

## **First Raj Krishna Memorial Lecture, 1995 : Economic Reforms for the Nineties**

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I consider it a great honour been asked to deliver the first Raj Krishna Memorial Lecture. I had the privilege of knowing Professor Raj Krishna and interacting with him in each of his three avatars, first when he was a teacher and I was a student in Delhi University, then again when he served briefly in the Research Department of the World Bank in Washington, D.C, and finally, during his stint in public service as a Member of the Planning Commission Raj Krishna was one of those very rare persons who combined high academic achievement and intellectual integrity with an openness of mind and a willingness to discuss with his juniors which endeared him to all who came into contact with him. The fact that he combined this with a tremendous sense of humour meant that interacting with Raj Krishna was not only elevating, but also always enjoyable.

Raj Krishna's interests were so wide ranging that no subject would be inappropriate for this lecture. However, I can't help feeling that he would particularly approve of my using this opportunity to talk of our ongoing economic reforms. He was one of the first to draw pointed attention to the inadequacy of our growth performance, when in the mid-seventies, he coined the much quoted phrase "the Hindu rate of growth" to describe India's disappointing trend growth, which at that time appeared stuck at 3.5 to 4% per year. I have no doubt that he would have approved of much that is being done today to bring about faster growth in India through economic reforms. He was profoundly sceptical about the effectiveness of the so called license-quota system and was deeply concerned about the inefficiency and corruption which it spawned. With his usual sense of humour he used to describe quota and license allocations, and the black-markets which they invariably create, as "socialist allocation in the first round followed by market allocation in the second round". And yet he was not, despite his Chicago background, an ideological free marketeer. He believed in an activist developmental role for the state and was particularly concerned about the need to provide institutional and infrastructural support to ensure efficient functioning of markets, especially in agriculture. He was also deeply concerned about the extent of poverty in India. He believed that India's poverty could only be tackled through strategies for rapid growth with a special focus on agricultural expansion, combined with targeted programmes for the benefit of the poorest sections. All these are key elements in the current programme of economic reforms.

The reforms introduced in 1991 had two dominant objectives. There was' an immediate objective of managing the balance of payments crisis and restoring viability in external payments and there was also a medium term objective of setting the economy on the path of rapid and sustainable growth. I do not propose to deal with the crisis management phase. The story is well known, and it is now generally accepted that this part of the strategy was highly successful. A situation of near collapse was transformed within two years to one with a manageable balance of payments, comfortable foreign exchange reserves and renewed international confidence. I will focus instead on the second and much more difficult aspect of the reforms which was to set the economy on a sustainable high growth path. Achievement of this objective involves basic changes in policy which are sometimes controversial. There are doubts and fears about one or other component of the strategy, differences of opinion about the speed of transition and the sequencing of policy changes, and most of all, a growing concern about the distribution of the benefits of growth How valid are these concerns ? Is it necessary to continue with the reforms now that the crisis is behind us ? Are the reforms incomplete or unbalanced and do we need to redefine priorities to achieve balance? These are some of the questions I would like to address in this lecture.

It is important to recognise that the need for basic changes in policy did not surface only with the crisis of 1991. It was felt as early as the start of the eighties, when Raj Krishna's disappointment with India's slow growth began to be widely shared, and the perception grew that we must rethink our approach to economic policy. A number of hesitant steps were taken in the direction of liberalisation and deregulation during the 1980s, especially in the second half of the decade. These experimental steps had the expected effect of an improvement in growth performance and India's rate of growth of GDP increased to a respectable 5.5% per year in the eighties. Since the acceleration was at least partly due to the changes in economic

policies introduced in the 1980s, it is logical that the reforms seek to strengthen these initiatives in the nineties.

There were other aspects of our experience in the 1980s, however, which were negative, and call for corrective action in the nineties. The acceleration in growth in the eighties was unsustainable on two important counts. There was a weakening of macro-economic control as the fiscal deficits of the Central Government deteriorated steadily. The deficit increased sharply from an average 3.7% in the 1970s to an average of 8% in the latter half of the eighties. Large fiscal deficits spilled over into the balance of payments and generated increasing current account deficits, which, in turn, had to be financed by increased resort to external commercial borrowing. The result was a large increase in external debt. India's debt service ratio increased from around 12% in 1980 to 31% in 1991.

