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Lessons of Public Finance for Developing Economies, with Special Reference to India*

by

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INTRODUCTION

The appropriate role of the public sector in promoting economic development and overall societal well being has been the subject of some of the most important writings of philosophers, economists and statesmen over the ages in virtually all cultures and societies. Principles of public finance are deeply embedded in everything from constitutions and laws to public attitudes. For example, in my own country in the late 18th century, the Declaration of Independence and Constitution incorporated such principles as central themes. Questions such as how large and pervasive should the public sector be? How should it finance its spending? What taxes should be used? Who should pay them? For what purposes should debt, as opposed to tax, finance be used? What should be done at the national vs. subnational level? What should be the relationship between the national government and subnational governments? These are questions to which all societies must not only find answers, but must continuously evolve answers in response to changing demography, economic development, domestic political considerations, international competition and best practice.

Economists attempt to frame an answer to such questions with primary emphasis on various measures of economic performance. To be sure, other considerations may be important, but tend to lend themselves less to the kinds of analysis that are economists’ natural comparative advantage. Not surprisingly,
many generations of academic economists have focused on one or more of these issues, bringing to bear successively more rigorous analytical methods, empirical information, and practical historical and international real-world case study and comparative evidence. What follows are what I consider the main lessons that economists have learned from these analyses, empirical studies, and evaluations of real-world case studies on these various issues.

To be sure, the extent to which such lessons are relevant to today’s India would require a much more thorough and deep analysis of a wide range of specific current and prospective Indian tax, spending, regulation, intergovernmental, and debt policies than I can do here. Indeed, while I have advised on economic policy – from monetary, tax, budget and debt policy to trade and regulation – all around the world, virtually none of that advising has been in India. I know much more about most other major economies, developed and developing, than I do about India. Hence, my initial inclination when Nick Hope asked me to speak at this important conference was to suggest he find someone who knows more about India. But he persuaded me that drawing on my experience to discuss some general principles would be valuable. Because I believe it is useful to keep these principles in mind and for policy-makers, in all countries, constantly to try to evaluate particular fiscal programs or policies and to test them against these lessons, and also because I believe there is much
common applicability of these principles to all countries¹, I agreed. I leave it to the discussants and the audience to decide whether we were correct. Certainly, in the real world, various compromises will have to be made for numerous reasons, perhaps especially in a vibrant democracy like India, with disparate and complex interests across and within regions, between urban and rural areas, etc. But to the extent the fiscal program can, as a rough approximation, reflect these principles as opposed to contradict them, it will lead to far better economic performance over the long run. Finally, while it cannot be my focus here, the public finances closely interact with numerous other aspects of economic and social policy: monetary policy; trade policy; exchange rate policy; regulation; public administration; and even law and order and public safety. By referring to these subjects only briefly, I do not mean to discount their importance.

II. EIGHT LESSONS OF PUBLIC FINANCE

I present what I believe are the eight main principles or lessons of public finance of particular relevance to developing countries, together with a very brief comment on India’s performance relative to the criteria established in the eight lessons. I do so from the perspective of an outside observer and a great admirer of India. Anyone bothering to take a look at India’s neighborhood cannot but be awed by India’s vibrant democracy. Drawing a (rough) circle around India starting in Pakistan, one would pass through disputed Kashmir, China, Nepal, Bhutan, Myanmar, Sri Lanka, the horn of Africa and the Arabian Peninsula. You

¹ Indeed, I believe that to a large measure, people in different societies react quite similarly to economic conditions and incentives. There is a strong temptation to argue, “These principles don’t apply here,” for some reason or other, but such legitimate reasons are rare and always temporary.
would have encircled Bangladesh. Just outside the circle would be Iran, Afghanistan and Russia. That is a very tough neighborhood, representing a daunting set of issues from terrorism to civil war to illegal immigration that constantly challenges India.

