse repo

36. The availability of Repo and reverse-repos in any security impart liquidity to the market. This in turn facilitates the deepening and widening of the market for securities as holders of security are assured of getting cash for meeting temporary mismatches. Repo contracts must be standardised and restrictions on term & maturity (Repos and Reverse-repos in government securities & T-bills) and participants removed. This can be followed by introduction of Repos in other debt instruments such as CDs and Commercial paper.

3 Short sale & Security lending

37. Short sale of securities must also be de-controlled, subject to a well-regulated system, which allows security lending and borrowing. A 'when issued' market must also be permitted on electronic exchanges with screen

based trading. All this could be carried out easily in a well managed & regulated electronic exchange such as the NSE.

IV. NEW REFORM DIRECTIONS

A. ROLE OF GOVERNMENT

38. In the early days of development it was assumed that private entrepreneurs & firms were unwilling or unable to undertake investment in and production of many goods and services. This assumption has long since become invalid. The role of government must therefore change from being an entrepreneur, investor and producer of goods & services, to an enabler and facilitator of development. It must continue to fund the provision of Public goods and provide for the correction of externalities and the basic social safety net. It must catalyse the building of institutions & markets where these do not exist. But it need not produce all these services itself.
39. Though the fiscal problem is an old one with a substantial unfinished agenda, it is also the one crying out most strongly for radical reforms. A re-examination of the entire role and methodology of government is needed, if a lasting and permanent dent is to be made in eliminating the fiscal problem and fulfilling the role that only government can and must fulfil.

B. FISCAL RESPONSIBILITY ACT

40. Over the past two decades many countries in Europe, America and Asia, have gone through the process of bringing their fiscal deficits under control. Some have done this through a parliamentary law such as the Gramm-Rudman act in the USA. Given the diverse nature of our political system with numerous parties in the Centre and States and the pulls & pressures of populism, such an act may be necessary for fiscal sustainability. One of the objectives of this act would be to bring the revenue deficit and primary deficit to nil within a defined time period. It would also specify the subsequent limits on the revenue and primary deficits, and the emergency situations in which these limits could be temporarily exceeded. Alternatively, limits could be put on total borrowing or fiscal deficit or on the debt-GDP ratio.

C. PUBLIC DEBT MANAGEMENT ACT

41. The management of public debt is currently fragmented among several departments and agencies. The CAA&A monitor foreign debt, the budget division of the Ministry of Finance monitors small savings while market borrowing are managed by the government debt department of RBI. With loosening RBI control, growing sophistication of domestic markets and the globalisation of financial markets, there is a need for more active, co-

ordinated and professional management of public debt. This requires a new public debt management act under which debt management could be handed over to a professional agency. In principle this could be a public, joint sector or private company or a combination of these, and the act must be flexible enough to allow all these. The government would provide the overall objectives and risk limits to agencies or companies that manage the public debt. Government would also monitor their performance.

D. RE-ENGINEERING GOVERNMENT

1 Reduce Size

42. One important reason for the increase in the revenue and fiscal deficit over the eighties was the increase in unproductive expenditures, subsidies and tax incentives. The difficulty in reducing such expenditures is that each ministry or department feels that their own programs or projects are more productive than that of others. To get wide agreement and consensus, without violating the autonomy of departments with respect to choice of programs, projects and expenditures an independent external group would be useful. A high powered committee should identify the projects, programs, divisions and departments which should be eliminated. The Expenditure Reforms Commission proposed in two earlier budgets can fulfil this role.
43. The high powered committee could also identify redundant staff in all ministries and departments. Redundant staff would be assigned to a computerised pool, members of which would get preference in filling vacancies over outside candidates. They could be physically located in one or more separate buildings with all facilities and given other benefits like flexible timings, re-training courses and time off to explore other economic opportunities. They would also be encouraged to take long leave (3 years say) and join a private organisation for a trial period. At the end of the period they could either resign or re-enter the government. An early retirement scheme could be introduced for those who are over 50 and have served a minimum of 15 years in government.

2 Quality of Governance

44. Government including related and subsidiary institutions, is the largest producer of intangible services such as policy, licenses and permits, legal judgements and information. Computers and computerised information systems are perhaps the most important productivity enhancing tools for provision of such intangible services. A comprehensive program should be drawn up with the help of professional consultants for computerising the operations of government and all related institutions. Large amount of time is currently wasted in duplicate collection, entry/re-entry of the same information and in retrieval of information (files, papers). Data base

management systems & access to data and the interface with the public can also benefit from better communication links, including those between computers in different locations. Management Information Systems would be set up as part of this process. These systems should make it possible for the government to provide quick and efficient service to the public and to focus its energies on better analysis and management of the economy.

45. Many of our administrative practices and methods have not changed since colonial times. We need to urgently introduce modern management practices in departments that provide a well-defined service such as Posts or have a well-defined objective like tax collection. Management consultants should be hired by large departments such as CBDT, CBEC, Posts and Defence Production to assist them in a thorough re-examination of objectives, methods, and procedures using BPR, ERP or other recognised methods. Developed countries commonly applied techniques like PERT and CPM to project management three decades ago, and these became widespread with the proliferation of computers. These techniques reached India only recently and are still not in common or widespread use. Departments can also benefit from the application of modern cost accounting techniques like ABC. All ministries, departments and subsidiary organisations should make a budgetary provision for introducing modern management systems and hiring management consultants where needed. There is also need for decentralisation of financial powers to subsidiary institutions along with systems and procedures for greater accountability need to be introduced.
46. A sustained decrease in unproductive expenditure and enhanced effectiveness of desirable expenditures requires greater transparency in purchase & procurement. The rules and procedures for public procurement should be brought up to international standards. We should consider signing the international convention on public procurement. Greater transparency in sale of public resources & property and market pricing would also generate more resources for meeting the basic needs of the poor. Under pricing of public resources in the name of the poor is usually a good indicator of the decision-maker's resolve to siphon off money in violation of the public trust.

