

SUSTAINING THE GROWTH MOMENTUM — SOME ASPECTS OF THE POLICY AGENDA

Fiscal and monetary policy issues

2.46 Fiscal policy plays a dual role as a short-term counter-cyclical tool and an instrument to maintain macroeconomic stability and promote growth over the medium term. This becomes all the more important because of the reality of business cycles in an era of globalization. Indeed, in order to balance these two objectives two key aspects of fiscal policy need to be addressed and strengthened. The first would be to restructure the tax and expenditure policy to strengthen the “automatic stabilizers” and the other would be in the area of improving fiscal transparency.

2.47 Tax policy initiatives since the economic reforms of the 1990s have helped in considerably simplifying the tax system and broadening the base. Within this broad trend there have been occasions when revenue imperatives have led to the imposition of surcharges and cesses and a number of new taxes such as CTT, STT, FBT and DDT, which have partly reversed the move towards a simpler system. In addition, higher interest payments, a result of an erratic process of fiscal consolidation, particularly from around 1997-98 to 2002-03, and an ever-increasing magnitude of subsidies, both explicit and those funded through bonds in the recent years, have reduced the headroom for short-term counter-cyclical fiscal policy. At times, higher inflation (such as in

the first half of 2008-09) and on other occasions political imperatives, have prevented a better alignment of fuel, fertilizers and food (Targeted Public Distribution System) prices with the border/market prices. With a moderation in global commodity prices and moderation in domestic inflation, it is, perhaps the best time to address some of these issues.

2.48 With the enactment of Fiscal Responsibility and Budget Management Act, Indian fiscal stance has become more transparent, rule-based and predictable. As the anchoring of the fiscal policy to FRBM Act has facilitated the Government in pursuing the medium-term growth and stability objectives, as apparent in the experience of the last five years, it would be imperative to get back to the path of fiscal consolidation with FRBM II at the earliest.

2.49 The Centre’s fiscal deficit will have to be restored to the FRBM target of 3 per cent of GDP at the earliest. A number of factors will make it possible to do so: (a) The Pay Commission arrears would have been paid out in 2009-10 (60 per cent of total) with no further liability in 2010-11; (b) most of the farm loan waiver amounts would be paid out in 2009-10 leaving marginal amounts for the next year; (c) much of the decline in business and corporate tax collections is cyclical and will tend to be reversed when growth accelerates from the second half of the year; (d) the expected introduction of the GST in 2010-11 provides an opportunity for setting indirect tax system on the path to producing a sustained increase in revenues, reversing the temporary stimulus provided during 2008-09 and 2009-10.

2.50 In an open-economy context, monetary policy is the first line of defence in addressing volatility in domestic markets and for managing short-term cyclical downturns. Often, its effectiveness in addressing the objectives is undermined by the lags that exist in transmitting the policy impulse to the relevant financial and the real sectors of the economy. These lags may vary from one to several years and the transmission channel itself may not always be very clear. In India, monetary transmission has had a differential impact across various segments of financial market. The transmission has been more efficient in the money and bond markets and somewhat sluggish in the credit market with its implications for the real economy. The credit market suffers from structural rigidities, for instance on account of small savings deposit rates which are often sticky in their downward movement. Indeed, such rigidities may also have been reinforced in the last few years due to a high credit demand, encouraging the banks to raise deposits at higher rates for maintaining long-term liquidity. These high

