SUSTAINABLE ECONOMIC REFORM

Arjun Sengupta

The following is the text of the A.K. Dasgupta memorial Lecture delivered in December 1994 by the author who is a distinguished economist and at present Member Secretary of the Planning Commission, India. The Lecture was organised under the auspices of the Indian Economic Association.

I am speaking here today, addressing this august body of Professional economists, in the memory of one of the finest theoretical economists that India has ever produced. When Professor Dasgupta wrote about consumers' surplus in the 1930s, very few Indians engaged themselves in theoretical research in economics. Since then, of course, many Indians have established themselves as major contributors in the frontlines of theoretical research. Both in terms of analytical techniques and in the sophistication in the use of econometric tools, the younger generation of economists are undoubtedly better equipped than the older generation and this is true all over the world. But Professor Dasgupta was one of those economists of the older generation who brought to bear, in all his writings till his last days, a superior insight into his analysis of economic problems and issues, which was the product of the wisdom of seeing things in their totality, in the perspective of the history of both ideas and events. That wisdom was a touch of genius, a quality that is inborn and instinctive, going far beyond trained expertise. Professor Dasgupta could take up any simple problem or dwell on a not very striking economic event, and with his vast expanse of knowledge of history and the nature of different economies, he could lift them up into major analytical issues with fascinating dimensions. One thing he was not- quite unmistakably. He was not given to any dogma. He would never have been cocksure about any theoretical or empirical propositions. He was open to critical disagreement and would welcome controversy. I am sure that if he was alive today he would have passionately engaged himself in the current controversies regarding economic reforms in India.

I have chosen my subject today in the same vein, in the hope that the issues I raise should be at least able to generate some controversy. I have no definite answer to questions about sustainable economic reform and I submit that no one else has either. I wish to reflect upon some views which can be controverted, rejected or supported in the light of one's understanding of the empirical realities of reforms. There is now much disagreement about the theoretical models of economic reforms, their rationale, their objectives and their designs. All the disagreements and controversies about reforms now centre around issues of sequencing and pacing of the measures, their applicability in the particular circumstances and the packaging of the different measures considering their complimentarities and mutual trade-offs. These issues are basically empirical, in the sense that specific answers to any of the problems depend upon the empirical contexts within which they have to be applied. There cannot thus be any uniform and unequivocal answer to any of these problems. The only general answer to them would be "it depends". However, in policy matters, actions have to be taken because inaction itself is some sort of a policy decision, and one, therefore, has to take an unequivocal stand on the basis that one's best judgements, however careful one may be, can seldom be totally objective. By their nature, therefore, such propositions have to be controversial.

Basic Principles of Economic Reforms

Consider the essential basis of economic reforms. especially of the type that has been introduced in India in the last few years. There are mainly three components of these reforms: deregulation, competition and strong budget constraints. Deregulation allows the market to have a free play. But allowing freedom of market forces does not necessarily result in a competitive market economy, and efficient allocation of resources, even in the sense of Pareto, is associated with competition, which has to be promoted and nurtured as a policy decision. The budget constraints, especially in the government but also applicable to all agents in an economy, refer to limiting expenditure to income, where income consists of both current income and sustainable borrowing against future income. Such a budget constraint is a necessary condition for macro- economic stability and macro-economic stability is a necessary condition for market prices playing their role in the efficient allocation of resources.

I do not think there would be any disagreement about these basic principles of reform, especially since I have talked only of the First Welfare Theorem about Pareto efficiency in a competitive economy and so long as I do not bring in the Second Welfare Theorem related to problems of distribution. Indeed almost all the specific policy measures in a reform package, when taken individually, can be derived directly from one or the other of these basic principles. But when we adopt a programme of such measures, to be implemented in a particular situation, all the questions I have referred to above, namely sequencing, pacing, coordinating and packaging become relevant, on which views may differ. The issues can become more controversial, if in an actual application of these measures, problems of distribution as well as other social objectives, such as removal of regional disparity or looking after special interest groups such as women, bonded labour or backward classes, are brought up. Add to that the complications created by the Second Best Theorems which say that in the presence of a number of distortions, removal of one does not necessarily move us closer to the optimum.

We can thus be all unanimous about the basic principles of reforms but continue to vigorously disagree among ourselves about how these specific measures are to be applied in a particular situation. I want to raise some of these questions in today's lecture, because I believe that the time has now come for all of us to be engaged in these controversies about policies that are shaping our economy. The universe of discourse must change from simplistic categorisation between pro-reform and anti-reform positions to what is feasible and among all the options what is most desirable.