And internally, the vast regional disparities, loosely between the southern and western states and the northern and central ones; the myriad languages and cultures and subcultures; and the legacy of the Soviet-influenced state-dominated economy, to name but a few, the challenges to economic development seem almost as daunting as those to preserving democracy. Indeed, the period from independence to the 1991 reforms seemed to many to reinforce India’s so-called “Hindu growth rate” of a meager 3+. So, before proceeding to a (perhaps too-) gentle reminder that much remains to be done to facilitate strong future economic growth, the post-reform growth acceleration, the recent “miraculous” growth rates and the continued vibrant if contentious democracy lead this observer to begin with a round of applause for a comparatively remarkable economic and political accomplishment. But history is replete with reminders of complacency leading to problems, so let’s proceed to a framework for evaluating India’s public economics policies, and to suggest some principles to guide their improvement.
Lesson #1: Relative Prices Should Reflect True Relative Scarcity Values, to the Maximum Extent Possible.

Production efficiency is desirable in virtually all circumstances. Relative prices of different goods and services and of inputs should be allowed to reflect their relative marginal scarcity value, or marginal cost. This is a fundamental analytical result in modern economics\(^2\). It also accords with the historically well-documented difficulties and inefficiencies that tend to result from sustained substantial deviations from production efficiency. Differential taxes or subsidies, and price supports or ceilings, for example, create serious distortions, embed powerful constituencies to retain them, and generate an eventual, more costly unwinding.

For example, India’s subsidized retail pricing of energy is costing the state oil companies up to 4% of GDP (at an annual rate) at current crude oil prices. Such subsidy programs are unsustainable and will eventually force increases in retail gasoline prices – a process underway in Indonesia, Taiwan and Malaysia. The potential economic and social disruption can be quite damaging and might have been far less if the subsidies had been reduced or eliminated earlier. Also a problem in this regard is the reliance on excises and customs duties, discussed below.

\(^2\) See Diamond and Mirlees (1970) and Stiglitz and Das Gupta (1974) for a discussion, the latter detailing lots of second-best rules under various assumed constraints.
Keeping the price of some essential goods and services artificially low may seem like an appealing method to help relatively low-income people, but it is a very inefficient way to do so. If the price of a commodity is subsidized at the margin at well below market rates, everyone pays the lower price: rich, middle income and poor alike. The net subsidy to the poor occurs only to the extent their propensity to consume the good differs substantially from others' consumption propensity. It is more efficient to have a targeted program, to transfer resources directly to people in need rather than to subsidize their purchases via a much larger, more expensive program that broadly subsidizes purchases.

India, like most countries, should utilize user fees for public services more, both to efficiently ration the services and to avoid the need for higher tax rates. A special case increasingly used in advanced economies is peak-load pricing – charging higher prices during times of peak congestion, lower prices at other times. In sectors such as energy and transportation, peak-load pricing properly used can decrease the need for expensive extra capacity and help internalize the external congestion costs.

Most societies, however, do subsidize the production and/or consumption of various goods and services, from public education to food, electricity, and health care. If these policies are used, it is best to restrict them to what

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3 Perhaps that was not much of a consideration in India a couple of decades ago, as the middle class was relatively small. But much stronger growth in post-reform India has led to a sizeable middle class. A decade or two from now, if strong growth continues, it could well be much larger still, as witness China.
economists call inframarginal prices, or the price on an initial subset of consumption. Prime examples include low prices on a minimum electricity usage or on lifeline rates for minimal telecom services, e.g. the first few kilowatt hours or minutes, respectively, with the price rising to the full market price for all consumption thereafter.

