Business Standard

VOLUME XI NUMBER 257

Not a fertile idea

The stock markets can, at times, misinterpret the signals emanating from official documents. Or so it seems from the way the share prices of some fertiliser companies have looked up in the recent past on false hopes. The comments made in a recent finance ministry paper on government subsidies have been perceived by the markets as a positive signal for the relaxation of controls on the pricing and distribution of fertilisers. The report said that the subsidy on domestically manufactured fertiliser, in its present form, should be done away with and that urea imports should be decanalised. As an alternative, the report recommended the introduction of a flat-rate subsidy with two different rates—one for domestic producers and the other for importers—to begin with. This is to be replaced with a single rate subsequently.

This recommendation is neither a worthwhile relaxation of controls nor a judicious policy prescription. Decanalising imports will make little difference as long as imported urea continues to be subsidised. In any case, very little urea has been imported in the last few years. The flat rate of subsidy disbursal, too, seems to be a modified version of the none-too-successful old group retention price formula. In fact, a single rate of subsidy for all domestic fertiliser producers, regardless of feedstock, vintage and location, can create more problems than it intends to solve. For, it would introduce disparities in the disbursement of doles even for units using the same feedstock but differing in age, location, and technology.

The real reason for the fertiliser subsidy's prolonged run lies neither in the way it is computed nor the import procedures. Rather, it can be traced directly to the government's inability (read: lack of political will) to raise the retail prices of fertilisers in line with rising prices of hydrocarbon feedstock and other raw materials. This apart, some of the recent problems regarding subsidy payments have arisen because of the government's underestimation of the likely subsidy burden at the time of budget preparation. For instance, the budgetary allocation for concessions on indigenous urea for 2003-04 was Rs 7,555 crore against the actual bill of Rs 7,790 crore in the previous year. Similarly, the current year's Budget has set apart only Rs 12,662 crore for subsidies on all kinds of fertilisers—which is woefully inadequate. This results in avoidable delays in the payment of subsidy arrears, creating liquidity problems for the industry.

The net result of the uncertainties on the fertiliser front is that no fresh investment is forthcoming in this sector. Worse, both the production and consumption of fertilisers have been stagnant for several years. This is already being reflected in a deceleration in crop output growth. The best course under the circumstances is to totally decontrol and deregulate the fertiliser sector, leaving market forces to determine prices, production and import of nutrients. Since doing this abruptly at one go may not be politically advisable, it can be done in well-defined and time-bound phases, giving farmers as well as industry time to adjust to the new realities.

Sins of commission

Given the rapid pace at which the government has been setting up expert groups, committees and commissions, it is becoming difficult to keep up with what's going on. Committees may help bring issues into sharper focus, but in India the politico-bureaucratic establishment typically tends to tick off an issue as taken care of once there's a committee looking into it. By the time the committee or expert group actually submits its report, the focus would have shifted, and the report is consigned to some over-crowded shelf of a joint secretary in one of Delhi's various bhavans.

Forming committees to examine issues makes sense only if there is some official willingness to take the advice. This has often not been the case. In the case of the expert committee set up on VAT, for instance, several suggestions were made to ensure that the state governments had a real stake in increasing collections. But these were simply ignored and the states given a virtual blank cheque to lower tax rates on various commodities. They can now claim a revenue shortfall which will have to be made good by the Centre. The complete ease with which the Kelkar Task Force's recommendations on ending various unwarranted tax exemptions has been given the go-by over the past two Budgets is another good example of why committees don't really work.

In the case of the Investment Commission, which is supposed to help boost FDI, the fundamental issue is whether it has any real power to make a difference. Does it, for instance, have the power to hike FDI limits in telecom, if this is what investors are clamouring for? Clearly it doesn't. If the investors' complaint is that policy is being stood on its head to accommodate certain players, as one saw in telecom, there is precious little the Commission can do to rectify matters. Nor does the body have any power to intervene in problems of implementation at the state level. The promoters of the Bangalore-Mysore corridor are allegedly being subjected to various kinds of harassment by the state government, but it is not clear if even the central government can do anything about this, leave alone the Investment Commission. Once again, one can only wonder what the Infrastructure Development Board, reportedly under consideration, will manage to achieve.

