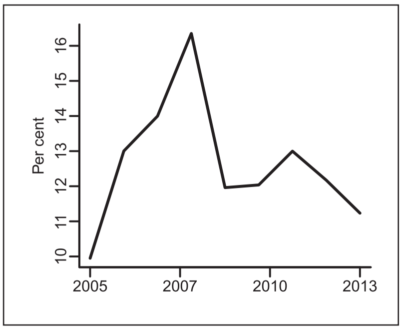
Chapter 2

Issues and Priorities

Reviving investment, essential for growth of jobs and income, requires a three-pronged approach that works through improving India's long-term growth prospects. First, the government must ensure low inflation by putting in place a framework for monetary policy, fiscal consolidation, and food market reforms. Second, it must put public finances on a sustainable path through tax and expenditure reform. Tax reform requires a GST, DTC, and more predictable tax administration. Expenditure reforms must focus on public goods, new designs for subsidy programmes, and mechanisms for accountability. India requires the legal and regulatory frameworks for a market economy. This requires repealing the old legacy laws and creating state capacity to address market failures.

The reform agenda

2.2 The defining challenge in India today is that of generating employment and growth. Jobs are created by firms when firms invest and grow. Hence it is important to create an environment that is conducive for firms to invest (Fig. 2.1). The recent business cycle downturn has seen a sharp decline in investment. Reviving investment, is therefore, on top of the government's priorities.



Source: Central Statistics Office (CSO)

Figure 2.1 : Private Corporate Investment as per cent to GDP

2.3 Investments are made on the basis of long-term growth prospects. The key to reviving investment in India lies in reviving the trend growth rate of the Indian economy. Reforms are needed on three fronts: creating a framework for sustained low and stable inflation, setting public finances on a sustainable path by tax and expenditure reform, and creating the legal and regulatory framework for a well-functioning market economy.

2.4 First, the government has to work towards a low and stable inflation rate through fiscal consolidation, moving towards establishing a monetary policy framework, and creating a conducive environment for a competitive national market for food. Initiation of reforms on these fronts will reduce inflation uncertainty and restore a stable business environment. Further, lower inflationary expectations would increase domestic household financial savings and make resources available for investment.

Improving long term-growth prospects will help revive investment.

2.5 Second, public finances need to be put on a sustainable path. India needs a sharp fiscal correction, a new Fiscal Responsibility and Budget Management (FRBM) Act with teeth, better accounting practices, and improved budgetary management. Improvements on both tax and expenditure are needed to obtain high quality fiscal adjustment. The tax regime must be simple, predictable, and stable. This requires a single-rate goods and services tax (GST), a simple direct tax code (DTC), and a transformation of tax administration.

2.6 Government expenditure reform involves three elements: shifting subsidy programmes away from price distortions to income support, a change in the focus of government spending towards provision of public goods, and a systems of accountability through a focus on outcomes.

2.7 Fiscal responsibility and tax and expenditure reform is a medium-term agenda and likely to take two to three years to implement. The positive effects, however, are likely to become visible as soon as the government makes a commitment to some of these reforms. Improvements in credit ratings, lower inflation, lower cost of capital, and greater business confidence that would ensue will yield short-term benefits in response to long-term initiatives.

2.8 Third, the government faces the task of putting in place the legal foundations of a well-functioning market economy for India. This must be a carefully executed project as it involves legislative, regulatory, and administrative changes. It involves building state capacity to allow businesses to operate in a stable environment. It involves setting up regulators with clear objectives, powers, flexibility, and accountability.

Default setting for government intervention in the economy needs to change from 'prohibited unless permitted' to 'permitted unless prohibited'.

2.9 Theoretically, there are fundamental differences between the legal and regulatory framework of a command-and-control economy and a market economy. In the former, economic activity is restricted to those activities that are permitted by the state. In a market economy, the economy thrives because the state interferes only when there is 'market failure', i.e. monopoly power, asymmetric information or externalities. As a consequence, laws permit all activities, unless the state specifically restricts them in the context of market failure. The restrictions need to be part of a known and predictable regulatory regime unlike now where a lot of restrictions-well intentioned as they are—are not part of a stable framework.

2.10 The global eonomic downturn and structural weaknesses in the domestic economy has had an adverse impact on investment. Issues such as getting permissions for land use, raw materials, power, water, and other inputs, and also issues such as obtaining long term finance, as the financial sector is still not deep and developed, need attentions. The inflexibility of labour markets have prevented high job creation. The interventions existing in food markets also contribute to higher food inflation.

2.11 The liberalisation of 1991 focused on the industrial sector. While industry was liberalised and allowed to buy from, and sell to, anyone in the world, Indian farmers in many states, are still required to buy and sell only in the government-designated Agricultural Produce and Marketing Committees (APMC) to licensed entities. Farmers are not allowed to sell their produce directly to the consumers. A national market for food is yet to develop.

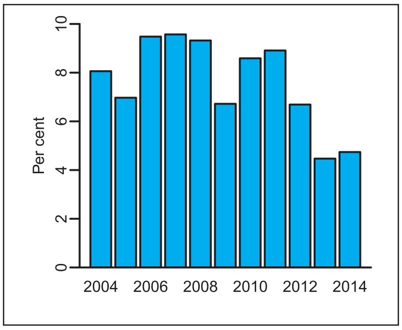
2.12 This reform agenda has three elements: short-term stroke-of-the-pen reforms, medium-term reforms that can be undertaken through executive decisions or the Finance Bill, and long-term reforms for institutional change. Long-term reforms involve the challenging task of building capacity and institutions that provide the foundations of a market economy. This, for example, includes changes in the legal and regulatory environment for factor markets, businesses, financial-sector regulation, capital flows, and food markets. A well-developed thought process for reform lies in the field of finance, where the Financial Sector Legislative Reforms Commission (FSLRC) has drafted the Indian Financial Code, which proposes to transform the regulatory framework of Indian financial markets by bringing in a modern legal and institutional framework. Similar reform projects are required in many areas. The path to sustainable job creation and income generation is to move on all of the above. Improving India's long- term growth prospects will also feed back into the present and raise investment in the short run.

Business cycle conditions

2.13 Post 2008, the economy witnessed a worsening of the economic outlook and a downswing in the investment cycle. Expansionary fiscal and monetary policies pulled up gross domestic product (GDP) growth in 2010-11 and 2011-12. However, the consequent increase in fiscal deficit and sustained high inflation led to a reversal of the expansionary stance of macroeconomic policy. In May 2013, the external environment worsened, leading to a sudden rupee depreciation and an interest rate hike in the first half of 2012-13.

Growth and Employment

2.14 In recent years, the Indian economy has suffered from a decline in business cycle conditions. The peak of the business cycle was 2006-07. GDP growth slowed down in 2013-14 to 4.7 per cent as per provisional estimates (Figure 2.2). In 2006-07, India witnessed growth of 22.51 per cent in exports, supported by strong economic conditions worldwide. In 2012-13, exports declined by 1.82 per cent. Export growth has picked up to 4.1 per cent in 2013-14 (Table 2.1).



Source: Central Statistics Office (CSO)

Figure 2.2 : Annual year-on-year growth rate of GDP at constant prices

Table 2.1 : Business cycle indicators

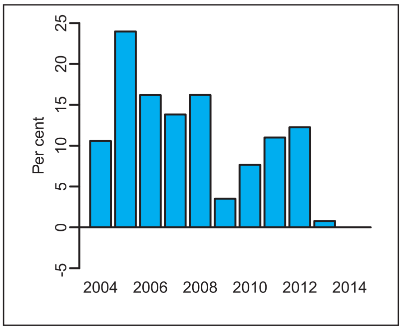
Growth rate		2006-07	2012-13	2013-14
GDP growth	Real	9.57	4.47	4.74
GFCF	Real	13.82	0.78	-0.11
GFCF of private corporate sector	Real	17.94	-3.2	N.A.
Exports	Dollars	22.51	-1.82	4.31
Inflation	Change in CPI (IW)	6.70	10.44	9.7

Sources: Central Statistics Office (CSO), Directorate General of Commercial Intelligence and Statistics (DGCIS), and Labour Bureau.

Notes: GDP is gross domestic product; GFCF is gross fixed capital formation, CPI (IW) is consumer price index for industrial workers.