Sometimes, price subsidies end up creating problems that have long-lasting and socially expensive consequences. For example, in the United States, subsidies to health care financing through government provision, the tax system and third party payment divorce most medical decisions from any relationship to their cost at the point of purchase. This encourages consumption to the point where the marginal value is zero, not the opportunity cost of the resources, and thus greatly increases medical spending. The United States is in an early-stage, politically contentious reform effort to have pricing reflect costs over a much wider range of medical care purchasing decisions. Also in the U.S., the cross subsidies among consumers in telecommunications pricing have been at the core of difficulties in regulatory reform. And, of course, the agricultural subsidies in many developed countries – including the U.S. but especially Western Europe – are inefficient, expensive and grossly distort world trade.

Finally, even a casual observer is struck by the amount of public production of private goods and services in India. This legacy of the post-
-independent statist policy regime should be phased out as rapidly as policies to
deal with the excess workers transition can be implemented.

**Lesson #2. Subsidize Only the Lowest-Income People, Not Special Groups or Commodities. Help People Invest in Their own Skills and Future Income**

To the maximum extent possible, rely on individuals' and families' decision-making for their economic well being, with two notable exceptions: to assist those who do not have some minimally decent standard of living, relative to the society at the time; and to ensure against catastrophes, such as immense medical costs, for which a sufficient private market may not exist.

Do not try to micromanage the redistribution of income; concentrate on those with the very lowest skills and those suffering economically catastrophic emergencies. Avoid large transfer programs that risk establishing a permanent government-dependent underclass, worse yet, that may become intergenerational. The extensive European welfare state is a large part of the explanation for Europe’s slow growth and high unemployment. In the U.S., our 1996 welfare reform, with its emphasis on temporary welfare, moving people back to work, etc., has been a great success.

Transfer payments should be designed in such a way as to minimize the disincentive to work effort, and should emphasize relief from extreme destitution
or catastrophic events and investment in human capital. In this regard, investment in education and public health are particularly important, especially so in rural areas. As the old saying goes, “Give someone a fish and you feed him today; teach him to fish and you feed him for a lifetime.”

It is also important to manage expectations in developing programs of assistance to the poor and/or poor provinces. When I was Chairman of President George H. W. Bush’s Council of Economic Advisers, he asked me to advise Chancellor Kohl on the economic issues in the reunification of Germany. Recall, at the time, many thought that uniting East and West Germany would be politically impossible. Chancellor Kohl wanted to exchange one Ostmark for one Deutschemark – a huge overvaluation. When I said this would be an economic disaster (Bundesbank President Karl Otto Poehl said so as well), Chancellor Kohl’s response was, “I have to do this for history”. I leave it to others to decide if the Chancellor was correct in his viewpoint. Unfortunately for Germany, my analysis has proved to be correct. The huge transfers from the West have become quasi-permanent and a major drag on West Germany, and the (unrealistic) initial expectations fostered in East Germans of quickly catching up with their counterparts in the West have been dashed, leaving deep resentment. Even the prospects for the East German economy were damaged. Thus, policy makers should manage expectations and should be careful not to radically over-promise what they can reasonably expect to deliver.
India’s explicit transfers and pensions are quite modest. How to develop them over time, as India develops and resources grow, to meet minimum standards of decency to the poor, while making certain that overall tax rates do not damage growth, will be a major determinant of India’s success as an economy and society over the next few decades.

Lesson #3. Keep the Hand of the Government in the Economy as Light as Possible. Keep Taxes and Regulation to the Minimum Necessary

While it is important for government to finance various types of spending, e.g. for national defense, some infrastructure, and a social safety net, experience indicates that, after some stage of development and after some point, the value of a larger government quickly hits diminishing returns and becomes inimical to growth. Keeping tax rates as low as possible is vitally important. The harm done by tax distortions of private economic decisions, e.g. to work, save and invest, rises with the square of tax rates, e.g. doubling tax rates quadruples the damage. There is a negative correlation between the size of government, as measured by spending and tax shares of GDP, and economic growth rates among developed countries. When government grows large, it becomes involved in too many things which might be left to the private sector; powerful political constituencies develop for rent-seeking to try to get through the political process what they cannot achieve through private activity. Taxes get too high. Incentives to work, invent and innovate are weakened and economic performance is seriously
damaged. The United States has demonstrated that if most of the economy is governed by market forces, an overall federal-state-local-tax share of about 30% is consistent with strong economic growth and low unemployment. The large, complex economies of continental Europe – France, Italy and Germany – have demonstrated that tax and spending burdens (mostly transfers) approaching 50% of GDP are not consistent with a vital, growing economy.

