What the Economy Needs Now

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juggernaut

JUGGERNAUT BOOKS
KS House, 118 Shahpur Jat, New Delhi 110049, India

First published by Juggernaut Books 2019

10 9 8 7 6 5 4 3 2 1

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P-ISBN: 9789353450311
E-ISBN: 9789353450335

Typeset in Adobe Caslon Pro by R. Ajith Kumar, Noida

Printed at Manipal Technologies Ltd

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How to Read This Book

The fourteen chapters in this book contain individual notes from thirteen economists. Each of these notes addresses one particular economic issue or sector that needs attention from the government. These notes represent the economists' own views, not that of any party or institution.

Some of the papers analyse these problems in considerable detail. So, to make it easier for all readers, the editors have provided a brief statement of the problems that need to be addressed before each paper discusses them in depth. In addition, each chapter ends with a summary of the suggested solutions.

The introduction, 'Why Strong, Equitable and Sustainable Growth Is Vital for India', serves also as an overview of the agenda we propose.

Finally, there is an afterword that identifies eight particular reforms to deal with the eight biggest challenges India faces.

Why Strong, Equitable and Sustainable Growth Is Vital for India

India is one of the fastest growing large economies in the world, having grown at an average of almost 7 per cent for the last twenty-five years. There have been many notable reforms over this period – most recently, the cooperative fiscal federalism that brought the goods and services tax (GST) into being; the enactment of the Indian Bankruptcy Code; and the dramatic dis-inflation of recent years, partly as a result of a move to an inflation targeting regime.

While all of this is commendable, we should not be satisfied with this. India is still one of the poorest countries in the G-20, and poor countries ought to grow faster because catch-up growth is easier. Also, the benefits of growth in India have been distributed extremely unequally, with top incomes rising much faster than the rest. We have seen new environmental challenges in the form of sharp increases in both local pollution levels and carbon dioxide emissions that, if unchecked, threaten to stall or reverse progress.

India is also not creating enough jobs: even though data on employment in India are both low quality and controversial, the recent news that 28 million applied for 90,000 low-level railway jobs suggests we are not satisfying the demand for jobs (Singh 2018). Unfortunately, we are not well-positioned to follow the export-led growth path that allowed many Asian countries to climb out of poverty. Despite abundant cheap labour, we are not part of many global supply chains. Even as global firms seek to diversify away from China so as to reduce political risk, India is rarely seen as an obvious alternative.

Given India's continental size, it need not follow the export-led path. It will, however, have to ensure that growth generates jobs and incomes across the skill spectrum, in the process:

- **Creating semi-skilled jobs** for those currently underemployed or unemployed and those who are seeking to leave low-productivity agriculture – even while enhancing the productivity of agriculture itself and the earnings of the agriculture-dependent population.
- **Increasing labour participation of women**. India has one of the lowest female participation rates in the labour force, down from 35 per cent in 1990 to 27 per cent in 2017. It is one of the few countries where this ratio has fallen. This limits the talent pool that the economy can draw upon, even as it constrains the life choices of women, many of whom, the evidence suggests, would like to be working.
- **Spreading jobs and economic development** from the coastal states to the interior, as well as to Kashmir and the North-Eastern states.

There are tremendous possibilities for reforms that will take us towards faster and more equitable growth, as this report will lay out. However, we have to **allocate scarce resources carefully to make sure that there is enough investment in sectors such as infrastructure to create jobs**. India's aggregate fiscal deficit (state plus Centre) is still close to 6.5 per cent of GDP, higher than almost any in the G-20, and not significantly lower than levels that existed five years ago. However, our investment rate has fallen sharply in recent years. Despite that, our external financing requirement (as measured by the current account deficit, or CAD) increased appreciably in early 2019, increasing vulnerability. Moreover, to the extent that India grows while being more reliant on domestic demand than were other Asian emerging markets, it needs a much greater focus on macroeconomic stability than they did. For all these reasons, it needs to **prioritize government spending better**, focusing on filling clear investment gaps and protecting the vulnerable. It also needs to increase revenues by **making the tax system more progressive** both in taxes levied and through more effective collection from rich non-payers, by bringing more people into the tax net and by charging users for government services where appropriate.