Gross fixed capital formation

2.15 Gross fixed capital formation (GFCF) of the private corporate sector (at constant prices) declined sharply: from growth of 17.94 per cent in 2006-07 to a *decline* of 3.2 per cent in 2012-13. Difficulties in obtaining clearances and raw material supplies and of financing brought numerous investment projects to a halt. Demand conditions were also hampered by global conditions. GFCF (at constant prices) grew by 13.82 per cent in 2006-07 but only 0.78 per cent in 2012-13, and declined by 0.11 per cent in 2013-14 (Figure 2.3). An incipient recovery after 2008 stalled in 2013.

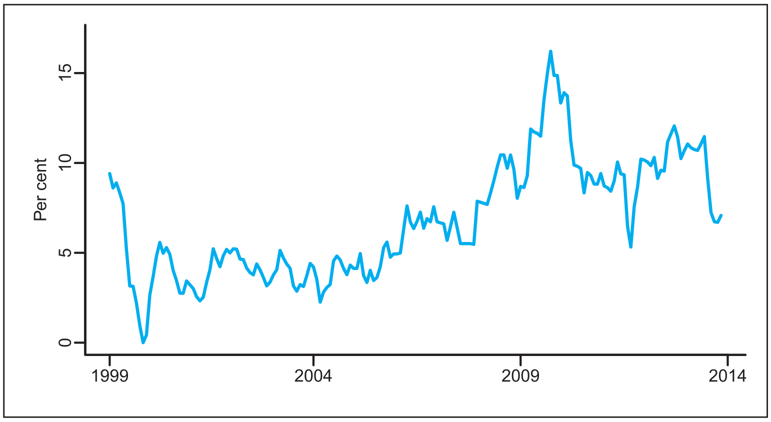


Source: CSO

Figure 2.3 : Growth Rate of Gross Fixed Capital Formation at Constant Prices

Inflation

2.16 Unlike other emerging markets (EMs) that also witnessed a slowdown in the post-crisis years, in India the slowdown in growth and investment was accompanied by elevated levels of consumer price inflation (Figure 2.4). The possibility of stagflation raises serious challenges for macroeconomic policy.



Source: Labour Bureau

Figure 2.4 : Year-on-year CPI inflation

2.17 Inflation in India began rising after 2005-06 with rapid credit growth (Figure 2.5) arising from difficulties in sterilising foreign exchange intervention. Though policy interest rates were raised, liquidity continued to rise, and consequently the overall stance of monetary policy remained easy.

2.18 With the benefit of hindsight, it appears that the fiscal and monetary stimulus provided by the government in 2011-12 proved to be excessive and fostered high inflation. Post-crisis fiscal stimulus raised aggregate economic activities above their long-term trends since the first quarter of 2010 and led to higher inflation. This outweighed the negative effect on exports from declining global demand and real exchange rate appreciation. The net effect of the stimulus was high enough to sustain a positive output gap till the beginning of 2012.

Source: Reserve Bank of India (RBI)

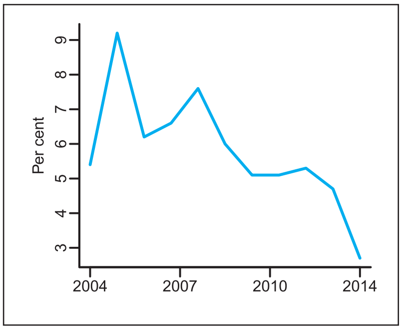
Figure 2.5 : Growth rate of bank credit

Investment

2.19 During the high growth years of 2004-07, a large number of projects had been initiated, assisted by high credit growth. Investment activity started facing difficulties in the global crisis. These were exacerbated by domestic factors.

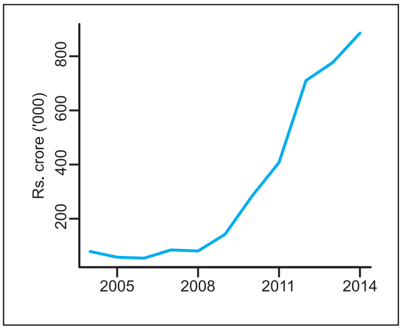
2.20 The crisis reduced export demand and increased uncertainty. The lack of price stability in India exacerbated uncertainty. Investment requires planning and it became more difficult to envision future values for growth, prices, and interest rates. As demand slowed down, some existing projects became unviable. Difficulties in contracting and providing clearances on time and the lack of a framework to shut down, sell off, or withdraw from projects created further difficulties.

2.21 Many large projects were unable to get timely clearances related to environment, forest, and land acquisition or raw materials required for completion. This resulted in a number of projects getting stalled (Figures 2.6 and 2.7). Many firms had over-leveraged themselves during the pre-crisis boom in bank credit. When conditions changed, they faced balance sheet distress. These firms were unable to close projects, settle claims, and repay loans. This led to cost escalations, further leading to difficulties in loan repayments for companies and bad assets for banks. These problems have to a certain extent been addressed by the Cabinet Committee on Investment (CCI) which was set up by the hovernment in January, 2013 with the Prime Minister as Chairman.



Source: CMIE Capex database.

Figure 2.6 : Infrastructure projects, rate of completion



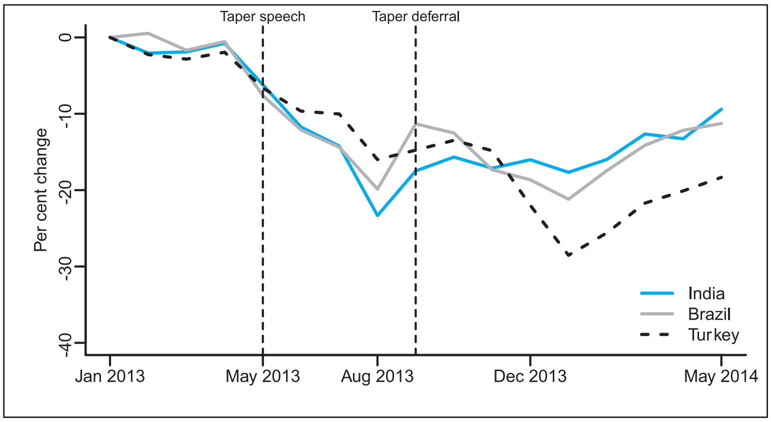
Source: CMIE Capex database.

Figure 2.7 : Value of implementation projects that are stalled

External environment

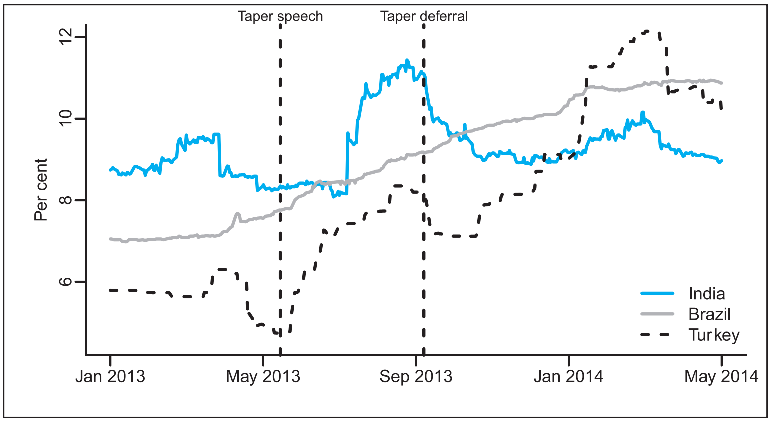
2.22 The cost of borrowing in domestic markets suffered a sudden increase after 15 July 2013. After the onset of the 'great recession' in the period after the global financial crisis, advanced economies introduced unconventional monetary policy tools. The US Federal Reserve, for example, announced asset purchases, popularly known as quantitative easing (QE), to ease monetary policy which had hit the zero lower bound. In May 2013, the US indicated that tapering of these unconventional methods would begin. This led to a sharp outflow of capital from emerging markets and a pressure on their exchange rates to depreciate. Like other EM currencies, the rupee also witnessed pressure to depreciate (Figure 2.8).

Figure 2.8 : Emerging market currencies in 2013-14



Source : Thomson Reuters Database

2.23 Some EMs including India, Brazil, and Turkey responded to this depreciation with an interest rate hike (Figure 2.9). The cost of capital remained high for most of the year as the uncertainty in global markets encouraged central banks to keep the stance of monetary policy tight.



