

The Indian Economy: Progress and Challenges

by Ajay Shankar, Senior Fellow, Delhi Policy Group



Since the initiation of economic liberalization in the early nineties, India has been making steady progress in becoming an open free market economy with increasing economic engagement with the global economy. It has benefited from this process.

Prime Minister Narendra Modi envisages his place in history as the leader who transformed India. He has not been looking for quick fixes, as he thinks he is there for the long haul. In one of his first addresses, he had asked to be given ten years to be focused only on development. He has completed three years in office with the confidence that his personal popularity remains very high. His sweeping election victory in the recent state elections in India's largest State, Uttar Pradesh, with a population of around 200 million, was a ringing endorsement as he personally led his BJP party to a victory without even naming the state leader. The Indian economy has been growing at around 7% and is one of the fastest growing large economies in the world. This has been the case when global economic performance has been generally subdued. As the Modi government enters the last two years of its term, it is natural to take stock of the progress made, initiatives undertaken and the major challenges facing the Indian economy.

Given its size, diversity, uneven development and complexity, India is never easy to understand and always appears full of contradictions and paradoxes. New policies and programs usually take time to have an impact and outcomes are never quite certain. It is also useful to see reforms and challenges from a political economy perspective in addition to a purely economic one. The political economy dimension was highlighted in the early days of the government when, in an interaction with economists, the Finance Minister, Arun Jaitley, made it quite clear that for any proposed reform to proceed, it had to be seen and judged politically.

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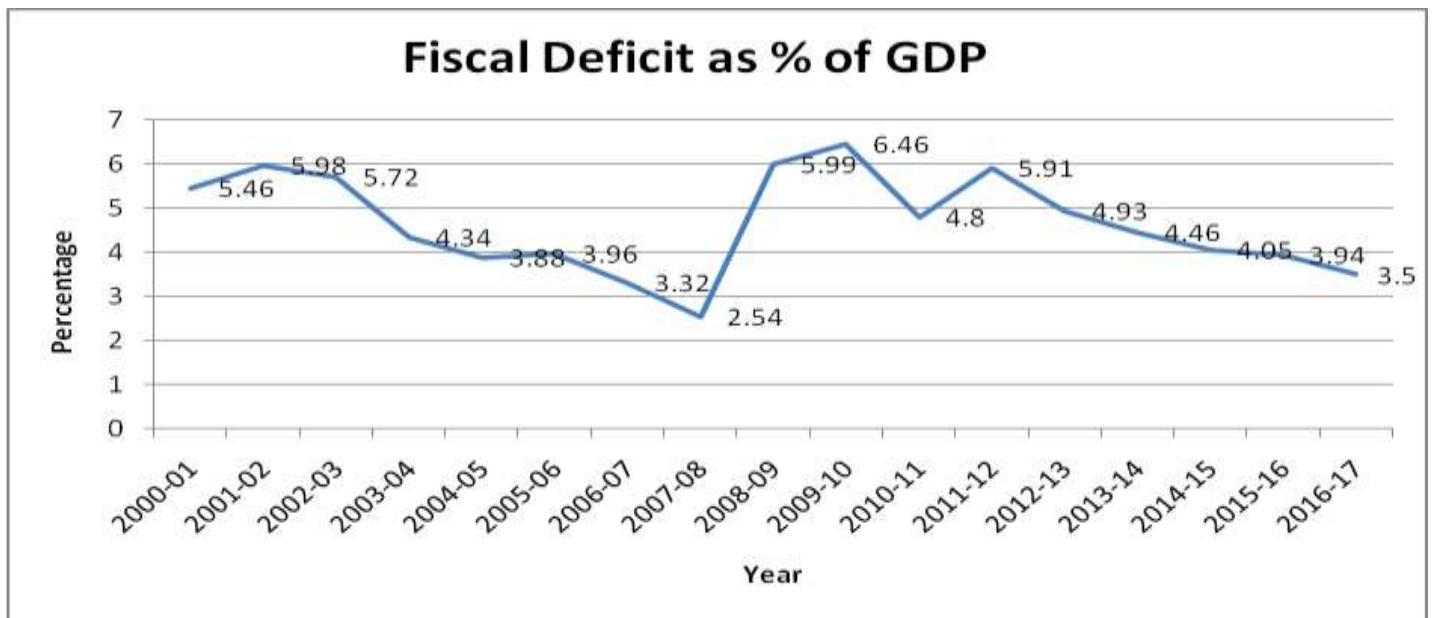
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Director General