A key factor in spurring growth will be reforms that alleviate 'supply side' constraints on growth and job creation. We have to enable both the industrial sector and the service sector to operate at larger scale. This involves embracing **highly overdue labour reforms** including allowing for a rich menu of contracts with workers that allows for more possibilities than just permanent workers and short-term contractual labour in firms. Such additional contracting possibilities could give workers more job security, give firms the incentive to train and invest in their skilling, even as it gives firms more reason to scale up. Similarly, **cleaner title to land**, as well as a land acquisition process that protects the seller while simplifying acquisition, will reduce the cost of developing land, a critical need if we are to create jobs. A more predictable and smoother regulatory environment – which prunes redundant or unnecessary regulation, carefully sets regulations in new areas necessitated by our development and enforces regulations effectively and impartially – will create a much better environment for business. We must also improve the capabilities as well as strengthen the independence of our regulatory institutions.

Scale is also key for productivity growth which, in turn, is essential for India to expand its share of world exports. The ongoing reorientation of the United States away from dependence on China provides India with a great opportunity to position itself as a viable alternative for cheap sourcing of goods and parts. But this would require macro and industrial policy reforms of the kind outlined above, which **remove existing impediments to India becoming a valued partner in global supply chains**. Rolling back the recent increases in import tariffs, along with a renewed commitment to resisting protectionist policies, would be a good way of signalling this goal.

In outlining an economic agenda, we have to recognize that government capacity is limited – the number of government employees is often low relative to the tasks they are assigned. This is often compounded by low staff motivation and relatedly high absenteeism, as well as inadequate training. **Government takes on too much, while**

delivering too little. Yet, for growth to be equitable, a must in our democracy, effective and well-targeted government engagement is essential.

One partial solution is more decentralization, with more powers and funding delegated to the states, and, perhaps more importantly, within the states to **municipalities and panchayats**. It will allow for a much more dynamic decision-making process, resulting in government policies that are more sensitive to local conditions as well as more local democratic control of officialdom.

The strategic use of technology has the potential to help here – as long as we are careful not to make a fetish of technology, are mindful of the human dimension of transactions and deploy technology with enough safeguards. Technology can make it easier to monitor flows of funds and uses of funding locally, allowing for more devolution of funding, something that has been proposed by previous Finance Commissions. More generally, **effective use of technology can help substitute for government manpower**, increase the points of access to government services, help monitor service provision and reduce leakage in the system.

The debate on whether the public sector should occupy areas that can be serviced by the private sector will no doubt continue, and there is an obvious case for exiting areas where the public sector contributes little while draining the exchequer and distorting competition. The government should also reconsider its interventions in areas where it adds noise and uncertainty. For instance, the constant fiddling with agricultural import tariffs, the unpredictable closure or opening of export and import windows and the inability to procure agricultural commodities or release them effectively do significantly more damage than good to agriculture. While actions are taken in the name of the farmer or the consumer, it is the middleman who often benefits.

Moreover, even **when the consumer benefits from high farm production and low agricultural prices, which also help contain inflation, the cost to farmers can be significant**. The case of pulses is revealing. In 2016–17, for example, India witnessed its highest ever domestic production – close to 23 million metric tonnes – likely reflecting a combination of a normal monsoon after successive droughts and the farmer response to higher market prices and minimum support prices (MSPs). This was sufficient to fully satisfy domestic demand. Despite that, India imported a hefty 6.6 million tonnes of pulses (almost a third of total domestic production) at zero import duty – leading to a massive domestic supply glut and a sharp and sustained fall in prices of pulses over the next two years, which continues to this day, with prices currently 30 per cent lower than their 2016 peaks.

In addition to getting the government out of areas it should not be in, there is an equally urgent task: strengthening the government in areas where it does poorly or is virtually absent. These include regulating and certifying educational or medical service providers; apprehending and successfully prosecuting economic offenders; and regulating haphazard development and environmental despoliation without blocking growth.

