PP No-001

EGROW

FOUNDATION FOR ECONOMIC GROWTH & WELFARE

EGROW POLICY PAPER

How to Revive our Economy: Some Suggestions

Charan Singh

CEO & Director, EGROW Foundation

August 2019

EGROW Foundation

Policy Paper No-001

How to revive our Economy: Some Suggestions

Charan Singh*

***Charan Singh is CEO & Director at EGROW Foundation, Noida.** **The views expressed are personal.** **Research assistance provided by Sahil Krishan Mawa and Praveen Singh is acknowledged.**

How to Revive our Economy: Some Suggestions

Is the Indian Economy slowing down?

Indian Economy has unfortunately been in a difficult situation for the last one year. The RBI has scaled down the growth for 2019-2020 from 7 percent projected in June to 6.9 percent as announced on August 7, 2019. The reduction in projection for first half of the current financial year is stark, from 6.4 – 6.7 percent to 5.8 – 6.6 percent. The consumer perception index incorporating Current Situation and Future Expectation Index recorded a substantial decline in July 2019 as compared with a peak in March 2019. The situation is also not promising, both globally and domestically.

Globally, there is slowdown of growth in the US, UK, Japan and the Euro area. The trade war between the US and China is also adding immense uncertainty in global economy. The output in emerging countries like Brazil, Russia, and South Africa is not promising either. And gold prices are rising while crude prices are declining. Globally, financial markets are reflecting weak sentiments.

Domestically, according to the RBI, rainfall is scanty, and sown area currently under *Kharif* is lower than that in the previous year. The IIP for June 2019 reveals a slowing trend mainly because of manufacturing, especially in paper, fabricated metal products, electrical equipment, vehicles, trailers, transport equipment, furniture, etc. The capital goods manufacturing and that of consumer durables recorded a negative growth during April-June, 2019 while intermediate goods and consumer non-durables recorded a high growth. Unfortunately, demand is shrinking - in rural areas, sales of tractors and motor cycles has contracted; and in urban areas, sales of passenger cars shrunk and that of commercials vehicles is slowing down. Construction activity is suffering with shrinkage in output of cement and slower growth in steel consumption.

Why worry about the Slowdown?

India is the fastest growing economy of the world despite being a vibrant democracy. India, a country with population of nearly 1.3 billion people adds about a million people in the workforce every month, and has the advantage of demographic dividend given that two-third of the population is less than 35 years and half below the age of 25 years.

The slowdown can lead to wastage of labor and capital available in the country. The country which has the potential of growing at a rate of nearly 10 percent is cruising at sub-7 percent, then the consequences could be devastating apart from lost opportunity to become a super power, given the rich demographic profile. The slowdown can obviously lead to unemployment, social unrest, delay in marriages in absence of jobs, and increase in crime rate, including militancy. The Government is effectively using MGNREGA but a social security measures is never an alternative to productive activity contributing to GDP while engaging the mind and body of the work force. It can also be argued that too much dependence on social security in terms of doles can be counter-productive, if unemployment is structural and not frictional. Hence, there is need for creating appropriate employment-providing opportunities in the economy.

In the slowdown, given that nearly 30 percent of our population is below poverty line, many people are vulnerable and lack resilience to face adversities. This is true for most of businesses in India too, especially in the unorganized sector. The mortality rate, therefore, is high, which can cause harm to financial institutions in the organized sector. For such segment of the population and business, there is little distinction between the short, medium and long term. Hence, for planners in public policy, time to react to emerging situation is scarce.

Anecdotal Evidence - Select Indicators and Reasons of Slowdown

In interaction with industry and representatives from trade associations, in Bangalore, Mumbai and NCR select indicators are representative of the concern. In automobile/earth moving sector, two things have happened in last few quarters – a) cut in production with consequences on employment, and/or b) accumulation of inventory to the extent of 4 times the normal trend. In the housing sector too, there is an inventory build-up which would take 7 to 10 years to clear. This inventory in housing implies frozen money in glacier type phenomenon stuck in large number of building projects lying incomplete. The reasons that have led to this situation are many and varied. Some of these, gathered anecdotally, are –