Programme of Economic Reforms

The programme of economic reforms supported by the IMF and the World Bank that we adopted in 1991 and which we are trying to carry out today is of a kind that many countries had adopted with the Fund-assistance of upper-credit-tranche facilities, with their conditionalities. The prevailing international economic environment always played a large role in the implementation of these programmes in any individual country. That environment has changed drastically in the 1980s, especially in the latter half of the decade with a virtual disintegration of the socialist bloc countries and disappearance of central planning. But even after that, between mid-1988 and mid-1991, 36 countries in the world tried to implement Fund-supported programmes. Except for five central European countries, Bulgaria, Czeckoslavakia, Hungary, Poland and Rumania, which adopted Fund-programmes after undergoing systemic changes in their economies, most of the other countries had been familiar with the principles of conditionality of these programmes either through some form of previous arrangements or through Article IV consultations with the Fund. Quite a number of them had indeed several previous arrangements with the fund. Outcomes of their programmes adopted between 1988 and 1991 may, therefore, be regarded as the result of being under some sort of Fund-discipline for an extended period of time.

The initial conditions in countries adopting the Fund-programmes and the specific causes of the crises that force the countries to seek Fund assistance usually vary quite widely and so were those for the countries entering into the Fund-programmes in the last part of the 1980s. Nevertheless, the broad thrust of the programme of measures for all of them were very similar, based on financial stability, outward looking policies and deregulation of markets. Although the programmes were supposed to be designed to tailor them to the varying initial conditions and the specific causes of the problems of the individual countries, the actual policy measures were quite uniform in practically all of them. They were supposed to restrain domestic demand by reducing fiscal deficits, by three to four percentage points over a period of two to three years, and these were to be complemented by restrictive credit policies, lowering the stock of net bank credit to the government and reining in the growth of bank credit to the non-government sector, supported by shifts from bank to non-bank financing with the liberalisation of financial markets. The demand restraint policies were supplemented by large nominal effective depreciation of exchange rates to improve external competitiveness. For a number of countries exchange rates, after their initial depreciation, were made the nominal anchors of the monetary policies to re-establish the credibility of the policy intentions, even if that meant an appreciation of the real effective exchange rates for the subsequent period. In other countries with moderate inflation and low inflationary expections, some flexibility was retained in the exchange rate management in maintaining external competitiveness. These policies were supplemented by other structural reform policies like deregulation of prices and investment, changing the structure of taxation and public expenditure, moderating wage increases, privatisation of public enterprises and moving the economic activities towards greater integration with the world economy.

To anybody familiar with the Fund-bank Adjustment Programmes or the basic elements of the programme of economic reforms adopted in India, all these would appear to be very similar. It is this similarity of the package of measures, applied to different countries with different initial conditions, that has given the Fund-Bank Programmes of economic reform an identity of a compact, mutually consistent, model. There is by now quite a large literature on the validity of this model based on the assessment of the outcomes of this model. Because of the differences in the conditions of the different countries where the model has been applied, the specific outcomes have also been quite different, making it very difficult to judge whether the programmes have been on the average successful or not. I do not want to get into that debate, because the criteria for the assessment of success of these policies have been so varied that it is practically impossible to have an unequivocal answer to that question. What is important, however, is to appreciate that the outcomes have been different and there is no automatic assurance that a country which has adopted the Fund-Bank Programme would be necessarily successful in achieving the intended results.

About the programms of the 36 countries, adopted in 1988-1991, the Fund-Bank staff has recently made a thorough analysis of their outcomes in terms of a number of their objectives. The results of the analysis were again not much different from those of earlier examinations of the outcomes of Fund-Bank Programmes. Some of the objectives were satisfied but others were not. For example most countries were able to meet the external goals of the programmes, by re-building the foreign exchange reserves, reducing the current account deficits and lowering the debt-service ratios. But domestic objectives were quite often unfulfilled. Inflation remained in general high, and output growth quite low and below the potential. Investment rates showed little change and employment growth remained sluggish. Indeed a number of countries could not complete the programme. Some of them went off-track almost at the beginning of their programmes and those who had relatively greater success in fulfilling the performance criteria of different policies were mostly those which had undergone one or several previous arrangements with the Fund type of programmes over a relatively long period and had a greater chance of success than otherwise.

