

# Indian social democracy: The resource perspective

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# 1 Executive summary

This paper examines the strategy for obtaining adequate resources for the Indian State, where the goals of the State comprise the provision of public goods (which, by definition, benefit everyone) and income transfers to those below the poverty line.

Living beyond our means is infeasible in the long run. A government has to fundamentally spend only tax revenues. The failure to live within our means yields the risk of crisis, it reduces the headroom available for policy makers to respond to catastrophic events, and it reduces the average GDP growth rate. The key parameter that requires focus is the ratio of government debt to the output of one year (i.e. GDP). This is analogous to the ratio of the indebtedness of a person divided by annual income. The two key rules which India must attain are: (a) This ratio must not cross 60 per cent and (b) In most years, this ratio must decline. It must be emphasised that this discussion of the debt/GDP ratio pertains to the aggregate consolidated debt of centre, states and local governments, and not just the debt of the central government.

Unlike some Asian countries who have a long history of fiscal prudence, India has a long history of fiscal stress. Hence, these concerns have to be taken seriously. At present, the debt/GDP ratio is well above 60 per cent and an immediate reduction of over 20 percentage points is required. Happily, the international experience shows that it is not difficult for a country to get sharp reductions in the debt/GDP ratio over a few years. The fiscal consolidation plan presented in the report of the 13th Finance Commission envisages a reduction of the debt/GDP ratio (of the Centre alone) from 80.7 per cent to 68 per cent over five years.

Once spending by borrowing is ruled out, resourcing the State is primarily about tax revenues. The most powerful determinant of tax revenues in India, in coming decades, is going to be sheer GDP. The international evidence shows that a country of India's level of per capita GDP finds it very hard to achieve a tax/GDP ratio of above 20 per cent. The experience of other countries including emerging markets suggests that it is only when per capita GDP crosses \$9,206 that the tax/GDP ratio is able to get beyond 20 per cent. Hence, for the foreseeable future, the scenario that we have to envisage is one where the tax/GDP ratio works out to 20 per cent. It must be emphasised that this prospect, of a tax/GDP ratio of 20 per cent, pertains to the aggregate total tax revenues of the Indian State, summing across centre, states and municipalities.

While keeping this goal of a tax/GDP ratio in mind, there are seven immediate areas where tax policy can yield immediate increases in GDP. These are worth undertaking because even though the tax/GDP ratio will not go beyond 20 per cent or so, the overall tax revenues will go up owing to larger GDP:

1. When a series of distortionary taxes is replaced by the GST, Indian GDP will go up significantly, reaping the benefits of a dynamic ‘common market’. The GST will help spur labour-intensive manufacturing, including export-oriented manufacturing, in poor regions of India.
2. The second is a gradual evolution of the personal income tax to a point where a full one-third of the households of India pay income tax, albeit at a low rate. This will encourage a better engagement of the citizenry in public goods: A citizen that pays income tax is likely to be more demanding about the performance of government agencies. In addition, a broad tax base enables reduced rates, which strengthens GDP growth by reducing tax-induced distortions and reducing the size of the black economy.
3. We are now ready for the end-game of customs reforms, which involves eliminating customs duties on manufacturing.
4. New thinking needs to be brought into the question of taxation of capital. Conceptually, Indian GDP growth critically requires immense ‘capital deepening’ where trillions of rupees need to be devoted into building up the capital stock of the economy, which is the path to high output and high wages. The key idea proposed here is a scaling up of the exempt-exempt-tax (EET) system of taxation to cover a much broader array of investments by individuals, through which individuals will be incentivised to save and invest (thus helping the growth of the country), but will be taxed when they liquidate their investments for the purpose of consumption.
5. Fundamental rethinking of the taxation of corporations is called for. Corporations, associations, clubs, partnerships, etc., are all mere mechanisms through which individuals obtain income. As long as the comprehensive income of individuals is taxed, once, the purpose of tax policy is met, and this implies elimination of the income tax on corporations. It is more efficient for India if we tax the *individuals* who own corporations, instead of getting into the complications of taxing corporations while trying to have a dividend distribution tax in order to counter-balance the double-taxation.

6. As with all maturing middle-income countries, India needs to graduate to the ‘residence-based taxation’ approach for dealing with cross-border capital flows. At present, this is the *de facto* reality given the Mauritius route. Efficiency gains are available by making it the *de jure* route for capital coming in from all major countries, e.g. the members of OECD.
7. There is a case for an estate duty, through which the intensification of wealth concentration across generations can be counteracted. At the same time, the size of this estate duty needs to be modest, so as to avoid distorting the incentives for hard work in each generation.

All these seven areas for reform will foster higher GDP, and interacting with relatively small changes in the tax/GDP ratio, will yield bigger resources for the exchequer. Alongside this, a fresh approach to the portfolio of assets of the State is required. It is far better for the government to own 2000 km. of highways or “greener” environmental capital, instead of owning Rs.10,000 crore of shares of Air India.

There are two areas where ownership of companies or shares by the government is clearly inappropriate. The first is the goods and services of ordinary competitive markets (e.g. hotels or steel). These things are best done by competing private firms. The second is in regulated industries. The ownership by government of companies in a regulated industry – e.g. telecom – reduces the confidence of the private sector in the extent to which policy and regulation will be unbiased, and thus deters investment into these areas.

A fresh effort on rethinking the portfolio of government, shifting away from public ownership either in competitive markets or in regulated industries, will generate massive resources for the exchequer, and also spur GDP growth. Since the proceeds from the sale of assets will not be a continuous flow of resources coming into the State for the long term, spending this money on consumption expenditure of the government (e.g. for paying salaries of policemen or for running welfare programs) is not appropriate. The best use of these resources would be to unburden the government of debt, thus bringing down the flow of annual interest payments which presently stands at 3.6 per cent of GDP for the Centre alone.

We turn to the challenge of envisioning a European-style social democracy in India. Evidence is offered showing low levels of “trust capital” in India. As is well known to political scientists, welfare states are unlikely to be successful or flourish in countries with high heterogeneity and low levels of trust capital. Hence, we argue that India is not fertile ground for the creation of a European-style welfare state, for the coming 10 to 20 years.

A more fruitful line of enquiry concerns a rethinking of government programs in an incentive-compatible way. Three key ideas need to be emphasised. The first is the ‘Aadhar’ program, which can ideally culminate with every household under the poverty line having a number, a bank account, and being known in a master table of the poor households of India held with the Ministry of Finance. Once this is in place, the comprehensive elimination of poverty in India is feasible through the direct transfer of Rs.2,292 per month into each household directly from North Block into the bank account of this list of the households below the poverty line. The cost of such a program would be 2 per cent of GDP, which is well within the goal of spending no more than 20 per cent of GDP.

The second theme that deserves emphasis is decentralisation. Local governments are of particular importance in cities. We need to pursue the ‘Unfinished Revolution’ launched by Rajiv Gandhi through the 73rd and 74th Constitutional Amendments by achieving genuine local government, atleast in cities. The GST reform can be accompanied by a mechanism through which a part of the GST collections of a city are paid as tax revenues of that very city, thus closing the loop from public goods to higher GDP to greater resources within each city of India. The third theme that deserves emphasis is the decoupling of public expenditure from public provision. In many areas, it is more efficient for government to contract-out the actual production of public goods, while continuing to fund their creation. While this can work well in some areas (such as education or health) it is not useful for core public goods which are defence, police and judiciary.

European-style social democracy is seen as a safety net where individuals are protected from an array of risks. Social programs which interact with individuals are transaction-intensive and hard to implement, particularly in the contemporary Indian governance environment. However, a substantial part of the problem that these programs seek to address can be addressed by *macroeconomic* policy frameworks which reduce the fluctuations of the market economy. As an example, in the downturn of 2008, many workers in India were thrown out of job. While a system of unemployment insurance is one way to address their concerns, it is also important to undertake the fiscal, financial and monetary institution building through which business cycle stabilisation is achieved. This is a key area where the new issues that India faces, as a middle income economy, necessitate substantial reforms when compared with the institutional apparatus presently in place.

Two scenarios for the next few decades are presented in the paper. In the first scenario, India pushes ahead to a tax/GDP ratio of 24 per cent, with an

early expansion of welfare programs, weak institutional reforms in the areas of fiscal, financial and monetary policy, and a low pace of integration into the world economy. This scenario is projected to yield a trend GDP growth of 6 per cent. In the alternative scenario, India accepts a tax/GDP ratio of 20 per cent, and holds back on expenditure programs which will go beyond this level of resources. This is a scenario which goes along with strong reforms of fiscal, financial and monetary policy, and a high pace of integration into the world economy. This scenario is projected to yield a trend GDP growth of 8 per cent, thus capturing the 'once in a lifetime' demographic opportunity that is available to India today.

Even though the tax/GDP ratio in the second scenario is lower by 4 percentage points, over the next 10 or 20 years, the tax revenues of the State prove to be significantly higher. In addition, of course, citizens would prefer the latter scenario given that personal incomes would be much higher over the next 10 or 20 years by going down that route.

In summary, this paper emphasises the primary tool through which the State can obtain resources is higher GDP growth. A tax/GDP ratio of 20 per cent, with expenditure that is just slightly above 20 per cent, is the reasonable scenario which can be envisaged for the coming 30 years. Mobilising greater resources for the State is thus synonymous with undertaking reforms which yield higher GDP growth. Alongside this, a good part of the concerns which lead to a desire for European-style social democracy can be addressed by undertaking fiscal, financial and monetary policy reforms through which business cycle fluctuations are diminished and governance vastly improved. In addition, fresh thinking about mechanisms of expenditure can yield greater bang for the buck thus freeing up resources while improving social justice and welfare outcomes.

## **2 The role of the State in the new India**

A large fraction of the Indian people lead a difficult life. A better functioning State is of critical importance in improving the lives of the people, both through its impact on everyday life through public goods, and through its positive impact on GDP growth and growth in employment.