a) Industrialists perceive that the tax authorities and the Government views business community with suspicion and therefore pursue business houses with tax evasion and avoidance
b) GST has yet not stabilized and regular changes in GST rates cause uncertainty in business environment.
c) The matching of invoices has not yet stabilized and continues to be a cause of inconvenience to industry.
d) GST rates are confusing. Illustratively, there are different rates for different commodities within the yarn sector. Similar is the case with automobiles having different rates for different components.
e) GST rates on some commodities are higher than the profit margin available in the industry. Illustratively, automobile industry is very competitive globally and profit margins are less than 10 percent. The GST rate of 28 percent on passenger car, including small cars, is relatively too high and hence deters demand.
f) There is lack of clarity on input tax credit of GST and its use in industry.
g) The amount of sales in automobile industry has suffered because of emphasis on electric vehicles, and increasing use of Ola and Uber that deters purchase of personal cars.
h) The housing sector is suffering from complex issues like different stamp duty rates in different states, and capital gains tax depending on circle rate of houses which automatically keeps increasing annually.
i) The combination of corporate tax and dividend distribution tax above 50 percent deters many companies to expand business in India.
j) The economy, addicted to corruption, has yet to recover from cleansing process initiated with demonetization. The process of converting demonetized currency was completed but now with eagle-eye tax

authorities, people are finding it difficult to use that cash for investing in houses, illustratively.

k) The fight against tax evasion sought to be achieved through digitalization and implementation of GST will take time, as still there are pockets in the country which have yet to successfully pursue these. In the interim, there is uncertainty prevailing in the economy, resulting in lack of sales.

l) The slowdown in rural wages is also impacting demand of industrial products.

How to stem the slowdown – Need for a multi-spectrum Approach?

The slowdown in growth has been recognized by the Government and the RBI. The remedial measures have to be rational, aiming not only at immediate recovery but also confidence building and long term sustainability of the initiatives providing durability to revival.

First and foremost, in current economic situation, globally and domestically, participation of the private sector in nation building is very important. The surveys conducted by the RBI at end-July reflect that business sentiments are suffering. Hence, the Government, both Central and state, will have to work at various levels to stem the slow down and inspire confidence in the policy formulations by the Government. The Prime Minister's interview widely published on August 12, 2019 is certainly aimed to generate confidence in the private sector, especially when he has emphasized that Entrepreneurs are India's growth ambassadors.

India Growth Council: Recognizing the Role of Private Sector in India's Economic Growth

An important aspect, philosophical in nature, related to absorbing the increasing number of youth joining the work force is to dispel the image that private sector is inferior to public sector. Over the years, under the shadow of socialistic pattern of growth that India followed for nearly six decades, general opinion is that private sector is exploitative, and therefore employment in public or government sector is most sought after. To accommodate increasing millions, this negative image of private sector needs to change as most employment opportunities in future will have to come from commerce, mainly located in non-government sector. Further, private sector needs to be encouraged and supported, not financially but philosophically, and industry should be permitted to relentlessly pursue profit motive, and build sufficient buffers/reserves to absorb losses in short period. In contrast to profit-making private sector, financially strained private sector would only cause stress to commercial banks, mainly public sector, and public finance, given well recognized inter linkages. Hence, the aim of the Government should be to partner with the private sector to generate employment and not simply to pontificate curtailment of their profit margins. At this crucial juncture, going forward, both private and public sectors are necessary for India's growth.

The Government could consider establishing India Growth Council (IGC) with select captains of Indian industry as members, in addition to chief Ministers and other officials. IGC could meet regularly, discuss issues as they emerge and inspire team spirit in expanding India's GDP.

Establishing NITI Grid: Encouraging State to have NITI-type think tanks to spur Growth

NITI Aayog has established as a think tank of the Central Government and inspires confidence, credibly replacing the erstwhile Planning Commission. However, there is no such institutional framework at the state level which corresponds to vibrancy of the NITI Aayog unlike the earlier times of State Planning Boards. As India is a large continent size country, a NITI-Grid, spread across the country to consider issues, undertake studies and conceive schemes of public policy, provide feedback on existing and prospective schemes would help in even distribution of growth and undertaking productive activities.

