

Fiscal Policy, Public Policy and Governance:

(Editor's Remarks)

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I ncreasingly, it is becoming apparent that efforts at economic policy improvements, such as in the area of fiscal policy, are being made in vacuum since more fundamental changes that are imperative in the environment within which such measures are being introduced, are not occurring. These relate to public policy and rules of governance which are the issues that are probably foremost in the minds of the polity today. The focus of this symposium reflects this concern.

A nation may be able to survive many crises over a long period as long as there is a critical mass of support behind its governance. However, there may come moments in a nation's life when only great transformations can save it for, otherwise, that underlying foundation may imperceptibly slip away. India, I am confident in saying, is at such a crossroads. A catharsis, celebrating the 50th anniversary of the 1947 one and transporting the country to the next century, is present. Some of its aspects are discussed below.

First, as democracy in India matures, expectably fiscal federal issues assume ever-increasing importance. As that happens, different areas in the country tend to become more diverse in their economic destinies as more and more decisions are left to states and local governments. They experience widely divergent rates of economic growth as well as population growth.¹ If the economic rationale for a fiscally federal nation state is mainly redistribution of income since an economic union could be devised even outside of it, the Central government has to carry out its redistributive role in an ever transparent manner. While the Finance Commissions have provided regularity and stability to this effort, they are progressively coming under the criticism of partiality (see Bagchi, 1995). Improvements in the prevalent redistribution mechanisms are, therefore, vital.

¹ Population policy has to be resuscitated from its deep slumber and put back into the heart of policy making at the Centre.

Second, there seems to be a significant rise in corruption in all walks of life.² One could argue that decentralisation leads to greater corruption since it lessens state control and monitoring. However, corruption seems to have already enveloped the administrative structure of the Centre corroding the rules of governance perceptibly. It is not at all clear, therefore, that a fiscally federalist state would be more corrupt than a centrist one. Corruption may take many pernicious forms with government—in its legislative, executive, and judiciary branches—functioning with the cooperation of vested interests in the private sector. That corruption may have something to do with the fear of the counterfactual is also obvious. The change in the rules of appointment of the judiciary freeing it from the control of the executive branch's powers of appointment has clearly had the benefit of a new judiciary taking determined action on the control of corruption. Similar changes are necessary in the other branches of Government. More fundamentally, an entirely new social contract will have to be developed if there is to be a system in place comparable to the transformed economies in the rest of the world.

Third, and in continuation of this premise, the inherited rules of executive branch appointments may have outlived their purpose. Executive decision making in government should be based on a combination of administrative, technical and professional skills. Otherwise, they tend to become mainly and merely decisions based on directives received from above—the legislative branch—and on fear spread below—the private sector.

In the modern world, government has increasingly become non-intrusive, imperceptibly playing the role of a facilitator or catalyst, flowing in with a particular administration and formed from the professional private sector, and flowing out with the termination of that administration. If permanent tenure is what the executive branch enjoys it also creates fertile ground for corruption which takes visible and invisible forms (see Tanzi, 1995). Only strong and non-discretionary penalties—defined meaningfully, carrying some teeth and bearing down on both receiver and giver—can make initial dents on the problem while societal values modify and reform over time.

Fourth, an economy performing under strict administrative and structural controls perpetuates rent seeking and rent generation. Therefore, liberalisation as an option is better. It would be better for keeping corruption under check if liberalisation is of the variety that makes the

² And this is surely not just the case here. For an international perspective, see Mauro (1997).

system more transparent. For example, even a system based on the ideology of socialism, despite its lofty ideals, may attempt to micromanage too many objectives; it then becomes opaque and gridlocked and generates rents for particular players at the cost of efficiency of the system and adverse equity of its members.³ Further, while socialism as a concept having been inserted into the Constitution through an Amendment, has always hung in the Indian air, its maturation in terms of land reform or other redistribution measures such as the Public Distribution System has either been selective or ineffective.