India scores highly for a relatively modest level of explicit taxation, both absolutely and relative to other developing countries. The total (central plus local) tax share in GDP at under 20% is below Malaysia’s (about 25%), Argentina’s (about 30%) and China’s (32%). The lowering of marginal tax rates in recent years is a big plus. However, on the still overbearing bureaucracy; the arbitrary and at times harrassing tax administration; insufficient reliance on competitive markets; regulation; and continued importance of inefficient public enterprise, India scores poorly.

To the extent regulation is necessary, use flexible market mechanisms to achieve sensible regulatory goals, not command and control regulation. On the environment, for example, emissions trading regimes are preferable to cumbersome command systems. When I was in the White House, we put in a cap and trade system of emissions allowances for sulfur dioxide emissions from coal burning power plants that reduced the cost of compliance by two-thirds. Indeed, a futures market in the permits was established virtually simultaneously with the spot market. This has been heralded by all sides in the environmental...
debate as a spectacular success. On regulation of traditional natural monopolies, use incentive price regulation, not rate of return regulation; i.e., give the firms a profit incentive to innovate, invest and reduce costs.

Lesson #4. Use Comprehensive Broad Base, Low Rate Taxes.

The most efficient taxes are general, flat-rate consumption taxes, such as a consumed income tax or value-added tax. These will be the least inimical to long-run economic development and future standards of living. Even a flat rate income tax will double tax saving, retard capital formation, and ultimately result in a lower standard of living than would otherwise have occurred. A progressive rate structure potentially creates four main problems: 1) The top rates get too high and impede incentives, thereby limiting future incomes. 2) Unstable government revenues surge in booms, collapse in busts. The government must then respond to the collapse with counterproductive higher taxes or politically difficult spending control. This leads to tremendous economic and political upheaval, as happened in my own state of California (and eventually led to a recall of the last Governor) and is recurring now; 3) It tends to create vast differences and political disruption over spending; those paying high taxes want it limited, those paying little or nothing want more; 4) Perhaps most important, as I demonstrated 30 years ago (Boskin, 1975), a progressive-rate income tax retards individual human capital investment, as the returns to such investment would be reduced by people driving themselves into higher tax brackets, more
than offsetting the benefit of much of the investment cost being paid out of (non-
taxed) forgone earnings. Thus, the main attempt to redistribute income ought to be on the transfer payment side of the ledger, not on the tax side of the ledger.

However, if issues of fairness and social cohesion make it impossible to sustain public support for primarily relying on flat rate taxes, it is vital that any progressive income (or consumed income) tax structure keeps the highest rate as low as possible. India does pretty well on the tax rate metric as the top federal marginal tax rates have been brought down to about 30% (individual) and 34% (corporate). However, on the tax base metric, despite considerable progress, a series of issues plagues the tax system and its administration, especially in services and agriculture. One hopeful sign is the move toward a destination-based VAT at the local level, which also will facilitate the greater development of national markets.

Tax rules and budgeting should be as transparent as possible. There should be as much long-term stability in the rules and laws as possible to facilitate long-range planning by households and firms. This may be particularly vexing for an economy in rapid transition such as India’s. But it is important to avoid the substance, and the appearance, of arbitrarily changing fiscal rules. In all societies, people believe that other people are getting a better deal from the tax system than they are themselves. People would like their taxes to be lower, and for other people to pay taxes to finance the things they want from the
government. A relatively stable, transparent tax system will give people more confidence that it is being administered fairly, a serious concern in India, and it will result in greater tax compliance and in less social disruption and bitter debate over taxes.