F*iscal Policy*

To push growth to higher levels, available resources of labor, land and capital must be optimally utilized.

Simplifying Tax Regime and Reducing Tax Rates: An important axiom of public finance is simplicity of tax regime. The GST regime is complex with multiple tax rates and slabs. There is need to rationalize the GST rates and optimize them urgently. Illustratively, a simple rule, understandable in the remotest village and computable without a calculator, would be to have 3 slabs – Nil for uncooked food items; 10 percent for all other items, except luxury goods; and 20 percent for luxury items.

The fiscal instruments of taxation, expenditure and deficits have implications for availability of labor in the market. There is need for rationalization of direct takes in the country keeping the success of collections in the GST. The Government could consider lowering rates of direct taxes which would encourage availability of more labor hours for work as well as consider higher tax incentives to female force participation, and start-ups.

The corporate tax rates need to be aligned with those in other countries, as increasing number of multinationals have operations in different international locations. This is especially true for companies in the automobile segment.

The taxation of income in the rural sector needs to be re-examined given that the Prime Minister has promised to double rural income. This initiative of the Government in doubling rural income implies that agro-processing and allied activities in rural India are expected to increase significantly.

Spur demand by accommodative Fiscal Policy: The country is passing through a critical phase with demand shrinking in both rural and urban areas. The agriculture sector is impacted because of weak monsoon and industrial growth is stagnating. In such a situation, the Government can consider pause button on clauses of FRBMA to invigorate demand. In view of the global evidence, many countries relaxed the provisions of the Maastricht Treaty of deficit restricted to 3 percent of GDP and Debt restricted to 60 percent of GDP in aftermath of the great

Global Recession of 2008. Consequently, many countries even now, a decade later, are recording fiscal indicators much above the stipulated limit of 3 percent and 60 percent of GDP.

The relaxation of FRBM provisions would yield resources which can be used to reduce tax rate, finance infrastructure, temporarily enhance amount under MGNREGA, and support housing and automobile sector. The cost of power for industry has to be reduced as also additional surcharge on open access power should be removed. There is also need to reduce logistics cost to make industry competitive, globally.

Permanent Fiscal Body: The focused approach of the fiscal policy pursued by the Centre, states and local bodies can help infuse strength in initiatives taken to spur growth. To achieve a synchronized approach, it would be helpful to have a permanent fiscal body that coordinates activities of various governments.

The experience gained by truly federal structure of GST Council should be replicated in taking decisions on other fiscal issues. Logically, given the success of GST Council, the Government could consider establishing a permanent fiscal body, subsuming the council. As is the Reserve Bank of India, a permanent monetary policy institution, India will benefit from a permanent Fiscal Policy Institution which should focus on fiscal policy issues of Central, state and local bodies

It is nearly three decades since the Constitutional Amendments of strengthening local bodies but the situation has not changed. In fact, unlike the transparently prepared and available budgets of the Central and state Governments, budgets of local bodies, individually or consolidated state-wise, are not available. The ensure a better understanding of revenue and expenditure pattern in the country, of total tax collection and subsidies provided, the Government could consider initiating measures to compute public sector borrowing requirements, encapsulating public sector enterprises in the consolidated government sector finances. The standardization of budgets of state governments and that of local bodies is also required for appropriate policy initiatives.

Separating Debt Management from Monetary Policy: This will help in reducing government debt which pre empts nearly 25 percent of government tax revenue in interest payments itself. To ensure that composition of debt and pattern of deficit financing gets appropriate attention, separating debt from monetary management could also be considered.

Monetary Policy

Pause to Inflation Targeting of the RBI: The Government has assigned an inflationary target regime to the RBI which it is mandated to follow in word and spirit. The Government has to consider, about the trade-off between unemployment and inflation. In a young demographic country like India, with sagging growth and teeming millions, mostly young, appropriate employment would be preferred over inflation. The Government could consider either, temporarily, raising the inflation target assigned to the RBI, or instructing the RBI to observe "pause" on inflation targeting and pursue, singularly employment and growth, in a focused manner.

In India, nominal interest rates are still higher than that in China, and that impacts not only business activity and industrial output but also the export sector. Similarly, availability of financial resources in competing countries also need to be considered for our commerce and industry.