3 Construction Technology & Quality

47. The government is the largest user of construction services in the country. Its procurement & construction rules therefore have an overwhelming effect on the development of the construction industry. The government's procurement rules and standards have barely changed since independence. It is no wonder therefore that our construction industry is one of the most primitive among the emerging markets. This leads to shoddy construction and interminable delays, which impose large negative costs on the rest of the

economy. We must urgently modernise CPWD, PWD, DGC&S and other construction & procurement rules to promote use of new efficient, effective, non-polluting technologies.

E. DEPARTMENTAL ENTERPRISES

48. The production and service provision functions carried out by government departments such as Telecom, Ports, Airports, Railways, P&T, Broadcasting and Defence production (civil goods, dual use items) need to be removed from government. Governmental rules and procedures (including CAG audit) are not conducive to quick decision making and commercial risk taking. Departmental enterprises should therefore be converted into public companies with professional boards. Technological developments over the last two decades have made it possible to un-bundle the 'natural monopoly' segments of infrastructure from the rest. In general there are three parts to an infrastructure department enterprise, namely production of goods used in the sector, the 'natural monopoly' segment (e.g. rail track, telephone/telegraph line) and provision of services. Each of these segments should be dealt with separately.

1 Privatised non-core activities

49. The production units of infrastructure departments and the defence production units producing civil goods should be sold to the private sector. Telecom and Railways should focus on their core business by selling to the highest bidder, captive units producing equipment and parts. This will ensure full exploitation of economies of scale, while imports provide potential competition in supply. Peripheral services, not related to the core infrastructure service, could also be privatised.

2 Convert into Companies

50. The 'natural monopoly' segments and service provision should be converted into separate companies, which can be termed the 'Network Company' and the 'Service Provider' respectively. The network companies must operate on the 'public carrier' principle, subject to independent regulatory supervision, which ensures that all 'service providers' especially new entrants have equal and fair access to the 'natural monopoly' network at non-discriminatory prices. Over time, up to 74% of the equity in 'network companies' and up to 100% of the equity in 'service providers' should be sold to the public. Investment must be fully de-licensed, with no artificial barriers such as division into basic, cellular, ISP, paging or Internet Telephony. It is only through free private entry and competition in providing all services that the gains from technological change, economies of scope and productivity improvement can accrue to the public. Natural resources such as natural

harbour or radio frequency spectrum should be dealt with separately as a problem in resource pricing and contractual resource rent collection (if any).

3 Telecom

51. The key 'natural monopoly' segment in Telecom is the telephone wire linking customers to the local telephone exchange ('last mile'), and this should be made into a separate 'network company.' This makes it easier to ensure non-discriminatory pricing & equal access to new telecom service providers. Benchmark competition can be promoted if the network is divided into a number of regional (or state/circle) network companies. Similarly all the service provision functions of DOT can be made into one or more companies. If the division is done on a regional/circle basis each regional/circle network company can be an independent subsidiary of the corresponding regional/circle service provider.
52. Policy and procedural barriers between different communication media such as telephone, telegraph, cable and (even) electric wires must be eliminated if India is to become a Communication, Information Technology and Media leader in the 21st century.

4 Railways

53. In the case of the railways it is the railway lines and related signalling equipment, which constitute the 'natural monopoly' network. These could be converted either into a single Railway track corporation or into four regional and one trunk line (inter-metro) corporation. The service functions could correspondingly be constituted into either two transport companies (for goods and passengers), or into four regional and one inter-metro transport company. If five companies are formed each track corporation could be a subsidiary of the corresponding service-company.
54. An autonomous and independent railway regulatory body must be formed so as to ensure the public interest including passenger safety, and to ensure that new entrants have access to the railway tracks on the same terms and conditions as the government railway transport companies. Entry of private companies into the provision of railway transport services would be freed. The laying of new tracks would also be freed from investment licensing. All companies would have to register with the regulator so that it can ensure that they follow the safety, interconnection and other rules.
55. The railways also run a long distance communication network. With the opening of long distance communication to competition in 2000, this could either be sold to the private sector or be spun-off into an independent company with 26% government holding. This company would then be unshackled to exploit economies of scale, and supply communications services to other organisations besides the railways. In many countries

across the world railway-stations are an attractive and profitable commercial hub with retail outlets, restaurants, entertainment and department stores. Our metropolitan stations are more likely to be dirty and stinking with nooks and crannies used as urinals or garbage dumps. The only way to achieve international standards under the current circumstances in India seems to be by giving out stations in metros and large cities to the private sector on long lease or other methods such as BOLT and BOOT.

5 Ports and Airports

56. The core of an airport is the runway and traffic control facilities. The core of a port consists of the harbour and docking berths & related fixed structures. These core components of ports and airports should be converted into companies. In the case of major ports and airports there could be one company for each port or airport. In the case of minor ports & airports commercial viability may require amalgamation into regional companies. Non-core activities should be privatised and opened to competition to the maximum extent feasible, with a view to improving the quality of service to the international level. For instance the best airports of the world are very profitable up-market commercial centres, which provide shopping, food and entertainment. There is no reason except the public monopoly why our international airports are not as attractive and profitable as airports from Dubai to Hong Kong. Minor ports and airports can also be privatised after their reorganisation into companies.

6 AIR & Doordarshan

57. The principle of unbundling can also be applied to Broadcasting enterprises such as AIR and Doordarshan, by separating the physical facilities for radio & television broadcasting from media or broadcasting content. The physical facilities are in essence similar to the facilities used for cellular or mobile telephony, and similarly serve as communication channels. They can therefore be hived off into separate companies which would be regulated by a Communication Regulatory Authority of India (CRAI) which would subsume the TRAI and also have authority over Cable and other communication channels. Artificial barriers based on old technology would be eliminated so that companies are free to operate in any field of communication. The physical facilities of AIR and Doordarshan would therefore be made into separate companies, which would have to operate on the public carrier principle, by drawing up fair and transparent rules for usage by all broadcasting companies. The government could gradually divest up to 74% of their equity to the public. Setting up of new facilities would be de-licensed.

58. Prasar Bharati would then be converted into a purely media or broadcasting company which controls the content of AIR and Doordarshan, and leases

frequency and time slots from the facilities companies on a long term commercial basis. Broadcasting content would be regulated by an Independent Broadcasting Regulation Authority, which would require all broadcasting companies to be licensed.

