

# **A New Era of Growth: Reforms to Revitalize the Indian Economy**

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## Abstract

India is currently going through the most significant economic slowdown it has experienced in at least the past 20 years. Prior economic slowdowns, such as the crisis of 1991, were driven by macroeconomic challenges. A successful series of reforms between 1991 and 2004 set the Indian economy on a basis of sound fundamentals, paving the way for rapid growth up to this point. But not all of the necessary reforms were put in place, and as a result, India's political and economic institutions have been unable to keep pace with the country's rapid growth. Inefficiencies and policy distortions have grown more severe, and a recent series of economic shocks and policy missteps have threatened to highlight the cracks in India's economic foundations and throw the country off its growth trajectory entirely – made abundantly clear by the difficulties faced by the export and manufacturing sectors. To return to a path of rapid, inclusive, and sustainable growth, simple economic stimulus is insufficient. India must return to its unfinished reform agenda, introducing policies concerning land acquisition, labor law reform, mobilization of capital and ease of doing business which will bring Indian economic governance in line with the realities of a rapidly growing power operating within a highly globalized world. If India does not summon the political will to implement these reforms, then it will very likely witness marginalization in global supply chains, continued unemployment and economic stagnation, and ultimately the sacrifice of its demographic dividend.

## India's Economic Trajectory from 1991 to 2014

### Roots of the 1991 Economic Crisis

India experienced high and growing fiscal deficits over the course of the 1980s, as successive governments escalated programs at both the central and state levels which ramped up expenditures without significantly and concurrently increasing fiscal revenues. Government expenditures grew more rapidly than both GDP and revenue growth. The Government Expenditure to GDP ratio, which sat at 24.5% in 1981-82, had risen to 30.5% by 1986-87, before remaining roughly flat for the rest of the decade as inflation concerns, driven by excessive central bank borrowing, limited the amount the government could continue to borrow. Subsidies, managed at the state level rose even faster than expenditures, rising as a proportion of the expanding pie of total expenditure from 8.5% to 10.2% over the course of the decade.

Absent additional revenue, the expansionary borrowing the government undertook to finance this high level of expenditure drove up government deficits at both the central and state levels. During the 1980s, the central government deficit rose from 6.1% GDP to 8.4% GDP, and the combined deficit rose from 9.0% GDP to 12.7% GDP. To help make payments to the country's foreign and domestic creditors in this deficit environment, the Reserve Bank of India (RBI) began monetizing the deficit by increasing the money supply. This solved payment problems in the short term, but the high levels of inflation this policy created worsened India's macroeconomic position moving forward.

Over the course of the 1980s, India faced an increasingly severe balance of payments crisis. High inflation, peaking at 17% in August, had resulted from high levels of internal borrowing which had driven the overall debt from 35% GDP to 53% GDP in just ten years. This increased debt load caused net interest payments to rise from 2% of GDP and 10% of central government expenditure to 4% GDP and 20% central government expenditure over the same period. RBI's attempts to monetize this debt drove inflation and a weakening of the currency which reduced the price of exports relative to imports. As a result, the current account deficit increased from an annual average of 1.3% GDP over the first half of the 1980s to 2.2% GDP over the second half of the decade.

Additionally, India's foreign denominated debt had experienced a secular increase from 12% of GDP to 23% of GDP over the course of the decade as the government sought out external means to finance its growing deficit. This commercial borrowing helped temporarily stave off pressure to meet debt payments, but made the overall external indebtedness problem more severe, particularly as the currency weakened. Decades of protectionist policies which had left Indian manufacturing significantly behind the curve relative to global competitors limited policy efforts to boost competitiveness, which could have strengthened the currency and relieved the pressure of these external debt payments without contributing further to inflation. Private investment which could boost domestic export competitiveness was also unlikely to materialized, given the crowding-out effect of an expansionary fiscal policy which drove high inflation and high interest

rates by attempting to prioritize maintaining unsustainable levels of consumption over fiscal consolidation.

By 1991, India's macroeconomic position had reached crisis mode. Imports had bottomed out, shrinking at an annual rate of 16%, and were becoming ever more expensive. Thanks both to the weakening Rupee and the oil shock resulting from the disruption of the First Gulf War, the petroleum importing country's oil bill doubled to 6 billion USD during the fiscal year ending in March 1991. Liquidity crises had forced the government to resort to selling gold, using special IMF facilities, and making emergency bilateral agreements with Germany and Japan in order to meet increasingly difficult and urgent external payment obligations. A combination of long-accumulating macroeconomic factors, ranging from direct policy missteps such as the excessive fiscal deficit and use of inflation as a budgetary safety valve, in combination with more structural factors such as poor export competitiveness and failure to encourage public and private investment, had brought the Indian economy to the precipice, arguably its most precarious point since independence itself. The vast, multiparty democracy quickly reached a broad consensus that major, sweeping reforms were necessary to stop the bleeding, let alone set the country back on a path of growth.

### First Wave of Reforms

Having narrowly avoided default, the Indian National Congress government under Narasimha Rao embarked upon a period of significant opening and liberal reform. The Congress program followed the lines of the Structural Adjustment Programs which had grown common at this time and continue to undergo criticism for a perceived excessive focus on privatization and the hollowing out of government services. It was not the first time India had introduced liberalization reforms – limited efforts took place during the 1980s as the limits of the country's public sector-driven, Import Substitution Industrialization program became clear, although only the payments crisis set the country permanently on the track to switching away from this model. However, the policy and economic reforms, particularly in the industrial, trade, and financial sectors, which were introduced during the Rao government were far more ambitious and reached a far greater depth. This first wave of reforms did not take place during a strong period of growth, but they did lay the foundations for future growth by rebuilding the country's macroeconomic stability and starting dismantle long-standing barriers to international competitiveness.

First and foremost, the fiscal deficit, which had caused economic policymakers to undergo the contortions which ultimately forced a balance of payments crisis, was reduced. The deficit declined from 8.3% in 1990-91 to 5.5% in 1995-96, thanks to cuts in subsidies and defense expenditures. The revenue deficit remained reasonably high, at 3.4% of GDP in 1995, and continued to be a source of inflationary pressure, excessive public debt interest payments, and crowding-out of private investment. State fiscal deficits, driven by hidden subsidies from the chronic underpricing of utilities and public services, also remained stubbornly high at 3% GDP. But in contrast with earlier, neither the states nor the central government had to resort to emergency measures to remain solvent. In addition, the ad-hoc financing of the debt through monetary policy, which had risen as high as 2.1% of GDP in 1991-92, came to an end. This did

raise the cost of borrowing, but it increased RBI's control over monetary policy and independence from fiscal policy. Open-market operations, one of RBI's chief tools for exercising monetary policy, were made more efficient by allowing government securities to be sold publicly at market rates, which had the added benefit of strengthening an unprofitable banking sector which had inhibited domestic savings and investment. Through these efforts, external debt fell from 41% of total debt in 1991-92 to 36% in 1993-94 alone, and the debt service ratio fell from 30.3% to 24.8%, reducing the burden of past borrowing on the budget and contemporary policies to encourage future investment and growth.

While limiting expenditures was one half of the fiscal balance equation, increasing revenues was the other. Revenues in the past had been limited not by low rates, but by noncompliance and failure to collect, so the government took steps to increase rates of compliance. Tax collection was exercised in a more regular, standardized fashion, allowing companies to reliably predict when taxes would be due and to plan on them as an expense. The government also divested from many unprofitable public-sector companies, using the proceeds to help fund deficit reduction. Increased revenue collection was successful enough that India was able to reduce income taxes and the distortionary corporate tax, leaving businesses with more capital for investment and growth while reducing incentives for noncompliance.

Inflation remained high over the first half of the 1990s, due to continuing high fiscal deficits, the devaluation of the rupee, a high money supply from excessive acquisition of foreign currency reserves, and shortages of several important government-administered commodities for consumption. However, these supply bottlenecks for essential commodities were relieved as production increased and import licensing requirements were lifted. Further reductions in red tape caused FDI proposals to more reliably materialize as actual investment, which both moderated inflation by reducing excessive foreign reserve accumulation and directly contributed to growth. Results quickly materialized – 15 billion USD in FDI was approved from 1991-95, compared to less than one billion USD over the entire preceding decade.

Additional external reforms both encouraged further foreign investment and increased the competitiveness of Indian goods on the global market, gradually shrinking the current account deficit and mitigating the balance of payments problem. Where the once-prevalent import substitution paradigm had severely limited imports of capital goods, intermediary goods and raw materials, a new export-oriented trade policy abolished direct restrictions on all imports with the exception of final consumption goods. This encouraged industrial technology upgrades, which expanded the production capacity and efficiency for India's export industries. The maximum custom duty was also reduced from 250% to 50%, and the average tariffs on capital goods and machinery were reduced from 80-85% to 25%. Overall tariffs were reduced and somewhat standardized between goods, simplifying an extremely complicated schedule of levies and duties. These moves brought Indian tariffs in line with other developing countries, making it comparatively more attractive as an investment destination. Ultimately, costs were reduced for industry, production bottlenecks were relieved, and competition was encouraged, increasing output, quality, and price competitiveness. Other external reforms included permitting gold imports, allowing foreign institutional investors to invest in Indian capital markets, and establishing the full market-determined convertibility of the Rupee on the current account. This

last move, only made possible by a newly stable currency which did not require the sheltering of capital controls, boosted both imports and exports by dramatically simplifying foreign transactions while encouraging legal remittances. Between all these efforts to reform external economy policy, the export-import ratio rose from 65% in 1988-91 to 90% between 1991-94 while maintaining a current account deficit below 1% GDP.

