Current challenges to growth, and long-term constraints

Many distortions remain in the regulatory and institutional environment that are inimical for high growth over the long term

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Only about 2% of Indian workers have skill certificates compared to about 70% in Europe and 80-90% in East Asian countries like Japan and Korea. Photo: Hemant Mishra/Mint

The first advance estimate of gross domestic product (GDP) released earlier this month projected that GDP would grow by 6.5% in 2017-18, slower than the 7.1% growth recorded in 2016-17. This seemed to suggest that the growth cycle was still in a declining mode, battered by the twin shocks of demonetization and the goods and services tax (GST). However, that interpretation is misleading in my view. The first advance estimate of GDP is based on data covering only the first six or seven months of the financial

year, which absorbed the worst of the twin shocks. Moreover, it masks changes that are visible only with higher frequency data.

In my previous column (*goo.gl/3huVcw*), I had suggested that the growth cycle had bottomed out and moved on to a recovery phase. Quarterly growth, which had been persistently declining for the previous five quarters till Q1 of 2016-17, had finally turned around to 6.3% in Q2. Further, this was backed by a turn around in gross fixed capital formation (GFCF), a critical growth driver. Though modest at 4.7%, this was higher than the growth of GFCF during the previous four quarters.

I am happy to note that the advance estimate of GDP actually reinforces my conjecture. Implicit in the 6.5% annual forecast is a quarterly growth rate of 7% during the third and fourth quarters, implying that the growth recovery has now persisted for four successive quarters. The advance estimates indicate that GFCF growth has also gone up from only 2.4% in 2016-17 to 4.5% in 2017-18. This is still very low, reflected in an investment rate (GFCF/GDP) that is still declining. But it does mark an increase in investment growth, which had been persistently declining for several quarters till Q1 of 2017-18. This turnaround of the investment cycle, however weak, is quite significant because investment is the most important autonomous driver of growth in a trade deficit economy.

Thus, while some segments of the economy like real estate and the unorganized sector are still in the doldrums, and a crisis persists in agriculture, the economy as a whole seems to have got over the twin shocks and finally moved on to a recovery path. Moreover, the Central Statistical Organization's advance estimate is somewhat lower than the projections of the Reserve Bank of India, the International Monetary Fund and other multilateral or private organizations, which forecast a growth rate of 6.7% or more for 2017-18. If the upturn of quarterly growth persists, it is quite possible that growth in 2018-19 will exceed 7%.

That being said, these observations are nevertheless conjectures. Actual outcomes going forward will depend on a host of policy interventions and exogenous factors. On the policy front, the adverse impact of demonetization seems to be behind us, as already noted. However, it should be emphasized that this applies to output growth, not employment. The share of the unorganized sector, including agriculture, is much larger in

employment than in output. Hence, while output growth is recovering despite the persisting crisis in this sector, it is unlikely that there is any similar recovery in employment.

The GST is quite another story. Its poor design and the inept roll-out without adequate administrative and technical preparation, especially for the online goods and services tax network (GSTN) platform, caused a great deal of confusion and imposed an enormous compliance burden on the tax payer. But fundamentally, the introduction of the GST is a major progressive reform of India's tax system. As the initial design is rationalized and implementation problems are ironed out, the benefits of a huge common market with a unified indirect tax system will have a strong positive impact on growth. The ongoing deliberations of the Modi Committee on direct taxes are also expected to be reflected in a simplified and more effective direct tax system, possibly even in the forthcoming budget, with a further positive impact on growth.

In the financial sector, the government is finally coming to grips with the problem of excessively leveraged corporates and excessive levels of non-performing loans, especially in public sector banks. This has been the principal factor underlying the growth slowdown and stagnation of private investment. Recapitalization schemes for banks, combined with implementation of the new Insolvency and Bankruptcy Code, could give a strong push to private investment and growth. The same is true of public infrastructure projects, which have been a major priority of the present government.

