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Politics In Command

The growth story is fading, but a few bold strokes can revive it

Sudipto Mundle

It is ironic that the Indian growth story is fading when the economy could be soaring, powered by several ongoing processes of structural change. What are these structural changes? What are the negative short-term factors that are suppressing their growth potential? Can these short-term factors be rolled back?

Three key processes of structural change are underway. First, the share of working age group population in total population is rising. If this workforce is properly employed, the rising ratio of earners to dependents will in itself push up per capita incomes, savings and growth. Second, the GDP share of a slow growing, low productivity agriculture sector is shrinking, replaced by the rising share of a higher productivity, faster growing services sector that now accounts for 58% of India's GDP.

This should enhance overall productivity and growth. The third process, noted for the first time in the 2009-10 NSS survey of employment and unemployment, is a faster growth of employment in the organised sector than in the unorganised sector. Much of this is probably casual or irregular employment through subcontractors. Nevertheless, since productivity is much higher in large firms in the organised sector, this process again will drive up productivity and per capita incomes, savings and potential investment in the economy.

These three mutually reinforcing processes could raise India's potential growth rate to around 9%, or even 10% – the policymaker's holy grail. At present we are operating far below that level because this potential is being suppressed by negative short-term factors that are dominating the scene. The immediate manifestations of these negative factors are economic: slow growth combined with high inflation, declining investment, the large fiscal deficit, an unsustainable current account deficit driving down the value of the rupee, a depressed stock market, and so on. However, at their root these problems derive from dysfunctional politics, both outside India and within. As usual, politics is in command.

Thankfully, the rupee has stabilised for the time being

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Externally, the European crisis persists. The EU system is flawed. But the politicians have failed to agree on a serious programme of reforms. Instead, led by Germany, they have opted for short-term bailouts for individual countries, linked to harsh austerity programmes. Fiscal prudence is essential. But sudden imposition of excessive austerity on distressed countries merely leads to recession, declining revenues, and a worsening of the debt problem, as witnessed in several EU countries. Greece has just voted to stay in the EU, but the winning New Democracy party may seek to renegotiate the austerity provisions of the bailout programme. There are also signs that the austerity enthusiasts may be softening. The latest $125 billion Spanish bailout has reportedly come with conditions linked to banking reform rather than austerity.

On the home front, apart from the high interest rate policy pursued till last October to contain inflation, the decline in growth is largely attributable to the severe loss of investor confidence. This is the consequence of inordinate delays or repeated flip-flops on several policy issues. Some features of the last budget have also been very damaging: the temporarily postponed GAAR, retrospective application of reinterpreted tax rules, as in the Vodafone case, and government's inability to meet budget commitments on reducing fuel subsidies. The problem here is not petrol, for which prices were raised, but below cost pricing of diesel, LPG and kerosene, which account for the bulk of fuel subsidies.

An unfortunate outcome of India's coalition arithmetic is that a small regional party can block reforms at the cost of incalculable loss to the economy and the exchequer: jobs, output, revenue, market capitalisation, etc. The ruling party itself is also afraid of taking any tough decisions. The excuse was UP elections yesterday, it is presidential polls today, and it will be Gujarat elections tomorrow. The fact is that no one has tested how some bold reforms will actually affect votes. If anything, there was a negative result from the UP elections. Populism paid no dividends. The ruling party avoided all the tough decisions, and yet got a drubbing. Perhaps it is not a bad thing. Samajwadi Party's success has curbed Didi's capacity to punch above her weight.

Can these negative short-term factors be rolled back? On Europe, we shall just have to wait and see how things play out. On the domestic front, if the government can introduce even a few key reforms, negative market sentiments could turn around fairly quickly, investor confidence could be restored, and the underlying forces of high growth could reassert themselves. Prime Minister Manmohan Singh's candid admission, during a recent meeting to review key infrastructure projects, that there is a problem that needs fixing helped to arrest the gloom. The stock market has turned around and the rupee too has stabilised, at least temporarily.

But promises are no longer enough to power a sustained recovery. Delivering some solid results is essential. Where there is strong opposition to particular reforms, within or outside the UPA, progress will be slow. However, no such political constraint holds up the implementation of projects. Rapid, visible progress on some of those key infrastructure projects could turn around investor sentiments. Otherwise, as a recent Standard & Poor's report has warned, things could get worse. India could soon become the only Brics economy that slid to junk bond status.

The writer is emeritus professor at the National Institute of Public Finance and Policy, New Delhi.