That does not mean that liberalisation is a panacea for solving all lacunae of socialism. In fact, liberalisation is fraught with difficulties which raise their heads with unpreparedness in facing possible ramifications of the liberalisation process. In *taxation*, liberalisation requires full preparation for detecting if arms length rules—market based pricing among parent corporations and their subsidiaries—are appropriately utilised, or transfer pricing practices—multinationals minimising overall taxation by inappropriate pricing among their branches and subsidiaries—are not indulged in by multinationals operating in the country. In *health*, there must be a regulatory policy that is effective in minimising "junk food" imports or the like that are well known in the West to include questionable carcinogens and cause obesity directly through high fat content and indirectly through the feeding of steroids into live meat forms. The same applies to *environment*. Hazardous materials and waste—banned from their own countries—are and will be exported without compunction by Western business into developing countries. In reciprocity, the chances of quick enrichment will encourage individual operators in India to flout regulations and carry on international business. Discussions of these matters in the West are conducted only by the "radical" NGOs like Greenpeace which are usually relegated to the fringes of the public view and debate; and, to begin with, even they are mainly concerned about their own environment (as they may be expected to be). Developing countries tend to become cheap dumping grounds for the West and India has already revealed signs of succumbing to the same. In *research*, liberalisation would rightly bring in more ideas from abroad but the likelihood of theft of results for the West's own commercialisation through abducted proprietorial rights over research results and morally wrong patenting will be much increased as has already

³ LeGrand (1982), studying the impact of the British goals of the Atlee Plan whose stated goal was redistribution, concluded that in all objective public expenditure areas — transport, housing, education and health — the opposite resulted. Shome (1983) has a review.

been evinced. In *trade*, new nontariff barriers based on environment, child labour and other constructed standards by the West against developing country imports will mushroom. In *factors of production*, pressure will be put by the developed countries in favour of export of their capital while closing their boundaries to the import of all—even professional—labour from developing countries. The lesson is that multinationals are not charitable institutions; indeed, they are likely to be rather uncharitable. Nor are their parent governments mere grantors; rather, they are likely to be seekers. Despite these factors, gains from opening up the economy could appear like gains from international trade. That is what has to be culled out if liberalisation is to result in benefits to the Indian economy.

The expectation is that despite all the moral hazard that liberalisation will bring, it should still be better than the current system that generates undersupply because of inefficient use of resources and poor products because of dated technology. But liberalisation will serve better if, and only if, India can transcend its lack of preparedness to adequately face other nations and multinationals and deal with them with a practical yet firm set of rules, regulations and manner of conducting business. All this will have to be developed. Indeed, underneath, many of the current practices of contracting for and approval of business undertakings would have to be redesigned such that rumours of cutbacks and commissions catering to individual gains do not reappear. Yet again, full knowledge of and facility with multinational business practices in the context of law and taxation will have to be inculcated by a lot of Indians. For example, multinationals are pressing to be allowed to import legal advisors from abroad. Indians will have to quickly learn to withstand their strategy, approach and nature of advice. If appropriate preparatory action cannot be taken by Indians, it would be fair to say that liberalisation will fail, and characteristically, India will shy back into her earlier shell and to slogans of socialism with its concomitant basis of bureaucratic controls.⁴

Fifth, and in continuation of the fourth, India cannot be truly prepared for liberalisation until it can develop a clean set of rules with which it itself operates. Blaming the West for our own predicaments is a dated strategy. The world sees itself as too advanced and too complex to listen to complaints of this kind. Countries, far behind India at one time in terms of per capita GDP, have pulled themselves up despite seemingly opposing manoeuvres by the West to rush past India, to achieve incomes

⁴ An interesting, alternative and critical viewpoint on the process of liberalisation is found in Nayyar (1995).

several times higher. In India, today, the private sector could be said to be little better than being thrown into a cat and mouse game with administrators and politicians, who consider themselves more masters than public servants. On the other hand, would the private sector itself be willing to progressively redeem itself and allow punishment to be imposed on the erring few? Would Indian entrepreneurs be willing to face such possibilities if left free to go about their business of generating employment and wealth? The answer here should be in the affirmative if India is to face the demands of liberalisation.⁵