The definition of what is a tax should be thought of very broadly. When the government requires people or firms to do something and pay for it themselves, that is very close to taxing them and using the proceeds to finance government spending. But in the former case, it does not show up formally as part of taxes and spending in the budget. Such administrative or regulatory taxes are substantial in all societies, perhaps particularly so in India, and it is important to try to keep them to a minimum and rely as much as possible on explicit taxes and transparent spending. India scores poorly on the regulatory tax metric.

High tax rates eventually become counter-productive, not only lowering economic performance but eventually generating little, if any, additional revenue. Taxes are especially harmful on mobile factors of production, e.g., capital. It is useful to have the tax system as neutral, with respect to the types of investment and to the decision about whether to consume or invest, as possible. The most effective way to do this is through a broad, general flat-rate value-added tax or consumed-income tax.
A comprehensive low rate or rates income tax with broad personal exemptions would allow, for example, a widow receiving modest dividends to be taxed more lightly – or not at all, if below the exempt amount -- than a wealthy dividend recipient. Over time, capital income such as dividend and interest receipts and capital gains will become more directly important for a larger and larger fraction of the Indian population. It is important to keep any taxes on them light and to equalize them as much as possible. A flat rate income tax above a reasonable exemption level that allowed deductibility of saving would be the ideally efficient progressive consumed-income tax. Further, yet another form of double taxation should be avoided, by integrating business and personal taxes. Taxing returns to capital first at the business level and again at the personal level is both inefficient and unfair. It also encourages debt-paying, tax-deductible interest, rather than equity-paying taxable dividends. Given the problems of high leverage, a level playing field between debt and equity would help reduce instability in Indian firms and the banking system.

While India has made some good progress, e.g. in decreasing customs duties, its tax system, with still too-heavy reliance on excises and customs duties, falls far short of this mark of broad-based taxes. Its income taxes also require base broadening for its own sake and to preserve low future marginal tax rates. The much-discussed move by the states to a destination-based VAT might be a sensible start of tax reform. The move to a broad-based tax must also be
accompanied by renewed attention to appropriate levels and composition of spending, lest a new revenue source just grow inefficient government.

Lesson #5. Apply Rigorous Social Cost-Benefit Tests to All Spending and Regulation Decisions

Continuously implement rigorous, professional cost-benefit analysis to justify public expenditures. In the modern polity, there will be a tendency for the diffuse interests of the taxpayers to be subordinated to the narrower, concentrated interests of those benefiting from the spending. It is very hard to eliminate programs once they have become entrenched in a democracy, as the post-World War II histories of the United States, Western Europe and Japan suggest. Therefore it is vital to have very rigorous standards for enacting them in the first place. And, to the extent possible, to continually re-evaluate, reform and restructure them, as makes sense over time. That may be especially true for India, as eventually slower growth and demographic pressure will make some programs, such as defined benefit pensions, difficult to sustain.

There are two distinctively different episodes when a large expansion of social spending tends to occur. First is in times of great hardship, when the need is so apparent. For example, the New Deal of President Franklin Delano Roosevelt, which created Social Security and many other programs, was launched during the Great Depression of the 1930s. The second is in times of
rapid growth when resources are plentiful and everything seems affordable. The 1960s in the United States was one such period. India is in such a period now. It is important to see beyond the present and to test a program for robustness in the coming era of slower growth and/or more pressing demography.

The best advice I can give on the latter point is to adopt a no-regrets strategy: Do the things that make sense for governments to do in any event, such as investments in public infrastructure, education and public health that meet stringent cost-benefit tests, including in the poorer provinces. But be careful not to create an open-ended, never-ending, growing entitlement. The lesson of Japan in the last fifteen years is instructive. As part of an economic stimulus fiscal program to combat recession, the Japanese embarked on a program of huge public infrastructure spending. No doubt, as anyone who has been in Japan is aware, the public infrastructure certainly needed improvement. But the combination of the political process and the power of the construction companies has made it very difficult to slow the public capital spending, even as the highest priority projects have been worked off, diminishing returns has set in, and the original anti-recession goal has long since vanished.

