Pushing Through Reforms

Will the change of guard in the finance ministry reverse the present economic trend?

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For several months now, the economic news has been exceptionally depressing. Will the change of guard in the all-important ministry of finance make any difference? In his first innings as finance minister P Chidambaram had initiated the direct taxes code, pushed the introduction of the goods and services tax, and demonstrated his strong commitment to fiscal consolidation and the FRBM Act, until things came apart in 2008. During that period the investment rate peaked, growth soared to over 9%, real wages rose, the stock market rose, and more foreign capital flowed in than at any time earlier. Can he repeat that act?

During the first week of his new innings at finance, Chidambaram quickly put together his team of key officers. Since then there has been a flurry of announcements, pointing to the resumption of reforms. The Shome committee is reviewing GAAR. Another committee is revisiting the reinterpretation of tax laws with retrospective effect, a move with ramifications much wider than the Vodafone case. Yet another committee under Vijay Kelkar, with some of his 13th Finance Commission colleagues, will examine how to return to the fiscal consolidation path they had laid out earlier. Assembling an effective team of economic administrators and technocrats was a necessary first step. It gave the right signals. But rebuilding investor confidence will require the actual implementation of at least a few key reforms. This is where Chidambaram is likely to face his toughest constraints: administrative inertia and political resistance.

The 1991 reforms are usually attributed to Manmohan Singh, C Rangarajan, Montek Singh Ahluwalia, and a few other economists in government. Politicians like Narasimha Rao and Chidambaram himself are credited with having provided the necessary political leadership. However, the key role that the late A N Verma played remains an untold story. As principal secretary in the PMO, he made sure that the bureaucracy got things done, banging heads or patting shoulders as necessary. Today, once again, key civil servants in the PMO and the finance ministry need to play that catalytic role. It is a strong team and they can probably deliver at the administrative level.

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Can there be a revival of the spirit of 1991?

But political constraints are quite another matter. There are barriers to reform at three different levels in this terrain. First, there is the official opposition, the NDA and the Left parties. Then there is possible opposition from Congress partners within the UPA, and some of its allies. Finally, within the Congress party itself there is a preference for populist measures, and tough reforms are opposed. Any reform that requires legislation will depend on the arithmetic of votes in Parliament. The Left and the NDA by themselves cannot successfully block any legislation, except constitutional amendment requiring two-thirds majority in Parliament. Reform legislation will therefore depend on whether or not such legislation can get past the second barrier, UPA partners and allies. Pension reform, insurance reform and introduction of the goods and services tax belong to this category. All of these will take time. The last in particular will be difficult because it requires a constitutional amendment and agreement with all the states.

There is another class of reforms, which do not require any legislation, and could get past the first two barriers through simple executive decisions. FDI in multi-brand retail and civil aviation or cutting the diesel subsidy belong to this group. The Left and the NDA, and some of the UPA partners or allies, could oppose these reforms and may even agitate against them. But they cannot block these reforms in Parliament. It is unlikely, though, that the government would ram through such reforms if allies or partners like Trinamool Congress and SP make common cause with NDA and the Left against these reforms. More important, there is likely to be strong opposition to these reforms from within the Congress itself, the third barrier.

This is the political arithmetic underlying the gridlock which we call "policy paralysis". Can we then expect any mileage from the change of guard in the ministry of finance? One area in which Chidambaram can move quickly is reduction of the fiscal deficit. The switch from a positive to a negative list in service tax is already generating huge additional revenue, on top of additional collections from the increase in excise rates. Realisations from re-auction of 2G spectrum will also be a great bonanza, in addition to larger realisations this year from the sale of PSU equity. With these revenue gains the deficit reduction target should be met, even without a large immediate reduction in the diesel subsidy.

Diesel prices would still need to be raised, perhaps in small doses, for a cumulative impact on expenditure compression by next year, when the one-shot bonanza from spectrum sale will not be available. Softening of global oil prices would also help. Meanwhile, a reduction in the fiscal deficit will create space for RBI to lower policy rates if inflation cools down. These two policy moves would have a strong positive impact on investor confidence, especially if combined with investor-friendly resolutions of the GAAR issue and the Vodafone muddle. That in turn could reverse the decline in investment and drive up the rate of growth.

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