Source: Thomson Reuters Database

Figure 2.9 : Emerging economy interest rates in 2013-14

The investment downturn

2.24 Adverse global conditions were undoubtedly one reasons for the slowdown in business cycle conditions in India. However, it would be untrue to say that domestic factors such as inflation uncertainty, tight liqudity conditions and difficulties in contracting and financing infrastructure projects did not contribute to the macro-economic outcomes witnessed from 2006-07 to 2012-13.

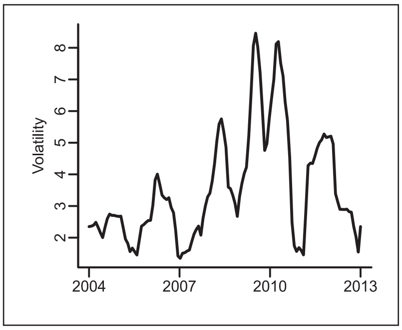
Inflation uncertainty

2.25 Under low and predictable inflation, households and firms can make plans about the future, face reduced risk, and undertake investments. The inflation uncertainty of recent years has been characterized by a surge in inflation and inflation volatility. High and unstable inflation has made it difficult to make projections about future profits from investment projects. In particular, it has an adverse effect on risk-taking by infrastructure firms, since these projects involve cash flows over multiple decades into the future. When consumer price index (CPI) inflation accelerated from February 2006 onwards, there was a corresponding increase in inflation volatility. This is depicted in Figure 2.10, which shows the rolling one-year volatility of year-on-year CPI inflation. This, in turn, made it harder to anticipate future inflation and make plans about the future.

2.26 Additionally, fiscal problems (Figure 2.11) exacerbated the cost of borrowing by the private sector. The large fiscal deficit (Figure 2.11) also spilled over to the current account. In June-August 2013, countries with high fiscal deficit and high current account deficit (CAD) faced the largest pressure on their exchange rates. The taper and the sudden depreciation added to the uncertain business environment.

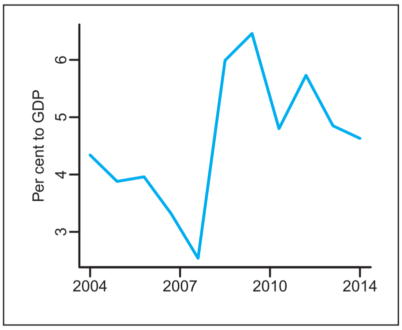
Fall in business confidence

2.27 There has been increasing concern about the difficulties faced by firms operating in India. In a purely economic sense it is easy to explain the actions of a government that restricts firms in certain ways in order to address market failures. However, the Indian landscape features numerous government interventions that are not connected to market failures. Therefore, there is immediate need to simplify processes including those relating to tax policy and administration.



Source: CSO

Figure 2.10 : Inflation Volatility



Source: CSO

Figure 2.11 : Central government fiscal deficit as per cent of GDP

Table 2.2 : Rank in the world on 'Doing Business'

	India	Brazil	South Korea	South Africa	Turkey
Ease of doing business	134	116	7	41	69
Starting a business	179	123	34	64	93
Dealing with construction permits	182	130	18	26	148
Getting electricity	111	14	2	150	49
Registering property	92	107	75	99	50
Getting credit	28	109	13	28	86
Protecting investors	34	80	52	10	34
Paying taxes	158	159	25	24	71
Trading across borders	132	124	3	106	86
Enforcing contracts	186	121	2	80	38
Resolving Insolvency	121	135	15	82	130

Source: World Bank, *Doing Business Report 2014*.

2.28 The *Doing Business Report 2014* prepared by the World Bank shows that India ranks 134 out of 189 countries in 2014 (Table 2.2). Global firms have a choice about where to invest, which is based on the ease of doing business there. In much the same way, many large Indian firms undertake foreign direct investment (FDI) outside the country and choose where they wish to invest. In an examination of 3102 large firms in India, 373 of these have done outbound FDI that is above 1 per cent of their total assets. The firms that have done outbound FDI account for 15.8 per cent of the total assets of the 3102 firms.

2.29 Although, India has raised concerns about the methodology used in the compilation of the World Bank's *Doing Business Report*, a sustained programme of reform is required on most aspects of the interface between firms and the state. The immediate objective must be to match the average value of EMs on the 'Doing Business' score.

Table 2.3 : Household Financial Savings and Total Government Borrowing as Per Cent of GDP

	As per cent of GDPmp
Household financial savings	7.1
Government borrowing	7

Source: CSO.
Note: GDPmp is GDP at market prices.

Financial System

2.30 The investment downturn has been exacerbated by difficulties in the availability and cost of finance. Data shows that the first claim upon the savings of households is physical assets such as gold and real estate. The second claim upon the residual financial savings is resource pre-emption that is done to fund the fiscal deficit (Table 2.3). In recent years, with a decline in the savings rate and an enlarged fiscal deficit, the external capital from outside the firm, available to the private sector has declined.

2.31 During the credit boom, bank credit growth was over 30 per cent. The difficulties experienced in the infrastructure sectors and of natural resources have made it difficult for some of these firms to repay their loans. High credit expansion for infrastructure has resulted in asset-liability mismatches for banks. Table 2.4 shows the rising share of infrastructure credit in total bank credit. In recent times, banks are approaching exposure limits to borrowers and infrastructure sectors. Further, the asset quality of banks has deteriorated with the gross non-performing assets (NPA) to gross advances ratio rising.

Table 2.4 : Infrastructure Credit as Share of Bank Credit

Year	Infrastructure credit as share of bank credit (%)
2004	4.43
2005	7.18
2006	7.49
2007	7.42
2008	8.68
2009	9.73
2010	11.71
2011	13.36
2012	13.42
2013	13.87

Source: RBI.

Infrastructure

2.32 The first wave of investment in infrastructure and natural resources, which began in 2002, has run into numerous problems, reflecting inter alia the complexities of PPP contracting and the limited capacity in the system.

2.33 Allegations of corruption, and interventions by investigating authorities and courts, have interrupted many projects and adversely affected firms. Problems of land acquisition and environmental regulation have led to stalled projects. The weakness in integrated planning has led to difficulties such as ports that lack railway lines or power plants that lack coal supplies.

2.34 Infrastructure projects are best financed through corporate bonds. However, other than issuance by large financial institutions, the corporate bond market in India has been largely missing. In the absence of a vibrant corporate bond market, infrastructure projects have resorted to borrowing from banks and in foreign currency. In the Indian experience, the leverage has often been mechanically set using rules such as 70:30 for debt: equity. In a sound financial system, the leverage of a project should be determined by financial firms based on an assessment of the risks faced by the project.

The present model of infrastructure contracting and financing needs to be rexamined.

2.35 There is a distinction between developing new infrastructure assets, and operating them. Over the years, we may expect large-scale assets in the hands of operating companies, while infrastructure developers with small balance sheets pursue new projects each year. This maturation has not yet worked out. Operating companies, which are low-risk utilities, have not emerged in the required numbers. The modest balance sheets of developers have been loaded with ever larger assets.

2.36 Over-leveraged firms have made mistakes in bidding based on over-exuberant traffic projections and on the expectation of being able to renegotiate contracts should problems arise. The renegotiation process has sometimes faced allegations of misconduct and interventions by the courts.

2.37 These problems have come together to result in a large number of stalled projects, a balance sheet crisis for many infrastructure and natural resources firms, and difficulties for banks which have lent to them. Subsequently, the pace of investment in infrastructure and natural resources has declined. The first wave of infrastructure investment in India has been grounded in an array of design flaws that now need to be addressed.

How long-run issues matter for the short term

2.38 In the conventional wisdom, there is a tension between the expedient pursuit of short-term objectives and the need to nurture the foundations of sustained long-term growth. With the emergence of a modern market-based economy, however, nurturing long-term growth influences the short term through four channels: expected GDP growth, valuation in the stock market, behaviour of households, and foreign capital flows.

Greater policy stability, higher long-term growth and a legal and regulatory framework that strengthens a market economy will help revive investment.

2.39 The first channel runs through the expectations of GDP growth in the eyes of private firms, both foreign and domestic. When there is an expectation that India will have high GDP growth in the long term, these firms increase their investment in India, which boosts short-term growth. Of particular importance here are long-term projections for sustained traffic growth, which influence the viability of infrastructure projects.

