

25 Years of Economic Reforms

Indian reforms story has been a fox's tale. Twenty-five years ago, India set out on a path of economic liberalization freeing it from decades of a misguided big statist model a process that remains incomplete even today. Decades of stifling government involvement and presence in every aspect of economy created the fertile ground for corruption and cronyism that exists even to this day. A few private conglomerates and the state controlling the economy was what this model created, till the economic reform process commenced. Indian economic reforms have had a very superficial application leading to a non linear growth if all sectors are combined. Reforms have not percolated to the last citizen of the country so much so that majority of the rural poor masses still do not have even food security in their kitty. Moreover these reforms had a biggest limitation; they were only in the sector of financial policy and brought about only a 20% relief to the economy. In context to some very good landmarks such as :

Downward adjustment of rupee value to the extent of 22 per cent and then making provision for partial convertibility of rupee initially and value of the exchange rate for the rupee was remarkably steady despite unification and lifting of trade controls. This has reduced the scale of hawala transactions. Foreign exchange is now flowing through legal channels in sample quantities instead of through hawala transactions as earlier.

The average import tariff had been reduced from 135 per cent to 35 per cent and the aim was to reduce it to 0 per cent by 2002. The increased flow of foreign investment, reaching the level of about \$ 3 billion since 1991, was possible only due to changes in ownership legislation, relaxation of MRTP Act and full convertibility of rupee on trade account. It is predicate to understand what actually needs to be instrumental to bring about a uniform and deep reforms process which the Indian economy lacks in. Some of the areas which need crucial attention in the form of reforms agriculture, food security, judiciary, taxation, financial policy, labor, infrastructure and national growth statistics. The Indian politics has failed to take cognizance that the sectors which emphatically required to be refurbished in India due to the very fact are the sectors of agricultural economy and law and order which form the backbone of any country. Agriculture reforms have been inadequate and our agriculture continues to be subject to the vagaries of monsoon. The most important change which needs to be brought about in case of agricultural sector is the subsidy issue. The Jan Dhan accounts undoubtedly made it possible for direct transfer of subsidy to a farmer's account however its regularization in all types of subsidies is a dream to be achieved. The processes need to be yet put in place with complete approach. Today we see that one subsidy is being transferred to the account where as some other not, leading to a disparity and lack of convenience in the process. In respect of cut on subsidies, whatever success was achieved in early years that could not gain its momentum in the later years. In respect of food subsidy also, the Government has failed to formulate a fresh policy for redirecting the food subsidy from the creamy layer and urban middle class of the society to the poorer sections. However, the fertilizer subsidy should be withdrawn altogether. On the issue of subsidies, the Government needs to act more in unison which has not actually happened.

In case of reforms in the Indian judiciary the impact will not only allow the law and order situation to be full proof but it will also entail smooth functioning of areas of other jurisdiction such as taxation, human rights etc. Taxation is an important sector which will benefit from reforms in Judiciary, fast moving courts and enactment of procedures for the trial of money laundering cases will ensure to seal black money. However one needs to understand that taxation policy itself requires reforms which are supposed to be presented in the form of GST, however much needs to be done in case of direct and indirect taxes. Due to inadequate restructuring of direct and indirect taxes, tax evasion has become a legal feature with India losing millions in this sector's contribution to GDP. Moreover, the Government has had a freehand levying many incoherent taxes in name of Swatch Bharat tax, service tax and sales tax for hotel industry, in addition to customs duty, imports are subject to other taxes and charges such as Landing Charge, Countervailing Duty, CESS, and CEX, education cess and various other surcharges which have led to effective taxation amounting to 50% for an average Indian. Taxation matters instead of being simplified are being made more complicated with the introduction of the most recent Swatch Bharat tax and the additional customs duty at a time when a general GST is being proposed at 18%. It is the Government's prime duty to check for organization and over population in cities and a distress in the same leads to dirtying of areas, a tumultuous application of such a tax leads to disappointment among the masses. Multiplicity of taxes is a big bottleneck for Make in India objective at the same time. Another sign of limited restructuring is that India's tax-to-GDP ratio has remained in the 15-17% range since 1991 despite the growth in per capita GDP. This ratio is significantly lower than the emerging market average of 21% and the Organization for Economic Co-operation and Development average of 34%. While there are multiple reasons for our low tax-to-GDP ratio—falling tax rates, multiple exemptions and the limited tax net—the implication is a much reduced government budget, which in turn hampers the scale and effectiveness of restructuring efforts. 60% of the population is based on agricultural income however only 10% of the 40% population pay taxes regularly. Estonia became the first in the world to adopt the flat tax regime, with a uniform rate of 26% regardless of the income a person makes. Rejecting claims of unfairness in taxing the poor and the rich at the same percentage rate, Tallinn decided to take on this radical experiment and succeeded wildly, as the nation's economy boomed. Today, Estonia has the highest GDP per person, almost \$13,000, of any country that used to be part of the USSR. Multiple former Soviet Republics have begun adopting Estonian policies. Even China is now seriously considering adopting a flat tax. As a result, all countries saw increased investment, domestic and foreign, as well as increased tax revenue due to a decrease in tax-evasion.