Vulnerability on the external front was compounded by poor export performance, reflecting basic competitive and technological weaknesses in Indian industry. It is important to emphasise that export performance is important not just as a means of reducing the current account deficit but also as an indicator of debt servicing capacity. This can be illustrated by considering a hypothetical situation in which the same current account deficits as emerged in the eighties are accompanied by a faster rate of growth of exports, with a correspondingly faster growth in imports. In this hypothetical situation we would incur the same amount of external debt to finance the same current deficits, but the external payments position would be much more viable since the debt service ratio, which is the debt service payments expressed as a percentage of exports, would be lower because exports would be higher. Country after country in East Asia, facing the same world market environment as we do, has demonstrated that it is possible to achieve dramatic gains in exports, but similar gains eluded us in India. In 1978 China's export levels were roughly the same as India's. By 1990 China was exporting four times as much.

This is the background against which the current programme of economic reforms was launched. It remains relevant today as we define our priorities for the rest of this decade. High on these priorities must be the achievement of faster rates of growth. We are the second largest country in Asia and we can ill afford to be marginalised in this dynamic and fast growing region. But marginalised we will be, if we do not adopt the objective of achieving at least the same rate of growth as the region as a whole. With China growing at about 9% per year, and other East Asian countries growing at rates between 6 and 8%, we ought to set ourselves a target of accelerating growth from the 5.5% level achieved in the eighties to a steady 7% as soon as possible.

Rapid economic growth provides the only lasting solution to the problems of poverty that have burdened us for so long. This is demonstrated by our own experience with the acceleration of growth in the eighties. Before the 1980s, the slow rate of growth made no difference to the percentage of the population in poverty, which fluctuated from year to year with no discernable trend. With the acceleration of growth in the 1980s, the percentage of the population in poverty declined steadily, reflecting the impact of faster growth on living standards. But progress in this dimension has been only modest because 5.5% growth was not enough. With population growing at 2%, and the labour force set to grow even faster for quite some time, we need to move to a faster rate of growth if we are to provide jobs for all the new entrants into the labour force in India. This is especially so if the new jobs are to be of the quality that the increasingly educated entrants to the labour force now expect.

This is not to suggest that the solutions to the problems of poverty lie in "trickle down" alone. It is now widely recognised that rapid economic growth may not reach all segments of the population in the initial phases and large sections of the poor may be bypassed by growth for many years which is clearly not acceptable in a democratic society. It is, therefore, necessary to combine strategies for high growth with concrete targeted programmes aimed at helping the poorer sections. Having said so, however, it must also be recognised that such programmes can be financed only in an environment where the economy is buoyant and the Government is able to mobilise tax resources from this buoyancy to finance such targeted programmes. In the absence of economic growth the Government's ability to finance such programmes is severely curtailed.

On all these counts, therefore, it is essential, to plan for an acceleration of growth to around 7 per cent over the next few years. This is obviously not going to be easy. Sectorally, it would require acceleration in all sectors of the economy. We would need to increase growth rates in agriculture from around 2.5% to 4%, in industry from around 7.5% to 10-12% and in services from around 6 per cent to 7 or 8 per cent. Can we achieve this acceleration while simultaneously avoiding the problems of unsustainability which surfaced in the 1980s?

Economists know that acceleration in growth depends upon higher rates of investment or higher productivity, or both. It is often pointed out that if we want to emulate our East Asian neighbours, then we must raise our investment rates from the present level of around 22 per cent to something close to 30% as prevails in the fast growing East Asian countries. There is no doubt that we should aim at higher levels of investment, but to be realistic we must also recognise that the very high rates of investment observed in some of the East Asian countries probably cannot be achieved in the near future unless consumption is severely constrained so that there is a large increase in domestic savings or alternatively there is large increase in direct foreign investment which enables higher levels of investment to be financed by foreign inflows without adding to external debt. There are obvious limitations to the extent to which consumption levels can be restrained in a poor country. In fact if the benefits of development are to be visibly felt by the common people we must allow for steady increases in consumption by the vast mass of our population. There are also strong compulsions for increasing public consumption of services in critical sectors such as health and education, which are directed at meeting the needs of the poorer sections in these critical areas. There is certainly scope for increasing the flow of direct foreign investment but again, it will take time for international investor confidence to build up to levels which can support significant inflows. All this implies that investment rates can be increased only gradually, as much as a consequence of growth as its cause. It follows that much of the initial acceleration in growth in our situation must come from productivity gains.

