

## **Summary of Proceedings**

### **Annual ICRIER-NBER-NCAER Neemrana Conference 2008**

#### **Session I: India Session**

The performance of the Indian economy, its challenges and the environment that it faces today were discussed in the first session chaired by Isher Judge Ahluwalia, Chairperson, ICRIER and Martin Feldstein, President, NBER.

The issues related to commodity prices, capital flows, infrastructure, growth, capital market, human resource, etc were discussed by the Finance Minister of India, P. Chidambaram. Mentioning the historic high in crude prices in recent times, he said that it was not possible to pass this price increase to the people in its entirety; therefore a combination of budgetary and non-budgetary instruments would be used to tackle the problem. He indicated his worries on increasing food prices (as also edible oil) and a possible shortfall in food production (esp. wheat and rice). Mr Chidambaram felt that the main drivers of growth of Indian economy are investment and consumption. Today, the Indian capital market is much stronger and deeper as compared to 4-5 years back. Enormous amounts of equity and debt are being raised by companies, and savings are as high as 35 percent of GDP.

In his opinion, human resources in India are getting better and awareness about education is increasing. "If we can ensure ten years of schooling for every child and proper immunization, nothing can stop us to become the economic power house in 15-20 years", he added. The most important concern raised by him was the improper functioning of the delivery mechanism. While the requisite programmes are in place and funding is available, the poor implementation is the problem, he felt. Among other concerns raised by him is the lack of determination to complete projects on time and within projected cost. He emphasized the need for improving the delivery of public services to poor. Regarding India-US relations, he said that the two countries share a cordial relationship. However, he suggested a review of the perception of US towards Islam.

The participants raised questions on several aspects such as fiscal issues relating to the Sixth Pay Commission, cyclical element in corporate profit tax rates, sustenance of high economic growth, labour laws, inequality, private participation in NREG (National Rural Employment Guarantee) programme,

health sector performance, subsidies, regional impulses in the state of Uttar Pradesh and Bihar, etc.

Mr. Chidambaram expected the continuity of recent growth spurt in the coming years given the high investment and high consumption, with no major expected disruptions - internal as well as external. He accepted that problem in public services delivery is one of the main reasons of rural-urban divide. The minister proposed to find out alternative model of delivery of subsidies for fertilizer, LPG /Kerosene and food. He informed that FRBM (Fiscal Responsibility and Budget Management) Act, VAT (Value Added Tax) implementation, removal of number of tax exemptions etc are some of the hard reform decisions taken by his government. Moreover, VAT will move to GST (Goods and Services Tax) on 1 April 2010. Referring to the NREG programme, he said that cash transfer is a better way to reach to poor. "Learning to manage as best as we can... Learning to accept the disadvantages and celebrate the advantages of an open economy", he concluded.

Giving a brief background to the economic reforms in India, Montek Singh Ahluwalia, Deputy Chairman, Planning Commission, dwelt on the four key areas of Indian economy *viz*, agriculture, infrastructure, health and education. He maintained that the existing dysfunctional set of subsidies in agriculture is actually counter-productive. For improving productivity in this sector, restructuring the subsidy pattern is required. The policies have failed to pull people out of the farms. A sound strategy to enhance growth in agriculture sector in India is needed, he said. Moreover, he underlined the fact that provision of quality and efficient infrastructure services is essential to realize the full potential of growth impulses surging through the economy. In the year 2006-07, the investment in infrastructure stood at 5 percent of GDP. Mr. Ahluwalia pointed out that the government is looking forward to increase this to 9 percent by the end of the Eleventh Five Year Plan. As the investment requirements in infrastructure development are enormous, it's not likely to be met from the public sector alone. Here, the private sector involvement is encouraged through PPP (Public Private Partnership) as preferred mode for execution and operation of infrastructure projects. Several initiatives have been taken to promote PPPs in sectors like power, ports, highways, airports, tourism and urban infrastructure. In the context of private participation in education, he said that it's impeded by numerous factors. Also, he appealed for introduction of innovative schemes of PPP to enhance service delivery in the health sector.

The major issues raised by the participants included the role of regulatory system as the private sector participation increases in these crucial social sectors of the economy and the public sector vacating space for private players to perform in the economic sectors of banking, oil and natural gas, and coal.

