GIST OF ECONOMIC SURVEY 2017

The Economic Survey 2016-17, written by **Dr. Arvind Subramanian**, Chief Economic Advisor, bears a complete new look in terms of the format and the subject matter.

Economic Survey has provided a refreshingly realistic assessment of the many challenges facing the Indian economy in the coming years.

This year's Survey comes in the wake of a set of volatile international developments – Brexit, political changes in advanced economies-and two major domestic policy developments: the GST and demonetization.

Survey discusses and makes a point to give attention to below areas/issues:

1. Brexit and its impact
2. How Political changes in advanced economies can impact India
3. GST – its impact and benefits
4. Demonetization – short term costs and long term benefits

Other important areas to focus:

1. Short term and medium challenges:

- Addressing **Twin Balance Sheet problem** of over-indebted corporates and bad-loan-encumbered PSBs
- **Fiscal policy of Centre and States**
- **Labour-intensive employment creation**

2. Effectiveness of targeting of major current programs

3. Discussion of providing a **Universal Basic Income (UBI)**

4. Addressing the paradox situation: India's internal integration and internal trade is strong and intensive. There is ostensibly free flow of goods, people, and capital across India and yet income and health outcomes are not converging.

Note:

➢ *Aspirants have to keep track of the above areas and develop basic understanding of all*

relevant issues, and ability to analyze, and take a view on conflicting socio- economic goals, objectives and demands. The candidates must be capable of giving relevant, meaningful and succinct answers for probable questions on these above topics.

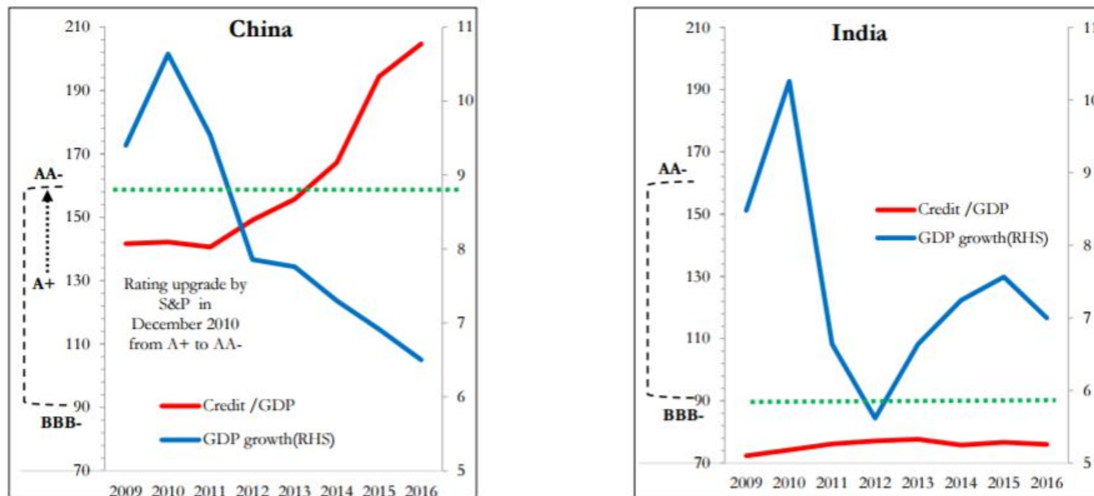
- *Improve your analytical abilities and thoughts on these topics. How the above issues will impact India and the world? Analyze critically on these issues. Think what steps should be taken? Etc.*

Eight Interesting Facts About India

Economic Survey has provided the below eight interesting facts about India:

1. **Indians on the Move:** India's internal (annual work-related) migration doubled (according to 2011 census)

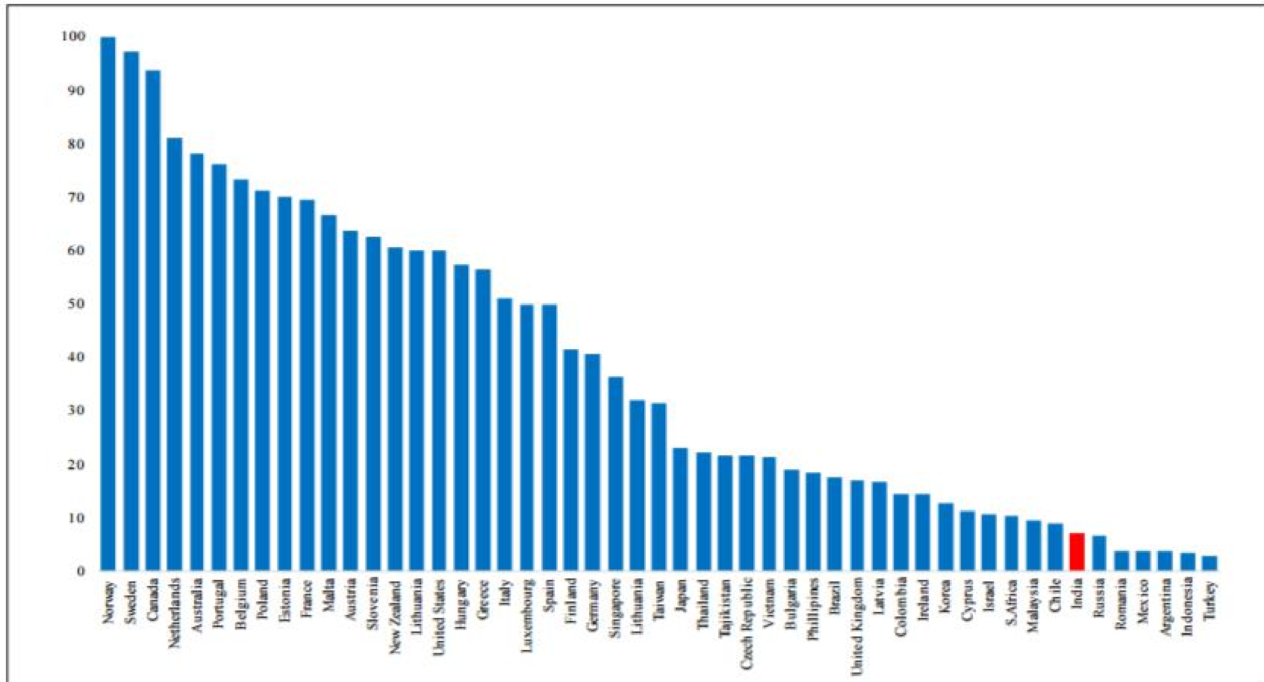
2. **Biases in Perception:** Poor rating standards by Rating Agencies – India's credit rating has remained unchanged at BBB- (even though our GDP growth increased and performing better than other countries esp. China). However, China's credit rating was upgraded from A+ to AA-, despite its growth decelerated.



3. **Weak targeting of Social programmes:** Welfare spending in India suffers from misallocation. The districts accounting for the poorest 40% receive 29% of the total funding.

4. **Political Democracy but Fiscal Democracy?:** India has 7 taxpayers for every 100 voters ranking us 13th amongst 18 of our democratic G-20 peers.

Taxpayers per 100 Voters

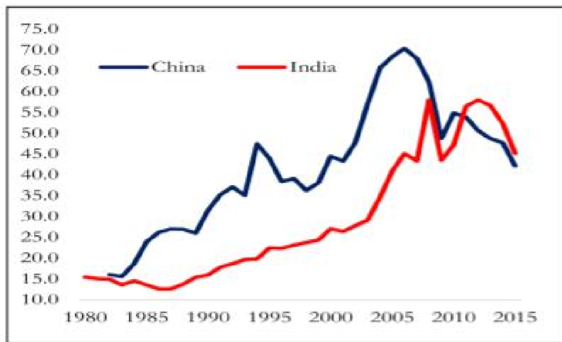


5. **India's distinctive Demographic Dividend:** India's share of working age to non-working age population will peak later and at a lower level than that for other countries but last longer.

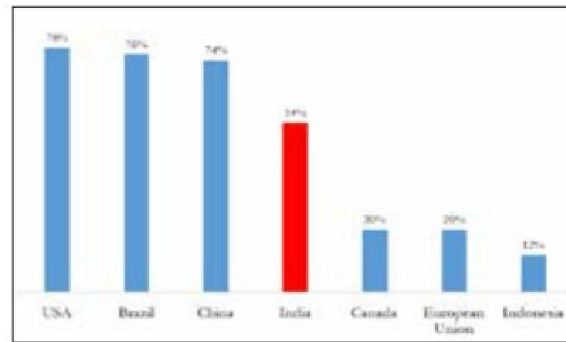
6. **India Trades More Than China and a Lot Within Itself:**

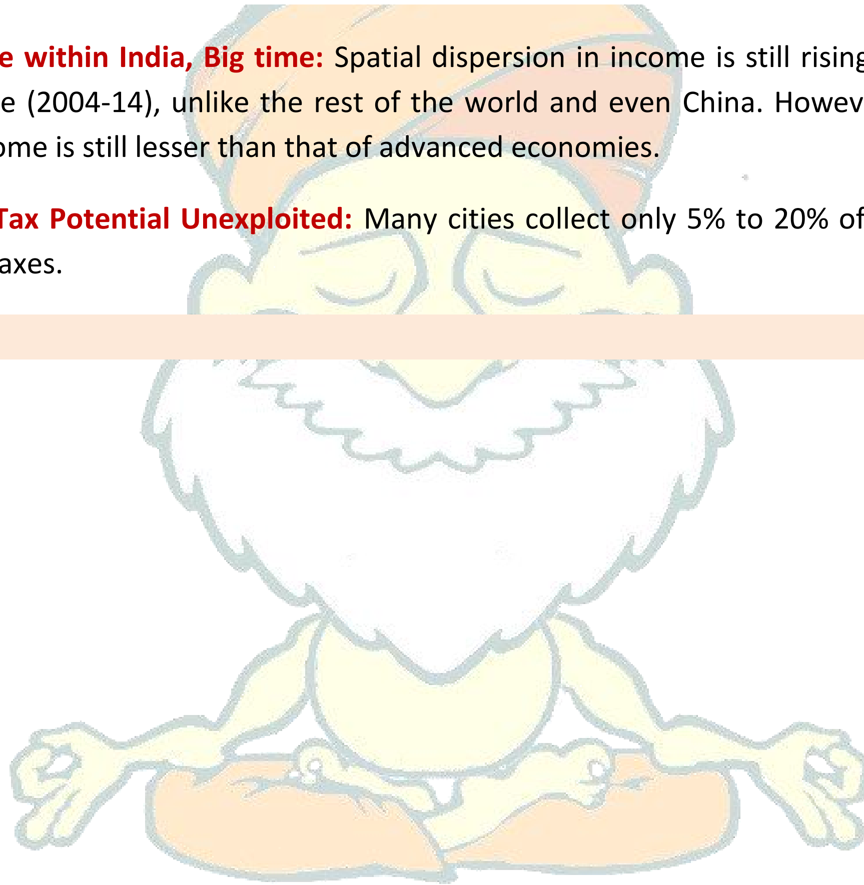
   - As of 2011, India's openness - measured as the ratio of trade in goods and services to GDP has far overtaken China's, a country famed for using trade as an engine of growth.
   - India's internal trade to GDP is also comparable to that of other large countries and very different from the caricature of a barrier-riddled economy

Trade (as percent of GDP)



Internal Trade (as percent of GDP)





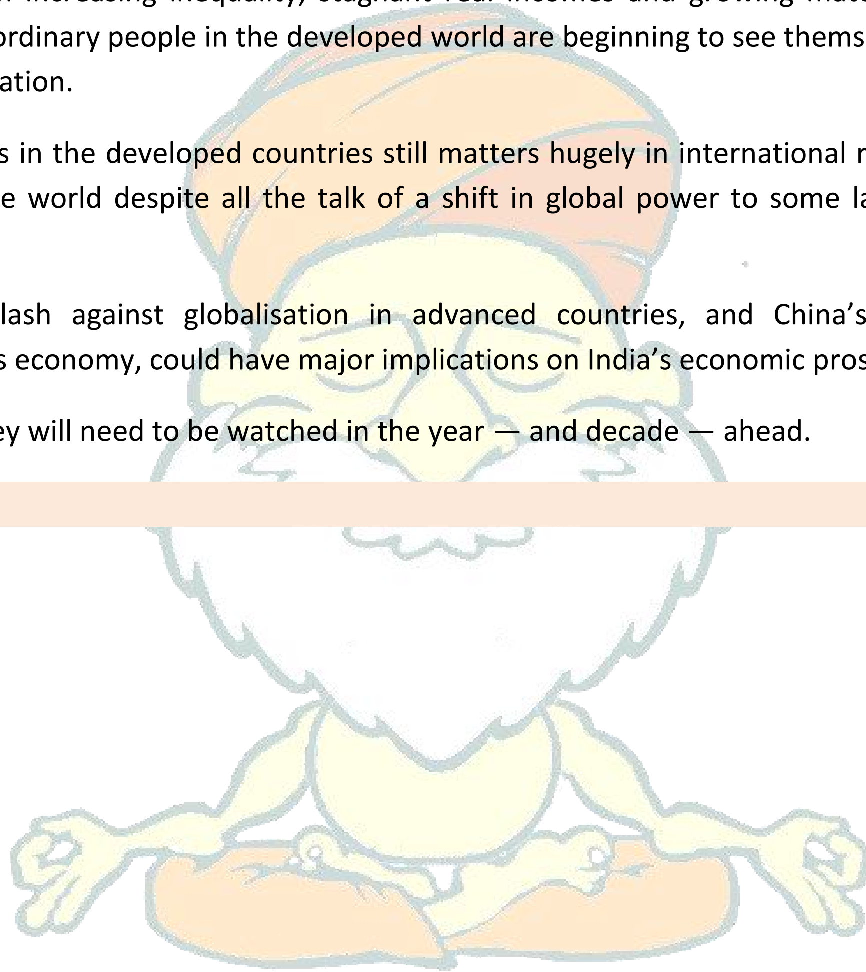
7. **Divergence within India, Big time:** Spatial dispersion in income is still rising in India in the last decade (2004-14), unlike the rest of the world and even China. However, average per capita income is still lesser than that of advanced economies.

8. **Property Tax Potential Unexploited:** Many cities collect only 5% to 20% of their potential property taxes.

IMPORTANT INTERNATIONAL DEVELOPMENTS

Political changes in advanced economies

- Appointment of Donald Trump as the Republican candidate for US President
- Rise and spread of blatantly racist anti-immigration political parties and movements in Europe
- There are tectonic shifts under way in the political discourse and practice in these countries
- Faced with increasing inequality, stagnant real incomes and growing material fragility of daily life, ordinary people in the developed world are beginning to see themselves as victims of globalisation.



What happens in the developed countries still matters hugely in international relations and to the rest of the world despite all the talk of a shift in global power to some large "emerging nations".

Political backlash against globalisation in advanced countries, and China's difficulties in rebalancing its economy, could have major implications on India's economic prospects.

Therefore, they will need to be watched in the year — and decade — ahead.

IMPORTANT DOMESTIC DEVELOPMENTS

- **Goods and Services Tax**
- **Demonetisation**
- **Other domestic policy actions**

Goods and Services Tax (GST)

The **Constitution (One Hundred and First Amendment) Act, 2016**, introduced a national Goods and Services Tax in India from 1 July 2017.

The GST is a **Value added Tax (VAT)** is proposed to be a comprehensive indirect tax levy on manufacture, sale and consumption of goods as well as services at the national level.

It will replace all indirect taxes levied on goods and services by the Indian Central and state governments. It is aimed at being comprehensive for most goods and services.

(or)

GST is a value-added tax levied at all points in the supply chain with credit allowed for any tax paid on input acquired for use in making the supply. It would apply to both goods and services in a comprehensive manner, with exemptions restricted to a minimum.