2.40 The second channel runs through the stock market. The stock market forms expectations about dividend growth in the coming decade and builds this into the present stock price. When there is an expectation of high GDP growth in the long term, stock prices go up. This increases the gap between market value and replacement cost, which fuels investment. This boosts short-term growth.

2.41 The third channel runs through the behaviour of households. When there is an expectation of high GDP growth in the long term, households become more confident about their income in the future, and respond by saving less, including through borrowing more. This fuels demand in the economy and boosts short-term growth. The rise of mechanisms through which the formal financial system is able to give loans to individuals has increased the magnitudes involved. In addition, confidence about low inflation will reduce the attraction of physical assets for households.

2.42 The fourth channel runs through the behaviour of foreign investors. The outstanding fact about international portfolio formation is 'home bias', where global investors place too little money in EMs like India. When there is an expectation that India will have high GDP growth in the long term, this creates incentives for global financial firms to build organisational capital in connection with India. Increased capital flows into India boost short-term growth.

2.43 These channels are stronger in India today when compared with India of the past and also when compared with many other countries. The share of private gross capital formation in GDP, which is a key parameter that changes in response to long-term considerations, is much larger when compared with past values and with many other countries. Household savings are much larger when compared with past values and with many other countries.

2.44 This encourages focus of policymakers upon the initiatives that will make a difference to long-term GDP growth in India. In addition, focus on making it easier to do business and providing a stable policy environment will make investment attractive. The market economy is likely to respond to these initiatives with enhanced investment, enhanced consumer demand, and enhanced capital flows, which can revive investment and yield high GDP growth in the short run.

Inflation

2.45 For effectively containing inflation requires putting in place a monetary policy framework defining a nominal anchor, as well as deregulating food markets to curb food inflation.

Monetary policy

2.46 Data shows that inflation is becoming entrenched in the Indian economy. Inflationary expectations are high and sporadic increases in prices of food items spill over to non-food prices.

Despite a business cycle downswing and underutilised capacity, inflation has persisted. A three-pronged strategy is required to tackle this stagflation.

2.47 Monetary policy is central to inflation in the long run. Intuitively, if the amount of money in the economy were doubled, prices would roughly double. Natural shocks, changes in technology, and consumer preferences generate *relative* price changes, but do not explain *aggregate* inflation which is a macroeconomic phenomenon.

Spillovers from food to non-food inflation can be reduced by putting in place a formal monetary policy framework.

2.48 Since 2010, there has been an upsurge in food inflation which has spilled over to non-food and general inflation. The spillover reflects inter alia the lack of proper monetary policy arrangements. There is need for a formal monetary policy framework through which the Reserve Bank of India is given clarity of objective (a CPI inflation target) and operational autonomy in pursuit of that target. This strategy has been used by numerous advanced and emerging markets and has delivered results in terms of low and stable inflation. This, in turn, has created a favourable environment for investment and employment growth. A low and stable inflation rate helps maintain the value of the currency, both domestically and externally.

2.49 In some countries, the transition away from the exchange rate to inflation as a nominal anchor has been a difficult one. However, in India, this transition is likely to be easier. Figure 2.12 shows the history of rupee-dollar volatility. There have already been two structural breaks in this volatility, in May 2003 and in March 2007. Rupee-dollar volatility has gone up from 1.84 per cent to 3.87 per cent to 8.65 per cent.

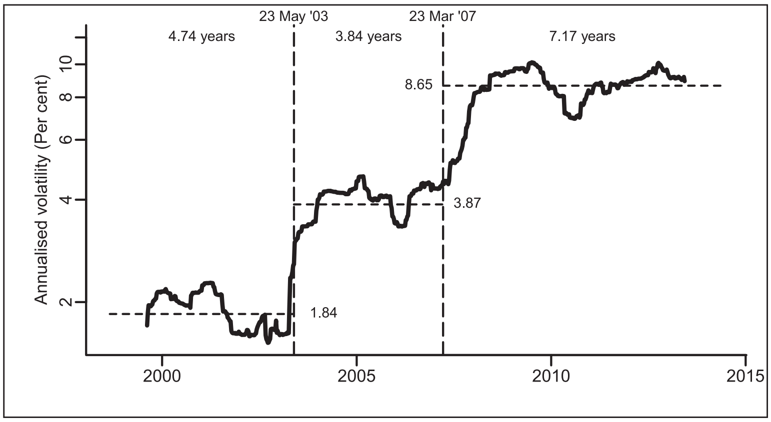


Figure 2.12 : Volatility in the Rupee-Dollar

Source : RBI and author's calculations.

2.50 The average volatility of the rupee-dollar exchange rate at 8.65 per cent is close to the volatility of market-determined exchange rates in EMs. Hence the economy has experienced the bulk of the adjustment to exchange rate flexibility and the stage is set for shifting focus away from the US dollar and anchoring the value of the rupee to the price of the household consumption basket.

Food inflation

2.51 There are many complex problems with food markets that need to be addressed. Cereal markets have resource misallocation due to government interference in every aspect of input and output markets. Rising prosperity has created heightened demand for food, particularly superior goods such as fruits, vegetables, and proteins that are consumed by people when they become richer. At present the supply response to these shifts in demand is inadequate owing to rigid constraints and anti-competitive practices. As a consequence, a substantial change in prices is required to elicit a unit change in supply.

Sustainable public finance

2.52 Putting public finances on a sustainable path has three elements: better accounting practices and budgetary management and a new FRBM Act which has consequences if it is not met; rationalisation and simplification of direct and indirect taxes; and expenditure reform.

A new FRBM Act with teeth is needed.

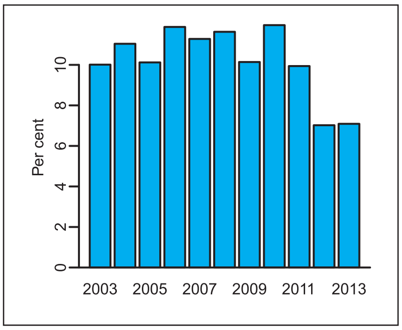
Fiscal responsibility

2.53 The fiscal situation of the central government is worse than it appears, given the acceleration of inflation from 2006 to 2014. These inflation shocks effectively reduced the value of outstanding debt. This has harmed the interests of households but has reduced the debt burden of the government. These inflation shocks are unlikely to recur in the future.

2.54 Fresh thinking on a responsible fiscal policy framework is required. This should feed into a new FRBM Act. The modified Act needs take into account business cycles and to have penalties that are strong enough so that it cannot be ignored.

Financial repression

2.55 In recent years, the problems of financing private investment have become more acute. High inflation and low real interest rates have deterred financial savings. As Figure 2.13 shows, household financial savings fell from 9.9 per cent of GDP in 2010-11 to 7.09 per cent of GDP in 2012-13. Alongside this, the centre and states (put together) borrowed 7.1 per cent from the domestic market. This resource pre-emption has put constraints upon external financing for the private sector. Addressing this will require a three–pronged strategy: reducing the fiscal deficit, reducing financial repression (so as to reduce resource pre-emption and give households a fairer deal), and reducing inflation.



Source: Economic Outlook Database CMIE

Figure 2.13 : Household financial savings as a per cent to GDP

2.56 When it comes to public debt, India is forcing financial firms to lend to the government such as through the statutory liquidity ratio for banks and investment guidelines for other financial firms. This method of capturing resources is known as 'financial repression'. It leads to lower returns for households who are customers of financial firms. It generates incentives for households to avoid holding assets with Indian financial firms, thus encouraging purchases of gold, real estate, and overseas assets. The government must move away from financial repression and set up a professional Public Debt Management Agency (PDMA) that sells government bonds to voluntary bidders.

Tax reform

2.57 In a non-market economy, in addition to laws, taxes and subsides are used for encouraging or discouraging activities that the central planner considers good for the economy. The result is multiple rates and exemptions. Industrial policy, where the government picks winners, has generally failed in most countries. Ultimately, distorted price signals cause resource misallocation and slow down productivity growth. Most market economies have moved away from complex tax systems towards simple and rational systems.

A CenGST could be the first step towards a full GST.

2.58 India's complex tax system suffers from problems in both structures and administration. The tax regime is used to do industrial policy where the state gives exemptions and rebates to certain economic activity. Uneven and high tax rates and uneven tax treatment of similar economic activities have induced distortions in the behaviour of firms and households. In addition, the manner of functioning of tax administration is imposing legal risk and substantial compliance costs upon households and firms.

