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Uttar Pradesh elections, reform and growth

During the next two years, the government is likely to focus on reforms which are almost ready to roll out or those which cannot be postponed without risking economic stability

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The dramatic outcome of the Uttar Pradesh (UP) elections is a game changer. Many had forecast after the exit polls that the Bharatiya Janata Party (BJP) would win by a handsome majority. But the awesome scale of its victory, capturing over 75% of the seats, was unexpected. It has been backed by an equally impressive victory in Uttarakhand, and the formation of BJP-led governments in Goa and Manipur. It is a great political moment for the BJP, and the *karyakartas* of the Rashtriya Swayamsevak Sangh who have powered the party to success. But it has to be recognized that in the main, this is a major victory for Narendra Modi and Amit Shah.

The dynamics of the new political balance that has now emerged will have far-reaching implications for the key political events to follow: the elections of the new president and vice-president, elections in other states and, most importantly, the next general election in 2019. Even a week is a long time in politics it is said. But unless something dramatic happens to change the current trajectory of politics, it is now virtually certain that the BJP will return to power in the next national election as well. Modi will indeed be the prime minister for at least 10 years, as he had hoped when he first became prime minister in 2014.

Given this background, it is a good time to speculate about the prospects of economic reforms. Economists often discuss the prospects of reform in the framework of a political business cycle. In a five-year term, a new government spends the first year getting itself organized. In the fourth year, its policy decisions are tempered to favourably position the ruling party for the next election and the fifth year is spent campaigning. So typically a government has just the second and third years to push through tough reforms. The Modi government will soon be completing the third year of its political cycle and it should start getting into election mode after that. However, the virtual certainty of a second term makes the cycle somewhat elastic without altogether eliminating it. Elections will still have to be won in 2019 and the massive popular support for Modi and the BJP will have to be sustained. Hence, notwithstanding the dramatically favourable UP election outcome despite demonetization, it is unlikely that the government will want to launch any major painful reform until after the 2019 general election.

Thus, during the next two years the government is likely to focus on reforms which are almost ready to roll out or those which cannot be postponed without risking economic stability. Also, all reforms are not bitter pills. So the government may also initiate those reforms which will be welcomed by the electorate. Other, tougher reforms could be postponed to the second term of the Modi government.

To put the reform question in perspective, let me turn briefly to the growth outlook. Much was made of the Central Statistics Office's (CSO's) second advance estimate of 7.1%, which allegedly negated any negative impact of demonetization. However, this growth rate referred to gross domestic product (GDP) at market prices, which adds tax revenue net of subsidies to the value added at basic prices. As the table shows, value added at basic prices grew at 6.7%, distinctly lower than the 7.8% in 2015-16. Further, disaggregating total value added between production sectors relatively insensitive to demonetization, such as agriculture, utilities and public services, and sectors expected to be more affected, i.e., industry and other services, which account for 70% of total value added, the official estimates do show a sharp growth dip in the latter from 6.7% in 2015-16 to only 4.5% in 2016-17.

This is despite the fact that the CSO's advance estimates are based on assumptions and proxies that cannot capture the full impact of a shock like demonetization. Moreover, the statistical picture was distorted because of all the gaming that went on to escape the impact of demonetization. I would, therefore, reiterate my earlier forecast of 6.1% growth for 2016-17 in this column (*goo.gl/evo7Sr*). This is only slightly lower than the 6.5% growth forecast in the Economic Survey. It is also almost identical to the 6.2% real growth assumed in the government's own budget, adjusting for the CSO's implicit inflation rate of 4.8%.

In 2017-18, growth is likely to go up to over 7%, partly because of a positive base effect arising out of the dip in 2016-17. But that is conditional on two key reforms that are discussed further below. For growth to be sustained at the 7-8% level or more in the long term, we would need reforms along a much wider front. These would range from education (see my earlier column in *Mint*, *goo.gl/OVGzAH*), labour market and land market reforms to reform of regulatory laws on everything from taxation to water and power supply, buildings, environment, transportation, etc., that are currently enforced by an army of predatory inspectors.

Most of these are state subjects requiring reform at that level. Moreover, the impact of these reforms will become visible only in the medium- to long-term. The Central government can at best play an advocacy and supporting role on these during its present term. In this article, I will focus only on the two key reforms that are immediately necessary to nurse the economy back to a 7%-plus growth trajectory.