Benefits of Goods and Services Tax (GST)

1. It will create a common Indian market
2. It will improve tax compliance and governance
3. It will boost investment and growth
4. It will reduce the cascading effect of tax on the cost of goods and services
5. It is also a bold new experiment in the governance of India's cooperative federalism.
6. GST will have a far-reaching impact on almost all the aspects of the business operations in the country, for instance, pricing of products and services, supply chain optimization, IT, accounting, and tax compliance systems.

Other advantages:

1. Wider tax base, necessary for lowering tax rates and eliminating classification disputes
2. Elimination of multiplicity of taxes and their cascading effects

3. Rationalization of tax structure and simplification of compliance procedures
4. Harmonization of center and state tax administrations, which would reduce duplication and compliance costs
5. Automation of compliance procedures to reduce errors and increase efficiency

DEMONETISATION

Demonetisation

- A radical governance-cum-social engineering measure designed to tax holdings of black money.
- was enacted on November 8, 2016
- The two largest denomination notes, Rs 500 and Rs 1000—together comprising 86 percent of all the cash in circulation—were "demonetised"
- There were two previous instances of demonetisation, in 1946 and 1978, the latter not having any significant effect on cash
- But the recent action had large, albeit temporary, currency consequences.

Aim of demonetization:

1. to curb corruption
2. to curb counterfeiting
3. to curb the use of high denomination notes for terrorist activities
4. to curb accumulation of "black money", generated by income that has not been declared to the tax authorities.
5. The honest citizens want that government fights against corruption, black money, benami property, terrorism and counterfeiting.

Long-term potential of demonetization:

- greater digitalization of the economy
- increased flows of financial savings
- greater formalization of the economy
- All of which could eventually lead to higher GDP growth, better tax compliance and greater tax revenues.
- Demonetization has been a redistributive device to transfer illicit wealth from the rich to the rest, via the government.
- misuse of cash has led to artificial increase in the cost of goods and services like houses, land, higher education, health care and so on.

Thus, this move is expected to bring more transactions under tax net, both direct and indirect taxes would move up, more digital transactions will take place and reduction in parallel economy will increase the size of formal economy as more people will disclose income and pay

taxes. This will make India a more tax-complaint society.

Short-term costs or **short-term macroeconomic impacts** due to demonetization:

- inconvenience and hardship especially those in the informal and cash-intensive sectors of the economy who have lost income and employment.
- There have been reports of job losses, declines in farm incomes, and social disruption, especially in the informal, cash-intensive parts of the economy
- The benefits of lower interest rates and dampened price pressure may have cushioned the short-term macroeconomic impact.

Demonetisation affects the economy through three different channels. It is potentially:

1. an aggregate ***demand shock*** because it reduces the supply of money and affects private wealth, especially of those holding unaccounted money;

2. an aggregate ***supply shock*** to the extent that economic activity relies on cash as an input (for example, agricultural production might be affected since sowing requires the use of labour traditionally paid in cash); and

3. an ***uncertainty shock*** because economic agents face imponderables related to the magnitude and duration of the cash shortage and the policy responses (perhaps causing consumers to defer or reduce discretionary consumption and firms to scale back investments).

Follow-up actions to minimize the costs and maximise the benefits include:

Demonetisation has had short-term costs but holds the potential for long-term benefits. Below are the follow-up actions to minimize the costs and maximise the benefits include:

- fast, demand-driven, remonetisation (by supplying as much cash as necessary, especially in lower denomination notes)
- further tax reforms , including bringing land and real estate into the GST
- reducing tax rates and stamp duties
- acting to allay anxieties about over-zealous tax administration

These actions would allow growth to return to trend in 2017-18, following a temporary decline in 2016-17.

Table 2. Impact of Demonetisation

Sector	Impact	
	Effect through end-December	**Likely longer-term effect**
Money/ interest rates	Cash declined sharply	Cash will recover but settle at a lower level
	Bank deposits increased sharply	Deposits will decline, but probably settle at a slightly higher level
	RBI's balance sheet largely unchanged: return of currency reduced the central bank's cash liabilities but increased its deposit liabilities to commercial banks	RBI's balance sheet will shrink, after the deadline for redeeming outstanding notes
	Interest rates on deposits, loans, and government securities declined; implicit rate on cash increased	Loan rates could fall further, if much of the deposit increase proves durable
Financial System Savings	Increased	Increase, to the extent that the cash-deposit ratio falls permanently
Corruption (underlying illicit activities)		Could decline, if incentives for compliance improve
Unaccounted income/ black money (underlying activity may or may not be illicit)	*Stock* of black money fell, as some holders came into the tax net	Formalization should reduce the *flow* of unaccounted income
Private Wealth	Private sector wealth declined, since some high denomination notes were not returned and real estate prices fell	Wealth could fall further, if real estate prices continue to decline
Public Sector Wealth	No effect.	Government/RBI's wealth will increase when unreturned cash is extinguished, reducing liabilities
Formalization/ digitilisation	Digital transactions amongst new users (RuPay/ AEPS) increased sharply; existing users' transactions increased in line with historical trend	Some return to cash as supply normalises, but the now-launched digital revolution will continue
Real estate	Prices declined, as wealth fell while cash shortages impeded transactions	Prices could fall further as investing undeclared income in real estate becomes more difficult; but tax component could rise, especially if GST imposed on real estate
Broader economy	Job losses, decline in farm incomes, social disruption, especially in cash-intensive sectors	Should gradually stabilize as the economy is remonetized

GDP	Growth slowed, as demonetisation reduced demand (cash, private wealth), supply (reduced liquidity and working capital, and disrupted supply chains), and increased uncertainty	Could be beneficial in the long run if formalization increases and corruption falls
	Cash-intensive sectors (agriculture, real estate, jewellery) were affected more Recorded GDP will understate impact on informal sector because informal manufacturing is estimated using formal sector indicators (Index of Industrial Production). But over time as the economy becomes more formalized the underestimation will decline. Recorded GDP will also be overstated because banking sector value added is based (*inter alia*) on deposits which have surged temporarily	Informal output could decline but recorded GDP would increase as the economy becomes more formalized
Tax collection	Income taxes rose because of increased disclosure Payments to local bodies and discoms increased because demonetised notes remained legal tender for tax payments/ clearances of arrears	Indirect and corporate taxes could decline, to the extent growth slows Over long run, taxes should increase as formalization expands and compliance improves
Uncertainty/ Credibility	Uncertainty increased, as firms and households were unsure of the economic impact and implications for future policy Investment decisions and durable goods purchases postponed	Credibility will be strengthened if demonetisation is accompanied by complementary measures. Early and full remonetisation essential. Tax arbitrariness and harassment could attenuate credibility

Earlier initiatives taken by the government to curb corruption and other illicit activities:

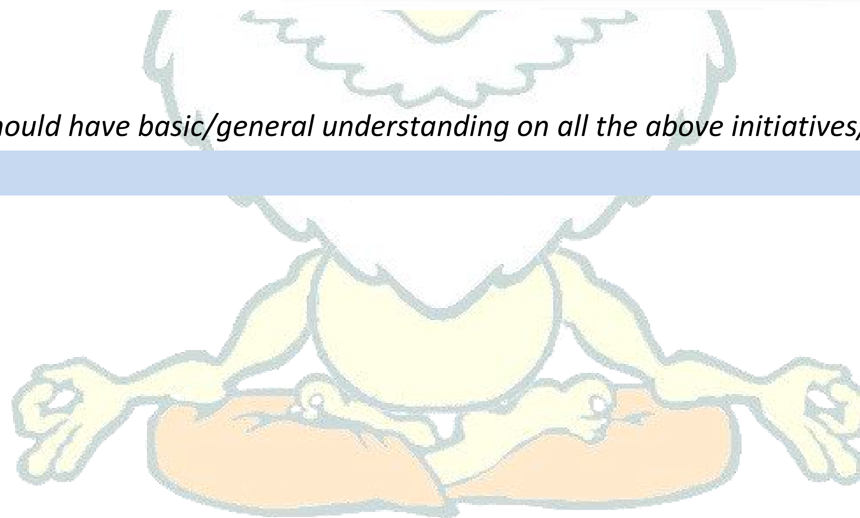
1. creation of the Special Investigation Team (SIT) in the 2014 budget
2. the Black Money Act, 2015
3. the Benami Transactions Act of 2016
4. the information exchange agreement with Switzerland
5. changes in the tax treaties with Mauritius and Cyprus, and
6. the Income Disclosure Scheme

STEPS TAKEN BY THE NARENDRA MODI GOVT SO FAR TO CURB BLACK MONEY

- The government sets up a special investigation team on black money on Supreme Court's orders.
- Government enacts the stringent Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 to curb illicit wealth abroad.
- Government enacts the Benami Transactions (Prohibition) Amendment Act, 2016 to curb black money within the country.
- Government announces one-time window for domestic tax evaders to come forward, declare their funds and pay a tax and penalty; the window sees declarations of almost Rs70,000 crore.
- Quoting of Permanent Account Number (PAN) made mandatory for all transactions above Rs2 lakh irrespective of the mode of payment
- Seeding of Aadhaar number with PAN to weed out duplicate PANs.
- Tightens income-tax return forms seeking more details from taxpayers earning more than Rs50 lakh a year.
- Rs500 and Rs1000 notes withdrawn from circulation. New Rs500 and Rs2,000 denomination notes to be issued at a later date.

Note:

- *One should have basic/general understanding on all the above initiatives/schemes*



Important policy actions other than GST and Demonetization includes:

1. **Insolvency and Bankruptcy Code 2016** - a vital reform that will make it much easier to do business in India.

Government revised the **bankruptcy laws** so that the **"exit" problem** that pervades the Indian economy **can be addressed effectively** and expeditiously.

- Last year Survey had likened the Indian economy in the 21st century to the **'Chakravyuh'** legend of Mahabharata – the **ability to enter but not exit** – cautioning the country is facing adverse consequences due to the lack of a way out for failed ventures.
- Just as a market economy requires unrestricted entry of new firms, new ideas and new technologies, it also requires an exit route so that resources are forced or enticed away from inefficient and unsustainable uses.
- **Stressed corporate and bank balance sheets** were partly because it was difficult for capital to exit enterprises or investments that had turned unprofitable.
- As a consequence, India was littered with firms that were too small and unproductive, taking up scarce resources more efficiently allocated elsewhere.

Government passed the Insolvency and Bankruptcy Code 2016 – this new bankruptcy law will ensure time-bound settlement of insolvency, enable faster turnaround of businesses and create a database of serial defaulters.
The move is also expected to help India move up from its current rank of 130 in the World Bank's ease of doing business index.
Overall this legislation is a huge step towards the ease of doing business in India and has the potential to bring business practices in India closer to more developed markets over the long term.

2. **More autonomy to RBI or monetary policy:**

Government codified the institutional arrangements on monetary policy with the Reserve Bank of India (RBI), to ensure that inflation control will be less susceptible to the whims and fancies of individual or governments.

3. **Solidified the legal basis for Aadhaar:**

- Union Government notified the **UIDAI (Terms and Conditions of Service of Chairperson and Members) Rules, 2016** to give legal status to Unique Identification Authority of

India (UIDAI).

- Solidifying the legal basis for Aadhaar helps to realise the long-term gains from the JAM trifecta (Jan Dhan-Aadhaar-Mobile)

4. **Reforms in clothing sector:**
   - Government enacted a package of measures to assist the clothing sector that by virtue of being export-oriented and labour-intensive could provide a boost to employment, especially female employment.
   - The Rs 6,000 crore package announced in 2016 for textiles and apparel sector was a step in the right direction but the industry needs lot of reforms for the revival of the growth.
   - Government has set a target to create another 30 million more jobs in the industry over the next three years.

5. **Unified Payments Interface (UPI) platform by National Payments Corporation of India (NPCI)**

   - UPI will make e-commerce transactions easier— improvement in the ease of making payments, the ease of saving and the ease for buying financial products
   - UPI will allow customers to instantaneously transfer funds across different banks with the use of a single identifier which will act as a virtual address and eliminate the need to exchange sensitive information such as bank account numbers during a financial transaction
   - By facilitating inter-operability it will unleash the power of mobile phones in achieving digitalization of payments and financial inclusion, and making the "M" an integral part of the government's flagship "JAM"-Jan Dhan, Aadhaar, Mobile-- initiative.

6. **FDI reform measures**
   - FDI reform measures were implemented, allowing India to become one of the world's largest recipients of foreign direct investment.
   - FIPB abolished, more measures to attract FDI
   - With more than 90 per cent of the foreign direct investment proposals coming through the automatic route, the finance minister said it was only logical to phase out the FIPB, the body which clears FDI plans up to Rs 5,000 crore.
   - The government will announce more measures to attract FDI (through further liberalisation of FDI policy), reform labour laws and push digital payments.

These measures cemented India's reputation as one of the few bright spots in an otherwise grim global economy. India is not only among the world's fastest growing major economies, underpinned by a stable macro-economy with declining inflation and improving fiscal and external balances. It was also one of the few economies enacting major structural reforms.

Yet there is a gap between this reality of macro-economic stability and rapid growth, on the one hand, and the perception of the ratings agencies on the other. **Why so? Box 1 elaborates on the possible reasons.**

Box 1. Poor Standards? The Rating Agencies, China & India

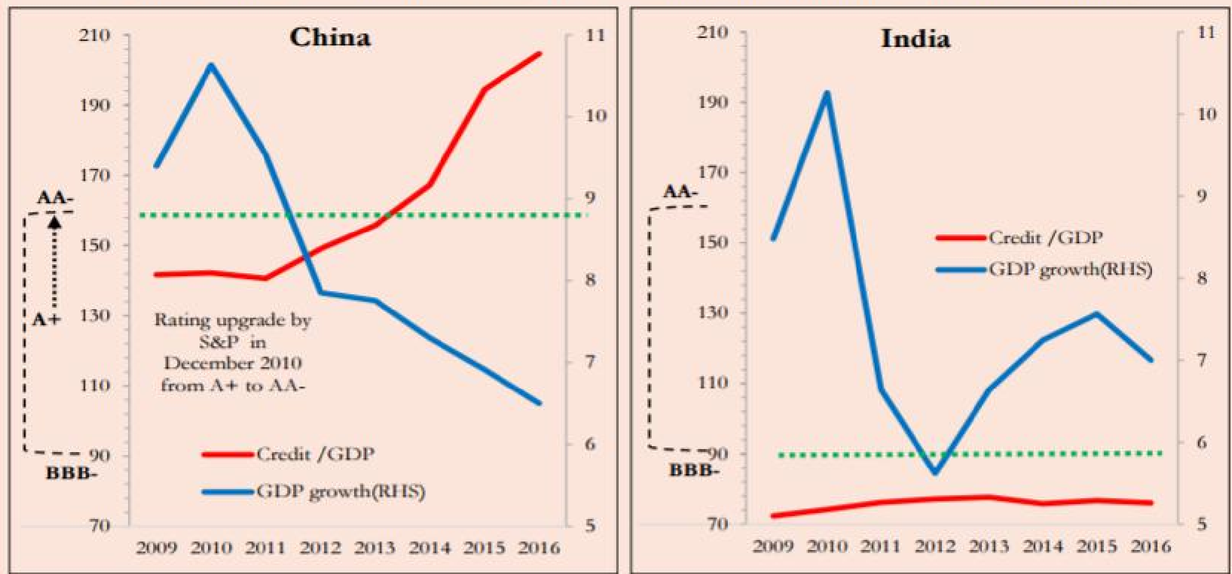
In recent years, the role of ratings agencies has increasingly come into question. In the US financial crisis, questions were raised about their role in certifying as AAA bundles of mortgage-backed securities that had toxic underlying assets (described in Michael Lewis' *The Big Short*). Similarly, their value has been questioned in light of their failure to provide warnings in advance of financial crises—often ratings downgrades have occurred post facto, a case of closing the stable doors after the horses have bolted (IMF, 2010; Krugman, September, 2015[2]).