In the context of such varied outcomes, sustainability of economic reforms will have to be assessed in terms of the number of objectives with reform measures successfully achieved and not by holding out the fulfilment of a single objective as the index of success. It is true that most Fund Programmes succeed in achieving the external objectives. At least the current accounts improve, reserves are built up and arrears are cleared. Analytically this could be a direct result of a demand restraint policy. Since the current account surplus is identically equal to the difference between domestic income and domestic expenditure, a policy that depresses domestic demand and therefore, domestic expenditure would almost invariably improve the current account, if of course external markets are open and a reduction in expenditure does not lead to a reduction in income. Freeing the market forces together with an effective depreciation of exchange rates (and helped very much by the assumption of a small country facing an elastic export demand, to obviate the possibility of a sharp fall in the terms of trade), which are the common elements of the Fund Programmes, could ensure the successful outcomes in the external sector. As external reserves are built up, the arrears and defaults that the countries might have fallen into could be cleared. But whether that would be the solution of the debt problem, as it afflicted many of the developing countries in the 1970s and 1980s, and whether it would lead to an increase in the inflows of foreign capital, would depend upon the improvement in the country's capability to generate export surplus necessary to service the external debt and thereby encourage the flow of new capital. This would in turn depend upon the growth of output in the country and expansion of the production capacity of the export sector. Even for a sustainable improvement of the external sector, a necessary condition then would be the growth in output and production capacity of the reforming country.

A demand restraint through control of fiscal deficit also faces similar problems. The reduction of overall deficit through increased revenue has to be largely achieved by increased tax coverage and tax compliance, both of which are time consuming and difficult to materialise. The tax reform programmes associated with the Fund-Bank prescriptions invariably lead to reduction of tax rates, both direct and excise as well as customs duties. On the expenditure side, both interest outlays and administrative expenditures are mostly inflexible, at least in the short term. The only manoeuvrability left would be with non-interest development outlays and capital expenditures. In most countries undergoing Fund-Bank Programmes, fiscal deficit reduction has been heavily tilted towards reduction in such development and capital expenditures. If a fall in such development and capital expenditure leads to a fall in the growth of GDP, which means if private investment does not crowd in, or lack of maintenance and complementary expenditure on balancing equipment reduces the overall productivity of the public sector assets, such a deficit reduction may not be sustainable.

By now there is a substantial literature on fiscal sustainability which clearly demonstrates the importance of facing the rate of growth. If financing of fiscal deficit through money creation is limited by the need for containing inflation, fiscal sustainability would depend very much upon the stability of the ratio of debt of GDP. In the countries undergoing Fund programmes in 1988-1991 overall fiscal deficits were reduced by almost four percentage points, but there was hardly any fall in interest outlays. Indeed except for those countries which had several previous arrangements with the Fund in the earlier years, for all other countries interest payment as a percentage of GDP actually increased significantly during these programme periods. Such an outcome was not consistent with sustainability of the fiscal accounts of the reforming countries.

Regarding policies to restrain domestic credit, the reforming countries often face the problem of choosing between containing inflation and preserving external competitiveness. In the countries under Fund Programmes during 1988-1991 there was a substantial reduction in net credit to the government and somewhat less but equally impressive reduction in net domestic asset. But that led to a sizeable increase in net foreign asset and a very large increase in the growth of money. Thus monetary developments in these countries had restraining effect on inflation. The situation was somewhat different in countries which adopted the exchange rate as a nominal anchor which enhanced the effects of fiscal reduction on inflation and slowed down the growth of demand for nominal money balance. But in general large increases in net foreign assets had a negative effect on curbing monetary growth and inflation.

A related issue has been the behaviour of interest rates. In almost all countries adopting Fund Programmes, reforming financial markets complemented measures for restraining fiscal deficit and credit growth. As a result controls were removed on a significant range of interest rates, auctions were introduced for government papers and a perceptible shift was made from bank to non-bank financing of deficits. The immediate effect in most countries was an increase in the nominal interest rates and a large number of countries succeeded in raising real interest rates to positive levels. However, in the 1980s in a significant number of countries, oligopolistic banking practices, without adequate regulatory supervision and large non-bank financed borrowing requirements plus a policy to defend the exchange rate, whether as an anchor or as a conscious effort to manage the rates in the face of large inflows of foreign exchange, and the need to sterilise those operations as a part of disinflation policies, caused concern about excessive level of interest rates and large spreads. Too much risk taking in the expectation of rewards from high real interest tended in several countries to weaken the banking system threatening a disruption of the reform process.