The first of these is the goods and services tax (GST). The GST council's deliberations are nearing closure. The new tax could be rolled out by July, if not earlier. The design of the multiple-rates GST is by no means ideal. The sharing of jurisdiction between the Union and states for administering the tax is also messy. We now know that the proposed arrangement is designed not to serve any larger national interest but simply to accommodate the self-serving turf interests of tax officials from the Central Board of Excise and Customs.

Nevertheless, it is better to have the GST, however flawed the design, than not have it. The design faults can always be ironed out later. Launching the GST will be the culmination of a long campaign that started over 10 years ago. It will create for the first time a unified Indian common market without multiple state-tax regimes and tax barriers. It will also create a tax credit chain that will eliminate cascading, or tax on tax. The associated information chain will also make indirect-tax evasion more difficult. Undoubtedly the most far-reaching reform since the grand reform programme of 1991, I am confident that it will eventually emerge as a global best practice model for value-added tax systems in countries with a complex multiple tax jurisdiction system and federal polity like ours. For the economy, it will be a strong positive shock.

The Advance Estimate puzzle

Sector	Share in GVA (%) 2016 17	Growth rates (%) 2015-16	Growth rates (%) 2016-17
Agriculture and allied activities	15.1	0.8	4.4
Utilities	2.1	5.1	6.6
Public services (including security and defence)	12.8	6.9	11.2
Industry and other services	70	6.7	4.5
GVA at basic price	100	7.8	6.7
GDP at market prices	--	7.9	7.1

Source: Central Statistics Office

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The second urgent reform is resolution of what the Economic Survey has called the twin balance sheet (TBS) problem

What is the TBS problem? The growth boom around the mid-2000s was financed, among other sources, by a dramatic increase in bank credit, which doubled between 2004-05 and 2008-09. But then conditions turned sour. First, there were huge cost and time overruns. Then the global financial crisis hit. Growth was halved, disrupting all the projections underlying investment programmes. Rupee depreciation and interest-rate hikes raised the cost of debt. Squeezed between higher costs, reduced revenue and higher cost of money, companies soon ran into debt-servicing problems.

In 2013, nearly a third of corporate debt was owed by companies with an interest liability to cash flow ratio of less than 1 (ICI companies). By 2015, that share had risen to around 40%. Corporate debt stress was also reflected in bank balance sheets. Non-performing loans (NPAs) had risen to 12% of GDP by 2015. In its excellent analysis of the problem, the Economic Survey has estimated that stressed assets, i.e., NPAs plus restructured debt plus "ever-greened" debt, amounted to 16.6% of outstanding bank loans. For the pubic sector banks, it amounted to an alarming 20% of bank loans.

The balance sheets were not cleaned up and the problem was allowed to fester. It was hoped that by giving more time and fresh credit to debt-stressed companies, they would return to financial viability and eventually repay their debts.

These hopes have been completely belied. Private asset reconstruction companies have been able to acquire only 5% of outstanding NPAs. Restructuring debt has not helped either.

The earnings of ICI companies had remained stationary at around Rs25,000 crore per quarter till mid-2015, but then shrank to Rs20,000 crore per quarter by the end of 2015, and further to Rs15,000 crore by the third quarter of 2016. Debts of the top 10 stressed corporate groups tripled in the last six years, even as their earnings shrank. They are now registering a loss of over Rs15,000 crore per quarter. Private investment growth slowed to 5% by 2012-13 and has actually turned negative for the first time in 2016-17. Total investment has also declined in absolute terms. A financial sector-led crisis is not impending. It is already happening.

What can be done? Many proposals are on the table. Essentially, a solution strategy would require strict recognition of stressed assets and NPAs along with a combination of some debt restructuring, some equity takeover and resale for hopelessly indebted firms, some debt write off, and some discounted off-loading of stressed assets to a public asset reconstruction corporation. Such a corporation could be financed by the capital market, issue of government securities and use of Reserve Bank of India assets.

These are not easy solutions. Many obstacles lie in the way. However, procrastination will not help. The crisis will only deepen and growth could collapse. It is imperative for the government to bite the bullet and initiate firm reform measures now. For a man who could demonetize 86% of the country's currency overnight, such firm action should not be impossible, especially after his massive mandate in UP.

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