7 Defence Production

59. Defence production currently consists of the three separable areas, namely civil goods, dual use items and weapons. a) Civil goods & services like food, uniforms, shoes, shelter, construction material, and general electrical, mechanical & transport equipment. These should be completely privatised. b) Dual use items, which are needed both by the defence forces and the civilian economy. This would also include parts and components of weapons. Units producing such items should be converted into corporations and a majority of shares (up to 74.9%) sold to the public. Management control could be gradually handed over to independent private management. c) Lethal defence platforms such as fighter aircraft, tanks and warships. Defence units assembling such defence items would also converted into corporations but government would retain a majority (50.1%) of shares along with management control.
60. The introduction of competition in the production and supply of goods and services used by the defence services would have to go hand in hand with the development of a modern systems of procurement, inventory control and logistics by these services. This in turn would require comprehensive computerisation of these activities.

F. EXPENDITURE PRIORITY

61. Since 1949 the government has diversified into so many areas of production and service provision that the original functions of government have been lost sight of. The limited resources available to the government have been spread so thin that there is no money available to undertake these functions satisfactorily. The basic or fundamental functions of government can be divided in three categories: a) providing public goods like defence, police, roads and epidemic control b) correcting externalities such as those involved in primary education, pollution and in generation & dissemination of knowledge, and c) promoting social welfare.
62. Poverty reduction and alleviation has been at the centre of government's development effort through the past several decades. Though growth creates job opportunities, the poor can only benefit from these new opportunities if they are healthy and have the basic educational requisites. Human development is essential for making the poor full participants in the market economy.

1 Public Health

63. Public health is a fundamental entitlement of the people. It is only when there is an outbreak of an epidemic such as plague, dengue fever or cholera that we remember the importance of and the need for sustained measures for its avoidance and control. Government must fund R&D in contagious diseases, particularly tropical diseases, which do not interest researchers in the developed temperate countries. Private Indian companies should be drawn into this effort by provision of tax incentives. Research is also needed on epidemic avoidance, monitoring & control measures. A centre for disease control can be constituted for this purpose, by strengthening an existing institutions or amalgamating a number of them. Dissemination of information on best practice and public education are essential ingredients of public health. Particular attention must be paid to urban slums and their inhabitants.
64. Clean drinking Water, Sewage, Sanitation and Waste disposal are also vital ingredients of public health. The great declines in mortality and increases in longevity occurred across the world because of an improvement in these elements of public health. Our performance in these areas has been embarrassing if not shameful; even in the capital city there are areas where the water is not fit for drinking and the slums can become cesspools of sewage during the monsoons. The condition of most provincial towns is worse, with open sewers characterising many small towns. It is the government's duty to ensure that every citizen has access to clean drinking water, sewage and sanitation facilities. State and local governments must refocus their attention from grandiose development plans to ensuring 100% coverage in the next 10 to 15 years.
65. This is not just a matter of providing enough funds, but of motivation, planning and implementation. Simple matters like ensuring that sewer outlets are not constructed upstream from drinking water intakes, and that there are waste collection systems to ensure that drainage channels are not used as garbage dumps, have not been thought worthy of serious attention. Further it is not necessary that government provide all these services itself. Private providers must be harnessed to increase the quality and efficiency of supply. The examples of private & co-operative efforts such as Exonara in waste collection and Sulabh in provision of toilet facilities must be propagated and supported. Wholesale supply of clean drinking water, sewage & solid waste treatment and disposal (e.g. manure manufacturing, energy generating incinerators, waste dumps) are other areas that are ripe for private initiative and competition. Municipal rules and procedures must be changed to attract such initiatives. User charges must also be raised to economic levels, while ensuring that the poor have access to basic facilities at affordable prices. Municipal authorities must also encourage water

conservation and harvesting and pre-treat sewage before dumping into water bodies.

2 Primary Education

66. Though all policies and programs over the last 50 years have been justified in the name of the poor, literacy and primary education the most essential aspect of human development has been pathetically neglected. Not just the individual but the entire society benefits if all its citizens are literate. All States must achieve 100% adult literacy and free and compulsory primary education in a time bound manner, but not later than 2010. Achievements should be monitored and publicised and Non-Government Organisations must alert the public on the anti-poor nature of State governments that do not provide either the funds or the motivation for achieving the targets. For ensuring that the remotest rural areas are part of this effort, it is necessary to de-centralise funds and control over teachers to the Panchayat level. An Educational Guarantee scheme on the lines of the successful one in MP can be tried by other states. Education must also be made more meaningful by educating children about the need for smaller families, the equality of women, basic nutrition, hygiene and health science, environmental pollution & preservation, and social & constitutional rights & responsibility.
67. The highly laudable success of Kerela in achieving universal literacy and high basic education levels has not been based only on public provision of schooling. Private schools have played a very important role in the achievement of high levels of human development in Kerela. The governments role in creating the right atmosphere of encouragement and helpfulness is however critical to the success of any such private effort. Unfortunately, too many state governments are more inclined to interfere in, obstruct and harass any successful private educational institution. This must change if we are serious about universal literacy & primary education. A framework for private and co-operative entry into education is spelt out elsewhere.

3 Rule of Law

68. One of the fundamental characteristics of a democracy is the 'rule of law' as against the rule of men that characterised monarchy, dictatorship and feudal societies. Effective functioning of the market economy requires that economic laws such as the law of contract be appropriate to the current & projected environment. The foundation of the 'rule of law,' are the Laws themselves, and a sound superstructure cannot be built on shaky foundations. Many of these laws are archaic, being framed half a century ago, others have been added over the years so that they are now replete with contradictory stipulations, definitions and standards. There are now about 800 Central acts and possibly about 1000 acts, regulations and ordinances in each state. As

per the recommendation of various commissions, 166 Central acts need to be scrapped along with 11 British statutes and 17 wartime ordinances. States should repeal 114 Central acts relating to state subjects. All other laws should be thoroughly re-evaluated with a view to modernising and integrating them in the light of the transformation of the Indian and world economy.