Progress and Positives

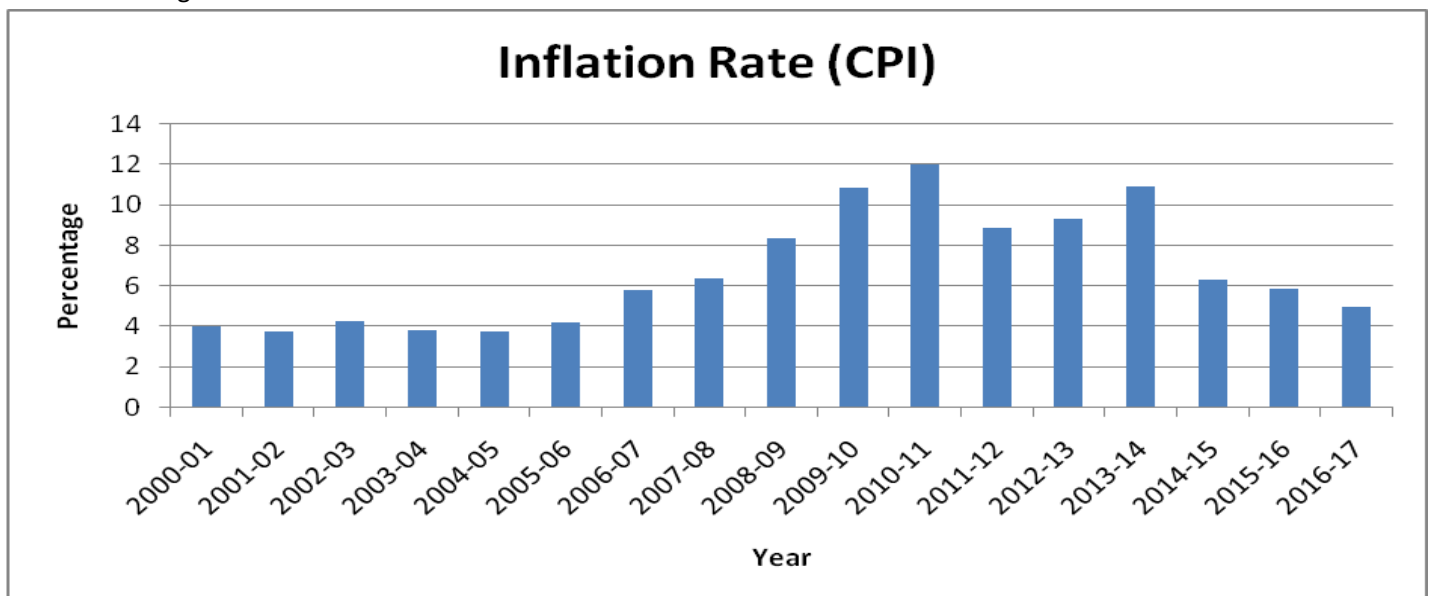
• Macroeconomic Stability and Fiscal Consolidation

From the macroeconomic perspective, it has been good for India that early on the government gave priority to sustaining low inflation and accepted the importance of fiscal consolidation for stable medium to long-term growth. This meant resisting the temptation and the urgings from many quarters for measures to stimulate growth in the short run following the decline in growth rates since 2011-2012. After all, the elections had been won on the mandate of rapid development. Then there were so many election promises to fulfil which needed fiscal resources. India's past record had been a mixed one; enacting legislation on fiscal responsibility (FRBM Act) on the one hand and being tardy in implementation on the other, with the fiscal deficit going down and then up. Progress towards fiscal consolidation has been far better than expected, as can be seen from the following chart:



Graph 1: Fiscal Deficit from 2000 to 2017, *Source: Indian Public Finances Statistics 2015-16, Ministry of Finance*

Both inflation at 5.87% and the current account deficit at 3.5% have been low enough and are expected to remain so, which is a breakthrough.