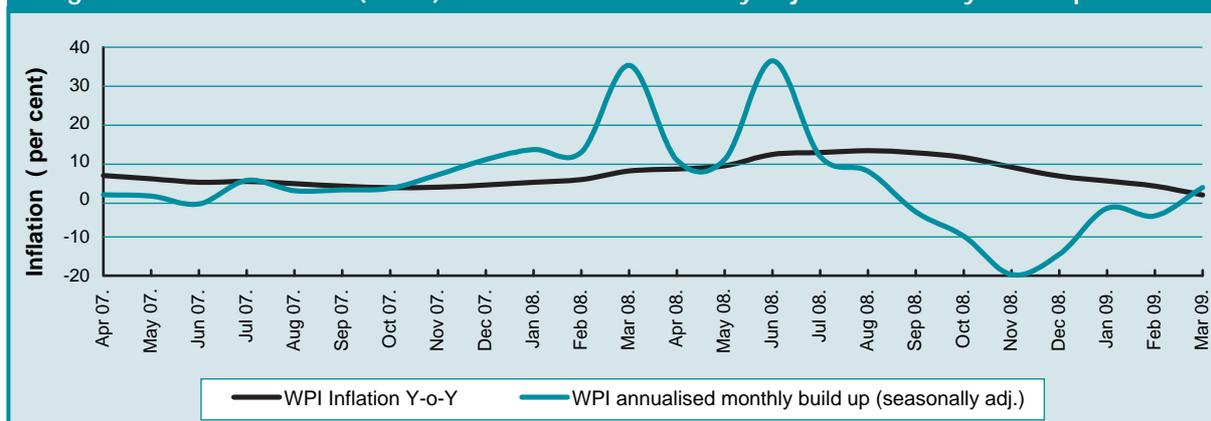
rates have now come in the way of cutting lending rates at a pace which is consistent with the current outlook on inflation and the need for stimulating investment demand.

2.51 The issue of deseasonalized data has caught media attention in recent years. About a decade ago a research project of the Economic Division, Department of Economic Affairs, had found that deseasonalized IIP data did not add much to forecasting accuracy. About three years ago analysis with deseasonalized WPI data showed that it could occasionally improve lead time by a few months. Figure 2.10, however, illustrates the difficulties. During 2007-08 and 2008-09, there were two occasions when deseasonalized data was giving very similar signals. In both cases the sharp upward spike in deseasonalized data, way above the general trend resulted in an upward shift in annual rate. However, results of the downward movement in deseasonalized data were quite different in the two cases. In the first instance, it was reversed, while in the second it was indicative of a trend. Nevertheless use of

Box 2.3 : Fiscal sustainability and tax simplification

- FRBM-2: Examine the possibility of a new target of zero fiscal deficit on a cyclically adjusted basis.
- Reform of Petroleum (LPG, kerosene), fertilizer and food subsidies to reduce leakages and ensure targeting, so that all the needy get the intended benefit. Limit LPG subsidy to a maximum of 6-8 cylinders per annum per household. Phase out Kerosene supply-subsidy by ensuring that every rural household (without electricity and LPG connection) has a solar cooker and solar lantern.
- Convert fertilizer subsidy from a part-producer subsidy to a wholly farmer-user nutrient related subsidy, with freedom to producers to set prices of formulations with different mix of nutrients.
- Auction 3G spectrum. The auctioned spectrum must be freely tradable, with capital gains on spectrum to be taxed under the Income Tax Act.
- Revitalize the disinvestment program and plan to generate at least Rs. 25,000 crore per year. Complete the process of selling of 5-10 per cent equity in previously identified profit making non-navratnas. List all unlisted public sector enterprises and sell a minimum of 10 per cent of equity to the public. Auction all loss making PSUs that cannot be revived. For those in which net worth is zero, allow negative bidding in the form of debt write-off.
- Introduction of the new Income Tax Code, that results in a neutral corporate tax regime.
- Rationalize Dividend Distribution Tax to ensure full single taxation of returns to capital in the hands of the receiver (i.e. neither double taxation nor zero effective taxation).
- Review and phasing out of surcharges, cesses and transaction taxes (such as commodities transaction tax, securities transaction tax and Fringe Benefit Tax). Incentivise states to do the same with respect to stamp duties.
- Revise specific duties in the textile sector to ensure that they approximate a similar ad valorem rate as originally intended. Reduce these gradually that they do not exceed 30 per cent ad valorem. Convert them to ad valorem rate once WTO negotiations are concluded.
- Review customs duty exemptions and move to a uniform duty structure to eliminate inverted duties.
- Implementation of GST from April 1, 2010 to be done in way to ensure long run fiscal sustainability.
- National ID card based on unique identification number. Rapid operationalization of the UID authority (3 months), issue of UID to all residents (6 months) and creation of an integrated data base of information on all actual and potential beneficiaries of government programmes, subsidies and transfers (one year). A Household ID (HHID) could be created simultaneously or in parallel by linking it to a set of UIDs of individuals constituting the household. These IDs will form the base of a multi-application smart cards (MASC) system that can be used to empower the poor and insure that they get the full benefits of all programmes such as NREGA, PDS, publically provided education, skill development, health services, social security (to persons at special risk), fertilizer subsidy, solar lanterns, solar cookers, etc.
- Convergence of plan schemes with focus on outcomes. Thrust on quality of expenditure and systems of monitoring and evaluation to improve the productivity of public expenditure.