The basic problem in most sectors, for both domestic as well as foreign investors, remains that of getting the system to respond. The problems do not relate to policy per se. The Electricity Act, for instance, talks of allowing genuine competition through "open access", but the problem is that when companies are allowed to bypass the state electricity boards and go to private suppliers for their power, they have to pay such huge charges that it negates the whole purpose of the exercise. When industries go bankrupt, the law allows them to close down and exit the country. But it takes upwards of 10 years to be able to complete all the formalities involved in closing down a business. Such issues cannot possibly be resolved through powerless commissions or boards. They can be sorted out only if there is political will backed by effective response at the bureaucratic level. It's time to stop the charade of appointing more committees and commissions without the requisite will to follow it through.

THE CHINESE ECONOMIC MIRACLE: II

The dangers ahead

The 'policy' and 'social burdens' carried by state enterprises need to be eliminated, says **Deepak Lal**

In my last column I delineated the sources of the Chinese miracle: high savings, the growth of labour-intensive small-scale non-state rural export industries in town and village and individual enterprises, a massive increase in infrastructure, a large unilateral liberalisation of foreign trade, and the market determination of nearly all domestic commodity prices. This labour-intensive growth allowed the transfer of a vast amount of low-wage labour from both the rural sector and the declining state-owned enterprise (SOE) sector. It enabled China to grow by "walking on two legs": by keeping the SOE sector alive whilst the non-state enterprise leg was growing stronger. It thus avoided loss in output and employment and the attendant social disorder that had characterised other transition economies' move from the plan to the market. But this strategy now faces serious obstacles.

The heart of the problem lies in the financial repression needed for a capital-intensive heavy industry biased development strategy, requiring government monopolisation of the mobilisation and deployment of savings in the economy. In China this meant complete control of the economy by the planners. The savings were provided by the profits of the state enterprises. With the reforms these profits collapsed. In the rural sector they now accrued to private agents. The price reforms and growing competition from efficient non-SOEs turned SOE profits into losses, worsened by continuing the welfare commitments for health, housing, education, pensions, and jobs for life of the planned era. As a result, the central government's revenues fell from 32 per cent of GDP in 1978 to 11 per cent in 1995. The fall being worsened by the various tax concessions the local authorities offered in their locational competition for joint ventures with foreign investors.

This acute fiscal crisis was met by two fortuitous circumstances. The large increases in private savings with rising incomes in the rural and small-scale non-state sectors were held as deposits in the state banks, whose deployment was determined by the central authorities. Moreover, the growing incomes led to a rapid monetisation of the economy, with the ratio of money supply to GDP rising from a third to equality from 1978 to 1995. This provided large seigniorage gains. Nevertheless, the government had to run large fiscal deficits funded by bonds held by the state banks. Apart from public investment in infrastructure, much of government expenditure is on implicit or explicit subsidies to the loss-making SOEs. With savings having reached a plateau and future seigniorage gains likely to be limited, the incipient fiscal crisis of the state requires a reform of the SOEs.

The first danger from the debauching of the financial system is the inefficiencies caused in the deployment of China's massive savings. Currently, nearly 90 per cent of household savings are still held in deposits with the state-owned banks, in part because of the lack of alternative savings instruments. Most of the deposits in the banks are loaned to the SOEs. Most of the investment in the viable private non-SOE sector is either self-financed or else dependent on foreign capital. Much of this "foreign" capital is in part the recycled profits of non-SOE enterprises, making use of the legal protections and financial intermediation available in Hong Kong. With few of these private growth enterprises being willing or allowed to issue stocks in their companies, SOE stocks are the only ones traded on the domestic stock exchanges. The non-transparent accounting practices of SOEs and perceived non-viability deter households from holding much of their savings in their stocks, leading to thin and volatile domestic stock markets.

The lack of adequate savings vehicles, and the low return households currently get from their savings in the state-owned banks, pose a threat to the maintenance of China's high savings rate, particularly when account is taken of the natural depressant of savings with the projected rise in the dependency ratio—with the ageing of the population—from 6 at present to about 2 in 2040. But the state-owned banks cannot promote higher savings by raising their deposit rates without a rise in their lending rates to the unviable SOEs, whose losses would increase, leading the banks to further increase their loans to cover these losses and thus to a further increase in the non-performing loans in the banking system.

