ECONOMIC CHALLENGES FOR THE NEW GOVERNMENT

SUGGESTIONS FOR POLICY FORMULATION

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BACKGROUND

Since 1991, the Observer Research Foundation has assisted and participated in India's progress towards Economic Reforms by providing a non-partisan intellectual space for free, frank and wide ranging discussions amongst economists of various hues. It has attempted to provide alternatives to the political leadership in policy formulation. The "Agenda for Economic Reforms" published by the ORF in 1991, was one such document prepared by four of India's brightest minds. We believe it played a key role in catalysing the political will for undertaking reforms, the beneficial results of which are witnessed today. Albeit at its own measured pace, the Indian economy has traveled a vast distance in the past 18 years. Today, India is a fine example of transformational reforms in the developing world and is recognized as an important driver for the recovery of the world from an unprecedented global economic downturn not experienced since the Great Depression of the 1930s. The Indian Economy, though less affected has not been immune from the adverse effects of the global financial crisis and the ensuing economic slowdown.

These difficult times undoubtedly pose serious challenges, but at the same time offer vast opportunities. The needs of the times and the consequent policy responses to them would have to be very different from those crafted in 1991 in response to our own economic crisis. Today, we would need to discover ways to maintain the growth momentum, while simultaneously expanding its inclusiveness in order to benefit the weaker sections of the society. At the same time, we need to maintain fiscal prudence in the face of the currently justifiable need for yet another fiscal stimulus. All these are easier said than delivered, particularly in the current circumstances where government revenues are strained due to slowing growth rate.

The Observer Research Foundation held a series of internal discussions and prepared a discussion paper outlining the core challenges that the new government would need to respond to on an urgent basis. This paper was then circulated amongst and discussed with India's finest economic minds on June 1, 2009, at a closed door roundtable, to allow for free and frank debate. The participants included Dr. Rakesh Mohan, Dr. Saumitra Chaudhury, Dr. B.B. Bhattacharya, Dr. S. Narayan, Dr. N.K. Singh, Dr. Jagdish Shettigar and Dr. Charan Wadhva. Dr Arjun Sengupta chaired the roundtable. The internal ponderings and suggestions received at this roundtable meeting form the basis of the suggestions and recommendations contained in this paper.

ECONOMIC CHALLENGES FOR THE NEW GOVERNMENT

The economic situation today compels the new government that took office in May 2009, to take specific action on some important fronts **that** are in line with the mandate received in the recent elections. The success of the National Rural Employment Guarantee Act (NREGA) and rural health mission scheme has won the mandate of vast majority of the voters. It was manifest that the UPA Government's second generation of reforms, investment in infrastructure and improved governance focused on the efficient delivery of public expenditure on capital and social schemes specially resonated with the urban voters and won popular support in the major metros. The President's address at the inaugural session of the 15th Lok Sabha, along with the message that can be read in the popular electoral verdict, provides a fair indication of the future economic policy of the new government. Accordingly, three specific areas emerge that require immediate attention. These include: responding to the current economic slowdown; continuing with calibrated reforms; and expanding social schemes to provide relief to the weakest sections of our society. These would need to be addressed concurrently and would need pragmatic thinking.

The first concern is the global economic downturn and its adverse effect on India. Although India may not be as badly affected as some of the European countries, Japan and the USA, it has certainly not been insulated from the global recession. India's annual GDP growth in 2008-09 is reported to have fallen to 6.7 percent from over 9 percent in 2007-08. The decline in GDP, though significant, does not reveal the actual slowdown witnessed by the agricultural, industrial and service sectors over the past one year. It also does not reveal the fact that this significant fall in growth rate is despite the fact that there was only a marginal fall in the rate of investment. The reason was that enterprises had already been committed to their investment decisions before the downturn took effect. But now, the effect of curtailed future commitments would pose a significant challenge in the current fiscal.

Additionally, it also must be appreciated that even this lower level of GDP growth may have been reached only due to the large increase in government expenditure because of NREGA, the impetus provided by the payouts under the Sixth Pay Commission and the expenditure associated with the recent Lok Sabha elections. Going forward, in the absence of these factors, a growth rate of even over 6 percent will need creative and focused policy making under an adverse external economic environment of the severe global recession. **It may not**

be prudent to create expectations of 8-9 percent annual GDP growth until the world economy shows definite signs of recovery.