Figure 2.10: WPI inflation (Y-o-Y) & annualised seasonally adjusted monthly build-up



deseasonalized data, with due caution, can improve inflation forecasts. It is therefore useful to note that deseasonalized data is now clearly indicating that the period of negative WPI inflation will come to an end before the year end.

Financial markets and intermediation

2.52 The events of 2007-08 and the outflows and inflows of FII equity has brought home with renewed force the volatile nature of certain capital flows. Global capital flows to emerging and developing economies tripled from US\$ 202.8 billion in 2006 to US\$ 617.5 billion in 2007 and then collapsed to US\$ 109.3 billion. India shared in the global boom in private

capital flows to emerging economies with private capital inflows more than doubling from about US\$ 36.7 billion in 2006 to about US\$ 88.8 billion in 2007, them falling back to US\$ 31.2 billion in 2008. Total net capital inflows consequently increased from 4.4 per cent of GDP in 2006 to 9.1 per cent of GDP in 2007 and back to about 3.3 per cent of GDP in 2008. Though the private flows provide critical risk capital with long-term benefits to the economy, the volatile nature of these flows creates a negative externality for the real sectors in the short term. This negative externality can be overcome by internalizing this externality through some form of Pigouvian taxation. An Economic Division working paper (2006) had

Box 2.4 : Financial markets – Funds for dynamic entrepreneurs

- Passage of the Banking Regulations (Amendment) Bill, 2005.
- Lift the remaining ban on futures contracts to restore price discovery and price risk-management.
- Bring all financial market regulations under SEBI with a view to encourage integrated development. Broaden the long-term debt market by liberalizing the investment norms of insurance and pension funds and development of credit enhancement institutions. Government can consider a guarantee mechanism (fund) for credit enhancement of long-term infrastructure debt. Tax incentives for long-term debt markets can be considered.
- Liberalize and develop spot and futures currency markets (exchange traded). Raise position limits for domestic companies and allow trading in SDRs and SDR currencies.
- Introduce/allow repos and derivatives in corporate debt.
- Introduce exchange traded interest rate derivatives, such as interest rate swaps (IRS).
- Introduce standardized credit default swaps that can be traded on exchanges, subject to stricter than normal limits on eligible participants.
- Extend spot commodity trading in electronic form to agricultural markets by involving APMCs.
- Auction rights to commercial borrowing within the already defined limits, with in-built (designed) preference for long-term borrowing. Auction of rights to invest in government securities by FIIs (under sub-limit of ECB) has already been successfully carried out.
- High Net Worth Individuals (HNIs) should be allowed to register and invest directly through authorized Indian investment intermediaries. This will allow ban of indirect ways of investment such as P notes.
- Align voting rights in banks with equity holdings. Allow public to hold greater equity in public sector banks within the policy of maintaining social control of management.
- Phased increase in FDI limits in banks and greater entry of foreign banks with tighter regulation of investing foreign banks and other foreign entities.
- Allow trading of directed credit obligations among banks and other financial institutions. This will allow and encourage the development of financial institutions that can specialize in and exploit economies of scale and scope in unbanked/low banked areas and sectors.
- Link small savings rates to government debt instruments or bank deposit rates of similar maturity. Make responsive to deposit-credit market conditions.