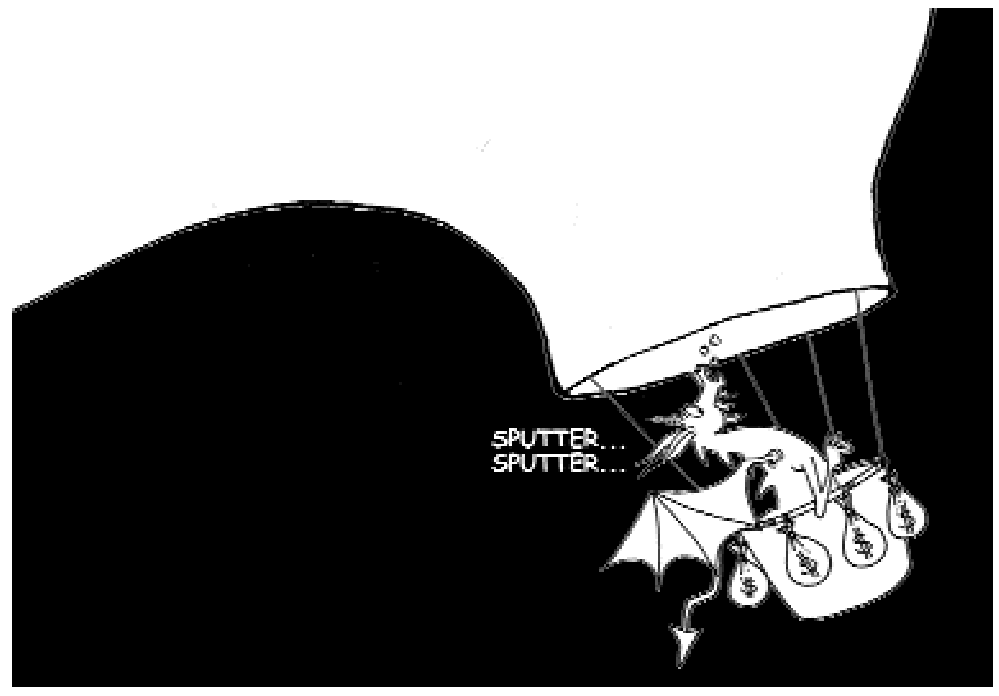

Illustration: R PRASAD

These micro-economic difficulties in using the interest rate to stimulate savings and for the efficient sifting and deployment of investments through a well-functioning stock market are further compounded by the macro-economic consequences of financial repression. As the interest rate cannot be used as an instrument for managing aggregate demand, heavy-handed administrative measures, with all their inherent inefficiencies and limited effectiveness (given the self-financed nature of most private non-SOE investment), are needed to cool the economy.

Furthermore, given the fragility of the banking system, fully opening up the capital account of the balance of payments, followed by a move to a fully flexible exchange rate system, is ruled out, because it could lead to a serious financial crisis. I do not think that China's export-led growth has depended, as many other observers believe, on maintaining an undervalued exchange rate. For, as most of Chinese manufactured exports are processed goods with little domestic value added (estimated to be about 20 per cent of the value of output), changes in the exchange rate would not markedly affect their profitability. A flexible exchange rate would not damage China's phenomenal export-led growth. It is also required to fend off the growing pressures for a revaluation of the yuan from both private speculators and China's major trading partners.

Behind all these prospective dangers currently facing the Chinese economy lie the "policy" and "social burdens" carried by the SOEs, which need to be eliminated. Fortunately, China's large build-up of foreign exchange reserves provides the means. China's foreign exchange reserves in October stood over $600 billion, which in a roughly $1 trillion economy amount to about 60 per cent of GDP. They are largely held in US treasuries. Apart from the absurdity of a relatively capital-poor developing country making these large unrequited capital transfers to a capital-rich country, China must have seen a loss in the real value of these assets with the 30 per cent depreciation of the dollar from its peak in 2002, and a modest return of 2.3 per cent on US treasuries.

There is a much better way to deploy these foreign exchange reserves. Only a small part—say, $100 billion—are at best needed to fend off speculative attacks on the dollar peg. The rest and future accruals could be put into a social reconstruction fund (SRF) under the central bank. This SRF would be run like many public pension funds. If it matched the 10-year return of 8 per cent p.a. of the World Bank's pension fund, the SRF would yield an annual income of about 4 per cent of GDP. This could be used to retire the "social" burdens of the SOEs, allowing their privatisation. This would end the subsidies from the banking system, which have led to its fragility, allow a transparent accounting of SOE stocks, allow monetary policy to operate, and, with the restoration of health to the financial system, allow China to float the yuan. As the SOE problem disappears, the income from the SRF could become the basis for a fully funded pension system for its increasingly aging population. A similar deployment of India's burgeoning foreign exchange reserves in an infrastructure construction fund (ICF) under the RBI would be an obvious Indian counterpart.