Financial Sector

Beyond Consolidation of commercial banks: The national exchequer has been repeatedly burdened by the need to regularly recapitalize public sector banks. Therefore, to reduce this fiscal drainage, there is the need for re-examining the necessity of having so many public sector banks, especially when all nationalized banks are clones of each other and generally do not have any distinct niche area. Hence, to reduce cost to the fisc and eliminate competition amongst twin-like banks, more strategies than simply consolidation, should also be carefully examined. While mergers reduce the number of competing branches, illustratively, not only in each street, but even nationally, it is also advantageous in terms of providing economies of scale but certainly not in immediate future. So, being a public sector bank, financial support from Central Government would continue as merger of loss-making banks cannot immediately catapult a merged entity into a profit-making institution.

In view of the fact that recapitalization of PSB's is a burden on national exchequer, role of PSBs also needs to be revisited. Earlier, when banks were nationalized, the need for brick and mortar branch was necessary, as well as penetration in the remotest part of India. In view of spread of mobile and internet banking, small banks, payment banks, postal bank, self-help groups, micro finance institutions, and direct benefit transfers, does the country still need so many PSBs to extend credit in rural areas? Therefore, like disinvestment in public enterprises, the Government could consider, denationalization of PSBs. Still, another way could be to privatize PSBs by allowing higher volumes of shares listed on the stock exchange. Finally, in a bold decision, given the renewed mandate in the Parliament, the Government could consider offering some select PSBs for sale to the private sector banks. These initiatives would reduce burden on the national exchequer.

Finally, the Government could consider institutionalizing a mechanism to compensate public sector banks for fulfilling social obligations which would lead to strengthening business revenue and hopefully reduce amount required for recapitalization.

Regulatory Framework for Non Bank Finance Companies: In the financial sector space, non-banking finance companies (NBFCs) play an important role, mainly intermediating between commercial banks and small business enterprises. NBFCs accounted for nearly 15 percent of the balance sheet of scheduled commercial banks in March 2018. NBFCs have a distinct characteristic different from commercial banks, in terms of ownership, general governance, constitution of board, sources of funds, and therefore, licensing. The RBI, does a soft touch regulation of NBFCs, despite NBFCs mainly sourcing resources through RBI-regulated commercial banks in recent months and exhibiting strong inter-relationship. The RBI as a prime regulator of financial sector is totally focused on ensuring liquidity, solvency and robustness of commercial banks but not of NBFCs. As NBFCs are a different set of financial entities, generally covered under shadow banking provisions globally, are not strictly regulated elsewhere in the world. But, in view of their sensitivity for our commercial banks and economy, due to their entrenchment in small and micro business, the Government could consider having a separate and dedicated regulatory framework for NBFCs, with a stricter licensing stipulation, standardized reporting mechanism, and difficult, entry and exit. To ensure level playing field, and principles of symmetry, the profits and losses should both be private, and the entrepreneur should be held accountable and responsible for any systemic risks that a respective NBFC causes to the economy.

Financial Sector Commission - Need for a Comprehensive Financial Sector Framework: There has been fiscal implications of inefficiencies in the financial sector and regular reforms are essential as banks and financial institutions are primarily responsible to provide capital to productive activities in an emerging country like India. Apart from simply focusing on banks, there is need to examine the complete eco-system of flow of credit and lending in the economy including non-banks finance companies, micro finance institution (MFIs) and self-help groups. Interestingly, there is still no regulator for the MFI sector. Therefore, the new Government could consider instituting a Financial Sector Commission to study various aspects of evolving financial markets, including linkages in different segments like banks and NBFCs, and make implementable recommendations to the Government to ensure ease of flow of credit to industry.

<u>Basel Norms need a revisit - India needs own Banking Norms – Bharat Norms</u>: The application of Basel norms, universally to all commercial banks, have restricted the flow of credit to industry and commerce. The slowdown in the economy, which is significantly dependent on banks, is correlated to slowdown in credit off-take and recognition of NPAs in the banking sector. There is need to examine whether application of Basel norms are effective in an emerging country like India or dwarf growth which eventually impacts banking industry taking recourse to PCA.