Given India’s apparent need for substantial public investment, e.g. in infrastructure, and the issues surrounding efficient design, project choice, build, pricing and maintenance, it would be hard to overemphasize the importance of rigorous cost-benefit analysis from conception to actual implementation.
Lesson #6: Keep a Comprehensive Measure of the Ratio of Government Debt to GDP under Control, by Both Limiting Liabilities and Policies Promoting Economic Growth

Traditional explicit central government debt in many countries, including India, is modest, but large local government liabilities, the liabilities in state enterprises and future pensions also need to be managed. Sound debt management, however, does not necessarily require a nominally balanced budget, even over the business cycle, because inflation erodes the real value of previously issued debt and because it may make sense to debt-finance particularly large net (of depreciation) public capital investment, (so long as it passes stringent cost-benefit tests – see Lesson 5). A small nominal deficit is not a problem if the real operating deficit is under control. With economic growth, a modest deficit can still be consistent with a stable or declining debt/GDP ratio. For example, with modest (by India’s recent standards) nominal growth of 7% and a debt/GDP ratio of 60%, an annual nominal deficit of 4.2% of GDP – about the current level -- is consistent with a stable debt/GDP ratio; a smaller deficit would reduce the debt/GDP ratio. Adding in the deficits of local governments and applying the same analysis leads to a more worrying conclusion. At 7% growth and a (combined) debt/GDP ratio over 80%, a deficit over 5.6% of GDP is problematic. And the combined deficit in recent years has been around 7%. While 10+% growth handles this problem, when growth inevitably slows, the
pressures on deficits and debt will rise. A more comprehensive measure would include the deficits of public enterprises, etc., e.g. it would add the so-called petroleum bonds to the regular deficits and debt, bringing the total government deficit to about 10+. Finally, because India’s saving rate is fairly high – roughly 30% -- (though well below China’s) even if deficits crowd out private investment, there is still a sizeable investment rate. Further, it is important to keep tax rates stable or smooth as well as low. In times of temporarily large spending, debt finance may be appropriate; conversely, when spending is temporarily low, debt should be retired. Tax levels should be geared to the normal or average spending level.

India typically has run sizeable budget deficits (roughly 4% central; 3% local; 7% combined; higher if state enterprises are included). Recently, the primary (i.e. net of interest) deficit has been about 2-3% of GDP. Since the present value of all future primary SURPLUSES must cover the (net of assets) consolidated public debt, such primary deficits during booms are troubling. However, since some of the public debt is held at below-market rates, it may be temporarily acceptable. While not so large as to send the debt-GDP ratio soaring, the deficits are too large to prevent it from rising if growth slows and are worrisome at a time when growth is so rapid, demography still not too difficult and public infrastructure investment still quite modest.
Finally, it is important to recall that deficits are the difference between spending and taxes, which are the more fundamental fiscal indicators (see the discussion of tax and spending principles in lessons 1-5 above). A balanced budget with much higher taxes and spending would likely damage economic growth. And as the European nations have shown, higher taxes do not necessarily eliminate budget deficits, as the political process may intervene in favor of more spending.

Stable low inflation should be a key goal of economic policy. High inflation distorts relative price signals, increases uncertainty, retards investment, and risks recession to bring it under control. Outright deflation would radically worsen the debt problems for all debtors, including government, as the real value of debt rises when prices fall. Further, outright deflation creates immense difficulty for traditional monetary policy because of the zero lower bound on nominal interest rates, as the Bank of Japan has experienced for many years and which the Federal Reserve was deeply concerned might occur in the U.S. earlier in this decade. It is important that the Reserve Bank of India be free to target inflation and combat temporary deviations of real output from potential. It must be free of the political pressure to monetize government debt and to pursue social engineering goals in its oversight of the banking system.