In terms of the central tasks of government, there is a broad consensus about eight elements:

1. Effective legal protection and the justice system,

2. Defense and internal security
3. Elementary education,
4. Public goods that enable better health outcomes
5. Policy frameworks which reduce transactions costs,
6. Protection of the environment,
7. Macroeconomic risk reduction, and
8. Income transfers to people below the poverty line.

One of the key tasks that is faced in Indian economic reform is that of fostering a State apparatus which can deliver these eight functions efficiently, with requisite resources being obtained in a non-distortionary manner.

Many in India aspire to additionally embark on two more functions: providing risk insurance to the population at large and undertaking population-wide redistribution. It is argued that some advanced countries, such as Sweden, perform these ‘social democracy’ or ‘welfare state’ functions relatively effectively, and that Indian voters desire such an expansive State. In countries like Sweden, the tax revenues of the government exceed half of GDP. This agenda involves much more ambitious social engineering, where massive tax revenues would have to be obtained, and politically directed towards certain households through suitable government programs. In this paper, a resource perspective is brought to bear upon these two distinct sets of objectives.

### **3 Living within our means**

In recent months, television screens worldwide have highlighted the contrast between Greece and Sweden. Both countries aspired towards constructing a similar social democracy. While Sweden has been able to achieve stability, Greece was living beyond its means. Political compulsions can often lead to the enactment of ambitious social programs. However, as economists emphasise, there is no free lunch, and when there is a gap between the resources commanded by the State and the expenditure profile which has been adopted, this can have devastating consequences.

The divergence between resources and expenditure-aspirations are met by borrowing from citizens or from foreigners through financial markets, resulting into growing indebtedness of the State. Financial markets often accept



such slow increases in sovereign indebtedness upto a point. But at some point, financial markets can abruptly get extremely uncomfortable about solvency of the government. Disruptive mistrust of solvency on the part of the financial markets often, unfortunately, coincides with political or economic crises, thus exacerbating the difficulties.

This ‘nonlinear’ behaviour of financial markets suggests that the present relatively calm conditions should not induce complacency in Indian policy thinking. It is important to be clearly in safe territory, amidst the ranks of the fiscally healthy countries of the world, so as to rule out the scenario of a sudden financial crisis. In addition, the extent to which the country is far removed from fiscal distress represents the headroom that is available for fiscal expansion in the catastrophic situations that seem to arise in the global economy once or twice a century.

### **3.1 Identifying the danger zone**

The most important parameter which describes fiscal distress is the ratio of government debt to GDP. Fiscal prudence involves ensuring (a) That this ratio is not increasing and (b) That this ratio stays at reasonable levels.

It is useful to have a sense of what is the danger zone for the debt/GDP ratio. While some OECD countries (e.g. Japan) have very high debt/GDP ratios, the practical reality of being developing country is that debt tolerance is lower. Government debt was below 60 per cent of GDP in most episodes of default by governments in emerging economies in recent years (Reinhart, Rogoff, and Savastano, 2003).

India has some advantages on the outlook for debt owing to the hope of attaining and sustaining high GDP growth. Yet, until India becomes a high-income country, it is prudent to assume that financial markets will be wary about fiscal, financial and monetary policy institutions in India, and will become uncomfortable about owning Indian government bonds at high levels of the debt/GDP ratio. The Indian rules about the debt/GDP ratio should hence be calibrated based on emerging market experiences with default, and not the experiences of countries like Japan which have sustained very high levels of the debt/GDP ratio in recent years.

### 3.2 Impact of reducing the debt/GDP ratio upon growth

While large values for the debt/GDP ratio go along with enhanced crisis vulnerability, *reductions* in the debt/GDP ratio directly impinge upon growth. A recent paper (Kumar and Woo, 2010) measures the direct contribution of a reduction in the debt/GDP ratio upon growth, after controlling for a diverse range of extraneous factors. They find that on average, a 10 percentage points of GDP reduction in the debt/GDP ratio, by itself, adds 0.2 percentage points per year to GDP growth. The mechanism through which this works is increased investment and increased productivity growth.

From an Indian perspective, this suggests that when the debt/GDP ratio is brought down from the region of 90 per cent of GDP to the desirable target of 60 per cent of GDP, this (by itself) would yield a rough acceleration in growth of 0.6 per cent. In addition, the risk of a fiscal or financial crisis would be reduced, which is a prerequisite for a sustainable social democracy. Fiscal prudence is thus good for growth in addition to being good for stability (Feldstein, 2004).

### 3.3 Debt capacity as a reserve for extreme conditions

When a country has healthy values for debt and deficits under ordinary times, this creates the space through which the rare use of discretionary fiscal policy can help the economy in rare and extreme events. The deeper consequence of this fiscal space is that the private sector feels more confident in the outlook for the country, knowing that the State has the capability to marshal remarkable responses when extreme situations arise once or twice a century. This confidence induces bigger investments in financial and human capital and into long-term projects.

As an example, Table 1 looks at the experience with the consolidated deficit of the UK. From 1998 till 2007, the average value for the deficit was 1.43% of GDP. From 1999 till 2001, the fiscal balance was in *surplus*. In 2007, the deficit was at 2.6% of GDP.

In 2008, when the UK was hit by a once-in-a-century financial crisis, this healthy starting position gave the government the ability to undertake emergency actions, which more than doubled the deficit to 5.4% of GDP in 2008, which went further to 9.8% of GDP in 2009 and is estimated to be 10.9% of GDP in 2010. If the UK had not engaged in fiscal prudence from 1998 till 2007, with an average deficit of 1.43% of GDP in this period, it would not

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**Table 1** Deficits in the UK

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Year	Consolidated Deficit
1998	0.1
1999	-0.9
2000	-1.3
2001	-0.6
2002	1.9
2003	3.3
2004	3.3
2005	3.3
2006	2.6
2007	2.6
2008	5.4
2009	9.8
2010	10.9

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have been possible to enlarge the deficit in this fashion in response to the once-in-a-century crisis.

A longer historical perspective on the UK, going back to the late 18th century, shows a long-standing pattern where large deficits were run and debt was enlarged to deal with catastrophic events like wars. In normal times, for decades on end, fiscal surpluses were obtained and used to pay off debt, thus rebuilding the position for a next catastrophic event which might necessitate borrowing. Such a framework gives fiscal policy the opportunity to respond in extraordinary ways to the extraordinary events which take place once every few decades.

This suggests that sound fiscal institutions should yield an equilibrium where, in the typical year, the debt/GDP ratio goes down. This would create the space for government to enlarge debt substantially once or twice a century through discretionary fiscal policy, when catastrophic events come about.

At the same time, when these rare catastrophic events materialise, and governments desire a substantial enlargement of the debt/GDP ratio, the bond market is concerned about the possibility of insufficient repayment through inflation. The willingness of the bond market to fund public debt in these episodes is critically related to the extent to which such a scenario is ruled out. An inflation targeting central bank, which reassures the bond market that unexpected inflation will not arise, is an important component of the institutional architecture that makes discretionary fiscal expansion possible

without driving up interest rates.<sup>1</sup>

### 3.4 Feasibility of reduction of the debt/GDP ratio

If India starts out with a daunting value for the debt/GDP ratio, how difficult is it to bring this down to the sub-60 zone of comfort? There is a somewhat unexpected relationship between deficits and debt. When deficits are held down to modest levels, and when GDP grows, the debt/GDP ratio comes down quite dramatically.

As an example, the UK debt/GDP ratio dropped dramatically from 65% to 40% from 1996-97 to 2001-02. In other words, in a five year period with only modest surpluses, the debt/GDP ratio declined by 15 percentage points.<sup>2</sup> In similar fashion, the Canadian strategy of ‘budget balance or better’ resulted in a decline of the debt/GDP ratio from 70% in 1996 to 40% in 2004. These examples show the feasibility of obtaining large reductions of the debt/GDP ratio in relatively short periods of time, through a combination of the prudent policy of running surpluses in normal times, alongside GDP growth which increases the denominator.

Reductions of the debt/GDP ratio critically rely on the primary surplus (the budgetary surplus calculated after excluding interest payments) and on the GDP growth rate. When GDP growth is high, and when there are primary surpluses, rapid reductions in the debt/GDP ratio are feasible (Mundle, Bhanumurthy, and Das, 2010). The former has been repeatedly achieved in India, but the latter has not.

Table 2 shows some examples of developing countries which obtained strong gains in the debt/GDP ratio in recent years. The average starting point of these examples – a debt/GDP ratio of 80.7% – is coincidentally similar to India’s present starting point. Over an average five-year period, in these examples, the debt/GDP ratio was reduced by an impressive 26.1 percentage points. Of this, 10.6 percentage points came from the primary balance (‘PB’), 8.1 percentage points came from the gap between GDP growth and the nominal interest rate, and 3 percentage points came from currency appreciation. This gives us a rough sense of the contours of the composition and scale of a strong fiscal correction, judged by the standards of developing countries.

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<sup>1</sup>See <http://tinyurl.com/inflationfears> on the web.

<sup>2</sup>Source: *Debt and reserves management report, 2008-09* of the UK Debt Management Office.

**Table 2** Emerging markets which achieved strong reductions in the debt/GDP ratio

Episode	Initial debt	Reduction	Contribution		
			$PB$	$r - g$	Curr. apprec
Poland ('93-'98)	84.3	47.7	3.3	22.6	9.6
Chile ('90-'98)	45.9	33.0	30.0	11.5	3.9
Ecuador ('88-'90)	113.5	32.1	4.1	11.4	-11.8
Pakistan ('01-'07)	84.8	29.7	6.4	17.1	5.1
Egypt ('03-'07)	114.9	27.7	-11.0	29.9	1.9
Jamaica ('02-'07)	122.0	27.4	50.8	-30.3	3.8
Brazil ('02-'05)	85.0	20.8	12.4	1.7	4.6
Colombia ('02-'07)	49.8	16.4	14.4	1.0	4.6
Malaysia ('03-'07)	44.4	14.5	-4.3	8.3	2.4
Tunisia ('01-'07)	62.7	11.8	-0.7	8.1	6.4
Average	80.7	26.1	10.6	8.1	3.0

*Source:* Table 6.3 from *Fiscal implications of the global economic and financial crisis*, IMF Staff Position Note, 9 June 2009, SPN 09/13.