But it is also worth assessing their role in more normal situations. In the case of India, Standard & Poor's in November 2016 ruled out the scope for a ratings upgrade for some considerable period, mainly on the grounds of its low per capita GDP and relatively high fiscal deficit. The actual methodology to arrive at this rating was clearly more complex. Even so, it is worth asking: are these variables the right key for assessing India's risk of default?

Consider first per capita GDP. It is a very slow moving variable. Lower middle income countries experienced an average growth of 2.45 percent of GDP per capita (constant 2010 dollars) between 1970 and 2015. At this rate, the poorest of the lower middle income countries would take about 57 years to reach upper middle income status. So if this variable is really key to ratings, poorer countries might be provoked into saying, "Please don't bother this year, come back to assess us after half a century."

Consider next fiscal variables. The practice of ratings agencies is to combine a group of countries and then assess comparatively their fiscal outcomes. So, India is deemed an outlier because its general government fiscal deficit ratio of 6.6 percent (2014) and debt of 67.1 percent are out of line with its emerging market "peers" (See Table 1 in Chapter 5).

But India could be very different from the comparators used by the ratings agencies. After all, many emerging markets are struggling. But India has a strong growth trajectory, which coupled with its commitment to fiscal discipline exhibited over the last three years suggests that its deficit and debt ratios are likely to decline significantly over the coming years. Even if this scenario does not materialise, India might still be able to carry much more debt than other countries because it has an exceptionally high "willingness to pay", as demonstrated by its history of not defaulting on its obligations (Reinhart, Rogoff and Savastano, 2003).

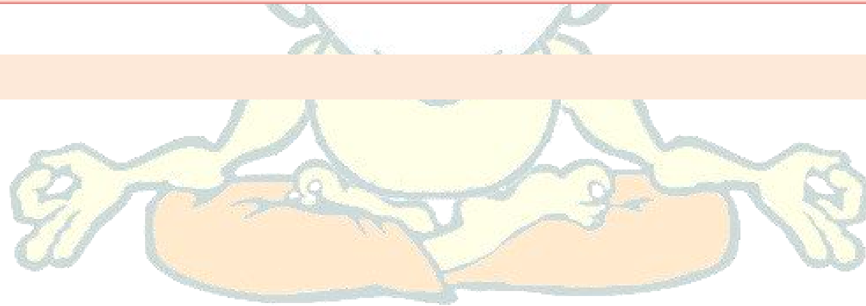


India also compares favourably to other countries on other metrics known to be closely related to the risk of default. Consider the contrast with China. In 2009, China launched an historic credit expansion, which has so far seen the credit-GDP ratio rise by an unprecedented about 63 percentage points of GDP, much larger than the stock of India's credit-GDP (Figure). At the same time, Chinese growth has slowed from over 10 percent to 6.5 percent.

How did Standard and Poor's react to this ominous scissors pattern, which has universally been acknowledged as posing serious risks to China and indeed the world? In December 2010, it increased China's rating from A+ to AA- and it has never adjusted it since, even as the credit boom has unfolded and growth has experienced a secular decline.

In contrast, India's ratings have remained stuck at the much lower level of BBB-, despite the country's dramatic improvement in growth and macro-economic stability since 2014.

These contrasting experiences raise a question: can they really be explained by an economically sound methodology?



Domestic challenges that India is facing today

Especially after 1991, India has progressively made considerable strides in improving the management of the economy. Yet much more needs to be done to realize its ambitions -

1. Accelerate growth
2. Expand employment opportunities
3. Achieve social justice

PUBLIC vs. PRIVATE:

India is not yet following the standard development model.

Broader societal shifts are required in ideas and narratives to address three long-standing meta-challenges:

- **First,** there has been a hesitancy to embrace the private sector and to unambiguously protect property rights, combined with continued reliance on the state to undertake activities that are more appropriately left to the private sector.
- **Second,** state capacity has remained weak, as can be seen from poor delivery of essential services.
- And **third,** redistribution has been simultaneously extensive and inefficient.

1. Ambivalence about private sector and property rights

All states, all societies, have some ambivalence toward the private sector. After all, the basic objective of private enterprises – maximizing profits – does not always coincide with broader social concerns, such as the public's sense of fairness.

But the state of having mixed feelings or contradictory ideas towards private sector in India seems greater than elsewhere. It appears that, **India has distinctly anti-market beliefs** relative to others, even compared to peers with similarly low initial GDP per capita levels.

The symptoms of this ambivalence (mixed feelings or contradictory ideas) toward the private sector can be manifested in multiple ways:

- The most well-known example is the **difficulty of privatizing public enterprises**, even for

firms where economists have made strong arguments that they belong in the private sector.

- Consider the **civil aviation sector**. Defying history, there is still the commitment to make the perennially unprofitable public sector airline "world class." Recently, airport privatization has taken the form of awarding management contracts rather than change in ownership. Moreover, policy reform in the sector has been animated as much by an interventionist as liberalizing spirit, reflected for example in restrictions on pricing.

- A similar spirit pervades the policy approach to the banking sector. Discussion of **disinvesting the government's majority stake in the public sector banks** is often difficult in part because of the view that they are legitimate instruments for the state to allocate and redirect resources.

- The **agriculture sector is entwined in regulation**, a living legacy of the era of socialism. While progress has been made in the last two years, producers in many states are still required by the Agricultural Produce Marketing Act to sell only to specified middlemen in authorized markets (mandis). And when this system nonetheless generates price increases deemed to be excessive, the Essential Commodities Act is invoked to impose stock limits and controls on trade that are typically procyclical, thereby exacerbating the problem.

- A similar legacy from the past circumscribes **property rights**. Initially the right to property was inscribed as a "fundamental right" in the Constitution. But during the socialist era the 44th Amendment removed Articles 19 (1) (f) and Article 31 and replaced them with Article 300-A, thereby downgrading property to that of a "legal right".

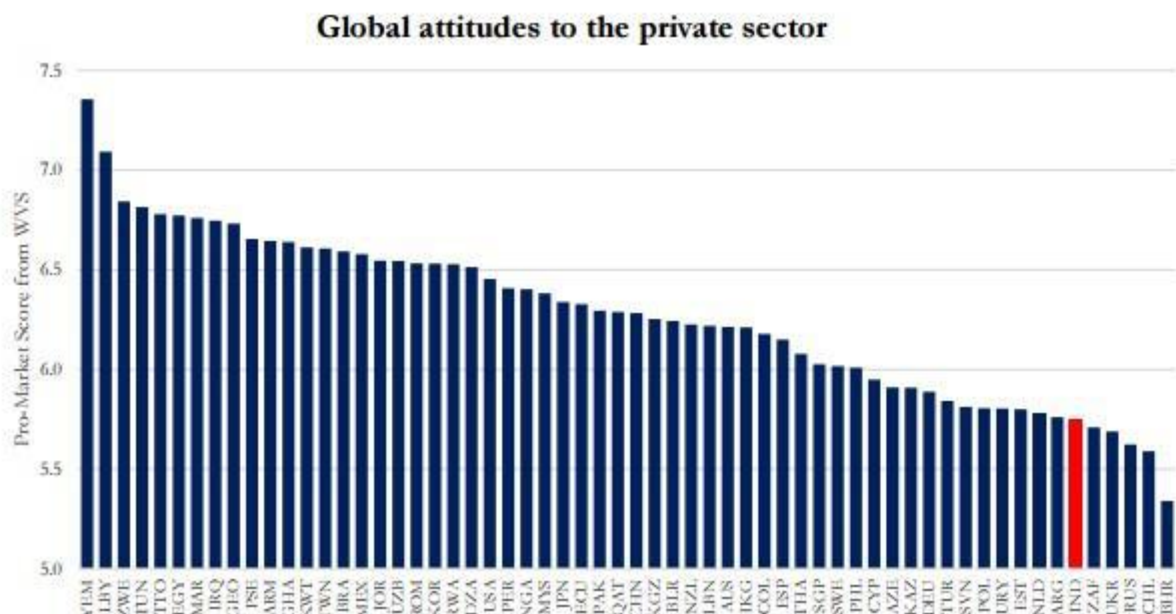
- The ramifications of this decision continue to be felt to this day, in such issues as **retrospective taxation.** The government has made clear its commitment not to act retroactively on tax and other issues. But the legacy issues of retroactive taxation remain mired in litigation, with uncertain prospects for early resolution.

- Any (expropriation) action by the state or an authority of taking property from its owner for public use or benefit is being seen as favouring the private sector, especially the foreign private sector.

Gist: All these anti-market or anti-private laws and excessive intervention by public sector have hampered private investment and hence aggregate growth. One important reason this problem has not been resolved in the many years is the political difficulty to take decisions favouring private sector.

Therefore broader societal shifts are required in ideas and narratives to address these

problems.



2. State Capacity

A second distinctive feature of the Indian economic model is the weakness of state capacity, especially in delivering essential services such as health and education.

Nearly all emerging markets started off with weak state capacity at independence. But as their economies developed and prospered, state capacity improved, often at an even faster rate than the overall economy. In India, by contrast, this process has not occurred.

Reason: The Indian state has low capacity, with high levels of corruption, clientelism, rules and red tape.
There were some recent measures taken by the government to strengthen state capacity in delivering essential services and regulating markets, such as

- Bringing reforms in public distribution system (PDS)
- Reforms in the power sector to improve delivery and cost recovery

However, on health and education in particular, there are insufficient instances of good models that can travel widely within India and are seen as attractive political opportunities.

There is abundant caution in bureaucratic decision-making, which favours the status quo.

For example, in the case of the twin balance sheet problem, it is well-known that senior managers in public sector banks are reluctant to take decisions to write down loans for fear of being seen as favouring corporate interests and hence becoming the target of the referee institutions, the so-called "4 Cs": courts, CVC (Central Vigilance Commission), CBI (Central Bureau of Investigation) and CAG (Comptroller and Auditor General). This encourages ever-greening of loans, thereby postponing a resolution of the problem.

3. Inefficient redistribution

- Third distinctive aspect of the Indian development model.
- Redistribution by the government is far from efficient in targeting the poor. Welfare spending suffers from considerable misallocation: the districts with the most poor suffer from the greatest shortfall of funds.
- This leads to: exclusion errors (the deserving poor not receiving benefits), inclusion errors (the nonpoor receiving a large share of benefits) and leakages (with benefits being siphoned off due to corruption and inefficiency).
- The central government alone runs about 950 central sector and centrally sponsored schemes and sub-schemes which cost about 5 percent of GDP.
- In India for past long we have witnessed that our subsidy programmes are benefitting more the non-target groups compared to the intended beneficiary of the subsidies. Recent Economic Survey 2016 also highlights that India's rich feed off subsidies worth over Rs. 1 lakh crore a year that are meant for the poor.
- A very high leakage in distribution. Once a former PM said if government spends 100 rupees, only 15 rupees reaches the actual beneficiary.
- Mistargeting of subsidies is another problem. Many of the people, who do not actually need subsidies are also entitled to get subsidies.

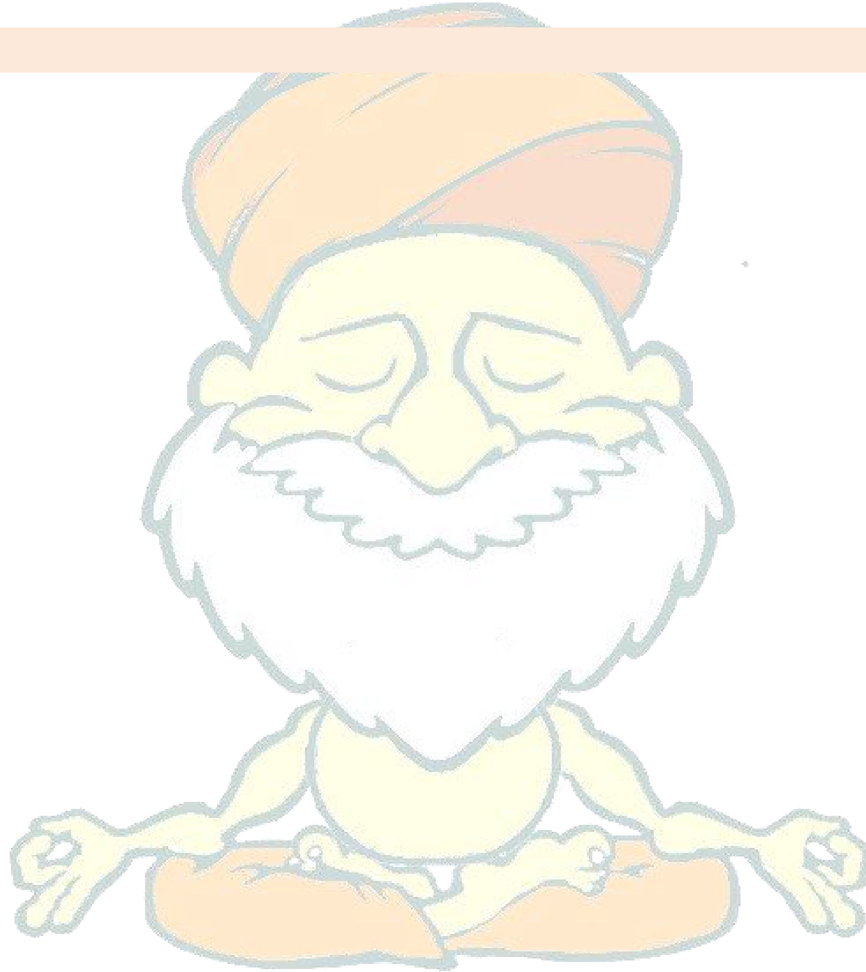
What steps have been taken by the government to improve the efficiency of redistribution?

1. The government has made great progress in **improving redistributive efficiency** over the last few years, most notably by **passing the Aadhaar law**, a vital component toward

realizing its vision of JAM.

2. Over the past two years, the government has made considerable progress toward **reducing subsidies, especially related to petroleum products**. Not only have subsidies been eliminated in two out of four products, there is effectively a carbon tax, which is amongst the highest in the world.

3. Pilot project of **Direct Benefit Transfers in fertilizer** represent a very important new direction in improving redistributive efficiency.



Universal Basic Income

The Survey has advocated the concept of Universal Basic Income (UBI) as an alternative to the various social welfare schemes in an effort to reduce poverty. The Survey points out that the two prerequisites for a successful UBI are:

(a) functional JAM (Jan Dhan, Aadhar and Mobile) system as it ensures that the cash transfer goes directly into the account of a beneficiary and
(b) Centre-State negotiations on cost sharing for the programme.

* Universal Basic Income (UBI) proposal a powerful idea, but not ready for implementation

* UBI an alternative to plethora of state subsidies for poverty alleviation

* UBI would cost between 4 and 5 per cent of GDP

The Conceptual/Philosophical Case for UBI

- Universal Basic Income is a radical and compelling paradigm shift in thinking about both social justice and a productive economy.
- It is premised on the idea that a just society needs to guarantee to each individual a minimum income which they can count on, and which provides the necessary material foundation for a life with access to basic goods and a life of dignity.
- A universal basic income is, like many rights, unconditional and universal: it requires that every person should have a right to a basic income to cover their needs, just by virtue of being citizens.

