Fiscal Correction for Economic Growth

Data Analysis and Suggestions

Rapid economic growth is the only solution to the problem of poverty and such growth is not possible without significant fiscal correction. The key objective of fiscal reform has to be a reduction in public debt service payments. This article analyses data on state and central government revenues and expenditures to suggest ways to climb out of the debt trap.

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We have come a long way since independence (Table 1). The year 1947 marked a major departure from almost a thousand years of political, economic and social subjugation. The country was then literally in darkness. Compared with 85,000 MW of installed power generation capacity today the total installed capacity in 1947 was 1362 MW. The life expectancy at birth was 32 and overall literacy was 17 per cent. By 1991 life expectancy had increased to 60 and literacy to 52 per cent. Official poverty estimates hovered around 50 per cent in the first three decades after independence but have declined since to about 35 per cent. The 1960s witnessed a serious bout of food insecurity but measures taken since then have resulted in more than 20 years of relatively comfortable food self-sufficiency.

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

The progress achieved in the 1980s should have taught us the lesson that higher economic growth must be the key objective of economic policy, and that it is only higher economic grwoth that makes reduction in poverty possible. Redistribution of wealth is no answer when there is nothing to distribute. The nation cannot be secure without economic strength and economic strength cannot be achieved without substantial economic growth. This can be seen by looking at the long-term decline of both China and India. India began its decline as an economic power from the early part of the 18th century, while China's decline perhaps began in the early part of the 19th century (Tables 2a and 2b). It would appear that India accounted for about 16 per cent of world income in the early 1800s whereas China was about double that at 32 per cent. The share of both these countries declined over the next century and a half and fell to about 4 per cent for India and 5 per cent for China by 1950. Correspondingly it was Europe and the US that gained substantially over this period. It is also notable that Europe's economic peak came at the turn of this century, which also coincides with its zenith in terms of political and military power. India's improved economic performance since the early 1980s has substantially increased its share of world income from about 3.4 per cent in the late 1970s to about 4.6 per cent now. However during this period China's superior economic performance doubled its share of about 5 per cent in the late 1970s to about 11 per cent now. This has been achieved by a major step up in investment and economic efficiency brought in through the active implementation of economic reforms throughout this period. Thus the achievement of long-term and sustainable economic welfare requires a major acceleration in Indian economic growth over the next 10 to 20 years. This requires substantial enhancement of overall investment levels and improvement in economic efficiency.

The countries which have achieved high annual growth in excess of 6 per cent in per capita income in the last three decades have done so through significant increases in their gross investment rates (Table 3). The achievement of per capita income growth of 6 per cent in India over the next 10 years will require a GNP growth rate of over 7.5 per cent per annum. Even if this were achieved Indian per capita income in the year 2010 would not exceed what the per capita income was of countries such as Thailand before 1985. In other words, even if we are able to achieve a significant step up in our economic growth we will still be substantially behind most east Asian countries. Most countries which have succeeded in stepping up their growth rates to about 6 per cent were able to do so by substantial increases in gross domestic capital formation in excess of 30 per cent of GDP. The current Indian investment ratio is hovering around 25 per cent to 27 per cent. This needs to be stepped up to more than 30 per cent within the next few years. A primary driver of higher economic growth is investment in infrastructure. The *India Infrastructure Report* had projected that the achievement of GDP growth of over 7 per cent will require an increase in investment in infrastructure from the prevalent levels of about 5 to 5.5 per cent of GDP in the mid-1990s to about 8 per cent of GDP by 2005-06. It had concluded that it would not be possible to achieve this unless the public sector kept up its existing rate of investment in infrastructure amounting to about 4.5 per cent to 5 per cent of GDP, while increasing private sector investment in infrastructure substantially to account for the balance. Private investment in infrastructure would have to increase from about 0.5 to 1 per cent of GDP in the mid-1990s to 2.5 per cent to 3 per cent of GDP by about 2005. Thus, the achievement of higher growth requires the maintenance of public investment in infrastructure facilities at a high level while policies are changed to facilitate increasing levels of private investment.

The main impediment to the achievement of this scenario is the deteriorating fiscal situation of both the central and state governments in India. Government's ability to invest has been declining continuously since the late 1980s because of its deteriorating fiscal position (Table 4). What is encouraging, of course, is the increase in private corporate sector investment levels subsequent to the 1991 reforms. The reforms have therefore succeeded in encouraging higher levels of private investment as envisaged. But further increases are constrained by declining public investment levels.

I am therefore concentrating on the rapid deterioration of the fiscal balance at both central and state levels. I believe that the key deterrent to achieving higher economic growth in the country lies in its deteriorating fiscal performance.

I
Central Government Finances 1980-2000

In order to understand the current fiscal predicament of the central government it is necessary to examine the pattern of central government expenditure and revenues over at least the last 20 years. As already mentioned above, the key threat to sustainable economic growth and to economic security is the substantial decline in investment expenditures made by the government.

The total expenditure of the central government increased from an average of 16.8 per cent of GDP in 1980-85 to about 20.5 per cent in 1985-90 and has then declined to between 16 to 17.5 per cent in the late 1990s. At the same time non-plan expenditure has increased substantially from about 10 per cent in the early 1980s to about 13 per cent of GDP now. (Tables 5a, and 5b). What is most notable is the very significant increase in expenditure that occurred in the second half of the 1980s. These increases took place in almost all categories of non-plan expenditure such as interest payments, defence expenditure, subsidies, pensions, and loans to states. During this period other non-plan expenditures, which consist mostly of salary payments to government servants, remained roughly stationary at about 2.25 per cent of GDP. Plan expenditures were kept high at about 6.5 per cent to 7 per cent of GDP throughout the 1980s. Correspondingly capital expenditures of central government were sustained at levels of 6 per cent to 7 per cent of GDP. Both plan expenditures and capital expenditures of the central government have fallen to levels of about 4 per cent of GDP or less now.

The great improvement in growth in the 1980s (Table 6) was therefore partially bought by high government expenditures: both plan and non-plan and revenue and capital. That this was not a sustainable pattern of growth was demonstrated dramatically in 1991 by the twin balance of payments and fiscal crises, which led to the economic reform programme begun in 1991. The non-sustainability of such fiscal expansion is demonstrated by the sustained increase in interest payments from 2.2 per cent of GDP in the early 1980s to about 4.7 per cent now. Interest payments now constitute the largest component of expenditure of the central government. The Fifth Pay Commission is currently regarded as the villain of the piece in causing the current fiscal problems. Analysis of the data as documented here suggests that this is not the case at the central government level. The total cost of government salaries excluding defence and police (roughly corresponding to the item 'other non-plan expenditure') when expressed as a proportion of GDP, can be seen to be much lower now than it was throughout the 1980s. In other words, non-plan expenditure on government salaries and wages has not increased as fast as GDP over this period. Interest payments are now at least three times that the non-plan government expenditure excluding the military and the police. The key area for action in correcting this fiscal imbalance is related to rising debt servicing obligations of the central government.