For growth to be equitable and sustained, we have to reform our education, skilling, healthcare and welfare systems significantly. Our record on primary education is dismal, with **only about half of the children in class five**

able to do maths or reading at the class-two level. Parents have responded by increasingly migrating their children to private schooling, but private schools are only slightly better than government schools, and in their current form will not solve the problem of low education quality. It does not get better at higher grades – our scores in the Program for International Student Assessment (PISA) exams were so low that we refused to participate again in that international benchmarking exercise. The **poor quality of human capital may already be constraining growth** (industry is increasingly concerned about the large and growing skill deficit) and limits its inclusiveness and may prompt a premature move to replace workers with machines.

Healthcare is another area of major concern. In particular, the **public system has largely been abandoned by those patients who are seeking regular primary care.** They prefer paying for private treatment – even though many practitioners are unqualified and prescribe the wrong treatment in more than 70 per cent of the cases. This is partly a consequence of the failure of the public sector: public sector practitioners are often absent, and when present they put very little effort into treatment. This is especially worrying because dealing with the large, growing burden of non-communicable diseases (NCDs) and the many, only partly solved, child and maternal health issues would need front line providers to lead the charge. It is unclear how the recent Ayushman Bharat insurance scheme, which is the main current effort to deal with healthcare issues, will address these problems.

Similar concerns apply in the education sector. A **failure to ensure high-quality education and healthcare provision**

means that a substantial proportion of our future labour force will grow up underequipped with skills needed in the labour market and suffering from the long-term consequences of stunting and wasting. Much of the middle-aged population will be dealing with debilitating diseases that could have been prevented or controlled. This obviously limits the sustainability and the inclusiveness of growth.

The environment is, of course, a critical challenge to the continuation of our growth and to the extent to which growth translates into improved quality of life. Many of our cities are increasingly experiencing levels of pollution that border on the toxic. If we cannot manage the environment at our present level of development, greater growth will make matters far worse. The consequences of environmentally myopic policies are reflected, for example, in the **rapidly falling water table** in many parts of the country, which threatens the sustainability of our agriculture. Relatedly, climate change has already had significant effects on productivity and the quality of life in India and we need to be at the forefront of global efforts to combat it.

That our current policies do not add up to an inclusive and sustainable growth agenda is reflected in growing agitation across our society. Agrarian unrest, with the accompanying constant demand for farm loan waivers, is now compounded by demands for some form of government support from sections of society that are nowhere near the poorest. This reflects Indians' growing anxiety about their future and that of their children in an increasingly winner-take-all society, where they often end up on the losing side. Our welfare schemes like the Mahatma Gandhi National

Rural Employment Guarantee Scheme (MGNREGS) and Pradhan Mantri Gramin Awas Yojana are mostly directed towards the very poor (the one exception being the public distribution system [PDS]), so they do not serve the purpose of protecting those outside that group. **Without stronger, sustainable and inclusive growth we simply do not have the resources to expand our welfare schemes significantly,** but if we do generate that growth, not only will there be less demand for welfare but there will be more resources to service any demand.

The bottom line is that while we have performed creditably in the last twenty-five years across different administrations, there is no room for complacency given our economic challenges. They are mounting.

We are a group of economists, each with different specializations and interests, who have come together to offer proposals for the way ahead. Some of us are based in India, some outside, but we are all closely engaged in, and concerned about, India's development. We do not belong to any party, nor are we from the government. We hope this non-partisan analysis of our situation, while not intended to be comprehensive, will help spur debate as India moves to elections.

The rest of this introduction summarizes our proposals and offers our consensus view on some key issues we face. Individual notes by members of the group offer more details of individual views and proposals; each reflects the view of the author(s) in their personal capacity and does not necessarily represent the institution they are affiliated with.

Macroeconomic stability: A prerequisite to sustainable growth and job creation

India's economic history demonstrates over and over again the same lesson: preserving and protecting macroeconomic stability is an essential prerequisite to strong and sustained growth. **Every time macro stability has been traded off to boost growth, the economy has been pushed towards a crisis**, the consequences of which have undermined the very growth that was the initial policy focus.

