FROM POVERTY TO MIDDLE INCOME:
Reforms for Accelerating Growth in the 21st Century

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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 high tax rates. As a result of these reforms India will likely have an annual average growth rate of about 6% over the last two decades of the 20th century. 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.

B. Goals and Objectives

2. As we enter a new millennium, this 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), primary education, 'public health' & population control and degradation of common resources (water, forests). These responsibilities have been virtually lost sight of, squeezed between rising fiscal deficits and expanding role of the state in every area of economic activity and the inevitable rent seeking that followed. 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 encompasses 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. Though in many parts of the economy this should be sufficient to generate competition, there are other sectors such as physical infrastructure, where some parts are characterised by natural monopoly, which require regulatory structures to foster and mimic competition. Other sectors such as banking, finance and capital markets characterised by fiduciary responsibilities require a different type of regulation focusing on transparency, reduction of systemic risk and detection and punishment of fiduciary irresponsibility.

II. INDIA IN GLOBAL PERSPECTIVE

A. India's Position

5. Fifty years have passed since India gained its independence. The 20th century is coming to a close and we are at the threshold of the 21st. We have still to meet many of the unmet challenges of the past half-century and convert these into opportunities for transforming the country. In looking towards the future of the country in the 21st century, it is best to start by taking stock of the present state of the country. There are two levels at which we can and must address this question. Where does India stand today in the comity of Nations and what is the condition of our people, particularly the poorest (36%) among us?

6. India is today the fifth largest economy in the World, measured in Purchasing Power Parity terms (the only acceptable way to compare the size of different economies). Only the US, Chinese, Japanese and German economies are larger than our economy. By the year 2000, India is expected to become the fourth largest country, by overtaking Germany. Size matters in determining the international standing of a country, but not just the current size. The countries' future size depends on the rate of the growth of the economy, and therefore faster growth adds to a country's standing. A country's influence in the world also depends on the degree of interaction with the rest of the world. This in turn depends on the degree of openness of the economy. Since 1980 China's economy has out-performed the Indian economy in all these dimensions. Not only has China grown faster than India, but it is also now more open in terms of both foreign trade and foreign Investment (that is both these play a larger role in China's economy than in India's). That is why China's standing in the world has improved faster than India's, over the last two decades.

7. At the same time both India and China are among the poorest countries in the world coming in at 126th and 88th position respectively in terms of per capita income (again measured in PPP terms). Besides measuring the standard of living of the people, this is also a measure of the relatively unsophisticated nature of the economy as a whole. For instance a large

fraction of our labour force is engaged in low productive activities in agriculture and services. Its average education & skill level is also low compared to countries with high per capita income. This affects the economy's ability to produce quality goods & services and meet new technological challenges. We are justly proud of our scientific and technological achievements in selected fields. It is, however, the low average level of education & skills that is quite visible to any foreign visitor or interlocutor, and affects the international standing of the nation and its people.

8. More importantly, per capita income measures the average standard of living of the people and is closely related to the degree of poverty. It is a matter of great sadness that our people are so poor, that such a large section of our people remains illiterate and below the poverty line. The urgent need for moderating population growth should not be forgotten, as it seems to have been for the last few decades. Economic growth remains the key to eliminating unemployment and poverty. What is needed is efficient self-sustaining growth, which generates productive employment. Employment generation nurtured by subsidies and protection cannot grow in a self-sustaining fashion because it leads to fiscal deficits, mounting debt and ultimately bankruptcy. The old paradigm of the all knowing, all powerful and moral state has failed to eliminate poverty and illiteracy over the last five decades. At the turn of the century many state governments do not have the resources and some not even the motivation, to carry out even the most basic functions of the state. In many instances, Law & order, justice, Civic amenities and education have deteriorated beyond belief. We need a new paradigm for the 21st century, which recognises the strengths and weaknesses of the people and the state and allows each its due role in the development of the economy.

9. A similar deterioration has taken place among the industrialists and workers. Controls, intrusive regulations, subsidies and protection have led to a deterioration of the work culture and induced rent seeking by traditional industry & services. The new paradigm must therefore include a transformation of the mind-set of both old industrialists and organised labour. Industrialists will have to learn to earn profit through competition and innovation; labour will have to learn to advance through hard work and acquisition of new skills & education.

10. It is important, however, not to confuse low per capita income (poverty & underemployment) with high *degree of inequality*. Of all the countries in the World, data on income or consumption distribution is available (WDR 1998-99) for about 80 countries. Using both the 'Gini' co-efficient and the share of the poorest 20% as a measure of consumption/income distribution, there are only 15 countries in the world, which have a better consumption/income

distribution than India. Nine of these are in Eastern Europe, six in Western Europe and only one (Rwanda) is outside Europe. Beside this, one Western European country has a better Gini co-efficient and one Asian country (Laos) has a higher share for the poorest 20%, than India. India thus has one of the most equal consumption/income distributions among the developing countries and emerging economies.

B. Growth Performance

11. Though we have not performed as well as several other countries and have a long way to go, it is important to appreciate that our performance has improved considerably over the decades of the eighties and nineties. This performance is a far cry from the so called, 'Hindu rate of growth' of the seventies, which is still unthinkingly bandied about by the indigenous 'Cassandra.' Prof. Raj Krishna coined this phrase during the period of increasing controls and slowing growth rate, when the economy averaged a growth rate of about 3.5% per annum between the mid-sixties and the end-seventies. De-control and de-licensing, which during the eighties was limited and selective, gradually restored growth to a level closer to potential.

12. The best way to have a realistic appraisal of Indian growth performance since 1980 is to compare it with the star performers in the world using standard internationally comparable data on GDP growth rates published in the World Development Report, 1998-99. According to this data, during the eighties (1980-90), India was one of the ten fastest growing economies in the world. The annual growth rate was marginally less than that of Indonesia (6.1%) the ninth fastest growing economy. The so called 'miracle growth' economies of East and South East Asia such as China (10.2%), S. Korea (9.5%), Thailand (7.6%), Hong Kong (6.9%), Singapore (6.6%) and Indonesia (6.1%) grew faster than India (5.8%).[1] With the exception of Mauritius (Africa) the top performers were all in Asia.

13. Comparable data from the same source for the nineties is available only till 1997. In the case of India this includes the crisis year of 1991-92. It can be argued, that the reforms initiated in the eighties were also accompanied by negative fiscal policies, which were an important contributor to the BOP crises in 1991. The effect of the reforms was on the other hand felt after a lag of about a year. In the case of several East and South East Asian countries their reforms and strong growth performance started in the middle of the eighties, while their crisis occurred towards the end of 1997.[2] In comparing across countries we have to use a uniform time period. It is

[1] Collins and Bosworth (1996) and others have suggested that the statistical methodology used in China may overstate the growth rate by 1 to 2%. Comparable data for Taiwan is not given in the World Bank publication.
[2] Similar lags would apply in their case also.

therefore best to use as long a time period as possible, which averages out the different cycles of every country. We therefore combine (average) the growth rates for the two periods, 1980-90 and 1990-97, given in the WDR to obtain the growth rates for the period 1980-97. Adding to this the data for 1998 from the IMF WEO & ADB AEO, we can get the average growth rate for the eighteen-year period 1980-98.

14. India was the 8th fastest growing economy of the world for this longer eighteen-year period. [3] Two South East Asian countries (Indonesia, Hong Kong-China) dropped below India during this eighteen-year period and two S. E. Asians over-took us. China (10.7%), S. Korea (7.8%), Oman (7.1), Singapore (7.0%), Thailand (6.7%), Vietnam (6.1%) and Malaysia (5.9%) grew faster than India (5.8%). There were three growth rate clusters: One around 6% (in which our growth falls), the second between 6.7% and 7.1% and the highest at over 7.5%. [4] The simple average growth rate of the countries falling in the middle cluster is about 7%. This suggests that with appropriate policy reforms, a growth rate of 6.5% to 7.5% is quite feasible. Given current growth projections, it is quite likely that India's growth rate for the two decades ending 2000 will be the 6th highest in the world. Thus our growth performance over two decades provides a firm foundation for accelerating growth even further. If economic reforms proceed with firmness and determination, a target growth of 7% per annum appears feasible for the next decade.

C. The 21st century

15. Though our per capita income position at the start of the 21st century is a matter of sadness, our growth performance over the last two decades of the 20th century provides confidence that we can do much better in the first two decades of the 21st century. It is therefore possible to visualise a quite different India, two decades from now. If India grows by about 7% per annum in the next two decades it will become the third largest economy by the end of the second decade of the 21st century. Only the USA and China would have a larger economy than ours at that point. Such a sustained growth rate would also transform our position among the comity of nations, especially if accompanied by an opening of the economy to the same degree (in terms of the trade ratio) as the other two continental economies, China and USA. We would then truly be the third largest markets in the World.

16. More importantly, in terms of per capita income this would mean that India has transited from a low-income to a middle-income country. It would

[3] Even though the IMF estimates a growth rate of 5.6 % compared to the CSO's estimate of 5.8% for 1998-99.
[4] Even an adjustment of growth by 2% points leaves China at 8.7% as the fastest growing economy in the world over this 18-year period.

also mean a transformation in the lives of the common people. Fast efficient and sustained growth over two decades would be accompanied by a rapid and sustained growth of productive employment, which would eliminate disguised unemployment and under-employment in agriculture and informal services. Associated with this would be an elimination of poverty among families headed by healthy able-bodied persons. The mere fact that any able bodied person can get a job whenever (s)he wants would result in a revolution in human dignity. Instead of getting tens or hundreds of applications for every job, employers would be out searching for sincere, honest & hard working individuals. Past prejudices based on caste, religion, gender etc. would fade very rapidly under such conditions, as would the need for reservations.

17. The challenge for all of us (people's representatives, government, industry, farmers and labour) is therefore to translate this vision into reality. This paper attempts to outline some of the reforms needed to take the economy from a 6% growth rate (of the last two decades of the 20th century) to the 7% growth rate in the first decade of the 21st century. Even a growth rate up to 7.5% in the second decade is possible, but raising growth to 8% or higher requires something additional. A universally shared goal of equalling or excelling the growth performance of the best performing country (China) and a single minded pursuit of this goal.[5]

III. ECONOMIC POLICY REFORM

A. Overview of Past Reform

18. There was a vast increase in controls during the sixties and the first half of the seventies. By the end of the seventies many practical and pragmatic people not bound by ideology were beginning to notice that these controls were not only unable to achieve their professed objectives, but were also creating many other problems and distortions. This awareness permeated even the political sphere and manifested itself in the appointment of committees to look into the issue of controls. These included the committee on 'Controls and Subsidies' (Dagli) and on Import-export controls (Alexander). As result of various reviews, de-control started in a gradual and limited way (mainly industry and exports) during the eighties. De-control accelerated in the wake of the BOP crises of 1990 and extended to include broader areas of reform such as the financial sector and taxation.

[5] It is only through such goal setting and single-minded pursuit have S. Korea and China (and Japan in earlier years) attained such high growth rates.

1 PRICE CONTROLS

19. Though in numerical terms, price and distribution controls covered only a fraction of the total number of commodities in the economy, they reflected a lack of appreciation of basic market economics. Price controls covered what were perceived as key industries, in the belief that this would help the economy grow faster. The effect of price controls was in reality the opposite. By discouraging investment in and production of these commodities they retarded efficient growth. Alternatively, price controls are and proved to be a motor for evasion and rent seeking, thus undermining the true entrepreneurial spirit and diverting it into (what may be termed) 'immoral innovation'. During the first phase of reforms, price controls have been abolished on iron and steel, newsprint, coal, molasses, phosphate and potassium fertiliser and naphtha. The ambit of drug price controls has been reduced from 143 basic drugs to 76.

2 INVESTMENT LICENSING

20. Investment licensing reflected a similar lack of appreciation of market economics. Investment generates employment, output and growth. It also creates tangible assets, which along with human capital is the predominant means of raising a nation's productivity and per capita income. By its nature, investment licensing can only retard growth by restricting entry and creating oligopolies. It cannot promote it. Reservation for the public sector or small industry has similar effects. If the public or small sector is efficient and productive, reservation is redundant. If it is inefficient or less productive, reservation entails a cost in terms of slower growth and employment generation in the economy. By saving the jobs of existing employees in the particular sector it gives the illusion of employment, while in reality ensuring that new high productive jobs that propel the entire economy forward are not created. Controls on Foreign Direct Investment are another form of investment licensing or reservation (for domestic entrepreneurs).