What becomes clear from examination of the data is that the 1980s were characterised by a significant increase in public sector investment as well as other government expenditure. It is also noteworthy that defence expenditure increased substantially in the late 1980s, rising from

Table 1: Progress Since Independence: Key Indicators

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

Table 2a: Shares of World GDP
(Per cent)

	1700	1820	1890	1952	1978	1995
China	23.1	32.4	13.2	5.2	5.0	10.9
India	22.6	15.7	11.0	3.8	3.4	4.6
Japan	4.5	3.0	2.5	3.4	7.7	8.4
Europe	23.3	26.6	40.3	29.7	27.9	23.8
US	0.0	1.8	13.8	28.4	21.8	20.9
USSR/ Russia	3.2	4.8	6.3	8.7	9.2	2.2

Table 2b: Rates of Growth of World GDP
(Annual average compound growth rates)

	1700-1820	1820-1952	1952-78	1978-79
China	0.85	0.22	4.40	7.49
India	0.26	0.54	4.02	4.63
Japan	0.21	1.74	7.85	3.21
Europe	0.68	1.71	4.27	1.74
US	2.57	3.78	3.46	2.47
USSR/Russia	0.86	2.08	4.75	–5.56
World	0.57	1.62	4.52	2.70

Source: Maddison, Angus (1998): *Chinese Economic Performance in the Long Run*, OECD, Paris.

Table 3: Gross Investment Rates in Current Prices – Selected Countries

Country	Gross Investment/GDP (Per Cent)		
	1952-57	1958-77	1978-94
India	12.0	16.4	23.3*
China	23.2	28.0	34.2
Japan	26.9	34.3	30.3
Korea	NA	23.3**	32.5
Taiwan	15.2	24.4	25.9
France	18.8	25.2	21.0
Germany	23.4	25.2	20.6
UK	15.3	18.7	17.4
US	19.0	18.5	18.7

Notes: * 1978-91. ** 1960-77.
Source: Maddison 1998, op cit.

Table 4: Declining Public Investment

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

Source: Government of India, *Economic Survey*, various issues.

about 2.8 per cent of GDP in the early 1980s to about 3.4 per cent in the late 1980s and then declining to a relatively constant level of about 2.5 per cent of GDP.

The debt service burden of the government would not rise as a proportion of total expenditure if the investments made by the government from borrowings yield it adequate returns either through the generation of non-tax revenues or through tax revenues. As the government borrows resources from the public to invest in new assets, tax revenues should rise through additions to public good assets. Improvement in public infrastructure should lead to improvement in efficiency and in aiding new private investment, and hence to buoyancy in tax revenues. Similarly, non-tax revenues should rise through increasing dividends from public enterprise investment in infrastructure and other activities. If, however, resources are borrowed for investment in activities which do not yield adequate returns, debt service payments will rise continuously as a proportion of total revenues. This is what seems to have happened in India over the last 20 years. The return on net worth in central public sector enterprises, excluding petroleum companies, is not significantly different from zero. Thus investments made in infrastructure or other activities through public sector enterprises have not yielded pecuniary returns to the government. Such returns would occur as increasing dividend payments from the public enterprises to the central government. In the budget they would be shown as 'non-tax revenues'. Wrong pricing policies, inefficient public enterprise operations and other difficulties have all contributed to this situation of low returns. With the government running a revenue deficit since the early 1980s, all government and public sector investment has come from resources borrowed by the central government. In the presence of no returns from such investments, debt service payments are bound to become an increasing burden.

It is now useful to examine the revenue pattern of the central government over the last 20 years to understand how debt service payments have been increasing so continuously. Corresponding to the increase in expenditure in the late 1980s an attempt was clearly made to also increase revenues over that period. The main increase in revenues took place in collection from custom duties, rising from about 2.8 per cent of GDP in the early 1980s to about 3.9 per cent in the late 1980s. This happened both as a consequence of increased imports (which led to the balance of payments crisis) and increase in levels of custom duties. The latter of course led to greater inefficiency in resource allocation as well as decline in export competitiveness. By the end of the 1980s, at an average of almost 110 per cent, India probably had the highest level of customs duties in the world. Subsequent to the economic reforms in 1991 there has been a consistent increase in the share of direct taxes from about 2 per cent of GDP right through the 1980s to about 3 per cent now. This increase has taken place both in corporate income tax collection and in personal income tax collection (Tables 7a and 7b) despite reduction in rates.

The loss in tax revenues has taken place in indirect taxes, both in customs and in excise duties. Whereas customs duties collection were expected to fall as a result of major cuts in customs duties levels, the fall in excise duty collection is more difficult to understand. In principle, rising industrial production should give rise to buoyancy in excise duty collection levels as a proportion of GDP. However two factors have inhibited such expected growth. First, apart from the period 1993-96, in-

Table 6: Growth of the Indian Economy

Year	GNP	Per Capita
1950-80	3.5	1.3
1980-90	5.5	3.5
1990-2000	6.0	4.3
2000-2010	7.5	6.0

Ttable 5a: Profile of Expenditure of Central Gpvernment

(Per Cent of GDP)

	1980-85	1985-90	1990-95	1995-99	1997-98	1998-99 (RE)	1999-2000 (BE)
Non-plan expenditure	10.09	13.41	12.72	12.17	12.22	13.14	11.46
Interest payment	2.20	3.38	4.38	4.63	4.64	4.75	4.87
Defence	2.81	3.35	2.63	2.43	2.49	2.53	2.53
Total subsidy	1.41	1.95	1.78	1.34	1.38	1.52	1.32
Food subsidy	0.44	0.60	0.51	0.51	0.53	0.54	0.45
Other subsidy	0.97	1.34	1.27	0.84	0.85	0.98	0.87
Police	0.21	0.28	0.29	0.32	0.35	0.35	0.33
Pensions	0.27	0.42	0.40	0.47	0.49	0.62	0.56
Loans and advances to states and UTs	0.51	1.23	0.96	1.09	1.12	1.47	0.01
Grants to state and UTs	0.43	0.56	0.46	0.40	0.31	0.28	0.45
Other non-plan expenditure	2.25	2.25	1.82	1.48	1.45	1.62	1.39
Plan expenditureq	6.73	7.06	5.17	4.18	4.17	4.21	4.26
Total expenditure (plan + non-plan)	16.82	20.47	17.89	16.35	16.39	17.34	15.73
Revenue expenditure	10.69	13.70	13.27	12.78	12.74	13.42	13.13
Capital expenditure	6.13	6.78	4.62	3.58	3.65	3.92	2.60
Developmental	10.76	11.38	9.49	7.72	8.02	7.96	NA
Non-developmental	7.32	8.79	8.89	8.94	9.11	9.04	NA
Total expenditure (developmental + non-developmental)	18.09	20.16	18.39	16.66	17.13	16.99	NA