69. The delays in the legal system are by now legendary. Decades pass with repeated, innumerable and wasted court appearances. Delays help defendants to win acquittals. Witnesses forget the exact details of various events, or become untraceable, which helps in generating “reasonable doubt”. Court personnel are illegally persuaded to delay listings. The delays and the attendant cost of transacting business have had a dangerous effect on society. For instance, in property disputes, the plaintiff knows that a settlement can take anything between 15 to 20 years, during which time the property will be in the possession of the defendant. This encourages people to settle property disputes by resorting to criminal means, rather than follow the rules of law. Justice can only be built on sound laws and an effective legal system. Government must take steps to stop and then reverse the deterioration. False economy in the creation of judge’s posts and in provision of modern facilities for their effective performance and courts’ functioning has enormous costs for the entire economy.

4 Public order

70. The right to life is the most fundamental right of any citizen. Physical safety and security of all, provided as a right under the ‘rule of law,’ is one of the important characteristics distinguishing a market economy from a semi-feudal one. If feudal landlords can force their will on the poor, the scheduled caste or land-less labourers it is the very anti-thesis of a market economy. The market economy can only be based on and function under an administrative system which ensures the safety, security and freedom from physical coercion of all market participants. Investment in production and employment generation cannot but be severely affected if personal security and the safety of investment are under threat. The slow & steady deterioration in the ‘law and order’ situation over the past several decades has not left any of us untouched from the affluent suburbs of Delhi to the semi-feudal regions of East India. We cannot afford to ignore this deterioration much longer if the negative consequences on economic growth and development are to be avoided. Sporadic and short-term campaigns to tone up the police are not enough. Fundamental changes are needed in the entire system and structure of policing.

71. The objectives, work ethic and effectiveness of the police has been undermined by constant political interference, transfers, and use of the police

for personal and other purpose. Their poor emoluments and basic living conditions and inadequate education and training also contribute to inefficiency and low morale. The sole objective of the police must be to uphold the 'rule of law' and ensure 'law and order.' Previous police commissions have identified the need for creating a structure in which police autonomy and independence is ensured. One possible method is an independent police commission, with subsidiary commissions in each state, which would make senior appointments, monitor their performance and ensure integrity. Given the resistance to such change, an alternative could be to leave normal policing duties with the existing set-up, but create a separate autonomous organisation for investigating and prosecuting a defined set of serious crimes. The concept of a specialised public prosecutor could also be included in this structure.

72. Given the frequent complaints about police harassment and worse, there also has to be an independent set-up to police the policemen and to protect the citizens against arbitrary actions by the police. As in the case of judges all professional equipment and facilities (e.g. modern forensic labs) needed by the police for effective functioning must be provided to them.

5 Roads

73. The market cannot supply local and municipal roads because the cost of collecting tolls on such roads is prohibitively expensive. In the case of most state roads there are high developmental benefits that accrue to the surrounding areas and which cannot be captured by the market. That is why building and maintenance of roads is one of the most important developmental functions of government. Roads are essential for bringing remote areas into the market, for facilitating trade and developing a national market in which all can participate. Both the central and state governments must focus their limited resources on building higher quality roads. This will also require a modernisation and up-gradation of rules, regulations, procedures and specifications for road building, to promote use of new material like concrete & fly ash and newer more efficient methods.
74. Both these problems (of non-excludability & externality) are diluted to some extent in the case of national and state highways, so that the likely-hood of market supply improves. It is, however, by no means assured. Technological and financial innovations such as 'shadow tolling' however now make it possible for the government to restrict itself to planning, land acquisition and provision of subsidy, while leaving the job of construction and maintenance of highways to the private sector.

6 Knowledge and Information

75. Knowledge is the most important source of growth. One of the reasons why some countries are poor is because they either do not have all the knowledge

available in the developed countries or their people do not have the ability to understand adopt and adapt this knowledge for their own purpose. By its very nature the market for information cannot be perfect and there is an important role for government in fostering and disseminating knowledge. All over the world governments have played a critical role in the generation of agricultural technology and its dissemination to farmers. This was well recognised during the green revolution days but seems to have lost its thrust. Government must continue to play an important role in the generation, adaptation and dissemination of agricultural and rural technology while encouraging and supporting private, co-operative and non-governmental organisations to do the same.

76. Science and technology is another area requiring government funding and support. This support should however be focused at the post-graduate levels and on making available the latest available equipment and facilities for research. New administrative arrangements such as public trusts & societies and government industry joint ventures must also be tried, to free serious scientists from stifling bureaucratic procedures. At the same time accountability must be increased through international and national peer review.
77. The spill over effects of R&D means that income tax incentives for R&D can be justified on hard headed economic grounds. It does not follow that end use exemptions on customs duty and excise are justified, because they distort the tax system as well as the incentive structure. Similarly a ban on technology import or on goods incorporating high technology cannot be justified on the basis of spill over effects.
78. One must however distinguish between commercial technology, which is available on international markets in one form or another, and strategic technology whose export is banned or controlled by the source country purely for geo-political reasons. Strategic technologies are in essence technologies of global power, and the only assurance that we will have access to such technology is by developing it ourselves. Policy for development of strategic technology has to be based on India's strategic perceptions, plans and relations and not on market principles or inter-personal morality.⁷

7 Social Welfare: Hunger

79. A truly democratic and civilised government cannot allow its citizens to starve to death. That is why famines have been virtually eliminated in free India, even though semi-annual reports of starvation deaths in Kalhanidi

⁷ For instance, after the break up of the USSR many countries hired key strategic experts or purchased technology from individuals willing and able to sell it. Similarly a prominent Asian country routinely denies transferring nuclear technology to another, unconcerned about the real facts.

stand as a rebuke. Though chronic hunger has also declined over the decades, some still remains. The most important social function of government is to eliminate chronic hunger. The public distribution system, despite its considerable cost has failed to accomplish this. We must experiment with more innovative solutions, like replacing the PDS by a system of food stamps as in Sri Lanka or using food debit cards. Southern Africa is reported to have a successful system of paying pensions in remote areas through electronic money cards which have a password coded into them to minimise diversion. Modifying the PDS to induce self selection can also be an interim solution. This would require issuing coarse cereals & inferior grains, reducing the amount & increasing the frequency of ration issue, and locating Fair price shops only in poor areas.