Ideally the reforms process should have been initiated from the judiciary reforms to financial policy reforms ending with the banking reforms, however this was not the case and devaluation of Indian currency only formed a 10% makeshift in bargain, with the government expecting 100% shift in growth to happen. It is final that the RBI guidelines still use the colonial era definitions though attempts were made to make the banking sector more effective, competitive and efficient through Narasimham Committee-I (1991) report and the Narasimham Committee-II (1998) report, however, the reforms did not reflect much effectiveness in the allied sectors connected to the banking sector. Nevertheless this

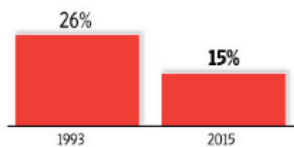
sector has been subject to discussion about the rising NPAs in the system due to no coordinated prescriptions and mishandling of the same. The Vijay Mallya example being the latest one. Not only is the Indian rupee overvalued but also high interest rates prevail in the Indian scenario, this has made the manufacturing process and trade very difficult to deal with. India needs to bring in vibrant pension sector reforms and make it very lucrative and hedged for a 100 year horizon to deal with Inflationary trends forecasted for that period. Indian trade policy is presently receiving a lot of attention and is undergoing reforms. For 22 years India was ridden with a feeble trade policy which produced poorly drafted FTAs and developed poor intra country relations leading to a large loss in trade and foreign currency. Another point of criticism raised by the critics against the policy reforms is that the new economic reforms are a complete surrender to the World Bank-IMF precepts and the Government has surrendered its sovereignty in order to procure a huge amount of loan from such international agencies. Liberalization of trade policies through withdrawal of import duties is being done to facilitate imports from developed countries, particularly USA, facing a recession in their economics largely. This sort of criticism may not be totally baseless or politically motivated. Thus the Government should take proper care in maintaining the sovereignty or economic interest of the country so that it does not serve any policy under external pressure and also should not dilute its long-term strategy for attaining self-reliance. Unless the savings ratio goes up significantly and the real export growth accelerated, there are chances of the country's economy going the Latin American way with soaring inflation rates and growing social injustice.

Labor reforms form the other constituent of the basket which is actually in shambles. In India wage fixation has no link with productivity. But rationality suggests that wages must be equal to marginal productivity of labor. Labor market in India is having dual character, representing organized laborers enjoying security and high wages and unorganized workers, on the other hand, which remained exploited, totally defenseless and poor. Thus in this context, economic reforms through its market mechanism will either improve productivity of workers or face closure or exit by the employer concerned. There is an urgent need to not only provide employment to the masses but the same needs to be a qualitative one with an integrated approach leading to the application of single labor law based for a pay extending up to Rs 5lakh pa with further slabs as a bench mark, having uniform applicable benefits and job security. We observe today that a peon in the union cadre and an officer cadre at the same scale of pay drawing different benefits and job security thus leading to disparity. The term for employment needs to be unified and formalized so as to absolve complexities. Moreover agricultural labor is treated differently as compared to Urban labor and has tax austerity for the fact that India being a agricultural economy and it is considered to be a fact that rural income generation is more stressed than urban one but one needs to note there are enough examples of agricultural income holders who have displayed better luxuries against their contemporaries in the organized sector. Also this has considerably led to aberration in GDP reflections. First, the employment structure has remained more or less static and is increasingly out of sync with sectoral GDP split. Agriculture today is less than 20% of India's GDP but still accounts for 50% of the labor force. Second, overall jobs have not grown much National Sample Survey Office data shows