Economic Survey considers that the time has come to think of UBI for a number of reasons:

Social Justice:

- UBI is, first and foremost, a test of a just and non-exploitative society. From Tom Paine to John Rawls, nearly every theory of justice has argued that a society that fails to guarantee a decent minimum income to all citizens will fail the test of justice. It should be evident to anyone that no society can be just or stable if it does not give all members of the society a stake.
- A Universal Basic Income promotes many of the basic values of a society which respects all individuals as free and equal. It promotes liberty because it is anti-paternalistic, opens up the possibility of flexibility in labour markets. It promotes equality by reducing

poverty. It promotes efficiency by reducing waste in government transfers. And it could, under some circumstances, even promote greater productivity. It is not an accident that Universal Basic Income has been embraced both by thinkers of the Left and of the Right.

Poverty Reduction:

- Conditional on the presence of a well-functioning financial system, a Universal Basic Income may simply be the fastest way of reducing poverty. UBI is also, paradoxically, more feasible in a country like India, where it can be pegged at relatively low levels of income but still yield immense welfare gains.

Agency:

- The poor in India have been treated as objects of government policy. Our current welfare system, even when well intentioned, inflicts an indignity upon the poor by assuming that they cannot take economic decisions relevant to their lives.
- An unconditional cash transfer treats them as agents, not subjects. A UBI is also practically useful. The circumstances that keep individuals trapped in poverty are varied; the risks they face and the shocks they face also vary. The state is not in the best position to determine which risks should be mitigated and how priorities are to be set.
- UBI liberates citizens from paternalistic and clientelistic relationships with the state. By taking the individual and not the household as the unit of beneficiary, UBI can also enhance agency, especially of women within households.

Employment:

- UBI is an acknowledgement that society's obligation to guarantee a minimum living standard is even more urgent in an era of uncertain employment generation.
- Moreover, UBI could also open up new possibilities for labour markets. It creates flexibility by allowing for individuals to have partial or calibrated engagements with the labour market without fear of losing benefits. They allow for more non-exploitative bargaining since individuals will no longer be forced to accept any working conditions, just so that they can subsist.

Administrative Efficiency:

- In India in particular, the case for UBI has been enhanced because of the weakness of existing welfare schemes which are riddled with misallocation, leakages and exclusion of the poor.

- When the trinity of Jan-Dhan, Aadhaar and Mobile (popularly referred to as JAM) is fully adopted the time would be ripe for a mode of delivery that is administratively more efficient. The administrative argument however has to be made with some care. While Aadhar is designed to solve the identification problem, it cannot, on its own, solve the targeting problem.
- It is important to recognise that universal basic income will not diminish the need to build state capacity: the state will still have to enhance its capacities to provide a whole range of public goods. UBI is not a substitute for state capacity: it is a way of ensuring that state welfare transfers are more efficient so that the state can concentrate on other public goods.

The Conceptual Case Against UBI

From an economic point of view there are three principal and related objections to a universal basic income. The first is whether UBI reduces the incentive to work – a worldview encapsulated in the quote by Gandhiji above; critics conjure up images of potential workers frittering away their productivity.

This argument is vastly exaggerated

For one thing, the levels at which universal basic income are likely to be pegged are going to be minimal guarantees at best; they are unlikely to crowd incentives to work.

One school of thought would argue that it truly is a diminution of human dignity to suppose that the only motivation for which people work is necessity; take away the yoke of necessity and they will be lazy.

The same kinds of arguments used to be made against high wages: that if wages rise beyond a certain level workers will choose leisure over work. There is very little evidence to sustain that proposition.

The **second concern** is this: **Should income be detached from employment?**

The honest economic answer to this concern is that society already does this, but largely for the rich and privileged. Any society where any form of inheritance or accepting non-work related income is allowed, already detaches income from employment. So, receiving a small unearned income as it were, from the state should be economically and morally less problematic than the panoply of "unearned" income our societies allow.

The **third is a concern out of reciprocity**. If society is indeed a "**scheme of social cooperation**", should income be unconditional, with no regard to people's contribution to society?
The short answer is that individuals as a matter of fact will in most cases contribute to society,

as stated above. In fact, UBI can also be a way of acknowledging non-wage work related contributions to society.

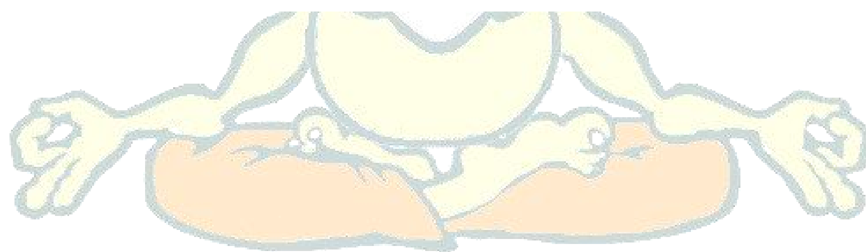
In the current social structure, for example, homemaking contributions of women are largely unacknowledged economically, since they do not take the form of wage or contract employment. It is important that UBI is not framed as a transfer payment from the rich to the poor. Its basis is rather different. UBI gives concrete expression to the idea that we have a right to a minimum income, merely by virtue of being citizens. It is the acknowledgment of the economy as a common project. This right requires that the basic economic structure be configured in a way that every individual gets basic income.

All these arguments require that UBI be indeed universal, unconditional, and involve direct transfers.

Table 1 lays out succinctly the arguments – conceptual and practical – in favour of and against UBI.

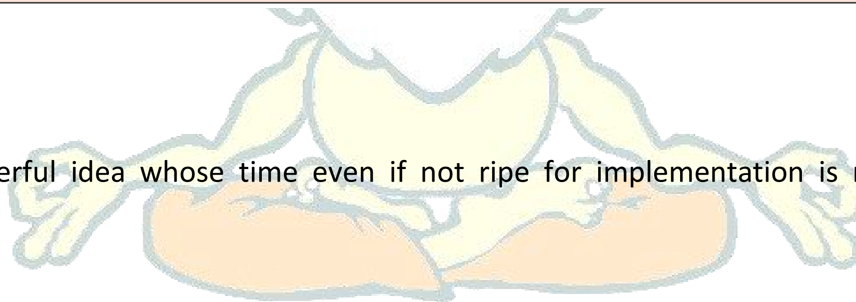
Table 1. Arguments in Favour and Against UBI

Favor	Against
Poverty and vulnerability reduction Poverty and vulnerability will be reduced in one fell swoop.	**Conspicuous spending** Households, especially male members, may spend this additional income on wasteful activities.
Choice A UBI treats beneficiaries as agents and entrusts citizens with the responsibility of using welfare spending as they see best; this may not be the case with in-kind transfers.	**Moral hazard (reduction in labour supply)** A minimum guaranteed income might make people lazy and opt out of the labour market.



Better targeting of poor As all individuals are targeted, exclusion error (poor being left out) is zero though inclusion error (rich gaining access to the scheme) is 60 percent[5].	**Gender disparity induced by cash** Gender norms may regulate the sharing of UBI within a household – men are likely to exercise control over spending of the UBI. This may not always be the case with other in-kind transfers.
Insurance against shocks This income floor will provide a safety net against health, income and other shocks.	**Implementation** Given the current status of financial access among the poor, a UBI may put too much stress on the banking system.
Improvement in financial inclusion Payment – transfers will encourage greater usage of bank accounts, leading to higher profits for banking correspondents (BC) and an endogenous improvement in financial inclusion. Credit – increased income will release the constraints on access to credit for those with low income levels.	**Fiscal cost given political economy of exit** Once introduced, it may become difficult for the government to wind up a UBI in case of failure.
Psychological benefits A guaranteed income will reduce the pressures of finding a basic living on a daily basis.	**Political economy of universality – ideas for self-exclusion** Opposition may arise from the provision of the transfer to rich individuals as it might seem to trump the idea of equity and state welfare for the poor.
Administrative efficiency A UBI in place of a plethora of separate government schemes will reduce the administrative burden on the state.	**Exposure to market risks (cash vs. food)** Unlike food subsidies that are not subject to fluctuating market prices, a cash transfer's purchasing power may severely be curtailed by market fluctuations.

Conclusion:



UBI is a powerful idea whose time even if not ripe for implementation is ripe for serious discussion.

One can easily imagine the Mahatma as fair mediator, deliberating and examining both sides of the argument carefully.

The Mahatma as the embodiment of universal moral conscience would have seen the possibility of UBI in achieving the outcomes he so deeply cared about and fought for all his life. But the Mahatma as moralist would have had doubts because of seeing uncompensated

rewards as harming responsibility and effort.

As a fiscal conservative he would permit UBI only if convinced that macro-economic stability would not be jeopardized. Recognizing the difficulty of exit, the Mahatma as astute political observer would have anxieties about UBI as being just another add-on government programme. But on balance he may have given the go-ahead to the UBI.

External challenges

Political changes in advanced economies

- Appointment of Donald Trump as the Republican candidate for US President
- Rise and spread of blatantly racist anti-immigration political parties and movements in Europe

The impact of Brexit and the US elections, though still uncertain, risk unleashing paradigmatic shifts in the direction of isolationism and nativism.

The post war consensus in favour of globalisation of goods, services and labor in particular, and market-based economic organization more broadly, is under threat across the advanced economies.

What happens in the developed countries still matters hugely in international relations and to the rest of the world despite all the talk of a shift in global power to some large "emerging nations".

For India, three external developments are of significant consequence:

1. **First** in the shortrun, the **change in the outlook for global interest rates** as a result of the US elections and the **implied change in expectations of US fiscal and monetary policy** will impact on India's capital flows and exchange rates.
2. **Second** in the medium-term, changed political outlook for globalisation and stagnant or declining trade at the global level (due to protectionist policies). This changed outlook will affect India's export and growth prospects. (See box 2 below)
3. **Third**, developments in the US, especially the rise of the dollar, will have implications for China's currency and currency policy. If China is able to successfully re-balance its economy, the spillover effects on India and the rest of the world will be positive.

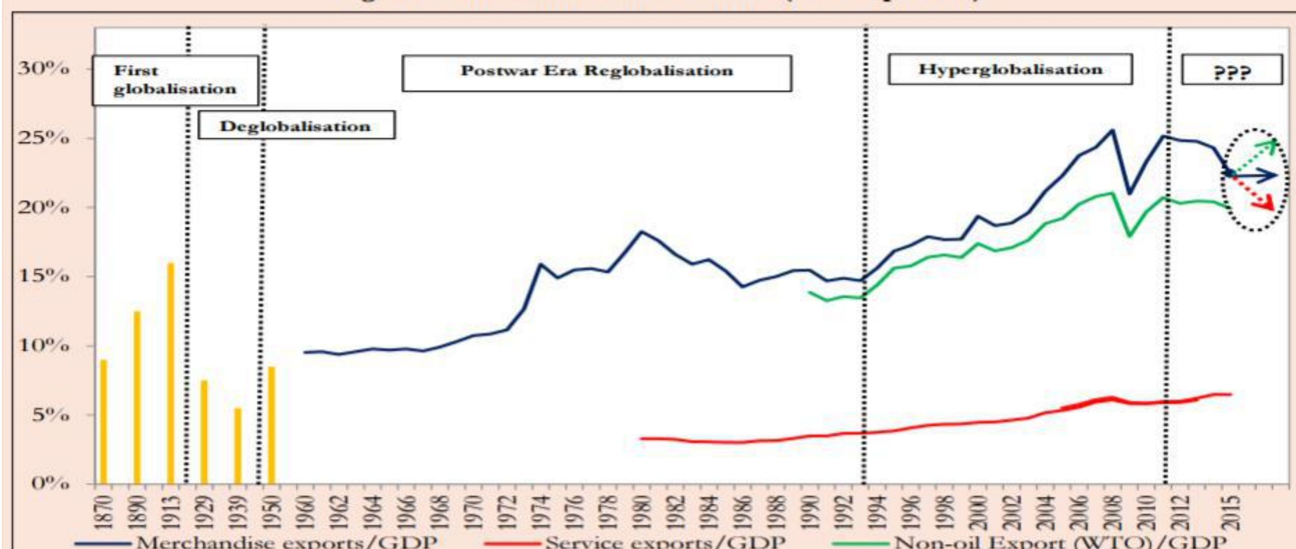
   On, the other hand, further declines in the yuan, even if dollar-induced, could interact with underlying vulnerabilities to create disruptions in China that could have negative spillovers for India

Box 2. Political Carrying Capacity of the West for Openness and Impact on India

If as T.S. Eliot said that humankind cannot bear too much reality, recent events suggest that the world cannot bear too much globalisation either. What does this mean for India's exports?

The first figure plots the trade-GDP ratio for the world since 1870 and highlights four phases. There were two phases of globalisation (1870-1914, 1945-1985), one phase of hyperglobalisation (Subramanian and Kessler, 2014) between 1985-2008, and one phase of deglobalisation in the inter-war period. The question today is what is likely to happen going forward represented by the three arrows: further globalisation, deglobalisation, or stagnation? These will have potentially important consequences for Indian exports and growth.

Figure: Globalisation and the World (1870 to present)



Therefore, any political backlash against globalisation in advanced countries, and China's difficulties in rebalancing its economy, could have major implications on India's economic prospects.

During the boom years between 2003-2011 India's real GDP growth averaged 8.2 percent, and exports grew at an annual rate of between 20 and 25 percent.

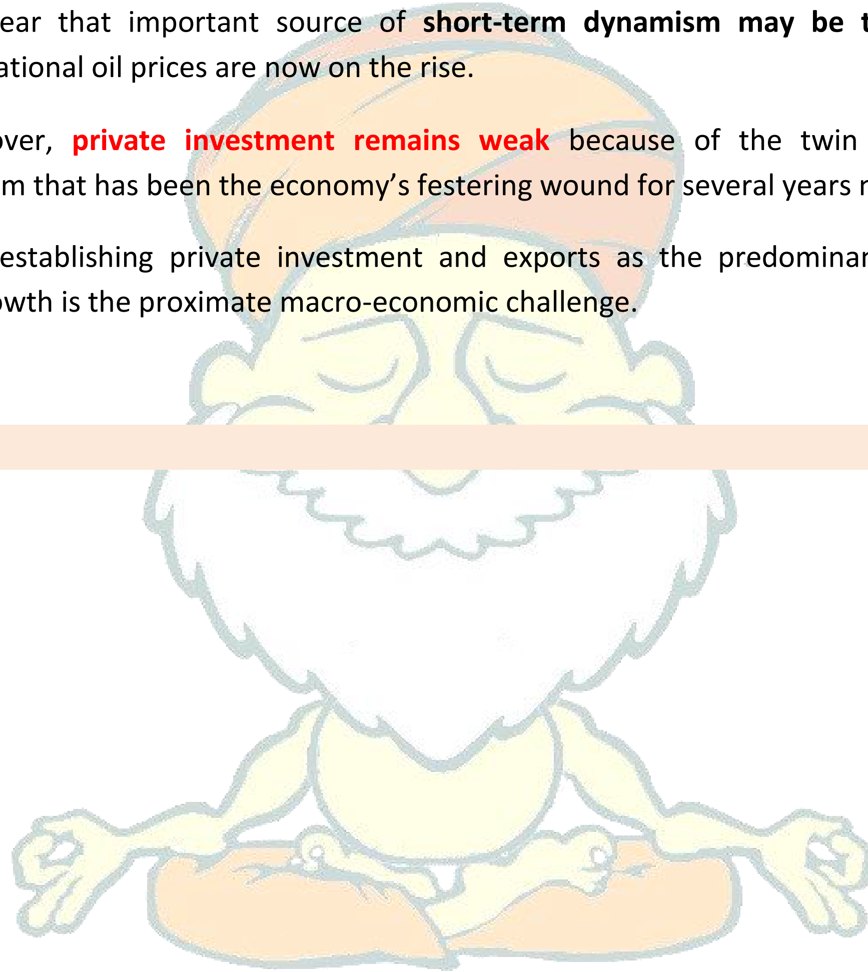
Given the India's current growth ambitions of 8-10 percent, it requires export growth of about 15-20 percent and any serious retreat from openness on the part of India's trading partners would jeopardize those ambitions.

