Opinion | The growth outlook and the investment potential of states

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The Indian economy is now growing at over 7% per year despite an uncertain external environment and mixed domestic conditions. Provisional estimates indicate that the economy grew at 6.7% during fiscal year 2017-18 (FY18). But high frequency quarterly data in the same estimates also indicate that the growth cycle bottomed out in the first quarter of FY18 and growth has exceeded 7% since the third quarter of FY18. Based on these high frequency indicators, which are much sharper than the blunt annual estimates, virtually all official and private forecasts, both domestic and international, have projected that the economy will grow at over 7% during FY19. This is not as high as the 8.7% average growth recorded during FY07 to FY11 as per the recent backcasting of the new gross domestic product (GDP) series (2011-12 base) in the report of the National Statistical Commission’s Committee on Real Sector Statistics. But it marks an upturn compared to the 6.8% average growth for the period FY12 to FY18.

This return to 7% plus growth is quite remarkable given the mixed growth environment. Despite robust growth in the US and other advanced economies, the external outlook remains grim with gradual monetary tightening in these countries, elevated oil prices, and the Donald Trump-triggered tariff war. Internally, the price situation is still benign. But rainfall is still in deficit in large parts of the economy, though the situation is improving. The economy has also not yet fully recovered from the shocks of demonetization and the goods and services tax (GST), though their short-term growth effects seem to be fading.

That growth has remained high despite this mixed environment has much to do with the fact that a large part of the economy, particularly relating to agriculture and the public services segment, is supply-driven and independent of demand-side market sentiments.

Though these supply-side drivers reappear on the demand side because of the circular flow of income, there are clearly limits to such supply-driven growth, as opposed to productivity or demand-driven growth. For the growth prospects of what Indira Rajaraman has called the “core economy" (Mint, 6 July)—the economy excluding agriculture and public services—investment is perhaps the single most important driver, especially when the export outlook is bleak.

The quarterly data cited earlier indicates that along with overall growth, the growth of real investment or gross fixed capital formation (GFCF) also bottomed out in the first quarter of FY18 and has risen since then. But the recovery remains weak and the investment rate (GFCF/GDP) remains well below the peak rate of 34.3% achieved in FY12. Revival of the private investment cycle is key in this context as private investment is the main component of real capital formation.

Macroeconomic factors like the aggregate fiscal and monetary policy stance are clearly critical for revival of the private investment cycle. So are structural policy reforms such as the GST and the Insolvency and Bankruptcy Code (IBC), though the recent reversal of reforms in trade and tariff policy has been disappointing. Apart from strengthening indirect tax compliance, GST is unifying India into a vast common market. Similarly, the IBC should help break the banking sector gridlock, which is perhaps the most important macro-level roadblock to reviving the private investment cycle.

Apart from these macro or countrywide factors, investment conditions in individual states are also critical for private investment. These state-specific conditions on the ground ultimately determine the success or failure of investment projects and, therefore, affect aggregate trends. They also determine the geography of growth, whether growth is likely to converge or diverge across states going forward. In this context, the NCAER State Investment Potential Index (N-SIPI) report recently released by the National Council of Applied Economic Research is quite revealing. The N-SIPI has ranked 20 major states and the Union territory of Delhi for their investment potential based on indicators for six major pillars—land, labour, infrastructure, economic climate, political stability and governance. Apart from other information, the N-SIPI also incorporates the perceptions of entrepreneurs, based on a survey of 1,049 industrial establishments.

The land pillar is based on factors such as land availability, land policy, transaction efficiency, and price. The six states ranked as the best performers according to this pillar are, respectively, Telangana, Madhya Pradesh, Tamil Nadu, Kerala, Andhra Pradesh, and Maharashtra. The states ranked as the worst performers on this count are Chhattisgarh, Odisha and Uttarakhand.