21. Recognition of this basic fact led to a gradual and incremental liberalisation during the eighties. More significant steps were taken in the nineties, with the abolition of licensing in all but 6 industries. The licensing aspects of MRTP were eliminated. The list of industries reserved for the public sector has also been pruned to six. Foreign Direct Investment (FDI) has been liberalised as it has additional advantages such as promoting transfer of technology and international best practices in organisation, management and marketing. Automatic FDI approval is now available for foreign equity up to 51% in a list of 48 industries and up to 74% in a list of 9 industries. 100% automatic approval is also available in power and other sub-sectors. As a result of these and other measures, real private fixed

investment has risen to 16.8 per cent of GDP in 1997-98 from 12.7 per cent of GDP in 1990-91 and 10.7 per cent in 1980-81.[6] Further in 1997 (the latest available data), India was for the first time among the top ten emerging market (i.e. excluding developed countries) destinations for FDI. It has maintained its position in 1998.

22. The remaining investment licensing restrictions on domestic industry reflect an attempt to deal with other issues such as pollution, health, public security and national security through the medium of investment licensing. These issues can and should be dealt with in a more direct and forthright manner, rather than through investment licensing.

3 IMPORT LICENSING

23. Import licensing has been another important area of reform. The import licensing system built during the sixties and seventies started undergoing change in the eighties with the primary objective of freeing imports for exporters. In the nineties change accelerated with the freeing of industrial and mineral raw materials, intermediates and capital goods. Gold imports have also been gradually freed, though imports of precious stones remain restricted or licensed (SIL). A certain amount of import de-licensing has also taken place for agricultural goods and manufactured consumer goods.

24. 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.[7] 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.

4 FOREIGN EXCHANGE CONTROL

25. At the end of the eighties, the foreign exchange market was even more strictly controlled than imports, coming as it did under the draconian Foreign exchange regulation act (FERA). Only limited easing with respect to transfer of residence and non-resident Indians had taken place. The reduction of import licensing and reduction in protective import tariffs during the nineties was accompanied by de-control of the foreign exchange market. This was facilitated by a 24% depreciation of the rupee in July 1991. A dual exchange rate regime replaced the strict exchange controls in 1992. The

[6] The 1997-8 GDP is in 1993-94 prices, while the 1980-1 and 1990-1 estimates are in 1980-81 prices.
[7] 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.

dual rate was integrated into a single flexible rate in 1993. This was followed in 1994 by declaration of full current account convertibility, as per international norms. A number of steps have been taken to liberalise restrictions on current account transactions. These culminated in the introduction of new modern Foreign exchange management bill in parliament. The flexible exchange regime has responded well to changes in the flow of foreign exchange, with RBI intervening to ensure orderly market conditions and to dampen excessive volatility.

26. De-licensing of manufacturing investment and manufacturing imports, along with price de-control and tariff reduction, has introduced competition into many sub-sectors of manufacturing for the first time in decades. As exchange rate adjustments offset much of the effect of import duty reductions on domestic producers, much of the threat was in the form of potential competition and pressure to contain price increases. The threat of competition is the most potent force for promoting innovation, productivity and efficiency. Freedom to produce, price, invest and import goes a long way in ensuring this even when actual imports are minimal.

5 TAX DISTORTIONS

27. 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.

28. 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 from 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.

6 BANKING CONTROL

29. The Banking sector was, at the start of the nineties, one of the most heavily controlled sectors of the economy. As most banks were government owned they were subject to direct dual control of the finance ministry and the RBI. The private and foreign banks were subject only to the latter. During the nineties, interest rates on both deposits and loans have been substantially de-controlled. Interest controls remain, however, on saving deposits and very small loans. The statutory liquidity ratio (SLR), which forced banks to invest in low interest government paper, has been reduced from 38.5% to 25%. This has been accompanied by a move to market based determination of interest rates on government securities. The cash reserve ratio (CRR) for banks has also been reduced from 15% to 10.5%. Selective credit controls have been abolished, though priority sector credit requirements remain with an expanded list of eligible sub-sectors. These measures have reduced the implicit taxation of savings (through the banking system). Entry of new private banks and an increase in the number of foreign banks with branches in the country has increased the competitive pressure for performance improvement.

30. All areas of banking operation, such as debt, advances, investment, capital expenditure and non-fund based business were subject to detailed rules, regulations and guidelines. Some of the more obvious ones have been removed, and there has been an effort to replace them with modern systems of regulations. Thus prudential norms and standards relating to capital adequacy, asset classification, income-recognition and provisioning have been introduced. The supervisory system has also been re-organised and strengthened. These and other measures have led to a decrease in the net non-performing loans of the public sector banks from 16.3% of loans/ advances to 8.2%. Net Non Performing Assets as a proportion of total assets of the banks were, however, only 3.3% because of substantial investment in risk free government securities.

7 CAPITAL MARKET

31. 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.

32. 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.

B. FIRST PHASE OF ECONOMIC REFORM

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

1 REVENUE BALANCE

34. The fiscal problem first raised its head during the eighties, though there was 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 that 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 that is more efficient and less subject to leakage. To achieve this objective it is necessary to eliminate wasteful expenditures and target subsidies more carefully.

35. Any subsidy on a good or service distorts the consumption and production of a particular 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.

a) Fertiliser retention price system

36. Some academics have estimated that 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. The Hanumantha Rao committee report provides a basis for moving to a de-controlled system in which the farmer gets fertiliser at international prices. To achieve this goal Urea prices could be raised by 10% a year till price reaches world price. The maximum (minimum) retention price would be simultaneously lowered (raised) by appropriate amounts to reach world levels at the same time. A part of the subsidy savings could be given as additional allocation to irrigation and watershed development schemes that particularly benefit small and marginal farmers.

b) Public Distribution System

37. 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:

- Sugar is neither nutritious nor is it health enhancing. If anything consumed in excess it damages teeth and aggravates diabetes. Sugar should therefore be removed from the PDS. This must be coupled with complete de-control of sugar so that consumers are not deprived of competitive prices.
- 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 income tax payers from PDS. Indicators that can be

used for this purpose are property owners/permanent tenants, motor vehicles, telephones, electricity usage and foreign travel.

- 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 determination of carrying charges.

c) Petroleum APM

38. The administered price mechanism is to be dismantled by 2002. This process should be accelerated so as to bring about complete de-control, with the elimination of the LPG subsidy and a reduction of the Kerosene subsidy.

39. Neighbouring countries, some much poorer then 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.

40. 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.

d) Budgetary Reform

41. 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.

42. 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.

2 TAX REFORMS

43. 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.

44. 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.

a) Central Value Added Tax

45. 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.[8] 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 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

[8] Though it may be called CVD or Additional customs duty.

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 pan masala & tobacco products would have a 25% special excise (i.e. total = 40%). Special excise on large and small 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 and HSD could have a special excise of 15%. Cars for physically handicapped, scooters, motorcycles, 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.

b) Customs Duty

46. 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 majority of basic customs duty rates to between 10% & 20% by 2003. The only exception could be alcohol.[9]

47. 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 Developing 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 a lower (uniform) rate. We can

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

target a 10% duty on all manufactured goods and 5% on all primary products by 2005.

c) Personal Income Tax

48. 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.

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

d) Corporate Tax

50. 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) Inheritance Tax

51. 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%.

3 PRICE & DISTRIBUTION CONTROL

a) Sugar

52. The dual pricing regime for sugar (and other commodities in the late seventies and eighties) was originally viewed as a painless way of transiting from a controlled to a free system. It has inadvertently become a permanent fixture of the sugar industry. It should be dismantled, sugar prices freed, the industry decontrolled, and sugar removed from PDS. This is consistent with the recommendations of the Mahajan committee.

b) Fertiliser

53. 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 small and medium farmers at the lowest possible cost. Tax/tariff policy cum subsidies can be used where necessary. The recommendations of the Hanumantha Rao committee can form the basis for initiating de-control.

c) Hydro-carbons

54. The dismantling of the Administered Price Mechanism could be accelerated, so that this important manufacturing sector can start seeing the benefits of competition.

4 IMPORT & EXPORT DE-CONTROL

a) De-canalise Import

55. Canalisation has been used either as a means of subsidising the canalising agencies or as means of implicit taxation (petroleum). These hidden subsidies must be brought out into the open by complete de-canalisation of imports and exports. An export duty can be imposed if needed.

b) Agricultural goods

56. A major reason for the high and volatile price inflation in Primary goods is that imports are still restricted and several exports are subject to quantitative restrictions (QRs). Such a system is not in the interests of farmers and often not even the consumers, as the government's information systems and speed of reaction is inferior to that of private trade and industry. The lagged government response often tends to aggravate volatility rather than dampening it. Both imports and exports of all agricultural items should be de-licensed. The best way to dampen excessive volatility is by allowing derivatives in all these products, and imposing import tariffs and export duties on selected products. The latter creates a price band around the international price, so that fluctuations in world prices within this band do not affect domestic prices, while domestic price volatility is also restrained

beyond this band. This will be in the interests of both farmers and consumers, as a stable environment is more likely to encourage investment and productivity growth.

c) Consumer goods

57. Most manufactured consumer goods could be put on OGL without affecting production significantly because the existing customs duties provide sufficient protection. Even the most important consumer durable, the personal automobile (car) can easily meet the competition at current rates. It is nevertheless extremely important to complete the process expeditiously, as the threat of competition is a potent force for efficiency and productivity.

d) Export control

58. Export controls should be eliminated. In a few cases such as inferior food grains an export duty can be imposed to ensure that domestic prices remain below world prices.

5 TECHNOLOGY IMPORT

59. Controls on technology import are even more difficult to justify than investment controls. Transfer of technology from the developed countries is the easiest way to close the huge technology gap and technological change is an important source of economic growth. Licensing only serves to slow technology transfer and consequently it slows growth. Technology import should be completely free. Any fears regarding transfer pricing (payments to foreign promoter companies) should be addressed through disclosure rules and transparency norms under company law.

6 EXCHANGE CONTROL

a) Current Account

60. Given the imminent passage of FEMA and the continuing liberalisation of trade, current account payments must continue to be liberalised. Despite India having moved formally to complete current account convertibility five years ago, many still do not appreciate that foreign exchange is just another form of money. As it is a different type of money it has a market price in terms of rupees called the exchange rate. All citizens now have a right to buy foreign exchange at the market price for use in any current account transaction. Our attitude and approach to the foreign exchange market and to exchange rates must change drastically if we are to go confidently forward to meet the challenges of the world economy.

61. Rules and procedures for exporters of both goods and services and for knowledge-based industries like Information Technology and Pharmaceuticals must change urgently. The policy focus must be on making

the average Indian feel that complete current account convertibility truly exists in India. EEFC account holders can be allowed 100% retention of foreign exchange for current account use and permitted capital account transactions. Greater and clearer delegation of powers to Authorised Dealers would remove persistent complaints, even regarding routine transactions. Dishonest individuals or illegal activities can be dealt with through better flow of information to and co-operation with appropriate authorities such as ED & CBDT.

7 FOREIGN DIRECT INVESTMENT

62. Foreign direct investment is the best means of transferring business knowledge from the developed countries. This consists not only of technology defined in the conventional sense of production processes for existing and new products, but also organisational, managerial, marketing, distribution, procurement and logistics knowledge & systems. Skills and technology diffuse from such foreign companies into the rest of the economy through movement of skilled personnel, through demands on input suppliers, through supplies of superior output to users and by imitation.

a) Insurance

63. Serious development of the long-term debt market awaits the opening of the insurance sector to private competition and introduction of international best practices. The Insurance regulatory authority bill, which was cleared by the Standing committee in the last parliament session must be re-introduced and passed urgently by the new Parliament. The IRA must get its systems and procedures in place for quick processing of applications. Quick introduction of Health Insurance and Pension funds must be encouraged. In the not too distant future up to 49% foreign equity investment should be permitted. This could be conditional on the Indian promoters having a larger proportion of shares than the foreign joint venture partner (i.e. Indian management control).

b) Airlines

64. The brief spell of competition ushered in by allowing a few domestic airlines produced a dramatic change in the attitude of the staff of national airlines. This was short lived. Though natural barriers to entry and exit into this industry are quite low, the capital and organisational requirements are quite high. True competition therefore requires the entry of experienced players such as foreign airlines. Up to 49% foreign equity must be allowed to all foreign entities in domestic airlines. A start could be made by immediate lifting of restrictions on foreign airlines within the current 40% foreign equity cap.

c) Airports

65. The terrible delays at airports during the past winter combined with the air traffic controllers strikes have been a deathblow to the tourism industry. The quality of our airports compares very unfavourably with those in S. E. Asia. Private entry and foreign participation can change this situation dramatically in a couple of years. Up to 100% foreign entry can be allowed in the international and major airports.

d) Media

66. Distinguish facility ownership from control of content. That is there would be two types of companies, namely facility companies and broadcasting companies. Foreign investment in facility companies can be very liberal, with 100% foreign equity allowed if there is clear and effective separation from broadcasting content control. Foreign equity in companies that effectively control broadcast content would be less liberal (up to 26% say). An independent regulatory authority, which ensures equal and fair access to use of facilities by other broadcasting companies, must complement the liberal approach to facility ownership.

e) Automatic route

67. Allow 100% foreign equity in Software & Hardware Technology Parks (STP, HTP), 100% Export Oriented Units and Free ports (free trade zones). Allow automatic 74% foreign equity in all manufactured goods that are on OGL and automatic 51% foreign equity in manufactured goods that are on SIL. Allow automatic 74% foreign equity in all modern, technical, financial, professional, educational services, software & entertainment and construction services. This will help improve quality, promote international linkages and lead to a boom in export of services. Move to 100% foreign equity in manufacturing and exportable & importable services by the time all QRs related to BOP are eliminated. Move towards allowing 100% foreign equity in all infrastructure services constituting a 'natural monopoly' segment subject only to the condition that this segment must constitute a separate company, which provides universal access at fair and non-discriminatory prices under a regulatory authority. Government could keep a golden share in such 100% foreign owned 'natural monopoly' companies. Allow automatic 51% foreign equity in the production of all other goods and services.