8 Old and Disabled

80. The old, infirm & disabled and those who have fallen sick are disproportionately represented among the poor. A social safety net is required for those who are physically unable to work. There should also be some legal and moral pressure on able-bodied progeny to support the old. Poverty due to sickness can be dealt with by providing government subsidy for health insurance for the poor, which includes an income supplement for maintaining dependants. The health insurance system should however be run on competitive commercial lines so that pressure for cost reduction and quality improvement can be maintained.

9 Child Labour

81. Childhood must be protected and all children have the right to basic education. The ban on child labour (below age 14 say) has to be complemented by free, compulsory primary education. Given administrative constraints and weakness, priority in enforcement must be on eliminating child labour from hazardous industries. There cannot be any excuse for allowing children of even desperately poor parents to work in jobs that harm their health and stunt their growth & development. 100% tax deductibility can be provided for expenditure incurred on education of child labour.

G. PUBLIC SECTOR REFORMS

82. Most public sector companies, with the exception of oil production & refining companies that are part of the OCC mechanism, make losses or marginal profits. Historically the OCC mechanism virtually resulted in a public sector monopoly to which oil resource rents also accrued. Thus the profits of this sector are not a measure of efficiency but of monopoly cum resource rents. Similarly the monopoly profits of public insurance can not be taken as a measure of efficiency. The opportunity cost of public ownership is larger than the losses of the non-petroleum, non-financial

companies, as a considerable part of the costs of servicing the public debt is attributable to subsidised supply of capital to these companies in the past. Public sector reform and privatisation is therefore essential for bringing about a sustained reduction of the revenue deficit and releasing revenues social objectives.

1 Privatisation

83. Privatisation is the only method of liberating potentially efficient enterprises from incentive distorting shackles. In principle, government should privatise all public sector units except those producing lethal weapon systems, nuclear fuels & materials, aerospace vehicles & systems and units producing goods or services incorporating 'strategic technology' (as defined earlier). An argument can also be made for retaining control of 'natural monopoly' segments (networks) of infrastructure departments or PSUs, till such time as regulatory authorities acquire sufficient expertise & experience. Other arguments, which may have had some validity in the past, will become redundant with the completion of full de-licensing, de-control and move to appropriately regulated, competitive markets. For instance, the nationalised coal industry must be privatised if it is to meet the challenge of competition from imports.
84. Our experience of dis-investment since 1992 shows that there are considerable delays in the implementation of government decisions regarding individual PSUs. This happens because normal decision processes in government are slow, cannot respond rapidly to changing external conditions while being excessively responsive to negative internal changes. It follows logically that the best & quickest path to privatisation is to create an independent organisation (Privatisation trust), which has complete managerial & decision making powers once a unit is handed over to it. Formally this would require that a person of the rank of secretary be the full time secretary to the trust, and the CMD of the unit come under his authority. The charter (memorandum, rules etc.) of the Privatisation Trust would be framed by the government.
85. Government would also continue to decide which companies or units are to be privatised. But once this decision is taken the company would be handed over to the trust, which would have complete autonomy in implementing the privatisation as per rules. This would speed up the process of privatisation and ensure that government gets the best value for its investment. The existing backlog of unimplemented recommendations of the dis-investment commission provides a menu of firms for consideration of the government. A start could be made, by handing over to the trust, all those companies that have been recommended by the commission for more than 50% public equity sale.

86. So as to combine authority with accountability, government could also transfer to the trust a certain amount of public debt along with the equity of the companies marked for privatisation. This could be done at the end of each financial year, with a commitment to meet the interest liability on the transferred debt for the next financial. The trust would have to amortise the debt thereafter from its earnings. There could also be a grace period of a couple of years before any debt is transferred.

2 Closure of Loss-making units

87. Till such time as the Privatisation Trust is set up and starts working, the earlier proposals to revive, sell to a strategic investor along with management control or close down loss making units should be implemented. The country cannot afford this continuing drain on fiscal resources and waste of land and other assets, which still have other productive uses.

3 VRS strengthening

88. The voluntary retirement scheme should be strengthened. The rules of the VRS must insure that the best people do not leave. Funds should be provided to facilitate re-training and job search.

4 Professional Autonomous Boards

89. In the nineties there was a serious attempt at professionalism the boards of banks and financial institutions and to give them autonomy from the banking department. This has had a salutary effect in improving their commercial orientation. A similar policy should be adopted in all departments and implemented within a period of 3 years.

H. TAXATION

1 National VAT

90. One of the advantages that India has is a potentially large domestic market. This is vitiated by the system of Octroi and the diversity in sales taxes. One of the important steps towards an integrated national market would be a National Value Added Tax to replace such taxes. The National VAT could be a dual (central cum states) VAT with identical base and uniform base rate for all states. Thus the states VAT rate could be about 5%, making a total of 20%. As about one fourth of excise collections go to States, the rates could be simplified to 10% each for Centre & States. States would have some flexibility to impose special sales taxes on selected, finished, final consumer leisure goods & services that are not eligible for VAT credit. The national VAT must incorporate wholesalers and large retailers as well as all relevant

services. A constitutional amendment would be required once consensus has been built.

2 Double Taxation

91. One of the issues in tax reform is the 'double taxation' of companies. The changes already made in the taxation of dividends and capital gains on shares mean that the 'double taxation' is only about 10%. These are however pragmatic responses not based on principles of corporate income taxation. A well-designed and integrated corporate tax is neutral in its effect on the financing decision of companies, as well as between saving in corporations versus privately. One method for eliminating double taxation entirely while maintaining the integrity of the personal income tax system is a 'Cash flow tax' on companies.

3 Global Income

92. With the increasing globalisation of the economy there will be a need for a comprehensive review of the income tax system to take account of greater movements of capital and labour in and out of the country. New developments like Internet commerce would also have to be accounted for. Within the next five years we must modernise these elements of the tax laws to put them on par with the best in the world.