Competitiveness was not only boosted by reforming external policy, but also by reviewing internal policy. For instance, the Narasimha Rao government put an end to licensing requirements for firms which wished to modernize or expand their production capacity. This policy had been put in place prior to the crisis to avoid the accumulation of what was described as “excess market power,” but its real effect had only been to prevent manufacturers operating in a global market from making the investments needed to remain competitive and profitable. Lifting the production licensing requirement helped encourage these businesses to make their investment decisions to meet the needs of the market, rather than a regulatory regime designed around an economic paradigm which globalization had made obsolete. Further internal competitiveness reforms included the lifting of price controls for noncritical goods not managed under government monopolies, further increasing the responsiveness of manufacturers to the market, and freer policy around the import of technology. With the increased industrial activity which Indian industry witnessed during this period, brought on by these more liberal policies, the sector experienced sharp increases in joint ventures, technical collaborations, and other FDI and capital inflow. This industrial investment, emphasizing technology upgrades, industrial restructuring and export orientation, represented a beneficial step toward long-term industrial growth.

In the financial sector, banks had been weakened by excessive liquidity requirements and other red tape which had limited profitability and therefore the flexibility necessary to make strategic investments with spillover effects on growth. The reforms passed during this period loosened these requirements and eliminated the majority of deposit ceiling rates which had prevented the commercial arms of banks from raising capital as freely as possible. Financial sector profitability was further bolstered by encouraging the development of a money market and a secondary market for government debt, both with free, marketized interest rates.

Liberalization in the financial sector was matched by support for ailing banks and new forms of oversight to better meet the challenges faced by the rapidly evolving industry. Weak banks were recapitalized, profitable banks were given direct access to capital markets both foreign and domestic, Foreign Institutional Investors (FIIs) were provided access to the Indian stock market, itself the beneficiary of new trading technology, and the Securities and Exchange Board of India (SEBI) was established to strengthen stock market regulation. The sector also experienced a wave of privatization, as the government divested from some of its least profitable public-sector enterprises, including banks, in order to raise funds to reduce the deficit. At this point, the government did not fully privatize most of these enterprises, choosing to remain in charge as a majority owner and effective manager. This postponed some of the most critical governance reforms within the financial sector to a later date, and bureaucratic controls continued to restrict the functioning of many of these enterprises. Nevertheless, the influx of new private capital encouraged innovative approaches to leasing, mutual funds, and new applications of technology

to existing business practices. To meet the regulatory needs of these financial innovations, RBI modestly expanded its supervision over commercial banks and Non-Bank Financial Institutions (NBFCs) by establishing standard practices for income recognition, loan-loss provisions, capital adequacy and account transparency, information which would help prevent banks from shielding dangerous liabilities on their balance sheets and avoid the need for the high liquidity requirements which had so held back the sector.

While the effort put forth to make India's macroeconomic fundamentals suitable for long-term growth bore fruit, insufficient infrastructure undermined this growth at every turn. Public investment was insufficient to meet demand in key sectors such as power, telecommunications, petroleum, mining and transportation, particularly as public investment fell over this period as part of India's fiscal retrenchment. Public-sector infrastructure companies remained too unprofitable to make investments off their own balance sheets, as the hidden subsidies represented by the chronic underpricing, often below cost, of their services deprived them of the necessary resources. Governance reform within these PSCs was unlikely as long as they remained public and vulnerable to politicization. Additionally, private and foreign investment largely failed to fill the breach, thanks in part to unclear policies governing private investment in infrastructure.

Overall, however, this was a period of great progress for Indian institutions and the Indian economy. Fiscal and monetary policies had been aligned in common purpose to stabilize the budget and incentivize investment, while foreign exchange reserves had returned to a level robust enough to smooth the impacts of disruptive short-term capital outflow. With an improved fiscal position, a more stable balance of payments situation, a stabilized and liberalized exchange rate and a newly open set of trade policies, India had announced to the world that it was open for business. As long as savings and investment continued to remain at satisfactory levels, India would remain well situated for economic growth into the foreseeable future.

## Second Wave of Reforms

Over the first decade and a half following the 1991 economic crisis, reforms were put forth by an alternating series of governments and political coalitions. Whereas the first wave of reforms had been led by the Congress government under Narasimha Rao, the next series of reforms were spearheaded by a BJP coalition under the purview of Atal Bihari Vajpayee. Within each of these governments, as a broad pattern, parties in power supported economic reforms while opposition parties opposed them. Yet reforms generally continued in the same direction even after changes in party. This demonstrated that despite day-to-day political gamesmanship, this was an era of broad consensus across Indian society regarding the types of economic reforms that were necessary. The reforms which had already been put in place had set India on track for roughly a 6% annual long-term growth rate. But if the full, ambitious slate of expenditure and institutional reforms which were envisioned at the time were implemented, then growth could increase to 7% or even 8%. This extra growth would itself boost the domestic savings rate and attract foreign savings, increasing investment further and paving the way for even more long-term growth.

But significant challenges still remained. The fiscal deficit was stuck at 5.5% GDP as of 2000-01, mainly due to a stubbornly high revenue deficit of 3.4% GDP. Although reductions in expenditure, including slashed capital expenditure, reduced central government outlays from 18.5% GDP to 15.5% GDP during the 1990s, overall government expenditure remained as high as 33% GDP when state budgets were taken into account. India's fiscal deficit as a percentage of GDP was good for fourth-worst out of 75 countries listed on the World Economic Forum's 2001-02 Global Competitiveness Report (GCR).

The persistently high budget deficit put an effective floor on interest rates, which made government debt repayment burdensome and limited private investment. It likewise hurt public investment and overall growth by reducing net national savings and investment. High taxes to cover these deficits could also imperil growth, and the experience of the balance of payments crisis rightly discouraged RBI from attempting to monetize the deficit again (inflation from 1996-2001, in fact, dropped to its lowest point since the mid-1950s). The task fell to policymakers, therefore, to find ways to decrease government expenditures without risking the social safety net or the country's other investments in its long-term well-being. Without such fiscal adjustment, India risked another period of high inflation and monetary instability which could jeopardize the path of growth. Expenditures could be decreased by selling off failing public-sector companies, reducing and targeting central government subsidies, and reducing the size of the public administration. But while expenditures were excessive in some areas, public investments in core areas of development such as education and health and remained inadequate, especially at the state level, to the task of providing for sustainable, broad-based and inclusive development.

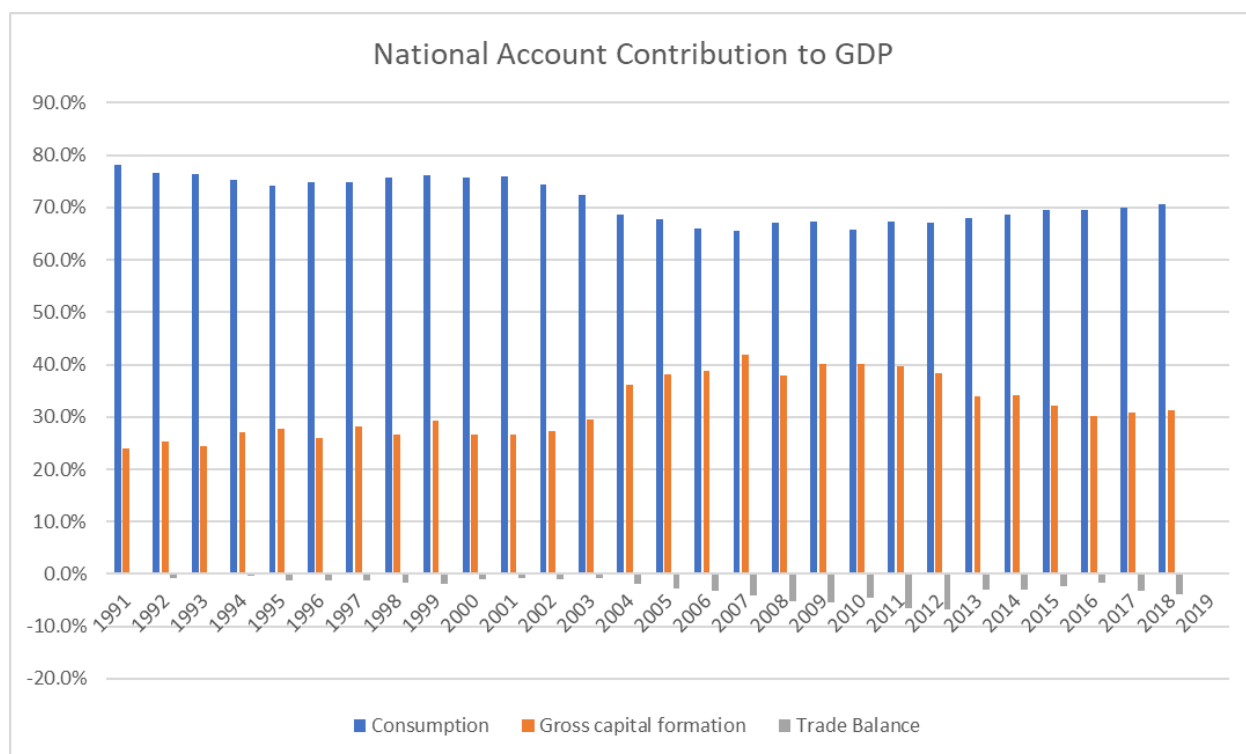
The low public investment caused by budgetary reforms also left India's infrastructure, which ranked 66<sup>th</sup> out of 75 on the 2001-02 GCR, inadequate for the demands of the newly growing economy. Underinvestment was most obvious in electrical power generation, transport infrastructure such as roads and railways, and trade infrastructure such as port facilities. For example, newly built public power generation capacity in 2001-02 barely met half of national targets. Private investment did not fill the rest of the gap, which signaled a paradox: India's public capital expenditures had been drastically cut to meet budgetary constraints, but new public investment would once again be necessary to jumpstart the process of infrastructure construction which private investment could then continue. Solving the fiscal knot grew ever more urgent.