C. TRANSITION FROM 1st TO 2nd PHASE OF REFORM

1 USER CHARGES & INVESTMENT FINANCING

68. 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.
- 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.

2 PRICE & DISTRIBUTION CONTROL

a) Drugs

69. If price controls are justified in the name of the poor, they should only apply to drugs that are on the list of drugs identified for the primary/basic health system. Other drugs included in the UN list of essential drugs could also be added. A dual pricing system could be set up for this set of drugs. The rest should be de-controlled, as price control does not benefit even the poor. By discouraging investment in new drugs and imposing regulatory costs that have ultimately to be paid by the consumer, it may harm the poor and the middle class.

b) Transport & Storage

70. Remove controls on price, storage and transport of agricultural produce and processed goods. Price control on cold storage, an anti-farmer policy, still prevails in two states. Other states still restrict movement of commodities outside the state, resulting in the absurd situation in which farmers in a district in one state (e.g. Kalhandi) cannot sell to processing units in the neighbouring district falling in another state (MP). The Essential commodities act is one such impediment to modern systems of storage and transport. A start could be made, by exempting modern silos as well as organised grain handling storage and distribution companies from its purview. These companies can easily be monitored on a post facto basis.

c) Utilities

71. Prices of public utilities must be de-controlled and subject to independent regulatory authorities whose objective would be to protect the long-term interests of consumers. The current consumers of power and other public utilities are now paying the cost imposed by price controls and public monopoly on new investment and the quality and quantity of production.

d) De-control Rents

72. Price control on rented property was introduced in many countries during World War II as part of comprehensive but temporary price control and rationing in aid of the war effort. India, which was merely a British colony during the war, is probably one of the few countries, which still retains this colonial price control. Control on rental charges is a control on the price of rented residential and commercial space, and needs to be abolished. It can be phased out gradually on properties that are currently under 'rent control' to ease transition. For such property 'rent control' on commercial property would expire in three years and on residential property in five years, from the date of de-control of rents. During the transition period the increase in annual rental charges can be limited to the highest of 20% or Rs 6000 per annum [Maximum (Rs. 6000, 20% of rent)].

e) Educational Institutions

73. Removal of price controls on educational institutions must be accompanied by a system of dual pricing for poor students. The most common and tested method of doing this is through means cum merit scholarships. Removal on price controls would be conditional on providing a specified (minimum) number of such scholarships.

f) State & Local

74. Many other controls remain hidden and largely unidentified at the State and local level. A concerted effort must be made to identify and eliminate remaining controls.

3 INVESTMENT DE-LICENSING

75. Investment licensing and public sector reservation reduces competition, is anti-growth and must be completely and unambiguously eliminated. Laws already exist to deal with issues such as health, pollution, safety, public and national security and other such concerns. They must be dealt with directly under these laws. This will also ensure that both the authority and the accountability are located in the same department/ministry. Among the sectors urgently requiring de-licensing, private entry and competition are the following:

a) SSI De-Reservation

76. The list of industries reserved for exclusive investment by SSIs is a form of investment licensing, which is no longer prevalent anywhere else in the world. Many countries provide various types of incentives to small and medium size firms (usually defined in terms of the number of employees), but none bans large firms from investing in any sub-sector of industry. Excluding large firms from sub-sectors in which they would be more efficient & productive than small firms increases the capital intensity of the economy and reduces the total number of productive jobs generated. Reservation in areas in which small firms are more efficient and productive is redundant and unnecessary. SSI reservations must be eliminated in a time bound manner, starting with, a) numerous items which are not even produced by Small Scale Industries, followed by b) items on OGL and free import from Sri Lanka under the free trade agreement, and c) Labour intensive goods with export potential. SSI reservation should be completely eliminated by the time import licensing on BOP grounds is eliminated.

b) Infrastructure services

77. Public utilities like Telecom, Railways, Post & Telegraph (central) and Power generation, canals, urban utilities (water & sewage) and road transport (states) are vital for production, employment, growth and social welfare. The poor quality of our infrastructure is directly due to the public sector reservation policy, which has created unresponsive monopolies. This along with price controls has led to large supply gaps. Monopolistic inefficiency has imposed a heavy cost on the international competitiveness of our manufacturing and service industry. As a result manufactured exports have suffered and service exports are likely to be stunted unless urgent steps are taken. All these infrastructure services must be de-licensed, and a level

playing field provided to encourage new private companies to compete in providing all infrastructure services.

c) Energy: Coal

78. Private entry in coal and mineral oils is being allowed. The monopoly of the public sector in coal has led to enormous X-inefficiency and a deterioration of international competitiveness. Though captive coalmines have been allowed, this is not enough to exploit economies of scale. Improvement in productivity requires the entry of large specialised coal producers. To rebuild an internationally competitive industry, the coal nationalisation act needs to be repealed and royalty rates on poorer quality coal reduced & perhaps eliminated. A healthy and diverse coal industry will also support the development of the private power industry, instead of acting as another barrier as it has in the past. Mineral oils should be de-licensed. ‘Resource rents’ on quality energy deposits would continue to accrue to the state through an appropriate contracting & auction system.

d) Social Services

79. The current approach to private provision of social services is ad-hoc, arbitrary and based on extracting rents from any quality provider who is successful. Suppliers of quality services, particularly education, are subject to excessive and oppressive interference while low quality & fly by night providers remain relatively unchecked. We must develop a framework for entry of private, co-operative and joint sector in the provision of all social services. This framework should provide a stable and predictable environment that is so essential for serious long-term suppliers of education and training services.

e) Dual-use defence, nuclear and aerospace items

80. Defence electronics and aerospace is currently reserved for the public sector. The assumption that only the public sector can be trusted, on which this reservation is based is no longer valid. Export of such products to unfriendly countries can be controlled under the EXIM policy or the National security act. As the sole buyer of lethal weapons, government already has a domestic monopsony. Competition in the production of dual use defence, nuclear and aerospace items would benefit the nation in terms of better quality, reliability, speed of delivery, and cost reduction.

81. A new dimension has been added to this issue by the introduction of technology denial regimes, purportedly on defence, nuclear, missile and dual-use goods and technology. These constitute what be may be called ‘strategic technology,’ the flow of which is determined by geo-politics, as distinct from normal commercial technology which is available on world

markets. Our national R&D effort has to focus on development of 'strategic technology.' It is in the interest of national security that such strategic items be produced in India. Paradoxically, it is also in our national interest to open all such areas to 100% foreign investment (FDI, and even provide special incentives for transfer of this technology to India.

4 EXCHANGE CONTROL

a) Capital Account

82. Debates about capital account convertibility often seem to treat it as an indivisible monument that you can either afford to have or not. In reality it is a continuum with infinite degree of possibility. Our experience of the BOP crisis of 1990-91 is sufficient for handling the phasing and sequencing of capital account convertibility. Even before the BOP crises, the eighth plan working groups on BOP had emphasised the need for reducing the country's debt-equity ratio and the short-term debt. Subsequent reforms have also emphasised the importance of exchange rate flexibility based on underlying market fundamentals, and the importance of banking reform, capital market development and modern regulatory systems for the financial sector. All these are lessons that East and S. E. Asians, as well as observers across the world have re-learnt from the Asian crisis. We must therefore move confidently forward toward complete capital account convertibility, without taking undue risk, but with all deliberate speed. A possible target date for capital account convertibility defined as 99% (say) of USA or EU level, could be 2010, by which time our financial system and fiscal management must meet international standards.

83. Given sound macro-economic policies and a reasonably well-developed and regulated financial system, the main area of risk is short-term capital movement. Though short term is generally defined as one year, this should be viewed as an upper limit. The focus of restraint has to be on agents and instruments through which large amounts of funds could be moved legally over a short time period. In other words these are agents who have large amount of liquidity, leveraging capability or access to credit.

84. It follows from the above analysis that both long-term capital inflows and outflows can be quickly freed up. Purchase of derivatives and guarantees by residents from non-residents against known exposure, must be freed urgently as this has the additional benefit of reducing 'country risk.' All restrictions on hedging of risk by all those with foreign exchange exposure should be lifted. Foreign direct investment abroad by Indian companies and foreign portfolio investment by individuals can also be freed, starting with manufacturing and export or import related services. Indian individuals should be freed to carry portfolio investment abroad from their (declared) personal wealth or income. A start can be made by channelling this

investment through SEBI registered financial intermediaries, who could be required to report large investments to RBI. A system of registration could remain for the time being, with suitable communication to CBDT and other authorities to aid in detecting undeclared income & wealth. Similarly, investment in listed or unlisted Indian companies and in unincorporated firms can be allowed for nationals of developed countries that are a potential source of knowledge.

85. Now that Indian banks and companies have learnt from the experience of other countries, long term debt (over 3 years) can also be freed for all domestic banks and corporations, followed by medium term borrowing (1 to 3 years). This would be subject only to the condition (auditors certification) that they have the capability to assess the real risk adjusted cost of such borrowing and adequate systems for exchange risk assessment and management. An electronic non-deliverable forwards and futures market should be set up as a precursor to a free foreign exchange market. Strict prudential requirements could be imposed on leveraged purchase of foreign exchange in the future/forward market and on credit given for this purpose.

b) Dual Exchange Rate

86. To aid the transition to full capital account convertibility a dual exchange rate mechanism or a tax on capital flow could be used as a phase in device. Lifting of controls on capital flows can in principle be combined with a dual market for such flows, which is completely free with no RBI intervention to control volatility. Alternatively a tax could be imposed on all purchase of foreign exchange (spot or forward), with an exemption for import of goods & services into India. The money collected would be used to create a country risk insurance fund separate from the foreign exchange reserves. This fund would have a specific constitution, an independent management board and rules for use in a potential crisis. The tax can be complimented by the imposition of CRR on foreign deposits and debt with banks & financial institutions, which is greater than the CRR on domestic deposits.

5 FREE ZONE FOR EXPORT

87. As already declared export processing zones should be converted into Free Trade Zones(FTZ/SEZ), on par with the best in East and S. E. Asia. A free foreign investment regime would be applicable to the zone, with free inflow and outflow of all capital except short-term debt (less than one year). The only condition on debt would be that it is related to production activity within the zone, and is not used as a channel for flows into the domestic tariff area. Any remaining controls licenses and reservations (e.g. SSI) should not apply inside the zone. Labour laws inside the zone and their procedural applicability would be put on par with those of successful

exporting countries and regions. Private enterprise would be free to supply any and all types of infrastructure services within the zone without any price or investment control. Radio frequency spectrum would be auctioned only if there is excess demand, other wise it would be free.

6 CAPITAL & DEBT MARKET

88. 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 commercial & competitive insurance market.

a) Government Securities

89. 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.

b) Repo, Reverse repo

90. 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.

c) Short sale & Security lending

91. 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.

d) Venture Capital

92. There is a tendency in India to confuse start-up capital with venture capital. Start-up or initial risk capital is always provided either by the entrepreneur or his (her) family and friends. This is the essence of entrepreneurship, and also has the merit of eliminating harebrained schemes. Venture capital is designed to support new products & services and innovative approaches and

ideas, not new persons producing/supplying the same things in the same way that n other firms are already doing. Venture capital funding needs to be strongly supported, but this can only be done if it is not confused with the provision of risk capital or start-up capital. Venture Capital Funds can be key engines for growth in technologically intensive knowledge based industries & services.