4 Inheritance Tax

93. There is less justification for a wealth tax than there is for an inheritance tax, and abolition of the wealth tax on land & property could be coupled with the imposition of an inheritance tax on the same items. The latter entails an increase in the net wealth of the receiver, and thus constitutes income under the purist definition. As any inheritance would not be drawn down for 10-20 years (if at all) the present value of income tax liability at the maximum rate of 30% would be less than 3%. Compliance problems and the potential negative effect of an inheritance tax on aggregate private saving, suggest that the inheritance tax rate should be about 1%.\

5 Rent Control: Tax Base

94. The 'Rent control act,' which was introduced in World War II is even more pernicious than ordinary price controls. Unlike price control on ordinary goods and services it virtually amounts to expropriation of the rented asset. Rent control ensures that even those who have unutilised space prefer to keep it locked up rather than risk losing it permanently to a tenant. It discourages and inhibits construction of residential apartments solely for the purpose of rental. The lower middle class and the poor are most dependent on rental housing (as seen across the world). It can therefore lay claim to being an anti-poor policy, which is substantially to blame for the creation of

slums in Delhi, Bombay and other metros subject to rent control laws. The periodic collapse of Bombay's rented buildings is the direct result of rent control, as there is no incentive to maintain and keep rented property in habitable condition. Rent control on commercial property is a major reason for the culture of tax evasion and black money that characterises the real estate sector. We must abolish this colonial law, if a housing and real estate boom is to be initiated which benefits not just income tax payers but also those who live in the slums of metropolitan and big cities.

6 Negative Income Tax

95. At some point in the next decade (3rd phase), we can consider replacing all subsidies by a comprehensive negative income tax. A prerequisite for this would be complete and comprehensive computerisation of the (income) tax system and establishment of modern management systems and practices. Introducing some form of electronic debit cards with information on identity could make a start.

I. RESOURCE RENT

96. Though in the broad economic context natural resource markets are not as important as other factors of production as sources of productivity, they can be quite critical for individual sectors. Unlike normal goods & services, which can in principle be produced in quantity & in which production cost determines price, resources are finite and have a scarcity value, called 'resource rent,' which is an additional element in its market price. Efficiency in the use of natural resources requires that the optimal resource rent and extraction cost be competitively determined and prices mimic competitive pricing.

1 Minerals & Oil

97. Deposits of minerals, coal and oil vary in quality across the world. In a competitive market for a given resource, demand and supply determines a cut-off quality whose resource rent is zero, and whose cost of production determines the market price. Mines or oil pools of lower (higher) quality or higher cost of extraction have negative (positive) resource rent which falls (rises) with quality and should not be opened.

98. One of the problems of Indian natural resource pricing has been that historically we violated commercial principles by extracting such low quality minerals (such as zinc & copper) in the name of self reliance and even paid royalty to States. This represented inefficient use of capital, management & labour resources. Where resource rents are positive, as in minerals such as iron ore & aluminium and in some coal & oil sites, the resource rent should be determined through a second price auction. The auction variable can be a resource rent tax rate or a profit share. For this to produce a competitive

solution other parameters (such as time period of concession) should be specified and fixed before auction begins.

99. In the case of items in which an internationally competitive market exists and India is a small producer, the international price can be used as a reference price for production decisions. Mineral or oil deposits should be exploited only if the full cost of production, including the market interest rate on debt and market return on equity, is less than the world price. As the cost of most oil production has been less than the world price, these have 'positive resource rent.' Historically these resource rents have not been collected directly by the government, but feed into the cross-subsidy mechanism of the Oil Co-ordination committee, and to the public sector oil companies.

2 Electro-magnetic spectrum

100. The radio frequency spectrum, which is a part of the Electro-magnetic spectrum, is finite. It has many different uses and potential users. The number of users it can accommodate depends on technology. For instance, with the technology in use in India today the available (after taking out defence/police usage) can only accommodate a maximum of four users. In any given region, the scarcity value of this spectrum depends on demand. If more than four users want to use it to supply services, as they might in the major metropolitan cities than it has a scarcity value which must accrue as 'resource rent' to the nation.
101. On the other hand in all non-urban areas and in most small towns the number of potential users may be one or two (at most). In these areas the radio spectrum has no scarcity value and there should be no charge for its use. It must be freely usable by any resident firm. Technological change can result in rapid increase in the number of possible users of the spectrum. It is anticipated that within the next few years the number of potential users could expand tenfold. This would result in an elimination of the scarcity value in almost all cities, and any spectrum usage charges must be reduced to zero if efficient & productive use is to be made of this natural resource.

3 Air and Water Pollution

102. There are dire forecasts that India will run into a serious water shortage in about two decades. Economical and careful use of available clean water is not made because it is grossly under-priced. At the same time industry is dumping chemicals and toxic waste and municipal authorities are dumping untreated sewage, into our rivers. Excessive use of subsidised fertiliser and pesticides is also saturating farms and leaching into underground water bodies and running off into rivers. The air in large cities like Delhi is highly polluted. We must adopt the 'polluter pays' principle so that those who generate the pollution pay for a significant part of the cost of clean up. This

would require that the price of pollution causing materials like diesel, fertiliser and pesticide not only reflect the full cost of production but also be taxed to discourage excessive and irresponsible use. Clean water must be priced to reflect its full production cost. Highly polluting industries must be required, individually or jointly, to ensure processing of their toxic waste. Government must also do its part by encouraging water conservation and harvesting, and the use of bio-pesticides and natural fertiliser. Municipal authorities must also be required to pre-treat sewage before dumping into water bodies.

J. FINANCE AND CAPITAL

1 FINANCIAL SYSTEM

103. The financial system plays a vital role in the economy by channelling funds from savers (saving) to investors (investment). The financial market is the pivotal market for economic growth and cyclical fluctuations. The health and efficiency of the financial system and of financial markets can therefore play an important role in improving the efficiency and sustainable growth prospects of the economy. Given that finance professionals of Indian origin have demonstrated their capability all over the World, financial services are a potential source of competitive advantage and exports in the 21st century. This, however, requires a sharp improvement in the average level of skills, an environment with international regulatory standards and free competition unhindered by outdated controls.
104. One of the under-remarked lessons of the Asian crises is the need for making a clear distinction between control and regulation. In very simplistic terms, Control systems are there for making firms and organisations do things which are not perceived by them to be in their own best interests. In contrast regulatory systems are designed to ensure that the collective interests of honest, efficient firms and organisations in the category are served. This requires an enormous change in mindset even if some of the regulations appear prima facie to be almost the same as under the control system. Once the change over from controls to regulation is made, the cost of regulatory compliance must also be kept in mind, with a view to minimising the cost of compliance without skimping on the quality.
105. Where control systems have been in operation for decades it is necessary to search actively for provisions in the law, rules, regulations and procedures which are inconsistent with a modern regulatory system. This is essential for focussing the attention of both the regulators and the regulated on the systemic and prudential aspects that lie at the core of modern regulatory systems.