## **Session II: US and the World Economy**

The fourteen trillion dollar economy, the United States was the focus of second session chaired by Kapil Sibal, Minister of Science and Technology, Government of India. Martin Feldstein, President, NBER said that one of the most important issues of US at present is the slowdown in the economy. In the last quarter, the economy registered growth of less than 2 percent. Mr. Feldstein addressed three important questions: i) What is the likelihood of a recession? ii) If there is a recession, then whether it would be small, average or severe? iii) What will US do to do away with the risk of recession?

Two important factors that can be noticed in the economy are increase in price of oil and increase in short term Fed rate of interest. Also, there is a general decline in housing prices and it is big drain on household wealth, he said. Sub-prime mortgage crisis has affected the US economy and it's one of the many ways financial sector can get into trouble. He held that the problem of lack of trust is more than the problem of liquidity. The capital adequacy requirement is shrinking in all financial institutions. But, the trade balance of the US economy is showing improvement. According to one of the forecasts, average possibility of recession is 42 percent whereas Mr. Feldstein said, "We will avoid recession". But if the US has a recession, it could be severe, he added. Explaining the ways to avoid recession, he pointed out that monetary policy may not be as effective because of the lack of confidence. Also, financial institutions have been weakened. Fed should continue to reduce the rate of interest and supplement monetary policy with fiscal policy, he suggested. Fiscal stimulus is required in the form of tax cuts or rebates and increase in transfer payments, he added.

Rakesh Mohan, Deputy Governor, Reserve Bank of India put forth his observation of asset price increases in European countries in the last 5-6 years. He pointed out that in the US, correction has started but the housing prices in European countries are rising. When the bubble created in these countries burst, he expects a severe correction. Households having low personal savings, decreasing consumption in these economies could lead to serious recession. He said that there could be relatively more capital flows in emerging markets. As the Asian markets have limited exposure to US, the sub-prime crisis may have

limited impact on their financial markets. But if the housing price correction is severe in North America and Europe, there could be significant impact on Asia.

Raghuram Rajan from the University of Chicago questioned the role of regulators in industrialized countries referring to the US sub-prime mortgage crisis. As the US, the UK, Spain and some other economies are slowing down, something else has to pick up, viz. the emerging economies, he noted. Depreciation or appreciation of exchange rate reflects a shift in demand. Talking about the exchange rate appreciation in the emerging economies, the big question he raised was *how to make it (exchange rate appreciation) comfortable and competitive?*

A wide range of issues such as innovation in financial markets, appreciation of Chinese currency, credit worthiness of corporate borrowers, new avenues of capital flows (Middle East), adjustment of interest rate etc. were also discussed by the participants.

### **Session III: Trade and Competitiveness**

The Chair Uday Kotak, CMD Kotak Mahindra Bank invited the panelists to focus their comments on the relationship between exchange rate, trade and competitiveness, the politics of trade and status of multilateral trade negotiations for this session.

The lead speaker for the session, Gopal Pillai, Commerce Secretary, India conceded that the trade concerns of recent times are more political than economic, and in the latter, specific problems are emanating from the interest rate and exchange rate concerns. However, the real issue in all this is that the exporters must be provided a level playing field and that taxes are not exported. Addressing these two would ensure that countries remain competitive against most odds. It is hoped that the promised introduction of GST would tackle these problems in the near future, he said. Additionally, he also pointed out that the Government of India is working at introducing trade facilitation measures to aide the exporters by way of universal EDI clearances at customs points and adopting related de-regulation measures. He maintained that trade and competitiveness statistics indicate that all sectors other than textiles, leather and handicrafts have been doing well for past few years, but in the three affected sectors, productivity is low and structural readjustments within the economy is necessary to ensure that the people engaged in these sectors are gainfully employed. This latter might lead to some reallocation of human and physical

capital in the domestic economy, which however is not easy to undertake because of the politics of trade and electoral economics.

While discussing the presentation, Takatoshi Ito from the University of Tokyo acknowledged that while the current WTO talks are facing difficulties, it is expected that in the interim the bilateral and regional FTAs would help create a more open global trading regime *de facto*. Towards that end, the India-Japan FTA is seen as an important step forward, and for Japan in particular, India is an important trade partner, second only to the ASEAN block. However, he mentioned that India should insist on opening up the services as a part of the FTA for a comprehensive liberalization package under the proposed FTA. Giving his comments, Elhanan Helpman of Harvard University discussed the role of trade integration in improving productivity of the trade partners, which aspect he felt was under-researched and merited more attention. In particular, the role of institutions in sustaining competitiveness of countries needs to be analysed in detail.