There is also the need to separate economic slowdown (that India started experiencing in 2007-08) from the economic meltdown in order to respond effectively to our economic challenges. The slowdown could be addressed through corrective measures in the monetary policy and through targeted fiscal stimulus whereas, for the meltdown, government would need to manage issues of employment generation and demand generation. Due to the global meltdown and the tighter overseas markets, unemployment has significantly increased in export-oriented sectors like textiles, garments, gems and jewelry and in services like IT and BPOs. Conventional domestic markets are also strained and employment opportunities in the manufacturing sector are dwindling. Some sources project the number of job losses to be in the range of 10 to 15 million jobs in export-oriented sectors alone. **India's most important challenge lies in the area of job creation for the young population that is at the margins of growth.** World Bank estimates that every 1.0 percent decline in the growth rate in developing countries traps an additional 20 million people in poverty. India would need to respond to this slowdown by creating jobs in urban and rural spaces, and providing vocational training and skill development programmes for the unemployed rural and urban youth.

Supply side policy measures for substantially increasing private and public investments would also be required to reverse this slowdown. India's problem today is not as much in the realm of domestic demand as it is in the supply side bottlenecks and capacity challenges, especially in public services like water, electricity, roads etc. Nation building through investments in roads, water, power, ports and airports could generate new economic impetus while also generating employment. Capital Expenditure as a percentage of GDP is at is lowest level in the last decade. There is an urgent need to increase capital expenditure through public enterprises in case private sector investments are not forthcoming at this juncture. Simultaneously, a significantly higher and effective public investment towards improving health and education services would enhance the productivity of the Indian labour force on the supply side, thereby accelerating the economic growth.

There needs to be a great emphasis regarding government expenditure on infrastructure, and on the need for the revival of capital spending. Enhancing public outlays for infrastructure projects is predicated on the belief that when private investment remains subdued, public

investment leads to demand escalation and income generation, besides creating employment. The increase in infrastructural spending has the added advantage of leading to an increase in the demand for capital goods and also inducing private investments (crowding, in effect). Infrastructure cannot primarily be developed by the private sector, considering that most other countries have no more than about 10 percent infrastructure development through the Public Private Partnership (PPP) route. Even for PPP projects, we need a paradigm shift in our approach. **Efforts should now be made to promote projects for private participation in priority areas after procuring all approvals, including regulatory and environment permits, in order to avoid 'approval arbitrage' that is witnessed today**. This will ensure pricing and schedule competitiveness.

Effective and speedy utilization of funds for public projects also remains a serious handicap. Most public sector projects face endemic time and cost overruns. As per a Rajya Sabha report in early 2009, of the 909 infrastructure projects worth Rs. 4,18,567 crores, 346 projects are running behind schedule. Systemic overhaul of the process of project approvals, disbursals and implementation must be undertaken to improve the speed and quality of public expenditure. There is also an urgent need for the development of IT infrastructure in rural and peri-urban areas. The 11th Five year Plan may need a mid-term review to refocus the emphasis of public expenditure in the wake of the downturn in the global economy. The gross budgetary support (GBS) for all plan projects also needs to be properly utilized and this aspect is required to be addressed by the government.

While there appears to be adequate availability of funds, there is the imperative of improving the efficiency of funds utilization and the quality of expenditure. Better Governance and programme implementation must be at the forefront of this government's reforms agenda. An example of ineffective programme implementation is the JNNURM mission, a Rs.50,000 crore Central government-funded scheme that finances up to 90 percent of urban development work in 63 cities. There has been no effective monitoring and therefore no course correction of this important programme by the Centre and the State governments.

The government also needs to take initiatives to address the wastage and rotting (pilferage as well) that account for nearly 30% of agriculture produce. According to the Rajya Sabha report presented by the Minister of State for Food Processing Industries, the wastage of harvested food items was estimated to be around Rs 58,000 crore at various stages of handling. This was due to lack of adequate post-harvest infrastructure, cold storage chains,

transportation and proper storage facilities. Investments in rural development, in particular in agriculture projects and in developing supply chain infrastructure must also be undertaken as a national mission. Considering that the level of investments may not be as high as in some other infrastructure projects, private sector investments must also be encouraged in supply chain infrastructure as well as in the agriculture and rural sectors through tax reductions and other incentives. This would also result in increasing the contribution of agriculture to the GDP and may usher in a second "green revolution".

Consumer demand also needs an impetus. There must be attention paid to specifically creating demand for consumer durable goods, as there has been an increase in savings in banks by consumers. We cannot ignore the rural markets and the peri-urban demand. China has initiated a "Down to Village Policy" to spur domestic consumption of durable and non durable goods in 2009 in response to the slackening of overseas consumption for its goods. India also must script its own specific response where tax on sale of such goods could be refunded to the farmers' bank accounts directly. Also the credit delivery system needs to be transformed to more effectively serve the common man in the rural hinterlands. The government must become more 'business like' and 'customer friendly' so that private investments and personal consumption can be encouraged, thereby benefiting the economy.