93. The two most important reforms needed to promote venture capital are a Limited partnership act and rationalisation and simplification of tax incentives for venture funds. Limited partnership allows for 'pass through' which makes a VCF more attractive to investors. In essence Venture Capital Funds pass through their losses in the initial years of the fund to their investors, so that investors can set-off their share of losses against profits in later years. Provisions of the Indian Trust Act 1988 could be modified to accommodate limited partnership and pass through in line with the Venture capital trust act of the UK. The investment pattern required for getting tax benefits needs to be liberalised. For instance Venture Capital Funds should be allowed to invest in quasi-equity such as partially or fully convertible debentures and convertible preference shares of target companies. Venture capital could be allowed to invest in the modern service sector with export potential such as electronic media, Internet, publishing, health & education related services. SEBI code on Acquisitions and Take-overs may also have to be liberalised for Venture Capital Funds.

e) Mutual funds

94. World wide, mutual funds are the most important channel for retail investors to enter the equity market. By their very nature debt instruments are more risky than bank deposits, which are in turn more risky than equity. Inherent in this ordering is a similar ordering of returns, i.e. that higher risk instruments will also have higher returns. These risks and returns need to be properly balanced in an investment portfolio. For small retail investors, mutual funds should in principle be the best channel for investment in capital markets. Assured (higher than deposit) returns, independent of market performance, are contrary to the principle that higher returns go hand in hand with higher risk. They must therefore be phased out in the interest of healthy long-term development of the market. The rules, regulations and procedures for mutual funds must be modernised to promote competition, ensure prudential behaviour and protect the interests of small investors. These could include de-materialisation of mutual fund units, elimination of the 15-day lock-in period and a rise in CP investment limit to 15% (from 3%).

f) Commercial Paper

95. A long-term debt market must be anchored on a government securities yield curve and built on the foundation of a healthy market for short-medium term private debt. The development of the commercial paper market is part of this development. Restrictions on CP issue can be phased out. For instance minimum CP size can be reduced from Rs. 25 lakh to Rs. 5 lakh. As the systems and procedures in banks improve, the linkage of CP issue to working capital limit set by banks can be removed and back-up loan facility allowed.

7 BANKING & FINANCE

96. The baking system is still an overwhelming constituent of the financial system. Significant improvements in the efficiency of the financial system therefore require reform and improvement in the banking system. With an overwhelming proportion of banks owned by the government, an oligopolistic situation is inherent in the current system. This is so despite central government effort to promote professionalism on the boards of directors of public sector banks & financial institutions and to decentralise management to such boards and management committees. Unfortunately relations between unions and management are always viewed in the context of government and its employees, rather than in commercial terms, thus transferring bureaucratic rigidities into the banking system. The result is that public sector banks have some of the highest spreads among the emerging markets. A competitive banking system requires privatisation of banks, so that the full benefits of competition can accrue to the economy.

a) Regulatory reforms

97. Increased competition in the banking system requires elimination of controls and must be accompanied by strengthened regulations. Restrictions in the form of norms and guidelines imposed on public sector banks by RBI (acting as a proxy manager for the government in a different historical situation) must also be identified and removed. The RBI has recently set up a Regulation Review Authority that will receive representations and complaints against any rule, regulation, procedure or form coming under the purview of the RBI. With the co-operation of all affected and concerned parties, it is hoped that this authority will be able to identify and then make a bonfire of all controls (non-prudential regulations) relating to the banking sector and particularly relating to public sector banks. Other regulatory organisations, including government departments, which regulate various activities, should emulate this example.

98. We have to move in a time bound manner to global regulatory norms, standards and best practice. The issue of cross holding of equity between

banks and industrial companies must be addressed to ensure free & fair competition and open & equal access by all borrowers. The experience of Latin America and East & South East Asia demonstrates the need for safeguards against violation of commercial and prudential norms in lending to cronies, which characterised banks owned by industrial groups.

b) Micro-credit & Directed Lending

99. The transaction costs of banks have both a fixed per borrower and a variable with loan amount element. The implication of this elementary fact is that cost of lending is inversely related to the size of the loan. In addition, the experience of organised banks all over the world is that the risk of lending to smaller borrowers is on average greater than for large borrowers. The risk includes delays and default in payment of interest and principle. For lending to be commercially viable to these segments, the interest rates charged must be higher by 4% to 8%. That is why a host of informal institutions with smaller transaction costs have existed for decades or have come up recently to provide finance to smaller borrowers. Instead of forcing organised banks to lend below cost to a host of small borrowers, they should channel funds to non-bank financial companies, local area banks, co-operatives, non-governmental organisations and even money lenders for lending to unorganised (tiny/small) agriculture, trade, services and industry. This requires the creation of commercially viable methods & procedures and the complete abolition of interest controls on small loans. Factoring services are another way of reaching small industry and trade. The bottlenecks preventing these services from really taking off need to be identified and corrected.

100. Once these channels for inter-mediation of loans to tiny & small borrowers are set up, 'directed lending' should be abolished. Even before such channels are fully operational the laudable purpose of expanding the credit market to small borrowers would be better served by replacing the 40% directed credit requirement by a small 1%-2% subsidy on lending to these groups. This subsidy could be either in the form of RBI re-discounting of loans to these sectors or the creation of a collateral fund, which would partially compensate for defaults.

c) NPL Recovery

101. The most serious problem confronting public sector banks today is the overhang of non-performing loans (NPLs) from the past decades (seventies & eighties) of politically directed credit and 'Loan melas.' The establishment of Debt recovery tribunals (DRTs) is gradually beginning to change the moral, social, and legal environment facing defaulters. The DRT need to be strengthened & remaining bottlenecks to their effective functioning removed. New Debt Recovery Tribunals may also have to be set-up in areas where

they do not exist today. Registration with BIFR has, however, become the favourite method of defaulters to save themselves from being taken to DRT. This loophole will have to be plugged by changes in SICA. Foreclosure laws need to be strengthened not only for housing loans but also for other types of loans. A market for Non Performing Loans and Assets should be created, by developing a framework and encouraging the formation of appropriate institutions. New instruments may also have to be created. Laws and rules need to be change to allow securitization and sale of such loans and assets. Private or Joint venture Asset Reconstruction Companies should be encouraged. These could even have majority foreign equity participation by those with expertise in loan recovery and bank restructuring.

d) E-Commerce

102. If we are to be active and prominent participants in the information (IT) revolution we must quickly upgrade our payments system. The information technology society requires an urgent introduction of a nation-wide Electronic Funds Transfer (EFT) system that can transfer funds anywhere in the country within one day if not quicker. This must be followed by introduction of systems and procedures for electronic banking, wider use of debit cards and E-commerce. Appropriate legal, regulatory and system change will have to be made to insure security and confidentiality of information and funds.

IV. SECOND PHASE OF ECONOMIC REFORM

A. ROLE OF GOVERNMENT

103. 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.

104. 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.

1 FISCAL RESONSIBILITY ACT

105. 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 Grahm-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.

2 PUBLIC DEBT MANAGEMENT ACT

106. 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.

3 FREEDOM OF INFORMATION ACT

107. The Official Secrets Act virtually prohibits civil servants from giving any information to the public, by providing a stringent penalty for ‘unauthorised’ disclosure. Thus in principle any information can be hidden if desired by the head of the ministry. This is an anachronism in a modern democracy, whose people value the freedom of information, thought and action. The official secrets act should be replaced by a freedom of information act. The objective of such an act would be to open government to its people to the maximum extent possible, by carefully delimiting the areas (e.g. foreign affairs, defence plans, strategic R&D, personal files) to which secrecy needs to apply. It would be designed to give the public the right to information about decision & actions that affect their lives. This must include every item of expenditure (small or large) made in the name of the poor, the weaker sections, scheduled castes and tribes. It must also include the various

permits, licenses and permissions given to the public at the municipal and block or district level, so that they are available for public inspection. It should be compulsory under this law to disclose to researchers, data collected through surveys and other data collection exercises (after ensuring individual privacy & anonymity of data sources). This one simple act if enacted and enforced can transform the relationship between the government and the people from colonial over-lordship to one of true servant of the people. For this reason it may be strongly resisted by those in government.

4 RE-ENGINEERING GOVERNMENT

a) Reduce Size

108. 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.

109. 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.

b) Quality of Governance

110. 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.

111. 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.

112. 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.

5 DEPARTMENTAL ENTERPRISES

113. 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 unbundle 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.

a) Privatise non-core activities

114. 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. The same should be done with defence production units producing civil supplies like food, uniforms, shoes, shelter, construction material, and general electrical, mechanical & transport equipment.

b) Convert into Companies

115. 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).

c) Telecom

116. The key 'natural monopoly' segment in Telecom is the telephone wire linking customers to the local telephone exchange ('last mile'), and this should 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.

117. According to some observers Internet telephony costs only a third of conventional basic telephony. Though the quality of Internet telephony is currently quite inferior to conventional analogue telephones this is expected to change rapidly over the next few years. If costs continue to fall, Internet telephony would be ideal for providing non-subsidised service to rural areas and for fulfilling universal service obligations. Government should therefore put the new network companies on par with the private sector and stop all subsidies, so as to induce faster introduction of Internet telephony. Private communication service providers should simultaneously be freed to provide Internet telephony. Once this is done there would be rapid expansion of the Internet backbone across the country. The existing Telegraph network, whose reach into villages is much greater than of telephones, must be made available to those who want to provide Internet access and Internet telephony through this medium. 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.

d) Railways

118. 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.

119. 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.

120. 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.

e) Ports and Airports

121. 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.

f) AIR & Doordarshan

122. 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.

123. 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.

6 EXPENDITURE PRIORITIES

124. 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. Here we focus on goods and services that have a significant bearing on economic and social well being.

a) Rule of Law

125. 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,' is 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. There is a need for a basic revaluation of all other laws with a view to modernising and integrating them in the light of the transformation of the Indian and world economy.

126. 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 the 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.

b) Public order

127. 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.

128. 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 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.

129. 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.

c) Roads

130. 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.

131. 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.

d) Human Development

132. 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. The environmental degradation of life-giving natural resources such as water, air and forests, under the pressure of poverty and population, has shown that containing population growth is necessary for sustaining an improved quality of life for the entire population. The fiscal crunch and the

limited resources available to the States for human development and infrastructure, add to the difficulty by spreading expenditures more thinly the greater the population growth.

133. Population containment efforts must be re-invigorated, drawing from the success achieved most recently in Tamil Nadu. Social education of old and young must play an important role by bringing about a change in the attitude towards the girl child and the enhancement in the quality of life that fewer children make possible. This should be done in schools and through health professionals, Child and maternal caregivers, media and other channels. Some of these channels can also be used to increase public awareness about contraceptives, as was done very successfully by Prof. Machai in Thailand several decades ago. We must enable and encourage retailers to sell non-drug contraceptive products, and wholesalers to set up condom vending machines in airports, railway stations, government offices and other public places.

134. To signal the importance of population containment, political parties should agree to the reintroduction and passage of the Constitution (79^{th} amendment) Bill, 1992, to disqualify from Central and State legislatures, any person having a third or higher child after the passing of the bill (grace period of one year). Similar provisions could also be considered for eligibility for jobs in government and other public institutions. If the speed of demographic transition is accelerated through these and other measures like education of girls, we could attain the per capita income growth rates seen in E. Asia and Singapore.

135. Though all polices 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 (EGS) 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.

136. The enormous, but un-remarked, contribution of private schools in achieving high educational levels in Kerela must be more carefully studied and replicated. At the least a friendly, positive and transparent environment for private provision of schooling is essential.

137. Public health is another one of the basic and unglamorous functions that government must ensure. 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.

138. 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 of Delhi 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.

139. 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 competition 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, pre-treat sewage before dumping into water bodies.

e) Spill-over Effects

140. 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. 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 peer review.

141. 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. 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.[10]

f) Social Responsibility

142. 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 annual reports of starvation deaths in Kalhanidi 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.

143. 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.

144. The only other critical objective of social policy is to ensure that all able bodied but poor citizens who are willing to work at the prevailing market wage for unskilled work are provided a job at that wage. Faster economic growth and employment generation will in a decade or so eliminate underemployment and disguised unemployment. In the meanwhile we need a simple well-focused program, which is financially sustainable. Over the last few decades there has been a proliferation of poverty alleviation and employment generation schemes. Each has its own administrative infrastructure and works relatively independently. These schemes are commonly believed to deliver only a fraction of total expenditure as benefits

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[10] 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 facts or truth.

to the intended beneficiaries. There are also numerous schemes for building local infrastructure. An Employment Guarantee scheme (EGS) patterned on the Maharashtra one would be ideal if all these other schemes are eliminated and the funds allocated to a National EGS. By integrating infrastructure building, including watershed development and water harvesting, at the Pnachayat and block level, in the EGS its effectiveness could be greatly increased. The scheme must be counter cyclical in terms of district/region wise demand for unskilled labour, based on average off-season market wages (designated as the minimum wage for that district/regions EGS) and incorporate a transparency clause which requires supply of information on people hired, time spent and wages paid.