2.59 Tax reform in India can improve the ease of doing business and promote efficiency and productivity growth. The tax/GDP ratio of the government must be obtained through a burden-sharing mechanism where low rates apply on a broad swathe of the population, through effective enforcement mechanisms. Taxes clarified as 'bad' in public finance theory like cesses, surcharges, transaction taxes, and taxes imposed for ease of collection such as the dividend distribution tax, need to eventually go. Reducing tax-related distortions can increase efficiency and fuel GDP growth.

GST

2.60 There is consensus that the GST will be a major milestone for indirect tax reform in India. Replacing all existing indirect taxes by the GST will create a national market, eliminate cascading taxes, and align taxation of imports and exports correctly. This will improve the competitiveness of production and export from India.

2.61 The implementation of a Central GST (CenGST) could be the first step towards the GST. Once the CenGST is implemented, and the information technology system for CenGST has worked, estimation risk will be lower and it will be easier for the centre and states to move to the GST.

DTC

Removing exemptions will help simplify the tax regime.

2.62 Just as the GST is a transformation of indirect taxes, the DTC is required as a clean modern replacement for the existing income tax law. As with the GST, the key objective must be a simplification with a clean conceptual core, and the removal of a large number of special cesses and exemptions that favour special interest groups. The tax system must move away from industrial policy, with incentives for one activity or another, towards a simple framework.

2.63 As with the GST, the DTC will yield gains by removing distortions of individual and corporate decision making, reducing compliance cost and litigation, and improving tax collections.

Taxation of firms

2.64 Firms are ultimately owned by individual shareholders. When individuals are taxed, the taxation of firms acts as double taxation. From the viewpoint of shareholders, the post-tax returns on investment in a firm are shaped by two levels of taxation: the corporation tax rate and the dividend distribution tax.

2.65 A considerable body of work has demonstrated two problems with the taxation of firms. First, domestic and international firms are likely to invest in countries with lower tax rates. Second, high taxation of firms hinders the process of capital formation and ultimately results in reduced wages. The wages of workers reflect their productivity and deepening capital stock of firms increases the productivity of workers.

2.66 India stands out, among the EMs, with a high rate of total taxation of corporations. It would be desirable to track the median value for EMs. This would ensure that India is a competitive destination for investments of global and Indian firms.

Tax administration

2.67 The *Doing Business Report 2014* ranks India at 158 out of 189 countries under the head 'paying taxes'. Expert Committees have identified problems with the taxation system, including retrospective amendment of laws, frequent amendments, especially after the executive is unable to establish a tax claim in courts, and issues with arbitrary tax claims, especially in transfer pricing. This is coupled with long pendency of disputes and a taxation regime that is unfriendly to foreign investors.

Expenditure reform

2.68 Expenditure reform is required for government to achieve desired outcomes with minimum cost. This requires a change in the budgeting process and accounting practices, subsidy reform, a focus on public goods, and mechanisms for feedback and accountability.

Expenditure reform must create feedback loops for accountability.

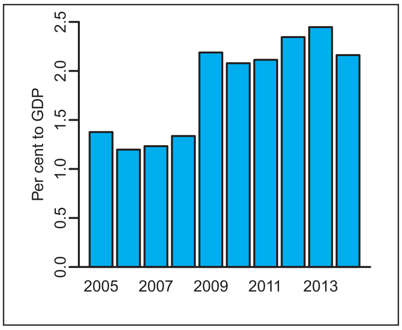
Budgeting process

2.69 At present in India, a government department gets resources through two mechanisms: the budget process run by the Ministry of Finance and the budget process run by the Planning Commission. This leads to sub-optimal resource allocation as well as diffused accountability.

2.70 A more effective budget process would be conducted in the language of outcomes, targets, and the cost of achieving alternative targets. The focus of a sound budget process would be upon *outcomes* as seen by citizens and measured by independent bodies, and not the internal activities of departments of government. Budgetary allocations should be associated with concrete targets for outcomes and departments held accountable for achieving these targets.

2.71 The creation of feedback loops towards enhanced performance requires four elements. The first is the unification of budget making at the Ministry of Finance. The second is the design of a report card about the work of every ministry, and the preparation of the report card by independent organizations, based on technical knowledge. The third is a formal budget process that works with budget constraints, outcomes, and targets. The fourth is a set of consequences that arises when a department fails to achieve its targets. This would provide feedback loops of pulling back resources and modified allocation for expenditure that fails to deliver results.

2.72 There has been much criticism of the Indian cash-based accounting process. Greater clarity, and better decisions, would be achieved by moving towards an appropriately modified accrual-based system, where the income and expenditure for the year is measured as that which is attributed to the activities of the year. As an example, if a fertiliser subsidy were operating in a year, the cost of that subsidy would be counted in that year – regardless of when the actual payment of the subsidy took place.



Source: Various Budget Documents

Figure 2.14 : Food, fuel, and fertilizer Subsidies as a share of GDP

Subsidies

2.73 Not all the money put into subsidy schemes reaches the poor. Programmes such as food subsidy have huge overhead costs (Figure 2.14). In other cases, such as the fertiliser subsidy, the expenditures generate a distorted resource allocation that hampers productivity (Box 2.1).

2.74 Subsidy programmes are particularly problematic when they hamper changes in prices and the consequent shifts in resource allocation which must take place. When the price of diesel rises, in the medium term, the economy shifts away from diesel. But this adaptation is blocked if the price of diesel is not actually raised. When the purchase price for cereals is raised, cereal production becomes more attractive, even though consumers might want more non-cereals.

Cash transfers to poor households, instead of procurement and distribution of cereals, offer savings on the subsidy bill.

2.75 It is increasingly feasible to identify households below the poverty line and give them cash. The new technologies of biometric identification, and payments through mobile phones, have created a range of new possibilities for the design of programmes. These would lead to a reduction in poverty at a lower cost when compared with the present subsidy programmes.

Box 2.1 : Resource misallocation: Fertilizer subsidy

Urea is highly subsidised. Farmers pay approximately ₹ 5360 per tonne, and the government pays ₹ 11,760 per tonne. Subsidy for other fertilizers has been capped since 2010 under the Nutrient Based Subsidy (NBS) regime.

The correct proportions in which Nitrogen (N), Phosporus (P), and Pottasium (K) should be used are 4:2:1. These are the proportions in which these nutrients are used by plants. The skewed subsidy scheme has given farmers a distorted notion that urea, the main provider of N, is cheap while the other two elements are expensive. As a consequence, fertilizer use in India is taking place in the ratio 8.2:3.2:1.

For each unit of K, instead of 4 units of N which are required, 8.2 units of N are being put into the soil. The incremental output of the excessive 4.2 units of N is zero or somewhat negative.

This purchase of urea, beyond what is required, works out to roughly 50 lakh metric tonnes (MTs). Farmers and the government are wastefully spending Rs 2680 and Rs 5860 crore respectively for this. These costs are ultimately paid by the consumers as higher food prices and higher taxes, in return for a zero or negative impact upon agricultural output.

The distorted policy has also led to stagnation of private investment in the sector, especially in urea, and increased reliance on imports. The fertilizer subsidy hurts everyone: farmers, firms, taxpayers, and consumers.

2.76 Rational analysis of subsidy programmes would be assisted if the accounting systems of government, and budget documents, classified all government expendtiures into public goods and subsidies. This would make it possible to obtain a full picture of subsidies and enable a more rational budget process. Shifting from the plan/ non-plan distinction to the subsidy/public-goods distinction would improve clarity of thought. This is consistent with the July 2011 report of the Planning Commission's High Level Expert Committee on Efficient Managment of Public Expenditure.

Education

2.77 There has been remarkable expansion of expenditure on elementary education in recent years. Combining central and state spending, this has gone up from ₹ 62,063 crore in 2006-07 to ₹ 147,750 crore in 2011-12. As Figure 2.15 shows, this translates into a substantial expansion from ₹ 5202 per child in 2007-08 to ₹ 11,418 per child in 2011-12.