A modest literature has now sprung up on understanding the enabling conditions (on an international scale) for large debt reductions, of the kind that are now needed in India. A recent contribution to this field is Nickel, Rother, and Zimmermann (2010). They find that over 1985-2009, many events of total debt reduction averaging 37 percentage points of GDP can be identified, across the world. This encourages us about the feasibility of the quest for large debt reduction in India. Under what conditions do such large debt reductions materialise? They identify two key factors. The first is an environment of high GDP growth. India satisfies this requirement. The second requirement, in their words, is:

*“decisive and lasting (rather than timid and short-lived) fiscal consolidation efforts focused on reducing government expenditure, in particular, cuts in social benefits and public wages.”*

This suggests the area of focus for policy today.

### 3.5 Summary

India has a long history of fiscal indiscipline (Buiter and Patel, 1992). Hence, the fiscal problem requires particular focus. Any plans for expenditure by

**Table 3** Central government's fiscal stance

	(Percent to GDP)						
	2005	2006	2007	2008	2009	2010	2011
Receipts	15.6	14.2	13.5	15.0	15.1	16.5	15.9
Expenditure (ex. interest)	11.5	10.1	10.1	11.0	12.4	12.9	12.3
Interest payment	3.9	3.6	3.5	3.5	3.5	3.5	3.6
Expenditure	15.4	13.7	13.6	14.5	15.9	16.4	15.9
Primary surplus	0.0	-0.4	0.2	0.9	-2.6	-3.1	-1.9
Stock of debt	61.6	61.0	59.3	57.3	56.7	56.4	56.5

the State must stay within the budget constraints of taxation. This, in turn, translates into one tangible goal and one intermediate test.

The tangible goal is that the government's debt (fully measured) must not be increasing through time and must not cross 60% of GDP.

The intermediate test is that every year, India must run primary surpluses. That is, there must be a fiscal surplus once interest payments are excluded. In good years, there should be strong fiscal surpluses, and in bad years, the fiscal surplus can dwindle away to zero. Once this intermediate test is satisfied, under ordinary circumstances, the Indian debt/GDP ratio would decline from year to year. This would create the space for enlargement of the debt/GDP ratio when faced with exceptional situations. However, Table 3 shows these key calculations for the central government in recent years, which shows that we are far from this required configuration. These years had India's greatest ever business cycle expansion.

The recently submitted Finance Commission report has outlined a feasible path of fiscal consolidation which will reverse this trend. The Finance Commission has shown that under the proposed Fiscal Responsibility and Budget Management Act (FRBM Act) framework, the consolidated debt/GDP ratio would decline from 80.7% to 68% in next 5 years. Such a reduction in debt/GDP ratio should be considered as a minimum achievable target, since these calculations have assumed a rather modest growth path for the economy. With energetic implementation of tax and expenditure reforms, the growth performance of the economy can be even better and consequently the reduction in debt/GDP ratio can improve upon these projections.

## 4 How can resources be obtained?

Once a sound set of rules are in place governing borrowing, the expenses of a government are largely circumscribed by its revenues. Modifications in tax policy can yield greater tax revenues. In addition, there are also some important opportunities for obtaining resources from non-tax channels.

### 4.1 Architecture of the tax system

The simple channel – higher tax rates – involves two problems. The first is that of tax evasion. Higher tax rates inspire greater efforts at evasion. This matters directly insofar as an increase in the tax rate fails to yield the hoped-for tax revenues. More importantly, high tax rates induce citizens and firms to undertake far-reaching re-organisation of business and personal life so as to evade taxes. This sets the stage for deeper problems for law enforcement and for the political system. It is, hence, important to avoid high tax rates.

The second problem is that of economic distortions. High tax rates distort behaviour and the organisation of production. Economic analysis shows that the distortion associated with a tax rate goes up with the square of the rate. Higher tax rates produce much larger distortions. These distortions adversely affect the foundations of economic growth. Since economic growth is the only robust foundation of poverty alleviation, and given that the very resource base of the State is linked to GDP, these distortions are worth avoiding.

In thinking about tax policy, the ideal channel is one where reforms of tax policy are undertaken which yield higher tax revenues by increasing efficiency and thus GDP, and by building mechanisms for obtaining tax revenues which are very hard to evade. Our strategic thinking about the tax system should be grounded on three big ideas:

**Fiscal rules** As emphasised above, government must live within its means. Tax revenues must define expenditure aspirations.

**The criticality of growth** Once we have a commitment to live within our means, growth in expenditure can, then, only be achieved through growth in GDP. The tax system is an important part of the determinants of GDP growth. A well designed tax system is one which would be compatible with high incentives to save and invest, to organise production efficiently and achieve high growth. This is the path to achieving large values for the absolute size of resources of the exchequer.

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**Table 4** The opportunity for tax revenues

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Range of per capita GDP	Tax revenue (Per cent to GDP)
Below \$745	14.1
\$745 – \$2975	16.7
\$2976 – \$9205	20.2
All developing	17.6
Above \$9206	25.0

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**A sense of the possible** Using modern computer technology, tax revenues can and should improve. Systems such as the ‘Tax Information Network’ can have a major impact upon tax collections. But India cannot aspire to Western European style tax/GDP ratios. The cross-country evidence shows that until \$10,000 of per capita GDP, there is only a modest rise in the tax/GDP ratio. Table 4, drawn from Gordon and Li (2009), shows the striking empirical regularities on this subject. This suggests that till India achieves per capita income of \$9,206, tax revenues of all levels of government put together, are unlikely to go much beyond 18-20% of GDP. The task is, then, one of using these revenues effectively to get beyond \$9,206 of per capita GDP, after which bigger opportunities would become visible.

## 4.2 Elements of Indian reform of tax policy

Within this strategic perspective, seven big ideas should now shape our thinking about tax policy.

1. **GST** Ten years ago, our fiscal experts felt that a well structured Goods and Services Tax in India was infeasible. Gradually, this pessimism has eased. The automation of income tax showed that India can build IT systems; the State VAT effort showed that coordination between states could happen (Rao, 2005; Kelkar, 2004).

Done right, the GST will be accompanied by removing almost all other existing taxes, leaving only three taxes: the income tax, the GST and the property tax. This will reduce compliance costs, economic distortions and harassment. Many of the taxes that would be removed are ‘bad taxes’ on turnover such as the stamp duty or octroi. This policy package has been termed the ‘Model GST’: single rate GST that covers all Goods and Services, which replaces all indirect taxes of the Centre and States, with a harmonized exemption list, and a common IT platform.

The GST will enable the next phase of customs or import tariff reform. The



sound architecture is one where imported goods are charged GST at entry, and exports are refunded the full GST. By this arrangement, local firms face fair competition in both the domestic market and the global market.

The GST would unleash India as a common market. Even though India is a giant economy with a GDP of \$1.25 trillion, Indian firms often operate within one state. Nationwide optimisation of production, storage and logistics is not taking place. The GST would make possible productivity gain, GDP growth and lower prices.

When market forces govern behaviour, firms gravitate towards low-cost production centres. A firm that sells in Gujarat might setup a factory in Madhya Pradesh. But this evolution - which tends to reduce inter-state disparities - is blocked by barriers to movement of goods. The GST would promote growth of lagging regions; in particular, poor states adjoining rich states will obtain sharply increased investment.

Global manufacturing now involves a large number of processes, spread across many firms in many countries. India has not been able to achieve Chinese-style employment-generation in manufacturing partly because of the burden of cascading taxes. GST will make India a competitor in Chinese-style manufacturing and employment, and set the stage for a great boom in employment-intensive and FDI-intensive manufacturing exports.

One of the major impacts of GST will be on the Construction Sector. Bringing real estate into the GST will have many beneficial effects. It will reduce housing costs, improve the working of the land market and greatly reduce the 'black economy' alongside yielding improvements in governance in the urban and semi-urban areas (through visibility of real estate prices and thus the establishment of a tax base for the property tax).

Many economists have argued that achieving the 'Model GST' is the most important single reform in Indian economic policy. A recent NCAER study has estimated the impact of the GST upon GDP. They find that the economic value of the 'model GST' reform will exceed \$0.5 trillion (Chadha, 2010).

There are four stepping stones to a functioning GST:

1. The first task concerns IT systems. The Tax Information Network (TIN) system is the right foundation for implementing the GST. TDS in an employer/employee context is exactly the same as GST in a supplier/purchaser context. Since TIN does TDS, it is ideally placed to also do the GST. TIN already reaches 700,000 establishments. IT development work needs to be initiated at NSDL, for enlarging the TIN to do GST for the identical 700,000 establishments.
2. The first test case for the new IT system should be a merger between CENVAT, the Service Tax and VAT on imports (i.e. CVD) into a

single tax called the Central GST.

3. The next task is that of arriving at a ‘grand bargain’ with states. The most fair formulation involves placing the entire GST collection into the hands of the Finance Commission for sharing with States. As all commentators have emphasised, a piecemeal allocation of certain services for taxation by States will derail the possibility of such an agreement. The fair deal that States should be offered is one where they tax all services, in return for cooperation in the administration of the GST, and removal of distortionary taxes.
4. The last task is that of coordinating tax administration with the states. Each firm should face only one tax man, and all firms should face the same IT system. One possibility is that of using the centre as tax collector for big firms and the state as tax collector for small firms.