The tentacular effects of tax evasion in India are well known. To quote Jalan (1996), "Tax evasion is not only a revenue and a moral problem. As the potential and propensity for tax evasion vary across sectors, it has pervasive economic effects on demand and supply of various kinds of goods and services, savings and investment. Off-market and unrecorded transactions, outside the legal framework of contracts and regulations, become much more attractive. Savings and investment tend to flow to sectors where evasion is easier and where potential for evaded incomes is high. Similarly, skilled personnel are likely to gravitate towards those occupations and professions where the ratio of incomes that do not have to be declared, legally or otherwise, to taxable incomes is high. All these effects of a distorted tax system are visible in India. There is no shortage, for example, of supply of savings for investment in real estate, where tax evasion is rampant and monetary returns are large. On the other hand, the demand for private investment by farmers in irrigation may be strong, but there is no equivalent supply response. The supply of highly trained doctors or teachers for public hospitals or universities is limited, but there is no shortage of doctors in private practice or teachers in private tuition. Similar examples can be found in virtually all sectors of the economy." (pp.60-61).

Indeed, there is no choice with the prevailing international milieu in which many countries have done the necessary by successfully cleansing their own erring systems. Argentina closed down factories and retail outlets for infractions in VAT returns. It publicly posted lists of importers whose declarations had to be reassessed by customs officials. Peru drastically cut down the number of tax administrators, replaced them with officials with an average age of little more than 30, and put in place a salary structure multiple times the earlier one. Korea successfully matched most invoices

⁵ One reader of an earlier draft has commented that this would need a cultural revolution.

between each seller and corresponding buyer when introducing the VAT. The United States routinely put tax evaders behind bars irrespective of their social standing. Mexico introduced a minimum income tax based on gross assets as a presumptive method, netting a whopping increase of one per cent of GDP in corporate tax revenue. Argentina did the same (see Shome, 1995). In the absence of such cleansing, India too would sink back into extra-institutional decision making based on the whims and fancies of politicians. The few progressive geographical areas would increasingly question the efficacy of vast and increasing subsidisation of the majority by the minority which cannot be maintained simply by greater cabinet and like representation from successful areas in an otherwise bankrupt economy, in debt and without ethical standards.

For success, new ideas amenable to quick change even at the cost of initial mistakes must replace "business as usual". In the *legislative* branch, the lack of manoeuvrability of the last Government (United Front, comprising thirteen disparate parties) was underlined by the fact that it had to depend on most parties other than the main opposition party for its existence, and by April 1997, it fell after only ten months in operation because of sudden and inadequately explained withdrawal of support from another party (Congress) outside it.⁶ Thus, the Government's select economically meaningful measures reflected, on the one hand, a certain self-generated strength but their truncated nature betrayed, on the other, the obvious misalignment and even internal discord within it. The subsequent resurrection with a new Prime Minister, hopefully, will not be too ephemeral. All this also increasingly demonstrates, however, that the parliamentary form of government is beset with obstacles in an emerging fiscally federal state and that the efficacy of a presidential form of government demands close and urgent examination. In the *judiciary*, the backlog of cases is so monumental that the Indian case has become a perennial citation for the rest of the world. Here independent tax courts, commercial courts and the like must be considered. Only that will put in place a dynamic judiciary and firm up some of the pathbreaking measures that it has recently taken to challenge the lack of action in the other branches. In the *executive* branch, civil servants are rarely complemented by professionals with specialised training and, instead, are moved from one specialised department to another. There is little effective interaction or involvement with researchers. Fundamental reform is necessary, therefore,

⁶ It is chastening that the main opposition party (Bhartiya Janata Party) was stopped, by almost all parties, from obtaining parliamentary support after forming a Government earlier which lasted a mere thirteen days.

to allow the infusion of specialised knowledge from different professions into the executive branch. In terms of professional research itself, various research and related institutions continue to be created even though there seem to be far too many of them. Under the assumption that they exist to enhance the stock of intellectual capital, often this process is veritably thwarted, however, by making it well nigh impossible to develop a framework that would accommodate researchers with recent high quality training, or familiarity with international trends. New ideas tend to get stifled as a result.