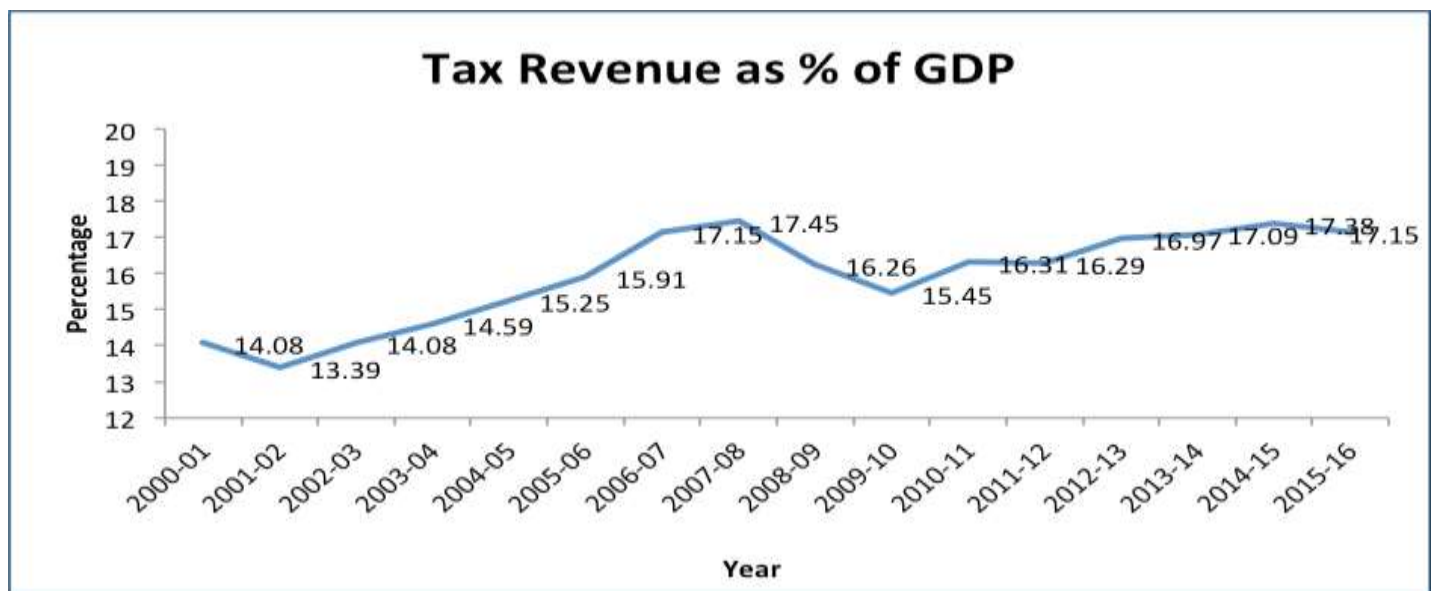


Graph 2: Inflation Rate (CPI) from 2000 to 2017, *Source: Open Data Government Platform; Tax Revenue: Indian Public Finance Statistics Report 2014-15*

• GST

The combined Goods and Services Tax (GST) being rolled out now is a real game changer. It would create a unified, single Indian market as far as the tax regime for all economic activity is concerned. This has essentially changed the basic federal structure of the Constitution in terms of the States agreeing to cede their powers, individually, and becoming part of the joint mechanism of the Centre and the States for taking decisions on the GST rates. Though initiated by the earlier Manmohan Singh government, GST still needed a lot of consensus building with the states and flexibility for give and take, and adjustments to get everyone on board. This marks a major achievement.