Tax cannot be expressed on a postcard

John Kay

INSIGHT

If only all reliefs and allowances were swept away, the tax code would be much simpler and the government's requirements could be met from a single low rate of tax on all income. British taxpayers have just completed their annual returns and American taxpayers must soon start. But perhaps these long forms are unnecessary. If you look up "flat tax" on the internet you will discover several mock-ups of the one-page return a simplified levy would require.

Clint Eastwood is a passionate supporter of the flat tax and, untroubled by political correctness, looks forward to the day when the tax system can be administered by a little old lady with a personal computer. But the appeal of the flat tax extends beyond millionaire film stars. The latest revival of this perennial campaign is orchestrated by rightwing think-tanks such as the Heritage Foundation and the Adam Smith Institute, which believe the flat tax is responsible for the remarkable economic success of Russia and Georgia (I am not kidding).

But the notion that an advanced economy can express the requirements of a fair and robust tax system on a postcard is an impossible dream. Some complexity, as the flat taxers have argued, is attributable to the accretion of allowances and ad hoc reliefs. Members of Congress secure favours for constituents; finance ministers canvass their advisers for pieces of economic or social engineering. Every few years, these measures need to be cleared away, like the barnacles that adhere to the hull of a ship. Tax reformers in the 1980s made a good job of this, but since then the concessions and the gimmicks have been making their way back.

But the main reason tax codes are so complex is that income is inherently a complex concept. The most widely cited definition of income is that of Sir John Hicks: income is what a man can spend and expect to be as well off at the end of the period as at the beginning. You do not have to be a Nobel prize-winning economist to recognise that translating that definition into a tax code or a set of generally accepted accounting principles is going to be difficult.

Experience of tax legislation and the regulation of corporate accounts has confirmed this. I remember a debate on principles of income measurement. A revenue official and a tax practitioner, impatient with academic argument, asked: "Why can't we just stick with the common sense definition of income?" The hundreds of pages of the tax code are the product of unsuccessful attempts to articulate the commonsense definition of income.

Income tax works relatively well when the accrual of income corresponds to the receipt of cash, as for wages and salaries or interest and dividends. Income tax does not work well when there is no such correspondence—when there are benefits in kind, when income accrues but there is no realisation, or when it is not clear where or to whom income accrues when it arises. Most of our income tax legislation, and most of the avoidance opportunities that arise from it, result from these problems.

Income tax works relatively well when the accrual of income corresponds to the receipt of cash, as for wages and salaries or interest and dividends

The more thoughtful flat tax advocates understand these difficulties and urge a shift from an income base to a simpler consumption tax. They are also right to argue that elaborately graduated rate structures add little to the progressivity of a tax system but a lot to both opportunities and incentives for tax avoidance.

Tax systems around the world have evolved in line with these principles. In two decades, the number of income tax rates fell from 25 to six in the US and from 13 to two in the UK (although the British figure has since crept back up to six). Payroll taxes and sales taxes have been the main source of revenue growth.

When Hicks elaborated that definition of income, he went on to conclude that income was "a bad tool, which breaks in our hands". His Cambridge rival, Dennis Robertson, also remarked that "the gaols and workhouses of the world are full of people who gave up as a bad job the admittedly difficult task of distinguishing capital from income".

Both were right. We find the idea of income hard to apply, but we cannot do without it. When you surf for that postcard-sized tax return, it is easy to come up instead with a list of results for flat earth campaigners. There is a similarity of tone.

Financial Times

Arthur Miller, 89: Out of the Crucible

Nilanjana S Roy

SPEAKING VOLUMES

I'm still feeling kind of temporary about the death of Arthur Miller, to steal one of Willy Loman's best lines from *Death of a Salesman*. The reaction to Miller's passing at the age of 89 from congestive heart failure varied between "I thought he *was* dead" and the usual tributes to one of greatest dramatists.

"I thought he was dead": no respectable obituary writer would admit to that naïve sentiment these days. But overwhelmingly, the articles and assessments of Miller's career chose to hail two of his plays—*Death of a Salesman* (1949) and *The Crucible* (1953). Some made passing mention of *After the Fall* and a few other works—all of them completed before Miller had reached his fifties. When Josh Greenfeld interviewed him for *The New York Times* in 1972, he would write even then that Miller, "at the still-youthful age of fifty-six," had been cast "in the unlikely role of a relic".