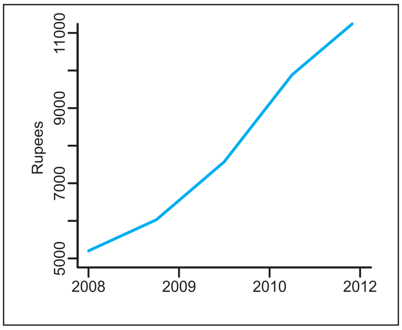
2.78 Parents face the choice of sending their children to public schools or to private schools. Public schools require no payments for tuition, uniform, midday meals, and books. In contrast, when a child is sent to a private school, these expenses are borne by the household.

2.79 The choices of parents are then a natural mechanism to obtain feedback about the performance of the government-run elementary education system. Figure 2.16 shows the fraction of children enrolled in public versus private schools in rural India. Public schools are free and the government spends more than ₹ 1000 per child per month to run them. However, between the period 2007-08 and 2011-12 where expenditure per child in public schools was increased by 119.5 per cent, a growing fraction of households chose to exit from public schools. This raises concerns about the effectiveness with which public spending on elementary education translates into learning outcomes of children.

2.80 Figure 2.17 compares the learning outcomes of public and private schools in rural India. Private schools in rural India work inefficiently: only 59 per cent of children in the IIIrd standard are able to read a Ist standard text. This may reflect the low resources per child available to private schools. Government schools fare worse. In 2006, this measure stood at a bit under 50 per cent. In recent years, while the spending per child in government schools has risen sharply, the learning outcome has declined to 32.4 per cent.

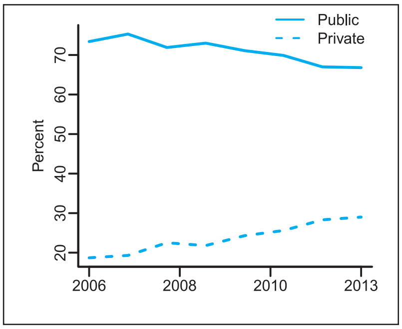
2.81 This evidence indicates that the design of government programmes in elementary education needs revisiting. Expenditure grew by 138 per cent between 2006-07 and 2011-12, but alongside this intensification of spending through the existing programme design.

2.82 This example of elementary education illustrates inadequate feedback loops: failures on outcomes did not feed back fully to resourcing, management changes, and fundamental redesign of public programmes.



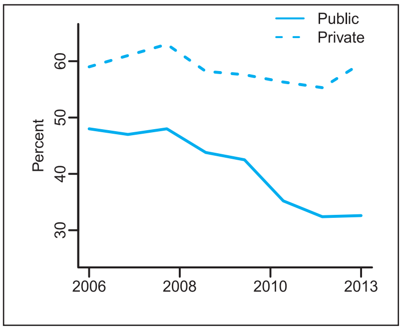
Source: Analysis of Budgeted Expenditure on Education, various reports & DISE, various reports

Figure 2.15 : Per child expenditure incurred by the government



Source: ASER, various reports.

Figure 2.16 : Rural children studying in different types of schools



Source: ASER, various reports.

Figure 2.17 : Rural children in Std III who can read Std I-level text

Health

2.83 India's health policy has focused on primary health centers and hospitals. The numbers of hospital beds, doctors, and nurses per 1000 persons have often been treated less as inputs and more as measures of success of the health policy. Health outcomes such as a reduction in cases of diahorrea, malaria, child and infant mortality can be addressed far more effectively with the same budgetary resources by addressing the lack of public goods in health. There is a need to focus the limited budgetary resources on public goods.

Category	2005	2012
Access to sanitation		
Rural	18.70	24.75
Urban	56.84	60.20
Access to water		
Rural	82.20	90.71
Urban	94.15	96.67

Source: World Development Indicators.

Table 2.5 : Per cent of population with access to water and sanitation facilities

2.84 The most powerful interventions for improved health may lie in the area of water and sanitation (Table 2.5). Epidemiological interventions such as vaccination programmes, and control of diseases, have the characteristics of public goods. Preventing stagnant water controls malaria. No one but the government has the incentive to undertake such expenditure. The government must focus first on these interventions. This calls for a fundamental and strategic shift in thinking about public spending on health.

Infrastructure

2.85 The role of government in infrastructure can be usefully divided into planning, contracting, and regulating.

> *Planning* is the decision to build an element of infrastructure. This inevitably requires inter-relationships between multiple elements: e.g. where there is a port, there will be a requirement for railway lines and roads.
>
> *Contracting* is the task of giving out the contract to a private producer for building an element of infrastructure.
>
> Once an asset is working, the question of *regulating* arises, as there is the market failure arising from monopoly power.

2.86 We may envisage the planning function being performed in government, the contracting function being placed in a specialized organization like the National Highways Authority of India (NHAI), and the regulation function being placed in an independent regulator.

The role of government in infrastructure can be usefully divided into planning, contracting, and regulating.

2.87 Transportation planning requires an integrated view of all aspects of transportation. Energy planning requires an integrated view of all aspects of energy. There is a legitimate role for political considerations in the planning process. As an example, political authorities may decide that it is important to build transportation infrastructure in backward states, or in states with greater law and order problems, even when their economic viability is lower.

2.88 Once a decision has been made to build a port or a highway, the contracting function involves the specialised skill of engaging with the complexities of PPP contracts. Many of the difficulties of the last decade in the field of infrastructure lie in inadequate state capacity for procuring and contracting complex PPP projects. Separation of this function would require establishing an independent organization with specialised expertise in contracting.

2.89 Once an asset is working, there is need for an arms-length independent regulator. Integral to a level playing field, in the eyes of the regulator, is the corporatization of government infrastructure assets, so that the regulator sees a landscape with multiple firms and can treat them in an ownership-neutral way.

2.90 Further, it may be useful to decompose the risks of an infrastructure project into the early stage and the steady state. The early stage risk is political risk, construction risk, regulatory risk, and the traffic risk of the first year of tolling. These are substantial risks.

2.91 Once an asset is working, and once the tolling revenues from the first year are known, the risks decline sharply. The risks faced from that point onwards consist of regulatory risk and traffic growth risk.

The early stage of an infrastructure project has political risk, construction risk, regulatory risk and, traffic risk.

2.92 So far, India has emphasised large contracts that combine all these risks. It is expected that consortiums of developers and operators will come together to bid in these large contracts. However, the risk-bearing capacity of the private sector is limited, particularly when it comes to risks induced by the political system including political risk, construction risk, and regulatory risk.

2.93 An alternative strategy of contracting is required where PPPs are not sucessful. An asset could stay on the public balance sheet at first. The first contract given out would be an engineering contract to build the asset, where the construction company is protected from political and regulatory risk. The government and the construction company would work together to overcome construction risk. The payment for the asset would be made on budget.

2.94 The second contract given out would be to a private firm to toll the asset for one year and produce data about present levels of toll revenue.

2.95 This could set the stage for a long-term, say 20-year, contract combining tolling and maintenance. A new cadre of dedicated operating companies, i.e. utilities, would emerge who would perform this role. These projects would be able to absorb a high level of long-term bond-market financing, and thus yield low tolls. These firms would generate cash flows for the government which would offset the original expenditure for constructing the asset.

2.96 This approach could induce a separation between construction firms, who have an expertise in building new assets, and operations firms, who have an expertise in running existing assets.

Natural resources

2.97 In the field of natural resources where there is global trading, appropriate incentives for exploration and extraction in India are obtained when there is pricing parity with the world price excluding transport costs or taxes. If firms obtain a lower revenue per unit of mineral extracted in India, there will be under-investment in exploration and extraction.

2.98 Auction-based procurement or fixed-price procurement has run into many difficulties. These can be avoided by using a percentage revenue share for the government, through which the government becomes a partner in sharing the risks of exploration, extraction, and world price fluctuations, alongside the private firms.

2.99 There is a strong case for removing pricing distortions seen by consumers such as administered pricing for coal. These fixed prices are dulling the market response of reduced consumption in response to higher prices and reducing the flexibility of the market economy. Vouchers for the poor, through which a certain fixed rupee payment is made to the household and the household pays market price, are one way forward. One elegant scheme through which many of these problems can be solved at once is a payment out of the revenue share to state governments, who would use this money to run voucher programmes for the poor.

Foundations of a market economy

2.100 India can increase its long-term trend growth by unleashing the entrepreneurial spirit of millions across the country by strengthening the economic freedom of the people. The biggest challenge today is improving state capacity suitable for a market-based economy. A long-term, careful and systematic effort is required for undertaking institutional change.