Another area where expenditure is vital is the social welfare sector. One of the immediate adverse impacts of the global meltdown has been on the international trade and the export sector of the economy. As mentioned earlier, with the decrease in global trade, there has been an increase in unemployment in the export sector directly affecting the urban poor. With the substantial success of NREGA at the rural level, a corresponding employment guarantee scheme for the urban poor could also be initiated to give immediate respite to this large constituency and this scheme could be combined with urban renewal projects for optimal utilization of the programme outlay.

Even the NREGA could in fact be combined with other social welfare schemes like the Gram Sadak Yojna to increase its efficiency and a direct bank transfer scheme could be instituted to enhance its transparency. The government could also rationalize its expenditure in social programmes by initiating schemes that give direct cash transfers to rural families, in return for which the families promise to keep their children in school and take them for regular health check ups. This would not only help reduce poverty, but also help families invest in

their children and thus break the cycle of intergenerational transmission of malnutrition and illiteracy.

Another important imperative for the new government would be to revive business confidence and optimism. The key to economic revival is as much in restoring public and corporate confidence as it is in targeted fiscal stimulus. This requires formulation of a stable medium term fiscal and macro-economic policy regime. This also requires the articulation and communication of the same to the all constituencies. The confidence in business and corporate balance sheets has taken a beating in the last six months. The profits are lower and the debts larger. IPO issues haven't materialized and the international market conditions are not conducive to fund future investments. Since future expectations in demand also seem uncertain, new investments have been delayed, thereby creating a cycle of depressed activity. Hence there is a need to devise public policy measures that will instill confidence in the investors so that the pace of investment is stepped up. As discussed earlier, these measures could either be sector specific such as for IT, exports, rural and agriculture sectors or cross-sectoral measures that would offer incentives for enhanced performance and green field investments.

Alongside these incentives, the overall outlook would also be improved by addressing the growing fiscal deficit, caused by the rising government expenditure in the backdrop of revenue constraints. India's combined fiscal deficit in 2008-2009 was over 11 percent and is now at its highest levels. Disinvestment can be used to finance expenditure and reduce the deficit for the government substantially, without reducing government equity below 51 percent in the enterprises under disinvestment. However, some further regulation is still required to ensure that the disinvestment is strategic in its timing and content. A comprehensive price discovery mechanism for assets under disinvestment must be developed. This should allow optimum returns to the government while ensuring the process results in higher productivity. **Disinvestment could also be a mechanism of restructuring public debt instead of filling holes in the fiscal debt.**

The avenues for disinvestment are banks and insurance companies, profit making public enterprises (like SAIL, BHEL), or loss making enterprises like NTC (with vast land banks and real estate assets). Disinvestment in banking sector, however, can only lead to expansion and recapitalization of banks and would not raise money for the government; this too may be beneficial in certain instances. Disinvestment in profit making enterprises on the other hand

will lead to increase in efficiency; enhanced investment activities; and also reduce future debt burden. The Power sector, particularly its distribution business, should be accorded the highest priority for disinvestment. The Centre will need to creatively encourage the state governments to follow through on this programme. As for loss making enterprises, they represent lost opportunities and cannot, in the current scenario, help create money for the government. However, assets owned by such loss making enterprises must not be allowed to idle and ways to generate government revenue from these must be explored.

The above discussion also emphasizes the importance of the Centre – State coordination on capital and social programmes. This relationship and coordination is central to effective delivery and governance. It needs to be reformulated and strengthened through performance incentives and other measures to significantly improve programme implementation. Incentives may also be offered to state governments for greenfield projects that aid in generating employment and also in instances where States have undertaken transformational reforms. The States that create and sustain jobs, investments and revenue must be offered additional benefits as "return on governance". One such example of governance would be the adoption of the already scripted GST regime. The government must decisively co-opt all state governments for its implementation by FY 2010.

The monetary policy must be the prerogative of the Central Bank. The current RBI and government bond interest rates vary between 8-8.5 percent. This puts a floor on the interest rates on deposits with the banks at about 5.5-6 percent. The banks would wish to remain close to this figure in order to maintain liquidity. While the government could subsidize the interest rates for selected sectors, it would be prudent to ensure that the monetary management is kept independent of fiscal policy making. Creating artificial demand for credit by reducing interest rates could lead to a debt bubble like the one witnessed in the United States during the recent sub-prime crisis.

To spur and strengthen the private sector, which accounts for nearly three fourths of the Indian GDP, access to competitive credit and capital would be critical. Clearly, reversal of capital flows and reduced access to credit are manifestations of the current economic slowdown. The current account deficit as well as the external Debt to GDP ratio is increasing at an alarming rate. Large borrowers and corporate houses are now turning to domestic sources of funds as the external markets are drying up. This has squeezed the availability of funds for SMEs, small traders and industry. The government needs to address the issue of

capital inflows. While the slowdown in FDI is still not critical, the decline in remittances from overseas (which constitute a large portion of the capital inflows) will start to affect business sentiment.

