Subsidy Cuts andFDI Inflow:
Two Catalysts forIndian Economy Revival

"No Power on Earth Can Stop an Idea Whose Time Has Come"

- ***Manmohan Singh (1991)***

Introduction:

The growth exhibited by Indian economy over the past decade has been truly inspiring. But the story was not a happy one in 1990. Once derided for its 2% "*Hindu Rate of Growth*", the economic might of India was unleashed in 1991.

Pre 1991, Indian economy faced a severe BoP crisis.With dwindling exports and rising debt, the situation appeared bleak. Forex Reserves stood at `11,416 Crores[1], barely enough to last 3 weeks. The situation was exacerbated by the increasing oil prices due to Gulf War. Inflation had reached its highest level of 13%. Subsequently, India's credit rating fell[2]. Simply put, the Indian economy was on the verge of default with respect to its external payments liability.

It was India's decision to open its door to FDI which led to tiding over the crisis. Sectors such as mining, banking, telecommunications and highway construction were opened to investors'[3]post 1991. FDI inflow rose from `2,705 Crores in 1990 to `18,486 Crores in March 2000 and `123,378 Crores in 2010[4]. With a growth rate of close to 7.7% over the past decade, India today truly occupies pride of place in the new economic order. India's journey has been an interesting one. Positive investor sentiment in Indian economy brought about by opening of the doors to foreign investors led to infusion of liquidity in funding starved Indian economy and filled the coffers of the Government. The push in upgrading Indian infrastructure was possible only because Government realized revenues brought about by FDI. The social benefits of this decision can be seen in the wide variety available to the Indian consumers, increased cosmopolitan fabric of our society and increased competitive nature of the nation's firms.

The Story Today

Today, India is slowly slipping from the path of high growth.IIP has plummeted from 9.69% in 2010 to a measly 2.4% in 2012[5]. There is a wave of pessimism and a loss of investor confidence that the India Growth Story is coming to an end. Fiscal Deficit is showing no signs of contracting, and India's External Debt has skyrocketed to $ 289.7 Bn from a stable $ 237 Bn just a year[6]ago (a 22% rise in just 1 year). Spiralingbudget deficit has led to inflation. Infrastructure projects are all coming to a standstill as major private sector companies are overleveraged and experiencing funding problems. Banks are constrained in their funding projects because of mounting NPAs on their balance sheets. There are fears of downgrades from credit rating agencies.

The Case against Subsidies

The biggest burden on Indian economy is its burgeoning subsidies bill. There has been a 200% rise in subsidies[7] since 2007-08.In 2010-11, the country's subsidy burden was `164,153Crores -- or 2.08% of the GDP -- and increased to `223,000 crore in the current financial year, which is 2.5%of the GDP.

As late as October 2012, the Kelkar Committee recommended that Government cut subsidies in three significant F's - Food, Fuel & Fertilizer - in order to meet its budgeted fiscal deficit target. The Committee further said that the current deficit level of 5.1% could balloon up to 6.1% if no corrective measures were taken.The Committee warned that India was on the edge of a 'fiscal precipice' and headed for a "fiscal storm worse than 1991"[8].

The problems with the current subsidy system are many. The ineffectiveness of subsidies is an open fact.Still, policy makers refuse to infuse a new line of thinking to solve the problems.Low property taxes have madeMunicipal Corporations unviable. Municipal Corporations and State Electricity Boards are reeling under heavy losses. Low electricity and water tariffs have reduced the incentive to optimize usage and have led to wastage of precious resources. The PDS system for distribution of foodgrains and kerosene has spawned practices like black marketing and hoarding. Subsidized urban housing is sold off and beneficiaries revert to squatting. Low-priced public transport tickets have pushedState Transport Corporations towards bankruptcy. Wage guarantees have distorted labor incentives and prevented efficient labor allocation.

The problem with fuel subsidies is that they impose a heavy burden on Government budgets, add to global warming, pollution and cause wasteful consumption in general.This, in turn, diverts much-needed resources from more pressing needs, such as health and education. As National Income rises, so does the consumption of fuel.Indian policy makers have been oblivious to this trap of rising fuel subsidy bill. The lingering uncertainty over the outlook for fuel prices may also affect investor and consumer confidence at a time when the global economic environment is more challenging.