Table 5b: Composition of Expenditure of Central Government

(Per Cent of Total Expenditure)

	1980-85	1985-90	1990-95	1995-99	1997-98	1998-99 (RE)	1999-2000 (BE)
Non-plan expenditure	59.90	65.52	71.02	74.41	74.54	75.75	72.89
Interest payment	13.07	16.52	24.59	28.34	28.28	27.40	30.99
Defence	16.72	16.35	14.70	14.89	15.20	14.61	16.09
Total subsidy	8.35	9.52	9.86	8.20	8.40	8.76	8.39
Food subsidy	2.62	2.94	2.85	3.09	3.23	3.09	2.89
Other subsidy	5.74	6.58	7.01	5.11	5.17	5.67	5.51
Police	1.24	1.35	1.65	1.94	2.11	2.00	2.08
Pensions	1.60	2.04	2.25	2.87	2.97	3.57	3.57
Loans and advances to states and UTs	2.86	6.03	5.31	6.62	6.82	8.48	0.04
Grants to state and UTs	2.58	2.76	2.52	2.49	1.90	1.61	2.87
Other non-plan expenditure	13.48	10.95	10.14	9.07	8.86	9.33	8.86
Plan expenditure	40.10	34.48	28.98	25.59	25.46	24.25	27.11
Total expenditure (plan + non-plan)	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Revenue expenditure	63.55	66.91	74.30	78.15	77.71	77.38	83.49
Capital expenditure	36.45	33.10	25.70	21.85	22.29	22.62	16.51
Developmental	59.53	56.41	51.56	46.34	46.81	46.82	NA
Non-developmental	40.47	43.59	48.44	53.66	53.19	53.18	NA

Source: Government of India, Budget Documents, various years.

dustrial growth has not been as high as had been expected from the economic reforms. Thus the share of industry in GDP has remained stagnant. It is the share of services that has risen continuously, and services largely remain untaxed at the central level. Second, the progressive extension of MODVAT to the whole industrial sector has also led to a fall in excise duty collection as a proportion of GDP. The share of non-tax revenues has remained stagnant between 2.6 per cent and 3 per cent since the mid-1980s. Higher investment has not provided higher returns.

Gross tax revenues have remained at a level of about 10 per cent over the last 20 years except for the second half of the 1980s. During this period and in the early 1990s total expenditure, however, was at much higher levels. The shortfall in revenues has been made up by the central government through consistently high capital receipts of between 6 per cent to 7. 5 per cent of GDP right through the last 20 years (Table 8). The notable feature in the pattern of capital receipts over the last 20 years is the increasing share of both public borrowing (internal debt) and small savings: the most expensive sources of capital receipts for the government. Whereas these two sources amounted to about 2.7 per cent of GDP in 1980-85 and about 43 per cent of total capital receipts in 1980-85 they now account for about 6 per cent of GDP and about 75 per cent of total capital receipts. External assistance is no longer an important source of financing for the government. Small saving receipts are extremely expensive forms of borrowing for the government because of the associated tax benefits that are given to small savers. Besides 75 per cent of small savings receipts are passed on to state governments to finance their fiscal deficits. (It is because of this that the system was changed as of the current year 1999-2000 to exclude both the receipts and advances to state governments related to small savings.)

Two changes in the system have made the cost of borrowing much higher for the central government in the 1990s. Earlier, a substantial portion of the fiscal deficits was financed by monetisation (Table 9). This is no longer resorted to and hence the explicit interest cost of the fiscal deficit has consequently increased. Second, interest rate deregulation has made the cost of government borrowings equivalent to market rates, which was not the case earlier, when banks had to lend to the government at lower than market interest rates.

The consequence of a sustained high fiscal deficit over 20 years can be seen in Table 10. Debt service payments of the central government have risen inexorably from about 30 per cent of tax revenues in 1980-85 to about 70 per cent now. The day is not far off when the tax revenues will equal debt service payments. As a proportion of total revenue receipts debt service has increased from about 24 per cent in 1980-85 to about 50 per cent now. As a proportion of GDP, debt service payments have increased from about 2.2 per cent in 1980-85 to about 5 per cent now. Another consequence of rising debt service is that the revenue deficit has increased from about

Table 7a: Profile of Total Revenues of the Central Government
(As Percent of GDP)

	1980-85	1985-90	1990-95	1995-99	1997-98	1998-99 (RE)	1999-2000 (BE)
Revenue receipts (net)[1]	9.43	11.11	10.07	9.72	9.46	9.70	9.59
Gross tax revenue	9.93	11.20	10.26	9.75	9.84	9.15	9.28
Direct taxes	2.06	2.08	2.36	2.84	2.62	2.98	3.03
Corporate	1.16	1.07	1.24	1.50	1.41	1.66	1.65
Income	0.90	1.01	1.12	1.34	1.21	1.32	1.38
Indirect taxes	7.50	8.82	7.54	6.45	6.23	5.90	5.98
Customs	2.76	3.92	3.28	3.00	2.84	2.62	2.71
Excise	4.74	4.89	4.27	3.44	3.39	3.27	3.27
Other tax revenue	0.37	0.30	0.35	0.47	0.99	0.27	0.27
Share of states in tax revenue	2.64	2.84	2.75	2.71	3.08	2.41	2.48
Non-tax revenue	2.13	2.77	2.57	2.68	2.70	2.96	2.80

Note: 1 Revenue Receipts (net) = (Gross tax revenue – share of states) + Non-tax revenue.
Source: Government of India, Budget Documents, various years.

Table 7b. Composition of Revenue of Central Government
(Per Cent of Total Revenue)

	1980-85	1985-90	1990-95	1995-99	1997-98	1998-99 (RE)	1999-2000 (BE)
Revenue receipts (net)[1]	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Gross tax revenue	105.46	100.80	101.84	100.31	103.97	94.31	96.72
Direct taxes	21.91	18.76	23.60	29.18	27.72	30.75	31.56
Corporate	12.27	9.64	12.42	15.44	14.95	17.16	17.18
Income	9.64	9.12	11.18	13.74	12.77	13.59	14.38
Indirect taxes	79.64	79.35	74.79	66.29	65.84	60.79	62.35
Customs	29.27	35.28	32.43	30.87	30.02	27.05	28.23
Excise	50.37	44.07	42.36	35.42	35.82	33.74	34.12
Other tax revenue	3.90	2.69	3.44	4.84	10.42	2.77	2.81
Share of states in tax revenue	28.07	25.61	27.39	27.93	32.52	24.84	25.86
Non-tax revenue	22.55	24.94	25.63	27.62	28.55	30.53	29.14

Note and Source: Same as Table 7a.