suggested that auction of ECB would be one way to reduce the volatility of ECB flows. Since then, a part of ECBs subject to a separate sub-limit, the part destined for the debt market (purchase of government securities and corporate debt) has been successfully auctioned under the supervision of SEBI. This idea can be considered for all forms of volatile cross-border capital flows. There are other issues in financial sector such as those related to the development of long-term debt markets and deepening of corporate debt markets for improving resource flows to infrastructure investments; improving future markets for better price discovery and regulation; encouraging financial inclusion through use of technology; and overcoming institutional hurdles to better intermediation. Some potential policy choice on these issues is reflected in Box 2.4.

Energy policy

2.53 The boom in oil and other energy prices during 2008 ended in July 2008. Thereafter global prices declined rapidly to around US\$ 40 per barrel. This was expected to be a temporary respite with oil prices likely to rise along with a recovering global economy. Though the time it would take for the recovery to start was very uncertain, it was clear that the respite would be temporary and that this provided a golden opportunity to reform the pricing and control system. It was therefore imperative that petrol and diesel prices be decontrolled so that buyers were aware of the opportunity cost of oil imports and thus contributed their mite to economizing on the use of

refinery products. As long as domestic prices remained below the cost of imports, demand would continue to grow, accentuating the negative impact of the terms of trade effect on national income. In simple words such a situation is a form of foreign taxation of national income, with more tax being paid the more oil/petrol/diesel we consume. As the low prices of oil has provided a temporary window for costless decontrol of petrol and diesel, this window must be utilized at the earliest. Other elements of energy policy, such as open access to power, decontrol of coal also need to be addressed to have a viable and long-term solution to our dependence on foreign oil and the debilitating effect of power failure (Box 2.5).

Investment environment

2.54 The reforms of the 1990s created a competitive environment in which Indian entrepreneurship could flourish. The fruits of these reforms emerged gradually in the form of rising output and employment and higher growth from 2003-04 onwards. However, there is a perception among financial and other investors that Government has been slow on policy reforms, in the past five years. As long as economic growth was above trend these apprehensions did not matter, but an economy where the industrial (manufacturing) growth has been steadily declining for nearly eight quarters over 2007-08 and 2008-09 with the revival still uncertain, policy interventions are necessary. More so the sector has been one of the main drivers of the recent spurt in

Box 2.5 : Energy dependence or independence

- Decontrol petrol and diesel prices. Develop a policy response system and financial buffer for use when diesel prices rise above the oil equivalent price of US\$ 80 a barrel (in 2008 prices).
- Competition from organized private bus companies (free entry on a level playing field with small operators and SRTCs) can increase fuel efficiency of public transport through modern planning and maintenance systems; Indirect taxes on buses can be eliminated to promote public transport.
- RGVY and other energy programmes should focus on gobar gas and solar energy in hilly or distant regions of the country and other areas where lack of electricity makes extension of grid futile.
- Private entry into coal mining under a well regulated and competitive coal sector to help reverse the substitution of domestic coal by imported oil and coal. Coal de-nationalization act would need to be amended to allow this on the lines of Coal Mines Nationalization (Amendment) Bill, 2000.
- The two sick subsidiaries of CIL, namely ECL and BCCL should be listed, 49 per cent shares sold to public and management control transferred to a private party (perhaps through an auction of 26 per cent of shares plus management control package).
- Sell old oil fields to private sector for application of improved/enhanced oil recovery techniques.
- A competitive electricity production market that pays the full global cost of fuel will help eliminate inefficiencies in the current monopolistic state electricity supply system. Open access must be expeditiously operationalized by each State Electricity Regulatory Authority (ERA) notifying a rational/reasonable cross-subsidy. With a competitive electricity sector the increasing trend in use of diesel Gen sets could be reversed.
- The Atomic Energy Act needs to be amended to permit private corporate investment in nuclear power, subject to regulation by AERB and AEC. Frame the rules for private and foreign entry (49 per cent FDI).