On the external front the picture is mixed. The global economy has seen a strong upturn in growth. However, a negative factor is now emerging that poses a serious threat, i.e. the rising price of oil. Low oil prices during the last few years were largely responsible for the sharp reduction in inflation, and the moderation of the external deficit as well as the fiscal deficit. Now, that benign scenario is changing. After having remained at $50 a barrel or less for several years, the price of crude has risen sharply during the past few weeks to $70 per barrel, thanks mainly to political uncertainties in West Asia and supply dislocation in some other oil-exporting countries. This will push up the rate of inflation and also put pressure on the balance of payments as well as the fiscal deficit. Thus, added to the challenges of stagnation in real estate and the unorganized sector, and continuing

administrative bottlenecks, the rising price of oil is a new threat to economic recovery.

These opportunities and challenges relate to the economy's prospects in the short run. I have greater concerns about the economy's capacity to maintain its global competitiveness and sustain high growth over the long term. Many distortions remain in the regulatory and institutional environment that are inimical for growth. Strong action will be required, especially at the state level with regard to reform of land and labour markets and the efficient delivery of public services. However, these are amenable to improvement when there is determined policy action, as demonstrated by India's jump this year from 130 to 100 in the World Bank's Ease of Doing Business rankings. Also, with 29 states competing with one another to attract investment, there is a rich experience of best practices in both the land and labour markets.

What will be much more difficult to change, given our foundational weakness, is the poor quality of our workforce. A report published not so long ago by a leading chamber of commerce celebrated the fact that the employability of the Indian workforce had gone up from 34% to 40% in four years. Ironically, this also implied that 60% of the workforce was not employable! This is not really surprising when we note how little is the effort invested in skilling the Indian workforce. According to some estimates, only about 2% of Indian workers have skill certificates compared to about 70% in Europe and 80-90% in East Asian countries like Japan and Korea (see "Employment, Education and the State" by Sudipto Mundle, *Indian Journal Of Labour Economics*, 11 December 2017). Reporting to a Parliamentary Committee on the Pradhan Mantri Kaushal Vikas Yojana, its flagship skilling programme, the government indicated that of the 1.76 million people trained under the programme till 25 April 2016, only 560,000 people could be certified as having successfully completed the training and only 82,000 were actually placed in jobs.

India's poor record in skilling its workforce derives from the neglect of basic education in its distorted policy priorities from the 1950s onwards. Basic education was seen as a desirable social goal but not as a part of the commanding heights of the economy like infrastructure, heavy industries, steel, etc. This is in sharp contrast to the "miracle" economies of East Asia where quality basic education on a mass scale was considered essential for

creating the army of skilled industrial workers necessary for successful global competition.

As recently as 2012, about 50% of India's population had only primary education or less compared to one-third or less in other emerging market comparators like China, Turkey and South Africa. Rukmini Banerji and Wilima Wadhwa point out in their recent article in *The Indian Express*("Ability versus aspiration", 16 January) that conditions are changing. An enrolment rate of over 95% in the 6-14 year age group has been maintained for over 10 years now. However, learning outcomes are persistently declining even for those with eight years of schooling, making them unfit for further skilling. Oddly, the 13% of population with tertiary education at the upper end in India is quite comparable with that in the emerging market economies cited above.

Thus, the elitist bias of India's education policy has resulted in a missing middle in its education profile. The large bulk is bunched at the bottom with only primary education or less and a disproportionately large share is bunched at the top with tertiary education. This peculiar bimodal education structure is also reflected in the employment structure of the workforce. About 20% are employed in well-paid, high skill jobs in large organizations. The balance 80% are mostly employed in agriculture or in low productivity, low technology enterprises in manufacturing or services employing 10 workers or less. There are very few employed in enterprises with between 10-200 employees.

It is evident that with this missing middle profile of education, skills and employment, the bulk of the Indian workforce lacks the capacity to move up to skilled, high-productivity jobs. This is a major constraint for the Indian economy in competing in the global market even at present, as reflected in its low share of global trade. How it would compete and sustain high growth in a world of rapidly changing, disruptive technologies such as robotics and Artificial Intelligence with such a workforce is hard to imagine.

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