Table 8: Profile of Capital Receipts of Central Government

	1980-85	1985-90	1990-95	1995-99	1997-98	1998-99 (RE)	1999-2000 (BE)
Per cent of GDP							
Internal debt (net)	1.93	1.85	1.79	2.70	2.30	3.99	3.72
External assistance	0.86	0.66	0.65	0.10	0.08	0.06	0.05
Recovery of loans	1.32	1.15	0.87	0.62	0.59	0.71	0.61
Small savings (net)	0.76	1.47	1.29	1.46	1.73	1.78	0.44
State povident funds (net)	0.19	0.24	0.22	0.26	0.31	0.33	0.33
Special deposits (net)	0.49	1.27	1.07	0.46	0.32	0.57	0.58
Disinvestment	0.00	0.00	0.26	0.17	0.06	0.55	0.55
Other capital receipts	0.66	0.66	0.40	0.34	1.55	-0.55	–0.16
Total capital receipts	6.21	7.30	6.54	6.10	6.94	7.44	6.14
Per cent share							
Internal debt (Net)	31.43	25.37	26.39	43.99	33.11	53.64	60.67
External assistance	14.38	9.03	10.26	1.82	1.11	0.75	0.76
Recovery of loans	21.46	15.79	13.65	10.35	8.47	9.51	10.01
Small savings (net)	11.48	20.38	19.39	23.90	24.95	23.96	7.22
State povident funds (net)	3.14	3.23	3.41	4.14	4.46	4.42	5.42
Special deposits (net)	7.96	17.54	16.50	7.82	4.56	7.63	9.44
Disinvestment	0.00	0.00	4.12	2.40	0.93	7.44	9.03
Other capital receipts	10.14	8.65	6.28	5.59	22.40	–7.36	–2.54
Total capital receipts	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Government of India, Budget Documents, various years.

17 per cent as a proportion of fiscal deficit in 1980-85 to about 50 per cent now. In other words, half of current borrowing goes to finance current expenditure. By definition current expenditure yields no economic returns in the future and hence debt service payments will continue to rise in the foreseeable future unless a significant correction is made in this situation.

I now summarise the story so far. The central government has resorted to a fiscal system of high fiscal deficits on a consistent basis over the last 20 years. The second half of the 1980s was exceptional in the attainment of much higher fiscal deficits than other periods and this resulted in the crisis of 1990-91. The consequences of such a sustained high fiscal deficit are many. With increasing levels of borrowing to finance activities which have zero or low yields, interest payments increase inexorably. Thus non-productive committed current expenditures rise giving rise to higher and higher revenue deficits. This leads to yet higher and higher borrowing levels. Second, because of debt service payments forming a higher proportion of both revenues and expenditures all other activities of the government suffer, since wages and salaries, interest payments, defence expenditures, pensions, food subsidies are all committed expenditures with little or no flexibility. The main sufferer in this process is government capital expenditure in both social and infrastructure facilities. Third, high debt service payments also preclude increase in or even maintenance of current real levels of expenditures in social services. The continued high levels of public borrowings also have an effect on the rest of the economy through prevalence of high interest rates. Because of the necessity to finance government deficits the Reserve Bank of India has to keep the level of both CRR (cash reserve ratio) and SLR (statutory liquidity ratio) high on the deposits in commercial banks. This leads to the necessity for banks to have higher margins on their commercial activities thereby subjecting the rest of the economy to high interest rates. Moreover, because of the voracious appetite of the government for garnering resources from the whole financial sector, including small savings, insurance and the like, the continued high fiscal deficit levels also impede financial sector reforms which are necessary for the economy to achieve higher efficiency levels. With this scenario the possibility of achieving a growth rate in excess of 7 per cent would seem to be ruled out. Such a growth rate cannot be achieved without investment levels higher than 30 per cent of GDP and this cannot be achieved without substantial increase in both public savings and public investment levels.

II
Deteriorating State Finances

Having documented the sorry state of central government finances it is now useful to examine state finances. We can remind ourselves of the function of state governments in order to appreciate the deleterious effects of deteriorating state finances on the economic security of the country. State governments are responsible for most public expenditures for the provision of social services. Further, they are responsible for most infrastructure services except for telecommunications, civil aviation, railways and major ports. They are also responsible for law and order. Thus a deterioration in the state's ability to invest is very serious for human development and hence for internal security, in addition to the harmful effects on economic growth.

I first examine the overall profile of state government finances before focusing particularly on their plan expenditure. As in the case of the central government, a significant increase took place in total expenditures during the late 1980s, from a level of about 16 per cent of GDP in 1980-85 to 17.3 per cent in 1985-90 (Table 11). This has been falling in the 1990s to about 16.5 per cent in the late 1990s. Similar to the central government, the main adjustment has been made in capital expenditure, falling continuously from a level of about 5 per cent of GDP in the early 1980s to about 3 per cent now. Whereas the ratio of revenue to capital expenditure was about 70: 30 in the early 1980s, it is now about 83:17, which constitutes a significant deterioration in the quality of expenditure. In the case of state governments, unlike the central government, capital expenditure fell during the late 1980s as well. But, just as in the central government, the main problem lies in increasing debt service payments, from only about 0.9 per cent of GDP in the early 1980s to about 2.3 per cent now. Similarly, other committed expenditures such as pensions have also been rising. The net result is that, with falling overall expen-

Table 9: Composition and Financing of Gross Fiscal Deficit of Central Government

(As Percentage of GDP)

	1980-85	1985-86	1990-95	1995-9	1995-96	1996-97	1997-98
I Total expenditure (A+B)	15.20	19.03	17.61	16.27	15.78	15.57	16.39
(A) Revenue expenditure	10.59	12.94	13.27	12.99	12.93	12.87	12.74
(B) Capital expenditure	4.60	6.09	4.33	3.28	2.85	2.70	3.65
II Total receipts (A+B)	9.10	10.69	10.93	10.45	10.39	10.35	10.11
(A) Revenue receipts	9.10	10.69	10.07	9.94	10.27	10.31	9.46
(B) Non-debt capital receipts	0.00	0.00	0.86	0.52	0.12	0.04	0.65
III Gross fiscal deficit	6.10	8.33	6.68	5.82	5.38	5.23	6.28
Financed by:							
(1) Domestic financing	5.16	7.78	5.95	5.51	4.51	4.99	6.21
(a) Market borrowings	1.97	1.86	1.77	2.70	2.96	1.57	2.30
(b) Other liabilities	1.37	3.89	2.94	2.54	1.52	2.39	3.91
of which:							
(i) Small savings	0.82	1.64	1.20	1.34	0.90	0.95	1.73
(ii) State provident funds	0.16	0.16	0.22	0.26	0.20	0.18	0.34
(c) Conventional deficit	1.82	2.03	1.23	0.27	0.03	1.03	0.00
(2) External financing	0.94	0.55	0.74	0.31	0.88	0.23	0.08
Conventional deficit/domestic financing (per cent)	35.29	26.04	20.85	10.66	0.63	20.68	0.00

Sources: Government of India, Budget Documents, various years.
Reserve Bank of India, *Currency and Finances*, various years.