Another challenge involved in consolidating the budget was reliance on distortionary indirect taxes for revenue. Tariffs, for instance, remained stubbornly high, ranking lower than only Nigeria in the 2001 GCR, because they served as a crutch for the budget. A shift to a more direct tax regime, and especially a VAT, was desired in order to reduce these distortions. Yet a national VAT, at this time, was not possible under the federalized tax authority operating within India in which states and the central government were responsible for enforcing different portions of the tax code. To accommodate this, India first introduced a Modified VAT (MODVAT) in 1986 which credited duties on imported inputs and capital goods which went towards the manufacture of domestic products. Doing so rationalized levies applied to imports and domestic products, serving as an operational, if complicated, VAT. By 1999, discussions had begun regarding simplification and replacement of MODVAT with a uniform Goods & Services Tax (GST), and a



government commission recommended rolling out GST in 2005. However, action on this would not take place for another twelve years. In the meantime, to broaden the tax base and improve compliance, personal income taxes were reduced from a top rate of 56% to a top rate of 30%, and corporate taxes fell from 57.5% as of 1991-92 to 35% in 2001. These moves were, in fact, so successful at improving compliance that personal and corporate tax revenues actually increased as a percentage of GDP despite the reductions in rates.

The external sector reforms which had been put in place during the first wave of reforms began to show real results during this period. The gradual liberalization of trade, as opposed to a shock therapiesque loosening of all restrictions within a short period, allowed domestic companies to adjust to the presence of external competition, and to eventually thrive against it. During the 1990s, merchandise exports rose nearly 250% to 44.8 billion USD, and while non-oil imports doubled to 43.6 billion USD over the same period, the current account deficit still remained at <1% GDP. One of the primary enablers of these newly liberalized trade policy was the new exchange rate policy which combined responsiveness to market conditions with a minimal level of intervention to cushion volatility. The remittances which flowed into India as a response to the new currency policy helped reduce the country's external debt from 38.7% in March 1992 to 21% in September 2001. Thanks in part to this decline in external debt, the debt service to revenues ratio dropped from 35.3% to 17.1% over the decade, and short-term debt fell from 10.2% to 3.5% of total debt.



*External and sectoral reforms led to significant increases in domestic and foreign investment, leading to high rates of growth. The investment share of GDP has since moderated as these reforms have failed to keep pace with the needs of investors, although low oil prices have helped support GDP by elevating consumption. Data: World Bank*

With encouragement of FDI and the opening of the Indian market to FIIs, foreign investment of all types skyrocketed. Portfolio investment was the main factor behind an increase in total foreign investment from 103 million USD in 1990-91 to 5 billion USD in 2000-01, but a total of 56.2 billion USD in FDI was also approved over the decade, compared to a mere one billion USD in the 1980s. FDI was spurred on to this degree by a new accelerated process which offered a window of automatic approval for potential projects, helping avoid approval delays caused by red tape, and with foreign investment came technology, marketing, and management resources to India's most urbanized and fastest-growing states. However, despite this newly streamlined approval procedure, opaque sectoral policies and bidding procedures, among other factors, prevented nearly 70% of approved FDI from materializing as actual investments.

Poor sectoral competitiveness remained a significant barrier to new FDI, abetted by an enduring set of byzantine restrictions. One of these, the Industrial Disputes Act of 1947, did not permit any firms with more than 100 workers to lay off any employees without explicit and rarely granted permission from the local government. Another law required firms to receive government permission to shut down, which ironically served as a barrier to entry for entrepreneurs who were unsure they could legally exit an industry once they had opened a business. Yet another regulation restricted competition by reserving specific sectors for cottage industry production and prohibiting the entry of large firms or the expansion of small firms

beyond a certain size, at the expense of efficiency and consumer welfare. These laws hindered formal private sector hiring by large and expanding companies to such a degree that between 1978 and 2000, a period when China's formal sector employment had increased from 95 million to 158.5 million, India's had only increased from 22.9 million to 27.9 million. Moreover, 19.3 million of these workers were in the public sector, leaving 8.6 million formally employed private sector workers in a country of over a billion. Repeal of the Industrial Disputes Act has been hotly debated over the decades, but there has been no change to raise the law's employment cap of 100 workers.

Specific sectoral policy reforms, such as the abolition of licensing for investment by "large houses," did boost certain industries. Software and services exports stemming from these reforms drove the technology industry, for instance, to grow by 42.4% annually between 1995 and 2000, which we know today as the start of the outsourcing and IT-enabled services boom. But on the whole, competitiveness was held back by a top-heavy and nonproductive group of public-sector firms which remained strikingly resistant to lasting reforms. For many of these firms, their cash value exceeded the present value of their dismal profits, limited by poor productivity, overmanning, excessive salaries, and poor overall management. Rather than closing these loss-making firms and selling off their assets, which would have yielded budget by reducing interest payments on the deficit beyond the profits these companies were capable of bringing in, the government examined reviving them on a case-by-case basis. In practice, when any decision to close a public firm would immediately be challenged by labor unions in the courts, this slow approach was tantamount to complacency.

India did make progress in reforming its public sector, which shrank as a share of GDP, capital investment, and final consumption expenditure over the decade and a half of reforms. Industries which had once been entirely reserved for the public sector, such as steel, heavy machinery, and power generation, had been opened to the private sector by 2002, leaving only sectors such as arms and ammunition, atomic energy, and railway transport under the exclusive license of public-sector companies. Yet the government still retained ownership of 240 enterprises, 27 banks, and two large insurance companies in that year, demonstrating just how much progress remained. The sum weight of these firms amounted to a series of state monopolies in sectors where the state had no intrinsic comparative advantage which prevented competition and productivity improvements while dragging down the nation's fiscal health.

The durability of public-sector management in the financial sector is perhaps the most prominent example of failure to privatize certain industries held back growth, and is certainly the sector whose public-sector firms contributed the most to future economic difficulties. The late 1990s and early 2000s was a time of fertile innovation in the financial sector, exemplified by new trading technologies, new market instruments, and the establishment of nearly two dozen stock exchanges within India by the year 2002. Yet public-sector banks remained turgid and rife with mismanagement. PSBs faced limitations on recruitment and salary payment imposed by bureaucratic procedure which private banks simply did not face, and their decision making was impaired by political considerations. Such considerations also disincentivized public disinvestment from the sector, exemplified by the government's failure to adopt the Committee

on Banking Sector Reform's recommendation to reduce the government equity holding in public-sector banks to 33%.

Power generation and distribution was another prominent example of where public-sector enterprises had failed to deliver needed results. Electricity was largely generated and distributed under a group of State Electricity Boards (SEBs), which set rates so low that they often failed even to recover their own costs. Political incentives linked to the public nature of the SEBs had prevented them from selling power at the rates necessary to purchase generating capacity efficiently and to make their own investments. At the same time, the state governments in charge of the SEBs were so financially burdened by the hidden subsidies inherent in charging such a low rate for power that they could not afford to invest in genuine development or poverty alleviation programs. In their place, they had a distortionary and regressive benefit which not only helped those who needed the least help the most, but could not muster the resources to meet the needs of their most disadvantaged citizens.