The experience with structural reform policy in the Fund Programmes has,however, been rather varied. This is bound to be so because the structural reform policies invariably affect the relative costs and prices of different economic activities. They have direct impact on the distribution of the benefits and costs associated with those policies. Political pressures of different interest groups play a major role in the outcome of such policies whether they are related to privatisation, tax reforms or removal of subsidies. In the case of privatisation, however, quite a number of countries have been able to raise substantial revenues from the divestment of shares as supportive of their fiscal deficit reduction policies, even though only a few of them succeeded in the actual sale and transfer of public sector enterprises to the private sector in any significant scale.

The Indian Programme

I have discussed these experiences of the reforms related to the Fund-supported-Programmes mainly to underline not only the similarity of the actual measures but also the predictability of their outcomes in most of the countries that have adopted these programmes. Although I have specifically referred to the programmes of the period 1988-91, in order to link them to a common international environment, earlier studies of the Fund Programmes also indicate very similar results. Indeed if one looks at the different elements of the Indian programme one should not be surprised at all by what has actually happened in India over the last three years. The outcomes of the reform measures introduced in 1991 were quite predictable even at that time on the basis of the past experience of the Fund Programmes.

There were three main points of the Indian reform programme as introduced in 1991. First, fiscal deficits were to be reduced drastically. Second, exchange rates were to be depreciated and third, a number of structural reform policies were to be introduced, including tax reform, deregulation of prices, delicensing of investment, liberalisation of foreign trade and foreign investment regime, as well as certain measures of reforming the financial sector and public enterprises. On each of these points, it would have been possible even in 1991 to build up a scenario of the expected outcomes of the policies in the next few years, in the light of the experience of the Fund-programmes in other countries.

For example on the fiscal side it would have been quite predictable that the burden of deficit reduction would have fallen overwhelmingly on cuts in capital and development expenditures. Since the main thrust of the tax reforms was in the nature of reduction of rates and since simple Laffer-curve relationship between reduction of tax rates and increase in tax revenues does not exceed, it should have been expected that significant increase in revenues would take some time to materialise as the ability of the government to increase tax coverage and tax compliance would be necessarily limited. The actual performance of the government in raising tax revenue has been quite impressive and the credit must go to the efficiency of tax administration. Nevertheless the tax-GDP ratio could not have been expected to rise very much and a reduction in the deficit GDP ratio would have to come mainly through reduction in expenditure. Since interest payments could not be waived, the only way primary deficits could be reduced was either by reducing administrative expenditures and subsidies or by cutting development and capital expenditure. Given the political realities in the country and also the fact that the beneficiaries from development and capital expenditures are too widely spread out to form a lobby, it was almost predictable that although the intentions of the policy makers would be to reduce the revenue expenditure, in actual practice it would be the development expenditure that would suffer. Furthermore, as these development expenditures including public investment have a direct impact on the growth of output, which because of other structural policies was expected to be in any case sluggish, a deficit reduction through the reduction of development expenditures need not reduce the deficit: GDP ratio as fast as the programme had intended.

The impact of this less than targetted reduction of fiscal deficit ratio on inflation would very much depend upon the growth of money supply. However, as we have seen in the experience of other countries, the programme measures actually increased the supply of broad money. The exchange rate depreciation would have immediately increased the possibility of expanding the exports. This, together with deregulation of the markets and their opening up to foreign trade and foreign investment, would have naturally increased the inflow of foreign capital. This effect normally takes a little time, needed to build up confidence in the country's persistence with policies and in India it took about two years for the foreign exchange inflow to accelerate. If the output growth had not picked up and if the foreign capital inflows did not materialise into physical capital formation and if also there was not a significant increase in import surplus, the policy makers would naturally be faced with a difficult choice. Either they would have to sterilise the unintended increase in reserves, which would push up the interest rates and raise the interest burden of the government and therefore, the fiscal deficit, or they would have to tolerate a substantial increase in the broad money supply raising the pressure of inflation. There could have been a third alternative of allowing the exchange rate to appreciate; but that would have made the export sector increasingly uncompetitive, reversing the benefits of the initial exchange rate depreciation. Indeed it is possible to argue that since all export subsidies have been practically withdrawn and since increases in the capacity of export production take time, the optimal policy should be a depreciation of the nominal exchange rates, at least,in line with, if not in excess of, the rate of inflation. In actual practice, the RBI seems to have chosen to defend the dollar exchange rate almost as if it has accepted the dollar as the nominal anchor without explicitly stating so. This has probably given stability to our monetary policy but might have also increased the risk of losing international competitiveness.