Table 10: Burden of Rising Debt Service of Central Government

	1980-85	1985-90	1990-95	1995-99	1997-98	1998-99 (RE)	1999-2000 (BE)
As per cent of							
Tax revenue	30.1	40.5	58.9	65.9	68.6	70.5	71.7
Revenue receipts	23.5	30.4	43.7	47.6	49.0	49.0	50.8
Total revenue	14.3	18.4	26.4	29.3	28.3	27.7	31.0
Total expenditure	13.3	16.5	24.6	28.3	28.3	27.4	31.0
GDP	2.2	3.4	4.4	4.6	4.6	4.8	4.9
Revenue deficit/fiscal deficit	17.0	32.0	48.0	50.0			

Source: Goernment of India, Budget Documents, various years.

diture and rising 'non-developmental' expenditures, the state governments' ability to invest in productive activities has been compromised very significantly. It is interesting to observe that, relative to the central government, states have performed better in keeping up their tax effort. Their own tax revenues have increased marginally from about 5.7 per cent of GDP in the late 1980s to about 6 per cent now (Table 12). Their share of central taxes has also remained stable. Hence, unlike the central government, they have not suffered from erosion of tax revenues. But it can be argued that, since service taxes such as sales tax are the responsibility of state governments, their share should have risen. In contrast, non-tax revenues (user charges + return from state public enterprises) have fallen. The net result is some deterioration in revenue receipts. Consequently with a rise in revenue expenditures in the 1990s, on account of rising debt service and other non-development expenditures, states have also recorded increasing revenue deficits in the 1990s. This has had serious consequences for their ability to sustain plan expenditure.

State finances have been undergoing significant deterioration particularly since the early 1980s. This has resulted in slowing growth in their plan expenditures relative to the centre. This is illustrated in Table 13, which shows the share of states in total plan outlays. Since the Second Five-Year Plan the share of states had been relatively stable from the mid-1950s to the late 1970s at around half of total plan expenditures. This has since deteriorated to only about 40 per cent or less in the late 1990s. The consequence is that the ability of state governments to invest in both social and physical infrastructure has declined considerably, since sub-national governments such as states are unable to indulge in deficit financing unlike the central government. Hence, whereas the states suffered slowing public investment through plan expenditures in the 1980s the central government was able to accelerate central plan expenditures which were financed by rising fiscal deficits, including deficit financing, right through the late 1980s.

The existing planning system has essentially resulted in the central government acting as a giant financial intermediary, borrowing from the public in different ways to finance plan expenditures at both the central and state levels. In this system there is no connection between the viability of projects and their financing costs. Since the introduction of the Gadgil formula for bloc plan assistance to the states, which comprise of loans to the extent of 70 per cent regardless of the end use of expenditures, the link between resources for financing and end uses has been completely broken. Different finance commissions have remarked on the untenability of this system, which does not distinguish between financing of public goods and private goods by state governments. The consequence has been that returns from these investments have been consistently low.

Table 13: Share of States in Plan Outlays
(*Per cent*)

Plan	Centre	States
First (1951-56)	36	64
Second (1956-61)	54	46
Third (1961-66)	49	51
Annual (1966-69)	51	49
Fourth(1969-74)	50	50
Fifth (1974-79)	48	52
Annual (1979-80)	46	54
Sixth (1980-85)	53	47
Seventh (1985-90)	59	41
Eighth (1992-97) (estimated)	62	38
Ninth (1997-2002) (projected)	58	42

Table 11: Profile of Total Expenditure of State Governments

Category	1980-85	1985-90	1990-95	1995-99	1997-98 (RE)	1998-99 (BE)
Per cent of GDP						
(A) Revenue expenditure (I+II+III)	11.1	13.1	13.6	13.5	13.9	14.1
I Developmental	7.9	9.1	8.9	8.1	8.5	7.8
II Non-developmental	3.1	3.8	4.6	5.2	5.2	6.0
– Interest payments and debt servicing	0.9	1.5	2.0	2.2	2.3	2.3
– Pensions	0.3	0.5	0.6	0.8	0.8	0.9
– Other expenditure	1.9	1.7	2.0	2.2	2.1	2.8
III Other Expenditure	0.1	0.1	0.2	0.2	0.2	0.2
(B) Capital disbursements (I+II)	5.0	4.3	3.4	2.8	3.0	2.8
I Total capital outlay	2.1	2.0	1.6	1.6	1.7	1.5
– Developmental	2.1	1.9	1.6	1.5	1.6	1.4
– Non-Developmental	0.1	0.1	0.0	0.1	0.1	0.1
II Others	2.9	2.3	1.8	1.3	1.3	1.3
Total expenditure (A+B)	16.1	17.3	17.0	16.4	16.9	16.8
Per cent of total expenditure						
(A) Revenue expenditure (I+II+III)	68.9	75.5	80.0	82.7	82.1	83.6
I Developmental	48.9	52.7	52.3	49.6	49.9	46.4
II Non-developmental	19.1	21.9	26.8	32.0	30.8	35.9
– Interest payments and debt servicing	5.3	8.8	11.5	13.4	13.6	13.9
– Pensions	2.1	3.2	3.7	4.8	5.0	5.2
– Other expenditure	11.7	10.0	11.5	13.7	12.2	16.8
III Other expenditure	0.9	0.8	0.9	1.1	1.3	1.3
(B) Capital disbursements (I+II)	31.1	24.5	20.0	17.3	17.9	16.4
I Total capital outlay	13.2	11.2	9.7	9.5	10.0	8.9
– Developmental	12.8	10.9	9.4	9.1	9.6	8.5
– Non-developmental	0.3	0.3	0.3	0.4	0.4	0.4
II Others	17.9	13.2	10.3	7.9	7.9	7.5
Total expenditure (A+B)	100.0	100.0	100.0	100.0	100.0	100.0

Source: RBI, *Report on Currency and Finance*, various years.