As a social insurance system develops, it is likely that India’s private saving rate will decline somewhat. Like all developing economies experiencing
rapid growth, India’s growth will eventually slow (although nobody can be sure when and how much). The ratio of retirees to workers will eventually rise rapidly and predictably. Hence it is important that as and when the social insurance system develops, it should not rely exclusively on a pay-as-you-go defined benefit program. India’s current pension system scores poorly on this account, but much more important is sensible reform as coverage expands in coming decades. What appears affordable today will be a huge problem in the future. Virtually every economy has or will confront this problem. It is better to forestall such problems well before they occur by combining defined benefit and defined contribution features of social insurance. How India’s social insurance programs eventually develop will be an important determinant of India’s future economic performance.

Finally, anticipating a future of slower growth and more burdensome demography, India has a window of time to address these problems. But if it gets to the end of that window to a future of slower growth and more difficult demography without having worked through these issues of tax and social insurance design of deficits and debt, the economic and social disruption will become progressively more severe.
Lesson #7. Align Responsibilities and Resources among Levels of Government

Spending – whether on the public infrastructure or social safety net – should be done and financed at the level of government closest to the decisions as possible, with due regard to the extent to which the benefits and costs will affect a broad population. The relative administrative capabilities of the central and state governments may also be important, both on the spending and tax collection sides of the ledger. It is desirable that they contain a matching feature, a non-trivial co-payment, so that local effort guarantees they will have considerable value to the local residents. General transfers of resources to local governments in non-short-run emergency situations will not necessarily be spent on assisting the neediest in the poorest places. India’s complex revenue sharing formula seeks to balance issues of equity and efficiency evolving over time (every 5 years), as the Finance Commission proposes. The formula allocates revenues based on population, income, tax effort and fiscal discipline⁴. The final result is a compromise, but at least contains features that make sense.

The United States tried such a program in the Nixon Administration, in what we called “General Revenue-Sharing”. The idea was that the federal government would collect taxes, send the revenues out to state and local governments, disproportionately going to governments in poorer states, for example, Alabama. However, the idea that these funds would flow through to the

⁴ See Singh and Srinivasan (2006)
poorest residents in the poorest places proved naive. They were partly used to
cut local taxes or to spend on goods and services that benefited non-poor
people. Worse yet, from the standpoint of the national elected officials, who were
getting all the blame for the [high national] taxes, the local officials, by cutting
local taxes or increasing popular local spending, generated a constituency and
ran against the national officials in subsequent elections. Not surprisingly,
General Revenue Sharing is the only large federal government program that was
completely abolished in the post-World War II era in the United States.

Finally, local jurisdictions should be given room to experiment, because
they will learn from, and adapt, each other’s successful policy experiments and
avoid the failures. In the United States, a famous Supreme Court Justice labeled
this “the states as laboratories”. China makes extensive use of this approach, for
example, trying out Social Security reform in a couple of northeastern provinces,
and more such approaches should be encouraged in India and elsewhere.

**Lesson #8. Rapid Economic Development Is Desirable, Despite the
Tendency to Growing Inequality**

It is important to emphasize that rapid economic development must be the
primary goal, despite at least the short-run tendency to growing inequality. Slow
or no growth will result in a bitter debate over division of a slowly growing,
stagnant or shrinking pie. While the benefits of growth tend initially to be
unevenly distributed -- inevitable in any event but heightened in a time of
remarkably rapid economic growth such as in contemporary India or China – rapid development is necessary both to generate the resources from which a general social safety net and basic human capital investment can be financed, and to generate opportunities for (at least many of) those who have not yet made it up the economic ladder. A comparison of the results of market reform in Russia, India and China is instructive in this regard.