I have spoken about the problems related to interest rate policies on another occasion, where I have highlighted the risks of adverse selection and too high a rise in the interest rates that may result from an abrupt deregulation in the face of a persistently large fiscal deficit. But there is another issue related to the management of fiscal deficits which has not been fully highlighted in our discussions on economic reforms. A fiscal deficit consisting of primary deficit and interest payments on domestic and foreign debt can be financed by domestic borrowing (including from commercial banks), foreign borrowing and domestic credit to the government from the Central Bank. The Central Bank's lending to the government is equal to increase in reserve money which generates seigniorage revenue which, when there is inflation, consists of increased demand of real money balances by the private sector and increase in the nominal money demanded by the private sector to preserve the initial level of real balances. It is a sort of inflation tax, related to the growth of output and demand for money of the private sector, which reaches a maximum at a particular rate of inflation with a given rate of growth of real GDP. When financing a deficit through borrowing has an effect of increasing the burden of interest payments, the trade-off for financing it through reserve money creation should be considered carefully. There are different models for calculating that and I am not suggesting that fiscal deficit should be automatically financed by RBI. But I am not convinced of the decision that RBI financing of budget deficit should be brought down to Zero, even if we cannot effectively reduce the ratio of fiscal deficit to GDP. Indeed a case can be made that the principles of controlling fiscal deficit should not be considered in isolation from the causes of this deficit or the impact of the budgetary expenditure on output and other variables.

If fiscal deficit cannot be reduced by reducing revenue expenditure, then one has to examine carefully the effect of reduction of public investment and development expenditure on the growth of output and thereby on the ratio of fiscal deficit to GDP.

The potentials of structural reforms policies are as much an issue of political economy, as they are of appropriate sequencing and packaging of the individual measures. I do not want to get into these political economy issues which will take me quite afar from the limited confines of my lecture today. The only point that I want to emphasise here is that so long as one is not certain about implementing fully the structural reforms policies, one should not be inflexibly wedded to any particular element of the fiscal and monetary policy related to stabilisation. Indeed I find that the debate between stabilisation and structural adjustment is rather facile, because without structural adjustment it is very difficult to have sustainable stabilisation. This is particularly true of the developing countries because most of their problems of stabilisation caused by excess of absorption over income are the results of structural constraints which prevent output from adjusting to demand or structure of production to change flexibly in response to changes in the pattern of demand.

Structural Aspects of Reform: Economic Growth and Investment

Some of these structural aspects of economic reform are integrally related to the questions of sustainability. The first and foremost is the problem of growth. Ever since the Bretton Woods Conference and the founding of the IMF and the World Bank, developing countries have been saying that the viability of any solution of their problems of balance of payments, problems of inflation and macro-economic instability, would depend upon the ability of the developing countries to adjust the structure of their economic activities leading to a sustained growth of output and employment. There was a very interesting debate at the Bretton Woods Conference itself when representatives of several developing countries including India pressed for incorporating the development objectives as a part of the IMF's Articles of Agreement. Indeed, a draft proposed by the Indian representative became the basis of a prolonged debate on the objectives of the international monetary system. In the event, the Indian draft was rejected but the thrust of the argument came back again and again in the IMF stabilisation policies and programmes of balance of payments adjustments throughout the history of that organisation.

The main problem with these stabilisation programmes is that since they were essentially based on restraining aggregate demand they had a depressing effect on the real output of the economies. There have been several studies which have built up models of economic growth and stabilisation programmes which show that the rates of growth of output of countries adopting stabilisation programmes together with structural policies would initially decelerate if not actually fall, then after a few years, would pick up and accelerate faster than the rate at which the GDP of the country would have grown, had there been no reform programmes. The eventual acceleration of the growth of output primarily results from the structural policies when they complement the usual demand restraining stabilisation policies. These studies have been invoked mainly to justify international agencies providing loans to finance the adjustment programmes. Only if a country's path of future income surpasses the path that would have resulted without adjustment, the financial assistance provided by these international agencies would have a chance of being repaid. The initial phase of deceleration of output, however, is result of certain inherent problems of adjustment under an overall restraint on demand-a result which has been corroborated by these empirical studies.