#### **Session IV: Political Economy of Reforms**

Session IV saw the participation of young members of Indian Parliament to discuss the political economy of reforms. B.J. Panda of *Biju Janta Dal* maintained that there are less than half a dozen committed reformers in the Indian Parliament today. It is really hard to take decisions in a new direction and implement reforms. He held that the skills requirement of a political leader has undergone significant change overtime. In the present era of coalition governments, the most important skill required in politics is *marketability* (of work and ideas). Discussing the issue of land acquisition, he said that there was no problem in this regard a decade ago. But now, as the farmers have a lot more to lose compared to earlier period, problems have cropped up which are more visible in case of big projects.

According to Manvendra Singh, Member of Parliament (from *Bharatiya Janata Party*), there has been a tremendous change in rural India and the two important things that changed the face of rural India are mobile telephony and PMGSY (a centrally sponsored programme for village roads connectivity). Also, he highlighted the problems of structural governance that exist in our political economy following a colonial model.

Naveen Jindal, an industrialist and political leader of Indian National Congress believed that land acquisition has to be there to implement development projects

but land losers must get proper compensation. He said that farmers are getting appropriate prices, jobs and in some cases equity holding as well. In his views, there is much more impact of bureaucracy than politicians (except PM, CM and DM) in India.

Pratap Bhanu Mehta, President, Centre for Policy Research focused on the importance of consensus building in the current state of fractured democracy. He opined that there is an urgent need to reform the sovereign system of policing, judiciary etc. While discussing the political economy of India, Mr. Mehta pointed out that there is a centralized closed structure of political parties and in the absence of clear rules therein, fragmented electoral system and under institutionalization create major barriers for reform.

Brian Knight from Brown University made his presentation on reform of the US federal system and the role of decentralization. He explained the advantages and disadvantages of centralization. In a centralized system, there is lack of experimentation and Tiebout competition (competition among small jurisdictions). Moreover, the state level preferences get ignored in the presence of policy uniformity. But, a political economy approach, instead of assuming policy uniformity accounts for bargaining between jurisdictions under centralization. According to him, the chief drawback of centralization is the common pool problem which stems from three features of legislatures - locally elected representatives, national taxation, and localized spending. Further, this problem creates conflict between regions which is often resolved in favour of jurisdictions with political power in legislature. In this regard, he mentioned two sources of political power, agenda control and over representation. Control over legislative proposals lead to spending distortion. Using the power of congressional delegation as an instrument for grant receipts, he found that federal grants crowd-out state contributions to public goods. Therefore, central governments desiring to expand local services need to introduce matching provisions into grant programs, he concluded.

There participants also discussed various issues such as campaign finance, accounts of political parties, fair system of land acquisition, major requirements of people in constituencies, possible outcome of next elections (coalition possibilities at centre), issues of service delivery, subsidy, license raj in education, women participation in Self Help Groups (SHGs), micro finance and local government etc. Responding to the issue of service delivery, Mr. Jindal emphasized to improve the work culture to get a positive outcome. B.J. Panda ruled out the possibility of BJP-Congress coalition at the centre while keeping all

other options open for the result of next election. Also, he said that tracking new ideas is next to zero in politics and it would take another one or two elections to have enough younger MPs to make a difference in the political economy of India.

### **Session V: State Session - Haryana**

Haryana government is committed to create of an efficient, investor friendly environment supported by coordinated development of infrastructure and sunrise areas. Thus the presentation by HSIIDC highlighted the challenges that the state is facing in agriculture sector, health, education, urban infrastructure, transportation and logistics. The presentation suggested the initiatives that the government is taking for Infrastructure Development, enhancing investment opportunities, towards Energy Security, Industrial Investment, Building Human Resource etc.

The speech by the Chief Minister B.S. Hooda highlighted that the state is concerned with balancing the sectoral development in Haryana, thus both agrarian economy and industrialization is going hand-in-hand. Haryana has garnered investment worth US\$ 7 billion in last two years alone. And proposals worth US\$ 15 billion are in the pipeline. It was further highlighted that it is the first state to formulate a labor policy aiming at maintaining balance between the labour welfare and requirements of the industrial promotions towards economic growth and creating additional employment opportunities.

It was highlighted that this state has 100 percent electrification and all villages are connected by roads. But the major concerns for the state that were repeatedly pointed out during the course of discussions focused on the high population growth in the state, deteriorating sex ratio, poor health condition, high subsidies in agriculture and loss of power in transmission and distribution. The discussants also raised the issue of decentralization from centre to state and further from state to citizens. The new national and international collaborations of industries in Haryana and the investments that the state is attracting are building up a new confidence in the industries in India and the state. The discussants further pointed out that new growth areas need to be tapped and should be given additional attention to further improve on the state's condition. It was suggested that Haryana should build large attraction centers in a planned manner keeping the long term view of increasing population to be able to compete with international cities.