Box 2.6 : Improving the investment environment, driving growth

- Passage of the Pension Fund Regulatory and Development Authority Bill, 2005; Forward Contracts (Regulation) Amendment Bill, 2006 and the Insurance Laws (Amendment) Bill, 2006.
- Raise foreign equity share in insurance to 49 per cent. In addition, consider allowing 100 per cent foreign equity in a special category of insurance companies that provide all types of insurance (e.g. health, weather) to rural residents and for all agricultural related activities including agro-processing. This may help dispel fears of foreign equity in insurance.
- FDI in multi-format retail, starting with food retailing. Initially this could be subject to setting up a modern logistics system, perhaps jointly with other organized retailers. A condition could also be put that it must have (for 5 years say) wholesale outlets where small, unorganized retailers can also purchase items (to facilitate transition).
- Raise FDI limit in defence industries to 49 per cent (from 26 per cent); allow up to 100 per cent FDI on a case by case basis, in high technology, strategic defence goods, services and systems that can help eliminate import dependence.
- Decontrol sugar and fertilizer industry, simultaneously converting any producer subsidies into direct consumer subsidies.
- Drug price control should be limited to essential drugs in which there are less than five producers. All others should be decontrolled.
- Create an Internet enabled data/information system(s) to help MSMEs market their goods and services across India and the world.
- Set up an independent environment professional regulator with complete autonomy and accountability for implementing environmental regulations. The ministry should be concerned only with environment policy. Real estate and housing developments should be outside the purview of Central environmental regulations and left to states.
- Set up a single regulatory body for the transport sector, covering highways, railways, ports and airports, with at least one member from each subsector. If needed the authority could also have specialized groups of professionals in each sector. The corresponding department/ministry could be the authority for appointing the subsector member and the specialized subunits. The chairman of the body would also be assisted by a neutral economic unit. The Planning Commission could act as the nodal body for carrying out the selection procedure for the chairman and for staffing the economic unit.
- Broadband-Internet connectivity: Allow open access to local loop for broadband provision and designate the cross-country/rural fibre-optic network as a "public carrier" for provision of telecom connectivity in rural areas. Eliminate revenue share and other telecom charges on provision of broadband connectivity to villages.
- Disaggregate telecom licences from spectrum allocation. Telecom licence should have a nominal regulatory charge and be based on capability to provide sustained service. Spectrum should be auctioned and be freely tradable among companies having a telecom licence. The auction price can be in the form of a fixed price or charge per unit of bandwidth per annum or a combination of the two.
- Private entry into provision of passenger train/railway services should be allowed to and from all tourist destinations. About a dozen tourist routes could be identified and a single licence issued to private companies to provide passenger services on any/all these routes.
- Corporatization of departmental enterprises providing commercial services. Convert port trusts (minus excess land) into publicly listed companies with at least 49 per cent of shares held by the general public.
- New bankruptcy law to ensure speedy and effective bankruptcy so as to save/preserve assets for alternative use.

GDP growth. Box 2.6 outlines some the reforms that could be considered for implementation in the coming months.

2.55 Another aspect that is worth noting is the emergence of a large gap between wholesale (WPI) and consumer (CPIs) inflation rates. It suggests that the supply chain is unable to cope with accelerating growth in income and consumer demand. This points to the urgency of reforming the land market and real estate sector, retailing, public transport and food supply chain, with a view to promoting modernization and competition.