Macro-economic challenges

Reestablishing private investment and exports

- The decline in oil prices from their peak in June 2014 – lead to **increased incomes and** which combined with **government actions imparted dynamism** by increasing private consumption and facilitating public investment, shoring up an economy buffeted by the headwinds of weak external demand and poor agricultural production.
- This year that important source of **short-term dynamism may be taken away** as international oil prices are now on the rise.
- Moreover, **private investment remains weak** because of the twin balance sheet problem that has been the economy's festering wound for several years now.

Therefore, reestablishing private investment and exports as the predominant and durable sources of growth is the proximate macro-economic challenge.



Review of Developments in 2016-17

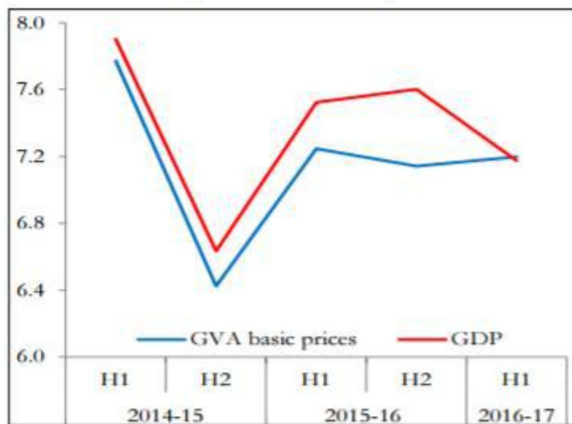
GDP

- Real GDP growth in the first half of the year was 7.2 percent (2016-17)
- Economic Survey 2015-16 had projected 7.0-7.75 per cent
- 7.6 percent rate was recorded in the second half of 2015-16

Economic Growth

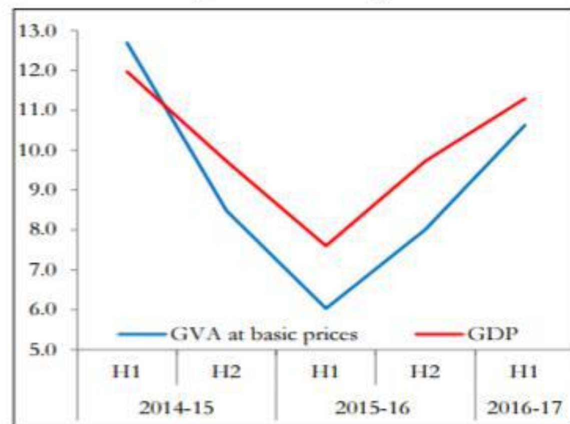
- The growth rate of the Indian economy has been estimated to be in the range of 7-7.5% in 2016-17.
- The medium-term growth trajectory has been pegged at 7-7.5% percent.
- The survey has emphasised that an 8% growth is possible only after two years, with continued economic reforms.

Figure 1a. GVA and GDP Growth (Constant Prices)



Source: CSO

Figure 1b. GVA and GDP Growth (Current Prices)



Source: CSO

Why low GDP?

- Fixed investment declined sharply as stressed balance sheets in the corporate sector continued to take a toll on firms' spending plans.
- Demonetisation
- International oil prices have stopped falling

The major highlights of the sectoral growth outcome of the first half of 2016-17 were:

(i) moderation in industrial and non-government service sectors;

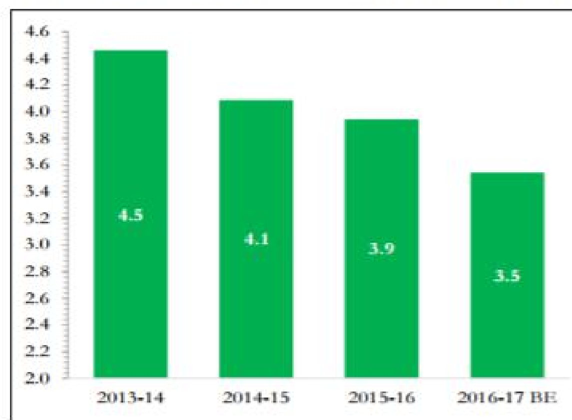
(ii) the modest pick-up in agricultural growth on the back of improved monsoon; and

(iii) strong growth in public administration and defence services

Fiscal Deficit

- Fiscal deficit refers to the difference between total revenue/income and total expenditure of the government. It indicates the total value of the government's borrowings.
- The survey states that fiscal deficit target of 3.9% for 2015-16 is attainable. However, the government wants to adhere to the fiscal deficit target of 3.5% in 2016-17.
- The survey points out that in 2016-17, the 7th Pay Commission recommendations and demands of the OROP scheme will pose a challenge to achieve fiscal target.

Figure 6a. Fiscal Deficit of Center (% of GDP)



Source: Central Government Budget documents.

Inflation

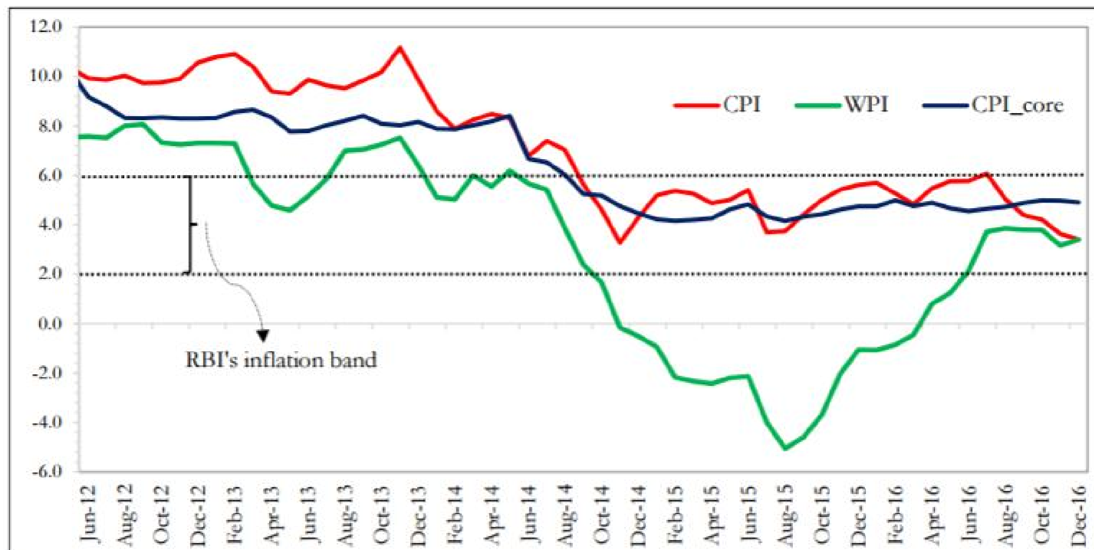
- Inflation is the percentage change in the value of prices of a basket of goods and services in a year.
- CPI inflation seen around 4.5-5% in 2016-17.
- The RBI is expected to meet 5% inflation target by March 2017.

CPI and WPI inflation

- Consumer Price Index (CPI)-New Series inflation, which averaged 4.9 per cent during April-December 2016, has displayed a downward trend, thanks to good kharif agricultural production and pulses.

- The decline in pulses prices has contributed substantially to the decline in CPI inflation.
- The second distinctive feature has been the reversal of WPI inflation, from a trough of (-)5.1 percent in August 2015 to 3.4 percent at end-December 2016 (Figure 2), on the back of rising international oil prices.

Figure 2. WPI and CPI Inflation



Source: CSO

Current Account Deficit

- CAD is a measurement of country's trade when value of goods and services imported is higher than the value of goods and services exported. It includes net income, such as interest and dividends as well as foreign aid/grants.
- Current account deficit is seen at around 1% of GDP in 2016-17.

Agriculture sector

- The growth in agriculture sector in 2015-16 has continued to be lower than the average of the last decade, mainly due to second successive year of lower-than-normal monsoon.
- As per the information of the Department of Agriculture, Cooperation and Farmers Welfare for 2015-16, the production of food-grains and oil-seeds is estimated to decrease by 0.5% and 4.1% respectively, while the production of fruits and vegetables is likely to witness a marginal rise.
- A brighter picture is expected to emerge from the allied sectors like livestock products, forestry and fisheries, with growth exceeding 5% in 2015-16, which will improve rural

incomes.

Subsidies

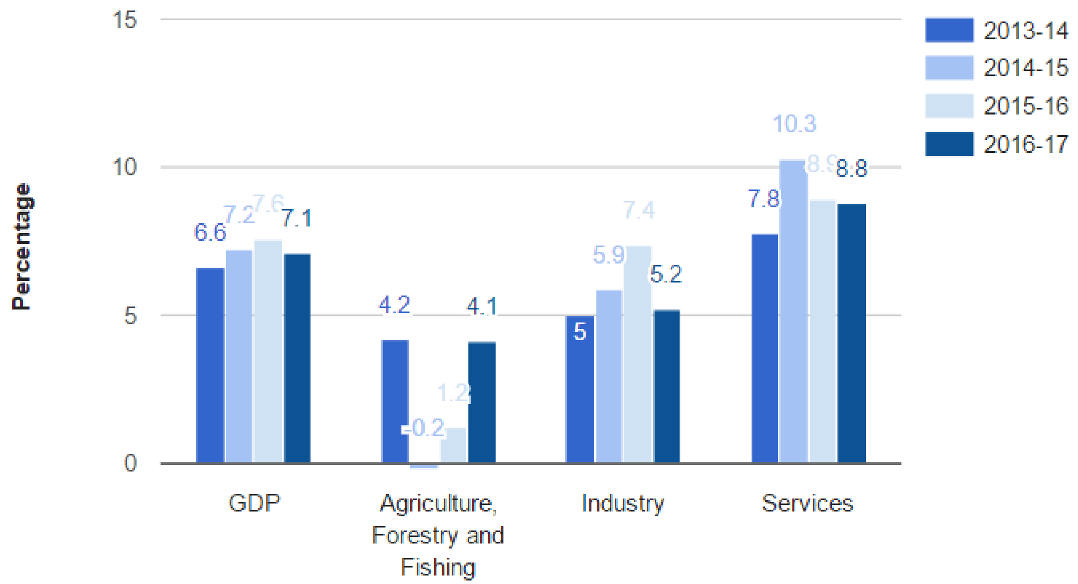
- It refers to a sum of money extended through a government grant to keep the price of a commodity low.
- The Economic Survey states that rationalisation and reprioritisation of subsidies through better targeting would be crucial role for fiscal consolidation and for targeting more expenditure towards inclusive development.
- The total subsidy bill as a proportion of GDP is expected to be below 2% of GDP as per Budget estimates for 2015-16.
- The 1.7% decline in majors subsidies was a result of nearly 44.7% decline in petroleum subsidy during April - December 2015, while other major subsidies-food and fertiliser - increased by 10.4% and 13.7% respectively during the period.

Industry sector

- Growth in the industry sector accelerated during the current year due to improved manufacturing activity.
- The Index of Industrial Production (IIP) showed that manufacturing production grew by 3.1% during April-December 2015-16, vis-à-vis a growth of 1.8% in the corresponding period of the previous year.
- The ongoing manufacturing recovery is supported by vigorous growth in petroleum refining, automobiles, apparels, chemicals, electrical machinery and wood products, including furniture.
- Apart from manufacturing, other three segments of the industry sector-electricity, gas, water supply-and related utilities, mining and quarrying and construction activities are witnessing a slump in growth.

Service sector

- The growth in service sector is moderated slightly but remains robust.
- Being the main driver of the economy, the service sector has contributed about 69% of the total growth during 2011-12 to 2015-16. It has, therefore, expanded its share in the economy to 53% from 49%.


State of the economy 2013-2017
Percentage
15
10
5
0
2013-14
2014-15
2015-16
2016-17
6.6
7.2
7.6
7.1
4.2
-0.2
1.2
4.1
5
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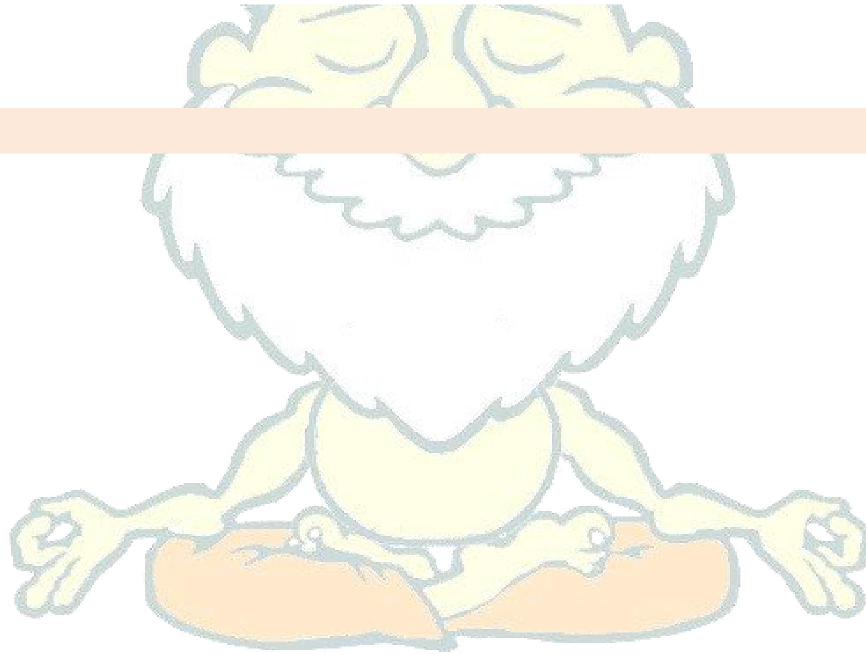
8.8
GDP
Agriculture, Forestry and Fishing
Industry
Services



India's Future Economic Outlook

A. GDP Growth

India's future GDP growth depends on its exports, consumption, private investment and government.

Exports:

- India's exports appear to be recovering, based on an uptick in global economic activity. This is expected to continue in the aftermath of the US elections and expectations of a fiscal stimulus.
- IMF's World Economic Outlook forecast projects an increase in global growth from 3.1 percent in 2016 to 3.4 percent in 2017, with a corresponding increase in growth for advanced economies from 1.6 percent to 1.9 percent.
- Given the high elasticity of Indian real export growth to global GDP, exports could contribute to higher growth next year, by as much as 1 percentage point.
- In the aftermath of the Global Financial Crisis, the eurozone crisis, and the China scare of 2015, international trading opportunities are becoming scarcer.
- As discussed in Box 2, the world export-GDP ratio has declined since 2011, and going forward a sharp rise in the dollar is expected with a corresponding decline in the currencies of India's competitors, notably China and Vietnam.
- Given India's need for exports to sustain a healthy growth rate, it is important to track India's competitiveness. A second reason to review India's competitiveness is the rise of countries such as Vietnam, Bangladesh, and the Philippines that compete with India across a range of manufacturing and services.

Private Consumption:

The outlook for private consumption is less clear.

- International oil prices are expected to be about 10-15 percent higher in 2017 compared to 2016, which would create a drag of about 0.5 percentage points. Geopolitics could take oil prices up further than forecast.
- The ability of shale oil production to respond quickly should contain the risks of a sharp

increase, but even if prices rose merely to $60-65/barrel the Indian economy would nonetheless be affected by way of reduced consumption; less room for public investment; and lower corporate margins, further denting private investment.