Overall, by the early 2000s, India had made progress from its early 1990s nadir, but the sum of its institutions and economic policies continued to inhibit medium to long-term economic growth compared to the rest of the world. Continued high average tariffs, unpredictable revenue collection, persistent red tape, distortive subsidies, the high fiscal deficit and confining labor and enterprise regulations collectively held back the competitiveness and productivity of Indian industries, even if progress had been made on all these fronts. Soft and hard infrastructure continued to be found wanting, whether it related to financial infrastructure and the embryonic venture capital scene, a weak civil governance infrastructure which enabled rampant tax evasion and politicization of everyday government functions, or the very real lack of telecommunications infrastructure, roads, and port facilities.

Moving forward, Indian reformers would have to face up to the vestigial explicit and implicit protectionism holding back their economy. Subsidies which propped up noncompetitive legacy industries would have to be dismantled. Inefficient state-owned enterprises would have to be broken up and sold off. The system of indirect taxation would have to be replaced with a consistently and fairly applied system of direct taxation. Expenditures on preferential programs and administrative bloat would have to be replaced by meaningful and intersectorally-minded investments in development. And the archaic edifice of labor laws would have to be torn down and replaced by a new set of rules which enabled flexible formal employment, free entry and exit regardless of the industry, and a symbiosis between the worlds of business and academia which could reliably mobilize India's vast pool of skilled STEM personnel as scientists, entrepreneurs, engineers, and educators who could contribute to a rapidly advancing and changing economy.

### India's Economy Outgrows its Governing Institutions

The new millennium was somewhat of a golden age for Indian development efforts. The country grew at an average rate of 8% from 2002-2012, an impressive rate in before accounting for the impact of the Global Financial Crisis (GFC) and making India one of the world's most impressive performers over this time period. This growth produced significant benefits for the population, whose per-capita income grew by 64% over the same period. Backed by the strong

economic growth resulting from the continued opening of the economy, India introduced some of the most comprehensive national investments in development in its history between 2000 and 2010. Programs such as the Village Road Scheme, the Swajaldhara drinking water scheme, the Education For All Campaign, the National Rural Health Mission, the Rajiv Gandhi Grameen Vidyutikaran Yojana rural electrification scheme, and the Bharat Nirman rural infrastructure scheme promised an India where the provision of basic needs would never be put into question.

The reforms of the past decade and a half had arguably made these programs possible by boosting the economy and governance institutions to a point where they could feasibly be imagined and implemented. But behind the scenes, the same sectoral inefficiencies and institutional shortcomings conspired to limit their success. Programs were underfunded and diminished by lack of oversight, accountability, and proficient management, particularly suffering from the exclusion of the local Panchayati Raj councils from their conception, design and execution. This weakened their impact in the rural communities which needed them most. With the disconnection of government resources from local knowledge, the atmosphere became ripe for corruption and misuse of funds, more so because local populations lacked any direct means to hold their government accountable for the outcomes of these programs.

In fact, the missteps which plagued these early development initiatives were symptomatic of India's larger unfinished reform agenda. India had grown to a point where economically, it was discussed as a superpower in waiting, and institutionally, it was capable of undertaking programs of the great ambition that these represented. But the institutions responsible for allotting resources to these vast enterprises, whether financial, governing or sectoral, remained too immature to distribute them quickly and efficiently. Excess demand and shortage of supply is a bottleneck by definition, and bottlenecks create pressures that lead to the prevalence of informal arrangements over the rule of law, and inevitably, corruption.

The Congress-led United Progressive Alliance (UPA) coalition in power under Manmohan Singh first from 2004-2009, then for a second term from 2009-2014, was indeed plagued by a series of corruption scandals which ultimately paved the way for the rise of the Modi government. If this sudden rise in corruption was caused by the failure to maintain a sufficient institutional framework to underpin growth, then one of the causes of the party's downfall was its failure to continue carrying out India's reform agenda. Having lost the once bipartisan consensus around reform within their coalition, the UPA government did not pursue reforms to the same magnitude as prior governments had for the preceding 13 years. Over the course of their time in office, this amounted to a decade of growth, during which India's GDP more than doubled from 700 billion USD to 2 trillion USD, without a matching and equally necessary record of reforms to keep pace with this growth. The high rates of investments which took place under this government, completed under the framework of existing reforms, did lead to the strong growth India subsequently experienced. Yet the pressures they placed on resources such as land, minerals, energy, and bandwidth overwhelmed public and private systems for efficient resource allocation. Ironically for a government which had prioritized inclusive growth so heavily within its major initiatives, inclusive implementation of these ambitious initiatives had been made impossible by the failure of private and public governance institutions to run at the required capacity.

In the face of mass street protests against the corruption which had become increasingly apparent, the government chose to introduce populist measures in the face of mass protests to shore up their popularity instead of undertaking difficult, but necessary reforms to target the deficiencies at the root of this corruption. And where certain reforms had attained a fragile consensus within the coalition, they were stymied once the protests drained the government of the rest of its political capital. Furthermore, with the end of the first round of Quantitative Easing in the United States, external macroeconomic conditions became less favorable as India, now perceived as an unstable environment for investment, experienced capital flight, creeping inflation, and a weakening currency. The old demons had returned, and to make matters worse, the corruption scandals had created a secondary contraction in the economy as bureaucrats and bankers, fearing investigation, became risk averse to the point of refusing to perform routine tasks or issue routine loans. By 2014, the UPA coalition had lost the national elections to Narendra Modi's BJP, their long and successful record of economic expansion in the face of challenging global conditions belied by the slow growth, inflation, high fiscal deficits and low popularity that faced them when they left office.

Modi swept into office on a mandate to fight corruption, but the corruption the new government faced was not the doing of a few bad apples, but rather the predictable result of a reform agenda which had gone neglected for too long. The new government would have to balance a sectoral agenda to boost productivity with a development agenda to continue the work of lifting hundreds of millions of people out of poverty. In the agriculture space, it would struggle to encourage industrialization in the face of a price crisis where inefficient markets, policy distortions, low productivity and chronic national underinvestment in agricultural R&D relative to other countries had left many farmers unable even to support themselves. The manufacturing sector, now lagging far behind India's neighbors, would have to be revitalized through continued labor and capital reforms along with a wholesale rethinking of tax and regulatory strategy within India's Special Economic Zones. National-level infrastructure for transport, energy and water distribution would have to be built to meet the needs of an economy whose infrastructure requirements had long gone unmet, while in environments from the largest cities to the smallest hamlets, India would have to face the challenge of sustainable development during an age of accelerating urbanization, rapid technological change and social upheaval, and climate change.

## Causes and Effects of Current Economic Slowdown

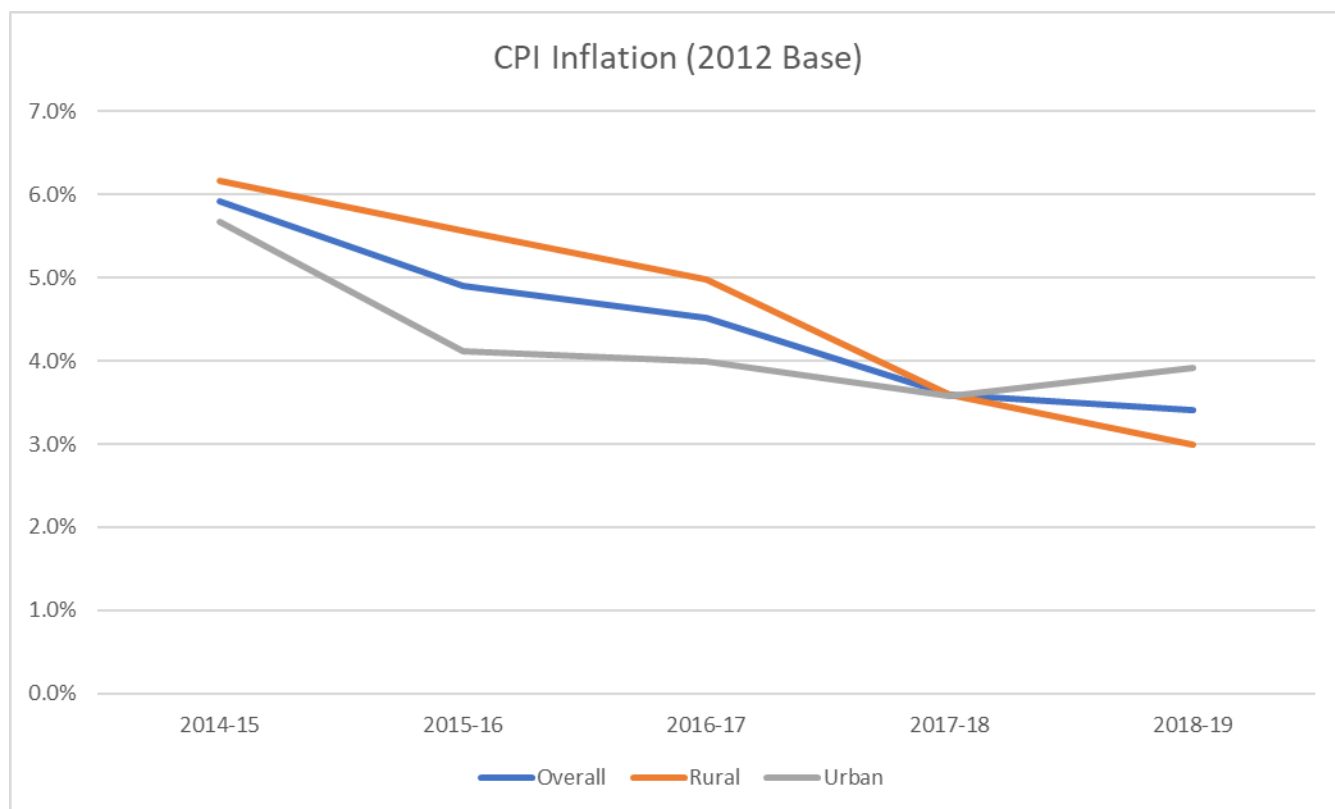
Today, once again, India is experiencing a slowdown. In 3Q 2019, annualized GDP growth had slowed to only 4.5%, compared to 7% earlier in Modi's term as Prime Minister. Additionally, research by Arvind Subramanian has demonstrated that this growth rate is an overly optimistic assessment of India's actual economic conditions, given what other indicators are showing. Figures such as investment, exports, imports, credit, and direct tax revenues flatlined relative to 2011, even during years when GDP growth stayed relatively constant thanks, in part, to a temporary boost in consumption from low oil prices. In fact, outside of GDP growth, ancillary indicators of the health of India's economy resemble nothing so much as the situation on the eve of the 1991-92 crisis. Consumer goods production growth has fallen from 4% in 2018-19 to only 1% in 2019-20. Electricity generation growth is at a mere 1.8%, its lowest rate in 30 years. And non-GST tax revenues have stagnated, in contrast with the 10% growth experienced in 2018-19.