Government should consider alternatives and setting up a history project on Banking in India. The banking history of India dates back to sixteenth century with Bank of Hindustan established in 1770. In India, 10 PSBs have a history of more than 100 years such as Allahabad Bank (1865), Punjab National Bank (1894), Corporation Bank (1906), Canara Bank (1906), Indian Bank (1907), Bank of Baroda (1908), Punjab and Sind Bank (1908), Central Bank of India (1911), Union Bank of India (1919), and most importantly, State Bank of India which traces its origin to Bank of Calcutta, 1806. Our Indian banks have survived through numerous challenges like the Mutiny (1857), Two World Wars, Great Depression (1933), India's Independence struggle, India's Partition (1947), Nationalisation (1969 and 1980), and recent global recession (2008). It is obvious that there must be good things in our banks that they have survived severe ordeals and tribulations for more than a century, and therefore, would have cogent lessons to offer to banking industry, both domestic and global. May be the distilled wisdom from history of Indian banks will help to frame banking norms, better than Basel norms. We could name them, Bharat Banking Norms.

Setting up of National Banking Academy: The Public sector Banks need to help financing the needs of the country and need to be focused on their approach. In fact, PSBs have been working as the financial army of the Government. As the Indian army unifies the country and protects the borders, so does the army of professional public sector bankers. These bankers, hailing from different parts of India are serving across the country, irrespective of region, caste, language or religion in pursuit of only one motto – to serve the nation, irrespective of compensation or competition from private or foreign banks. The officials of PSBs are serving in most remote areas of the country, like the army officers, many times without families, and are respected, by local population.

To recognize the hard work of bankers, and their persistent need in the future, the Government could consider establishing National Banking Academy (NBA), on lines of National Defence Academy (NDA), Pune. The entry to NBA should be open to students with a 12th class certification of senior secondary school, as is done in NDA. The entry of graduates and some experts can always be done through different schemes as is done in the army.

The training schedule in NBA would emphasize on ethics, honesty and integrity (EHI); values which are most important while dealing with public deposits. The selection process of NBA should screen banking cadets who assign strong value to tradition, as banking has a lot to do with people, language and culture. Similarly, for dealing with people's money, the banker has to be conservative and not a risk taker. In view of these principles, many banks in India survived for more than a century. Illustratively, in earlier years, in Punjab and Sind Bank, with a history of nearly 112 years, this dip-test of respect for traditional values and conservative approach was an integral part of the interview process. In contrast, in modern times, in absence of psychometric tests for EHI values, Basle norms have devised concept of risk appetite and risk weight capital, and despite such lofty quantitative indicators, western banks have demonstrated in 2008 with collapse of Lehman, hollowness of such superficial exercises wrapped in complicated mathematical formulas – meaningless sophistication.

Creating Employment Opportunities and addressing Poverty

Setting State-wise Entrepreneurship or MSME Universities: To enhance productivity of labor, the challenge would be to provide employment in industry, which given advances in AI and robotics, does not seem promising. Hence, the big push would be required for start-ups and incubation centres. Further, to create self-employment, medium, small and micro enterprises (MSMEs) hold a promise. Therefore, there is need to train youth and trainers in getting absorbed in MSMEs. As agriculture Universities in each state has helped India to gain food-independence, similarly, SME Universities can be set-up in different states, imparting knowledge in local languages and helping innovate in local products, to generate employment opportunities. The Government would need to spend resources for MSME Universities, probably carving out space and utilizing the vast campuses of Agricultural universities.

Special Package for Automobiles and Housing: The global slowdown and uncertainty is reflecting in India too. The data on increasing inventory of houses and automobiles is neither encouraging nor the developments in financial sector, including Non-Bank Finance Companies (NBFCs). In the automobiles, sales have been low and inventory in some cases higher by 300 percent. This is alarming because automobiles absorb output from more than 100 industries. In the housing sector, which has inter-linkages with more than 270 industries, inventory is of nearly 10 lakh houses across the spectrum.

