Interview

Have we mortgaged our future?

Jayanta Roy Chowdhury tries to find the answer from Deepak Nayyar

Deepak Nayyar is not just any other well known economics don. As the then chief economic advisor to the government, he helped Mr Manmohan Singh shape the initial liberalisation package in 1991. But Prof Nayyar did not see eye to eye with the powers that be on what direction liberalisation should take and eventually resigned his job to go back to his first love — the world of academics. In a recent interview with ***Business Telegraph****, Prof Nayyar tried to explain what went wrong with the liberalisation dream.*

What kind of a legacy has the previous government left behind for the new Cabinet?

In the run up to the election the government had unleashed a barrage of propaganda about the performance of the economy over the past five years. Much of it, however, is manipulative statistical jugglery, deceptive half truths or just plain imagination.

In fact, the macroeconomic situation in early 1996 is a cause for serious concern, just as it was in early 1991.

The fiscal crisis runs deeper as the government has continued its borrowing spree but at much higher interest rates.

What is worse, a much higher proportion of government borrowing is now being used to finance consumption expenditure (the revenue deficit of the central government has averaged more than three per cent of national income during the period 1991/2-1995/6) which yields no return. Such a fiscal regime is simply not sustainable. It has only postponed the day of reckoning and mortgaged our future.

The balance of payments situation remains fragile. The comfort implicit in the size of reserves is illusory because these foreign currency assets are more than matched by foreign exchange liabilities which have short-term maturities or can be withdrawn on demand. Short-term debt, the par value of outstanding portfolio investment (without allowing for capital gains realisable and repatriable) and the outstanding stock of repatriable deposits (held by non residents) in India adds up to $ 25 billion as compared with reserves of $ 16.3 billion at the end of January 1996.

The Indian experience with repatriable deposits and the Mexican experience with portfolio investment, not so long ago, only confirms that such capital flows are susceptible to capital flight at the hint of any crisis of confidence.

Inflation is worrisome. Contrary to the claims made by the government, inflation has remained in the range of 10 per cent per annum, over the past five years, despite a concerted attempt at stabilisation and five good monsoons in a row. In the mind of the citizen, there is a 'price perception index' which is based on prices paid. This judgement cannot be clouded by statistical jugglery. The woman in the household or the man in the street 'knows' that a basket of goods which cost Rs 100 five years ago now costs Rs 165; or that the price of wheat, rice, sugar and edible oils has almost doubled in these five years. Inflation has clearly been more pronounced in essential commodities. As a result, the poor have been hit the hardest. The prospects of growth in the medium-term are meagre. The economic growth, being trumpeted by the government is not sustainable, for the same reason that the economic growth in the second half of the 1980s was not sustainable.

It is based on borrowing and an untenable macroeconomic situation. What is worse, rates of saving and investment in the economy, (as a proportion of national income) have dropped significantly.

Public investment, particularly in infrastructure, has collapsed, while private investment is being squeezed by the high interest rates and crowded out by government borrowing in the domestic capital market.In sum, a difficult economic legacy for the government which assumes office after the elections. And the room for manoeuvring is much less.

Only a few have integrated with the global pattern in terms of consumption

But do you really believe the liberalisation process has been that hollow?

Economic liberalisation, in the past five years, has made a tiny proportion of our population better-off. And they have integrated themselves with the world economy in terms of consumption patterns or life styles.

The vast majority of our population has derived little benefit while the poor are worse-off. Even if their share of income in the economy is much smaller than their proportion in the population, it must be remembered that their share of votes in the polity is directly proportional. The electoral, if not political, compulsions of a democracy cannot be set aside.

If you were managing the economy, how would you have reduced the revenue deficit — by increasing revenue or cutting expenditure?

In reducing the revenue deficit, I would emphasise revenue-raising rather than expenditure cuts.

Economic reform has made a tiny proportion of our population better-off

The government has done just the opposite. During the second half of the 1980s, tax revenues of the central government were somewhat more than 11 per cent of GDP.