Table 12: Profile of Total Revenue of State Government

Category	1980-85	1985-90	1990-95	1995-99	1997-98	1998-99 (RE)
Per cent of GDP						
(A) Revenue receipts (I+II)	11.5	12.8	12.8	12.3	12.5	12.3
I Tax revenue	7.6	8.5	8.5	8.6	8.8	8.9
– Revenue from state taxes	5.1	5.7	5.7	5.8	6.0	6.0
– Share in central taxes	2.5	2.8	2.7	2.8	2.8	2.9
II Non-tax revenue	3.9	4.3	4.4	3.7	3.7	3.4
(B) Capital receipts	4.1	4.6	4.3	3.9	4.2	4.1
– Loans from center	2.3	2.7	2.1	2.0	2.2	2.2
– Revovery of loans	0.4	0.3	0.4	0.3	0.3	0.1
– Other receipts	1.5	1.6	1.8	1.6	1.7	1.8
Total revenue (A+B)	15.6	17.4	17.1	16.2	16.7	16.5
Per cent of total revenue						
(A) Revenue receipts (I+II)	73.7	73.6	75.0	75.9	74.9	74.8
I Tax revenue	48.6	48.8	49.5	53.2	52.9	54.1
– Revenue from state taxes	32.5	32.6	33.5	36.1	35.9	36.7
– Share in central taxes	16.2	16.2	16.0	17.1	16.9	17.4
II Non-tax revenue	25.1	24.8	25.5	22.7	22.0	20.7
(B) Capital receipts	26.3	26.4	25.0	24.1	25.1	25.2
– Loans from center	14.6	15.5	12.1	12.4	13.1	13.4
– Revovery of loans	2.4	1.7	2.3	1.8	1.6	0.8
– Other receipts	9.3	9.1	10.6	9.9	10.4	11.0
Total revenue (A+B)	100.0	100.0	100.0	100.0	100.0	100.0

In the existing system state governments borrow from the central government on the basis of the Planning Commission's Gadgil formula. Further, the volume of their market borrowings is governed by the central government, and the Reserve Bank of India borrows on their behalf at the same interest rate for all states. Thus their borrowings are not related in any way to their creditworthiness. Second their debt service payments, both to the central government and other institutional creditors are built into their budgets and are not at all related to the success or otherwise of the projects in which borrowed resources have been invested in. So far, all states have been able to keep up their debt servicing. But rising debt service payments have eroded their capacity to both maintain adequate levels of current expenditure and to make new investments. Since finance commission subventions are essentially formula based as well, there is little that it can do to address these problems. What is needed is some system of conditionalities to be embedded in both the Planning Commission and finance commission based fiscal devolution. If finance commission transfers to the states were increased, they would only result in higher fiscal deficits for the central government. The lack of connection between their fiscal health and ability to borrow or to receive subventions has encouraged states to be fiscally irresponsible and to subject user charges to populist considerations.

In principle, investments in public goods should result in higher tax revenues, whereas investment in private goods should result in higher revenues through the imposition of user charges for public services. This is true at the state government level also. The majority of public expenditures at the state level have gone into the financing of power generation, transmission and distribution through state electricity boards, the financing of state road transport corporations, the financing of urban development authorities for investing in urban infrastructure services, irrigation, housing and the like. Most of these activities (except irrigation) are carried out through public sector enterprises of different varieties. Irrigation is administered directly by government irrigation departments at the state level. If these enterprises had been able to impose appropriate economic pricing of their services they would have provided returns to state governments as dividends, and would have been able to service their direct debt fully. In fact, neither has happened. They have also not been able to generate net positive internal resources for investment for expansion of their services.

This is illustrated in Table 14, which shows the financing pattern of state plans for the Sixth, Seventh, and Eighth five-year plans, and the first two years of the Ninth Plan .The contribution of the balance of current revenue (BCR) to the financing of state plans, which was as high as 40 per cent of the total in the Sixth Five-Year Plan, has now declined to less than zero during the Eighth Five-Year Plan. Similarly the contribution of PSEs has been consistently negative through the whole period. Consequently, the share of borrowing by state governments has increased substantially from about 34 per cent of total resources for the state plan during the Sixth Plan to more than 50 per cent in the Eighth Plan (1992-97). Correspondingly the share of central assistance has also increased from 37 per cent in the Sixth Plan to more than 50 per cent plan in the Eighth Plan. The situation has taken a significant turn for the worse in the current Ninth Plan period. The BCR is significantly negative and the states have begun borrowing to finance current expenditures in substantial amounts. Thus the current situation is that almost the entire plan expenditure are now being financed by borrowing of one kind or another. Within the pattern of borrowing itself, the share of market borrowing has been increasing consistently and quite dramatically during the last few years.

That the overall worsening fiscal situation of state governments is relevant for the financing of investment expenditures is illustrated in Table 15. Capital outlays as a proportion of gross fiscal deficits have fallen from about 62 per cent in the late 1980s to less than 50 per cent now.

Similarly revenue deficit has risen as a proportion of gross fiscal deficit from about 7.7 per cent in the late 1980s to more than 35 per cent now. Consequently borrowing by state governments is now being devoted more and more to the financing of revenue expenditures rather than capital expenditures. This can only lead to further worsening of the fiscal situation in the coming years. The resources available for investment will decline continuously in the foreseeable future unless there is a change in the system.

The overall state averages exhibited above naturally mark the considerable differences between states. In general, the

Table 15: Selected Fiscal Ratios for State Governments
(*Per cent*)

Year	Capital Outlay/ Gross Fiscal Deficit	Interest Payments/ Revenue Expenditure	Revenue Deficit/ Gross Fiscal Deficit
1985-90	62.4	10.8	7.7
1990-95	55.3	13.6	24.6
1996-98	47.5	15.8	35.8

Source: *Reserve Bank of India Bulletin*, February 1998, Supplement: 'Finances of State Governments'.

Table 14: Financing Pattern of State Plans

Source	Sixth Plan (1980-85) Actuals (1979-80 Prices)		Seventh Plan (1985-90) Actuals (1984-85 Prices)		Eighth Plan (1992-97) Estimated (1991-92 Prices)		Ninth Plan 1997-98 Anticipated Outlay (Current Prices)		Ninth Plan 1998-99 Approved Outlay (Current Prices)	
	Rs Crore	Per Cent	Rs Crore	Per Cent	Rs Crore	Per Cent	Rs Crore	Per Cent	Rs Crore	Per Cent
Balance from current revenue	14826	41	17368	23	-2009	–1.4	–8703	–17.7	17360	–25
Contribution of PSEs	–4620	–13	–3757	–5	–2723	–1.9		NA		NA
Total borrowings	12679	35	27644	37	75750	52	38350	78	61110	88
Net borrowing	3406	9	9242	12						NA
Small savings	5901	16	19070	26		NA				
Term-loans from FIs	1887	5	4445	6						
Miscellaneous capital receipts	–2012	–6	–5113	–7						
Budget deficit	3497	10	–							
Total state resources	22885	63	41255	55	70335	48	29650	60	43750	63
Central assistance	13690	37	33264	45	75750	52	19520	40	25695	37
Total resources	36575	100	74519	100	146085	100	49172	100	69445	100

economically more advanced and better off states also exhibited more responsible fiscal behaviour in the past. This is no longer the case. The fiscal malaise has now spread across all the states. In the Annual Plan for 1998-99, the BCR was negative for all major states except Karnataka. Borrowings of some states such as West Bengal exceed the total plan outlay. As many as seven major states are now borrowing more than two-thirds of plan outlay requirements.