Similar is the case with subsidies in the form of free power, fertilizers etc. The biggest challenge for the government is selecting an appropriate channel for subsidy transfers.The current channelsof providing subsidies to thefarmers are deeply flawed.The most effective approach to minimizing such distortions is eliminating price subsidies and replacing them with direct equivalent cash transfers. In this context, the proposed Direct Cash Transfer system via Aadhar is revolutionary.

The Government, constrained by coalition compulsions, haspaid some cosmetic heed to the Panel's suggestions but with the caveat that certain subsidies were unavoidable. The recent hikes in diesel prices and cap on subsidized LPG cylinders are steps in the right direction. For a country with a burgeoning middleclass, such a cut in deficits is not a severe problem. The middle class can afford it. Indian citizens should be ready to pay the price for development.

IS FDI Really the Engine for Growth?

The rationale for economic liberalizationduring 1991 was to foster greater competition in private sector which would ensure efficient allocation of resources, greater efficiency and achieve a spread of income and prosperity.FDI in itself is not the be all and end all solution. FDI and growth form a complex cycle – where one is the cause of another. Only when there are conditions conducive for growth will multi-national firms invest in India. And their investing will provide a push to the economy. FDI inflows are a signal that the investment climate is fair and investors have a sense of comfort and security.

Though it is a vital step for the improvement of economy –it is only an addition that bridges the gap in capital formation required to sustain a targeted growth. Our economic strategy cannot be entirely based on FDI-led growth alone. In India, it is estimated that FDI contributed just 0.7% - 2.1% to GDP growth during the period from 2003-10. Thus, to root out prevailing pessimism, steps should be taken to ensure that FDI inflows increase. This can be achieved by:

- Adoptinga transparent policy framework
- Conducting an overhaul of the regulatory framework
- Evolving transparent procedures for allotment of land, power, environmental clearances, etc.
- Time-boundsingle-window approvals of various clearances
- Developing physical infrastructure comparable to international standards
- Developing a social infrastructure to attract both highly-skilled and semi-skilled human resources

For achieving high growth, India requires more knowledge cities, SEZs, Industrial clusters, IT Parks, Highwaysand R&D Hubs etc. A 9% GDP growth would need $1 Trillion worth of investment in core infrastructure alone. Funding for such ambitious prospects mean that we pave way for FDI.

FDI provides immense job opportunities to local people and also assists in improving the economic situation. Sentiment plays a major role in the growth ofan economy. Government recently allowed 51% foreign investment in multi—brand retail but left it to the states to permit global retailers to open stores.

The sectors where we are seeing stupendous growth today are the sectors in which FDI has played crucial roles. The drugs and pharmaceutical sector has seen a 15-fold jump in FDI in FY12. India has gained from FDI in automobile, IT/ITES and telecom sectors in terms of lower prices and myriad choices, flourishing infrastructure and continuous accumulation of knowledge capital.

Parting Shot

Faltering FDI flows have affected India's economic growth process and undermined its position. For India, considering its demographic challenge, achieving high growth is not an option but a necessity. The two catalysts - subsidy cuts and FDI inflows - are crucial Indian for unleashing the "*Animal Spirits*". Only time will tell if the revival in FDI is here to stay. Transitory or not, revival in FDI flows is certainly good news for the economy. And sooner our baggage of subsidies is trimmed, the better off we will be.

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[1]Bulletin RBI (Table 45); Economic Survey 2011-12
[2]India's Credit Rating -Rajwade (Business Standard May 1,2006)
[3]Study of FDI And Indian Economy – SapnaHooda (NIT-K)
[4]Impact of FDI on Indian economy -MahantaDevajit(RJMS Sept, 2012)
[5]www.indexmundi.com
[6] Finmin.nic.in – India's External Debt (End Sept, 2011)
[7]10 Problems Ailing The Indian Economy & Solutions To Revive It (ET June 2, 2012)
[8] Kelkar Committee Report (RBI) pp4