a) Single Integrated Law

106. Regulatory laws and systems have been evolving and progressing even in countries with highly developed financial markets and regulatory authorities such as the UK. One reason is the breaking down of barriers between sub-sectors for finance that were earlier considered distinct and separate such as banking, insurance, non-banking finance companies and investment banking. There is fear that some institutions and activities may escape the knowledge and regulatory reach of separate authorities because of regulatory arbitrage or simply by ‘falling between the cracks.’ We also need to consider the formulation of a single unified law on financial regulation, which could perhaps have sub-segments on specialised areas such as insurance or debt markets.

b) Separate specialised regulators

107. The other related issue is whether we should have single regulatory authority for the entire financial sector as has recently been done in the UK. It would appear that at our stage of financial market development, and given the regulatory skills available this may be a little premature. For the time being we may like to maintain separate regulators for banks, insurance, capital markets and commodity derivatives. This also serves to provide countervailing power and consequently greater likelihood of correcting regulatory mistakes.

c) Modern Regulations

108. Though we have made great progress in introducing modern regulatory systems in banking and capital markets during the nineties, it is worth restating some basic principles, which should be embodied in them. One essential difference between financial and other sectors is that fiduciary responsibility is inherent in the former. Consequently, in contrast to other sectors, regulatory oversight is essential to the functioning of financial markets, particularly underdeveloped markets. In common with other sectors there is a need for the government to promote competition in this sector, but unlike other sectors this is always subject to norms of fiduciary responsibility.

109. There are three basic principles of regulation. To promote information generation and disclosure to those who entrust the financial sector with their money, to introduce prudential norms that will promote fiduciary responsibility while these institutions compete, and fraud detection and punishment to deter irresponsible behaviour. To minimise regulatory burden, maximum use needs to be made of Self Regulatory Organisations in which financial intermediaries police each other to promote and protect their own reputation and thus attract customers. When modernisation of regulatory systems started at the beginning of the nineties, relatively high hurdle rates were set as a simple means of weeding out non-serious players.

This is, however, an entry barrier that reduces competition. With greater regulatory experience and market development, more refined prudential norms can be introduced so as to reduce the costs of entry & operation.

d) Private Insurance Companies

110. A competitive insurance market is essential for the development of the long-term debt market as well as the provision of new insurance products vital for risk mitigation by individuals and business. The passage of an Insurance Regulatory Authority bill and the freeing of private entry into the Insurance market will set the stage for increased competition. It should also be a precursor to the development of the long-term debt market, given appropriate & flexible investment regulation. IRA should plan and prepare for quick consideration of applications and issue of licenses once an IRA bill is passed.
111. There is an urgent need for new products and approaches in the Health insurance sector, so that the poor and middle class have access to private medical service. The introduction of insurance companies will also promote innovation in supply of health services including preventive health and introduction of Health Maintenance Organisations (HMOs). Expenditures on major sickness should be tax-free, as it is a kind of depreciation allowance.
112. Similar innovations in Life Insurance products are also expected. For instance there is a need to separate the saving element from the life insurance element, so that even people with low savings can afford to buy pure life insurance. To encourage such personal social security, there should be a comprehensive tax exemption for the latter. Alternatively, there could be a rational & uniform tax deduction based on net saving principle.

e) Pension & Provident funds

113. It is in the interests of society that all individuals who can afford to do so make provisions for their retirement and old age. This reduces the direct responsibility of government to more manageable levels. Thus there is a need for a comprehensive system of private pension/provident fund, centred on the individual rather than on the organisation or the job held. In other words the system must be portable in the sense that the benefits remain with and move with the individual even when (s)he changes jobs or organisations. Such a system must be a fully funded one, with any employer contribution deposited into the individual retirement account. It must have modern and flexible investment regulations, which allow the build up of a broad portfolio including higher risk-return assets like equity and private debt. It must ensure application of efficient governance structures and management so that the worker has access to the same returns that are traditionally available only to the wealthy.

114. Replacement of the plethora of income tax deductions by a comprehensive exemption based on the net saving principle will ensure a supportive tax environment. Once this is done, limits on employee or employer contributions will become unnecessary and can be abolished. It is sometimes forgotten that there are a large number of self employed people in the country some of them not much better of then unorganised workers. They must also be entitled to similar tax benefits for retirement savings. One approach, which could be an interim solution before a comprehensive net saving principle is implemented, would be to declare pension schemes as ‘deemed trusts.’

f) Interest Rate Flexibility

115. A number of saving instruments such as GPF and ‘Post office and Small saving instruments’ are used by Central and State governments as a source of funds. Because of historical rigidities interest rates on some of these instruments have barely changed over decades. When market rates are falling, this tends to put a floor under the entire structure of interest rates. These rates must become market based and flexible so as to reduce rigidities in the level of interest rates. Interest rates on bank saving accounts must also be de-controlled for the same reason.

2 RESTRUCTURING

116. The increase in domestic and foreign competition has put pressure on companies to focus on their core competence, exploit economies of scale and scope and dispose of unrelated and inefficient businesses. This requires mergers, acquisitions, de-mergers and corporate restructuring. Company law and income tax laws, rules & procedures that hinder restructuring must be changed. As already announced in the budget, the best way to reform the tax laws and rules for this purpose is to faithfully and strictly apply the principle of tax neutrality. Within the overall area of industrial restructuring the issue of Bankruptcy & winding up and the delays and problems associated with BIFR require urgent attention.

a) Sick Industrial Companies Act

117. India seems to be unique in labelling a bankrupt company sick. According to SICA (1985) sickness is defined as a situation in which the accumulated losses of a company exceed its net worth. This definition of sickness coupled with emphasis on rehabilitation leads to a situation where BIFR fails to distinguish between companies that can be turned around and that need to be liquidated. Ninety percent of the companies referred to BIFR since July 1987 have remained sick and gone from bad to worse. Not only is bankruptcy restructuring under BIFR tedious, liquidation is virtually impossible. Winding up is compounded further by delays in the high courts. 40% of the cases take up to 10 years while the rest can take anywhere from