For businesses, a single tax regime for the unified Indian market lowers transaction costs. For government, both at the Centre and in the States, it should effectively enable the plugging of leakages in tax revenues, which in India have been estimated to be pretty high. The full value chain comes into a single tax regime which is IT based. This rules out, in design, all tax evasion in GST. In practice, the system may not work fully in accordance with the theory, with some inevitable compromises becoming necessary for the sake of consensus by way of having quite a few different GST rates and some exemptions. The new system will also take time to settle down and there may still be some evasion at the margins. It should, nevertheless, after its initial teething troubles, lead to a surge in tax revenues. The long overdue increase in tax to GDP ratio in India, would begin to take place. Governments in India have been severely constrained by the fairly low tax to GDP ratio. As a result of GST the government would, in the coming years, be able to afford substantially more of the fiscal outlays it needs for improving infrastructure, education, health, and social security.



Graph 3: Tax Revenue as % of GDP from 2000 to 2015, *Source: Indian Public Finance Statistics Report 2014-2015*

• Ease of Doing Business

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016
Ease of Doing Business Rank	132	133	139	132	131	134	134	131	130

Table 1: Ease of Doing Business Rank of India, *Source: World Bank*

There has been a broad consensus across countries that in this globalized world, where capital is mobile and has the choice between many competing locations, it is important to address the issue of 'Ease of Doing Business'. This is very important not only for FDI but also for domestic investment, especially start-ups. In spite of the ongoing liberalization process of over two decades, India has not been an easy place for doing business. This is reflected in its persistent very low ranking in the World Bank's annual Ease of Doing Business report.

The Modi government has been focused on this, reflecting its pro-business and pro-market conviction that development needs entrepreneurship and empowerment more than doles. A dynamic system of comparative rating of states on identified key parameters aimed at reducing the regulatory burden and related transaction time and costs for enterprises has been introduced. The competition among states is driving genuine change. Radical ideas of self, and third party, certification are gaining traction. E-governance is rapidly spreading across the government's interface with business enterprises and individuals. Some of the more backward states have dramatically improved their ranking. India is finally beginning to make the transition towards being a better place to do business in and to launch start-ups.

But this faces a major ongoing challenge in the persistence of the strong statist tradition in India. This keeps resurfacing in impulses which range from issuing price control orders, to giving authorities more sweeping powers to punish poorly defined acts of wrongdoing by business, to introducing additional regulatory requirements, without thinking through the adverse effects on business and the likely public benefit. This area needs continuing attention and reform.

• Infrastructure

Weakness in infrastructure has been coming in the way of India achieving its full growth potential. There has been significant progress and the situation is now beginning to look more optimistic.

- **Power:** Thanks to a surge in private investment in power generation in the last decade, with private sector capacity addition exceeding that of the public sector, India is, at the macro level, surplus in power. This is a major transformation that was not expected so soon as India has perpetually lived with power shortages and frequent brownouts. India is also on the verge of completing electrification of all villages and all households over the next few years. This, again, is happening much earlier than was considered likely. As a result economic activity in cities as well as villages will no longer be constrained on account of lack of electricity.
- **Renewable Energy:** India surprised most observers by taking up an audaciously large national commitment of creating 170GW of renewable energy capacity as a part of the Paris Accord and has made a remarkably good beginning in getting private investment into renewable energy while moving away from coal.
- **Railways:** The Railways are undertaking a long overdue modernization and capacity augmentation programme. Dedicated freight corridors from the North to the Eastern and Western coasts should be ready in the next three years. Speedy container movement would reduce the cost of logistics and bring these closer to international levels, lowering India's glaring disadvantage on this count. Industrial corridors with new industrial townships are being developed to take advantage of lower costs of logistics.
- **Highways:** The Highway program had in earlier years included a large number of PPPs. Many of these had run into difficulties with the slowdown in the economy since 2011-12. After considerable effort and process re-engineering, the momentum of construction has picked up again. An expressway program could also see the light of the day soon.
- **Aviation:** Competitive growth of private airlines combined with considerable private investment in creating additional airport capacities has been a success story. Air travel in India is growing at the fast pace of 23.3%. Smaller towns are being brought onto the air map. Aviation is no longer a constraint in India.