- On the other hand, consumption is expected to receive a boost from two sources: catch-up after the demonetisation-induced reduction in the last two quarters of 2016-17; and cheaper borrowing costs, which are likely to be lower in 2017 than 2016. As a result, spending on housing and consumer durables and semi-durables could rise smartly.
- Since no clear progress is yet visible in tackling the twin balance sheet problem, private investment is unlikely to recover significantly. ***(Probable Mains question in this area)***
- Some of this weakness could be offset through higher public investment, but that would depend on the stance of fiscal policy in coming years, which has to balance the short-term requirements of an economy recovering from demonetisation against the medium-term necessity of adhering to fiscal discipline.
- There are risks from the possible eruption of trade tensions amongst the major countries, triggered by geo-politics or currency movements. This could reduce global growth and trigger capital flight from emerging markets.

B. Fiscal Outlook

The fiscal outlook for the central government for next year will be marked by three factors.

- First, the increase in the tax to GDP ratio of about 0.5 percentage points in each of the last two years, owing to the oil windfall will disappear.
- Second, there will be a fiscal windfall both from the high denomination notes that are not returned to the RBI and from higher tax collections as a result of increased disclosure under the **Pradhan Mantra Garib Kalyan Yojana** (PMGKY).
- A third factor will be the implementation of the GST. It appears that the GST will probably be implemented later in the fiscal year. The transition to the GST is so complicated from an administrative and technology perspective that revenue collection will take some time to reach full potential.

C. Trade Policy

- The environment for global trade policy has probably undergone a paradigm shift in the aftermath of Brexit and the US elections.
- At a time of a possible resurgence of protectionist pressures and India's need for open markets abroad to underpin rapid economic growth domestically, it is increasingly clear that India and other emerging market economies must play a more proactive role in ensuring open global markets.
- A vacuum in international trade leadership is being created which must be filled with voices and influences such as India's that favor open markets. This will, of course, require that India also be more willing to liberalize its own markets, a greater "openness to its own openness."
- Focus should be to promote labor-intensive exports. India could more proactively seek to negotiate free trade agreements with the UK and Europe.
- At the same time, with the likely US retreat from regional initiatives such as the Trans-Pacific Partnership (TPP) in Asia and the Trans-Atlantic Trade and Investment Partnership (TTIP) with the EU, it is possible that the relevance of the World Trade Organization might increase.
- As a major stateholder and given the geo-political shifts under way, reviving the WTO and multilateralism more broadly could be proactively pursued by India.

D. Climate Change and India

- The Paris Agreement on climate change in December 2015 has been one of the shining recent examples of successful international cooperation. The focus will now shift to implementing the agreements.
- So far, and for the conceivable future, India's reliance on fossil fuels remains well below China (the most relevant comparator) but also below the US, UK and Europe at comparable stages of development (this echoes the commitment made by India at **Heiliengdamm** that it would never exceed the per capita emission of advanced countries).
- Going forward, of course, India needs to bend the curve to ensure that its reliance on fossil fuels declines and keeping it below the level of other countries so that its good global

citizenship on climate change can continue.

E. Ensuring Women's Privacy

- In each of the last two years, the Economic Survey has focused on a dimension of concern to women.
- FY 2015 Survey focused on violence against women related to coercive family planning methods.
- In FY2016, the Survey featured a chapter on "Mother and Child," emphasizing the importance of government interventions to ensure long term well-being of women and children.
- This year Survey focuses on relationship between sanitation practices and health outcomes. How deficiencies in sanitation facilities affects women: threat to life and safety while going out for open defecation, reduction in food and water intake practices to minimize the need to exit the home to use toilets, polluted water leading to women and children dying from childbirth-related infections, and a host of other impacts.

Women and girl-children should take a key leadership role to play in Swachh Bharat's objective of creating defecation free communities, by nudging men and boys of the household to change their own defecation behaviors.

Indian economic policy: “Precocious, Cleavaged India”

From erstwhile socialist vision to Washington Consensus or standard Asian development model

Indian economic policy can be divided into two phases:

First came nearly half a century of socialism, where the guiding principles were economic nationalism and protectionism.

- During those years, the public sector occupied the commanding heights and the government intruded into even the most micro-decisions of private firms: their investing, producing, and trading.

(**Second**) This framework was rejected after 1991. India has replaced its erstwhile socialist vision with something resembling the **“Washington Consensus”**: open trade, open capital, and reliance on the private sector – essentially the same development model that has been tried and proven successful in most countries of Eastern Asia (excluding China).

Reforms along these lines have been adopted by every Indian government over the past quarter century.

For example, in the last two years, the current government has institutionalized a commitment to low inflation in the new monetary policy framework agreement. There has also been a great effort to reduce the costs of doing business and create an environment friendly to investment, both domestic and foreign.

The result of all these reforms over the past 25 years has been a remarkable transformation of India from a largely closed and listless economy to the open and thriving economy that we see today.

Country’s progress have been qualitative and measurable. Consider, for example, four standard measures: openness to trade; openness to foreign capital; the extent to which public sector enterprises dominate commercial activities; and the share of government expenditure in overall spending.

Compared to other large countries such as China, India, Brazil, the United States, and Japan; India is “above the line”, meaning that it trades far more than would be expected for a country of its size – a stark turnaround from the pre-1991 situation when India was an under-trader.

India’s trade-GDP ratio has been rising sharply, particularly over the decade to 2012. The

recovery from the global financial crisis in 2008 was also swift. As a result, India's ratio now surpasses China which is remarkable. India's FDI has risen sharply over time.

India is pursuing the standard Asian development path. It is open to foreign trade and foreign capital, where the government is not overbearing, either in a micro, entrepreneurship sense or in a macro, fiscal sense.

India has grown at about 4.5 percent per capita for thirty seven years, an impressive achievement. This achievement is particularly remarkable because it has been achieved under a fully democratic political system.

The Indian model of being a perennial democracy after acquiring independence is rare in post-war economic history – and successes are rarely democracies.

The only other countries that have grown as rapidly and been democratic for a comparable proportion of the boom are Italy, Japan, Israel, and Ireland. Other countries that have grown faster for as long have tended to be oil exporters, East Asian countries, and some that recovered after World War II.

Yet, there remains a niggling sense that India is not quite what it appears to be - that, despite all the data, it is not yet following the standard development model.

So, in what ways is India different?

Three lingering features capture the doubt that it has not yet traversed the distance toward some vague and unspecifiable end-point that could be described as desirable or optimal.

- First, there has been a **hesitancy to embrace the private sector and to unambiguously protect property rights**, combined with continued reliance on the state to undertake activities that are more appropriately left to the private sector.
- Second, **state capacity** has remained weak as can be seen from poor delivery of essential services.
- And third**, redistribution** has been simultaneously extensive and inefficient

(These parts has been already discussed earlier)

The above three distinctive features makes Indian development model unique. India's economic vision has followed a unique pathway to economic success, what might be called

“Precocious, Cleavaged India”.

Historically, economic success has followed one of two pathways:

1. Today’s advanced economies achieved their current status over two centuries in which ***economic and political development progressed slowly but steadily***. They did not begin with universal franchise. Voting rights, narrow and restricted to begin with, expanded slowly over time, a process that helped fiscal and economic development by limiting the initial demands on the state during the period when its capacity was weak.
2. The second set of accelerated economic successes mostly in East Asia began authoritarian, explicitly (Korea, China) or de facto (Singapore, Thailand, Taiwan), and ***gave way to political transformation only after a degree of economic success was achieved***. Explicit authoritarianism came in three flavours: military (Korea), party (China), or individual dictatorship (Indonesia).

India, on the other hand, has attempted economic development while also granting universal franchise from the very beginning.

India is amongst a handful of countries—Botswana, Mauritius, Jamaica, Trinidad and Tobago, and Costa Rica—which are perennial democracies.

Even rarer, India, at independence, was a very poor democracy (as shown in figure below)

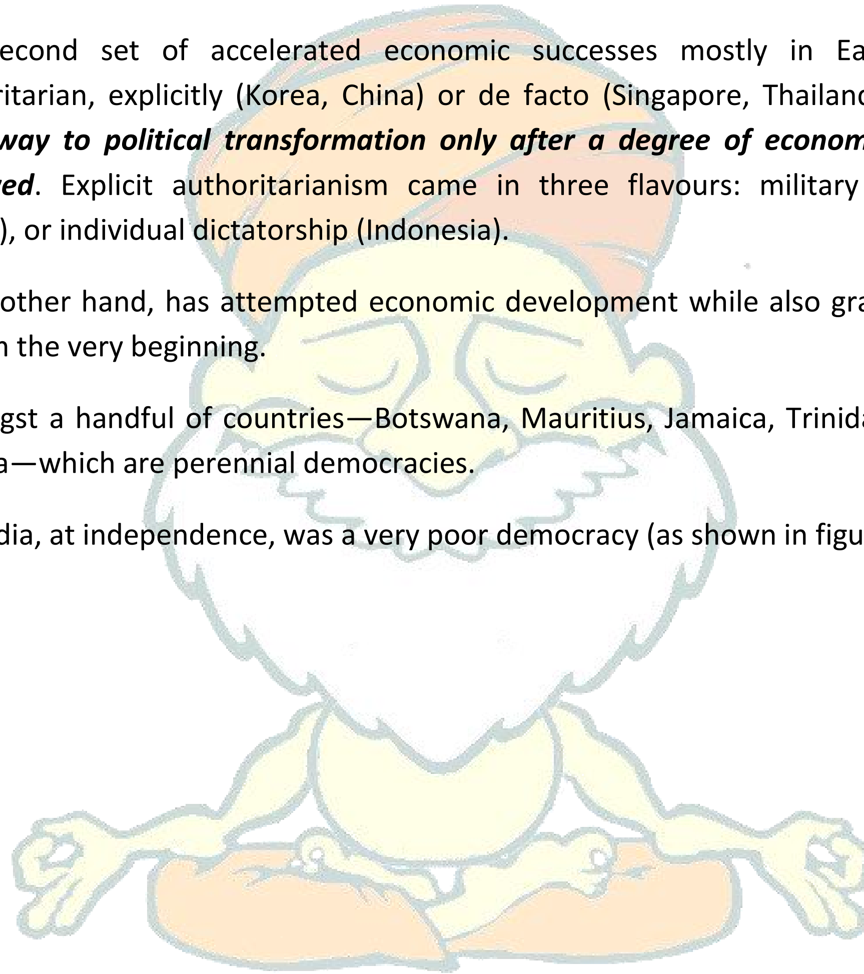
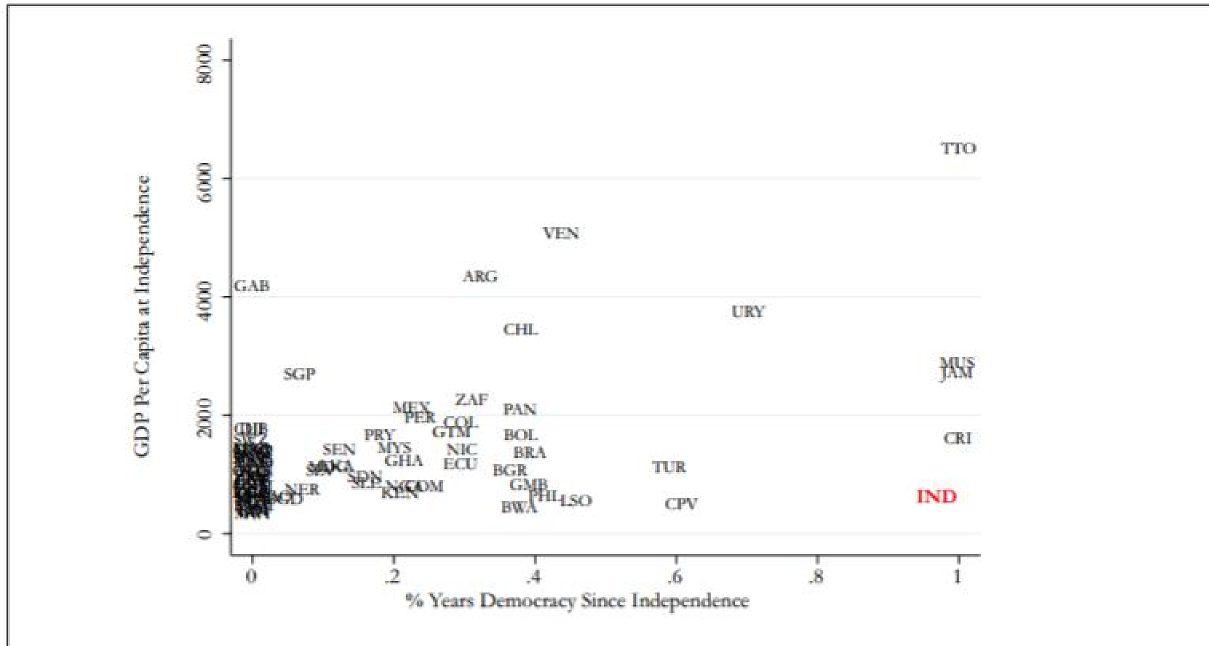


Figure 8. Precocious Democracy



At the same time, India was also a highly cleavaged society. Historians have remarked how it has many more axes of cleavage than other countries: language and scripts, religion, region, caste, gender, and class. A country with high levels of poverty and deep social fissures.

A precocious, cleavaged democracy that starts out poor will almost certainly distrust the private sector.

The founders of India wanted to "build the country" by developing industry that would make India economically, as well as politically, independent.

The private sector had conspicuously failed to do this under colonial rule, not only in India but in every other newly independent nation, giving rise to severe doubts as to whether it could ever do so.

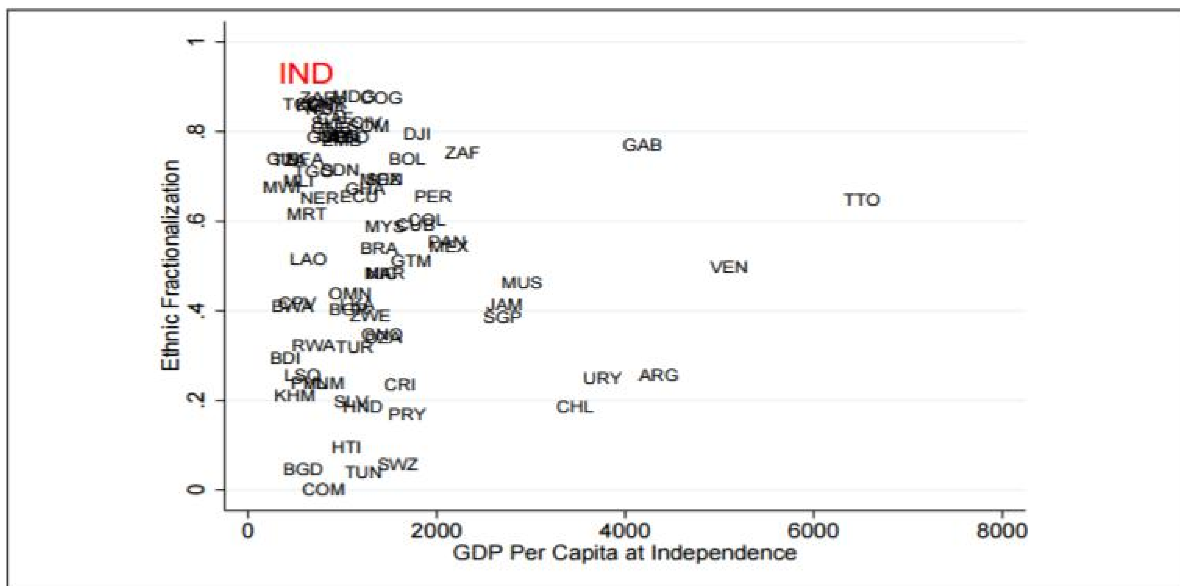
In contrast, the example of the Soviet Union, which had transformed itself from an agricultural nation to an industrial powerhouse in a few short decades, suggested that rapid development was indeed possible, if the state would only take control of the commanding heights of the economy and direct resources into priority areas.