7 TAX INNOVATION

a) National VAT

145. 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 (NVAT 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.

b) Double Taxation

146. 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 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.

c) Global Income

147. 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.

d) Negative Income Tax

148. At some point in the next decade, we must 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.

B. MACROECONOMIC

1 MACRO-MANAGEMENT

149. The role of macro-economic monitoring and management will continue to increase as the economy is de-controlled and de-licensed. Macro-management has two basic objectives: To put the economy on a sustained and sustainable high growth path, and to moderate any cyclical fluctuations that may arise from domestic or external sources. This role is complementary to the expenditure priorities outlined earlier. If the macro-management of the economy is successful in raising and maintaining a reasonably stable and higher growth rate the middle and higher classes will immediately benefit from the spurt in growth. If the expenditure priorities outlined above are also followed sincerely, than the poor (about 50% of the population in terms of international poverty lines), all over the country would be adequately taken care of as they are gradually drawn into the market economy and underemployment declines.

2 INDEPENDENT MONETARY AUTHORITY

150. Over the next decade we should move to a position in which the RBI becomes a modern Central Bank with a focus on monetary and exchange market management and adequate autonomy for this role. This would entail RBI shedding the functions it has acquired over the years of increasing economic controls and government take-over of banks and financial institutions. RBI would have to disinvest from banks and financial institutions and exit from bank boards. It may also have to give up its current role of government debt manager. The issue of whether the financial supervision functions should be made independent or kept within the RBI would also have to be addressed.

3 STATISTICAL AUTHORITY

151. We need to draw up a modern and comprehensive statistics law, which would also authorise setting up of an independent statistical authority (SA). The law would provide legal authority for collecting all data needed for macro-economic management of the economy while at the same ensuring complete and undiluted confidentiality to individual providers of this information. The statistics department would be abolished and the staff transferred to this authority. The Statistical Authority would have the right to levy charges and fees for the data generated by it. The National Statistical Commission to be set up to look into the matter of statistics could also suggest the approach to be adopted in the statistics law and for setting up a statistical authority.

C. SOURCES OF GROWTH: FACTOR PRODUCTIVITY

1 FINANCIAL SYSTEM

152. 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.

153. 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.

154. 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

155. 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

156. 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

157. Though we have made great progress in introducing modern regulatory systems in banking and capital markets during the nineties, it is worth re-stating 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.

158. 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

159. 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.

160. 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.

161. 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

162. 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.

163. 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

164. Central and State governments use a number of saving instruments such as Government Provident Fund and 'Post office and Small saving instruments' 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 CAPITAL & DEBT MARKET

165. Some of the policy measures which need to be set on a clear and unambiguous reform path for creation of competitive advantage are:

a) Primary Issues

166. A framework for issue of equity and debt through electronic exchanges is under development. The rules and regulations for such issue should be promulgated and primary issues allowed to be made through an electronic market. Such a system will increase the efficiency of the primary market and protect the interests of retail buyers of new issues, as it allows price discovery process before issue, through pre-issue trading on the electronic exchange.

b) Derivatives

167. With the reduction in controls and increase in competition the sources of risk have also increased. Economic agents must have access to hedging instruments if they are to manage this risk in effective and efficient manner. It is absolutely essential that the Securities Contract Act be amended to allow derivatives and that financial derivatives be introduced expeditiously. Among these are Stock index futures and Interest rate futures. A screen-based market in foreign exchange also needs to be set up which allows trading in non-deliverable foreign exchange forwards and futures.

c) UTI

168. Because of historical reasons UTI is the dominant player in the mutual fund market. This position is accentuated by the fact that its major scheme, US64 does not come under the purview of SEBI. To promote competition, the UTI act would have to be changed to convert UTI into a normal Mutual Fund, which comes under the purview of SEBI. Consequential system reforms need not however await reform of the UTI act by parliament.

3 BANKING & FINANCE

169. With an overwhelming proportion of banks owned by the government relations between unions and management are always viewed in the context of government and its employees, rather than in commercial terms, thus transferring bureaucratic rigidities into the banking system. The result is that public sector banks have some of the highest spreads among the emerging markets. A competitive banking system requires privatisation of banks, so that the full benefits of competition can accrue to the economy. Banking Laws and Labour-management practices also need to be changed to give them the flexibility to compete.

a) Privatisation of Banks

170. The Narsimhan II committee has recommended that government equity in public sector banks should be reduced to 33%. This recommendation should be accepted immediately, and we should target a greater reduction to 26% subsequently. A start should be made by freeing all strong banks to reduce equity to this level through sale of fresh equity to the public for the purpose of strengthening capital adequacy norms and bringing them to up to international best practice. In the case of weak banks, privatisation should be through sale of government equity along with transfer of management control to a strategic investor. This will require reduction of government share to 49% or less. A start should be made by privatising the three worst public sector banks. Potential bidders for these banks would have to be pre-qualified by RBI, as they would need a banking license to run the acquired

bank. To get the best price and also to provide an international benchmark for the future, foreign banks should be allowed to participate in the bidding. This would also give a tremendous boost to over all FDI by reviving interest in India. In the case of both strong and weak banks further reductions in government share to 26% can be through sale of remaining holding to the public.

b) Banking Laws

171. Increased competition in the banking system requires elimination of controls and must be accompanied by strengthened regulations. Some of these controls are inherent in the RBI Act and the Banking Regulations Act, as they were framed in an earlier control era when modern regulatory practices were not well known or prevalent. All the necessary regulatory powers should be incorporated in the Banking Regulation Act, and the Bank Nationalisation & SBI acts abolished. RBI act should focus on monetary, exchange rate and other macroeconomic management issues, and be made more flexible by removing numerical specifications of SLR, CRR etc.

c) Management & Labour

172. If public sector banks are to meet the challenges of competition and become profitable and prudentially strong, the current extreme rigidities in recruitment, wage negotiation and employment will have to be removed. The straight jacket imposed by forcing all recruitment through the Banking recruitment services board (BRSB) will have to be removed by phasing out BRSB. Weak banks cannot afford to keep paying the same wages as strong ones without going bankrupt. Industry wide wage negotiations must be replaced by bank wide ones, to provide labour & management in weak banks with the right incentives for recovery. Greater flexibility has also to be imparted into labour policy if the over-manning in some banks, particularly the weak ones, and some areas is to be reduced and these banks made viable.

d) Development Finance Institutions

173. Barriers to Universal Banking, that is the provision of all types of banking services by one institution, must be removed urgently. The most artificial barriers are between institutions that traditionally specialised in (short-term) working capital and those that specialised in (long term) investment loans. Both types of institutions must be allowed to undertake all activities that can be reasonably classified as banking. Mergers and acquisitions between the two types of institutions should be freely allowed. Chinese walls between such 'universal banks' and financial institutions undertaking non-banking activities such as equity investment could however remain for the time being. This separation can be re-considered once the risk monitoring, analysis and management capabilities have come up to global

standards. Cross-holdings of Development finance institutions in competing institutions must be eliminated to promote transparency and competition. This will mean that Banks and Development Finance Institutions that have non-banking subsidiaries should not be represented on the boards of competing institutions.

4 MANAGEMENT & PROMOTERS

a) Restructuring

174. 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.

b) Sick Industrial Companies Act

175. 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.

c) Bankruptcy Law

176. 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.

177. 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.

d) Take-over Rules

178. 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.

e) Corporate Transparency

179. The foundation for good corporate governance is information and transparency. This requires simple, uniform, consistent and strict accounting standards. It is in the interest of honest promoters, competent management, shareholders and equity markets that we tighten corporate accounting standards and bring them up to global levels by 2005. This could be strengthened by making it compulsory to appoint an audit committee consisting of independent directors including a chartered accountant, excluding the chairman & managing director of the company, and chaired by one of the independent directors. Company law could also be modified to give the (non-promoter-manager) shareholders and debtors the right to sue the company auditors for overlooking shady accounting practices.

5 LABOUR

180. Labour along with finance and management is the third critical factor on which the efficiency, productivity and growth of Indian Industry will depend. Just as it is necessary to increase competitive pressure on industry

by removing barriers to entry and competition, it is equally important to provide industry with the means to compete. Labour market reforms are essential for equipping Indian industry to meet the challenges of competition and for generating jobs at a faster rate. The objective is to impart greater flexibility to the organised labour market so that both sincere management and hard working labour feel more confident about leaving one job and moving to another. Once such confidence can be imparted, the rate of creation of new jobs in the organised sector will be accelerated.

181. There are two aspects to this reform. A greater flexibility in labour laws and rules and a strengthened safety net.

a) Labour Laws

182. India is probably unique among developing countries in moving so rapidly at such an early stage in its development from one extreme of worker protection to the other. At one stage our organised labour market, consisting of only 8% of all workers, was probably the most rigid in the World. Rigidity means that wages do not respond to either unemployment or productivity. As a result the employment elasticity of manufacturing has gone down and fewer jobs are generated for the same growth of output. Though some correction has taken place recently, it is not enough to give confidence to Industry that employing a large number of people in a new facility is not like tying a millstone around ones neck in a championship race. The result is that many new industrial facilities are too capital intensive & designed to minimise use of labour and several exporters have preferred to set up new export facilities in competitor countries rather than acquire this permanent handicap. The time has come to move the pendulum closer to the 'golden mean' of Buddha, by imparting greater flexibility to the laws, rules and procedures.

183. There is a plethora of labour related laws, with 47 statutes at the central level alone. Case law also differs under different statutes. There are variations in definitions of child labour, workmen, employee, wages, factory and industry. The National Labour code (1994) recommended unification & integration of labour laws, harmonisation of definitions, reduction of 'inspector Raj' and acceptance of records in electronic form. There is a similar need to unify and integrate the State labour laws with respect to the central ones. Creation of a national market requires that there be a consistent and uniform set of laws in all states.

184. The Trade Union Act should be reformed to make it democratic. Recognition of a Trade Union must be based on the cherished principles of secret ballot and majority vote. The multiplicity of unions need to eliminated, by allowing only one democratically selected union to represent

all workers. Non-worker office bearers should be limited to a maximum of 1% of the number of union members.

185. One of the keys to an efficient and internationally competitive economy is specialisation, including specialisation in supply of quality services. The Contract Labour Regulation and Abolition Act was intended to regulate contract labour. Though section 10 gave government discretionary authority to abolish contract labour this came to be interpreted by courts to mean mandatory abolition. This has put a virtual halt to all moves to outsource services. A start must be made by removing non-core activities of industry from the purview of section 10. The act should eventually refocus itself on regulation of all contract labour by removing section 10 if necessary. We should target a situation in which outsourcing of all services by industry is permitted so as to encourage firms to specialise in, train labour for and improve productivity in each activity.

186. The manner in which the Industrial Development & Regulation Act has been interpreted and implemented by the States has made it difficult if not impossible to remove even the most corrupt, disruptive or lazy employees. Such employees can tie up their cases in layers of litigation for years. This is particularly harmful for Small Scale Industries where the owner manager has to manage every aspect of the firm. Even the argument of direct loss of job is invalid in this case as one employee would be replaced by another leaving employment unchanged even in the same unit. Among the reforms that can be carried out in ID&RA to impart greater flexibility are;

- Put a time limit of one year for filing claims so as to discourage frivolous claims.
- Exempt Small Scale Industries with up to 20 workers from the purview of the act.
- Allow firms to remove delinquent employees up to a maximum of 1% of total employees per annum (without any questions). They must, however, be replaced by an equal number of new employees, within 6 months (say).
- Give greater flexibility to units in backward areas and in export oriented units. For instance export units could be empowered to retrench employees without permission provided they make a social security payment of 30% of the last wage for a period of 6 months. The employee would be free to seek or obtain alternative employment during this period. He (she) would also have priority in re-hiring by the unit if exports pick up.

187. The scope and reach of the Industrial Disputes Act (IDA) was arbitrarily extended during the emergency. The applicability of chapter V of IDA should be restored to establishments with 300 or more employees, as was the case before the emergency. Chapter V-B regarding closure, layoffs and retrenchment should also be restored to its pre-emergency state by removing provisions made during emergency. This would be balanced by requiring

provision of compensation as per Ramanujam committee report. Chapter IX A, which was intended to promote voluntary consultation at a time when trade unions were in their infancy, increasingly came to be interpreted as virtually requiring mandatory approval from workers. If Indian industry is to upgrade technology to meet the challenge of the 21^{st} century, this provision must be deleted. Both management & labour are now mature enough to carry out such consultation on a voluntary basis, so as to ensure and enhance the profitability and competitive strength of the units.

b) Safety Net Improvement

188. The second critical aspect of labour market flexibility is the support system for employees who are out of work and searching for new employment and the systems for matching such employees with vacancies. Both these need considerable improvement. The national unemployment register must be modernised, computerised and put online through the Internet, with sufficient safeguards for confidential information. The system should also be able to generate and display an inventory of skills, from both the demand and supply side. Access to information should become as easy as reading a newspaper, for potential employers, employees, educational & training institutions and students. The target should be to develop the system into a national electronic labour market that even allows interviews to take place online. The National Renewal Fund should be strengthened to assist in re-training and relocation of employees. It could also assist in skill formation & up-gradation to increase the mobility of labour.