that only 1 million jobs were added per year between 2004-05 and 2009-10, during a period of more than 8% GDP growth. Third, women's share in the labor force has gone down from 27% in 1990 to 24% in 2014, a trend driven by women in poor rural households leaving the labor force as men migrated in search of better job prospects. The government has failed to take into confidence the organized workers at any stage of the implementation of economic reforms. In a country like India, there is no social security net, no unemployment benefit and till today there are no institutions for retraining of workers in newer skills. Necessarily the economic reforms have failed to garner supports from the organized workers, in general. India is stuck in a low-wage, low-innovation equilibrium. The services sector is dominated by low-wage sectors such as construction and retail, which together employ more than a quarter of the workforce, up from around 12% in 1993. And formal employment has been stuck at around 7-8% over these 25 years. Innovation, leading to higher productivity and wages, suffers from limited financial and infrastructure support:

CHART 1: EMPLOYMENT TILTS TOWARDS AGRICULTURE

Agriculture contributes <20% of India's GDP...
Contribution to GDP (Production approach)



...but still employs ~50% of India's workforce
Contribution to labour force

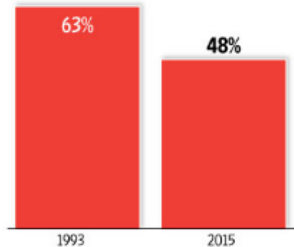
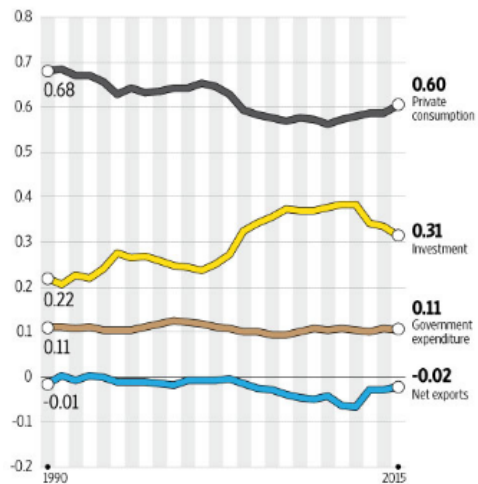


CHART 2: INDIA'S GDP STRUCTURE

Composition of GDP, India (% of GDP, expenditure method)



Sources: Euromonitor, CEB, Bain analysis

India spends just 0.8% of GDP on research and development, compared with China's 1.9% and the US's 2.8%. Removal of complexity in the Indian labor law needs attention for reforms to take place. Another criticism raised against economic reforms is in terms of unemployment arising out of large scale retrenchment of workers. Thus both the public sector, on the plea of overstaffing and redundancy, and the private sector, on the plea of modernization and technological up-gradation, workers are gradually being retrenched or forced to accept voluntary retirement scheme like 'Golden Handshake'. This sort of unemployment arising out of structural adjustment is a serious problem and must be considered seriously. The reform brought in this sector through the National Skill Development Agency needs to open its scope and implement a proper basic pay structure for the incumbents of this skill. If acquisition of a highly in demand skill does not pay the

incumbent enough there may arise tendencies to acquire skills informally which may lead to distortion in the objective of such an agency and will lose preference in long run.

The other area in dire need for reform is the infrastructure sector. The slowest growth in this sector has resulted not only rural poverty to a large extent but also urban inflation due to frequent transport hikes. Major issue is road connectivity to the last mile of the country's village which chokes rural exposure to the external economic weather. The other infrastructural need is stable supply of energy resources like electricity, LPG for cooking requirement for the rural poor which has helped eradication of poverty in large. Absence of adequate national highways and ports has led to dampening of manufacturing sector which has to spend enormously on transport logistics. The slow and unbalanced development of agricultural infrastructure comprising of irrigation systems, soil management advisory units per village etc and underdeveloped infrastructure are two weakest links which are holding up the economic reforms of the country. It is shameful, that after sixty years of independence and planned development, the country has failed to ensure uninterrupted power supply, continuous flow or supply of safe drinking water to the people of our country. Moreover, the conditions of our roads, ports, harbor and airports are really poor. Thus the Government should pay due attention for handling these sectors i.e., workers, agriculture and infrastructure so as to reap optimum benefits from economic reforms.