Of course, while India adopted planning and a large role for the state sector, it never abolished the private sector unlike the Soviet Union. Instead, it tried to control private businesses through

licensing and permits.

Paradoxically, however, this only further discredited the private sector, because the more the state imposed controls, the more the private sector incumbents were seen as thriving because of the controls, earning society’s harsh criticism in the process.

Figure 9. Precocious and Cleavaged India



Source: **Banerjee & Somanathan, 2007/*Survey* Calculations**

Another important implication of India’s precocious, cleavaged democracy is that India had to redistribute early in the development process, when its state capacity was particularly weak.

India did not invest sufficiently in human capital – for instance, public spending on health was an un unusually low 0.22 per cent of the GDP in 1950-51. This has risen to a little over 1 per cent today, but well below the world average of 5.99 per cent (World Bank, 2014).

The Festering Twin Balance Sheet Problem

The Economic Survey has devoted considerable attention to what it terms **India's Twin Balance Sheet problem** - overleveraged and distressed companies and the rising NPAs in Public Sector Bank balance sheets. The issue is important because it is holding up private investment in the country and therefore, growth in all sorts of sectors.

For some time, India has been trying to solve its Twin Balance Sheet problem– using a decentralised approach, under which banks have been put in charge of the restructuring decisions.

But decisive resolutions of the loans, concentrated in the large companies, have eluded successive attempts at reform. The problem has consequently continued to fester: NPAs keep growing, while credit and investment keep falling.

India's NPA ratio at its current level of 9.1% of the gross loans is higher than any other major emerging market (with the exception of Russia), higher even than the peak levels seen in Korea during the East Asian financial crisis.

What needs to be done?

RBI has over the past few years introduced a number of mechanisms to deal with the stressed asset problem. Three of these mechanisms are particularly notable.

1. For some time, the RBI has been encouraging the **establishment of private Asset Reconstruction Companies (ARCs)**, in the hope that they would buy up the bad loans of the commercial banks. In that way, there could be an efficient division of labour, as banks could resume focusing on their traditional deposit-and-loan operations, while the ARCs could deploy the specialist skills needed to restructure corporate debts.

   This strategy, however, has had only limited success. Many ARCs have been created, but they have solved only a small portion of the problem. The problem is that ARCs have found it difficult to recover much from the debtors. Thus they have only been able to offer low prices to banks, prices which banks have found it difficult to accept.

So the RBI has focused more recently on two other, bank-based workout mechanisms.

2. In June 2015, the **Strategic Debt Restructuring (SDR) scheme** was introduced, under which creditors could take over firms that were unable to pay and sell them to new owners.

3. The following year, the **Sustainable Structuring of Stressed Assets (S4A)** was announced,

under which creditors could provide firms with debt reductions up to 50 percent in order to restore their financial viability.

In principle, these schemes taken together might have provided a comprehensive framework for dealing with solvency problems. Their success, however, has been limited; while two dozen firms have entered into negotiations under SDR, only two cases have actually been concluded as of end-December 2016. And only one small case has been resolved so far under S4A.

All of this suggests that it might not be possible to solve the stressed asset problem using the current mechanism, or indeed any other decentralised approach that might materialise in the near future. Instead a centralised approach might be needed.

Therefore, Survey suggests that a centralised **Public Sector Asset Reconstruction Company (PARA)** be formed to buy the biggest, most complex NPAs and then dispose of them.

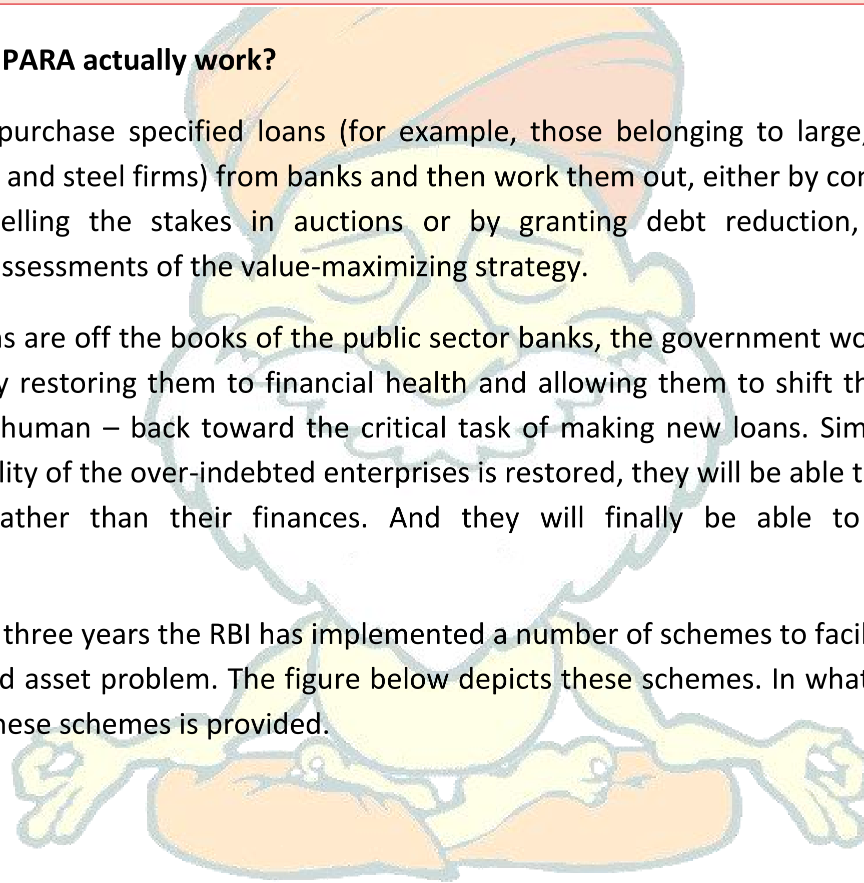
Box 1. Why is a Public Sector Asset Rehabilitation Agency (PARA) Needed?

The argument for PARA is developed at length in the third section. But it is worth outlining in advance the seven steps that lead to this conclusion.

1. **It's not just about banks, it's a lot about companies.** So far, public discussion of the bad loan problem has focused on bank capital, as if the main obstacle to resolving TBS was finding the funds needed by the public sector banks. But securing funding is actually the easiest part, as the cost is small relative to the resources the government commands. Far more problematic is finding a way to resolve the bad debts in the first place.
2. **It is an economic problem, not a morality play.** Without doubt, there are cases where debt repayment problems have been caused by diversion of funds. But the vast bulk of the problem has been caused by unexpected changes in the economic environment: timetables, exchange rates, and growth rate assumptions going wrong.
3. **The stressed debt is heavily concentrated in large companies.** Concentration creates an opportunity, because TBS could be overcome by solving a relatively small number of cases. But it presents an even bigger challenge, because large cases are inherently difficult to resolve.
4. **Many of these companies are unviable at current levels of debt requiring debt write-downs in many cases.** Cash flows in the large stressed companies have been deteriorating over the past few years, to the point where debt reductions of more than 50 percent will often be needed to restore viability. The only alternative would be to convert debt to equity, take over the companies, and then sell them at a loss.

5. **Banks are finding it difficult to resolve these cases, despite a proliferation of schemes to help them.** Among other issues, they face severe coordination problems, since large debtors have many creditors, with different interests. If PSU banks grant large debt reductions, this could attract the attention of the investigative agencies. But taking over large companies will be politically difficult, as well.
6. **Delay is costly.** Since banks can't resolve the big cases, they have simply refinanced the debtors, effectively "kicking the problems down the road". But this is costly for the government, because it means the bad debts keep rising, increasing the ultimate recapitalization bill for the government and the associated political difficulties. Delay is also costly for the economy, because impaired banks are scaling back their credit, while stressed companies are cutting their investments.
7. **Progress may require a PARA.** Private Asset Reconstruction Companies (ARCs) haven't proved any more successful than banks in resolving bad debts. But international experience shows that a professionally run central agency with government backing – while not without its own difficulties -- can overcome the difficulties that have impeded progress.

How would a PARA actually work?

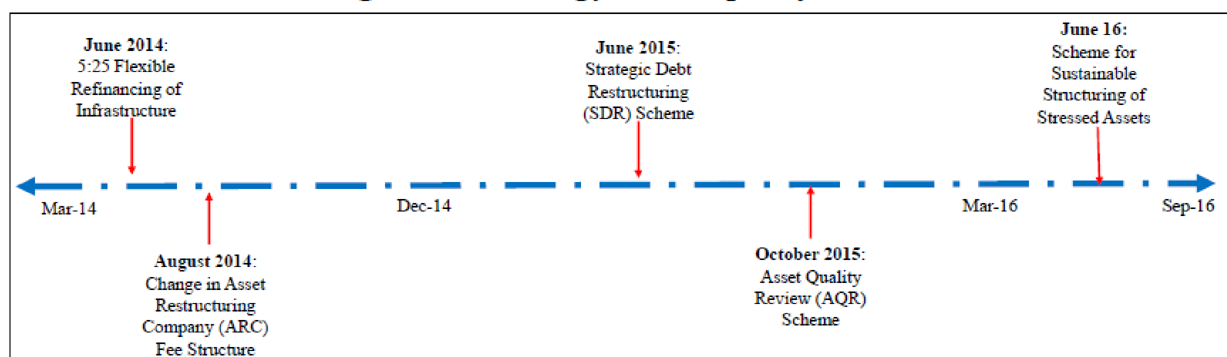


PARA would purchase specified loans (for example, those belonging to large, over-indebted infrastructure and steel firms) from banks and then work them out, either by converting debt to equity and selling the stakes in auctions or by granting debt reduction, depending on professional assessments of the value-maximizing strategy.

Once the loans are off the books of the public sector banks, the government would recapitalise them, thereby restoring them to financial health and allowing them to shift their resources – financial and human – back toward the critical task of making new loans. Similarly, once the financial viability of the over-indebted enterprises is restored, they will be able to focus on their operations, rather than their finances. And they will finally be able to consider new investments.

Over the past three years the RBI has implemented a number of schemes to facilitate resolution of the stressed asset problem. The figure below depicts these schemes. In what follows a brief overview of these schemes is provided.

Figure. Chronology of RBI policy actions



The 5/25 Refinancing of Infrastructure Scheme:

- This scheme offered a larger window for revival of stressed assets in the infrastructure sectors and eight core industry sectors.
- Under this scheme lenders were allowed to extend amortisation periods to 25 years with interest rates adjusted every 5 years, so as to match the funding period with the long gestation and productive life of these projects.
- The scheme thus aimed to improve the credit profile and liquidity position of borrowers, while allowing banks to treat these loans as standard in their balance sheets, reducing provisioning costs.
- However, with amortisation spread out over a longer period, this arrangement also meant that the companies faced a higher interest burden, which they found difficult to repay, forcing banks to extend additional loans ('evergreening'). This in turn has aggravated the initial problem.

Private Asset Reconstruction Companies (ARCs):

- ARCs were introduced to India under the SARFAESI Act (2002), with the notion that as specialists in the task of resolving problem loans, they could relieve banks of this burden.
- However, ARCs have found it difficult to resolve the assets they have purchased, so they are only willing to purchase loans at low prices. As a result, banks have been unwilling to sell them loans on a large scale.
- Then, in 2014 the fee structure of the ARCs was modified, requiring ARCs to pay a greater proportion of the purchase price up-front in cash. Since then, sales have slowed to a trickle: only about 5 percent of total NPAs at book value were sold over 2014-15 and 2015-16.

Strategic Debt Restructuring (SDR):

- The RBI came up with the SDR scheme in June 2015 to provide an opportunity to banks to convert debt of companies (whose stressed assets were restructured but which could not finally fulfil the conditions attached to such restructuring) to 51 percent equity and sell them to the highest bidders, subject to authorization by existing shareholders.
- An 18-month period was envisaged for these transactions, during which the loans could be classified as performing. But as of end-December 2016, only two sales had materialized, in part because many firms remained financially unviable, since only a small portion of their debt had been converted to equity.

Asset Quality Review (AQR):

- Resolution of the problem of bad assets requires sound recognition of such assets. Therefore, the RBI emphasized AQR, to verify that banks were assessing loans in line with RBI loan classification rules. Any deviations from such rules were to be rectified by March 2016.

Sustainable Structuring of Stressed Assets (S4A):

- Under this arrangement, introduced in June 2016, an independent agency hired by the banks will decide on how much of the stressed debt of a company is 'sustainable'. The rest ('unsustainable') will be converted into equity and preference shares. Unlike the SDR arrangement, this involves no change in the ownership of the company.

Since other approaches to resolve the TBS problem had failed or had limited success, the Economic Survey noted that international experience shows that a professionally-run central agency with government backing can overcome the difficulties that have impeded progress.

The twin balance sheet problem is a serious drag on credit growth. The setting up of a centrally-assisted rehabilitation agency will help in taking difficult decisions which the public sector banks are unable to take.

Fiscal Rules: Lessons from the States

India like several other countries, embarked in the mid-2000s on an ambitious project of fiscal consolidation, adopting fiscal rules aimed at curbing fiscal deficits.

The most well-known and best-studied part of this project was the **Fiscal Responsibility and Budget Management (FRBM) Act**, adopted by the centre in 2003.

This Act was mirrored by **Fiscal Responsibility Legislation (FRL)** adopted in the states, laws that were no less important than the FRBM, since states account for roughly half the general government deficit.

Most states achieved and maintained the target fiscal deficit level (3 percent of GSDP) and eliminated the revenue deficit soon after the introduction of their Fiscal Responsibility Legislation (FRL).

Reasons for effective fiscal consolidation:

- FRL was not the sole impetus behind this impressive fiscal performance.
- Acceleration of GDP growth helped boost states' revenues
- Increased transfers from the Centre because of the 13th Finance Commission recommendations and the surge in central government revenues
- Decline in interest payments on account of the debt restructuring package offered by the centre and increased central CSS expenditure

All these contributed significantly to such consolidation.

Fiscal challenges are mounting because of the Pay Commission recommendations, slowing growth, and rising payments from the UDAY bonds.

Moreover, macro-economic conditions will not be as favorable to states as they were in the mid-2000s. Going forward greater market-based discipline on state government finances will be a major imperative. And, the Centre must take the lead not only in incentivizing fiscal prudence by states but also by acting as a model through its own fiscal management.

Economic Survey attempted to answer two questions:

- To what extent did the FRL really make a difference?
- What are the lessons for future fiscal rules?

Summary of Fiscal Responsibility Legislation (FRL)

The FRL aimed to impose fiscal discipline through a number of mechanisms:

- Fiscal targets were established, which were the same for all states: overall deficit was not allowed to exceed 3 percent of Gross State Domestic Product (GSDP), while the revenue deficit was to be eliminated by 2008/9 (later extended to 2009/10).
- The 12th Finance Commission allowed states to borrow directly from the market
- States were required to publish annual Medium-Term Fiscal Policy reports, which would project deficits over the next three to four years

Assessment of Fiscal Responsibility Legislation (FRL)

:

- Most of the States achieved the fiscal targets. Within the first two years, states on average lowered their deficits to target levels -- 3 percent for fiscal deficit and 0 for revenue deficits – while the primary balance shifted into surplus.
- Therefore, FRL had a significant impact -- both fiscal deficit and revenue deficit fell sharply.
- Another indication that the FRL had a significant impact is that states kept a tight rein on wage and salary expenditure.
- FRLs clearly made an important difference, both in terms of outcomes and behaviour.
- States kept their average fiscal deficit at 2.4 percent of GSDP in the 10 years after the FRL, well below the prescribed ceiling of 3 percent of GSDP.
- And there was also a striking change in behaviour: budget forecasting procedures improved, and there was a more cautious approach to guarantees, a build-up of cash balances, and a reduction in debt.