There is need to re-examine all laws that empower the government to interfere in markets.

Addressing market failures

2.101 Under central planning, all decisions about what to produce and how to produce were made by the government. In the 1960s and 1970s a series of laws were enacted that increased the role of the government in the functioning of both product and factor markets. From the late 1970s there has been some progress in reducing this. Today, the situation is one of an awkward juxtaposition of over-intervention in some respects and inadequate state participation in others.

2.102 The key insight on the role of the government in a market economy is the idea of a market failure, i.e. a situation in which the unrestricted actions of private persons result in a suboptimal outcome. There are three categories of market failures: monopoly power, externalities, and asymmetric information. The concept of a market failure gives a framework for guiding state intervention. Before a state intervention is initiated, it is important to demonstrate that there is a market failure. It should be shown that an intervention will solve the market failure. Further, the costs to society of government intervention should be outweighed by the benefits.

The challenge of State capacity

2.103 The first generation of reforms in India was focused on deregulation: to dismantle central planning and put an end to inappropriate interventions by the government. As an example, many financial regulators in India tend to get involved in the detailed working of products and processes of financial firms. This kind of state intervention is easy to dismantle using stroke-of-the-pen reforms such as repealing a regulation or repealing a law or closing down a government organisation.

2.104 While the agenda of removing inappropriate government interventions is far from complete, it is important to also focus on the second generation of reforms. This is the positive agenda of constructing state structures that address market failures. Only the state can ensure provision of public goods such as defence, police, and judiciary. Only the state can address monopolies, externalities, and asymmetric information. In an environment of technologically sophisticated and internationalised firms, it requires considerable sophistication on the part of government to precisely address market failures.

2.105 This requires state capacity. India needs greater expertise for establishing intelligent, efficient, cost-minimising government organisations that successfully address market failures while avoiding the perils of central planning. A body of knowledge is now needed in India on how to construct laws, agency architecture, organisation structure, process manuals, and human resources through which an effective state appropriate for the present can be obtained. The present ways, of constructing and running public systems, are not useful in thinking about the new requirements.

Objectives, powers, flexibility, accountability

2.106 In thinking about public administration every government organisation is the agent, and the people of India, represented by Parliament, are the principal. In every principal-agent relationship, in order to achieve performance, the objective of the agent must be well understood, outcomes must be measured, and measurement must have consequences. Vaguely posed objectives lead to loss of accountability. Once a clear objective has been defined, laws should give the agency the minimum possible coercive power through which the objective can be achieved. If expansive powers are given, there is greater risk of abuse of power.

Laws need to clearly define the objectives of regulation and give limited powers to regulators to meet those objectives.

2.107 The extent to which the stated objectives have been achieved needs to be statistically measured with an emphasis on *outcomes*. The awarding of the report card and the measurement of outcomes must be done by an independent body. As an example, the outcome in education is the knowledge of children. The Organisation for Economic Cooperation and Development (OECD) Programme for International Student Assessment (PISA) is an internationally comparable measure of the science and mathematics knowledge of 15-year old children of the country: this can provide a report card that shows the performance of the state apparatus leading up to 10th standard education.

2.108 This approach will generate accountability. The leadership of every government organization can work better when there is clarity of purpose, when minimum powers have been given, and when there is measurement of the outcome. When there are ample accountability mechanisms, there is a case for greater operational autonomy, through which the leadership of the organization can reshape the organization in favour of delivering results.

Ease of doing business

2.109 In recent years, firms operating in India have faced an array of problems in the interface between firms and the government. This includes health-safety-environment regulation, regulation of companies, the working of the legal system, and problems of tax policy and tax administration.

Making it easier and less costly to do business must be a top priority.

2.110 Long delays are costly. Senior management time allocated to managing the relationship with government is time that could have been allocated for productivity improvements. The cost of doing business in India has generated increased incentives for Indian and global firms to favour investment elsewhere in the world. It has made it difficult for small businesses to be set up and prosper without harassment from the state.

2.111 A comprehensive transformation of all aspects of the interface between firms and the state is now required. This involves focusing the state on addressing market failures and strong accountability mechanisms through which public bodies deliver world class efficiency.

Reforming factor markets

2.112 The removal of industrial and import licensing in 1991 was among the first steps towards reform of product markets in India. Markets for manufactured products (though not agricultural products) were liberalised, giving firms the ability to produce, buy, and sell inputs and outputs. Price controls, such as those on steel and cement, were removed.

2.113 Factor markets such as those for labour, land, and capital, however, remained largely unreformed. This has proved to be a constraint for growth and employment generation. India has the potential of becoming a global hub in labour-intensive manufacturing. However, labour laws have hindered the creation of large-scale manufacturing in India. Clear land titles, acquiring land, and changing land use face various difficulties. This needs reform at all levels of government. Similarly Mumbai has the potential of becoming an international financial centre matching London, New York, and Singapore. However, this possibility has been blocked by weaknesses in financial regulation in India. Factor market reform needs to be an immediate priority for the government.

The Financial System

The Draft Indian Financial Code

2.114 The Indian financial system is increasingly out of touch with the requirements of the economy today and the even greater requirements of the economy in the future. Most changes in the framework of financial regulation in India have been made in response to the need of the hour. This has meant piecemeal changes to the various laws that give powers to regulators to regulate finance.

The Draft Indian Financial Code puts consumer protection at the heart of all financial-sector regulation.

2.115 Over the last decade, a consensus has emerged about the direction of reforms through a series of expert committees, which have drawn on hundreds of independent experts and a body of research on the failings of Indian finance. However, many of the changes proposed are incompatible with the basic structure of existing laws. The FSLRC was set up to review and redraft the laws so that Indian finance can be reformed to prepare India for growing into a modern economy, without having to constantly amend existing laws to incorporate each new step for the financial system.

2.116 The task for the Commission, which submitted its report in April 2013, was to question the fundamental arrangements between regulators, the government, the regulated, and the consumer for whose protection regulation is ultimately being done. The FSLRC proposed a new draft law: the Indian Financial Code. This law puts consumer protection at the heart of all financial regulation. In order to protect the consumer without putting a burden on the taxpayer, regulators do micro-prudential regulation and reduce the risk of failure of financial firms. They protect policy holders and prevent unsuitable products from being sold through regulations about consumer protection and through redressal forums. When financial firms fail, shareholders should bear the full brunt of the failure, but consequences for consumers and the economy should be blocked using a resolution corporation. Through systemic risk regulation, the regulators and the government prevent a large-scale disruption of financial services. This adds up to a rational approach to interventions by financial agencies in the financial system, as opposed to the existing approach of command and control.

2.117 A major theme of many of the recommendations of previous committee reports in India has been the impediments placed by financial agencies against progress. This issue has been addressed by the FSLRC by giving regulators clear objectives and enumerated powers. The regulator in this scenario needs to demonstrate that the regulation is required to meet the objectives assigned to him, and it lies within his powers, and that a cost-benefit analysis of the regulation shows that the additional cost, monetary or otherwise, of complying with this regulation is going to bring clear benefits to the economy.

2.118 The Indian Financial Code is on the legislative agenda. Existing financial regulators have committed themselves to complying with the *Handbook on adoption of governance enhancing and non-legislative elements of the draft Indian Financial Code*, through which some features of the draft Code are utilised for improving the working of existing agencies. This legislative and non-legislative work is now the centrepiece of financial reforms in India.

Capital controls

Capital controls under FEMA do not support a rapidly globalizing economy.

2.119 An integral feature of the maturation of the Indian economy has been the internationalisation of firms. Firms are much more connected into the world economy through exports, outbound FDI, imports of goods and services, foreign equity capital, foreign debt capital, and use of overseas derivatives markets.

2.120 Cross-border activities are regulated as per capital controls based on the Foreign Exchange Management Act (FEMA) 1999. All activities on the capital account fall under Section 6 of FEMA in which they are prohibited unless explicitly permitted. This is in contrast to Section 5 that covers the current account which is the mirror image of this philosophy and allows all transactions unless explicitly prohibited. Over the last 15 years, thousands of pages of subordinate legislation have arisen surrounding capital flows. This large mass of law is characterised by complexity, bureaucratic overhead, violations of the rule of law, and legal risk. The ground realities of this area are far removed from the good governance that India aspires for. There is a need to drastically simplify cross-border activities as an element of reducing the cost of doing business in India. Numerous EMs are doing better than India on this.