**2. A third of India paying personal income tax** The fundamental feature of the social contract between citizens and State is one where citizens pay tax and the State delivers public goods. On both fronts – the extent to which citizens are law-abiding and pay taxes, and the extent to which the State actually delivers public goods – there are severe collective action and principal/agent problems.

A tax system where a large fraction of households pay income tax, albeit at a low rate, is one in which a large number of citizens would be more demanding about public service delivery. A tax payer is likely to demand public services as a matter of right, and is less likely to be a supplicant.

The overall performance of the economy is enhanced when the tax *rate* is low and tax payments are dispersed across a large number of households. High tax rates generate heightened efforts on evasion, and large economic distortions.

In the coming decade, a reasonable outcome would be one where 33% of India’s households pay income tax. CMIE household survey data (Dec 2009) shows that this is a cutoff of Rs.45,000 of household income. A simplified flat tax of 10% can be employed for household incomes from Rs.50,000 till Rs.100,000 per year. Higher tax rates, and a more complex tax code, can kick in from incomes of above Rs.100,000 per year.

Through the years, as this cutoff of Rs.50,000 is held intact, a bigger fraction of the population would fall into the income tax system through bracket creep, thus generating a larger participation by the people into a government that should work for the people.

**3. Import Tariff Regime** India has benefited enormously from the opening up to the international trade. The average import tariff or customs collection are now at single digit levels and it is now time to move forward towards

elimination of import tariff or customs duties altogether, for manufacturing. Such a policy will also enable India to pursue a “Zero for Zero” option at WTO trade negotiations and, thus, strengthen the multi-lateral trading system in which India, as a rising trading nation, has great stakes. The tariff policy governing agriculture sector will require a separate and more nuanced treatment. This zero import tariff will be accompanied by the full force of GST on imports. This will give a level playing field to our industry.

- 4. Taxation of capital** Taxation of capital income has long been seen as something that stands symmetrically alongside taxation of labour income. It is often felt that the capital gains tax should be similar to the income tax on wage income. However, both need to be seen in a unified perspective: one of fostering high GDP growth in the long run.

A central source of high GDP growth in the long run in a poor country like India is growth of capital stock. A poor country has to save and invest, to build up the capital stock. This ‘deepening of capital’ increases the productivity of labour and underpins the expansion of labour income.

Fairly modest changes in the annual savings rate translate into an elevated trajectory of per capita income over long periods of time. Conversely, if five years elapse at a lower investment rate (e.g. owing to a period where tax policy incentivised consumption), then this permanently depresses the future trajectory of capital and thus per capita GDP.

The question that should be posed of tax policy is: *How can the tax code be structured to foster a high rate of savings and investment?* Once seen in this perspective, taxation of capital income is shown in poor light. Many projects which have a positive net present value (NPV) in a world without taxation are tipped into the zone of negative NPV once some cashflows are paid to the government (at future dates) as taxation of capital income. Hence, the introduction of taxation of capital income into an undistorted world leads to fewer projects being undertaken. It reduces the pace of capital deepening in the economy, and reduces the long-term growth of the country.

As an example, a prominent recent review, which summarises the lessons obtained from 50 years of research in optimal taxation policy (Mankiw, Weinzierl, and Yagan, 2009) identifies *Lesson 7: Capital Income Ought To Be Untaxed, At Least in Expectation*. As they say:

*“...the logic for low capital taxes is powerful: the supply of capital is highly elastic, capital taxes yield large distortions to intertemporal consumption plans and discourage saving, and capital accumulation is central to the aggregate output of the economy.”*

Going beyond the individual perspective, the behaviour of corporations also changes when there is a capital gains tax. Without a capital gains tax,

corporations are neutral between paying dividends or reinvesting post-tax profits. The rule that is prescribed to companies is that when a firm has internal projects that will yield a return on equity that is higher than investing in the market index, then the dividend payout ratio should be zero, otherwise it should be 100%.

When capital gains are taxed, firms have a tax-related incentive to payout more dividends. This reduces the savings of corporations and hinders their capital deepening.

A unified and symmetric solution to the treatment of labour and capital income is the Exempt-Exempt-Tax (EET) system of taxation. Under this, the income of a person (from any source) that is used for investment is deductible. Further, reinvestment is exempt from taxation. It is only upon exit, where money is taken out of investments for the purpose of consumption, that these withdrawals are treated as ordinary income, and taxed as ordinary income.

The key insight here is to encourage and support saving and reinvestment. So when a person takes labour or capital income and puts it into investments, this part should be tax-exempt. Further, when securities are sold and reinvested, the capital income should also be tax-exempt. This gives strong incentives for capital deepening in the economy. It is when the person liquidates assets and brings money into consumption that two taxes should come into play: the long-term capital gains tax that is paid on money that comes out of an EET system, and the GST that is paid on consumption goods purchased.

This approach requires scaling up the EET system to go from the present vision, of a few lakh rupees per person in the context of long-term savings, to cover all financial activities of citizens. Systems like the NSDL's Tax Information Network (TIN) can be designed to track a comprehensive portfolio of each individual, whereby sale of assets and reinvestment is tax exempt, but exit from the EET track is subject to the long-term capital gains tax.

**5. Fundamental rethink of taxing corporations** In any country, production can be organised through clubs, associations, partnerships, limited liability corporations, etc. All these structures are a means to an end: they result in personal income for individuals involved in the production process. That personal income would be taxed in a well designed income tax system. As a consequence, the taxation of any organisational form constitutes double taxation.

The taxation of corporations induces two kinds of effects. First, there is a distortionary bias in favour of tax-efficient organisational structures such as proprietorships or partnerships. If a certain kind of production is best organised as a limited liability corporation, then the productivity of the

country is reduced when tax considerations bias entrepreneurs in favour of an alternative organisational structure.

The second problem is that of locating production outside the country. In the European Union, the average value for the corporate tax in 2009 was 23.5 per cent: a reduction of 11.8 percentage points from the level of 35.3 per cent in 1995. This portrays the average: many countries have a corporate tax rate of below 23.5 per cent. Many developing countries, of course, have lower rates than those seen in the EU. India stands out as a high tax location, with an effective marginal rate of 33.99% for domestic companies and 41.2% for foreign companies. To the extent that India is a high corporate tax region, there is a greater bias in the favour of both Indian and foreign companies to avoid investment in India.

There is a broad consensus that the Indian marginal tax rate on corporations should not exceed that prevalent with other developing countries, which suggests a value such as 20 per cent. But there is a strong case for going further, and eliminating the corporation tax altogether.<sup>3</sup>

This would yield three direct benefits. First, it would eliminate the compliance costs at both corporations and government in the administration of corporation tax. Second, it would bring India to prominence in the investment planning of Indian and global firms. Third, it would remove the tax-induced bias in favour of debt financing for firms, thus reducing the extent of leveraging and thus risk taking. By reducing the demands for debt by large firms, greater space would be freed up in for bank borrowing by small and medium enterprises (SME).

When corporate income flows through to shareholders, it would be taxed as ordinary income. The increased resources of corporations would also generate increased employment, at which point increased flows of income tax would be obtained. Through this, the income of corporations would be fully taxed once – in the hands of the individuals associated with the corporation (shareholders and workers).

The residual problem with this strategy is the possibility that corporations might choose to not pay out dividends for extended periods of time. This can be avoided by having rules about a minimum dividend payout every year. At the polar case, it is possible to envisage a world where the entire profit is required to be paid out as dividends. This would flow through to shareholders and be taxed as ordinary income in their hands. Investment activities of the firm would take place through rights issues and external finance (both debt and public issues). This would have the additional advantage of improving corporate governance, by requiring that managers justify all investment plans to shareholders.

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<sup>3</sup>A paper-length treatment of this proposal is presently under development.

One of the profound implications of removing the tax paid by corporations on their profit is that it will vastly reduce the lobbying or rent seeking behaviour by the Corporate sector as there will be no tax benefits to obtain! This will help preserve a healthy distance between business and politics. Corporate lobbying has been one of the contributors to the creeping ‘crony capitalism’ and consequent difficulties of governance in India. Improvements in governance are of essence for India in the coming generation, and the elimination of the corporation tax will be one element assisting that governance transformation.

An important objection to this proposal is that no other country has a Zero Corporate tax rate. But then, there is no country in the world other than India which has a possibility to register double digit growth rate in coming two to three decades. We must radically rethink our policies so as to exploit this opportunity, so as to decisively break with the curse of poverty. The rapid removal of poverty requires miracle growth rates, as was done in China. This would crucially depend on increased investments and improved governance. The policy of Zero Corporate tax with full taxability of dividends and capital gains in the hands of recipients will greatly facilitate achieving such a growth turnpike.

- 6. Residence based taxation of finance** A core principle guiding discussions on tax policy and globalisation is that taxation should not generate distortions which influence the economic decisions of individuals or firms. Taxation should be neutral and neither generate a bias in favour of doing business at home nor a bias in favour of doing business abroad.

Tax neutrality as regards trade in goods and services has been achieved by focusing taxation purely upon the point of consumption through the destination principle. Under the VAT system, a British consumer of an Australian shirt only pays VAT in Britain. The global market for shirts is fully competitive: all high seas prices are free of taxation. The VAT system actively participates in the process of achieving neutrality, by *refunding* the entire burden of domestic taxation that was faced by the exporter. Critics of the VAT have sometimes termed this ‘subsidising foreign customers at the expense of domestic customers’, which is of course an erroneous characterisation. This approach of focusing taxation upon residents has delivered high levels of current account integration in the world economy without tax-induced distortions of behaviour.