The Government can help in these challenging times with policy announcements which will help build confidence in the markets. The first objective should be to unleash the productive forces to finance higher growth. Therefore, glaciered finances lying locked in inventory of housing and automobiles need to be unfrozen. The Government could consider incentives like lowering stamp duty on houses for a stipulated time window and easing of capital gains tax on housing and real estate for a specified period. Also, the Government could consider linking the unsold inventory of housing with PM's Awas Yojana to defreeze liquidity in housing. Similarly, for automobiles, the Government could consider similar tax concessions for a stipulated time. This exercise would kick-start flow of money in housing and automobile sectors benefitting many inter-linked industries.

Select City Approach to Develop Tourism in India: In creating employment and sustaining consumption demand, the role of tourism is most important. In a resource constrained economy, with high levels of poverty, religious, medical and nature tourism could be most affordable for the Government. The Government could consider developing these select tourist spots, specially selected across the country, in partnership with the private sector, industry and airlines. The virgin areas in Jammu and Kashmir, Leh Ladakh, and North East would offer excellent opportunity to attract domestic and international tourists, and inject liquidity in the economy. Tourism industry can also enhance female labor force participation which is very low at 30 percent as compared with global average of around 60 percent.

In this context, commercial banks will have to play an important role, as also Mudra loans. The Government could help create conducive opportunities where local artisans and flourish, illustratively, by selecting few cities in each state, with potential for tourism.

New Capital City for India: It would be in the spirit of ideology of NDA and celebration of victory, if the new capital city is planned by the Union Government. The current structure of Government buildings, including Rashtrapathi Bhavan reminds of colonialism, subjugation and India's painful exploitation for centuries. These existing structures can be converted into memorials and museums. But new and resurgent India should have its own Parliament and buildings, to house offices of independent Indian Government; all conceptualized, and designed by Indians. This initiative would also usher in new enthusiasm in the economy, arouse animal spirit, boost construction activity and provide positive impulse to growth.

Fight against Corruption should continue

Corruption has immediate effect in reducing tax collection and inefficiency in expenditure. As corruption distorts priorities and misallocates resources, therefore, relentless crusade against corruption should continue in sprit of demonetization and introduction of GST. Probably, in global history, India would be unique in which GST was introduced and despite severe teething troubles, the same political party has been voted back to power with thumping majority. The pulse of the people beats for clean and honest administration.

Globally, electoral reforms and transparent financing of elections led to cleansing the system of corruption. Therefore, in India, mechanism of financing elections should be made more transparent, after having experimented with electoral bonds.

The financial and economic cost of conducting elections should also be considered, as eventually fisc gets impacted. In last five years, given extensive reach of print and electronic media, political discourses in state elections involving local issues have impacted focused attention on reforms at the national level. Further, the markets, financial, commodities and goods markets have suffered a roller coaster ride mainly because of constantly politically charged state of election in the last five years. The timing of general elections, in first quarter of financial year, just before the monsoons, also could negatively impact growth of the economy. The Government could consider conducting simultaneous elections of all states and Center, together, every five years, preferably synchronized with the festival months of October and November.

Conclusion

The focus should be on creating a conducive environment in India for business to flourish. To enhance growth, there is need to create mutual trust and faith between public and private sector, to join hands in providing employment to teeming millions of youth. The demographic dividend can lead us into growth of more than 10 percent while demographic disaster can push India into social challenges of unemployment and unrest. The massive mandate with proper planning in next five years can help democratic India scale new heights to become a super power in the region.

The time for the Government to take bold decision is now. As the USA and other countries in the Euro zone decided to take bold steps after 2008, India needs to consider similar steps now. The initiatives proposed in the above discussion can be divided in three segments – to be considered immediately, in short term and in medium term – Table A.

Table A: Summary of Initiatives to Revive the Economy

Immediate – less than a year	**Short Term – 1 to 2 years**	**Medium Term 2 to 3 years**
Pause to FRBMA	Simplify Tax Regime	Establish NITI Grid across India
Pause to Inflation Targeting	Establish Permanent Fiscal Body	Revisit Rural Taxation Policy
Special window for NBFCs	Revisit Basle Norms	Establish Regulator for NBFCs
Establish India Growth Council	Electoral Reforms	Establish MSME University
Announce Financial Sector Commission	Initiate Financial Sector Reforms	Separate Debt from Monetary Management