Meanwhile, investment is trending down, consumption is slowing, and exports are once again shrinking as a proportion of GDP. What is hitting the economy so hard, why is this incipient crisis reflected in some of the data but not the rest, and what policy steps can be taken to right the ship before matters become worse?



*The current slowdown can trace its immediate causes to a series of financial crises taking place within a stressed post-demonetization, post-GST environment. However, its underlying roots go back to a failure to introduce adequate policy to promote investment, especially in manufacturing, through land, labor, capital, and regulatory reform. Data: FRED*

In fact, the present crisis is fundamentally different from the 1991-92 crisis in two ways. First, it is afflicting the real sector. India's macroeconomic fundamentals have remained solid, foreign reserves continue to be robust, and there is no serious risk of inflation, devaluation or a debt crisis. Rather than a macroeconomic breakdown, the current state of affairs has revealed a microeconomic breakdown in key sectors across the economy. In the corporate sector, companies face a potential debt trap in which they pay more in bank interest than their earnings. Locked in a cycle in which interest, now at an average rate of 10.5%, outstrips nominal growth, at 6.1%, these companies have experienced steep rises in corporate stress. Low agricultural prices have reduced farmer earnings, while climate conditions, poorly designed policy incentives, and insufficient R&D in the agriculture sector have conspired to depress agricultural productivity and overall incomes. And rural, commercial, and urban consumption demand, as measured by automobile sales for two-wheelers, trucks, and cars respectively, has contracted across the board to the tune of 30-40%.



*Inflation largely trended down over Modi's first term in rural and urban areas alike, indicating a discipline on the part of RBI which was lacking in earlier crises. Data: RBI*

Given how open India's economy has become relative to the last major crises it faced, it is tempting to pin the sudden and apparently inexplicable slowdown on external factors, such as conditions in the world market unfavorable to Indian exports. But Indian exports have performed relatively better than world exports, while global economic growth remains faster than it was prior to the most recent slowdown. Additionally, oil remains inexpensive and trade did not slow down significantly after this slowdown commenced. It is more likely that after experiencing a period of unnaturally high consumption, India is regressing to the natural long-term growth rate which its governing and sectoral institutions permit. Moving past this growth rate, and particularly boosting manufacturing from its anemic current state, will require a return to the reform agenda as it pertains to all four factors of production: land, labor, capital, and ease of doing business.

## Policy Drivers

### GDP and Employment Impact of Demonetization

The present slowdown may be a return to India's natural rate of growth, rather than a significant underperforming of its fundamentals, but two direct policy missteps helped spark the economic slide. The first, and most obvious, was the spontaneous decision to demonetize 87.5% of the nation's currency without substantial preparation or adequate printing of replacement currency.



Over the next 3-4 months of remonetization, banks saw lines out the door, poor families feared the possibility of losing their savings, and the informal sector, whose economic activity is often not fully accounted in GDP calculations, lacked the hard currency it needed to exchange for transactions. None were hit harder than poor entrepreneurs, especially in rural areas.

Demonetization did not only impact the informal sector. Real estate, another cash-heavy sector which had already been weakened by a series of financial crises, was also strongly affected, impacting the financial health of developers and eventually the NBFCs they relied on for financing. Overall, demonetization is estimated to have cost up to 2.3% annual GDP growth in measurable sectors of the economy alone, let alone the informal sector, while substantially increasing unemployment. Nor did demonetization substantially reduce black money, as was its goal, and while some argued that demonetization produced a long-term benefit for the economy by jumpstarting e-payment systems and formalization in the economy, others such as Raghuram Rajan have argued that demonetization itself did not have a lasting impact on these factors.

### Implementation Challenges of GST

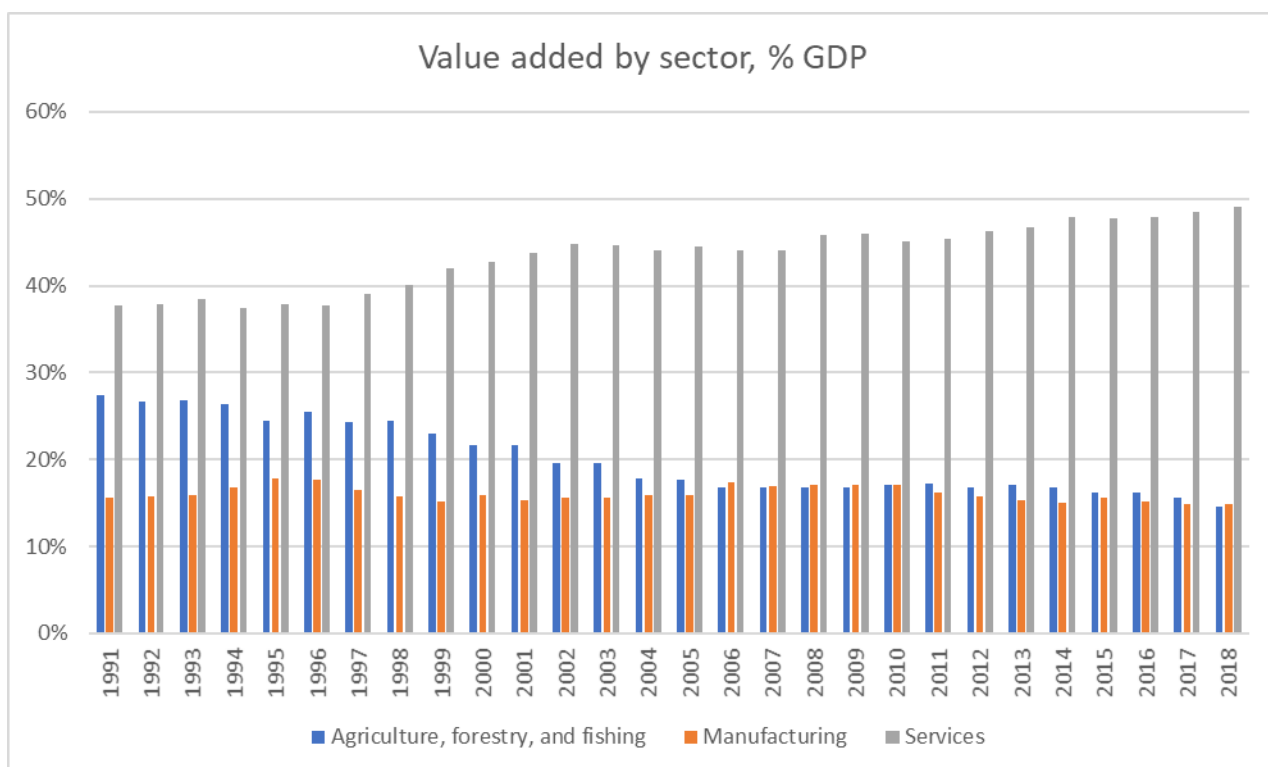
The Goods and Services Tax (GST) was a long-proposed reform, pursued by both major political coalitions and finally passed into law in July 2017. By replacing and simplifying the complicated set of indirect taxes which the government had long relied on for revenue, including excise duties, the services tax, customs duties, surcharges and MODVAT, the GST stands to streamline the revenue collection process, cut down on administrative expenses, increase rates of compliance, and ultimately spur growth in the economy by making exports more competitive. However, following the passage of the constitutional amendment which put GST into practice, insufficient preparation was undertaken to smoothly roll out the new tax. Computers were not set up to handle the new volume of transactions, submission forms were unnecessarily complicated, and rates were frequently and unpredictably adjusted. To make matters worse, this resulting unexpected uncertainty emerged just as the economy had started rebounding from demonetization, prolonging the national economic shock.