Similar issues arise in the treatment of capital account integration. In order to achieve tax neutrality, the strategy which has been adopted worldwide is to have ‘residence based taxation’ (Sinha, 2010). A country taxes the global financial income of residents but exempts all income of non-residents. Critics of residence-based taxation in finance have sometimes termed this ‘subsidising foreign financial players at the expense of domestic ones’, which is of

course an erroneous characterisation. Under a residence-based tax system, the global market for financial services is undistorted by tax considerations to the extent that the investor does not have to take into account the tax regime of the source country. The British buyer of an Australian financial product only pays income tax in the UK. This delivers the end result of global competition and freedom of choice. The UK tax authorities tax the global financial services income of UK residents and the Australian tax authorities tax the global financial services income of Australian residents.

India has a *de facto* residence based taxation system through the Mauritius route. Foreign investors route their capital flows to India through Mauritius, and are thus immunised from domestic taxation, while local tax authorities tax the global income of residents. The construction of a rational tax framework requires shifting this from *de facto* to *de jure*, by giving all non-residents the Mauritius treatment.

There are concerns about entering into tax treaties with residence-based taxation when dealing with capital inflows from tax havens. In the long run, relatively complex tax policy needs to be crafted in order to deal with the issues associated with tax havens. In the short run, it is immediately feasible for India to enter into reciprocal residence-based tax treaties with all countries who are members of the OECD, none of which are tax havens, and all of which have high quality governance.

- 7. Estate duty** Alongside this framework, there is a case for a modest level of estate duty on wealth holders beyond inheritances of Rs.50 crore. This would generate certain fiscal revenues without inducing significant distortions. Such an estate duty will also play an important role to improve inter-generational equity and to promote philanthropy, while preserving incentive-compatibility on the core business of savings and investment through the working life of each person.

To sum up, over the next few years, we need to head towards a tax regime with zero import tariffs, zero tax on corporations (with rules about paying out profits to shareholders so that income tax is applied there), a 'Model GST' which is essentially a consumption tax, and a small estate duty.

These seven directions of policy will yield a tax system which is compatible with high GDP growth by encouraging integration with the world economy, by encouraging savings and investment, by generating low distortions in the economy, and by encouraging efficient organisation of production. It is not difficult to show that with our proposed tax reforms, the Indian Tax System will become more equitable than the current one. All this would yield high and sustained GDP growth, which is the only long-term foundation of resources for the State. The ideal scenario which we should aspire for is

one where Indian inflation is at 4% and GDP growth is at 8%, where an unchanged tax/GDP ratio yield a 12% nominal growth in tax revenues year after year. Under these conditions, tax revenues would double every 9 years in real terms through sheer GDP growth.

In this scenario, the tax base of local bodies will essentially consist of tax on properties and a share in GST. As introduction of the model GST implies elimination of distorting taxes such as entry tax, octroi, etc., the local bodies will require a commensurate share in the GST tax collection.

All seven areas involve questions of transition. In the short term, deficits may rise. These reforms have many implications for the fairness of resource sharing with the states. Technical studies need to be undertaken on estimating the magnitudes of these effects, and finding transition mechanisms to smooth the short-run effects.

### **4.3 Non-tax sources of resources**

The Indian State possesses a large stock of assets, particularly in the form of shares of PSUs and land. There is a need for a strategic perspective on the portfolio composition of these assets.<sup>4</sup>

Budget constraints are a harsh reality of life. Ultimately, there is a budget constraint in terms of the overall assets of the State. When the State chooses to own Rs.1 of something, this comes at the cost of owning Rs.1 of something else.

The interesting and important question that we should all be asking ourselves is: What should the portfolio composition of the government be? What assets should be held by the State?

The portfolio composition of the State is not something that should remain static at all times. A few decades ago, India was in a very different setting. After independence, the Bombay Plan was drafted by the business community. It envisaged government investment in capital-intensive and technologically-complex problems of the time, such as production of steel or electricity. In the 1970s, the argument was made that if the government did not run an airline, then the private sector could not. By 2010, conditions have changed considerably.

Most of us would agree that the airline industry works quite well as a purely

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<sup>4</sup>This treatment draws upon Kelkar (2010).



private affair. All over the world, governments have got out of airlines. The decades of losses and poor performance of Alitalia is commonly held up as an example of what goes wrong when a firm is brought under public ownership. At the opposite end, most of us would agree that rural roads have to be on the balance sheet of the State. These roads typically do not have adequate traffic, and tolling would not generate adequate revenues. If the government did not own rural roads, these roads would not exist. Similarly, a significant fraction of the stock of capital involved in public health in our cities will need to be owned by the government. Equally, the preservation and improvement of forest cover will have to be a new priority for the public sector assets.

So there is a spectrum of assets, ranging from airlines to rural roads, where government ownership is inadvisable for airlines but required for rural roads or public health infrastructure. How should we think about where each problem falls? There are two broad categories with considerable clarity:

**Goods and services in ordinary competitive markets** The first area where we have a good understanding is goods and services on ordinary competitive markets. An example is steel. Now that India has near-zero tariffs on steel, it is a globally competitive market. Many private companies produce steel. The old argument - about capital and technology required for steel companies being out of reach for the private sector - is no longer convincing. We are now seeing Indian firms exporting steel into the global market - which demonstrates that there is no gap in technology. And, we are also seeing Indian companies turning into multinationals and buying up global steel companies - which demonstrates that there is no gap in capital availability for Indian companies.

Under these conditions, private ownership works best. This should be seen at different levels. First, under ordinary circumstances, private ownership generates the best incentives for cost-minimisation, innovation, and dynamic adjustment of corporate strategy. This is not an ideological position. An extensive research literature has examined privatisation experiences from all across the world, and the findings suggest big gains in productivity from private ownership.

The second aspect of public versus private ownership concerns the issues that arise when a company approaches bankruptcy. In the private sector, bankruptcy is taken seriously. The fear of bankruptcy generates drastic responses in terms of selling off parts of the company, modifying business strategy, etc. These are healthy responses from the viewpoint of the economy. When an unhealthy company sells off a factory to a strong company, the control of assets of the economy moves into the best hands.

Output and employment are optimised through these adjustments. In con-

trast, in the public sector, managers have a tendency to be relatively relaxed about the prospect of bankruptcy. Drastic adjustments when faced with extinction do not take place, because the managers know that there is no real danger of extinction. Public sector companies are always able to draw on the taxpayer to pay for losses. So there are two problems. Adjustments do not take place because of the lack of fear of extinction, and the taxpayer suffers from periodic claims on resources every time the company gets into trouble. There is also a deeper problem here. If in the market place, one of the participants like a PSU is operating under a ‘soft budget constraint’ and that too with deep pockets, then it can adversely affect the performance and fortunes of even efficient private sector companies operating in that sector and such a market structure will systematically misallocate resources.

**In regulated industries** The second area where private ownership is clearly desirable is in regulated industries. In India, we are now seeing numerous regulated industries, ranging from finance to infrastructure, where a government agency performs the function of regulation and multiple competing firms are located in the private sector. Here, the simple and clean solution – government as the umpire and the private sector as the players – is what works best. This configuration is used in every advanced country, and we in India also face the challenge of setting up this architecture of government as regulator with massive investment coming in from the private sector which builds multiple competing firms.

In many of these industries, we have a legacy of government ownership either directly by government departments or in the form of PSUs. The problems described above are very much there: productivity tends to be lower in public sector companies, the fear of bankruptcy is absent, and the risk of asking for money from the taxpayer is ever present. There is an additional issue. This is the conflict of interest between government as an owner and government as the regulator. For instance, the formulation and implementation of competition policy will be more vigorous and fair if government companies are not in the picture. One example is the recent measures taken by the government to support Air India: many of these can be construed as anti-competitive as these vitiate the playing field for our private airlines.

India’s future lies in building a new institutional architecture with government as regulator and with the private sector doing investment. There is a problem when the government is conflicted. If the private sector feels that the regulator will not be an unbiased umpire in the competitive process, because a ward of the government is one of the players, then this makes the private sector feel uncomfortable. In the eyes of the private sector, this is a political risk. To pay for higher risk, the private sector demands a higher return. Fewer projects are implemented: the magnitude of investment goes down. With a higher rate of return on capital demanded by the private

sector, user charges go up.

If we think of the next 25 years, a very substantial portion of the investment in all regulated industries in India is going to come from the private sector. It would be myopic for the government to have a regulator who is conflicted, which reduces the quantum of investment and drive up user charges. It makes more sense for the government to reorganise itself, shifting into the role of the umpire and away from the role of the player. We must move towards a clean solution: government as an umpire and the private sector as players.

There are other areas where there are shades of grey or complexities. For instance, natural resource based industries such as upstream hydrocarbons sector are a complex question. Here, there is a strategic issue as well as the issue of optimal appropriation of the underlying vast resource rent. Similarly, the role of government vis-a-vis universities is also complex. Barring a few such gray areas, we can confidently set about reformulating the activities of the State in the following two key areas. Firstly, the State should not be producing things which can be produced in competitive markets: this covers areas like steel or aluminium or cars. And secondly, the State should not be a player in regulated industries: this covers areas like airlines, running railway trains, shipping, telecom, banking or insurance.

A useful way to visualise this is essentially as a balance sheet adjustment. Suppose the government undertakes a portfolio adjustment, where Rs.10,000 crore of shares of Air India is sold and used to build 2000 kilometres of highways. Let us trace through the full implications of this. Even if Rs.10,000 crore of shares of Air India constitute a minority sale (i.e. 'disinvestment' in the Indian jargon), then certain efficiency gains are obtained. We now have our own Indian empirical evidence which shows that the mere act of listing induces improved productivity. Four channels seem to be at work: listing induces increased transparency, the stock market brings pressure on senior managers by doing daily performance evaluation, corporate governance is typically improved after listing, and to the extent that employees are given some shares, they become more aligned towards the growth and success of the organisation.