The role of productivity gains is particularly important because in the past our planning has focussed too much on investment, including especially public investment, as the source of growth often, investment expenditure became an end in itself, to the neglect of productivity and efficiency. And yet, research on the experience of several countries shows conclusively that most high growth experiences are characterised by high rates of productivity growth. Economic policies should, therefore, place a high premium on encouraging efficiency and productivity. It is interesting to recall here that in 1960, when Korea began to take off with high rates of GDP growth, rate of investment as a percentage of GDP, was not very different from what it is in India today. I venture to suggest that implementation of policies which ensure efficient use of resources could easily contribute at least an extra 1 percentage point to our growth rate, even with roughly the present rates of investment. The structural reforms currently underway are aimed precisely at achieving the objective of enhancing productivity and efficiency in the Indian economy and also increasing our international competitiveness which is crucial for sustainability. The reforms are comprehensive in scope, covering several aspects of economic policy. The following seven areas are especially important :

- i) Liberalisation and deregulation of domestic investment.
- ii) Opening up the economy to foreign competition by reducing protective barriers such as import controls and high tariff.
- iii) Encouraging direct foreign investment as a source of technology upgradation, marketing linkages with global networks, and also as a source of non debt finance for investment.
- iv) Reform of the public sector to force greater efficiency of operation.
- v) Reform of the Tax system to create a structure with moderate rates of tax, broader base of taxation and greater ease of administration.
- vi) Reform of the financial sector including banking, capital markets and insurance, which would help to mobilise larger amounts of savings and also to improve the allocation of these savings.
- vii) Opening up of key infrastructure areas hitherto reserved for the public sector for private sector participation.

All these reforms are closely inter-related, and progress in one area helps to achieve objectives in others. However, because the reforms are being introduced at a graduated pace,

the extent of progress differs from area to area. There are also some areas, such as for example labour market policies, where reforms have yet to be initiated.

Perhaps the area where the reforms have progressed furthest is in deregulation of domestic investment. The earlier system of Central Government industrial licensing covering virtually most of industrial activity, with a few exclusions, has been replaced by a system in which investment in almost all industries is de-licensed. Decisions on capacity, location, optimal scale and technology are left to the entrepreneur which is as it should be. The only areas where licensing restrictions continue to apply is in a small list of industries which remain subject to licensing (in many cases because of the hazardous nature of the production process; and in the areas which are reserved for the small scale sector, where investment beyond the small scale limit is not allowed.

The liberalisation of industrial licensing has been widely welcomed. This reflects the fact that there is widespread recognition that industrial enterprise in India has come of age and will benefit from a more competitive domestic environment in which efficient producers will be able to expand freely, to upgrade technology, and move to optimal scales of production. Part of the explanation for the slow growth and lack of competitiveness in Indian industry in the past lies in the fact that the system of industrial licensing limited competition by restricting entry and expansion, especially by the larger producers who may have been most able to expand. The system also encouraged fragmentation of capacity by licensing a large number of units of sub-optimal scale instead of fewer units of optimal scale. This was true in industry after industry, especially in chemicals and petrochemicals, but also in industries such as sugar, cement and many others. It is not easy to quantify the impact of these policies on efficiency and growth but there is little doubt that it created high cost industrial units, which then had to be shielded from international competition by shutting out imports. In this process, uneconomic costs were passed on to downstream units making the entire industrial sector uncompetitive.

These shortcomings were recognised in the 1980s when efforts were made to liberalise the system through piecemeal measures aimed at giving greater flexibility to entrepreneurs. These measures included selective de-licensing of certain sectors, allowing automatic expansion upto a certain percentage, and allowing broad banding of licenses. Where licensing control continued, the system was operated more liberally and a conscious effort was made in the second half of the eighties to encourage new capacity to be set up at optimal levels of scale. The current reforms have made a clean sweep of this cumbersome system. I have no doubt that the new system will lead to a much more efficient industrial sector which is essential, if we are to achieve the growth targets we have set.