20 to 50 years. The SICA amendment bill, which has been pending for two years, can be a partial solution. Once a modern bankruptcy law is introduced, BIFR (and SICA) could be abolished.

b) Bankruptcy Law

118. There is a need to distinguish between companies, which are legal entities and assets, which produce income and wealth. No country, certainly a poor one, can afford to let assets lie unused and deteriorate. All over the World debt default is a clear sign of bankruptcy. Poor bankruptcy procedures protect inefficient management at the expense of secured creditors. A properly designed and implemented bankruptcy policy has more to do with exit of inefficient management and replacement by more efficient ones, than with labour. Barriers to exit soon become barriers to entry, and also lead to widespread corporate mis-governance. Poor protection of creditors' rights gives enormous and ultimately deleterious discretionary space to inefficient management. It allows management to reallocate funds to highly risky investments, needlessly raises the cost of credit, undermines the disciplining role of debt and if unchecked eventually ruins the health of the country's financial sector. We need to move to an international definition of bankruptcy and make bankruptcy a market driven process.

119. The new bankruptcy law must encourage voluntary winding up, as this is more cost and time efficient. The act must catalyse rapid, transparent market determined sale of assets. The sale of assets must be separated from and precede distribution of the sale proceeds. Professionals such as chartered accountants, lawyers or company secretaries should be empanelled by the High courts as company liquidators.

c) Take-over Rules

120. One reason for the retail investors' loss of faith in equity markets was the absence of a disciplining force on promoter-managers. In addition to a properly functioning debt/credit market, a market for management is needed to ensure competitive pressure on promoter-managers. Such a market operates through take-over of badly managed companies. The rules and regulations for acquisitions and take-over are of critical importance in ensuring that such a take-over market is created and acts a disciplining force. The existing rules will have to be revised and updated to ensure that they are fair and neutral and provide a realistic threat to lazy management.

K. STATE FISCAL REFORMS

121. Most of the issues connected with state governments have been touched on earlier. They are, however, brought together here in a summary form.

1 MOUs

233. A few States have started the process of fiscal reform over the last few years. This process has gained new impetus in 1999 with the signing of MOUs between the centre and a few states. In these MOUs States have agreed to undertake a series of specific fiscal measures, in return for the provision of extra financial liquidity. More important than the signed document is the process of thinking, discussion and cross-fertilisation that can be set in motion. This process needs to be accelerated given the dire state of many States finances. Among the fiscal reforms which need to be initiated by the States are;

2 User Charges

234. The assets created in the past have deteriorated tremendously because public services do not even charge enough to cover maintenance & running expenses. Charges must be raised in a phased manner to cover the full cost of production, so that financing of new investment becomes feasible. Raise bus fares, electricity and water usage charges to economic levels. Raise tuition fees at college level, and for health service consultation & diagnostic tests. Levy parking charges for road parking in residential areas.

3 Expenditure Priorities

235. With State finances in a dire state, there is an urgent need to re-set expenditure priorities at the state and local level. Downsize state administration and focus limited resources on public goods (e.g. law & order), infrastructure and knowledge services with strong externalities (e.g. roads, agricultural extension, libraries) and basic social services (primary education, literacy, public health). Treat O&M expenditures as capital expenditures. Freeze net hiring to zero. Reduce size of govt staff through attrition (retirement) and reduce non-educational grants.

4 Privatisation

236. State transport corporations and Public sector units, many of which are loss making, must be privatised to salvage State finances. State electricity boards and other departmental enterprises should be converted to companies. This can be followed by privatisation.

5 Tax Reform

237. Harmonise tax laws across states starting with a rate band, followed by a uniform rate on most goods and then move to State VAT. Harmonise and rationalise stamp duties. Restore land revenue and property taxes to rational levels. Tax agriculture income directly or through a differentiated (e.g. irrigated-non-irrigated) land revenue system.

6 Legislative Transfer

238. Transfer to local bodies, monitoring authority over all public services that are provided at the local level. The experiment of decentralising primary schooling has apparently already proved successful. This experiment should be extended to other local services. In areas in which continuous interaction of field staff with higher levels of administration is essential as in agricultural extension work, a mechanism for joint control may have to be worked out.

7 Re-Engineering State Govts

239. The size of State governments must be reduced and its quality improved along the lines indicated in section 4.1.4.

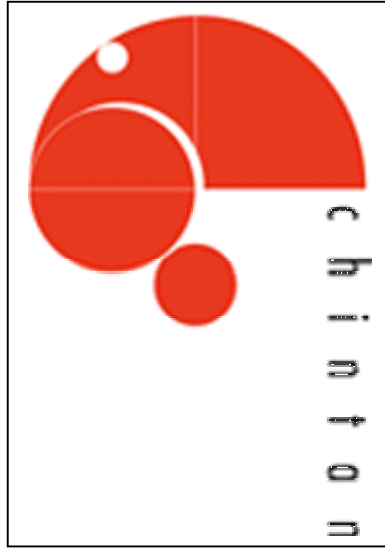
8 Freedom of Information

240. The people must have the right to obtain information on programs and projects purportedly carried out for their benefit. Rajesthan was the pioneer in introducing a freedom of information act. Other states could improve upon this achievement.

CHINTAN POLICY PAPER SEREIS**

Policy Paper No.	TITLE	DATE
1.	Policy Measures for Meeting Capital Inflow Surge,	March 1997
2.	An Agenda For Tax Reform,	May 1997
3.	A New Foreign Exchange Act,	June 1997
4.	Development of Government Debt Markets,	July 1997
5.	Exchange Rate Management,	December 1997
6.	A Communication Policy For the 21 st Century,	November 1998
7.	From Poverty to Middle Income: Reforms for Accelerating Growth in the 21 st Century,	April 1999
8.	Urban Infrastructure, Real Estate & Housing Policy,	May 1999
9.	Administrative, Institutional & Legal Reform,	June 1999
10.	FDI in Media,	June 1999
11.	Agricultural & Agro-Processing Policy Reform,	September 1999

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