If Rs.10,000 crore of shares of Air India constitutes a majority sale (i.e. 'privatisation') then even bigger efficiency gains are obtained. Extensive international evidence shows that productivity goes up strongly after privatisation. The increase in India's GDP because of a better run Air India is the first gain from the proposed portfolio adjustment. The second gain from the proposed portfolio adjustment lies in obtaining an additional 2000 kilometres

of highway. The benefits for India of this public asset are simply enormous. The 2000 km. of highway that we do not have is the opportunity cost that we suffer every year owing to an investment of Rs.10,000 crore in Air India.

It would make a lot of sense for India to undertake this portfolio adjustment of public sector assets to switch from owning Air India to owning highways or public health infrastructure or augmenting 'environmental capital'. The full picture should be seen. The motivation for disinvestment or privatisation should not be narrowly seen as being only about maximising the proceeds from the sale of assets. The real big gains come from the full picture. We gain when the private sector obtains higher productivity (and this happens even with mere disinvestment, but it happens much more strongly with privatisation). We gain when the private sector becomes more comfortable bringing capital into investing in India in regulated industries. And, we gain when the government is able to build highways and canals, metro systems and railroad, which are crucial for India's growth and legitimately belong on the government's balance sheet.

Over the years, the size of the public sector has increased in our economy and currently, there are 473 central PSUs including banks and insurance companies. Of these, 104 are listed and 369 are unlisted. At the State level, there are 1160 State PSUs. It is estimated by informed financial analysts that the valuation of central PSUs (on a P/E basis for the listed companies and P/B basis for unlisted companies) can work out to roughly 500-600 billion dollars or 40-45 per cent of GDP. These are very substantial resources which would become available to the Government to unburden itself of debt thus freeing up fiscal space, and to pursue its own legitimate expenditure goals.

One area of concern about privatisation lies in its political consequences. If PSUs are auctioned off, many of them would be purchased by the top 100 business houses of the country today. This would lead to a further increase in their economic and political influence in the country. In addition, in many regulated industries, there are concerns about the possibility of corruption when profit-maximising firms interact with weak governance. The strategy which addresses these concerns is one in which the shares of PSUs are dispersed across the wide investor community, and the firm is run by professional managers. Such firms, examples of which include L&T or HDFC, are controlled by no family or business house.

## 5 Intelligent design of government programs

There is widespread discomfort with the inefficiency of government expenditure programs in India. A recent paper (Bandiera, Prat, and Valletti, 2009) proposes a useful distinction between ‘active’ and ‘passive’ waste by government. Active waste generates private benefits for politicians and bureaucrats while passive waste does not. In India, there is a strong focus on the former. As an example, a recent article<sup>5</sup> estimates that a government of the size of the State government of Karnataka yields Rs.3,000 crore of bribes per year. Scaled up to the level of India as a whole, this suggests a very large scale of flows of money through corruption.

Corruption represents an immense roadblock to the prospect of achieving an effective government. Controlling corruption is a moral imperative. However, Bandiera, Prat, and Valletti (2009) harness a fascinating dataset and estimate that of the total waste in government programs, 83 per cent is passive waste. That is, in an OECD country, the elimination of corruption would only eliminate 17 per cent of the overall waste. Further, corruption control might often require overheads which further increase passive waste.

The challenge, then, in obtaining an effective government is that of finding mechanisms of public administration through which both passive waste and active waste are controlled. This is a truly daunting challenge in India. In addition to the ‘active waste’ which is prominent in policy thinking in India, where there is a strong attention upon corruption, there is also a big problem of ‘passive waste’ that needs to be confronted. Until far-reaching new ideas are implemented on these questions, spending more money on public programs is often futile.

### 5.1 Envisioning European-style social democracy in the Indian setting

European-style social democracy involves the establishment of large-scale population-wide programs which directly address risks faced by individuals and which undertake redistribution. But building a large State, beyond the minimalist functions of a ‘watchman’ State, involves solving complex problems of collective action. Social norms are required that prevent a small number of citizens from exploiting the welfare state, which would result in

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<sup>5</sup>*Government, a lucrative business* by Vivek Kulkarni, in *Hindu Business Line*, 28 October 2010.

**Table 5** Trust capital: a cross-country perspective

Rank	Country	Agree that most people can be trusted Overall	University grads
1	China	52.3	70.1
2	United States	39.3	43.2
3	Japan	39.1	46.9
4	Germany	36.8	48.8
5	UK	30.5	42.0
6	South Korea	28.2	38.0
7	Russia	26.2	29.7
8	India	23.3	21.4
9	South Africa	18.8	23.5
10	Brazil	9.4	18.8
11	Turkey	4.9	4.5

*Source:* World Values Survey, 2006/2007.

exploding public expenditures. Political scientists have long emphasised the greater feasibility of establishing a welfare state when a country has low heterogeneity and high social capital.

When a country is homogeneous, voters believe that social programs benefit people like them. India has very high levels of heterogeneity by ethnicity, religion, language, and class. The analysis of size of government across developing countries and across time by Shonchoy (2010) shows that on average, a one standard deviation increase in linguistic fractionalisation is associated with a decrease of expenditure to GDP by 1.07 percentage points. India has one of the most extreme levels of linguistic fractionalisation, which would tend go along with a smaller State.

A related issue is that of trust capital, or the extent to which individuals in a country agree with the statement ‘*Most people can be trusted*’.

Cross-country data from the World Values Survey for 2006/2007 is shown in Table 5. Among major countries, China stands out as a country with high trust capital: 52.3% of the overall population believes that most people can be trusted. India has much less trust capital, with only 23.3% of the population feeling similarly trusting.

It is useful to focus upon attitudes among university graduates since this gives a sense about how things might evolve in the future with the spread of university education. University graduates are generally more trusting: in China’s case the proportion of the trusting goes up to 70.1% when considering university graduates only. In India’s case, only 21.4% of university graduates

believe that most people can be trusted. Only Brazil and Turkey have less trust capital amongst university graduates than India.

In recent work, Bergh and Bjornskov (2010) offer empirical evidence which emphasises a causal connection between trust capital and the welfare state. They conjecture three mechanisms through which high trust levels increase the feasibility of social democracy:

1. Social programs are, by definition, available to all. With low trust capital, individuals are more likely to free ride on the system to the maximal extent, leading to exploding costs.
2. A key dimension of trust is trust in the bureaucracy. When trust capital is low, bureaucrats cannot be trusted with discretionary power, which makes it more difficult to build and implement universal welfare policies. European-style social democracy involves case workers interacting with poor families, making discretionary decisions. This requires building and running large transaction-intensive discretionary programs, which present the hardest problems in public administration (Pritchett and Woolcock, 2004).
3. Finally, large welfare programs require a high tax/GDP ratio. In high trust societies, tax compliance would not deteriorate and a large underground economy would not develop.

Trust capital evolves only slowly over the decades. Hence, for the coming few decades, we have to work within the existing environment, where India is a highly diverse society, where voters are likely to think that the people benefiting from a welfare program are unlike themselves, where trust is low, and where civil servants cannot be trusted with discretion in the operation of welfare programs.

From a resource perspective, trust capital matters in thinking about welfare programs in two respects. First, with low trust capital, citizens are likely to engage in strategic behaviour and maximally exploit the provisions of welfare programs, thus exacerbating their cost. In addition, with low trust capital, a high tax/GDP ratio is likely to be elusive.

## **5.2 Sophisticated thinking with incentive-compatible programs**

Given a budget of the tax revenues of the State, high efficiency in provision of public goods and in operations of poverty programs is supremely important. A key dimension which needs to be brought into the process of design

and refinement of government expenditure is the power of incentives. The behaviour of individuals and firms is remarkably malleable: once ‘rules of the game’ are established by the government, behavioural changes are undertaken by the private sector aiming to maximise self-interest. This often leads to unanticipated effects.

Hence, the task of public administration in India has to be rooted in sophisticated and incentive-compatible government programs which deliver a high bang for the buck - where resources are used frugally and yet a great deal is done in terms of delivering consumption and risk-reduction to the bottom quartile.

As an example, consider the public distribution system (PDS). At first blush, the objective of giving food to poor people is a noble one. However, the PDS distorts market signals, promotes black market activity and smuggling, is poorly targeted. As Rajiv Gandhi observed, the bulk of the money spent on PDS fails to reach the poor.

Even when PDS money *does* reach the poor, there are subtle consequences which need to be taken into account. By lowering the cost of wheat or rice, PDS free up resources that can be spent in other ways. Households may shift resources towards expensive foods (such as meat) or towards non-food items. The overall impact of the PDS money that reaches the poor, for nutrition of the poor, is not obvious.

The academic literature offers many warnings about these effects. Kochar (2005) finds that the PDS has only a limited impact on calorific intake (suggesting switching by households towards non-food consumption). Tarozzi (2005) finds that PDS had a limited impact upon the weight of children. Jensen and Miller (2010) undertake randomised experiments in China, and find *no* evidence that subsidies improved nutrition.

This example illustrates the basic point: While it may appear that subsidised rice and wheat for poor people is a desirable activity of the government, the overall impact is far from clear, both in terms of the leakages in administration (which were visible in Rajiv Gandhi’s time) and in the overall impacts upon households (which are now visible in the academic literature).

The subsidy on petroleum products, which became deeply entrenched in India and has taken considerable effort to remove, needs to be seen in a historical perspective.<sup>6</sup> From 1970 to 1973, the world price of oil went up from \$1.2 to \$3.65 per barrel. This tripling of prices was *fully* passed on to

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<sup>6</sup>We are grateful to Swaminathan Anklesara Aiyar for these ideas.



the Indian consumer. In 1973-74, the world price went up further to \$10 a barrel. This next tripling was also *fully* passed on to the Indian consumer. Finally, a third tripling took place in 1980, when crude oil tripled to \$30 a barrel. Once again, Indira Gandhi passed on the entire price rise to the consumer. Policy makers in India need to go back towards this ability to abjure from administered prices under conditions of dramatic fluctuations of the free market price.