Closely related to the reforms in industrial licensing, which may be loosely termed "domestic liberalisation", are the reforms in trade and foreign investment policies, which are described as "external liberalisation". Prior to 1991 our trade policy was exceptionally restrictive by any standards. Imports of raw materials and components were subject to import licensing requirements, and in some cases were canalised through Government agencies. Capital goods of the type produced in India were also subject to import licensing. Imports of consumer goods were completely banned. In addition to import restrictions we had tariff rates of over 200% even on many industrial inputs. All successful developing countries have relied on protection and import substitution as an important stimulus for industrial growth, but none carried it quite so far as we did.

Since 1991 we have embarked on a gradual process of trade policy reform opening up the economy to import competition and reducing levels of protection. Today, virtually all imports of raw materials, components and capital goods are freely importable subject only to tariff protection. The tariff levels have been lowered gradually over the past four years and the peak rate is now 50%, though this is still high by the standards of other developing countries.

There is considerable support for these changes in professional and business classes but there is criticism also. Fears are sometimes voiced that this process may harm Indian industry and lead to a flood of imports which might destabilise the Balance of Payments. There are some who say that they favour domestic liberalisation but not external liberalisation. Others argue that domestic liberalisation should come first and external liberalisation should follow, but only after Indian industry has had sufficient time to adjust. I would like to address these issues one by one.

First, it is important to be clear about the basic issue of whether high levels of protection are good for the economy. Economists know that a policy of protecting domestic industry effectively raises the domestic price of the protected sector, and this encourages import substituting production and employment in that sector. Economists also know that this gain of production and employment is obtained at a cost to others in the economy. First, it is at the expense of consumers, who pay higher prices. Second, it is at the expense of producers in other sectors which are not protected, and which therefore become less profitable relative to the protected sector. To that extent these sectors expand less than they otherwise would. What are these other sectors in our context? They are, first and foremost, agriculture, which bears the burden of the high industrial prices created by the protection of industry. The negative effect of high levels of industrial protection on agriculture is not adequately recognised in our country and given the importance of agricultural development it is one of the most powerful reasons for lowering our protection levels. The other major group which suffers from policies of high protection are exporters. Unlike domestic producers, who can pass on the higher domestic costs arising from protection to domestic consumers, exporters cannot simply increase their prices in the highly competitive international markets. Export profitability therefore suffers, and unless exports are heavily subsidised, which is simply not feasible, it is inevitable that export performance is adversely affected. It is sometimes said that Indian exports have not done well because the large Indian market too is attractive for Indian producers. This is a slight misreading of situation. It is not the size of the market which makes it so attractive—it is the fact that it is highly protected.

Since both agriculture, and export sectors generally, are more labour intensive than most of the highly protected sectors, the policy of heavy protection afforded for so long to Indian industry has also meant that our growth pattern has been less employment oriented. It can be argued that eliminating these biases in policy will create more additional jobs and will reduce the necessity to create jobs through special employment creation schemes.

It is interesting to ask why these problems arising out of an inward looking industrialisation were not perceived earlier? The fact is that in the early stages of development planning in the 1950s, economists all over the world were sceptical about the prospects for exports from developing countries. They did not foresee the tremendous expansion in world trade nor the opportunities which this would offer to developing countries. Many developing countries, especially in East Asia, saw emerging possibilities of exploiting world markets fairly early and changed course. Unfortunately, we in India did not.

A radical overhaul of our trade policy was therefore absolutely essential if we were to improve productivity and efficiency in the economy and also to generate the export levels needed to ensure sustainability. As far as the pace of transition is concerned, it should be recognised that the pace of opening up in India has been very gradual compared with other countries. The need for opening up began to be articulated at high levels in the mid-eighties and small steps were taken to liberalise import licensing. The steps taken since 1991 are also carefully calibrated. Our maximum rates of duty at 50% are still very high compared to most other developing countries. Import of consumer goods still remains largely restricted, except for very limited window for import of selected items allowed against special import licenses. The Government has indicated that it will progressively enlarge this window with the objective ultimately of eliminating quantitative restrictions entirely and relying entirely upon tariffs to regulate imports and provide moderate levels of protection.

Fears that trade liberalisation would lead to a Balance of Payments crisis have been shown to be largely misplaced. The strategy of gradual liberalisation has proceeded satisfactorily without any noticeable negative effect either upon the balance of payments or upon Indian industry. On the contrary, the management of the Balance of Payments in the post reform period is acknowledged to be a major success. Indian industry has also done well in this period. After an initial slowing down of growth in the immediate aftermath of the crisis, we have seen a healthy rebound in 1994-95, which is expected to gain momentum in 1995-96. The experience of the capital goods industry is particularly instructive. This sector was the first to be opened up to external competition, with all capital goods being placed on CGL, and tariff rates lowered to 25% in the Budget for 1995-96. The sector has boomed with 25% growth in 1994-95 and is expected to continue to do well in future.