India's GDP even today is consumer expenditure driven rather than investment and export revenue driven, absencing the stimulus from investment and exports, a reflection of the limited restructuring in our labor and land markets. Take the case of Estonia as part of the country's re-orientation towards the West, the government in Tallinn decided to embrace foreign trade, with Europe quickly replacing Russia as the main partner. Driven in part by Estonia's embrace of foreign trade and in part by large-scale privatization of government assets, investment poured into the country. The state's money became stable, with the government controlling supply and increasing dollar reserves. This allowed entrepreneurs to have greater confidence in long-term investments and by 1993, the economy fully recovered having a budget surplus of about 5% and within a few short years, wages were far above what they were under communism. The investment share of Indian GDP has risen gradually from 22% in 1990 to 31% in 2015 while the comparable numbers for China are 33% and nearly 50%. This discussion on GDP proves that reforms process in India has neither been an integrated one or restructured at required intervals. We see stable GDP growth levels hovering around 8% from 2003-2010 but 50% of the population is still living below the poverty line in the same years. Reforms process in India has been very secluded for each area of growth thus giving it a ripple effect instead of a wave effect for the country as a whole. Inadequate fiscal adjustment have remained the most intractable problem over the past decade with interest payments now constituting over 69 per cent of Centre's tax revenue, subsidies continuing to increase to unaffordable levels and do not necessarily reach the deserving beneficiaries, the pension liability of the Government is becoming onerous, public investment in infrastructure and social sectors being inadequate due to falling total public sector savings, private investment constrained due to high real interest rates and inadequate infrastructure.

Recommendations

The final recommendation for various policy reforms would be integrated restructuring through a rule based approach time tested by taking into account the beneficiaries of the same.

Integrated restructuring means laying out guidelines for a particular policy keeping in mind its implication on other policies or implication of other policies on that particular policy to lawfully happen for the betterment and progress of the society. Policies are made for the benefit of the citizens in order to govern them, however it is observed governance at times leads to oppression if the same is not tweaked for the betterment of the beneficiaries with changing times. Lack of rules creates governance based heavily on political and bureaucratic discretion. Government decisions based on discretion instead of rules in dealing with public resources, contracts and money is a fertile ground for corruption. This has been shown again and again. This kind of corruption in doling out favors has significant impact on a nation like India. First, this impacts the type and nature of politics and democracy. The quid pro quo type of economic model creates a nexus of vested crony interests and political process, with money power increasingly driving the political process that, in turn, creates a vicious cycle of money and political success to those pandering to or backed by crony capitalists. Deal-based governance also fosters an economic model where political connections determine success for the economy. This phenomenon, also written about by Reserve Bank of India governor Raghuram Rajan before taking office, shuts out 'un-connected' entrepreneurs from opportunities and participating in the economy. This, in turn, has structural implications on issues such as innovation, competition and efficiency all important elements for a successful, sustainable economic model for a country like India.

In a remarkable example of how thoughtful, transparent policies can lift up countries, Estonia, which was economically crippled due to the Soviet annexation from the 1940s to 1991, lifted itself up to become a country with the highest number of start-ups per capita. This was done through a host of market reforms since the mid-1990s—including free trade and privatization—designed to remove red tape and simplify the process of starting a business and, most importantly, following well laid out processes. Rule-based governance creates transparency in its functioning and improves the trust between citizens/ investors and government. The impact of this transparency due to a move away from a deal based economy was that crony wealth reached 18% of GDP (gross domestic product), putting it on a par with Russia. Today it stands at 3%, a level similar to Australia."Over the past 25 years, we have done the relatively easier bit of opening up our economy, but as we have seen, integrated rule based restructuring after a testing for its effectiveness amongst the beneficiaries will factor the markets which have been far less successful. This will require changes at multiple levels individual, firm and sector enabled by appropriate regulations and governance. A number of programmes launched over the past few years like skill development, Make in India, Start-up India and agriculture sector spends are all in the right direction. A concerted action across all these areas will drive us toward a middle-income country, one where land, labour and capital markets are structured for sustained growth and productivity. Moreover figures will reflect the ground realities.