The major reason China is a less equal society today than thirty years ago is the vast improvement in the well-being of 400 million Chinese citizens. This is a very different outcome from market reform than in Russia, where very few benefited much in the early years of reform and many were made worse off initially. India is perhaps closer to the Chinese experience but, for several reasons, the gains from growth have not been shared as widely\(^5\). Whether a future of strong growth will spread progress broadly over a long period of time is difficult to predict. For example, economists’ tests of whether the different regions of India (and also other countries) will converge to a common level and growth rate of income per capita or to separate levels (so-called absolute and conditional convergence, respectively) have thus far been inconclusive. And in any event, such very long-run predictions must be played out against the potential political frailty of a federal democracy with much greater population and poverty in the poorer states.

\(^5\) See T.N. Srinivasan (2003), who emphasizes that China’s more pro-growth, pro-poor results derive from factors such as higher rates of saving and investment; deeper integration with the global economy; more agriculture reform, and more infrastructure investment, especially power.
Conclusion

I have taken this opportunity to summarize what I believe are some useful practical lessons for any government fiscal program in any society at any point in its development. These derive from rigorous economic analysis, statistical evidence, historical-international case studies and comparisons, and my practical experience in, and as an advisor to, governments for several decades.

Exactly how these principles relate to India’s current and likely future economic development requires deeper analysis of each potential policy in India’s own context than I am able to provide here. Indeed, that is certainly a comparative advantage of the discussants. From an overall strategic viewpoint, India will be much better off if its fiscal programs broadly reflect and are consistent with these principles than if they are far removed from them. While some sizeable progress has been made since the 1991 reforms, a sympathetic outsider like me is struck by how much more could have, should have and needs to be done. The recent growth success should not be an excuse to delay further reform.

India has an opportunity to learn from what has gone right and what has gone wrong in the fiscal programs of many other countries, recently and historically. Policy makers in China study such episodes diligently. And a major reason why the economic performance of the United States has been so much better than that of Europe for many years, to the point where the standard of
living is about one-third higher in the United States, is that we saw the much earlier development of the extensive welfare state, high regulation, rigid markets and high tax regimes in Europe. That combination has resulted in economic stagnation, high unemployment and socioeconomic ossification. That window on our own future resulted in a series of changes in United States fiscal policy, starting in about 1981, that have led the relative role of government in the American economy to stop well short of European levels, about one-third compared to one-half. This smaller role of government in the economy is certainly a substantial part of the explanation for the superior economic performance of the United States relative to Europe.

Finally, India, like China, should be justifiably proud of its recent economic development. As near as anyone can tell, there has never been a time in human history where so many people, or such a large fraction of the population, have been lifted out of abject poverty into a substantially improved standard of living in so short a time frame. That is a remarkable achievement. But the many, especially rural agricultural Indian citizens, who have not yet had that opportunity and made that improvement (a much larger percentage of the population than in China), remain a source of concern, as does the environment. They should neither be ignored nor overemphasized. The biggest blight on the environment would be if the many millions of Indians lifted out of poverty since reform were still desperately poor. Likewise on the environment, growth will generate the

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6 See, for example, Prescott (2004), who attributes virtually all of the difference in output per capita between the United States and France to France’s higher taxes.
resources to switch to cleaner technologies. As mentioned above, use prices, not command and control regulation, to internalize environmental externalities. Avoid the excesses, e.g. in Western Europe, of environmental and inequality policies sapping initiative, vitality, employment and growth from the economy.

While a rising tide will not lift all boats, it will lift by far the most boats. It is important to continue strong economic growth to lift as many as possible and to assist those who have not or cannot make it from some part of the extra resources generated from the strong growth. That is a far more sensible strategy than one which sets in motion a process, however well-intentioned, that will leave so large a role of government that eventually it becomes inimical to economic growth and rising and spreading prosperity.

**References**