Ensuring macroeconomic stability has at least three elements to it: maintaining low and stable inflation; ensuring the consolidated fiscal deficit leaves enough space for private investment; and ensuring that the CAD is sustainable and can be financed largely through stable capital inflows, to help insulate the economy from sudden swings in global sentiment.

High and variable inflation constitutes a regressive tax, with the poor bearing the biggest brunt, since their incomes are typically least indexed to inflation. It also dissuades foreign investors from investing in rupee assets. Similarly, large and unsustainable fiscal/external imbalances impart significant macroeconomic and financial market uncertainty, push up borrowing costs and risk premia in the economy and threaten financial stability. All this impedes private and public investment.

Fiscal consolidation to create space for more investment

The economy has made significant progress in combating inflation in recent years. Over the last four years (2014–18) inflation has averaged just over 4 per cent, versus almost 10 per cent in the previous five years, and household inflation expectations are getting progressively anchored. The same, however, cannot be said of the fiscal side. While the Centre's fiscal deficit has been steadily brought down, the combined deficit of the states – even after adjusting for the Ujwal DISCOM Assurance Yojana that saw states take on some of their power utilities' debt – has continued to widen in recent years. This increase has largely undone the Centre's consolidation. Consequently, the consolidated fiscal deficit, of both the Centre and the states, stood above 6.5 per cent of GDP in 2017–18 – not very different from its levels five years ago.

Our primary suggestions to make progress on this difficult issue are to:

- Stick to the path laid out by the Fiscal Responsibility and Budget Management (FRBM) Review Committee such that the **consolidated fiscal deficit is brought down to 5 per cent of GDP** and general government debt to 60 per cent of GDP.
- Formulate a 'grand bargain' between the Centre and the states, **giving states incentives to be aligned with the Centre's fiscal goals**, which is currently almost entirely missing:
  - Use the model of the GST Council as a successful example of cooperative fiscal federalism.
  - Use Finance Commission awards to reward good behaviour.
  - Gradually remove Central guarantees for the market borrowings of the states that go beyond pre-specified limits so that a state faces market borrowing costs that are correlated with its fiscal performance.

- **Adopt better accounting** for contingent and off-balance-sheet liabilities of the states and the Centre so as to estimate overall government financing needs, and therefore its claim on savings. This is especially important when we add the necessary healthcare and pension schemes that will last well into the future. Such entitlements have to be costed based on long-term usage and growth, not on current costs, especially since entitlements are virtually impossible to withdraw.

Reduce risks from the external sector

India's **heavy dependence on oil imports often results in 'boom–bust' cycles** on the balance of payments (BoP) when crude prices change. For example, the CAD narrowed to 0.7 per cent of GDP in 2016–17 as crude prices fell and was then tracking close to 3 per cent of GDP in 2018 when crude prices bounced back up. This resulted in a large BoP surplus in the first instance and a large deficit in the second. These sharp swings complicate monetary policy, as well as exchange rate and liquidity management, and create undue external and fiscal volatility (since oil prices also alter the fiscal maths). We should:

- Undertake a systematic programme to **hedge global crude prices**, as Panama, Ghana and Mexico have begun to do.
- Adopt a set of steps to **de-risk the external sector** by:
  - Attracting more foreign direct investment (FDI).
  - Dis-incentivizing 'hot money'.
  - Encouraging more hedging of foreign currency borrowing by firms.

– Developing domestic substitute financial assets linked to gold prices.

Fixing the stressed sectors

Careful but quick policy reforms are needed for the sectors/areas that are stressed. These include agriculture, infrastructure (including power), exports and banking. There are common themes in any revival. Typically, we need to **redeploy government effort in each of these sectors, focusing it on areas where it is truly needed** to play an enabling role. Excessive or misplaced bureaucracy and intervention result in inadequate access to markets, distorted prices and poor incentives. Whereas the recent focus on improving India's ranking on the World Bank's 'Ease of Doing Business' measures is commendable, we should guard against the temptation to focus on the specifics of the World Bank measures, while neglecting the broader impediments to producing in India. We now consider each of these sectors in more detail.