The argument that new ideas tend to get stifled could be generalised across professions, whether politics or economics, socialists or rightists, development or market enthusiasts. Work output based on dated techniques by international standards and administration by a stifling and changeless hierarchy are often justified on grounds of reverence to elders who become synonymous with wise, with all the pampering and paraphernalia that such position commands, even if at great direct and social cost. The fact that the world's "learning curve" is rapidly changing with a high rate of obsolescence is virtually ignored. The result is that there is a falling out from the more dynamic and pace-setting real world, with the country tending to enshroud itself in intellectual autarchy. Only a fundamental change that opens the way for a new and younger generation to impact on policy making can resurrect the country's ability to keep up with the rest of the world. Peculiarly, but thankfully, there is a general feeling in the present atmosphere that this is possible, but many complementary actions would also have to occur. The emergence and activism of non-governmental groups, the cautious optimism of the new generation, and the stream of innovative ideas that are breaking through the firmness of stagnancy are playing to that intuition.⁷

The above issues cannot all be considered in a technical context in one setting. In what follows, concerns in public policy and governance, as related to selected fiscal policy issues, are addressed. As NIPFP celebrated

⁷ One commentator, Amaresh Bagchi, was not so sanguine. I quote him lest, if I summarise, the spark in his language should suffer: "The optimism of the new generation, though cautious, may not take the country forward unless some way is found to resolve the conflicts simmering particularly in North India over 'caste' and the distrust of each other among the constituent units of the federation. Ultimately, it is the awareness of the people that can take the country out of the present mess and that cannot come without education. Tensions generated by inequalities (inter-personal and inter-regional) that accompany growth in the initial stages also need to be kept in view."

its twentieth anniversary year, the nation prepared for its fiftieth anniversary. It seemed fit to bring to the social science readership, a collection of papers focussing on broad aspects of the governance problem which is accepted as paramount today. Since the understanding—leave alone eradication—of the problem must be centred not just on an economic approach but also on related disciplines such as political science, sociology and law, an attempt was made to bring together papers from various fields.

In what follows, each Section is preceded by a discussion of the various papers which appear in it. Section I on "Public Policy and Governance" explores issues such as the relationship between policy outcomes and the nature of governments; the impact of crime and corruption on the stability of countries, as well as guidelines on public policy as we approach the next century. Section II on "Tax Policy and Administration" explains that good governance is crucially dependent on sound tax policies and effective tax administration. The papers presented in this section dwell on the key constraints in the existing tax policies and systems of administration, explore the possibilities and potential of such options as presumptive taxation and tax deduction at source, and suggest ways to simplify administrative procedures. It also addresses the problem of local governance and the role property taxation could play in it. Section III on "Expenditure Control and Fiscal Management—The Federal Dimension" deals with the overall context of an overgrown government and its fiscal management. This section is devoted to an indepth scrutiny of the system of control and management of government expenditure which evinces rising magnitudes, falling efficacy, pervasive leakages and considerable waste. Issues like soft budget constraints, myopic and partitioned processes of formulating budgetary demands for spending, budgetary mispredictions, inadequate ex-post scrutiny and weak corrective feedbacks are discussed with a view to identifying such reform measures as can muster a greater mileage out of each budgeted rupee. The practice of providing free social and economic services and its primary and other implications are also discussed in the fiscal federal context. Section IV on "Inter-disciplinary Approaches" is a window into the recognition of public policy and governance as the outcome of not only economic forces, but also the overall legal framework and political environment. In recognition of these factors, this section throws some light on possible impediments to the channels and mechanisms in the process of efficient governance, such as legal obstacles or multi-level structures of institutions of governance, as well as alternative forms of government such as democracy or otherwise.

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