Another aspect of opening up the economy is the new policy towards foreign investment-welcoming foreign investment in all sectors, but especially in infrastructure. Developing countries all over the world are adopting similar policies attracting direct foreign investment not only for the resources it brings but also as a source of technology and linkage with markets and global production networks. As the world becomes increasingly integrated and transport and communication linkages shrink distances, the networks of inter-country investments will expand. We are bound to be net importers of both capital and technology for a long time and it makes sense to establish multiple linkages with the rest of the World. Fears of foreign investment as some kind of a return of the East India Company are not only grossly exaggerated, they miss the essential point that the world has changed dramatically. No country today believes that economic strength comes from keeping foreign investment out. It comes from developing a strong vibrant economy which can deal with foreign investment on equal terms. In the past four years there has been a substantial increase in direct foreign investment into India from around \$100 million earlier to \$800 million or so in 1994-95. This is still only a fraction of the level of foreign investment in China and much lower than the other East Asian countries. It is only 1% of the total investment in the economy. There is room for much more inflows before we start getting worried.

The third major area of reform relates to the public sector. When we embarked on a development strategy with a major role for the public sector it was always envisaged that the public sector would operate commercially and would in fact help to "socialise profits" in the sense that it would generate surpluses for reinvestment. Unfortunately experience in India, as well as in most other developing countries, has belied these expectations. There are cases of public sector undertakings functioning well, but taken as a whole the public sector has clearly not generated the surpluses that were expected of it and many PSUs are running large losses. Not all losses are necessarily a reflection of economic inefficiency. There may be cases where they reflect uneconomic pricing. But this is not the only problem and there is no doubt that inefficiency of operations, outdated technology, over manning are all serious problems affecting many units.

We cannot continue to tolerate inefficiency in the public sector in the nineties if we are to achieve the objective of strengthening efficiency and productivity in the economy. Given the scarcity of resources, it is not feasible to run the public sector in a manner which imposes continuing burdens on the Budget, either in terms of covering losses or even as a source of funds for new investment. It is not necessary to take an ideological position in favour of or against the public sector as such. But it is essential to create an environment in which the public sector learns to operate in a competitive environment and to sink or swim on the basis of its performance.

Developing countries all over the world face similar problems and have undertaken far reaching reforms of public sector enterprises. The extent of these reforms varies from country to country. At one extreme, many countries have embarked on wholesale privatisation of viable public sector units, combined with closure of unviable units. The proceeds of privatisation have been used to reduce the fiscal deficit or to finance social expenditure. We have not adopted the route of complete privatisation but we are attempting to give public sector enterprises greater functional autonomy to enable them to become more efficient. We have also decided to dilute the Government's equity in public sector enterprises upto 51% partly through divestment of Government equity and partly through fresh issue of capital by the undertakings themselves.

Public sector enterprises are being told that they cannot expect to get resources from the Budget to finance their expansion plans. They must either raise the resources from internal generation or seek them from the capital markets. In either case good commercial performance and profitability will be critical for expansion. In this way only good performers among the public sector enterprises will be expanding in future. Similarly, loss making public sector enterprises do not have any assurance of an open ended access to the Budget. Sick public sector enterprises have been referred to the B1FR where the scope for rehabilitating these enterprises is being carefully considered. In cases where rehabilitation plans can be evolved, which are credible enough to persuade banks and financial institutions to provide the necessary financial support, efforts will be made to revive the unit. Units that are felt to be irretrievably unviable will have to close down. It is hoped that this new environment will have a

favourable effect upon the operations of most public sector undertakings and will lead to a new culture of management in these organisations. The Rangarajan Committee has recommended that Government should also consider reducing its equity holding in certain public sector organisations below 51%. This issue remains on the agenda of public sector reform for the nineties.

Another major area in which reforms were long overdue is the financial sector. Structural reforms in industrial and trade policy can succeed only if resources are redeployed towards more efficient producers who should be encouraged to expand under the new policies. This reallocation is only possible if the financial system plays a supportive role. The reforms in the banking sector and in the capital markets are aimed at achieving this objective.