Central Planning permeates every aspect of the food economy.

2.121 For example, a single window for FDI can be effectively created if all rule making under FEMA rests within a department of the Government of India, and all transactions are permitted other than those in explicit negative list.

Food

2.122 One area which has been left behind in India's liberalisation and competition agenda is food. In the field of services and industry, Indian producers have achieved substantial freedom of action, and compete all over India and the world. In the field of food, Indian producers face substantial restrictions. The government does not permit a producer to sell freely to a neighbour or neighbouring district. A complex regulatory system is in place.

The welfare of both consumers and farmers lies in freeing up agricultural markets in the same way that economic freedom was given to other producers.

2.123 The most comprehensive central planning system is in the market for cereals. The state controls input prices such as those of fertilizer, water, and electricity, which distorts input choices. The state sets output prices and supplants private trade with an administrative machinery that undertakes procurement. It supplants the private sector in the field of storage through godowns of the FCI. It supplants the private trade in distribution, attempting to deliver cereals all across the country through the PDS. This central planning system harms the country in three ways. The visible cost is the direct cost of operations and delivery. In addition, there is the hidden cost of leakages, inefficiency, and illegality that flourish alongside the public system. The most important cost, however, is the inefficient utilisation of resources and structure of production that follows from the choices of the central planner. This was necessary for a long period of time because of inadequate development in the agriculture sector. The time has perhaps come to remove many of these inefficiencies by introducing a more competitive framework.

2.124 In recent decades, rising incomes in India generated a shift away from staples like wheat and rice towards superior goods like vegetables, fruits, eggs, milk, and meat. In a market economy, resources would get reallocated reflecting this shift in purchasing patterns. A modest shift in relative prices, e.g. the ratio of the price of spinach to the price of wheat, should generate a shift in the resource allocation away from wheat towards spinach. The rigidities of the command-and-control economy have impeded this process. As a consequence, a large shift in relative prices is required to generate the required supply response. This has resulted in high food inflation.

Market-based economies often provide income support, food stamps, and cash transfers to farmers and producers for protecting them but without distorting market signals.

2.125 Other interventions by the government are also problematic. The first is the maze of restrictions on transactions and storage. This includes state-level APMC laws, the Essential Commodities Act, and the administrative measures at local and state levels that distort the decision to grow and the decision to store.

2.126 Another problem concerns international trade. In industry and services, Indian producers have thrived owing to international economic integration. Producers have benefited from vast enhancement of potential market size. Specialisation has come about: India imports capital-intensive computer hardware and exports labour-intensive computer software. The rolling back of autarkic policies has been the central source of India's growth acceleration from 1979 onwards.

2.127 India has a unique opportunity to achieve prosperity through agricultural production. The weather permits multiple crops around the year. While there are other locations in the world that excel at mechanised production of cereals on large tracts of land, large parts of high value agriculture are highly labour intensive. India can be a producer and exporter in all these areas. This can result in high incomes for all participants in the production process. A livelihood in agriculture does not have to be a promise of poverty.

Liberalising Agriculture

2.128 State APMC laws are a major hurdle to modernisation of the food economy. They have artificially created cartels of buyers who possess market power. The proposed Model APMC Act 2003 is an inadequate solution, as APMCs remain a non-level playing field. In addition, some state governments have introduced barriers to trade within the country through taxation and technical requirements. The Essential Commodities Act 1955, an enabling Act which gives powers of intervention to state governments is incompatible with an integrated competitive national market for food.

The key to investment and productivity growth on the farm is liberalization of agriculture.

2.129 Parliament has the power to legislate a national market under the Constitution, which gives it the ability to legislate the freedom to buy and sell, for farmers and traders, across state lines. This law can override state APMC laws and restrictions that have been placed on the farmer's right to sell food within and outside the state. Under such a law, APMCs would become one among many trading venues in a competitive market. Further, under the Constitution, Parliament can legislate the creation of a Commission that monitors the country for anti-competitive practices. To create a national market the central government needs to use powers under the Union List and the Concurrent List of the Seventh Schedule of the Constitution to end the monopoly powers of the APMCs and replace other punitive and coercive state laws affecting the food market.

2.130 Alongside the removal of conventional interventions in the food economy, there is a need to place a priority upon the three national-level public goods in the field of food: production of knowledge, financial regulation of futures trading, and information interventions that address the market failure in warehousing.

2.131 There are three groups of public goods in the field of food. The first consists of scientific research and extension. Knowledge is non-rival and non-excludable; the private sector has inadequate incentives to produce knowledge. Hence there is a role for intelligent public funding for multiple competing research programmes at universities globally and for public-sector extension programmes to communicate current research knowledge to producers across the country.

Farmers must have the same economic freedom, to buy and sell their produce, as do other producers.

2.132 The second lies in the field of commodity futures trading. The standard market failures of organised financial trading are found in commodity futures trading. Commodity futures trading is essential for a modern food sector as it generates forecasts about future prices that shape sowing and storage decisions across the country.

2.133 The third lies in the field of warehousing. The market failure in the field of warehousing consists of asymmetric information between the producer and the user of warehousing services about the level of care that will be exercised in safe storage. Information-based initiatives can help reduce this asymmetric information. The Warehouse Development and Regulatory Authority (WDRA) has begun a work programme on creating public goods of information systems about the performance of warehouses across the country. This addresses the cause of the market failure in warehousing.

Institutionalizing institutional change

2.134 India's journey to prosperity is primarily about utilising labour and capital better, i.e. in improving productivity. While the productivity of firms is the consequence of decisions by managers of firms, these actions are strongly shaped by government policies, laws, and regulations. In the last 20 years, many major initiatives have induced productivity growth, including rationalisation of tax policy, removal of trade barriers, shrinking of the licence raj, floating of the exchange rate, and establishment of an equity market.

2.135 This chapter has sketched the agenda for change in numerous areas, with an emphasis on the problems of state capacity: the modifications to laws, agency architecture, organisation structures, process manuals, and human resources through which state effectiveness can be obtained.

A continuous process of improvement of institutions must be created.

2.136 In the past, reforms have taken place in a sporadic and episodic manner, reflecting crises and divergent responses of individuals to policy problems. A key objective for policy should be to institutionalise the process of institutional change, so that a continuous process of improvement of institutions takes place at all times – regardless of whether there is a short-term crisis and regardless of the persons making decisions.

2.137 Drawing on international experience, this process could be assisted by the establishment of a Productivity Commission, which would be an advisory expert body. This would establish metrics and contract out the production of report cards about areas where outcomes are desired. It would review laws, regulations, organisation structures, and process designs with the objective of improving productivity. This should be a statutory body, which is obliged to undertake these reviews and release findings into the public domain, while having no executive powers.

2.138 Many advanced economies have institutionalised the process of bringing about institutional change through these kinds of mechanisms. However, these are generally slow-growing countries that achieve one doubling every 20 to 25 years. In contrast, Indian GDP doubles every 10 years or less. As a consequence, an even greater pace of institutional change is required in India for government structures to keep up with the needs of the economy. The design of the Productivity Commission needs to be commensurately modified, reflecting the need for comprehensive redesign of the government every decade in India.

Conclusion

2.139 The ultimate goal of economic policy is to create a sustained renaissance of high growth in which hundreds of millions of good quality jobs are created. Good quality jobs are created by high productivity firms, so this agenda is critically about how firms are created, how firms grow, and how firms achieve high productivity.

2.140 Labour laws create strong incentives for firms to avoid hiring a large number of low skill workers. An array of problems holds back the entry and maturation of new firms. This protects existing businesses, even if inefficient, and limits entry and competition. It is imperative to use India's unique demographic moment wisely and unleash the second generation of reforms.

2.141 The pursuit of long-term initiatives will feed back into the economy in the short term, with a rise in consumption and investment. In India today, there is a coincidence between the priorities for the long term and the priorities for the short term. At the same time, the deeper impact of these policy initiatives will kick in with a lag. When there is an open array of opportunities for individuals and firms, it will take some time for economic agents to understand the new landscape and how they should optimally act in it. Firms will require time and commitment in order to build up organizational capital. Hence we may envision a five year period within which the reforms are put in place, followed by a period within which the economy has fully absorbed the new environment and achieved a higher trend growth rate.