Agriculture and the rural economy

We need deep-rooted transformation of agriculture, treating it not as a sector that has to be propped up through repeated sops, but as an engine of India's job creation and growth. For that, it is imperative that we thoroughly reform agricultural and land policies. A key source of agrarian distress in recent years has been that the terms of trade confronting farmers have turned progressively more adverse, partly as a result of policies to combat food inflation. **While low inflation is**

desirable in itself, the impact on farmers also needs to be taken into account. A policy priority should be to reduce distortions in farm product prices as well as in input prices. Another important enabler is technology, both in educating and informing farmers and in opening access to markets. Some specific proposals to transform agriculture are:

- Increase investment in **research** – covering new seeds including those that have been genetically modified (GM), and the latest farming and irrigation techniques – and disseminate new techniques widely, including through digital means. Invest in infrastructure such as **irrigation, roads and improved transport and storage logistics**. Eschew loan waivers that divert resources from needed investment.
- Ensure that farmers receive more of what is paid by the consumer by:
  - Improving **farmer access to domestic and international markets** by reducing fees and restrictions on competition and building the necessary infrastructure.
  - Eschewing frequent closing or opening of access to international markets.
- Facilitate farming at scale for relevant crops:
  - Through the creation of farmer/producer cooperatives.
  - By enabling easier long-term leasing of land; ensuring landowners have clear title to their land is an important prerequisite.
- Move to a fixed cash subsidy per acre cultivated based on digitizing and identifying plots (as demonstrated successfully by the Rythu Bandhu scheme of the Telangana government).

  - **Replace price support schemes** that are costly (because of corruption and inefficiencies in procurement and storage), ineffective (because procurement is not widespread, especially when and where most needed) and distortionary (because the wrong crops are incentivized).
- Improve and expand the current Pradhan Mantri Fasal Bima Yojana (PMFBY), especially as the climate gets more volatile.
  - Here **quick assessment of crop damage** using new technologies such as satellite images and drones, as well as quick payout into bank accounts, will increase the number of farmers who adopt this insurance scheme.
- For landless labourers, the best short-term policy option is likely to be to strengthen the NREGS. Evidence suggests places with well-implemented NREGS have significantly higher market wages – without hurting employment. Thus, increasing allocations to, and ensuring better implementation of, NREGS may be the best immediate policy option to protect the landless rural poor.
  - **Efficiency of NREGS spending** can be increased by working with line departments to improve asset quality and create better quality rural infrastructure.

Infrastructure

Accelerating the pace of infrastructure buildout will help in a number of ways. It will create jobs in construction and new economic activity around the resulting roads, ports, airports, railways and housing; it will promote inclusion as it connects interior rural areas to markets; it will make our exports (and import-competing manufacturing) more competitive as it reduces input costs such as land (as cheaper areas are connected) and power and improves logistics and reduces transportation costs; and it will open up India to both domestic and foreign tourism, which can be a tremendous source of semi-skilled jobs.

For this acceleration to happen, we must:

- **Untangle stalled projects** through continued efforts to improve the land acquisition process, while addressing environmental clearance issues, improving raw material availability and establishing various sector regulators.
- Improve access to land for development, through **computerized land mapping**; government-guaranteed titling; the creation of land banks; the use of auctions for land acquisition; and so on. Some states have had much success in these while others have lagged behind. The model of the GST Council can be used for sharing best practices between the Centre and the states, as well as for formulating national actions such as land titling reform.
- Free up public resources for investment through public finance reforms (asset recycling, asset swaps, expenditure reform).
- Revitalize public–private partnerships (PPPs) with appropriate and enforceable risk allocation.
- Create **special economic zones** (SEZs), not necessarily with the focus only on exports, but also for domestic production. Improved infrastructure and access to land and environmental clearances in such zones can

accelerate investment. These can also be 'laboratories' for some experimentation with alternative regulations before there is a decision to scale them up. It is important, however, that the SEZs do not degenerate again into opportunities for land-grabbing and rent-seeking.