The arguments for such deceleration are quite straight forward. Even if the initial conditions were marked by excess demand or expenditures exceeding output, the reduction in expenditure would not just reduce prices or the rate of inflation but also real output or at least the rate growth of real output. The effect is more explicitly brought out if we consider changes in the relative prices, either because reduction in the rate of inflation is seldom neutral regarding the relative prices or because the stabilisation policies are complemented with other policies such as devaluation and deregulation of prices which change the relative prices between different sectors. Consider, for example, a devaluation which changes the relative price between tradeable and non-tradebles. In the long run, resources will move from non-tradeable to tradeable sectors improving national income. But in the short run there may be factor market rigidities. For example, when some factors are sector-specific and some factor prices such as wages are downwardly rigid, changes in relative prices may well lead to reductions in the national income in the short run. There are several models which can demonstrate this and an interesting example of such is J. Peter Neary's articles in *Economic Journal* in the 1980s based on the Marshallian Neo-classical Models, which show these possibilities of output reduction. That result, incidentally, is not associated with only devaluation, but with any changes in the relative prices between production sectors, and is essentially related to factor market rigidities.

Whether the GDP of a reforming country actually declines or its growth rate decelerates in the initial phase of reform, would depend upon the empirical conditions of production and factor supplies. But there is one simple point which remains valid irrespective of the different empirical specifications. And that is based on the fact that a structural adjustment implies a shifting in the composition of production when some activities are given up or slowed down and other activities are taken up or expanded. Even if labour and other variable factors were fully mobile, responding to the changes in their prices, capital goods are not like mecano sets and cannot be shifted from one activity to another without actual investment in new machinery and equipment. In order that such investment take place, investors have to be convinced of the potential rate of return of the new activities. They will not only have to be fully informed of the production possibilities but also convinced of the sustainability of reforms which in the first place caused the changes in the relative prices and composition of activities.

In almost all countries which adopted the Fund-Bank Kind of reforms, with a heavy dose of stabilisation policy in the initial years, it appears that private investment does not pick up for a number of years. Even in the programmes of 1988-1991 discussed above, the significant increase in the real rate of interest in most countries did not have much impact on raising the rate of savings. And the rate of investment in most of the countries stagnated if not declined. It is very difficult to establish any clear empirical relationship to explain this non-responsive behaviour of private investment in countries going through reforms with deregulation of prices, freeing of market forces, reduction of direct taxes and opening up the opportunities of foreign trade. Several economists have written about it and probably the most famous contribution here is that of Dornbusch, (World Bank Annual Conference on Development Economics, 1990) who tried to explain this sluggish response of private investment to such economic reforms, in terms of investors exercising the "waiting option", until "the front loading of investment return is sufficient to compensate them for the risk of relinquishing the liquidity option of a wait-and-see position". This option precludes a quick repatriation of capital and even when capital does return, it would be placed in liquid forms in financial markets rather than in plant and equipment. The basic problem there is the question of credibility of the stabilisation policy-the possibility that the 'good state' which results after the reforms with a higher rate of return on investment may not actually come about and the 'bad state' of the pre-reformed condition with a lower rate of return may persist. If the investors continue to exercise their waiting options for a number of years the whole reform process may actually collapse. It is interesting to quote Dornbusch on this point:

> If the private sector does not respond with investment and capacity expansion, and if confidence and inflation fears bar a public sector expansion, then the policy maker becomes the proverbial emperor without clothes. That is, although the policy maker has sharply increased profitability in the traded goods sector (i.e. through devaluation and liberalisation), the profits are expatriated and there is neither growth nor equity.

Clearly this is a case where one must plead for an increase in public investment. The missing link here is not the potential of earning a higher rate of return which reforms are expected to secure for the investors, it is the expectation about implementing the reforms or the government's commitments to the policies propounded, which is lacking in the private investor's assessment of available information. Obviously the government should not have that problem and it should be more than willing to make that investment because that itself would help the implementation of the reforms, fulfilling its commitments.

It is not necessary that such public investment should take place only through public enterprises. Indeed, in a post-reform state there should not be a large difference in the operations of public or private enterprises. An investment decision of the government could be executed either by public or by private enterprises, whichever can do that more efficiently and effectively. There can be ways of implementing such investment decisions, which the government considers appropriate, through appropriate incentives, tax deductions or capital subsidies. The purpose of such policies would be to reduce the risks of the investors in a particular line of activity, which may be considered as particularly beneficial. One method of doing this could be for the government to share the equity with the private investors, without necessarily getting into a joint venture and involving with the operation of the enterprise. An example of this would be the government offering 'convertible equity', in which government is willing to share a portion of the equity capital with the promoter in a particular activity, say upto 49 percent to allow the promoter to retain complete control over its operation, and to give the promoter an option after, say, three to five years to continue to share this equity with the government or to convert it into a fixed-coupon rate debenture. Indian businessmen are familiar with convertible debentures. Our notion of convertible equity is a similar asset except that the equities are to be converted into debentures rather than the other way round.

