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Growth Slowdown, Reforms and Recovery

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1. Introduction

Indian economy has slowed for 6 consecutive quarters till July-Sept 2019. This decline was broad based, covering both private consumption and investment and led by manufacturing (including Automobiles). The first four quarter decline during 2018-19 mirrored what happened during 2016-17, from which the economy recovered quickly in 2017-18 (V shaped recovery). The current deceleration has already stretched into 2019-20 taking the number of declining quarter to 6, with few signs of an upturn. The recovery is therefore likely to be slow & prolonged (U shaped), unless policy steps are taken to accelerate it. This note outlines the policies needed to promote quicker recovery of GDP growth to its full potential. The next section outlines the legacy of corruption and Non-Performance assets left by the previous Govt. Section 3 outlines the institutional changes which designed to modernize the economy in the medium-long term, have affected the economy negatively in the short-medium term. *Section 4 provides the policy solutions* to rebalance the economy by moving policy attention from suppressing the Black economy towards promoting the White Economy, giving a boost to “Make in India” and entering, Global supply Chains, to drive employment intensive growth in the next 5-10 years. Section 5 concludes the note.

2. Background (2008-2013)

The economic reforms of the 1990s & 2000s reached fruition in 2002-2007 period, with a favourable global environment leading to the fastest growth that Indian economy had ever seen. When the Global Financial Crisis struck in 2008, GDP growth collapsed, but was quickly restored through a combination of fiscal, monetary and credit measures. Left-Socialists in UPA became over optimistic and continued to pursue fiscal expansion to fund wasteful, low quality social schemes, loose monetary policy and telephone banking through the Public Sector banks. Ever-greening of NPAs in Real Estate & Infrastructure became endemic and Corruption reached many sectors of the economy in the Union list, which were earlier relatively free from allegations. As a result, there was danger of another BOP crises in 2012.

3. Institutional Developments (2014-2019)

A number of Very positive steps were taken in 2014-15 & subsequently, to address the weakness in the Economy, such as on Spectrum, Coal & Mineral Auctions, breaking of Administrative-political gridlock in decision making & policy announcements of economic reforms(e.g. Land, Corporate tax) and the "Swachh Bharat" campaign. However, there were three broad institutional changes, which laid the ground for the current slowdown, so (for brevity) this note will focus on these developments: The Campaign against Black Money, Change in Monetary Policy Institutions & Governance and Fiscal Policy approach.

3.1 Black & White Economies

The Campaign against Black Money started with the setting up of the SIT on black money in June 2014, resulted in several laws & amendments related to black money in foreign banks & assets and domestic real estate & bank accounts and culminated in the Demonetization directed at black money held in cash. The moral & social objectives of this campaign are unquestionable. The economic assumption was that if enough pressure is brought on the black economy it will shift to the white economy and the overall efficiency & growth of the economy will improve. On the contrary the black economy slowed without stimulating white economy because the effort to incentivize the latter was insufficient. There is an urgent need to eliminate bottlenecks, bad policies & procedures which discourage the white economy from growing at a faster pace.

3.2 Monetary Policy Framework

The monetary policy framework was reformed to introduce Inflation targeting, a Monetary Policy Committee creates to implement it and the votaries of this approach appointed as Governor(s). This led to a dramatic tightening of

Monetary Policy, higher real rates, slower credit growth, and lower monetary growth. In a world in which the global financial crises resulted in global deflationary pressures, it contributed to a sharp decline in domestic inflation and nominal GDP growth (which drives Govt revenues). This unpredicted deflation transferred resource from borrowers (like Govt& infrastructure &/real estate builders) to lenders, domestic & foreign.

Simultaneously a much stricter regulatory policy was set in motion by Governor Raghu Ram Rajan for identifying & exposing NPAs (PCA et al), without sufficient attention to, and agreement on, solutions for the massive NPA problem that was lying unrecognized. The passing of the Insolvency and Bankruptcy Code (which if passed 10 years ago would have solved problem), could not stem the NPA bubble burst & clogging of Credit channels, which followed the IL&FS default. International Experience of 100s of countries over centuries tells us, that the NPA problem once exposed, must be solved quickly & pragmatically, otherwise it will create a vicious downward credit-growth cycle.

3.3 FRBM &Fiscal Policy

The FRBM formally expired in 2008-9 and nothing replaced it till the Govt and the Fourteenth Finance Commission, correctly reintroduced a realistic glide path to fiscal sustainability. Govt also took a slew of measures like the introduction of Aadhar linked Direct Benefit Transfers (DBT), digitization of all interfaces with the govt, creation of E-market for Govt procurement and promise of Corporate Tax reform. However, the pressure of revenues delayed its implementation and led to reintroduction of LTCG & rise in ceases & surcharges. The approach to taxation of the White economy, underlying the 2019-20 budget, was the second critical trigger (after IL&FS bankruptcy) for the sharp decline in GDP growth in April-Sept 2019.

The promise of the GST to raise direct tax collections was not met, because its design proved to be highly complex & very costly for SMEs to implement. It thus contributed to pressure on Black economy without incentivizing them to enter the white economy. It must be simplified urgently, along with the Direct Tax code. The short term (12-18 months) increase in Fiscal deficit will be accepted by capital markets, if they can be convinced that gains from efficiency and voluntary compliance will reduce the fiscal deficit over the next few years.

The Reform of the Corporate tax was a big bang reform that surprised everyone, and re-established the credibility of the Govt. We need more such fiscal reforms.