• Smart Cities

To any new visitor to India, the visual state of cities, including metros like Delhi and Mumbai, highlights the distance India still needs to traverse. Be it littered garbage, large slums with inadequate access to the basics of water and sanitation and woefully poor public transport, the challenges facing Indian cities are truly daunting. Under the Modi government, there is at last the recognition of how very important cities, with their positive externalities, are engines of growth and for innovation and entrepreneurship.

The "Smart Cities" challenge process has been quite innovative. Normally, India works in a highly centralized way, with Delhi laying out the design of a development program, issuing detailed guidelines and expecting implementation in a uniform

manner across the country. For the first time, cities were required to undertake citizen engagement and in a consultative process draw up their plans to win the contest to be selected for inclusion in the Smart Cities programme. The plans were required to have a holistic strategy for the city's economic and social development and the use of smart technology for improving infrastructure and governance. There has been a tremendous learning gain from this process. Gradually, a hundred cities are being taken up.

However, initial central funding has been far too modest. This would need to rise substantially if the program has to actually live up to the expectations it has aroused. Cities are exploring new ways of raising finances and getting private sector investment. Here, the continuing inability of India to put in place the availability of long-term debt for infrastructure would continue to handicap progress. Better project design and execution ability are also intrinsic to success.

This programme could transform urban India. There are also complementary initiatives of 'Clean India' and affordable 'Housing for All'.

As a late mover into rapid urbanization with over 500 million people moving into cities by 2050, India has the potential of learning from the experience of others and avoiding their mistakes. It could end up developing better, greener and smarter cities in the coming decades.

• Digital India

Recognizing the centrality of IT in this century, "Digital India" represents the aspiration to leap frog development. Universal broadband access naturally has to be the starting point. India's aggressive private Telecom Companies are vigorously creating capacities to meet the booming demand for data services. The work of creating a national optical fiber network to cover 250,000 of India's villages conceived a decade earlier has now been pushed and should be nearing completion soon. With this, covering all of the 640,000 villages of India with local wireless networks over the next few years is looking realistic.

Most Indians are discovering the rich and disruptive world of the Internet through smart phones without having ever seen a desktop, or, a laptop. In a few years, as it now seems likely, the interface of the citizen and of business with authorities and with each other will become primarily digital. With this, Indians, especially the young, would be enabled to achieve their full creative and entrepreneurial potential in the globalised digital world of the 21st century.

Major Challenges

Notwithstanding all the above positives, India still faces difficult challenges which need urgent attention. The major ones are:

Accelerating Growth

There has been a decline in the GDP growth rate in the last quarter, There is also a perceptible trend of declining private capital investment and credit off take over the last few quarters. Capital investment, from the peak of around 33% of GDP, has been declining gradually and is now below 29% of GDP. There is the further problem of growing Bank NPAs which are reaching critical levels of around 15%. These trends need reversal at the earliest.

Growth needs to get back to around 9% to meet the demands for productive employment and national ambitions as a leading power.

This should not be too difficult if specific innovative measures to create demand for domestic products are taken which revive domestic investment. Needless to add, the resolution of the NPA problem of Banks would be a necessary precondition. Housing and real estate development are traditional engines of growth and have been stagnant for some years now due to a variety of reasons. They need policy attention to regain their earlier higher growth momentum. Further, small and micro enterprises, which had traditionally been operating on cash, were hurt considerably by demonetization. Their revival with the return of cash needs monitoring and support.

The business case for value addition has to be made strong enough to revive and attract private investment. This would require some out of the box thinking and measures. An overvalued currency, as is the case now, is a recipe for 'not making in India', rather than for 'making in India'. The old orthodoxy in many circles in favour of a strong currency has become a burden. The sooner it is shed, the better.

India has the potential for being as good in manufacturing as China is. The challenge is to make it happen soon enough. Otherwise, India's growing demand can continue to provide an outlet for China's excess capacities.