Let me give one example to illustrate how these mechanisms work. Consider the power sector, whose expansion is essential for the infrastructural development of the country, the growth of its economy and the success of the economic reforms. Many private investors, and for that matter, several public enterprises also, will be quite willing to invest in the generation of power and execute their projects quite efficiently, provided that they know that the power generated would be properly evacuated, transmitted and distributed to the users who would be willing to make the full payments for the power charges. These are all interlinked functions whose implementation must be an integral part of any structural policy. It would be extremely expensive for the company which is generating power to perform all the functions since the government knows that all these inter-related functions have to be carried out for building up the power sector, it could quite logically offer to share a portion of the risks of the company which agrees to invest only in the generation of power. For an investor in the generating capacity, the expected return as such may be quite high if the risk of the subsequent activities and a realisation of the revenues, is shared with the government. A 'convertible equity' may be an appropriate solution in this situation.

If the logic of this argument is accepted, I may venture to add that sometimes it may be cheaper for the government to provide a guaranteed rate of return to the investor in the generating capacity, instead of providing a capital subsidy through the equity share. Indeed if appropriate procedures are followed, such as the World Bank method of International Competition Bidding for selection of supplies of plants, equipments and materials, the guarantee of a rate of return, with a probability that it may not actually be invoked if all other parts of economic reforms are fully implemented, may be quite a reasonable solution. For example, Rs. 1000 crores of investment and a guaranteed rate of return of 16 per cent for seven years after a three-year construction period would yield a net present value (at 12 per cent discount) of only Rs. 520 crores if the full guarantee is invoked. If the amount of guarantee invoked is lower, the present value would be correspondingly less. For instance, if the guarantee is invoked only half the times and if the debt equity ratio is 1.1 then the present value of the guarantees would become comparable to convertible equities.

I illustrate my proposition with a project in the power sector but clearly the logic is applicable to many sectors wherever such a nexus between public and private sector can be built up. The infrastructure industries are a particularly good candidate for the application of such policies, because the rate of return on investment there can be very high and also because public investment, facilitating an increase in the capacity in infrastructure, is not only going to make a substantial impact on the country's growth prospects but also would promote private investment, both foreign and domestic, in many other fields. The only caveat that should be noted in this context is that such a public sector contribution in the sharing of risks of the investors should operate on a level playing field. Any investor, domestic, foreign or even public enterprises should be qualified for such a support provided the technology and costing of production are properly negotiated for maximum cost effectiveness.

Economic Reforms and the Poor

Let me conclude this lecture with some discussions on the question of the impact of economic reforms on the poor. Frankly, there is nothing in the design of the structural adjustment measures which can be considered necessarily either as pro-poor or anti-poor. If resources are shifted from one set of activities to another, there would be some redistribution of incomes and also some unemployment of factors of production. There is no reason why these changes should be necessarily against the poor. In fact the deregulation of prices and better financing facilities, and increased export possibilities especially of agricultural products should actually improve the lot of the poor. There would, of course, be some unemployment in the industries or sectors which would contract. But if growth takes places and additional employment is generated, the net effect of that on the poor would be quite uncertain. There would, of course, be pressures from different interest groups which are affected by these changes and who would oppose these reforms. But these pressure groups are not necessarily going to be the poor.

The negative impact of reforms on the poor comes from other factors which usually accompany the reforms, even if they are not the necessary implications of those reforms. The first instance is, of course, when growth does not take place and unemployment does not fall. We have already considered this situation in detail. The second instance is when some growth takes place with some increase in investment over some years but mainly in response to market forces, which are guided by the existing distribution of assets and purchasing power. This would tend to militate against a redistribution of income and wealth. It is not at all surprising that market-based reforms get increasingly associated with meeting the requirements of the rich and producing and importing consumer goods for ostentatious luxury. In particular, this would tend to increase the regional disparities, because the richer states which have better infrastructure and richer people would tend to attract more investment and, therefore, generate higher growth than poorer states.

The other factors are associated with the need for reducing fiscal deficit which in practice appears to be a reduction in the rates of taxation coupled with reductions in development expenditure and capital investments as well as subsidies. Reduction of all subsidies is not necessarily anti-poor, because quite often the subsidies support the relatively richer vested interests. But the reduction of development expenditures and public investment can have the visible impact of upsetting many of the projects, especially those in the social sectors such as health, nutrition, child-care and primary education, which affect adversely the common masses. In that context, I see no option but to continue with the expenditure programmes in the social sectors and other essential public investments. The debate should necessarily be centered on how to increase the efficiency of these programmes and improve their delivery systems. But reduction in these expenditures could only serve as projecting the image of the reforms being anti-poor.