On the other hand, the volatile and unregulated entry of FIIs is leading to rupee appreciation which also compounds the problem of the growing current account deficit, as it is detrimental to the export sector of the economy. While FDI is taxed in India, the FII, despite all its inherent uncertainties, are accorded a red carpet treatment with a nil taxation regime. This anomaly must be corrected and a new and graded tax regime (based on investment tenure) for FIIs may be considered. This would also generate additional revenues for the government. This may also help in moderating the dramatic reversal and re-induction of portfolio investments that led to volatility in the Indian bourses despite the fundamentals remaining largely stable. While there are differing estimates on the magnitude, higher stock market capitalization definitely spurs consumption as well as savings and hence must be protected from geographic arbitrage to a certain degree. NGOs and trusts face heavy regulation in India when they seek to invest in public services and infrastructure shareholdings. Liberalizing procedures in this respect are called for. Some of these institutions have large resources and could be very useful in providing impetus to business and investment.

A disconnect between Wholesale Price Index and Consumer Price Index exists. While the Wholesale Price Index has stabilized at near Zero percent rise (per annum) level, the Consumer Price Index is currently rising at 8-9 percent per annum. This indicates that the **inflationary relief is not reaching the consumers**. The stockpiling and acquisition of resources (commodities and Oil and Gas) by China has created a supply constraint leading to an inflationary trend in global markets. This raises the prices of such imports by India. On the other hand, stockpiling of commodities such as steel and aluminum by China has raised the global prices of these metals, which is benefiting India as an exporter.

The outlook for Inflation is around the 4-5 percent level over the next three years. In order to manage the inflation over this time horizon, the SLR and CRR ratio should eventually be restored to the 2004 levels. This management of Inflation has also led to a greater need for resource mobilization.

Now is the time when we can remove unmerited and wasteful subsidy by deregulating the subsidized sectors. This is because, once the global economy recovers, international prices of

most commodities would increase significantly. One sector that warrants attention in this regard is the fertilizer sector. The government must move towards providing direct subsidy to the farmers rather than subsidize production, as it leads to unmanageable raw material pricing distortion, misuse, inefficient operations and unrealistic capacity creation. Though it would not be easy to navigate such reforms past the fertilizer lobby, it is not an unmanageable feat, considering the mandate received by the new government.

Re-pricing will be required in another key sector, Energy, to reflect the true economic and environment cost. India cannot continue to transfer volatility in crude prices from the present to the future and from the government to the Oil Industry. A stable and predictable pricing regime in which product prices reflect global changes in crude oil prices within a broad price band, modulated by pre-determined corrections in tax rates must be introduced in a phased manner, starting with Petrol and Diesel. Direct budgetary provisions should be made for subsidies towards Kerosene and LPG. A determined push to city gas networks will automatically significantly reduce the amount that the Government at present wastes on LPG subsidies to urban consumers. Now that a Downstream Regulator is in place, the government must demonstrate its confidence in the Regulator by withdrawing from micromanaging the sector. In the last coalition government, the Left parties may not have allowed many of these much needed reforms; these need to be embraced without delay if fiscal deficit is to be contained. The government may consider introducing dual pricing, based on an economic criterion or on the purchasing power of the consumer, so as to avoid subsidizing the wealthy and enabling the misuse of the subsidized product. In the Indian context, some subsidies (on cooking and lighting fuels) may be unavoidable. However, even in such instances the subsidies need to be targeted and transferred to the beneficiaries directly and in a transparent manner, so that their true costs are visible.

There is also a need to increase international competitiveness of Indian goods and services. We need to make India a manufacturing hub of small, medium and skill intensive enterprises with a focus on locating these hubs in the rural and peri-urban spaces. The global meltdown has created potential areas that India must exploit. Oil companies and other enterprises must seek out global acquisitions and partnerships to protect India's energy and food security. The depressed overseas markets today would offer far more attractive valuations for investors. The government must work with the private sector and public enterprises in devising a strategic roadmap for building a new geo-economic space for India. The Chinese drive for

acquiring real assets in these times is a pointer to the changing economic landscape of the future. It is important that India take a conscious decision as to where it wants to position itself in this new emerging order.

The post-crisis global markets would also offer new opportunities. India must be ready to exploit these. It must develop competitively priced high quality offerings (goods and services) for the export markets. Indian goods and services must move up the value chain and government policy must encourage this transition. India should also use the global downturn to develop and consolidate its trade and economic interactions with its neighbors and in other regions. Developing Countries that were until now preoccupied with their engagement with the West are now seeking other partners. India must position itself as the preferred partner. South East Asian and West Asian regions offer such opportunities. Free trade agreements and joint investment programmes must be formalized and implemented.