• Job Creation

India is experiencing a historically unprecedented demographic bulge with some 104.62 million people between the ages of 18 and 22 entering the work force over the next five years. Creating productive, well paying jobs for them is absolutely critical.

Maintaining social stability would become increasingly difficult without success in this area. The first warning signs have been seen in spontaneous leaderless eruptions of mass protests from the dominant peasant communities in some of the most prosperous states of India. Even in the best years of around 9% growth about a decade earlier, job creation for those at the bottom of the pyramid was largely in the construction and informal sectors and not in the modern organized sector.

Job creation has to be brought to the core of the growth strategy.

The traditional pattern of all industrializing economies capturing export markets in labor-intensive products such as garments, footwear, toys, etc. has eluded India. Notwithstanding the ambitious "Manufacturing Policy" of 2011 which aimed to create a hundred million manufacturing jobs in ten years through 12-14% manufacturing growth rates, and Prime Minister Modi's "Make in India" campaign, success in globally competitive labor intensive manufacturing still remains elusive. Lower wage jobs are moving out of China, but India is yet to become a destination. The window of opportunity may also be getting limited with technological transformations, such as automation, better and cheaper robots, and 3D printing which are sweeping the world.

Since the start of the economic reform process in 1991, reform of labor laws, or, even a serious discussion of this necessity, has been a no go area.

At last a beginning has been made in preparing four labor codes to replace the over forty laws that regulate enterprises which employ 'workers' in 'factories'. The onerous regulatory burden explains the paradox of India having extraordinarily successful start ups in IT where there are no 'factories' and 'workers' and the absence of successful start ups in manufacturing. The Finance Minister had, in his Budget speech in the beginning of this year, indicated the intention of the government of pushing the necessary legislation. It is to be seen whether this gets the requisite political priority and heft to get these crucial reforms through this year.

In addition, a radical change in social mindsets and the entire ecosystem is required. As mentioned earlier, the statist mindset of bureaucratic control and over regulation survives. So does the traditional cultural disdain for physical work. Manufacturing is not yet fashionable and glamorous.

Factor costs need to be made competitive. The worker has to become an asset and a partner rather than only a cost which needs to be reduced. The introduction of a social safety net for all workers along with housing had accelerated industrialization in many countries in the last century.

All this would need considerable political energy. The real proof of success would be when entrepreneurs, domestic as well as foreign, start choosing to invest in labor intensive large garment factories, ship building yards, IT hardware component supply chain plants, etc.

In 'Services', the IT sector has been the engine of growth and job creation in India. It is now facing challenges from automation and needs to adapt to new technological realities. India has not yet been able to get its act together in the employment intensive Tourism Industry. This is a low hanging fruit which has yet to get the political attention it deserves. The restoration of the growth momentum in the employment intensive real estate and construction sectors would also help. India also needs to accelerate the pace of urbanization and take steps for its success on a sustainable basis.

• Bottom of the Pyramid

India has historically been an extremely stratified, hierarchical and unequal society. The constitutional guarantees of equality of rights irrespective of gender, caste, religion, or language audaciously put in place in 1950 were way ahead of actual social mores and practices of the overwhelming majority of Indians.

Notwithstanding impressive progress, of which India can legitimately be proud, it still has to confront the challenge of a large percentage of the population in poverty (29.8% as of 2012) based on a bare bones definition. In all the key social development parameters of health, sanitation and nutrition, the absolute numbers of the deprived in India are comparable to those of sub-Saharan Africa.

This contradiction of extreme inequality and poverty has been one of the drivers of India's democratic politics. Early in his term, Prime Minister Modi faced attacks from the opposition for working only for the rich. In a major shift, the rhetoric of the government has since been more about the rural poor and farmers, the overwhelming majority of whom have very small holdings. Demonetization itself was successfully projected as a powerful attack on the ill-gotten gains of the wealthy.

The inherited pro-poor programs of rural employment and food security continue. There has been a major push for financial inclusion with the government driven program for opening bank accounts for all. With this, the transition to direct cash transfers has begun.