The current system for the financing of investments by state governments in India is clearly unsustainable. The problem has essentially arisen because of the lack of a link between borrowing and end use of expenditures in capital investment. This is ironic since the existing system was designed to preserve the fiscal health of the state governments in India through appropriate control being exercised by the central government. The state governments are not allowed to run deficit-financing activities and are therefore constrained from fiscal excess. The result however has been the opposite.

In view of the limits being placed on state government's borrowings and because of pressing demands for expenditures there has been a rising tendency by state governments to resort to public borrowings through public sector enterprises. There has been a rise in the issue of state government guarantees for their pubic sector entities enabling them to borrow directly from the market. Until recently, the issue of state government guarantees was adequate to enable their public sector entities to borrow successfully in the market. But with the rise in the volume of these guarantees, lending institutions are now beginning to question the quality of these guarantees. There is also much greater demand by lenders that state governments subject themselves to credit ratings. Thus there is now a move to collate information on the volume of existing guarantees so that the existing liabilities of state governments can be made more transparent.

The problem that has been outlined above suggests that action has to be taken at both ends of the system. Expenditure on investments for the provision of private goods must be related more directly to the generation of returns through the levy of appropriate user charges. The problem at present is that because of the lack of correlation between borrowing ability and returns to the activity, the levy of user charges is essentially done politically. It may be expected that once the ability to raise resources is made dependent on the financial health of the entities, this will affect political thinking on the appropriate levy of user charges.

For the raising of resources for investments for the provision of public goods, it may be desirable to subject state governments systematically to credit ratings so that their ability to borrow depends on their fiscal health. It is possible that such a system which provides appropriate signals to policy-makers might be more successful in ensuring fiscal health of state governments in the future since the existing system has clearly failed in this objective. The possibilities of this alternative system are explored more fully in later in this paper.

III
Where Do We Go from Here?

We have therefore seen that the current fiscal situation of both the central and state governments is unsustainable and poses a grave threat to economic growth. Whereas there is widespread recognition that all is not well on the fiscal front, the gravity of the situation has not received adequate appreciation. The combined fiscal deficit of the centre and states amounts to almost 10 per cent of GDP (Table 16). In other words, the governments of the centre and the states combined are borrowing resources amounting to a 10th of national income every year: about a half of these resources are being borrowed to defray current expenditures on items such as wages and salaries. The current trend is such that before long almost all borrowing will essentially finance current expenditure leaving almost nothing for investment. With declining public investment the current pace of increased private investment will also not be sustained. The consequence will be slowing of economic growth which will itself lead to a further worsening of the fiscal predicament.

Some clue to the possible consequences of such fiscal irresponsibility was provided by the Brazilian crisis of 1998 when one of the Brazilian states defaulted on its obligations to the Brazilian federal government. The credit rating of Brazil plummeted, its currency had to be devalued and immediate action had to be taken to make appropriate policy corrections. Technically, some Indian states have already defaulted to the centre, with the centre having to make adjustments of different kinds to avert an actual default. At the central level, if the fiscal deficit is not brought under control, excessive central borrowing will lead to further hardening of interest rates, which in turn affect private investment rates, leading to slower industrial and overall economic growth. The external balance of the country has been under reasonable control: external debt has been kept under strict watch since 1991; and foreign currency reserves are more than adequate for any reasonably foreseeable contingency for the present. Yet, the international rating agencies downgraded India's rating last year. The reason for this action related to their concerns about the fiscal situation of the centre and the states. Thus the serious fiscal situation has not escaped the eye of international analysts.

As noted at the outset, the key objective of economic policy should be the enhancement of India's growth process. One projection for China's growth prospects suggests that if Chinese per capita income grows by about 4.5 per cent annually (as compared with 6 per cent over the past 20 years or so) Chinese national income will exceed that of the US by 2015. If India's per capita income grows at 3.5 per cent annually over the same period its national income will then amount to only about 40 per cent of that of China, a proportion not too different from that of today. Thus policy action must be taken to accelerate Indian economic growth to at least 6 per cent per capita annual income growth. This cannot be achieved unless a significant fiscal correction is successfully implemented.

Table 16: Centre and State Deficits as Per Cent of GDP

	1980-85	1985-90	1990-95	1995-99	1997-98	1998-99 (RE)	1999-2000 (BE)
Centre							
Fiscal deficit	6.3	8.2	6.7	5.8	6.3	6.5	5.8
Revenue deficit	1.1	2.6	3.2	3.1	3.3	3.7	3.0
States					1997-98 (RE)	1998-99 (BE)	
Fiscal deficit	2.9	3.1	3.0	3.2	3.6	3.7	NA
Revenue deficit	–0.4	0.3	0.7	1.3	1.4	1.6	NA

Note: Not comparable with other years because of change in investment in small savings.

Higher economic growth requires concerted action on all fronts. Major improvements have to be made in the provision of public health services, education, nutrition and the like. In the areas of physical infrastructure, large investments have to be made in areas such as roads (from rural roads to national highways), railways, ports, power, telecommunications, civil aviation, urban infrastructure, irrigation and the like. Whereas in areas such as power, telecommunications, ports, and civil aviation, private investment can form a significant proportion of the needed investment, in other areas it is the state that will continue to play a dominant role. Even in the areas where private investment is relatively easy, public investment has to continue. As the economy grows and industrialises urbanisation will also grow apace. A critical area for increased investment is in urban infrastructure: water supply, sewerage, sanitation, roads, and transportation. All of these are difficult areas of investment and large amounts of resources will be required for these purposes. The lack of these basic facilities in our towns and cities gives rise to high degrees of anomie and alienation leading to social unrest. This in turn necessitates higher expenditures on internal security. Thus a renewal of public investment in a wide variety of areas in the social and physical infrastructure field is essential for higher economic growth and sustained national security.