Governance, public goods and institutional reforms

2.56 It has been variously argued that the government at the cutting-edge level, where it

interfaces with individuals and economic agents, is the most important constraint on raising and sustaining the growth rate of the economy. As substantial resources, both public and private, are being mobilized to fuel the growth of the economy and make it more inclusive in character, there is a legitimate concern that every bit of the public effort should count and yield better results. There is a need to strengthen the accountability mechanisms in the public domain and give them teeth. The enactment of the Right to Information Act at the Centre and in many states has bridged a critical gap in the public decision-making process, ushering in greater accountability of the public servants. This move towards greater transparency and right to access public information has been greatly aided by developments in information technology and e-governance. Benefits from these developments need to be extended to other areas.

2.57 With a view to improve transparency in distribution of funds and prevent leakages, an Internet-based public accountability (PAIS) system should be set up to provide information to the targeted population about (i) the expenditure allocated and spent, the receivers of the expenditure, (ii) the major programme inputs purchased (sources, amounts) the people hired and their actual attendance record (e.g. teachers), (iii) the output of the programme and when available its quality. These would be put on the website accessible through the Internet. To empower the target beneficiaries (users) to put up their own evaluation of the programme alongside the government provided data and information. A PAIS system should be designed for the police and courts and introduced on an experimental basis in Delhi and other Union Territories. PAIS systems could also be designed for local roads, sewage and sanitation, drinking water supply and tested in the Union Territories. In states PAIS would be a geographically multi-level, multi-layered system in which higher levels would present data after aggregation/integration from lower levels/layers.

2.58 There is also a need to strengthen the project monitoring and evaluation system for public programmes and linking the performance and

feedback with subsequent allocations of resources and continuation of programmes (Box 2.7).

Hunger, malnutrition and poverty

2.59 The notion of hunger, malnutrition and poverty though related are distinct in nature, both conceptually and in terms of policies required to address them. While hunger refers to inadequacy of food, malnutrition refers to an imbalance of both macro and micro-nutrients, which could be because of inadequate or inappropriate intake and/or inefficient biological utilization due to physiological or environmental factors. The notion of poverty in India for estimating the incidence of poverty involves the use of a minimum consumption expenditure, anchored in an average (food) energy adequacy norm of 2,400 and 2,100 kilo calories per capita per day. At the all-India level 1.9 per cent of the household suffer from hunger (NSSO data) and it is more prevalent in certain states like West Bengal, Orissa Assam and Bihar. Malnutrition, as measured by underweight children below three years, is estimated at 45.9 per cent as per National Family Health Survey 2005-06. The comparable estimates for 1998-99 at 47 per cent show a relatively stable incidence of malnutrition. The incidence of poverty at the all-India

Box 2.7 : Public goods and institutional reforms

- Integrated urban development policy and radical reform of urban governance.
- Amended land acquisition and rehabilitations laws to ensure equity between land owners (including farmers), land users and developers.
- Streamline rules, procedures and process of conversion of land from rural or semi-rural to well planned urban communities (network of roads, water, sewerage, drains, underground conduits for public utilities and public transport).
- Develop a model (or models) of land use policy that is responsive to local conditions and environment, fair to existing land owners and accelerate the development and transformation of urban land to most productive use.
- Change urban land use rules to separate land use for hotels from commercial land use and define transparent rules for setting up of hotels in mixed use locations and the borders between commercial and residential areas (subject to provision of internal parking and adequate size roads for access).
- Review and radical transformation of urban public transport policy and system. Open to organized private companies that use modern logistic and back office systems for planning routes and timings, acquiring and analyzing data on usage densities and running an integrated people movement system. A comprehensive system of road parking fees must be devised and implemented in large congested cities and metros.
- Allow use of degraded forest land for growth of tree crops for paper industry.
- Notify of the Delhi Rent Control Act long passed and approved by the President.
- Develop model Land Lease Act for use of states.
- National Waste Mission: With rising prosperity the country and its people will be swamped by mountains of solid waste and sewerage. We need to set up a national sewerage grid and a national solid waste collection and disposal system to complement a national clean water grid. This is a multi-level (states, districts, nagarpalikas and panchayats) and multi-component (collection systems, transport, processing, disposal) that will also require planning, training and building of professional bodies.
- Police Reform: Implement the Supreme Court decision/ directive on police reform.
- Legal Reform: Reform antediluvian procedures to eliminate delays and scope for creation of obstacles to speedy completion of trials. Carry out a systematic review of all old laws with a view to elimination or replacement by modern laws.
- Courts and Judges: Fill vacancies, provide comprehensive IT and other database services and modernize management of courts, cases and judgements.