4. Solution: Policy Reform

The policy reform that will help accelerate the growth recovery to ~7.5% potential of the Indian economy, related to the three broad problems outlined above:

4.1 Fiscal Policy

4.1.1 GST simplification

(a) There must be a single uniform rate of GST on all inputs (capital goods, intermediates) into the production of goods & services, of 15% (say). (b) The same rate should apply to most final consumer goods, with two specific difference: Basic food, Health services & Edu-Schooling (incl Pre-schooling) must be exempt to ensure equity. All other exemptions must be eliminated. (c) A handful of Goods in which evasion is difficult, raise large revenues & have high income elasticity, will continue to have higher rates to ensure revenue neutrality. (d) one or two more rates can be used for final consumer goods, to facilitate transition. (e) The Value-Added principle must be understood and applied by the tax collection machinery. If GST is simplified as proposed, both tax compliance & enforcement become very easy & cheap for Tiny & Small Industry & Trade (TSIT) & MSME.

4.1.2 Direct Tax Code (DTC)

The proposed DTC is Very important, along with simple GST, for easing & encouraging the shift from Black Economy to White economy. To reduce the short-term Revenue loss, the issue of elimination of Cess and Surcharges can be separated from the rest of the DTC reform, which must be done in next budget.

Govt can announce that the Cesses& Surcharges will remain in 2020-21 but will be phased out by 2024-25.

4.1.3 Govt Over Dues

As already promised by Finance Minister, Govt Union Govt and PSUs should clear all overdues by March 2020. This is the best way to inject demand into the economy without affecting the real fiscal deficit. While Fiscal Deficit measured on cash basis will show a one-time increase, it will either have no effect on Fiscal Deficit on accrual basis or permanently reduce it. The payments will help reduce private credit demand and ease flows to others in need of credit. If there is danger of a rise in interest rates, Govt should consider issuing a Sovereign bond as proposed in the budget.

4.1.4 Dis-Investment

Ensure that as many Strategic sales of PSE/PSUs as possible occur within 2019-20 i.e. by 31stMarch 2020. Zero sales in 2019-20, will again dent the credibility of the Govt, whatever the reason given to justify the delay!

4.2 Monetary & Credit Policy

4.2.1 Credit System

RBI & Govt must unclog the credit loan channels by dealing with the NPA problem in Banks and NBFCs. The grid lock between the alternatives should be broken by adopting a flexible approach fitted to type of borrower & type of Asset (e.g. Bad Bank for industrial assets, take over & auction of marketable assets like land & real estate, ARC for Infrastructure). An expert committee could be appointed to formally define which approach to use for which type of borrower and /or type of asset. Any legal changes required must be made & implemented quickly.

4.2.2 Monetary Loosening

RBI must reduce the Real Repo rate to zero (or even negative if expected Q3 < 4.5%) and accelerate growth of base money supply and aggregate credit. Some of monetary-credit action has happened in last 3-6 months, but it must be sustained & credible. Govt should complement it by increasing the flexibility of Small saving & other interest rates set by it.

4.3 Competitiveness & Global Supply Chains

4.3.1 Labor Policy

Amend Industrial Relations Act to improve flexibility. Make the 100-person cut-off for retrenching or dismissing labor, inapplicable in CEZs & SEZ and/or in specific Labor-intensive industries like Garments.

Introduce Portability & Pvt competition in provision of ESI, PF etc. to reduce labor costs without reducing benefits.

Amend Apprenticeship Act to facilitate practical, modern, industrial training. The Skill development corporation has not been successful in supplying the skills currently needed by industry, for which they cannot find enough workers. Modify rural school curriculum to promote problem solving & job skills in Agriculture, Processing, and Services.

4.3.2 Land Policy

Amend land laws to facilitate creation of Industrial Estates & Industrial Clusters, including through land pooling of Rural land. Expand chemicals clusters with environmentally approved pollution control facilities, so that the chemicals industry can expand quickly to meet the doubling of orders, arising from diversification of demand away from China.

4.3.3 Agriculture

The Wheat-Sugar-Rice economy & old policies to support it have reached a dead-end. De-control internal & external trade in agriculture, rationalize import & export duties is essential to for diversifying the agricultural economy into new products for which there is international demand or domestic demand can be developed by private companies (e.g. nutritional vegetable, fruit & coarse cereal snacks). Allow use of low-quality land (fallow or degraded) by Agriculture Companies!

4.3.4 External Trade

Rationalize EXIM policy, Import Tariffs & Export Duties; replace specific duties on Textiles by advalorem rates, to eliminate corruption in imports, Improve Ease of Doing Business in External Trade (World Bank Doing

Businesssub-index). We must grab the once-in-generation opportunity for "Make in India," by partly replacing China in Global Manufacturing Supply chains.

4.3.5 Electricity Cost

Amend Electricity Act(2003) to limit cross tax-subsidy by, either (a) banning differential pricing for different consumers without demonstrated differential in costs of production and delivery, as this is a monopolistic practice, or (b) Limiting the implicit tax on electricity supplied to manufacturing industry to certain percent of average cost of production (e.g. 10-15%).

5. Conclusion

It's misleading to focus on or argue that the economy will or won't recover. The issue before us today is the speed of recovery of GDP growth to the previously demonstrated growth potential of 7.5%. The speed of recovery will depend critically on the correct macro-economic policy mix and economic policy reforms to remove bottlenecks reduce bad policies and institute incentives for efficient growth and productive employment generation. The above note outlines the policies needed to accelerate the recovery. More detailed, data based, analysis linking these policies to what has happened in the economy is under preparation.