Given the timing, observers, especially among the political opposition, are often tempted to blame the recent slowdown on the introduction of the GST itself. These observers frequently point to how GST revenues have fallen since its introduction, suggesting that the tax suffers from some fundamental flaw. And uncertainty about how GST would ultimately be implemented certainly did result in a temporary slowdown as households decided to postpone consumption and major purchases until the policy had become settled. But GST revenues fell because the whole economy has started to slowdown, and blaming GST itself for the contraction deflects attention from the accumulated reform deficit which is at the root of India's economic challenges today.

### Accumulating Need for Reforms

Outside of GST and the passage of a modern law to replace the creaking and ineffectual bankruptcy mechanism, no significant reforms have taken place to propel economic growth in India since 2004. At the opening of Modi's first term, and following the corruption scandals of

the second UPA government, the new government prioritized anticorruption measures at the sectoral, household and macroeconomic level. But while these targeted the symptoms of corruption, they failed to target the need for structural reforms which had caused corruption to spread in the first place. Modest economic advances have taken place – for example, inflation declined from nearly 10% in 2013-14 to 3-4% in 2018-19 once RBI was given free reign to control it. Technological advances backed by the government such as the cutting-edge UPI retail payments system have improved commercial efficiency and transparency. But on the whole, investment has not revived, reducing potential long-term growth, and sectoral reforms have not addressed underlying sources of stress undermining both competitiveness and profitability.

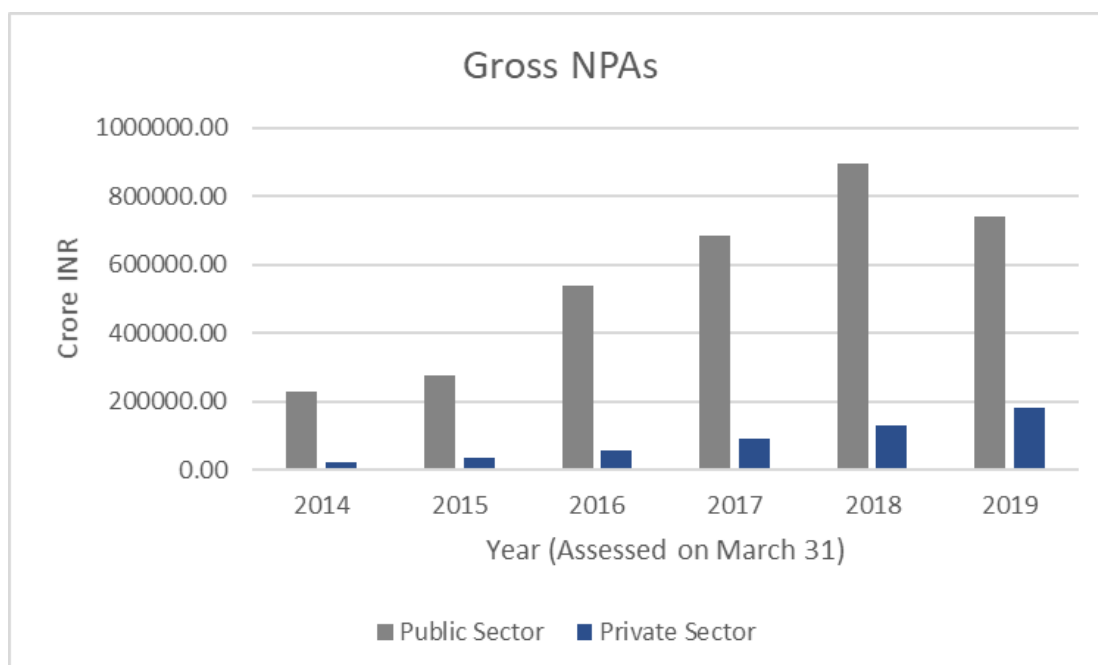


*Despite reforms meant to promote it, the manufacturing sector has consistently lagged behind agriculture and services in percentage contributed to GDP. Agriculture lacks significant growth potential, but manufacturing is likely to be a key driver of the next Indian growth boom, playing the same role as the services sector in the 1990s and 2000s. Data: World Bank*

Investment in the Indian economy has fallen steadily since the financial crisis. Current investors remain too stressed by existing debt to start new projects, while banks remain unwilling to make new loans for manufacturing and infrastructure projects. As a result, collectively, investment as a percentage of GDP over the period 2016-2018 has fallen to its lowest point since 2003. The low demand, slow earnings growth, and difficulty servicing debt fostered by these economic conditions has caused India’s ratio of corporate credit upgrades to downgrades to fall to .80, itself a six-year low.

*Non-Performing Assets and the “Twin Balance Sheet” Crisis*

The corporate debt which has grown to such dangerously high levels today was seeded during India’s boom years of rapid growth from 2004-2010, when public-sector banks began lending to infrastructure companies and NBFCs, or “shadow banks,” on a basis which was not always competitive. These arrangements often led to banks holding the debt of risky and deeply unprofitable companies. During times of economic plenty, these banks were able to conceal the impact of these Non-Performing Assets (NPAs) on their books. But the accumulated bad debt owed by these infrastructure companies could no longer be concealed once the economy cooled down and once reported NPAs of public sector banks rose as high as 14% of gross advances. In their attempts to continue concealing these bad assets, PSBs “evergreened” their bad assets, entrenching the problem and giving this bad debt opportunities to infect other areas of the economy. It was only once RBI ordered banks to undergo asset review that the true scope of the NPA problem emerged. As a result of the NPA crisis, all public sector lending has slowed significantly. With problems recovering costs for outstanding loans, these banks have become significantly more reluctant to issue any new loans, regardless of the borrower. Because NPAs have put such a chill on lending, resolution of these bad debts is a prerequisite to restarting the entire lending engine. The Modi government has applied the Insolvency and Bankruptcy Act, passed in 2016, in an attempt to force borrowers to repay lenders in order to solve this problem. Like prior legislative attempts, this worked at first, but the law weakened once loopholes were discovered and exploited through the judiciary.



*Disclosed NPAs in public-sector banking rapidly increased once RBI introduced asset review to identify and contain them. In contrast, private-sector banks have kept NPAs well under control, benefiting from stricter due diligence, better management, and lack of pressure to fulfill unfunded lending mandates. Data: RBI*

In the meantime, private banks and NBFCs have attempted to fill the gap left behind, but not without encountering challenges of their own. While private banks have been careful to complete due diligence while issuing loans, NBFCs lent to developers predominantly operating in the retail sector. With the economic slowdown, these developers have encountered trouble, which rebounded back on the NBFCs. Already a more inherently risky lender than normal banks because they don't accept money from depositors, NBFCs put themselves in an even more precarious position by financing unsold inventory with their excessive lending to real estate companies, or feeding a "non-bubble bubble." By 2019, out of ten lakh crore INR in housing value on the market, only two lakh crore INR would be sold.

The underlying vulnerability of the unsustainable lending in which NBFCs had taken part in was perhaps best exemplified by the collapse of Infrastructure Leasing & Financial Services (IL&FS), a major NBFC which had engaged with developers like so many others. The collapse of the IL&FS loan bubble in September 2018 was the peak of an NBFC crisis which revealed the overarching fragility of the sector, creating a high perception of risk and chilling lending there as well. After IL&FS, commercial housing loans, which had primarily been managed by NBFCs, dropped from 22 lakh crore INR in 2018-19 to a mere one lakh crore INR in 2019-20 to date.

The NBFC balance sheet crisis was ultimately so serious because it made it difficult for NBFCs to access credit precisely at the moment when bad loans had built up for them and they most needed it. Yet it was only the latest in a series of bank collapses and financial scandals, such as those involving Punjab & Maharashtra Co-op Bank, Punjab National Bank, and DHFL. A full 3.5 lakh crore INR of public funding, or nearly 49 billion USD, has gone toward propping up public sector banks in just the past five years, to the tune of much public anger. Public attempts at enforcing liability through prosecution have in a way backfired, further chilling lending by institutions which feared collateral damage from the heavy and ultimately counterproductive hand of arbitrary prosecution.