Lessons for Future Fiscal Rules

- As the fiscal challenges mount for the states going forward because of the Pay Commission recommendations, slowing growth, and mounting payments from the UDAY bonds, there is need to review how fiscal performance can be kept on track.

- Greater market-based discipline on state government finances is imperative -- at present, this is missing. There is a complete lack of correlation between the spread on state government bonds and their debt or deficit positions.

Clothes and Shoes: Can India Reclaim Low Skill Manufacturing?

Creating jobs is India's central challenge.

Survey indicates that government should pay attention to labor-intensive sectors to meet the challenge of jobs.

The **apparel and leather and footwear sectors** meet many or all of these criteria and hence are eminently suitable candidates for targeting and policy attention.

- It has good potential to create employment, especially for women
- Opportunities for exports and growth

With China planning to rise labour costs, it is gradually vacating its dominant position (losing market share) in these sectors, affording India an opportunity. To not cede this space to competitors such as Vietnam and Bangladesh will require easing restrictions on labor regulations, negotiating FTAs with major partners such as the EU and UK, and ensuring that the GST rationalizes current tax policy that can discriminate against dynamic sectors.

India has underperformed relative to the East Asian competitors. The Indian underperformance, has been particularly marked in the leather sector. Hence effective targeting and policy attention to clothing and leather apparel sector offers tremendous opportunities for creation of jobs, especially for women.

India is well positioned to take advantage of China's deteriorating competitiveness because wage costs in most Indian states are significantly lower than in China.
The space vacated by China is fast being taken over by Bangladesh and Vietnam in case of apparels; Vietnam and Indonesia in case of leather and footwear. Indian apparel and leather firms are relocating to Bangladesh, Vietnam, Myanmar, and even Ethiopia.
The window of opportunity is narrowing and India needs to act fast if it is to regain competitiveness and market share in these sectors. Hence, the urgency, the Survey indicates.

Challenges:

India has potential comparative advantage in terms of cheaper and more abundant labour. But these are nullified by other factors that render them less competitive than their peers in competitor countries.

The Apparel and Leather sectors face a set of common challenges:

- **Logistics:** The costs and time involved in getting goods from factory to destination are greater than those for other countries.
- **Labor regulations:** There are strict regulations for overtime wage payment as the **Minimum**

Wages Act 1948 mandates payment of overtime wages at twice the rate of ordinary rates of wages of the worker.

- **Tax & tariff policy:** In both apparel and footwear sectors, tax and tariff policies create distortions that impede India gaining export competitiveness. High tariffs on yarn and fiber increase the cost of producing clothing.

- **Disadvantages emanating from the international trading environment compared to competitor countries:** The global demand for footwear is shifting away from leather footwear and towards non leather footwear. India's share of leather footwear exports in the world market is more than double the share of non-leather footwear. Efforts are required to promote non-leather footwear to be able to effectively capture world market share.

- **Discrimination in export markets:** India's competitor exporting nations for apparels and leather and footwear enjoy better market access by way of zero or at least lower tariffs in the two major importing markets, namely, the United States of America (USA) and European Union (EU).

For example:

- In the EU, Bangladesh exports enter mostly duty free (being a Less Developed Country (LDC)), while Indian exports of apparels face average tariffs of 9.1 per cent.

- Vietnam could also attract zero tariffs once the EU – Vietnam Free Trade Agreement (FTA) comes into effect.

- In the US, India faces tariff of 11.4 percent. Ethiopia, which is an emerging new competitor in apparels and leather, enjoys duty free access in US, EU and Canada.

Therefore, an FTA with EU and UK will help.

Policy response and Conclusions:

Several measures form part of the package approved by the Government for textiles and apparels in June 2016. Their rationale is to address the challenges described above.

1. Apparel exporters will be provided relief to offset the impact of state taxes embedded in exports, which could be as high as about 5 per cent of exports. Similar provisions for leather exporters would be useful.

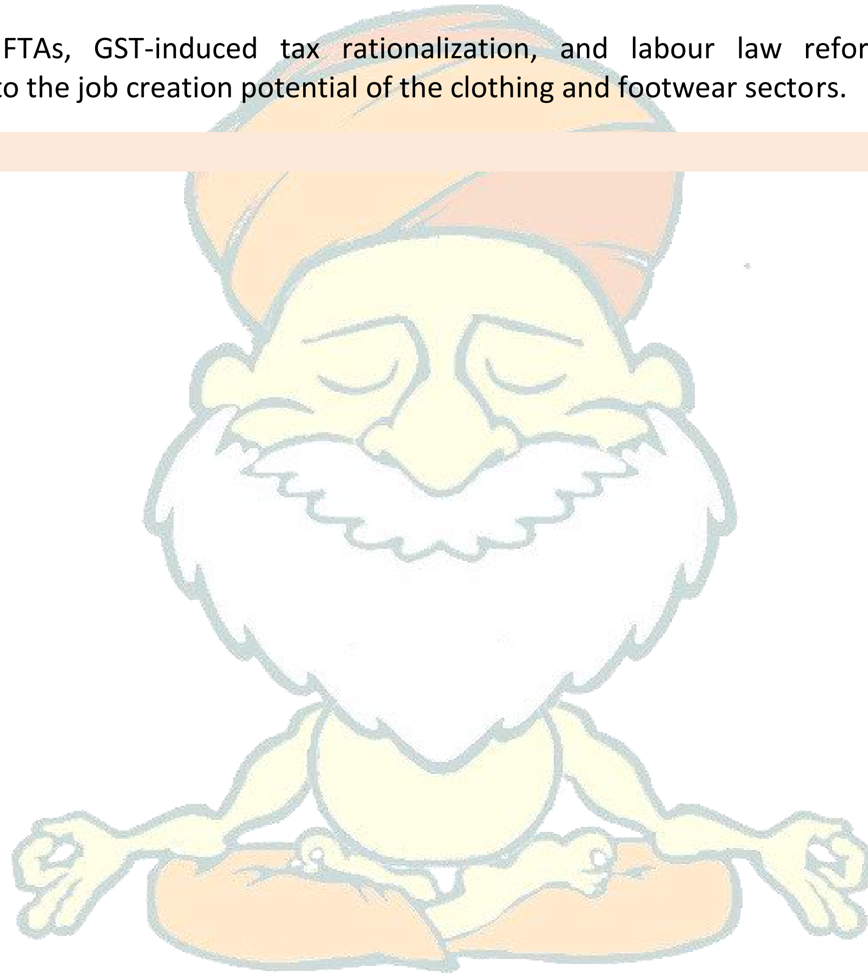
2. Textile and apparel firms will be provided a subsidy for increasing employment. This will take the form of government contributing the employers' 12 per cent contribution to the Employee Provident Fund (EPF) (the Government is already committed to contributing 8.3 per cent; so the new measure will be additional to that).

3. Negotiations are on the way for new Free Trade Agreements with the European Union (EU) and the United Kingdom (UK).

4. Introduction of the Goods and Service Tax (GST) offers an excellent opportunity to rationalize domestic indirect taxes so that they do not discriminate in the case of apparels against the production of clothing that uses man-made fibers; and in the case of footwear against the production of non-leather based footwear.

5. Number of labour law reforms are implemented to overcome obstacles to employment creation in these sectors.

Thus, more FTAs, GST-induced tax rationalization, and labour law reform would add considerably to the job creation potential of the clothing and footwear sectors.



Some important policy actions

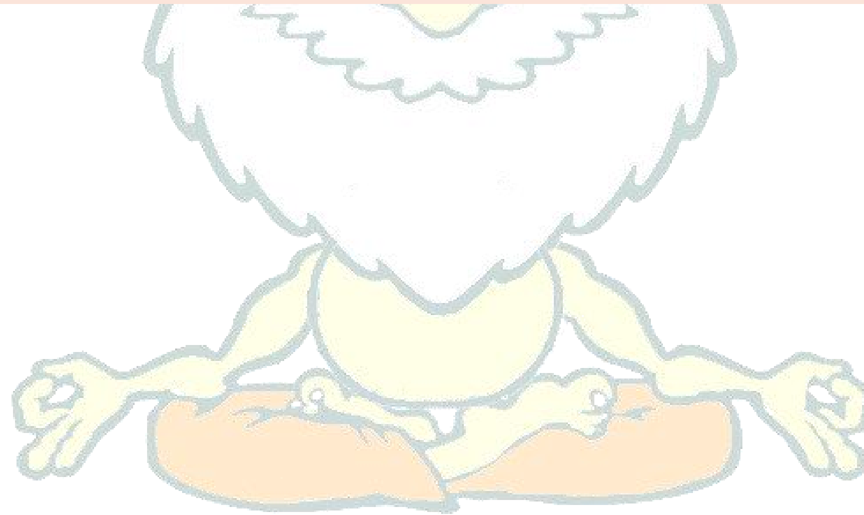
Persons with Disability:

Box 2. Accessible India Campaign (Sugamya Bharat Abhiyan)

As a society it is imperative to promote, protect and ensure the full and equal enjoyment of all human rights and fundamental freedoms by all persons with disabilities, and to promote respect for their inherent dignity (UN Convention on rights of Persons with Disabilities). According to Census 2011, the number of persons with disabilities in India constituted 2.2 per cent of the population. The Department of Empowerment of Persons with Disabilities (DEPwD) launched '*Accessible India Campaign (Sugamya Bharat Abhiyan)*' as a nation-wide Campaign for achieving universal accessibility for Persons with Disabilities (PwDs) with a focus on three verticals: Built Environment, Public Transportation and Information & Communication Technologies.

The 'Inclusiveness and Accessibility Index' launched by the Government as part of the Sugamya Bharat Abhiyan helps the industries and corporates to participate in the Accessible India Campaign (AIC) by voluntarily evaluating their readiness for making the workplace accessible for PwDs. The Index is a first-of-its-kind initiative in the country and will be an ideal instrument for the integration, assimilation and inclusion of PwDs into the mainstream. The Index enables the organisations to introspect over their inclusive policies and organisational culture in aid of PwDs, employment of such workforce and adaptations to meet the needs of PwDs.

Further, the ***"Rights of Persons with Disabilities Bill – 2016"*** passed by the Parliament aims at securing and enhancing the rights and entitlements of PwDs. The bill has proposed to increase the reservation in vacancies in government establishments from 3 per cent to 4 per cent for those with benchmark disability and high support needs. Further details of the bill are available at *http://pib.nic.in/newsite/PrintRelease.aspx?relid=155592*.



Box 1. Recent initiatives by the Government provide opportunities for urban rejuvenation

The Fourteenth Finance Commission (FFC) grant to ULBs for 2015-2020 is almost 277 per cent higher than the grant recommended by its predecessor. With the higher devolution of taxes to the states and grants to the ULBs, the overall public funds available for urban rejuvenation have increased. As a follow to the flagship programme (JNNURM) started by the Centre in 2005 across 65 cities, the Government has launched several new initiatives to rejuvenate urban areas. Some of the key schemes are - Smart Cities Mission, AMRUT, Swachh Bharat Mission (SBM), HRIDAY, Digital India, Skill development, Housing for All, Metro transport etc. The emphasis is now laid on strong convergence between area based and project-based schemes so as to exploit synergy and optimize benefits while avoiding costs overlap.

Smart Cities Mission

Smart Cities Mission (SCM) is a holistic city rejuvenation programme for 100 cities in India, The SCM initially covers five years (2015-16 to 2019-20) and may be continued thereafter based on an evaluation. Under the SCM, the core infrastructure elements in a smart city include: i) adequate water supply, ii) assured electricity supply, iii) sanitation, including solid waste management, iv) efficient urban mobility and public transport, v) affordable housing, especially for the poor, vi) robust IT connectivity and digitalization, vii) good governance, especially e-Governance and citizen participation, viii) sustainable environment, ix) safety and security of citizens, particularly women, children and the elderly, and x) health and education. The strategic components of area-based development in the SCM are city improvement (retrofitting), city renewal (redevelopment) and city extension (greenfield development) plus a pan-city initiative in which smart solutions are applied covering larger parts of the city.

AMRUT

Atal Mission for Rejuvenation and Urban Transformation (AMRUT) was launched on 25.06.2015 to improve basic urban infrastructure in 500 cities/ towns which would be known as Mission cities/ towns. The Mission is being operated for five years from financial year 2015–16 to 2019–20 and aims to cover all cities and towns with a population of over one lakh with notified Municipalities, including Cantonment Boards (civilian areas) and certain other cities like capital towns, some cities on stem of main rivers and tourist and hill destinations. The components which are to be covered under the Mission are: water supply, sewerage, septage, storm water drains, urban transport, in particular, with the focus on facilities for non-motorised transport and development of green space and parks with special provision for children-friendly components in 500 cities & towns.

HRIDAY

The Government launched the National Heritage City Development and Augmentation Yojana (HRIDAY) scheme on 21st January, 2015, with a focus on holistic development of heritage cities. The scheme aims to preserve and revitalise soul of the heritage city to reflect the city's unique character by encouraging aesthetically appealing, accessible, informative and secured environment. With a duration of 27 months (completing in March 2017) and a total outlay of ₹ 500 crore, the scheme is being implemented in 12 identified cities namely, Ajmer, Amaravati, Amritsar, Badami, Dwarka, Gaya, Kanchipuram, Mathura, Puri, Varanasi, Velankanni and Warangal. The scheme is implemented in a mission mode.

Swachh Bharat Mission

The Swachh Bharat Mission (SBM) was launched on 2nd October, 2014, with a target to make the country clean by 2nd October, 2019. All 4041 statutory towns as per census 2011 are covered under SBM. The programme includes elimination of open defecation, conversion of unsanitary toilets to pour flush toilets, eradication of manual scavenging, municipal solid waste management and bringing about a behavioural change in people regarding healthy sanitation practices. Under the solid waste management state/cities are being encouraged to come out with innovative solutions and MoUD supports them technically and financially. Some of the initiatives being taken are waste to energy, composting plants, capping of the dumpsites. All the initiatives are being supported by capacity building efforts to empower the Municipal Authorities to carry out their functions properly.

Urbanisation will pose considerable challenges for municipalities over the coming decades.

The first task is empowering ULBs financially.

- The analysis shows that municipalities that have generated more resources have been able to deliver more basic services. The states should, therefore, empower cities to levy all feasible taxes.
- Municipalities also need to make the most of their existing tax bases. There is a need to adopt the latest satellite based techniques to map urban properties. The Government should leverage the Indian Space Research Organization (ISRO)/National Remote Sensing Agency (NRSA) to assist ULBs in implementing GIS mapping of all properties in the area of a ULB. Property tax potential is large and can be tapped to generate additional revenue at city level.

Data and transparency also plays an important role

- MoUD should give greater priority to compile and publish comprehensive data on ULBs and urban sector. Perhaps, grants to ULBs should be more tightly linked to comprehensive and updated data disclosure and transparency by ULBs.

- NITI Aayog should compile comparative indices of municipalities' performance annually based on the actual accountability and administrative capacity to deliver the core public services.

Competition between states is becoming a powerful dynamic of change and progress, and that dynamic must extend to competition between states and cities and between cities. Cities that are entrusted with responsibilities, empowered with resources, and encumbered by accountability can become effective vehicles for competitive federalism and, indeed, competitive sub-federalism to be unleashed.

Note:

- *Chapter 10 and Chapter 11 of the Economic Survey should be read comprehensively.*

Please refer Economic Survey and prepare related notes.