## **Session VI: What Ails Indian Agriculture?**

Indian agriculture is getting constrained by the increasing fragmentation of land holdings by the farmers, while rest of the sectors in the economy are scaling up. This along with other constraints of the agriculture sector like lack of proper irrigation, investment, availability of appropriate technology, declining productivity along with underdeveloped markets are pressurising the sector. The irrigation policy of India is not at its best and due attention has not been given to investment and rural electrification. Lessons can be learnt from the way USA manages its water resources. Opportunities for water trade was highlighted in the presentation by Gary Libecap of University of California.

Another aspect is that not emphasised much is that the non-price factors need to be paid attention to attain the much needed growth in the agricultural sector. On the credit issues, the benefits of existing policies are not reaching the small and marginal land holders, but is being utilised by owners of land holdings of medium and above, and that too for purchase of tractors, pump sets etc. Although the agricultural activities in India is experiencing diversification towards the high value crops, but it was cautioned that there is going to be an additional increase in demand of food grains through increased feed requirement in the poultry sector and for bio-fuels. The fact that most of the farmers when interviewed wanted to leave farming was highlighted. But the problem of getting them employed in suitable places where there is a skill match is a big issue. Thus imparting skills to make them qualified for a rural non-farm employment is needed. Improving the public support system, research and development investment, district level agriculture planning, strengthening the supply chain etc. are the most important ingredients to enable the agriculture sector to grow at 4 percent per annum. During the discussions, issues of land reforms and introduction of transparency in the land lease market were flagged.

## **Session VII: International Capital Markets and Exchange Rates**

The presentation by Takatoshi Ito highlighted the interlinkage between the development of the international capital markets and the exchange rate regimes in countries. His suggestion was that in case of equity investment, countries need not worry too much. However, there are reasons for concern in the following 2 cases. (1) If current accounts are in surpluses, in which case central banks need to allow appreciation; and (2) If short-term capital inflows come into the banking sector and to fixed income securities. It is in the later case, that sudden reversal would present rather difficult policy choices like fiscal tightening (IMF favourite



advice), lowering interest rates, exchange rate appreciation, sterilization, taxing short-term capital flows *a la* Chile, or even controls on non-deliverable forwards (NDFs). He concluded that capital flows 'should be' managed and measures taken according to the nature of capital flows while maintaining a flexible exchange rate regime.

Elhanan Helpman discussed the FDI regimes across the world and their interlinkages with trade and MNC activities. He pointed out that MNCs account for 40 percent of world trade (intra-firm trade) and that trade and FDI in services have expanded in an unprecedented manner in the past few years. And this last has challenged the established norms and theories on FDI. Recent theories predict larger shares of intra-firm trade in more headquarter-intensive sectors as well as larger shares of intra-firm imports from countries that are well endowed with inputs that are intensively used in headquarter services. His findings are based on data from US and Japanese intra-firm trade.

The final panelist Michael Dooley from University of California focused his presentation on ability of countries to control capital flows, which he contended was a function of the nature of capital markets in the respective countries. He pointed out that the imperfect nature of the Chinese capital markets makes it more controllable. His argument was that it is the real exchange rate which is a more important variable, and an important issue is how countries can reap the benefits of integration into the international capital markets/finance. In pursuing this last, if reforms of the domestic financial system are not feasible, improvement in the quality of capital formation within a country may require bypassing the distorted domestic financial system; sterilization of capital flows in his opinion appears as a viable intermediate option in countries awaiting financial sector reforms.

### **Session VIII: Educational Reforms in India**

This session discussed the much desired reforms needed to revamp India's education system. Karthik Muralidharan of University of California pointed out that large inefficiencies exist in the delivery of education. In India, 25 percent teachers are absent, and of the remaining, less than half are teaching. Over 90 percent of non-capital spending goes to teacher salaries. Performance pay for teachers is a frequently suggested way for improving school quality. This can improve teacher motivation and lead them to increase the amount of effort spent on teaching. But the end results showed that although the problem of teacher absenteeism was not sorted out but an incentive based structure helped in

improving the quality of teaching and output. It was pointed out that the drop out ratio of children is very high in India, and out of 93 per cent of the students in school only 23 percent reach senior secondary schools of whom only 9-11 percent can make it to college level.