Major steps have been taken to improve the efficiency of the banks as mobilisers and allocators of capital. The Government has moved away from the earlier system of pre-empting a large portion of bank resources for the budget at artificially low rates of interest and Government borrowing is now being done at market determined rates of interest. This eliminates what was once a heavy implicit tax on the banking system and enables the banks to offer more attractive interest rates to depositors and to charge lower interest rates to good quality borrowers. Freedom given to banks to fix interest rates has enabled them to discriminate among borrowers according to their track record. The introduction of prudential norms has also forced the banks to improve the quality of their asset portfolio. The broad direction that 40% of advances must go to the priority sector remains in place but the new norms ensure that banks will look for credit-worthy borrowers in all categories. These changes are being accompanied by major efforts at improving banking technology including the introduction of computerisation.

The reforms in the banking sector have only just begun to make their impact. To some extent their urgency has been highlighted by the weaknesses revealed at the time of the securities scam, which revealed problems which had developed over time, in the pre-reforms period. The corrective steps taken in the past two years have undoubtedly set the stage for building a much stronger banking system. The early results are certainly encouraging. The financial performance of most banks in the year 1994-95 shows a distinct improvement, with substantially better recovery and a reduction in non-performing assets.

Similarly, reforms in the capital market introduced in the past few years have had a very beneficial effect. The volume of funds raised by Indian companies in the capital markets has increased enormously over the past few years testifying to the enormous potential in this area. However, this expansion has also revealed many weaknesses in the capital markets arising from inadequate regulation, lack of transparency and poor settlement system. These weaknesses are being addressed by the Securities and Exchange Board of India. With SEBI having been strengthened recently, and legislative changes for introducing centralised depositories under way, the Indian capital market is well set to evolve over the next two years or so into a capital market which will live up to high standards of transparency and investor protection.

Reforms in banking and the capital markets need to be supplemented by reforms in the insurance sector. Insurance companies are a major source of long term capital for infrastructure investment and a healthy insurance sector is therefore a critical element in a well functioning financial market. With financial liberalisation and competition sweeping the rest of the financial system, it is logical to extend the trend to insurance also. The Malhotra Committee has made a number of recommendations for reform in this sector, including opening up of insurance to private sector insurance companies. As a first step in this process the Government has decided to establish an independent Regulatory Authority for the insurance sector, which is a necessary precondition for the introduction of competition. Further progress in this area must remain high on the agenda for the near future.

Thus far I have talked primarily of reforms to promote efficiency and increase productivity, but these reforms can succeed only if macro-economic stability is maintained. We have seen that one of the reasons for the unsustainability of growth in the 1980s was the loss of macro-economic control as fiscal deficits increased. We have to ensure that the same problem does not derail growth in the years ahead.

The fiscal deficit of the Central Government in 1995-96 is projected at 5.5% of GDP. If allowance is made for the deficits of the State Governments the consolidated fiscal deficit of the Central and State Governments is probably around 9%. It is difficult to prescribe a rigid rule to determine what is the appropriate level of the fiscal deficit in any particular situation. The fiscal deficit is the volume of net borrowing by the government from all sources to meet the gap between government investment and government savings. It represents the pre-emption by the government from the pool of savings available to the rest of the economy and high fiscal deficits are felt to be undesirable because they absorb savings which could otherwise be available to finance higher levels of private investment. However, the fiscal deficit can be reduced either by reducing government investment or by increasing government savings, and the "quality" of deficit reduction is quite different in the two cases. A reduction in the fiscal deficit achieved by an increase in government savings is unambiguously desirable because it releases savings to finance additional investment elsewhere. On the other hand, a reduction in the fiscal deficit due to a reduction in government investment is at best a substitution of private investment for government investment. This may be desirable if efficient private sector investment is substituting inefficient public sector investment, but if the government investment being reduced is in infrastructure or in social sectors, the substitution of such investment by private investment in manufacturing may not be an improvement.