In addition to this, I would suggest consideration of a substantial expansion of the public distribution system. Although it is easier said than done, there is a lot of scope in improving the operation of the public distribution system and also making it better targetted. But the main reason I submit for continuing with a more efficient and more elaborate public distribution system than we have today, is the hope of making this an effective instrument of having some control over the prices of essential wage-goods. That has been the original aim of the public distribution system in India, covering food grains, edible oil, sugar, kerosene or even coarse cloth. It is not necessary to expand the coverage of products too much. But it is necessary to have the issue prices of the public distribution system substantially lower than the open market prices of those goods. If we succeed in expanding the public distribution system properly over the poor urban areas and the poor rural blocks, without expecting too much fine-tuning of the targetting of the beneficiaries, we can hope to make a positive dent in the inflation of the basic wage goods prices. It would, of course, imply quite a large subsidy, which would be higher if we keep increasing the procurement prices, under the pressure of interest groups. It may also be necessary to make some drastic changes in the institutions involved including the Food Corporation of India. But even after all that, it may be worth pursuing this system mainly as an anti-inflationary measure, containing the wage goods prices. The anti-poverty impact would then be an incidental but additional argument in its favour. Several countries, which adopted orthodox stabilisation programmes, went in for some heterodoxy by adopting some form of wages-incomes policies. If we can control the wage goods prices, and if we link the wage increases to the PDS prices, we shall partially achieve the results of such heterodox policies without actually adopting them.

All these, of course have implications for the budget and the fundamental policy base of reform will have to be a strong budget constraint; however, there are many trade-offs involved and a proper design of economic reforms programmes must take into account the totality of these trade-offs, playing with all the variables concerned. Fiscal deficits, their financing by borrowing or by seigniorage, tax rates, direct-indirect and customs duties and their sequencing and policies regarding expenditures of different kinds such as long term development expenditure for the social sector, public investment for infrastructure and for removing regional disparity, as well as subsidies necessary to maintain an improved public distribution system.

Let us not make any of these policies as the inflexible datum. The art of policy making consists in orchestrating these instruments, comparing their trade-offs and deciding their timings to realise the objective of sustainable economic reform. ■

Courtesy: Mainstream Vol XXXIII No. 14

BREAKDOWN OF "PEACE TALKS"

Jayadeva Uyangoda

The break-down of peace talks between the government and the LTTE has once again plunged the country into war. The resultant confusion in the South apart, the LTTE, the war lobbyists, the government and peace lobbyists are awakened to a new reality: there is no public enthusiasm, either in the North or in the South, for the third round of war.

After an event, particularly when that event is a disastrous one, we all can claim ourselves to be a little wiser. And in the post-April 19 wisdom, the government's behavior in the entire peace process has come under the sharpest scrutiny. A check-list of conclusions arrived at by critics and analysts should include the following: (i) Chandrika mishandled the whole situation, (ii) Prabhakaran took the government for a ride, and (iii), Chandrika should never have gone for peace talks with Tigers.

Mishandling Talks?

Of all this, it is the mishandling argument that warrants examination, because it is being presented by some peace advocates as well. The point in this argument is that Chandrika left space for Prabhakaran to run away from the peace process, by her amateurish and not-so-serious approach to talks. To illustrate the point, the critics say that the government peace delegations were comprised of novices, naive bureaucrats and individuals with anti-LTTE credentials. This point is further buttressed by the LTTE's own allegation against Chandrika that by sending low level negotiating teams, she only demonstrated her arrogance as well as the lack of a serious approach to the process of talks.

All these critics, including the LTTE, miss one point. The two chief negotiators during the past eight months have been none other than Chandrika Kumaratunga, President and Mr. Prabhakaran, the LTTE leader. Negotiations took place at two levels: face to face talks between teams representing the two sides and exchange of letters — nearly fifty in number, and rather long ones at that — between the two leaders.

At face value, however, the above argument has a validity. While the LTTE negotiation team was headed by the chief of its political wing, no Minister was ever included in the government team. The latter was always headed by a non-political bureaucrat, the Secretary to the President.

One has nevertheless to ask the question: why is the LTTE apparently angered by the perceived low level nature of government negotiating teams? In the post-April 19 political literature, I have not so far come across a credible answer to this question. The only point that approximates to an answer is the surmise that so-and-so should not have been sent as government delegates. This hardly explains so fundamental a question as the LTTE's return to war; was it simply because they felt belittled by the composition of the government peace negotiation teams ?