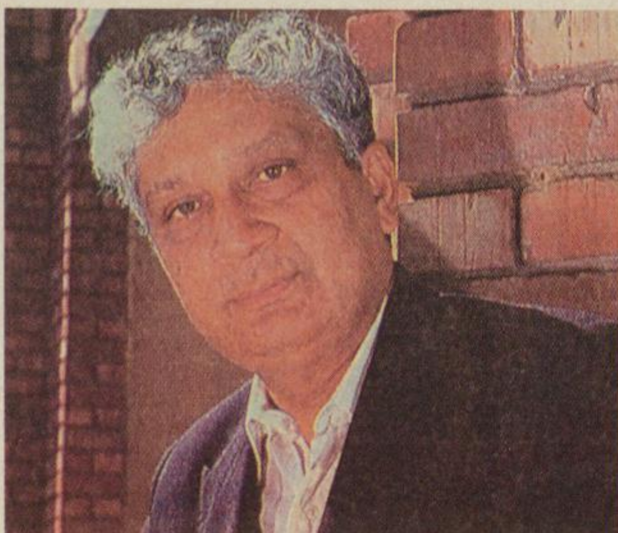
In the five years since economic reforms began, this proportion has in fact declined. In 1993-94, 1994-95 and 1995-96, central government tax revenues were less than 10 per cent of GDP. The brunt of the expenditure adjustment has been borne by social sectors and poverty alleviation programmes. Yet, the revenue expenditure of the government has increased rapidly. This is attributable, in part, to interest payments on the earlier debts. But the problem has been accentuated over the past five years because the government is borrowing larger and larger amounts at higher and higher rates of interest. This is, to say the least, a serious mistake. The only sustainable solution is to increase the income of the government through tax and non-tax revenues.

If you are going to increase revenue, will you increase tax rates or expand tax net?

In this pursuit, the object of tax reform should be to broaden and deepen the structure of taxation. In the sphere of direct taxes, it is essential to broaden the base so that a large number of people are brought into the tax net. This means that the exemption limit for income tax must not be raised. In an ideal world, the exemption limit should be lowered along with a reduction in the entry point rate of tax: from 20 per cent to say 10 per cent. But given our competitive and populist politics this will not be feasible.

Therefore, the exemption limit should remain where it is, and as inflation erodes its real value the tax base would grow larger over time. It is just as essential to deepen tax structures by increasing the average rate of tax (realised) as a proportion of income. This does not mean raising tax rates. It means reducing tax avoidance in the form of admissible deductions and reducing tax evasion through better enforcement and compliance.

Similarly, in the sphere of indirect taxes, the base for taxation must be broadened by progressively reducing exemptions and concessions: say for the small-scale sector. At the same time, average rates of tax must be increased by eliminating admissible deductions or end-use (sometimes even firm-specific) exemptions. Once again, this does not require higher tax rates. We need a tax administration that strengthens enforcement and improves compliance.



But given a situation where you have to cut expenditure to balance the books, where would your axe fall ?

The government's attempts at reducing expenditure, which have axed public investment and cut resources allocated to social sectors, are counter-productive. The axe on public investment, particularly in infrastructure, is bound to squeeze supply responses in the medium term.

The cuts in social sectors can only add to the burden on the poor in the period of transition. We need to reduce unproductive consumption expenditure of the government.

But expenditure cannot be reduced without reducing activities. This needs expenditure control systems which have not even been thought about. In any case, the fetish about levels of public expenditure makes little sense. It is the productivity of public expenditure that matters. If we can take care of the latter, the former would not be a problem.

Given a chance, what part of liberalisation will you reverse? Will you reimpose industrial licensing? Will you restrict the flow of foreign direct investment?

The dismantling of the complex regime of industrial licensing was both necessary and desirable. But deregulation may not assure competition and may, in fact, induce rent-seeking behaviour: for example, the merger of Parle and Coca-Cola or the tieup between Malhotras and Gillette, where the dominant market share so attained eliminated established competition or pre-empted potential competition. We must ensure competition by strengthening anti-trust laws which regulate monopolistic, restrictive or unfair trade practices.