B S Baswan, Director, Indian Institute of Public Administration said that administrative reforms in form of structural reforms and procedural reforms are also needed to improve the education delivery mechanism in India. It was highlighted that the last two governments through elementary education for all had been able to initiate some programs and some good results are evident now. Issues on need of vocational education, and quality higher education was also raised, on which Mrs. Sushma Berlia had a thought that a little low standard education is better than no education, thus the thrust should be on education to all. She added that along with the issues of accessibility and quality another issue of relevance is affordability. The skill based, innovated education should be encouraged so that the increasing demand of the industry is met. Availability of credit to students on effective rate of interest was proposed by her. Emphasis on girl child education, and development of infrastructure for physically handicapped children were also insisted upon.

### **Session IX: Fiscal Issues in the US**

M. Govinda Rao, Director, NIPFP, chairing the session started the discussion with a brief reference to the US Tax Reforms of 1986. Alan J. Auerbach, from University of California, Berkley, presented the current fiscal situation in the US (mainly the taxation system at federal level). He informed the participants that the federal government revenue accounts for 19 percent of the US GDP. According to him, there is unstable tax environment in the country at present. As per law, many provisions started in 2001 and 2003 such as reduced marginal tax rates, favorable rates (15 percent) on dividends and capital gains etc. will expire in the year 2010. Also, the Alternative Minimum Tax (AMT) in the US is growing more intrusive each year as it is not indexed for inflation. In the developed world, the US has one of the highest rates of corporate taxes, which has remained more or less same since 1986. Due to the changing demography and present system of social security and health care, it is expected that major gaps between federal revenue and expenditure will emerge. Though the social security costs will rise steadily, health care spending is expected to rise to 25 percent of GDP in 2082 from the current level of 8 percent.

Admitting that nothing will happen before 2008 election, Mr. Auerbach suggested three options for US tax policy reforms which can be grouped as small, medium and large. The small reforms may include permanently changing AMT without removing it, reducing the corporate tax rate while broadening its base and keeping some of the existing provisions. In the medium term, it was proposed to eliminate AMT, to reduce or cap tax deductions and not to increase taxes on capital income. In the “large reform” scenario, Mr. Auerbach suggested replacement of all or part of the tax system with a new one, providing the options of VAT (to replace corporate tax, payroll tax or income tax), progressive consumption tax and a retail sales tax (to replace all taxes). But all the major reforms to move in this direction will involve replacing capital and income taxes with consumption taxes. Definitely the new tax system will face problems and require consensus, he said. In his opinion, though large reform promises greatest increase in economic efficiency, small reforms are most likely to happen.

US health care system, which is considered as one of the major causes of mounting fiscal pressure in the economy, was discussed by Katherine Baicker of Harvard School of Public Health. Medicare and Medicaid are two major public health programs in the country. Health insurance based on employment is highly subsidized whereas private insurance by an individual is comparatively very expensive. Those who are uninsured get subsidized health care, amounting to almost half of the total spending. In the US, the national health expenditure is 16 percent of GDP and rising costs have made reform of this system a priority. She pointed out that there is considerable variation in quality/delivery of health care services as well as Medicare spending across regions. Moreover, higher spending is not associated with higher quality. The results of one of her studies in fact show a negative correlation between the two.

While comparing health expenditure (as a share of GDP) internationally, she found that the US spending in the last two decades has been much higher as compared to Canada, Germany, Japan and UK, whereas the health outcome is not better than these countries in terms of IMR (Infant Mortality Rate). According to her, the main reasons of inefficiency in the system are the reimbursements based on quantity, not quality; employers favor expensive plans instead of basic plans and this leads to high premiums for people buying insurance on their own. Federal Medicaid and Medicare spending is projected to consume 9.4 percent of GDP in 2050. In her views, current path of spending growth in health care is unsustainable, and therefore demand reform. She stressed on the need to find ways to improve quality rather than concentrating on quantity, and to promote healthy lifestyles and investment in prevention.

Questions were raised regarding low tax rate on investment income, composition and imposition of estate duty, health care outsourcing, reasonable level of health care spending (as a percentage of GDP) etc. Mr. Auerbach informed that estate duty contributes 1 percent of federal revenue and it is a very complicated tax. It's not a cheap tax to enforce, and therefore many countries don't go for it. Katherine hoped that better information on price and quality would help improving the US health care system but wasn't sure of the right amount of spending by government for providing health care.