For a writer who wrote every day, starting at 8:30 am and often going on for eight hours, sometimes writing as Greenfeld noted 2,000 pages of which 140 would end up as a playscript, this must have been hard. Miller wrote three plays in the 1990s, including *Broken Glass*, woven around Kristallnacht; all of them were reviewed respectfully. None of them made a tenth of the impact of his early work. It's hard to argue that his talents had degenerated over the years—indeed, those who've read his short story in Nadine Gordimer's recent anthology, *Telling Tales*, might have been surprised by the force and beauty of his writing in his eightieth decade. "I'm pretty convinced he was writing till the day of his death," Harold Pinter told the press yesterday. "He was born with a pen in his hand."

He believed passionately in the power of theatre to transform lives—even in our age of TV and the Internet. "The day will come when theatre again will surmount everything for the simple reason that it is an irreducible simplicity," he told Greenfeld in 1972. "It's a man up there facing other men. Somehow or other this always has to be possible."

It's easy to forget that he started his career with a novel—*Focus*, which was a partial polemic about anti-Semitism, where the main character was a Gentile who faced racism because he was mistaken for a Jew. His next work was *Incident at Vichy*, written after he had travelled to Germany and attended the Nazi trials. Unlike *Focus*, it stands up to re-reading, and highlights a technique that Miller was to use through his playwright's career—the ability to isolate one incident, apparently minor, in the lives of ordinary individuals and use it as a lens to look at a much larger issue.

Most critics would agree that Miller's greatest work was *Death of a Salesman*, where Willy Loman, antihero, everyman, epitomised the tragedy of the little man who gives his life to a system that will inevitably betray him. And much of his work, especially the plays written before he turned fifty, tapped into the eternal struggle between father and sons with an unflinching tenderness that few other writers have matched.

For some of us, though, the great Miller play remains *The Crucible*, of which he remarked in an essay written in 2000: "*The Crucible* is my most-produced play. It seems to be one of the few surviving shards of the so-called McCarthy period. And it is part of the play's history that, to people in so many parts of the world, its story seems to be their own. I used to think, half seriously, that you could tell when a dictator was about to take power, or had been overthrown, in a Latin American country, if *The Crucible* was suddenly being produced in that country."

The resonance of *The Crucible* goes far beyond the Salem witchcraft trials or even Miller's own experiences. That play was written after Miller had gone through his own trials by fire in the McCarthy era—been hauled up by the notorious HUAC (the House of Un-American Activities Committee), had an offer to let him off the hook if his then-wife, Marilyn Monroe, posed for a photograph with a certain committee member, been blacklisted in Hollywood, suffered persecution and questioning.

"Turning to Salem was like looking into a petri dish, an embalmed stasis with its principal moving forces caught in stillness," Miller wrote in retrospect. "One had to wonder what the human imagination fed on that could inspire neighbours and old friends to emerge overnight as furies secretly bent on the torture and destruction of Christians. More than a political metaphor, more than a moral tale, *The Crucible*, as it developed over more than a year, became the awesome evidence of the power of human imagination inflamed, the poetry of suggestion, and the tragedy of heroic resistance to a society possessed to the point of ruin."

A few days before Miller's death was announced, Salman Rushdie wrote an impassioned article titled: "Defend the right to be offended." Rushdie, along with a band of writers, actors, intellectuals and artists in Britain, has been arguing fiercely against a new law that would ban the "incitement of hatred on religious grounds".

Rushdie writes, "It seems we need to fight the battle for the Enlightenment all over again in Europe as well as in the United States … People have the fundamental right to take an argument to the point where somebody is offended by what they say. It's no trick to support the free speech of somebody you agree with or to whose opinion you are indifferent. The defence of free speech begins at the point when people say something you can't stand. If you can't defend their right to say it, then you don't believe in free speech. You only believe in free speech as long as it doesn't get up your nose. But free speech does get up people's noses. Friedrich Nietzsche called Christianity 'the one great curse' and 'the one immortal blemish on mankind'. Would he now be prosecuted?"

I remember a phrase from childhood, a playground shrug of sorts: "It's a free country, yaar." It was employed as the final closure to arguments, as shorthand for saying that you didn't agree with the other guy, but he was entitled to his point of view. This is the principle that Miller fought for, through his words as a dramatist, through his stint as head of the American chapter of PEN in the 1960s. This is what Rushdie and his colleagues are fighting for now, the right to allow people in the US and India and the UK to continue saying, well, it's a free country. One of those countries isn't free, any more; one has been perpetually beleaguered even as it uneasily lays claims to freedom; one is in the process of sacrificing its freedoms.

And I'm wondering how many productions of *The Crucible* we'll see in the next few years.