From this cautious perspective, three big ideas can be identified that are quite likely to be useful.

The first is the Aadhar program. If each household has a unique number and a bank account attached to the number, and if cash can flow directly from North Block to this account without any intermediaries, then the only impediment faced in poverty alleviation is a master table containing the names and numbers of all poor households in India. With this table in hand, the Ministry of Finance could directly eliminate mass poverty in India. A rough calculation is highly revealing: If 2% of GDP or Rs.110,000 crore are devoted to cash transfers into the poorest 20 crore people, this constitutes a transfer of Rs.27,500 per year (i.e. Rs.2292 per month) for a household of five. With such a capability in hand, a broad array of existing government programs and interventions, aimed at addressing the problem of poverty, can be dismantled, thus yielding enormous improvements in India through the elimination of corruption, downsizing of government, reduction in expenditure, and removal of economic distortions thus enabling higher GDP growth. This scale of expenditure – 2 per cent of GDP for the comprehensive elimination of poverty in India – is consistent with the broad goal of living within a tax/GDP ratio of 18-20 per cent of GDP.

The second grand theme is that of decentralisation. The 73rd and 74th amendments represent an “unfinished revolution” that was begun by Rajiv Gandhi. The implementation of the Model GST, and transfer of a fraction of GST revenues to the local government, will create a new resource flow into local government. The creation of such a fiscal base is also incentive-compatible as it aligns the interests of citizens with the interests of elected officials of local bodies. As an example, the GST collections of Bhopal will partly go back into the municipality of Bhopal, thus closing the loop from local public goods to local GDP to local tax collections to local expenditure on local public goods. By improving accountability, the outcomes in critical local public goods would be improved, which would yield strong increases in the welfare of citizens.

The third grand theme is that of public provision coupled with private pro-

duction. As an example, the Rashtriya Beem Swasthya Yojana (RSBY) combines public resources with access to privately run health facilities. Participating households are empowered to become customers, to choose from multiple competing private health service providers. Payments are only made to a private health service provider when a household patronises this provider: thus poor people are empowered as customers, and there are strong incentives for producers to serve the citizen. This is in contrast with public sector health facilities, where salaries and budgetary allocations are insensitive to the views of citizens. There are enormous efficiency gains which can be obtained by separating public sector *provision* from public sector *production* and by empowering citizens as customers through public funding.<sup>7</sup>

## 6 Diminishing economic risk

European-style social democracy involves two grand themes: redistribution from the rich to the poor, and of risk management at the *individual* level by the State. The risk faced by individuals on account of unemployment, health, disability, etc. is sought to be addressed by government programs.

When the government interacts with the individual *citizen* in understanding events such as illness, unemployment or disability, onerous challenges of public administration are faced in running transaction-intensive systems where civil servants have discretion. There is, however, an alternative path to risk reduction which works at the level of the *economy* and not the individual. This involves reducing macroeconomic risk.

The poorest of countries lack macroeconomic policy frameworks through which fiscal and monetary policy stabilise the business cycle. This yields substantial fluctuations of output, and generates political pressures from individuals faced with negative economic shocks. The volatility of GDP growth in India is between two to three times larger than that seen in OECD countries. A crucial part of the evolution into middle income is the creation of these policy frameworks through which macroeconomic uncertainty is lowered.

Macroeconomic crises have direct and adverse effects upon the poor. As an example, Bozzoli and Quintana-Domeque (2010) document the impact of Argentina's crisis of 2002 upon birth weight. The deterioration of birth

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<sup>7</sup>The Centre for Civil Society has produced a series of research papers on the subject of rethinking education on these lines.

weight in the crisis works out to one-sixth of the distance in birth weight between a rich country (the US) and a poor country (Pakistan). Reduced birth weight is associated with sustained difficulties through life on issues of health, learning and labour market outcomes.

The poor bear the brunt of business cycle volatility. Guillaumont and Korachais (2008) find that in addition to the negative impact of macroeconomic instability upon *growth*, macroeconomic instability reduces the amount of poverty reduction that is obtained per unit of growth. Those with tenured jobs and nominal wage rigidity do not experience the ups and downs of macroeconomic fluctuations. The industrial worker in the fringes of Surat is the one who lost his job in the global crisis of 2008. Once the poor fall into poverty traps in a downturn, they find it difficult to break free of the cycle of indebtedness, ill health and loss of human capital.

Stabilisation policy is important in that it would reduce the shocks that these households suffer. In recent years, considerable work has been done in India on designing the policy frameworks for reducing business cycle fluctuations (Rajan, 2008; Shah, 2008; Shah and Patnaik, 2010), and a good deal of international experience is available. The three key elements of this include:

1. Recasting RBI so that it has independence, and is held accountable for achieving an inflation target. This would involve divesting RBI of numerous other roles.
2. Achieving a high level of fiscal soundness, so that the debt/GDP ratio stays below 60% of GDP at all times. This involves achieving surpluses in good times and deficits in bad times.
3. Allowing automatic stabilisers to vary the deficit through the business cycle. In a downturn, the spending on NREGA would be higher and tax collections on personal income tax would be lower, thus yielding an enlargement of the deficit. Conversely, in good times, surpluses should ensue automatically.

Macroeconomic stabilisation thus requires relatively simple institutional structures such as fiscal, financial and monetary policy. From the viewpoint of public administration, this is an easier path to take because it involves policy frameworks at the level of the economy and not transaction-intensive programs which interact with individual citizens. In this sense, prevention is better than cure.

## 7 Policy directions in middle income

In the last 30 years, India has expanded GDP by six times, by achieving an average growth rate of 6.17 per cent per year. This has abolished the level of deprivation which was manifestly visible circa 1979. This growth acceleration is the first time in millenia that India has substantially enlarged the pie within a generation. This expansion of output has changed the opportunity set of policy makers. In 1979, it was not possible for India to build highways in India, given the price tag of \$1 million per kilometre; today it is.

The main goal of economic policy today should be to achieve a minimum of 8 per cent GDP growth over the next 30 years, so that GDP will grow by more than 10 times. This would take aggregate GDP from the existing value of \$1.2 trillion to a level of over \$12 trillion. If this is achieved, then the resources available to the State would be completely transformed once again, as they have been through the last 30 years of growth. When GDP is \$12 trillion, if 2% of GDP is earmarked for cash transfers, this would represent a sum of \$240 billion.

While this is a highly desirable destination, we should not take it for granted. Over the last 200 years, we have seen numerous examples of countries which failed to achieve sustained high growth. The task for a middle income country is to build State capacity on the core functions of the State, so that the engine of growth is able to continue to work for a few decades more, so as to avoid the ‘middle income trap’ where many countries have failed to produce sustained growth over long periods of time.

### 7.1 Empirical guidance on the two key questions

The empirical literature guides us on the constraints faced by policy makers in two respects:

- *How large can the tax/GDP ratio become, in a low income country?*

Gordon and Li (2009) analyses the tax/GDP ratio for developing countries from 1996 to 2001. The tax/GDP ratio for all developing countries, consolidating across all levels of government, averages to 17.6%. For countries in India’s range of GDP the average is 16.7%: this is not significantly different from that seen in India today. It is only beyond a per capita GDP of \$9,206 that a tax/GDP ratio of 25% is achieved. This suggests that for a few decades, it would be wise to live within our means with an aggregate expenditure of all three levels of government to below 18-20 per cent of GDP.

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**Table 6** Resourcing the Indian State: The inefficient scenario

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This table envisages the consequences of a direct pursuit for a high tax/GDP ratio through higher tax rates, with weak fiscal discipline leading to threats of a fiscal crisis, with poor fiscal/financial/monetary institution building that induces high GDP fluctuations with the consequent adverse implications for investment and immediate political pressure for welfare programs. This is also a scenario where a weak and unconfident India engages in reduced international economic integration out of fear of international crisis.

The two key parameters which characterise this scenario are: average GDP growth over the coming 20 years of 6 per cent per annum, and a high tax/GDP ratio of 24 per cent. An average population growth of 1% is assumed. All calculations are in real terms, at 2009-10 prices. Hence, rupee values are directly interpretable as relating to the 2009-10 value of the rupee.

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Year	GDP (Trn. Rs.)	Population (Bln.)	GDP (per capita)	Tax revenues (Trn. Rs.)	Tax revenues (per capita)
2009-10	58.6	1.10	53,272	12.9	12,785
2019-20	104.9	1.22	86,367	25.2	20,728
2029-30	187.9	1.34	140,021	45.1	33,605

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- *When can a country achieve significant redistribution?*

Ravallion (2009) analyses data for 90 developing countries, aiming to measure the ‘capacity for redistribution’. This is measured by the marginal tax rate on those who are not poor – by rich-country standards – that is needed to cover the poverty gap or to provide a poverty-level of basic income, judged by developing-country standards.

He finds that for low income countries such as India, the required tax burdens are found to be prohibitive: often calling for marginal tax rates of 100 percent or more. The opportunity for doing such redistribution is found later in the development process: after per capita consumption exceeds \$4000 per year.

These arguments suggest that the opportunities visible to policy makers differ dramatically between two groups of countries: the rich and the poor. In the present phase of India’s growth, it seems appropriate to have modest aspirations for the tax/GDP ratio and for redistribution.

## 7.2 An illustrative calculation

These alternatives on resourcing the Indian State are illustrated by comparing two scenarios. In both scenarios, population growth of 1 per cent per year is projected for the next 20 years.

The first inefficient scenario is one with:

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**Table 7** Resourcing the Indian State: The efficient scenario

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This table envisages the consequences of a growth-friendly environment, with a pursuit of a reduced tax/GDP ratio through lower tax rates, with high fiscal discipline, with high fiscal/financial/monetary institution building that induces low GDP fluctuations with the consequent positive implications for investment and reduced political pressure for welfare programs. This is also a scenario where a strong and confident India engages in high international economic integration without concerns about international crises.