Even with a wounded bank sector, high rates of household savings could give these banks the liquidity they need to pull out of their nosedive. After all, Asian economies have historically grown on the strength of well-invested private savings, and India's own recent economic history has demonstrated that with high savings and investment comes higher growth. But the opposite seems to have occurred. India's household savings rate has declined from 24% in 2012 to 17% in 2018, while household debt has increased from a low of 8.6% of nominal GDP in 2012 to 11.6% in 1Q 2019. While the debt level remains low, the rapid increase in household borrowing is a cause for concern, especially when paired with falling levels of savings.

### Declining Export Growth and Special Economic Zones

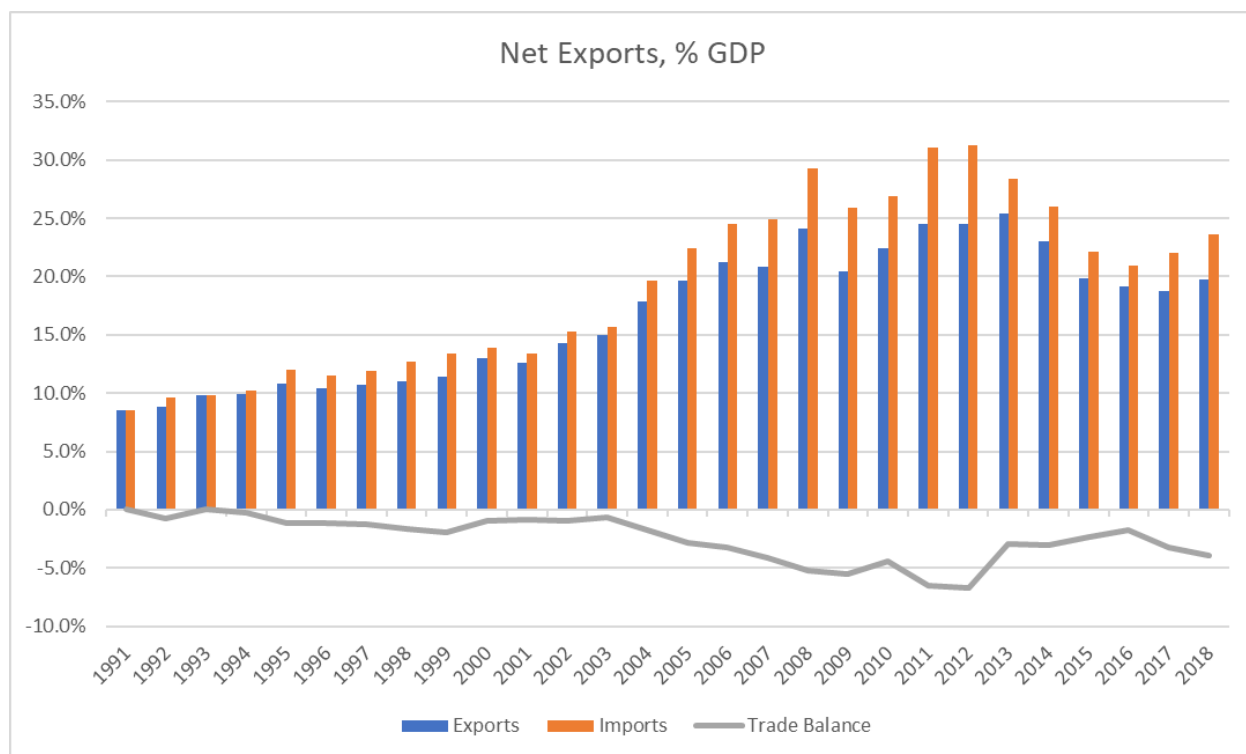
With the slowdown, India's economy has also gradually started closing to the outside world. Import growth has reached its lowest point in 30 years, contracting at 6%, and imports of capital goods have contracted even more by 10%. This has taken place despite substantially stronger GDP growth now compared to in 1991-92. While exports were never a strong source of growth, the GDP share of exports is now shrinking rather than growing, as exports have started growing more slowly than overall GDP. Compared to the double-digit growth non-oil exports, a strong

indicator of the health of the real economy, experienced in the 1990s and 2000s, non-oil exports this year instead fell by 1%. While various recent reforms have tried to replicate the export promotion success of early efforts, they have, for the most part, failed. Among these, the Special Economic Zones (SEZs) India began setting up in the early 2000s have become particularly symbolic of this failure.

Starting in 1965 with the establishment of the Kandla Free Trade Zone, India had, like many other countries, established Export Processing Zones (EPZs) to encourage the opening of the economy by targeting tax holidays and other incentives towards export goods produced within certain geographic regions. However, Indian EPZs experienced limited success because they lacked proper administrative control to create a beneficial policy environment, had insufficient infrastructure to accumulate a comparative manufacturing advantage, and lacked both the authority and the scope to introduce concessions that would serve as adequate incentives for businesses. The project had largely been abandoned until the world started taking note of the success of China's SEZs in establishing export promotion and manufacturing clusters which were powering that country's growth. Wanting to replicate this success, the Indian government recast its existing EPZs as SEZs starting in 2000 and put forth new incentives to attract manufacturing within these zones.

The new SEZs did have more policy authority than in their former incarnation as EPZs. To boost global competitiveness, SEZs permitted Overseas Banking Units (OBUs) which provided firms operating within them market simplified access to international finance by operating as Indian banks exempt from normal RBI regulations. But the successes of Indian SEZs were greatly outnumbered by their missteps. Far too many SEZs were established, and they were designated with little regard for the benefits of geography. India today has 373 SEZs, up from 221 in 2017, covering less than one square mile on average. These zones are too small to amass a critical mass of industry which can produce the clustering effects which power the most successful manufacturing districts. In addition, many of them are in landlocked states, in areas entirely unsuitable for shipping exports for the foreign market. China, in comparison, only has five normally-designated SEZs, but they cover entire metropolitan areas, averaging nearly 60 square miles in size. The Chinese SEZs are located along China's highly industrialized coast, tapping into shipping routes to manufacture goods for all points along international supply chains.

Other challenges faced by Indian SEZs involve the way in which they fail to take advantage of their special legal status in order to make the most of the four factors of production that go into manufacturing, namely land, labor, capital, and business environment. Much SEZ land is earmarked not for development in manufacturing or the services industry, but for residential and commercial properties – a perfectly fine use of land, but one which wastes the advantaged legal status of SEZs while preventing the industrial clustering they are meant to encourage. Unlike Chinese SEZs, which feature independent and liberal hiring, firing, and exit policies, Indian SEZs are subject to the relevant labor and industrial laws of their host states. This makes them overwhelmingly subject to anti-competitive rules such as the Industrial Disputes Act, restrictions on the entry of large firms in specific industries, and restrictions on firm exit from certain markets. To date, Indian SEZs have only received piecemeal exceptions from these rules.



*Rising consumption and a lagging domestic manufacturing sector has led to increased demand for imports and a relatively high trade deficit. Export promotion efforts have largely failed to this point, necessitating a holistic review of SEZ policy. Data: World Bank*

India’s export challenges, of course, go beyond the shortcomings of SEZs, touching on an overarching lack of hard and soft infrastructure. For instance, until the establishment of the Vallarpadom terminal in Kochi in 2012, India was entirely lacking in port facilities equipped to handle transshipment. This left 60% of India’s exports and imports to be shipped through foreign ports in Sri Lanka, Singapore and other nearby countries, at the cost of additional expenses and up to an additional week of transit time. More properly thought-out SEZs, however, would have not only provided the demand to build these domestic facilities earlier and in a geographically advantageous position, but could also have taken advantage of a more comprehensively export-oriented legal framework to develop industrial parks for exports, build the necessary infrastructure for export through more liberal land acquisition rules, and mobilize a fluid pool of skilled labor to fill the rapidly changing needs of the global market.

### High Deficits and Reduced Fiscal Space

High fiscal deficits continue to limit the government’s policy responses to a potential recession, and are in fact higher than official data indicates. Hidden expenditures such as food subsidies hide the true budget deficit. Whereas the official budget deficit is 3.5% for the central government, and 8.5% including state governments, JP Morgan estimates the actual combined fiscal deficit to go as high as 9-10% of GDP. The official figures conceal not only hidden expenditures, but excessively optimistic revenue projections following the recent corporate tax

cut; off-balance borrowing by public institutions; and various accounting tricks, such as accelerating revenues and deferring liabilities.

The bill for these maneuvers is now starting to come due. Borrowing by the Food Corporation of India, India's main agricultural market price regulator, rose from under .7% of GDP in 2015-16 to over 1.1% of GDP in 2017-18. Off-balance borrowing by the National Highway Authority of India (NHAI) similarly rose from .2% GDP in 2014-15 to .7% GDP in 2017-18. At the state level, programs that drive these hidden deficits, such as agricultural loan forgiveness programs, aren't just sources of fiscal stress. They also disproportionately benefit the wealthy which have access to formal financial structures, since the poor often rely on moneylenders operating outside the formal financial system. Debt relief, therefore, makes debt public without assisting the poorest farmers at the heart of India's ongoing agricultural crisis, reducing fiscal space for programs which could actually benefit them.