Our focus in the years ahead should therefore be on reducing the fiscal deficit in both the Centre and the States by increasing government savings. How can government savings be increased? Part of the answer clearly lies in containing expenditure to see what savings are possible. But much the largest part of the answer lies in raising tax revenues. It is widely believed that evasion of both direct and indirect taxes is widespread and a better tax system which encourages compliance and is easier to administer would help to generate much larger tax revenues without any increase in tax rates. This is why tax reform is a key element of structural reforms in most developing countries. We too have launched a major programme of tax reform in the past few years, covering both direct and indirect taxes. The basic aim of these reforms is to move to a simpler tax structure with moderate rates of tax and a modern tax administration. These efforts at the Centre need to be supplemented by similar efforts in the States. Abolition of taxes on inter-State movement of goods should have the highest priority. If experience in other countries is a guide, these initiatives should help to generate faster growth of tax revenues in the future which, if combined with restraint in public expenditure, should increase public saving.

A major problem facing us in the years ahead, which is related to the issue of macro-economic control, is how to finance infrastructure development, including especially power, roads, ports and telecommunications. These are all areas which have traditionally been monopolies of the public sector but limitations of resources in the public sector necessitate new initiatives. Major changes have been made in policy, throwing these sectors also open to private sector participation. There is encouraging response in the area of power generation and telecommunications, and to a limited extent also in roads and ports. In all these areas, however, public investment will continue to play the dominant role and it is important that the required level of public investment is achieved. This is especially true in the area of power generation, since private sector capacity is only 3% of the total capacity in the country.

Much depends here upon the ability of the State Governments to reform the functioning of the State Electricity Boards to increase efficiency levels and move to a rational system of power tariffs which permits financial viability. At present many SEBs suffer from serious problems of operational inefficiency reflected in low PLFs and high transmission and distribution losses, and all suffer from unremunerative tariffs for agriculture. As a result, most State Electricity Boards are running large losses. It is unrealistic to expect that such large losses can somehow be covered and resources obtained from the State Governments or elsewhere to finance expansion. Nor can we assume that private sector producers will be willing to set up power plants in a situation where the SEBs are financially bankrupt and unable to pay for power. A committee of the National Development Council has recently submitted a report on the whole issue of reforms in the power sector to overcome these problems. This should perhaps have the highest priority in the near future.

Let me now turn to the question whether economic reforms will have a beneficial impact on the poor. This is in some ways the most important question facing advocates of reform. The

answer is not very complicated. First and foremost, the reforms will help the poor by generating a faster rate of growth and creating more employment in the economy. It is important to emphasise that if the new jobs created do not go directly to the poor, they relieve the pressure in the labour market for other jobs, from which the poor would otherwise be displaced. In a situation of excess demand for jobs, additional jobs created higher up the income ladder ultimately improve job opportunities for the poor.

Second, the benefits to the poor are not limited to the improvement in the general employment situation described above. This process may take some time and the reforms therefore include targeted programmes which directly benefit the poor. Such programmes are very high on the priority of the Government. In fact, as the government has withdrawn from some of the older types of expenditures on expanding the public sector, it has greatly increased its expenditure on the social sector, including especially health and education. These expenditures not only directly help the poor, they also enable them to benefit from the process of growth stimulated by the reforms. The experience of all the fast growing countries of East Asia clearly shows that a precondition for accelerated employment generating growth is an educated literate population. It is a matter of great regret that we have lagged behind in this aspect of development. We have a large pool of skilled labour which is an asset, but our overall literacy rate is only 55%. Korea in the early sixties, when it took off, had achieved literacy of over 60%.

Third, and finally, economic reforms combined with macro-economic stability will help the poor by ensuring that inflation remains under control. Nothing hurts the poor as much as inflation does and macro-economic stability, with effective control over government deficits, is critical for maintaining control over inflation.

I have dealt only with some of the major issues facing us in the nineties and the agenda even on this basis seems large. The fact is that the task of re-orienting economic policy to produce growth rates which will allow us to catch up with our fast growing neighbours in Asia is a Herculean task. It is not surprising that it encompasses virtually every aspect of policy, not only in the Central Government but equally at State Government levels. It is also not surprising that it sometimes generates controversy and even heated debate. Sometimes in the midst of these debates I miss the presence of Raj Krishna. I have no doubt that he would have been an ardent supporter of the reforms, and with his erudition and inimitable sense of humour, he would have done more than his share in creating the intellectual consensus on main directions that is needed to ensure that we stay on the course.