The two key parameters which characterise this scenario are: average GDP growth over the coming 20 years of 8 per cent per annum, and a tax/GDP ratio of 20 per cent. An average population growth of 1% is assumed. All calculations are in real terms, at 2009-10 prices. Hence, rupee values are directly interpretable as relating to the 2009-10 value of the rupee.

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Year	GDP (Trn. Rs.)	Population (Bln.)	GDP (per capita)	Tax revenues (Trn. Rs.)	Tax revenues (per capita)
2009-10	58.6	1.10	53,272	11.7	10,654
2019-20	126.5	1.22	104,119	25.3	20,823
2029-30	273.1	1.34	203,494	54.6	40,699

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1. A direct pursuit for a high tax/GDP ratio through higher tax rates,
2. Weak fiscal discipline leading to threats of a fiscal crisis,
3. Incentives for distortionary policies including financial repression and monetary policy distortions in an attempt to respond to the fiscal problem,
4. Poor fiscal/financial/monetary institution building that induces high GDP fluctuations, with the consequent adverse implications for investment and continual political pressure for welfare programs from citizens exposed to high economic risk,
5. A weak and unconfident India engages in reduced international economic integration out of fear of international crises.

In this scenario, a higher tax/GDP ratio of 24 per cent is obtained. However, this combination of features is projected to yield an inferior growth rate of 6 per cent per annum.

The calculations about this scenario are shown in Table 6. Per capita GDP expands strongly from Rs.53,272 per person today to Rs.140,021 over the coming 20 years. Through this, tax revenues per capita – the resource base of the State – are projected to expand from Rs.12,785 per capita to Rs.33,605 per capita. This enhanced resource base will be available for the State for the purpose of either producing public goods or undertaking poverty alleviation for the poorest 20% of the population.

The alternative efficient scenario is one where:

1. The State aspires for a reduced tax/GDP ratio, with lower tax rates,
2. High fiscal discipline leading to the elimination of fiscal stress,
3. Strong fiscal/financial/monetary institution building generates reduced GDP fluctuations. This bolsters investment, and also reduces the immediate political pressure for welfare programs,
4. A strong and confident India engages in high international economic integration without fear of international crises.

In this scenario, a reduced tax/GDP ratio of 20 per cent is obtained. However, this combination of features is projected to yield a higher growth rate of 8 per cent per annum. These are modest and reasonable differences: A difference in projected GDP growth of 2 percentage points, and a difference in the tax/GDP ratio of 4 percentage points, across the two policy packages. Even in the pessimistic scenario, India is projected to be safely away from the 'Hindu growth rate' of 3.5 per cent: the projected value of 6 per cent optimistically replicates the average growth of 6.17 per cent obtained in the last 30 years.

The calculations about the efficient scenario are shown in Table 7. Per capita GDP expands strongly from Rs.53,272 per person today to Rs.203,494 over the coming 20 years. Through this, tax revenues per capita – the resource base of the State – are projected to expand from Rs.10,655 per capita to Rs.40,699 per capita. This enhanced resource base will be available for the State for the purpose of either producing public goods or undertaking poverty alleviation for the poorest 20% of the population.

The comparison between these two scenarios is striking. Table 6 assumes a higher tax/GDP ratio of 24 per cent: it assumes that the State will set forth in a quest for a high tax/GDP ratio and actually attain it. In contrast, Table 7 assumes a reduced tax/GDP ratio of 20 per cent. Yet, under the scenario shown in Table 7, the power of compounding with a higher GDP growth rate is so powerful that the per capita resources available to the State end up being 21 per cent higher – Rs.40,699 per person as opposed to Rs.33,605 per person. This emphasises the idea that the indirect route – of strengthening GDP – is a superior path to resourcing the State when compared with the direct path – of higher tax rates and a high tax/GDP ratio.

More importantly, the scenario of Table 6 yields inferior personal incomes because the GDP per capita is projected to grow to Rs.140,000 per person,

while the alternative scenario yields a superior value of Rs203,494 per person: a difference of 45 per cent. From the viewpoint of the individual, the scenario of Table 7 is thus superior because personal income is higher *and* because there is a greater provision of public goods by the State. If the citizen of India was presented with a choice between these two scenarios, there is no question about which one is superior.

These calculations are, of course, only illustrative. The results are entirely driven by two numbers: GDP growth of 6 per cent versus 8 per cent, and a tax/GDP ratio of 20 per cent versus 24 per cent. There is room for legitimate disagreement about how alternative policy packages can yield different numerical values for these two parameters. Yet, this calculation illustrates the key point: about the dominant role for GDP growth in generating substantial resources for the State.

Both scenarios err on the side of conservatism. The policy package sketched as the ‘inefficient’ scenario could easily yield outcomes worse than those projected, for the GDP growth projected envisages that India will replicate the performance of the last 30 years of economic reform. Global economic history encourages us to be cautious about trend extrapolation in economic growth: most countries which got high growth for 30 years failed to replicate that high growth in the next 30 years (Pritchett, 2000). Numerous countries got out of the ranks of the poorest, but floundered in the ‘middle income trap’. Conversely, there is also a good chance that the ‘efficient’ policy package described above could unleash growth of above 8 per cent; a few countries like Korea and Taiwan have managed to achieve long-term trend growth of above 8 per cent thus proving that it can be done.

## 8 Conclusion

The broad picture emphasised in this paper is one where in the next three doublings of per capita GDP – from \$1100 per capita to \$8800 per capita – the gains of the poor will come primarily from growth and from superior supply of public goods. In this period, there is limited scope for redistribution, and the focus of public policy should be on a government that delivers genuine public goods, which benefit all. This includes the establishment of frameworks for macroeconomic stabilisation, since reduced fluctuations are a public good which benefit all.

The primary tool through which the State can obtain resources is higher



GDP growth. A tax/GDP ratio of 20 per cent, with expenditure that is just slightly above 20 per cent, is the reasonable scenario which can be envisaged for the coming 30 years. Mobilising greater resources for the State is thus synonymous with undertaking reforms which yield higher GDP growth. Alongside this, a good part of the concerns about economic uncertainty, which lead to a desire for European-style social democracy, can be addressed by undertaking fiscal, financial and monetary policy reforms through which business cycle fluctuations are diminished. In addition, fresh thinking about mechanisms of expenditure can yield greater bang for the buck thus freeing up resources.

GDP growth is thus the most important element of all three points of view: the elimination of mass poverty, the increase in welfare of the entire population, and the resourcing of the State.

Very few countries of the world have sustained growth for many decades. The economic reforms of the early 1990s decisively broke with India's dirigiste past. This gave an escape from the Hindu growth rate which afflicted India in the 1970s. But it is important to avoid the complacent assumption that India will replicate this 'miracle' over the coming 30 years, or do better.<sup>8</sup> While the possibility is real, it would be incorrect to assume that our fond hopes are our destiny. Many countries have made policy mistakes through which the fundamental microeconomic foundations of high GDP growth have been damaged, through which an episode of growth petered out.

Considerable caution needs to be exercised in Indian policy thinking today. The gains of the last 20 years were rooted in the economic reforms of this period. If the pace of reforms slackens, then growth will decline. At the same time, India has an enormous opportunity over the next 30 years – rooted in sound demographics – to move GDP growth up, if fundamental change is achieved in the functioning of the State. If growth accelerates, then per capita GDP growth of 7 per cent is attainable. This would yield one doubling of per capita growth in each decade, through which per capita GDP would reach \$8800 over 3 decades.

If this happy scenario comes together, it will put India into the zone of per capita GDP of \$9,206 in 2040. Once this phase is completed, State capacity would be at a different level. The tax/GDP ratio would be higher and GDP would be higher, thus bringing bigger resources into the coffers of the State.

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<sup>8</sup>Episodes of high growth sustained over many decades are so rare in development economics, that Nobel Laureate Robert E. Lucas, Jr. termed them as 'miracles' (Lucas, 1993).

Administrative capacity would be higher. The burning problems of weak public goods on fundamental issues such as the police and judiciary would be absent, thus allowing a focus of top leadership upon other issues. At this point, it will become possible to evaluate a more ambitious expenditure plan for government since the tax/GDP ratio can then potentially rise above 20 per cent.

A premature escalation of expenditure plans has the possibility of contaminating the foundations of GDP growth, through three channels of influence. First, welfare programs undermine the incentives for work. As an example, to the extent that NREGA has reduced the incentives in favour of migration, this runs against the strategic picture of Indian growth being associated with rural to urban migration. Second, a large State requires high tax rates. The economic distortions associated with taxation goes up as the square of the tax rate; thus high tax rates undermine GDP growth. Third, expansive expenditure plans are often associated with an array of problems such as fiscal crises, financial repression, capital controls, and underdeveloped institutions on fiscal, financial and monetary policy. The slowly unfolding demographic transition, which led to a gradual crumbling of the European welfare state by reducing the number of workers in the economy, is an even greater problem for India given the projected rapidity with which the demographic transition will come about in India. All these three channels imply that there is a conflict between the core goal of high GDP growth and the prospect of undertaking a large expenditure program in the short run.

This thinking takes place at a time when India faces a unique and historic opportunity for high GDP growth, from 2010 to 2035, owing to the 'demographic dividend'. If this opportunity is not utilised properly, it will never recur again in the future. India will then face the bleak problems of a combination of mass poverty with an ageing population.

The most important responsibility of our generation is that of correctly executing the economic policy decisions today, so that this happy scenario does arise: one with 8 per cent average growth over the coming 30 years. If this correctly comes about, then the frontier of possibilities for policy that will be faced by the next generation will be enlarged. That generation will be able to choose whether it is beneficial to go beyond a tax/GDP ratio of 20 per cent.

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