Box 2.8 : Education and Employment generation

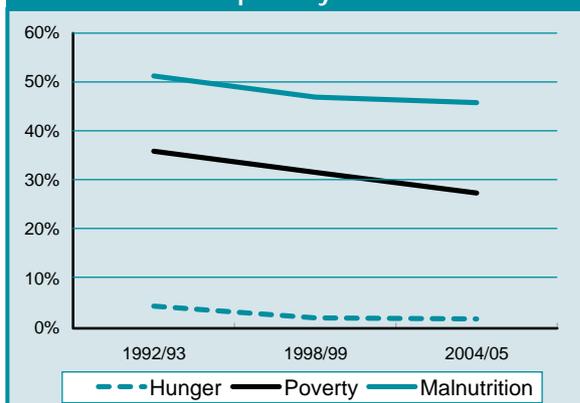
- Reform the regulatory framework and regulatory institutions for higher education, to focus on providing honest and transparent quality rating and information on financial costs. Allow regulated entry of high quality foreign and rated domestic institutions to provide higher education.
- Targeted and outcome oriented review and reform of elementary education, public health institutions and curative health infrastructure; Empower the poor and weaker sections through government funded smart card based payments to public sector providers of education and health. Set up rating system for providers of social services (education, health, social welfare), covering public sector, non-profits and NGOs and private sector.
- Set up a sophisticated, IT-based, employment information system for unskilled, semi-skilled and skilled labour, that can reflect demand and supply across the rural-urban divide, across education-income categories and across different states. The PPP mode can be used to ensure that both public and private good elements are accounted for.
- In water scarce areas (e.g. drylands and red groundwater areas with low and declining water levels) introduce free/low cost water entitlements for farmers using smart cards, vouchers or bank accounts and allow rest to be priced and traded. This will ensure efficient use of scarce water resources and payment by commercial users.
- Employee State Insurance (ESI): Review the system of administrative charges (3 per cent), penalties and interest (17 per cent) for delayed payments, which appear to be quite onerous for SMEs, particularly given their credit constraints.
- Retrenchment of workers: At present prior permission of Government as per Chapter V-B of Industrial Dispute Act is needed for this purpose. This needs to be removed with simultaneous increase in compensation from the present 15 days wages for every year of service.
- Contract Law needs to be amended to allow use of contract labour in non-core activities or when the activity is of intermittent nature during the year. Labour laws should be applicable to the contract labour providing company that pays their wages. Returns should be simplified.
- Factories Act needs to be amended to increase workweek to 60 hours (from 48 hours) and daily limit to 12 hours to meet seasonal demand through overtime.

level in 2004-05 was estimated at 27.5 per cent. There is often a tendency to use these concepts loosely, which is not only incorrect, but it also does not help in creating the right focus for policy redress (Figure 2.11, and Chapter 10, Table 10.4 for more details).

2.60 It is indeed a matter of concern that despite the country having attained self-sufficiency in food production for nearly three decades, and with

mounting public food stocks at its command, that there is still hunger in the country and that malnutrition is so widespread. It is time that the various interventions, at the state and at the Central level addressing these issues are reviewed and redesigned, if required, to address these social concerns in a time-bound manner.

Figure 2.11 : Incidence of hunger, malnutrition and poverty



Note : Hunger estimates from NSS data, poverty estimates from Planning Commission (interpolated for 1998-99) and malnutrition estimates from NFHS I, II, III. The data for the three variables corresponds to the year closest to the indicated years.