What is to be done? The key objective of fiscal reform has to be a reduction in debt service payments. This has to be achieved by a progressive reduction in public debt and through higher revenues. The possibility of achieving higher revenues through increased rates of taxes is both undesirable and infeasible. Higher tax revenues can be achieved only through buoyancy and expansion of the tax base. Thus the main instruments for achieving a sustained increase in overall revenues are (i) expansion of the tax base; (ii) widespread and bold imposition of user charges on all non-merit goods; and (iii) widespread and bold privatisation.

As has been documented above, the 1990s have witnessed a fall in the collection of indirect taxes when expressed as a proportion of GDP. With the opening up of the economy leading to large reductions in customs tariffs, revenue from custom duties was expected to decline and it will fall further in the years to come as these tariffs are brought down further. Buoyancy in indirect taxes can therefore only be achieved through increase in excise tax collections at the central level. The structural problem that exists in this regard is the constitutional provision which assigns excise tax to the central government and sales tax to state governments. As the share of agriculture falls with overall development there should be an increase in revenue since agriculture is largely untaxed. In fact the share of agriculture in GDP has fallen from about 40 per cent in 1980-81 to about 26 per cent now. Correspondingly the share of the secondary sector increased from about 24 per cent to about 28 per cent and that of services from 36 per cent to about 45 per cent. The long-term scenario is that the share of agriculture will continue to fall and that of services in particular will continue to rise.

Hence for tax revenues to increase as a share of GDP the imposition of indirect taxes on the service sector is imperative. This can essentially be achieved by the imposition of a widespread value added tax on all sectors of the economy. This would mean the levy of tax at every stage of value addition from production to sale of both goods and services. Levying such a tax will require an amendment to the Constitution along with the achievement of consensus with the states so that it becomes feasible to do so. Thus long-term buoyancy in indirect tax revenues can be achieved only if this major structural change can be brought about.

A good deal of public sector investment is in the provision of public services. The pattern and organisation of the provision of such infrastructure services has been done in such a way that the public has got used to not paying economic charges for these services. This includes key services such as power, water supply, irrigation, and transport, among others. The finance ministry has calculated that hidden subsidies on non-merit goods amount to as much as 10.7 per cent of GDP on an annual basis. It is no wonder that the combined fiscal deficit of the centre and the states amounts to almost 10 per cent of GDP. In the case of power alone the losses resulting from lower than economic pricing to the agriculture and domestic sectors amount to almost Rs 25,000 crore a year. It is primarily the absence of appropriate pricing of public services that has caused the large fiscal imbalance that afflicts the country. As the data showed, government wages and salaries are not the key cause of excess government expenditures. Whereas downsizing of government may be desirable for other reasons, the gains in expenditure reduction will be small on a proportionate basis.

Public investments made in the last 50 years have imposed an increasing burden on the budget rather than providing returns in the form of non-tax revenues through dividend payments to the government. The public has got used to not paying adequately for these services for two reasons. It is perceived that the services are provided by the government and therefore do not have to be paid for. Second, with the quality of service being poor, the public is loath to pay higher charges. This is a vicious circle, which needs to be broken. The imposition of higher user charges has to be accompanied by palpable improvements in the quality of service. The attainment of higher efficiency in the provision of service can, progressively, lead to lower charges.

It is only if government receives returns from the investments it makes, which are financed from borrowing, that fiscal health can be restored. The argument for not charging appropriate user charges has essentially been based on equity considerations. It is argued that the poor are not able to pay adequately for these essential public services. This argument has little basis in actual practice, since the better off sections of the society consume most such services. For example, at least 60 per cent of rural households and about 20 per cent of urban households do not have a power connection; only 60 per cent of urban households have taps within their homes, even fewer have in-house inside the latrines. Most infrastructure subsidies are therefore not going to the poor. Thus it should be possible to levy appropriate charges without affecting the welfare of the poor: in fact, if the better off are made to pay it would then become possible to provide essential services for the poor.

The fiscal health of both the central and state governments can improve dramatically over, say, a five-year period if this correction is made. It is only then that they would be able to invest adequately for the provision of social and physical infrastructure that is so essential for social justice, economic growth and economic security. But this reform cannot be done by mere announcement. It needs research, public awareness, public education and persuasion. The central government must lead this campaign and forge an understanding and consensus with state governments, who must do the same with local bodies. At the same time, acceptability of higher charges for such services will not be feasible unless there is greater efficiency in the delivery of these services. This requires widespread reform in the public sector.

Increase in user charges will only benefit the budget progressively in the future. This will involve large process change and will take some time to yield fruit. The government has to examine each infrastructure sector closely and programme the gradual imposition of economic pricing in each sector. The appointment of autonomous regulatory authorities can help in depoliticising the process. But this process will be successful only if the regulatory authorities are made autonomous by statute and the bureaucracy and political authorities learn to respect this autonomy. Some regulatory authorities have already been formed and may be expected to lead this process. They must be strengthened professionally and allowed to function independently. The campaign must be time bound: we cannot afford more than five years to restore fiscal health in the country.

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

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

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

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

A clear position must be articulated to privatise existing public sector enterprises except those that may be regarded as strategic. This action is not only necessary for generating resources for retiring public debt but is also necessary for the long-term health of the enterprises generating themselves. We must adopt a new approach to public sector enterprises which recognises that privatising them would be the best way of making sure that the core of Indian industry grows, remains competitive and is enabled to compete internationally. These are the enterprises which may have the potential of becoming Indian multinationals in the future. There are indeed industrial enterprises in the country which have potentially the highest technological competence and which can indeed hold their own against the new competition but to do this they must be freed from the shackles of government controls.

It is now clear that the procedure adopted for disinvestment has not been successful. The objectives of disinvestment have not been clear; the procedure has been too bureaucratic and time consuming; and the targets for disinvestment have seldom been achieved. Bold privatisation cannot be done in a business-as-usual manner.

Such a bold approach is clearly not easy. The government must first clarify the objectives of the process of privatisation and seek to forge a consensus. The objectives must be both the strengthening of these enterprises to enable them to compete and grow, and to contribute to the restoration of fiscal health of the country. Once again, this cannot be done by announcement and requires process change at the political and bureaucratic level alike. But there is now no time to lose and the problem has to be attacked immediately.

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

Ensuring long-term economic health of the nation requires acceleration of economic growth on a sustained basis. I have argued that the main impediment constraining India's growth in the future is the continuing fall in public investment in infrastructure which has been caused by the deteriorating fiscal environment at both the central and state government levels. Apart from ensuring higher buoyancy in tax revenues, the key solutions to India's fiscal predicament are bold programmes for imposing user charges on all public services amenable to such charges, and the implementation of a crash programme of privatisation. In the absence of such urgent action, the already serious fiscal situation will get worse and will pose a serious threat to economic security in the very near future. EPW

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