189. Provident and Pension fund system needs to be reformed on the line indicated above, to make into a fully funded retirement saving system, with a unified & comprehensive tax incentive based on the net saving principle, and complete portability of retirement saving. Once health insurance is opened to competition, it should also be integrated into the system in such a way that employees who move to another job continue to enjoy benefits during the search period and can carry any unused benefits to the new job.

190. Once untargeted subsidies and wasteful expenditures have been eliminated and the fiscal situation is firmly under control, an unemployment Insurance system for organised labour can also be considered.

c) Child labour

191. 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.

d) Unorganised Workers

192. A unified labour code would be useful for unorganised workers if it deals with work conditions such as age of entry, hours of work, health, safety & welfare at the work place (maternity benefits, compensation for injuries & health insurance). A system must be set up so that employers of unorganised workers can get a tax deduction for contribution to both a pension fund for employees and for work injury & health insurance. Enforcement of any law that controls hiring & firing or sets minimum wage above market rate would be unenforceable or worse. The priority should be on eliminating under-employment and disguised unemployment within the next decade or so.

6 REAL ESTATE & HOUSING

193. In many countries across the world the real estate sector has been a leading sector in promoting overall growth. This has been true of emerging markets such as those in E & S E Asia. A substantial part of China's FDI has been in this sector. The most visible sign that S E Asian countries were moving ahead of us in the eighties were the transformation of the skyline & roads of their capital cities. We have to remove the plethora of controls on our real estate and housing sector if we are to initiate a similar boom.

a) Rent Control

194. 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 loosing 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. 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.

b) Townships & Industrial Estates

195. The Urban infrastructure in cities & towns across the nation has deteriorated because of lack of interest & concern among those responsible

for running our municipalities. Till such time as the municipalities can be forced by their citizens to get their act together, the private sector can play an important role in setting higher standards of planning, organisation and efficiency. They can also provide a demonstration effect. For this to happen, the uncertainty & risk must be reduced, through a comprehensive law on private townships and industrial estates. This law must specify both the rights and obligations of developers with respect to urban services and utilities. These include inter-connection with existing systems (e.g. sewers, water mains, telecom, electricity lines), the processing of liquid & solid waste, treatment & disposal of industrial pollutants and maintenance of public goods & areas.

c) Land Monopoly

196. Many cities (e.g. Delhi) have created development agencies (Delhi Development Authorities) and handed over control over all urban land within the municipal jurisdiction to them. The belief that they would act in the interests of the public is mistaken because all such agencies tend to act like the monopoly that they are. It is in the interests of the monopolist to restrict the development and sale of new land & keep prices high, so as to maximise its own returns. Also like all monopolies X-inefficiency flourishes and monopoly rents decline over time, or are siphoned off into personal accounts. Introduction of a competitive construction boom requires abolishing the monopoly over urban land by such agencies, by completely separating control of land from its development. A time bound programme for auctioning of all vacant government land should be drawn up and implemented. Municipal development agencies can bid along with others for the land they want to develop.

d) Rural-Urban conversion

197. The presence of so-called villages in the middle of the capital city of Delhi is an anachronism & a monument to bad policy. It is difficult to find a worse policy for protecting farmers than preserving villages in the middle of a metropolitan city. Conversion of rural land at market prices should be completely de-controlled and left to the market. The assumption that farmers or owners of rural land on the outskirts of a city are ignorant & stupid enough to sell their land for a song is offensive. The problem has risen solely because the government gave the right to its development agencies to expropriate this land at below market prices. Once this power is taken away from development agencies and sellers are fully aware of this change (government must provide the information) they can look after their own interests.

e) Municipal laws

198. Our urban & municipal rules and regulations date back half a century if not more. There is a need to thoroughly review and modernise them in the light of the latest developments in urban infrastructure, transport, pollution control and zoning. A committee of eminent persons form concerned fields should be set up to draw up a model municipal law. Such a law must make provision for private investment in and supply of all public utilities and services. It must ensure that the municipal authority focuses its attention on data gathering, analysis, planning, organisation and monitoring. The proof that these aspects are sadly neglected is seen everyday in the city as roads are dug up within weeks of fresh asphalt being laid. The new law should also incorporate provisions for residents' right to information about the activities of the municipality. The new law could be introduced immediately in Delhi to gain experience and iron out its kinks.

f) Construction Quality

199. 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.

7 NATURAL RESOURCES

200. 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.

a) Minerals & Oil

201. 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.

202. 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.

203. 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.

b) Electro-magnetic spectrum

204. 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.

205. 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.

c) Air and Water

206. 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.

d) Rural Land

207. Ownership records, to the extent that they exist, are based on the age-old Patwari system. As a result land disputes abound and give rise to terrible violence in rural areas. The basic foundation of a land market is a modern system of registration, which makes proof of ownership as well as its transfer easy. Proof of ownership facilitates the flow of credit. Computerisation of all land records is therefore of vital importance to the rural economy.

208. Traditional land reform has been dominated by imposition of land ceiling and tenancy reforms favouring tenants. In areas characterised by feudal land ownership and production relations, these reforms have had a beneficial impact when sincerely implemented. They have, however, also had the effect of killing the land market in non-feudal areas and thus contributed to the fragmentation of land holdings. There are an estimated 105 million holdings, an average size of less than 1.6 hectare and about 80% being less than 2 hectare. A selective change in the land laws can free up the land market and facilitate consolidation of holdings. The land lease market can be freed from controls within the overall existing land ceiling limits and small & medium farmers allowed buying or selling land within these

ceilings. As a measure of abundant caution, this change need not apply to specified areas, which may be classed as feudal or semi-feudal.

209. Another dimension along which the rural land market can be freed is with respect to degraded land and wasteland, including desert, saline land & ravines. There are 24 million hectares of land characterised as culturable wasteland and permanent falloffs. We should promote commercial leasing of Degraded and wasteland. After detailed delimitation, such land can be can be taken out of the purview of land ceiling and tenancy laws, and agro-companies allowed to buy, mortgage, develop, cultivate and sell this land. This will result in the introduction of modern technology, organisation, management and marketing practices into the rural areas. All over the world such entry has had large spillover effects through the demonstration effect as well as diffusion of best practices.

210. Green revolution, capitalist farming areas no longer require the kind of safeguards envisaged 50 years ago under different conditions. On the contrary these areas require a well functioning land market if they are to move to the next level of productivity, as the gains from the 1970s green revolution technology have been exhausted. It is therefore necessary to free up leasing of land in these areas and promote efficient agglomeration and commercial farming. Tenancy laws can also be relaxed in areas such as Western UP and coastal Andhra Pradesh. To protect the rights of farmer owners, recovery of land by owner could be made non-justiciable.

e) Forests

211. At present all forests vests with the government and is looked after by the limited staff of the forest department. The proper potential of this renewable resource may not be fully utilised, while illegal felling damages it. Joint venture between reputable private companies and local residents should be explored, for protection, regeneration, use and development of forest areas under strict conservation rules.

D. PRODUCTION SECTORS

1 PUBLIC SECTOR REFORMS

212. 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 cannot 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.

a) Privatisation

213. 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 Public Sector Units, 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.

214. Our experience of dis-investment since 1992 shows that there are considerable delays in the implementation of government decisions regarding individual Public Sector Units. 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. Government would frame the charter (memorandum, rules etc.) of the Privatisation Trust.

215. 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.

216. 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.

b) Closure of Loss-making units

217. 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.

c) VRS strengthening

218. 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.

d) Professional Autonomous Boards

219. 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.

2 COMPETITION POLICY

220. Increased competition is the natural outcome of the policy of de-control and de-licensing. With an increase in mergers, acquisitions and take-overs there is, however, a possibility of that some development will damage competition. A modern competition policy therefore needs to be devised based on the last two decades of developments in Industrial economics, such as ‘Contestablity’, ‘Sunk Costs,’ ‘Entry barriers’ and ‘network effects’. The budget promised the setting up of a committee to look into this matter and come with such a policy.

3 AGRICULTURE & ALLIED

221. About 70% of the population still live in the rural areas, as do an overwhelming majority of the poor. Even though agriculture now constitutes less than a third of GDP and non-agricultural occupations have grown in importance, it is still the motor of rural growth. Productivity

improvement in agriculture requires not only an improvement in the quality of R&D and extension services, but a modernisation of the entire food chain from the farm to consumers. An improvement of the input chain from industry to farmers is also needed.

222. A better flow of information & knowledge into rural areas and its assimilation through universal literacy & primary education could raise productivity dramatically. This requires bold & radical thinking. For instance, opening of existing telegraph wires to anyone who wants to connect villages to the internet, could give the farmers a means of finding out whether the pesticide & dosage recommended by the local supplier is appropriate for his crop. Similarly, de-licensing Internet telephony could make it cheap & easy for a farmer in a remote village to call the retailer in Delhi to find out the price of onions, or to call Karachi or Chicago for the price of cotton.

a) Land Reform

223. The liberalisation of the rural land market for capitalist farming areas, degraded & waste lands and for small farmers within the land ceiling must go hand in hand with strengthening enforcement of traditional land reform in semi-feudal and Tribal areas. In such areas, we must implement traditional land ceilings, continue the ban on leasing of land and strengthen the tenancy rights of sharecroppers. These measures should be combined with provision of services such as micro-credit and transfer of technology. To do so effectively may require that planning and implementation be done one district at a time all are covered.

224. Commons and community land is currently owned at the state level. To make more effective use of such land, ownership rights could be transferred to Panchayats subject to rules on non-discriminatory access to use of land and its preservation. Alternatively, States could give the land on long lease of 20 years, renewable for another 20 years for specified sets of uses such as agro-forestry and fishery.

b) Food Act & Food Regulatory Agency

225. The authority and responsibility of protecting the public from contaminated and adulterated food is currently divided among a number of agencies. The Prevention of Food Adulteration Act & other laws, rules and procedures are outdated. There are interminable delays in approval of new products, even those that have been in use all over the world for decades. The CCFS, which approves manufacture of non-standard food products, flavours & colours, has met only 42 times in 44 years.

226. A single unified Food Act should be framed covering both domestic production and imports. The Food act must harmonise Indian food standards

with the quality norms of GMP and HACCP. Under this act there should be a single autonomous & independent food regulatory authority (FRA). Both the act and regulatory agency must adopt modern concepts of regulation. In particular the focus of law should be on fair and accurate labelling of materials used, size (weight, volume), and price (unit price) and identification & banning of substances that are hazardous to health. The old approach of requiring prior approval of every recipe and weight measure should be deleted. The focus of rules & procedures should be on detection of fraud in terms of mixing of non-edible material. The testing and fraud detection systems must be strengthened. An advisory panel of medical and health professionals could be set up by the FRA to advise it on technical matters.

227. The act should provide for information exchange and co-operation with similar agencies in other countries, so that testing & appraisal results from them could be used to take decisions about hazardous substances. New products should get automatic approval. If some previously unapproved material is used three could be a three-month (say) waiting period after which automatic approval takes effect. During this time the authority can call for objections or do any investigations that it desires. Alternatively automatic approval could be given for use of any material, which is approved in two out of three developed areas (USA, EU, Japan). Directions could be given for subsequent testing & appraisal under Indian conditions, if & when thought necessary by the advisory panel of FRA.

c) Essential Commodities Act

216. Though introduced with the best of intentions, the Essential Commodities Act (ECA) has become a barrier to development of agriculture and allied sectors. Whenever the price of a commodity has risen, the authorities have thought it fit to subject it the full force of the ESA to demonstrate that they are taking decisive action. The number of commodities under ESA has grown steadily as there is no such incentive to remove a commodity when the price increase has subsided. In a competitive economy the best insurance against unreasonable price increases is a seamlessly integrated national market within which information about production & prices moves instantaneously, and goods follow as smoothly and quickly. This requires efficient telecommunication, storage, transport and trading systems.