The availability of an educated and appropriately skilled workforce and competitive wages are central to the labour pillar. Tamil Nadu, Andhra Pradesh, Karnataka, Uttar Pradesh, Kerala and Maharashtra are ranked as the best performers on this count, while Assam, Madhya Pradesh and Jharkhand are ranked at the bottom. Interestingly, there is an inverse relationship between the number of technically educated people in a state and perceptions about the availability of skilled labour, indicating that the kind of technical education being provided is inappropriate.

The infrastructure pillar includes road density, road and rail connectivity, and availability of power relative to demand. It also includes availability of credit, which is unusual. In terms of this pillar, Delhi, Punjab, Maharashtra, Haryana, Kerala and Tamil Nadu are ranked at the top. Surprisingly, Gujarat which has generally been known for its good infrastructure, is no longer among the top 6 states. This does not mean that infrastructure in Gujarat has deteriorated but that some of the other states have moved ahead faster since the rankings are relative.

The economic climate pillar combines a broad spectrum of parameters like government policy, market demand, resource endowments as well as levels of per capita income. There are also feedback loops between the growth rate and the investment potential of a state. On the other hand, high dynamism and concentration of industries can generate negative externalities of congestion, including high rental values and wages, overload on the infrastructure, and pollution. Incorporating all these factors, the economic climate pillar ranks Delhi, Telangana, Gujarat, Maharashtra, Karnataka, and Andhra Pradesh as the top 6 states, while Uttar Pradesh, Punjab and Bihar are ranked at the bottom.

The governance and political stability pillar includes components like the maintenance of law and order, crime, corruption, efficiency of government processes and political equity as reflected in the proportion of legislators in assemblies with criminal records. Tamil Nadu, Haryana, Punjab, Gujarat, Madhya Pradesh and Karnataka are ranked as the top 6 by this pillar, while Telangana, Bihar and Himachal Pradesh are placed at the bottom.

Pulling together the rankings by all the pillars, Delhi, Tamil Nadu, Gujarat, Haryana, Maharashtra, and Kerala are ranked as the top 6 in that order. Bihar, Jharkhand, and Assam are placed at the bottom along with Uttar Pradesh and Odisha.

Questions can be raised about specific methods of compiling individual indicators or about the nature of the data. However, some differences notwithstanding, the classification of best- and worst-performing states is consistent with other ranking exercises relating to the business environment in states, such as the "Ease of Doing Business" rankings of the Department of Industrial Policy and Promotion. It is also broadly consistent with our own earlier exercise that assessed the performance of states through a different lens, namely their service delivery performance (Mundle, Choudhury, Sikdar, "The Governance Performance of States", Economic & Political Weekly, 3 September 2016). This robustness across different exercises suggests that the N-SIPI rankings are reasonably objective.

There is some churn in the rankings compared to earlier N-SIPI rounds, with some states moving up or down in the rankings. But the one change that stands out in this round is the dramatic rank improvement of West Bengal. It has moved up from the bottom of the league tables to 10th position in overall ranking. In the perception survey, it has moved up even further to third position, just behind Gujarat and Haryana.

Another important takeaway is the variation in performance across pillars for individual states. Telangana, for instance, is among the best performers in terms of the land pillar and also the economic climate pillar but among the worst performers for the governance and political stability pillar. Similarly, Gujarat is the third-best performer in overall ranking after Delhi and Tamil Nadu, but it is no longer among the top performers for the infrastructure pillar, or for the land and labour pillars.

On policy issues cutting across states, the survey results suggest that ground realities are quite different from prevailing presumptions about the key constraints. Over 86% of respondents said they had no problem acquiring land. Similarly, over 68% of respondents reported no problem in the availability of skilled labour. On the transition to GST, only 15% of respondents reported it was a severe problem against 56% who reported it was no problem. Over 83% reported that following GST their business prospects were either better (40%) or the same (43%).

These positive perceptions of the surveyed entrepreneurs are consistent with the macroeconomic assessment presented earlier that though the investment rate is still below its past peak, the investment and growth cycles are beginning to revive. However, the N-SIPI report confirms an emerging pattern of divergence, with some states being left behind, which is a cause for serious concern.

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