### **Prof. Raj Krishna**

Professor Raj Krishna joined the Department of Economics of the University of Rajasthan in January 1967. By the time he left the University in 1973, Raj Krishna had become an institution. Admissions in the Department doubled within a year and Econometrics, surprisingly became the most popular optional subject only because RK was teaching the subject. Loved by his students, admired by his colleagues and sought after by policy makers for advice, he left an indelible mark in the University and in Jaipur. He came to the University from the Massachusetts Institute of Technology where he had gone for a brief stint after completing his assignment at the Food Research Institute at Stanford. He came with a reputation for not staying at any one place for long. Fortunately the University of Rajasthan was able to retain him for six years although he was constantly offered positions and assignments outside Jaipur. Even though six years is a short time in the career of an academic person, it is, perhaps, his longest stay at any one place. This reflects a certain restlessness to get on with work, almost as if he knew that God had ordained a short life for him. More than this his decisions to move arose out of the desire to work without constraints and without compromising on essentials.

Raj Krishna's reputation in economics was based on his work on estimating agricultural supply functions. This work was done for his Ph.D. at Chicago under the guidance of T.W. Schultz and D. Gale Johnson. This seminal work gave rise to hundreds of similar papers on the issue and put at rest, very conclusively, the commonly shared perception of that time that the farmers in the developing countries are not rational decision makers in that they do not respond to price signals. This work also made a methodological breakthrough in the measurement of agricultural supply functions. His training at Chicago also made him a positivist of the Chicago school in that he always insisted that in economics measurable facts are far more important than theory. Anything not based on demonstrable evidence was described by him as 'poetry'.

This epithet made a point but angered especially teachers of literature. His work on agriculture and on unemployment is methodological and analytical in nature and has played a significant role in policy formulation.

As a policy analyst Raj Krishna's contributions are no less important. After his return from the US in the mid sixties he was appointed member of the Agricultural Prices Commission. He resigned within a year because of differences on the issue of Food Zones after writing a Minute of Dissent in which he argued strongly for the dismantling of all restrictions on the movement of food-grains. He was later appointed a member of the Committee on Steel Pricing where his idea of dual pricing structure was developed. It was adopted by the Government not only for steel but later for other commodities like food-grains, sugar and cement. As member of the Seventh Finance Commission he recommended changes in tax devolution formulae for achieving a more equitable distribution among states. As member of the Planning Commission at the time of the formulation of the Sixth Plan he suggested an alternative approach for generation of employment. However political changes lead to the Plan being aborted. Nevertheless, it was at his insistence that a Working Group on Women's Employment was constituted. This resulted in the incorporation of a separate chapter on women in the plan document. At the World Bank, among other things, he contributed to the policy document on rural development which recommended a target oriented approach for alleviation of poverty.

Raj Krishna wrote more than 300 papers on subjects as diverse as Vedanta, Religion, the Nuclear Bomb and abstract economic models His work, interests and personality were multi-faceted. He was at one end a serious academic economist, a social thinker and an intellectual and at another end a polemicist ready to enter into a debate on any contemporary issue. What attracted people to him was his ideas on Indian economy. He summarized them in the G.L. Mehta Memorial Lecture entitled "The Centre and the Periphery-Inter-State Disparities in Economic Development" delivered on May 9, 1980.

#### PREFACE

The faculty of the Department of Economics, University of Rajasthan, recently took two important decisions. First, it was decided to institute Raj Krishna Memorial Lecture as an annual feature to commemorate Professor Raj Krishna, former Head of this Department and an economist of international repute. Secondly, the Faculty also decided to get these lectures printed.

The first Raj Krishna Memorial Lecture was delivered in April 1995 by Montek Singh Ahluwalia, the Finance Secretary, Government of India, who is widely known for his research on issues related to Indian Economy. It was felt that Montek has had a major role in reorienting our economic policies and making them more effective. Since Professor Raj Krishna had repeatedly drawn the attention of Indian policy makers and academic community on the constraints on development of Indian economy, we thought it appropriate to request Montek to deliver his lecture on *Economic Reforms For Nineties* with a focus on the fears expressed by many in India and elsewhere on the political and economic implications of liberalization policies embodied in Economic Reforms.

On behalf of the Department of Economics I express our deep sense of gratitude for Montek Singhji for providing the script of his lecture and helping us bring this publication. I also thank Prof. R.N. Singh, the Vice-Chancellor of the University who has been a great source of inspiration and help to our Department in organizing such lectures and bringing out such publications. I am also grateful to my colleagues in the Department for their help in bringing out this publication.

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