Power

Despite having some of the largest reserves of coal and substantial unutilized power generation capacity, India is short of both coal and power. This is the result of policy self-goals, arising from the dominant presence of government in coal mining and power distribution as well as from populist impulses in pricing. Nevertheless, our low base allows us to choose a path that is more energy-efficient as well as less polluting as we reform the system for the twenty-first century. For this we must:

- Free energy pricing to generate more exploration, especially for cleaner gas, while using **carbon taxes** (or tradable carbon use permits) to align private incentives and social costs.
- Expand participation in **auctions of mining rights** for coal.
- Allow more competition in allocation of natural gas blocks and exploitation of natural gas resources.
- Improve **access and reliability of the power grid** so that the use of inefficient diesel generators is reduced.
- Reform distribution by creating **competition for state monopolies.**
- Integrate **renewables** into power production, recognizing there will be a need for additional balancing power and storage.

Exports

India's non-oil, non-gold current account has deteriorated by almost 3 per cent of GDP in the last three years, which calls for urgent steps to improve the underlying competitiveness of the tradable sector. Boosting exports should be the linchpin of that strategy. The existing constraints in the export sector appear to be reflective of more general problems in manufacturing: low scale of production, low productivity, bureaucratic impediments and the high cost of inputs like land and power. In addition to our earlier suggestions to address these, we need:

- Trade agreements, simpler documentation procedures at ports and low and stable tariffs so that we can be part of global supply chains. High tariffs and other **impediments to cross-border trade** not only hamper domestic exporters but will also discourage foreign manufacturers from seeing India as a viable part of their supply chains.

Financial sector

Given the non-performing asset (NPA) buildup in the banking system, it is imperative we make the banking system more robust and well capitalized, expand its capacity to extend credit and improve its incentives to lend to the most productive sectors. While the recent travails of non-bank financial companies (NBFCs) are a matter of concern, some of their problems stem from an overly rapid expansion of their balance sheets as they grew to substitute for banks. Stability in the banking system will help spread stability to other parts of the financial system as, of course, will the reverse.

The main challenges for the banking sector are to **improve governance, transparency and incentives throughout the system**. Key measures should include:

- Cleaning up bank balance sheets by **reviving projects** that can be revived after restructuring debt.
- Improving governance and management at the public sector banks and then recapitalizing them.
- De-risking banking by encouraging the transfer or some risk-taking to non-banks and the market.
- **Reducing the number and weight of government mandates for public sector banks**, and banks more generally.

The non-bank financial sector needs a strong banking system as well as deep equity and bond markets, supported by liquid secondary markets and robust regulatory and legal infrastructure. Key priorities include:

- Developing **a liquid and deep corporate bond market** through policies to encourage institutional investor participation.
- Enhancing liquidity in the government debt market and making it more attractive to institutional and retail investors.
- Developing missing (or nascent) markets like fixed income derivatives to hedge the credit and interest rate risk of fixed income securities.

Making growth inclusive and sustainable

A good job is often the most important instrument of inclusion. We need to help individuals obtain the human capabilities that will enable them to secure and hold that job, and protect those who cannot get jobs. We now turn to proposals on inclusion.

Education

The single greatest limitation of the Indian education system is its inability to deliver universal functional literacy and numeracy at the primary school level. Several studies show that students who fail to achieve basic skills by the end of class three learn very little in subsequent years even if they are enrolled in school. Our top education policy priority is therefore:

- A **national mission to achieve universal functional literacy and numeracy by class three**. Key elements of delivering on this mission should include:
  - Improving incentives of existing teachers to attend and teach well.
  - Providing districts/schools with resources to hire supplemental tutors/utilize new technologies that will provide **small-group instruction** to students so that they can be taught at the right level.
  - Independent measurement of learning outcomes with rewards/recognition to states/districts/blocks/schools based on improvements in learning.

The Right to Education (RTE) Act's input-based approach to education quality was unlikely to succeed given