It is essential to broaden the direct tax base so that a large number of people are brought into the tax net

It is also essential that import liberalisation is combined with anti-dumping laws which can be invoked and used by domestic firms wherever necessary. There is no absolute virtue in reducing all tariffs or removing all quantitative restrictions. Trade policy can and should be used as a strategic means of supporting domestic firms in attaining international competitiveness. Every country in east Asia has done so. The speed and the sequence of tariff reduction should be planned and calibrated so that it enforces efficiency rather than closures.

I would also keep the option of using quantitative restrictions on trade in agricultural commodities, particularly foodgrain so as to ensure food security for poor consumers. The European Community and Japan preserve such quantitative restrictions to protect their rich farmers.

As far as foreign direct investment is concerned, inflows can provide the economy with access to technology and to markets. Such inflows must be encouraged. But there are others which should be discouraged. We must use the market our country provides to foreign investors as a strategic bargaining device that enables us to maximise the benefits we derive from FDI inflows. We must also remember that, in the long term, the development of managerial and technological capabilities by domestic firms is essential if we wish to become global players. Foreign firms can complement but cannot substitute for such capabilities.

Talking of technological capabilities, the public sector was supposed to have provided models in that area. But now many say they have failed and recommend privatisation. What is your perception?

The rhetoric of restructuring apart, the dominant motive underlying the sale of government equity in the public sector has been the desire to mobilise resources for the exchequer. The capital receipts from these asset sales have been digested quietly by the Union budgets to reduce the borrowing needs and the fiscal deficit of the government. This approach to public sector reforms, which emphasises asset sales and closures, is the most unimaginative form of privatisation and does not make any genuine attempt at restructuring. It is neither adjustment nor reform. It may simply mean selling the flagships and keeping the tramp-ships, or sending some white elephants to the slaughter house, but there is no systematic attempt to address problems of efficiency and productivity in the public sector.

In this context, I would like to stress that there is no unambiguous relationship between ownership and performance. It is motivated ideology, rather than fact, which leads some people to suggest that private ownership always means good performance and public ownership means bad performance. We would do well to remember that Pan American, a private airline, went bankrupt, while Singapore Airlines, entirely state-owned, is among the best. Such examples abound. The economic efficiency of an enterprise is determined more by competition in the market structure and competence together with accountability in management, than by the nature of its ownership.

Quantitative curbs on farm trade are must for food security

Are there any areas of reforms which you want to see move faster?

In my judgement, prudence in macro-management of the economy, which has been wanting despite the brave words and the clever propaganda, deserves priority attention. In this task, the size of the fiscal deficit is less important than the use or the cost of borrowing.

The fetishism about reducing the fiscal deficit despite a burgeoning revenue deficit, or eliminating the monetised deficit despite the much higher cost of government borrowing, or raising interest rates to combat inflation and attract portfolio investment even if it dampens private investment, is entirely misplaced. It is time to give up cosmetic devices which conceal the problem or postpone the day of reckoning and seek a sustainable solution to the fiscal crisis.

> It is time to give up cosmetic devices which conceal the problem and seek a sustainable solution to the fiscal crisis

Time and again you have come out against portfolio investment. Why are you so much worried about it? If they withdraw in a big way both the stock prices and exchange value will fall. Aren't the foreign institutional investors, who are bringing in these investments, in a way our hostages?

We can always delude ourselves. But it is important to learn from economics and from experience. In situations where portfolio investment becomes an important source of financing the current account deficit in the balance of payments, the economy needs a high interest rate and a strong exchange rate regime to sustain such inflows in terms of both profitability and confidence. This erodes the competitiveness of exports and enlarges the trade deficit. It is essential to recognise the macroeconomic implications.

Larger trade deficits and current account deficits require larger portfolio investment flows which, beyond a point, undermine confidence and create adverse expectations even if the government keeps the exchange rate pegged. But when the stifling of exports does ultimately force an exchange rate depreciation, confidence may simply collapse and lead to capital flight.

These problems did indeed surface in several Latin American economies. And the recent Mexican experience suggests that any stabilisation of the balance of payments based on portfolio investment or similar capital flows is fragile. Remember that FIIs may burn their fingers but will never turn hostages.