217. The stock and movement restrictions under ECA ensure that such a system cannot develop, and that competition is killed instead of encouraged. The Essential commodities Act has no place in a modern economy and should be repealed. A start can be made by modifying it to allow and encourage private sector to set up modern systems of procurement (grain mandis),

storage (silos), processing and transport. Private involvement in the new competition policy would also deal with anti-competitive practices & structures in this industry, and the ESA should be repealed by the time it is introduced.

d) Forwards, Futures and Options

218. Derivatives markets are as much about information as hedging and risk taking. Savvy traders and large industrialist with their host of employees always have more information than the farmer or tiny industrialist. Derivative markets are a small step in correcting this imbalance in information. In well functioning screen based derivatives market new information about production, stocks and demand available to any of the savvy economic agents, is instantaneously reflected in the price of contracts. Even the small farmer thus gets this information indirectly. The farmer can then have an idea of the likely future price of items he may be planning to sow and plan sowing accordingly. He could also hedge some of his risk by forward or future sale.

219. There is an urgent need to introduce forward, futures & options in all commodities, particularly agricultural crops as they are subject to the hazards of weather & pests. The ideal system would be a single Regulatory Authority for all commodity derivatives and a single unified electronic exchange with trading terminals all over the country. This derivative exchange could be linked to a similarly unified screen based commodity exchange under a single regulatory authority. The regulatory authority could have subsidiary regulatory bodies and regional commodity exchanges so as to incorporate the existing commodity exchanges. As derivatives are essentially financial instruments consideration could be given to making SEBI the regulatory authority for all derivatives and allowing NSE to trade in commodity derivatives.

e) Multi-state co-operative act

228. The great promise of co-operatives has not been fulfilled, either because of heavy politicisation or excessive bureaucratic interference. Co-operatives have often become a channel for rent seeking. They could still play a useful role if they go back to first principles and become genuine co-operative self-help groups and eschew the temptation to milk the government for favours. The multi-state co-operative act must be reformed to ensure professional management and elimination of government interference. An independent regulatory authority for co-operatives could be set up to ensure that they follow these principles.

f) Decentralisation

220. As a result of our colonial heritage, administrative structures are very hierarchical and much less de-centralised than appropriate in a grass roots democracy. Efforts must be made to de-centralise as many local government activities to the Panchayats as possible, without minimising administrative difficulties or ignoring caste conflicts. It appears feasible to decentralise local area development (e.g. watershed development, maintenance of public assets) to this level. A mechanism for joint control over functionaries responsible for field level activity in social and developmental sectors should be designed and tried. For instance part of the wages of these employees would be based on coupons allocated to panchayats. The coupons would have to be earned by employees from panchayats by providing satisfactory service. Devolution of funds must be conditioned on major decisions being taken in quarterly open Sabha. A system for training Panchayat heads should be set up.

g) Self Help Groups

221. Empowerment of the people requires the promotion of self-help groups and non-governmental organisation in social development and reduction of transaction costs. Micro-credit should be provided on group loan principles, through self-help groups. Water users associations should be promoted and encouraged to co-manage the system below the distributory, with a financially autonomous irrigation agency set up for this purpose.

h) Forests

222. Non-timber forest produce should be denationalised to promote its optimal growth and usage. Private trade and the local inhabitants could then carry out this activity on a more organised and open basis, to the mutual benefit of both. This would help distinguish it from illegal felling of timber and thus allow better monitoring of the latter. Great restraint & care must be taken in leasing degraded forestland to contractors. It would be preferable to promote protective recuperation by reducing biotic pressure, through involvement of local inhabitants.

4 EDUCATION

223. 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) Policy Framework

224. We need to develop a framework for easy entry of co-operative and private sector into the field of education, training and skill development. Such a structure must lay down a transparent set of rules and regulations for fee setting & adjustment, transparent accounting & audit, provision of minimum facilities etc., with no scope for subsequent arbitrary action. The basic elements of this framework would be market pricing of services, a scholarship fund created through below-market-price provision of land and comprehensive system of merit-cum-means scholarships. The framework must provide for an independent and autonomous Educational Regulatory Authority (ERA).

b) Public Regulatory Body

225. Once these rules and regulations have been formulated, they must be overseen by the ERA, free from motivated government interference. Public testing and funding organisations must be modernised to meet the needs of the next century. Their role must change and from executor to planner and propagator of best practices. Curriculum formulation and revision can be de-centralised to self-regulatory organisations at each level of education (e.g. Primary, Secondary, Tertiary, Technical, and Specialised). Much greater autonomy and freedom should be given at higher education levels, along with greater responsibility for generating revenues. Government should focus on monitoring performance and planning & co-ordinating overall educational effort.

c) Education Loan System

226. A national educational loan system can be set-up so that less well-off individuals who are not bright enough to obtain means cum merit scholarships can get loans for continuing their education. The governments contribution would be to share default risk to the extent needed to make it commercially viable for make such loans voluntarily.

d) Tax Holiday

227. The organised sector can be encouraged to enter the education sector by giving a tax holiday. This could apply to companies engaged in the business of education, training, skill development and information dissemination (extension).

e) Independent Rating Agency

228. The greatest difficulty facing parents to judge the quality of the education provided by different schools and colleges. To this will be added an additional difficulty of variation in fees, once such fees is de-controlled. To ensure that parents have adequate information for making their own decisions, an independent rating agency is needed. The rating agency would provide certification and rank private (and public) educational institutions by quality. Eminent retired educationists and venture capitalists could set it up with a one-time grant from the government.

f) Modern Testing Agency

229. The situation has come to such a pass that one cannot often trust the grades given by the official educational boards. Gross errors are sometimes made in grading exams, which are critical to the future of an individual. Sometimes recourse to re-grading or examination of the papers is blatantly refused. The country cannot afford further deterioration. The solution would be to set up a modern education testing service as a joint private-public venture, which would be run on highest standards of management, governance and social responsibility. Its board would consist of eminent and respected professionals from various fields including education.

5 INFRASTRUCTURE

230. The poor quality and relatively high cost of basic infrastructure services is the greatest source of competitive disadvantage to Indian agriculture, industry and services. It is also a major source of aggravation to the hapless consumer, who regularly faces the arrogance and arbitrariness of the employees & management of public monopolies. The nominal price is not a major issue save in exceptionally distorted cases, like one in power where the price is an exorbitant Rs 14 (33 cents) a unit (Kwh), the highest in the world. The effective cost of infrastructure services is far greater than the nominal price charged because of poor quality. For instance interminable power cuts result in purchase of back-up supply and erratic & low voltage damages equipment & machinery. This is matched by annual/ monthly disruption and weekly/daily delays at airports, by world beating (high) ship turnaround times at ports, by potholed highways, and inadequate signalling & safety equipment on railways. This disastrous situation is the result of five decades of absolute public monopoly and continuous interference in pricing by populist politicians.

a) Regulator

231. All infrastructure sectors, which have ‘natural monopoly’ segments, require a regulator. The most common ‘natural monopolies’ are networks

such as roads, canals, pipelines, railway tracks, and electricity and telephone lines. Natural harbours and dam sites can also be 'natural monopolies'. The regulatory law must provide for autonomy and independence of the regulatory authority, with full authority over pricing of 'natural monopoly' elements and over the conditions & quality of supply. This includes pricing of services in both the retail and wholesale segments. The regulator should however refrain from setting prices in segments where there is sufficient competition.

229. Regulation of the telegraph network should be under the purview of the Telecom regulatory authority. As the fixed (rail) line network of the railway constitutes a natural monopoly, an independent regulatory regime would have to be set up expeditiously. The Central government could also take the initiative in drawing up models for canal and urban utility regulatory authorities and urge the states to adopt these.

232. Government has the right to make policy and to undertake sovereign functions like leasing of natural resources. Nevertheless government should delegate these functions to the regulator to the maximum extent possible. Sovereign functions cannot, however, be defined to include price setting, as this is a fundamental negation of the concept of an independent regulation.

b) Network Access

233. The regulator must ensure interconnection to the 'natural monopoly' network or other such segment. This access must potentially be on the same terms and conditions as those available to the Owner Company. In particular it must be non-discriminatory vis-à-vis the historical monopolist.

c) Network Companies

234. Pricing of the 'natural monopoly' networks and ensuring fair access to this network by new competitors is the most difficult job for the regulator. This job is greatly facilitated if the natural monopoly network or segment is separated from other segments and the service provision functions. The two can be made into separate companies, with the former (network company) made a subsidiary of the latter (main company).

d) Investment De-licensing

235. Complete investment de-licensing is necessary to ensure that the public users get the full benefits of competition. Global experience is that the monopoly provider, who has the incentive & the means, works to

undermine competition. The regulator with the support of the users must actively thwart the monopolist in the interests of the public.

e) Prices, Fees & Taxation

234. License fees are a disguised form of taxation and should be replaced by an explicit tax. These can then be set in the context of the overall tax system so as to minimise distortion and optimise revenue collection. As already discussed (under natural resource section), resource rents when they exist must be collected separately. The regulator may also charge nominal fees to generate funds for its maintenance and functioning. These should be viewed as charges paid for the provision of regulatory service. Prices must reflect the full cost of production if investment, growth and quality are to be maintained. This must be supplemented by moderate taxes as in the case of other goods and services. The levy of license fees either in addition to this or in lieu of full cost pricing distorts the system.

f) Operational

235. There is an urgent need to set up power regulatory authorities at the state level and to expedite private entry into power distribution. Power theft is a serious problem, which results in financial bankruptcy and excessively high charges on honest users. Distribution metering must be introduced at the sub-station and lower level to identify the degree of theft and to fix responsibility. This will also make it possible to sub-lease collection. Dock labour reform is an essential for reducing the world record beating ship turnaround times in our ports.

6 OTHER SERVICES

a) Productive employment

236. One of the features of Indian poverty is under-employment or disguised employment in which people engage in informal work to survive. By the same token one of the features of economic development will be a move of this labour to more productive organised sector jobs. Our approach to the informal, tiny and small service sector is, however, a negation of these principles of development. For instance, we encourage small transport operators (killer buses!) instead of encouraging large organised bus companies who can be held accountable. Small-scale bus operators substitute low productivity self-employment for higher productivity organised wage employment. Elimination of poverty in the next decade requires us to look a little into the future. The service sector must be opened up to the organised sector, so that modern organisation and management techniques can be introduced in this sector.

b) Quality of Services

237. Improvement in the quality of services, is also necessary for improving the quality of production. High performance products require a complement of high quality services. Service quality can only improve if better-educated and trained people are available. This generally happens when the organised sector is involved, and acts as a vehicle for the spread of new technology, organisation and management into the service sector. The current system is characterised by a strong bias against the entry of the corporate sector and towards the small-unorganised sector & towards public provision. This bias should be removed, and the corporate or organised sector provided a level playing field for the supply of services.

7 EXPORT PRODUCTION

238. Exports are essential not only for long term sustainability of the current account and the Balance of payments, but also for sustaining high growth rates. Exports played a critical role in the high growth rates seen in Korea, China and other countries in Asia. These countries were successful because they subordinated other objectives to the combined objective of high export & economic growth. These objectives permeated the entire bureaucracy. In our case the indifference of many parts of government is apparent from the frequent and repeated complaints of exporters. A fundamental change in mind set is needed. Labour and SSI policy must be subordinated to export objectives.

a) Free Ports

239. The conversion of Export Processing Zones into Free Trade Zones must be a genuine one, which converts them into real free ports. Customs must treat them as virtual foreign enclaves where free import export is permitted without any duty. India despite being a low income, labour surplus country has a pathetic record in the export of labour intensive products. This has deprived many poor relatively unskilled people of jobs. The two main reasons are the highly inflexible labour laws, rules and procedures, and SSI reservation. We must introduce a highly flexible labour regime in the Export Promotion Zones and de-reserve all industries within the zones.

b) Service Export Zone

240. Though ‘brain drain’ is better than “brain down the drain’ it would be even better if the brains could be re-cycled back to the country after gaining global experience. The only way in which can be done is by creating a Service Export Zone which is a replica of the living and working conditions available to these brains in the developed countries. Such zones could be a tremendous source of comparative advantage in the

modern service sector, including professional services. Service exports are the new frontier for developed countries, and the creation of service export zones with conditions matching theirs could put us on the frontier. This would, however, require the creation of a free market area with complete de-control & de-licensing and 100% freedom to private (including foreign) investment, including that in infrastructure and social sectors.