Steady progress in human development parameters continues to be made with skill development seeing greater momentum. But no dramatic breakthrough in the human development indicators is yet in sight. In many of these, neighbouring Bangladesh has done better. Business as usual will not suffice and is holding India back. A creative combination of the use of newer technologies, especially IT, and focused enhancement of the delivery mechanisms for each key sector is needed to start delivering desired results.

• Water

India could be facing calamities on account of water well before the doomsday scenarios of global warming begin to hurt. India's ability to feed its huge and growing population has been based on indiscriminate mining of water, that is, use of ground water for irrigation through pumping. Water tables are falling rapidly across India due to the annual use of ground water in irrigation being considerably in excess of the annual recharge from rainfall.

Water provided through canal networks for irrigation is free. The price signal to encourage efficient use of water for irrigation through recovery of the cost of electricity for pumping has also not been allowed to function. There is a political consensus in favour of supplying practically free electricity, with state governments giving increasing cash subsidies and keeping the power distribution Companies state owned - and in a condition of near bankruptcy.

Feasible instruments for coping with the water crisis are not even under discussion. There are no signs of any serious political recognition of the need for immediate and effective action on this front, but this is a vital necessity.

• Agriculture

Indian agriculture is mired in a structural maze of subsidy distortions. There are rising subsidies for inputs of fertilizers and water for irrigation on the one hand and for procurement at higher MSP (Minimum Support Price) for wheat and rice on the other. Yet investments, productivity and incomes in agriculture are rising far too slowly. It needs to be understood that agriculture today can and should be a modern technology driven activity. Clearly, more of the same will not do. With a similar or even lower outgo from the budget, far better outcomes are feasible. The recent farm loan waiver in UP has had a cascading effect across states with increasing farmers' unrest. Loan waivers are only a short term and very expensive palliative. A new paradigm is overdue. However, agricultural subsidies have been a political hot potato across the world. Prime Minister Modi clearly needs to bite the bullet if he wants to deliver on his promise of much higher incomes for farmers.

• Reinvigorating State Capacity

It is useful to see state capacity through the prism of its core functions of

- (a) Maintaining internal security and dispensing justice;
- (b) Delivery of public services; and
- (c) Taking decisions on complex issues and acting on them

The poor efficiency of the state machinery and its capacity to deliver has been a cause of growing concern for years. India has often been characterized as a ‘soft state’. This is clearly a major burden. Consultancies, outsourcing and letting the market mechanism take over may be good in many circumstances, but even these are not a panacea.

In controlling crime and providing public safety, the state alone has responsibility. And here, it is a shame that the people do not expect even murderers and rapists to get convictions and punishments provided under the law in a reasonable period of time, which would be considered normal in most of the world. The consequence is increasing criminalization and higher costs of policing and maintaining internal security.

For those at the bottom of the pyramid, the state remains the provider of key services of health, sanitation and education. Breakthroughs in human development indicators depend more on improved state capacity rather than on more resource inputs. The state must be able to get its well-paid teachers to go to school regularly and actually teach and its sanitation staff to keep public spaces clean. In short, government must increase the real value of outcomes from every Rupee it spends.

The failure to resolve the problems of PPAs in difficulty in infrastructure projects, and of huge Bank NPAs, are telling examples of the weakness in state capacity to take hard decisions to resolve difficult and complex problems.

A turnaround in state capacity is difficult. It requires patient and painstaking effort, which is clearly overdue. An early transformation for the better would hasten India’s rise.

Conclusion:

It is now over twenty five years since India embarked on a reform era. The achievements have been impressive. India is now the fourth largest economy in the world and the second largest source of additional global demand. Yet its per capita income is way below that of a middle income country and visible poverty is still much too high. Addressing the major challenges which have been discussed above would be the key to achieving and sustaining growth rates of around 9%, eliminating poverty and achieving the SDG goals. The result would be a stronger, stabler and more prosperous India with enhanced comprehensive national power, raising India’s standing in the global order.



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