With banks in need of recapitalization, NBFCs burdened by bad loans, and expansive social programs such as Ayushman Bharat whose fiscal impact has not yet been determined, contingent liabilities will continue to rise in a way which cannot be cleanly accounted for in current budgets, but will greatly impact future budgets. This means that while public stimulus is desirable in a contractionary environment, the government must remain mindful of the unknown and evolving fiscal impact of these existing liabilities. Stimulus via income tax cuts, which would only target spending and consumption for the wealthiest ten percent of the population, would fail the test of inclusivity necessary in a stimulus program. Nor should the government turn to monetary policy to inflate away its deficit after spending the past 30 years meticulously building up the credibility of the currency for the global market.

## Capital Reforms

### Non-Performing Assets in Public-Sector Banking

Public-sector banks are in desperate need of improved governance in order to function well without taking on excessively risky liabilities, but current attempts have stalled. The Modi government has created the Bank Board Bureau to make recommendations, but the body lacks power and independence. Likewise, the boards of public sector banks have become politicized due to lack of independence in their composition. To its credit, the government has attempted to improve the functionality of these banks by consolidating them according to the IT they use, the regions they serve, and the services they provide. But this low-hanging fruit has consumed management energy that was more needed to enforce reform from the top down and deal with more basic stresses such as the slowing economy and rising NPAs. Without addressing the basic causes of financial stress in these public-sector banks, these mergers have been more cosmetic than practical.

Public-sector banks have also been hamstrung by political pressure to fulfill a social mission, defined by often unfunded government mandates. For instance, the current government made MSME lending a major priority through the Mudra program, launched April 2015. But without furnishing sufficient resources for public-sector banks to follow standard procedures when taking

on so many new clients, the program rapidly ran into problems which have been brushed under the table. More informally, banks have been pressured into “loan fairs” which, while temporarily expanding access to capital for otherwise underserved groups, have worsened the NPA problem by encouraging lending without necessary due diligence. At the level of bank compensation structures, the conflict between the social and business missions of these firms creates staffing problems when low-level staff are paid above market wages and high-level staff are paid below market wages to compensate. This pushes away top management talent and exacerbates the governance problem in public-sector banking which has created so much sectoral turmoil.

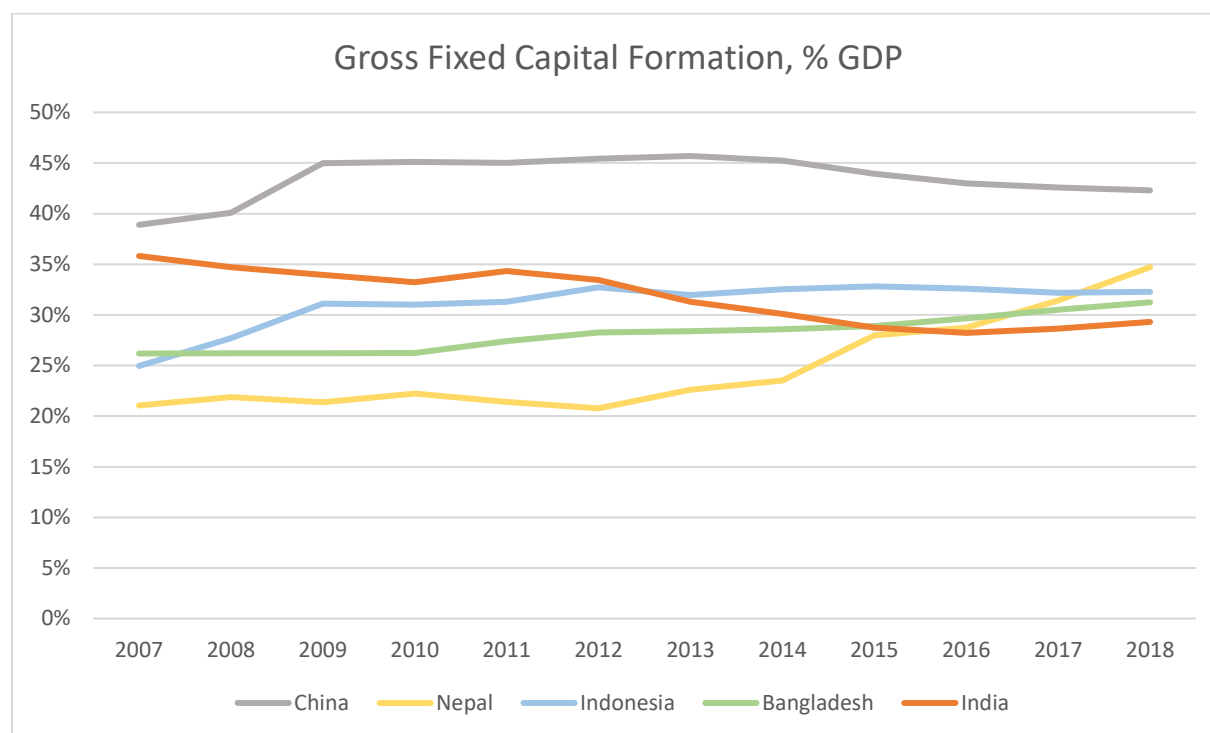
## Business Environment Reforms

Because high investment is a prerequisite for economic growth, and investment increases when firms plan to enter new markets or expand, improved practices and regulations regarding ease of doing business that lower barriers to productive investment is a necessary first step to increasing growth across the board. One of the major factors holding back FDI, which has flatlined since 2015-16 at 40 billion USD at best, has been the failure to continue pursuing meaningful reforms to improve the business environment.

Rather than meaningfully analyzing why businesses struggle and taking steps to simplify investment, India’s approach to improving the business environment has been a textbook example of Goodhart’s Law, or the idea that metrics which become targets cease to be useful metrics. In this case, the World Bank has published an Ease of Doing Business index since 2013. The Doing Business report grew from an attempt to quantitatively compare business environments between countries, an inherently flawed effort thanks to the great diversity of exogenous economic and cultural factors in every country measured. Regardless, the index has become enormously influential despite its unavoidable reliance on tracking the health of a business environment by its symptoms.

Since the inception of the index, India’s business environment reforms have been laser-focused on increasing its standing within the index. Between 2014 and 2019, India rose every single year on the ranking, going from 142<sup>nd</sup> place in 2014 to 63<sup>rd</sup> place in 2019. But despite this improvement, investors and officials such as M Damodaran, the former chair of SEBI, complained that rising rankings did not correlate with real improvements in the ease of doing business. When metrics are manipulated to attract business, rather than rising as a natural result of governance reforms, what investment does materialize is likely to struggle once it comes into contact with reality.





*India has recently started lagging behind neighboring lower-middle income countries in the region in terms of fixed investment, potentially foretelling declining long-term competitiveness particularly in the manufacturing space. In order to attract foreign investment which could otherwise go to these countries, India will need to comprehensively invest in improving its business environment, most critically in infrastructure. Data: World Bank*

The downstream impacts of India’s business environment can be seen by examining the health of its export-oriented manufacturing industries relative to its neighbors. Some industry stories, such as increased cell phone assembly, have been apparent success stories, but upon further examination are shallower than they appear. In this case, assembly of previously imported electronic components adds minimal value compared to the rest of the supply chain, and gaining more value would require an improved business environment in the electronics manufacturing sector to make manufacture and even design of original components feasible and cost-competitive. Others can be less easily explained away. For example, China’s share of textile exports has gradually fallen, and as an equally populous, industrializing country, India would seem perfectly suited to pick up the slack in this fairly low-tech industry. But rather than taking China’s position, India has been outpaced by smaller neighbors such as Bangladesh and Vietnam. Could business environment factors such as logistics, infrastructure, land and factory availability, and liberal access to a qualified labor force have contributed to this choice?

#### Poor Overall Policy Predictability and Transparency

Finally, the Indian business environment has been plagued by unpredictable policies, inefficiently organized markets, and poorly designed supports. In the agricultural sector, farmers are constantly undercut by a government habit of banning the export of commodities – most recently, onions in late 2019 – when prices go too high. This is intended to drive down prices for consumers in urban areas, but it has the side effect of unpredictably reducing prices for sectors

which may already be struggling with profitability. Other industries are the beneficiaries of high tariffs, legacies of the import substitution regime in place before the 1990s, which keep Indian manufacturers from integrating with global supply chains requiring the import of intermediate goods. Reducing these tariffs would increase trade and incentivize investment, and even holding them steady would simplify investment decisions. But tariffs remain both high and fluctuating in politically influential sectors of the economy, depressing demand, scaring away investment and estranging India from those supply chains. India's reputation for policy unpredictability has likewise prevented it from reaping the full benefits of the recent corporate tax cut, since investors have no assurances that the rate for the new manufacturing firms incorporated post October 2019 will stay put at 15-17%. Absent a formal process to stabilize these taxes and tariffs, India will struggle to retain investment and will not be viewed as the reliable link in global supply chains it must be in order to revive the manufacturing sector.

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