E. INSTITUTIONAL

1 ADMINISTRATION

a) Performance Measurement

241. Computerised management information systems should be set up for all government departments and agencies that provide an administrative service (e.g. courts, police, taxation, and municipal regulation). These would be the basis for monitoring individual cases and employees, doing statistical analysis by user and employee and providing management information. This would help in identifying and rectifying delays and bottlenecks in the administrative system.

b) Incentive structures

242. The secrecy of the ACR makes it irrelevant as a motivating device. A move from ACR to Annual Performance Review may be useful in motivating and rewarding employees. Retirement rules should also be changed to make it easier for those who get stuck at any particular level in the hierarchy to leave without losing any pension benefits.

c) Internal labour market

243. The departmental structures within the government are very rigid. Mobility could be improved by creating an internal labour market within the government. This would create a more open procedure for comparing the supply and demand for different posts, and for fitting the two better. There are currently about 41 different administrative & technical services (cadres) at the centre and 13 at the State level. It is therefore, necessary to breakdown the barriers created by multiplicity of separate cadres & services.

d) Planning & monitoring

244. The ideology of planning has contrasted with the pathetic lack of planning and co-ordination at the ground level. Roads are dug up within

weeks of fresh asphalt being laid. Drinking water is drawn from the river downstream from where untreated sewage is dumped. The emphasis at the ground level must be changed from service provision and control to planning, co-ordination, monitoring and rewarding/ penalising. Instead of national plans that are ignored by many states after the funds have been sanctioned, we desperately need good planning at the local (below the state) level.

e) Specialisation and Expertise

245. Management of the open market economy requires much greater expertise and skills than a controlled one. A greater degree of specialisation will be required in administering such an economy.

f) Education and Training

246. Older generalist officers would also have to acquire new skills. A system of training and re-training would need to be set up with greater emphasis on modern Human Resource Development (HRD).

2 REGULATORY AUTHORITIES

247. Set up strong, independent regulatory authorities dealing with prices, quality & conditions of supply, and access or interconnection by competitors to the natural monopoly networks. Prudential/ technical registration and licensing should be completely under the purview of such authorities. They should be made financially independent by allowing them to charge regulatory fees for running the regulatory system.

248. Existing regulatory authorities should be brought to this level of autonomy by changing the law. Training should also be provided to staff to bring them up to global standards. Technical assistance and co-operation should be facilitated.

3 ECONOMIC LAWS

249. A committee of consisting of government and outside experts has identified 50% of economic laws as redundant. A start should be made, by abolishing these redundant laws. A major effort must be made to modernise, integrate and simplify the rest of the laws. To force a review, a sunset law should be passed stating that all laws enacted before independence would expire in 3 years, those enacted between 1947 & 1960 in 5 years and those between 1960 & 1980 in 8 years. A sunset clause should be included in all future laws so that they would expire after a given time period unless they are reviewed and renewed.

4 LEGAL SYSTEM

230. The legal and judicial system has been unable to keep pace with the needs of a growing population and the increasing complexities of the commercial sector. The net result has been a surfeit of litigation and a build up of a huge number of pending cases. As per latest available estimates, pending cases number 28 million, and are growing at the rate of 8 per cent a year, implying an additional annual increase of more than 2 million pending cases a year. Among the reasons for the increase in arrears are inadequacy in the number of judges, delay in filling up vacancies and faulty appointment procedures and appointment of incompetent judges. India has one of the lowest numbers of judges per person. Vacancies are not only high but the shortfall in appointment has been rising. These vacancies must be filled urgently. Court timings must also be increased and enforced strictly A long-term solution to this problem requires a fundamental change in the method for appointing judges. An approach worth considering is an independent judicial commission, which will appoint judges, monitor their performance and ensure their integrity.

231. The government itself is responsible for a substantial part of the pending cases, as these suffer the maximum amount of delay. A National Law School (1993) study estimated that the government was plaintiff, defendant, appellant or respondent to appeals in 60 per cent of all the suits filed. Most government cases were in the five areas of taxation, credit, rent control, urban land ceiling and labour relations. In these cases, either the government counsel does not appear or the summoned official is absent. Government advocates are known for asking for long adjournments on grounds of "seeking instructions" from the minister or the department. Very often, court orders are blatantly flouted and nothing happens till the court finds the time to pull up the concerned official. The government also makes unnecessary appeals against decisions not in its favour. Repeal of the urban land ceiling act and the rent control act, reform of labour legislation, rationalisation & simplification of tax laws and computerisation of land records could considerably improve the situation.

232. The Indian Civil Procedure Code first enacted in 1859 and after many amendments, finalised in 1908, provides innumerable opportunities to lawyers to delay proceedings. Lawyers can file applications for interrogatories, appointment of a Commissioner for local inspection, a temporary injunction and arrest or attachment of movable assets before judgement. Each application needs to be heard and disposed of (may take up to a year), before things can proceed any further. The first appeal can take as much as 3 years and the second up to 7 or 8 years if admitted to the High Court. As applications for interim relief, take unnecessary time lawyers have started asking for it as a delaying tactic. Lawyers getting paid per

appearance have an incentive to prolong the case through long-winded arguments. When the Supreme Court initiated steps to curb the time taken for oral arguments, lawyers immediately went on strike.

233. The practice of getting innumerable adjournments is a major problem. Frequent & lengthy adjournments imply that judges deal with cases in a piecemeal fashion, and often over several years. Judgements cannot be delivered expeditiously since time is needed to put the entire case together. As a result Judges also become more willing to grant further adjournments, to avoid having to go back to the history of the case, hoping that the next hearing will come up in front of some other bench. Order 17 Rules 1 and 2 of the Code of Civil Procedure (1908) provides for unnecessary adjournments by requiring that the hearing of a suit once begun shall continue daily till all the witnesses have been heard, *unless the court finds the adjournment beyond the next working day necessary.* Something that was meant to be an exception, has become the rule!

234. Procedural bottlenecks like serving summons, adjournments and verbal arguments should be streamlined. The draft of a new Civil Procedure Code (1996) attempted to do this. Clauses on perjury should also be invoked, they have never been invoked since 1947. Courts must be computerised so that cases can be classified under different heads, such as labour, service, rent control, land, and assigned to judges dealing in similar, or related, areas. This system of grouping will expedite the disposal of cases as judges hearing disputes in similar areas will enhance their expertise in these areas. This has been successfully implemented in the Supreme Court and must be urgently extended to the High courts and the lower courts and tribunals.

235. Along with computerisation, other technical aids like photocopying machines should be introduced, allowing parties to get copies of judgements on the same day that they are passed. Microfilming should be used to preserve records to save storage space.

236. The functioning of sectional tribunals and quasi-judicial authorities needs thorough review. There is a need for rationalisation or elimination of those tribunals, which have become even more dilatory than the normal courts (e.g. rent control tribunals). Strengthen alternative dispute resolution mechanisms through modification of acts like CPC, Limitation act and Indian Evidence act. Consider 'London approach' to financial & credit dispute settlement. Unify subordinate legislation on a sectoral basis.

F. STATE & LOCAL

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

1 STATUATORY REGULATORY AUTHORITIES

238. The need for autonomous, independent and powerful regulatory authorities (SRAs) in the infrastructure sectors was spelt out in section IV A5 & D5 . At the State level SRAs are needed for the following sectors:

a) Electricity

233. The breaking up the State electricity boards into independent production, transmission and distribution companies must be accompanied by the setting up of a regulatory authority.

b) Canals

234. State Irrigation & canal regulatory authorities must be set up to regulate the canal networks including its distribution channels as well as underground water resources. Once the framework is in place co-operative water user associations can manage and maintain these distribution channels and canals.

c) State road transport

235. Road transport is vital for the development of the state from the remote rural areas to the biggest urban areas. Inter state Road transport is a state monopoly in most states and most State Road Transport organisations are loss making. Most of those making nominal profits would still be in the red if the indirect costs were accounted for. The state monopoly of road transport increases the cost of transport, reduces its quality & variety and distracts the government from its true responsibility for making roads.

236. Road transport should be completely de-licensed, with a modest registration fee for regulatory purposes. Revenues should be collected through a service tax and not license fees. A regulatory authority can be set up to manage the transition to a free and competitive system.

d) Municipal services

237. A municipal services regulatory authority should be set up with authority over all municipal services on which user charges can be imposed. Examples are water supply, sewage, drainage, public toilets, waste collection & disposal and pollutants & hazardous wastes.

e) Education

238. Regulation of education should be modernised as elaborated in section IV D 4.

2 FISCAL REFORMS

239. 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 sate of many States finances. Among the fiscal reforms which need to be initiated by the Sates are;

a) User Charges

240. 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.

b) Expenditure Priorities

241. 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.

c) Privatisation

242. State transport corporations and Public sector units, many of whom 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.

d) Tax Reform

243. Harmonise tax laws across states starting with floor rates and 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.

e) Legislative Transfer

244. 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.

3 Re-ENGINEERING GOVT

245. This can be done along the lines indicated in section IV A 4 (above).

4 FREEDOM OF INFORMATION

246. Rajesthan was the pioneer in introducing a freedom of information act. Other states could improve upon this achievement.

5 De-CONTROL & De-LICENSE

a) Agriculture and Agro-processing

247. De licensing and de-control of agriculture its transport, storage and processing as well as of allied & related industries is most important for the poorest states. This must be accompanied by greater attention to basic rural infrastructure like roads, water & drainage and agricultural extension.

b) Education

248. There is oppressive control and traditional price oriented regulation of educational institutions. This has to change to a modern regulatory approach, which stresses provision of information and fraud detection & punishment.

6 LAND REFORM

249. Liberalisation of land ceiling and tenancy laws for development of degraded land and in areas of modern farming. In semi-feudal areas traditional land reform should be enforced. It can be bundled with services such as micro-credit and technology dissemination, and taken up as a package on a district-by-district basis.

7 POPULATION POLICY

250. With the severe financial crunch, States have little funds for maintaining public services at historical levels. They have none for extending these services to an expanding population. A change in attitude and approach of

State governments, with little addition to funds, could go a long way in moderating population growth.

8 URBAN & MUNICIPAL REFORM

251. Laws, rules and procedures relating to land use, construction, housing, urban utilities and urban services have not changed for fifty years and perhaps even longer. They must be systematically modernised, if we are to see a real estate boom. Such a boom has been an important source of growth in many high growth countries.

9 POLICY PAPER

252. Each state should prepare its own paper on 1st and 2nd phase reforms. Perhaps the Planning Commission could take the initiative, by having a model paper on State reforms prepared by an expert group or committee.

V. PRIORITIES, PHASING & SEQUENCING

253. A large number of policy issues requiring the attention of decision makers within and outside the government have been discussed in detail above. The major issues requiring priority attention are listed below.

A. Central Economic Priorities

1 FISCAL REFORM

a) Subsidy Control & Targeting

b) Re-set Expenditure Priorities

c) Raise User Charges

2 PUBLIC ENTERPRISE REFORM

a) Privatise Public Enterprises

- Transfer of management control to private sector.

b) Corporatise Departmental Enterprises

- Convert Departmental Public Enterprises into companies in such a way as to promote competition. Follow up with privatisation.

3 BANKING

a) Privatisation

- Dispersed public ownership instead of government majority.

4 LABOUR & MANAGEMENT

a) Labour Laws

- Change laws to introduce greater flexibility

b) Management Laws

- Abolish SICA.

c) Social Safety Net

- Reforms to facilitate mobility of labour and offer safety net.

5 MODERN REGULATORY SYSTEMS

a) Financial Markets

b) Infrastructure Sectors

c) Social Sectors

6 De-CONTROL & De-LICENSING

a) Drugs

b) Sugar

c) Energy: Coal

d) Rental Property

e) Infrastructure: Telecom, Railways

B. State Priorities

1 FISCAL

a) Subsidy control & User charges

b) Expenditure Priorities

- Literacy & Primary education
- Public Health, Epidemic control
- Water, Sewage, Sanitation
- Roads
- Irrigation & drainage
- Agricultural extension

2 PUBLIC ENTERPRISE REFORM

a) Privatisation of PSEs

- Privatise State Road transport corporations.

b) Corporatisation of Departmental Public Enterprises

- Convert State electricity boards into companies.

3 MODERN REGULATORY SYSTEMS

- Modern regulatory systems are urgently needed in the following sectors.

a) Infrastructure: Power, Irrigation

b) Social Sectors: Education, Health

4 De-CONTROL & De-LICENSING

a) Agricultural Land

- Develop market for land and land rental in advanced agricultural areas by changing land ceiling & tenancy laws.

b) Urban Land

- Abolish Urban Land Ceiling acts

c) Rental Property

- Abolish Rent Control Acts

d) Power

- Un-bundle generation, transmission and distribution of electricity.
- Promote benchmark competition in distribution.

e) Canals & Irrigation

- Allow & encourage co-operative management of canals & irrigation systems.

f) Road transport

- Allow free entry of private sector into state road transport.

5 LABOUR Rules, Procedures

- Labour rules and procedures need to be changed to remove the current disincentive to use labour intensive methods of production

6 LAW & ORDER

- Reform police, courts and legal system.

VI. REFERENCES

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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 21st Century,	November 1998

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