

Modinomics at Four

Why India Is on the Path to Long-Term Prosperity

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When Prime Minister Narendra Modi took office in May 2014, India faced major economic challenges. Growth had plummeted to 5.9 percent during the last two years of the outgoing government, down from a nine-year average of 8.2 percent. During the same two years, inflation had averaged 9.7 percent. Meanwhile, the government was in the grip of paralysis, unable to rein in corruption or complete large projects and in need of key structural reforms.

Four years later, the [Modi](#) government has largely succeeded in addressing these problems. On average, inflation has come down to 4.3 percent and growth has climbed to 7.3 percent over the last four years. Bold steps such as the demonetization program in November 2016 have been effective in curbing corruption. And the government has introduced numerous efficiency-enhancing initiatives, such as the replacement of a complex set of central- and state-level taxes with a single goods and services tax (GST). Taken together, these policies put India on the path to long-term growth and prosperity.

BOOSTING EFFICIENCY

One of Modi's main points of focus since taking office has been improving governance and efficiency. The last two years of the outgoing government under Prime Minister Manmohan Singh had been characterized by deep paralysis. Large projects had been stalled due to a lack of coordination among different ministries and inordinate delays in environmental clearance. Upon taking office, Modi directly intervened to speed up clearances and decision-making. He instituted a process whereby he himself regularly presides over meetings of senior staff members of ministries relevant to making decisions on specific projects and policy issues.

Early in its tenure, the government also made a major effort at the level of the states to simplify and digitize various clearances for businesses. That effort led to the unprecedented jump in India's position in the World Bank Ease of Doing Business rankings from 140 to 100 between 2014 and 2018. In parallel, the government has also taken steps to simplify citizens' lives. In the past, job and school applicants had to go through a cumbersome process of getting diploma copies certified by senior officials or judges. The government has replaced this decades-long practice by a self-certification policy bringing relief to all, especially rural residents. Citizens can also store digital copies of their diplomas using a free service provided by the state, and numerous government services can now be accessed online. The government has also provided 40 million poor rural households with stoves that use liquid petroleum gas instead of the black carbon generated by wood- and coal-burning stoves.

India under Modi has also taken up the fight against corruption. Its most daring measure on this front has been demonetization, which ended legal tender status of 500 and 1,000 rupee notes overnight on November 8, 2016. The move temporarily wiped out 86 percent of the nation's currency in circulation. Holders of these notes were required to deposit them in bank accounts to eventually receive new legal tender currency notes in return. The government had hoped that those holding unaccounted wealth in these notes would not deposit them for the fear of being caught. That turned out not to be the case, with most holders finding ways to work around the program. Many of them sold the notes at a discount to those who could game the system to account for more wealth than they actually held. Nevertheless, subsequent analysis of the bank accounts has led to the detection and closure of hundreds of thousands of fake shell companies and disqualification of a similarly large number of company directors to serve as directors in the future.

Demonetization also led to a 25 percent decline in the value of real estate, thereby eroding a substantial amount of black wealth held in buildings and structures. Finally, demonetization has sent a strong signal of the government's resolve to combat corruption, leading to a jump in the number of income-tax payers and placing those transacting illegally on notice.

Modi also greatly improved government efficiency by replacing the erstwhile Planning Commission with the National Institution for Transforming India (NITI). A bipartisan consensus had evolved over time that with India having moved toward a market economy since the 1991 reforms, the Planning Commission had lost its relevance. Yet no past government did anything to replace it with a more contemporary, market-friendly institution. Launched in 2015, the NITI has emerged as an active promoter of the reform agenda of the Prime Minister. It has also forged a more equitable relationship between the center and the states. On the one hand it offers policy advice to states while on the other it seeks their advice in the formulation of central government policies.

SPECIAL PROJECTS

Until now, an important difference between China and India has been the ability of the former to complete projects on scale and at speed. Under Modi, India has finally seen at least some progress in this direction. Three specific examples are worthy of mention: the spread of biometric identity cards, the opening of Jan Dhan bank accounts, and the building of toilets under the Swacch Bharat Mission (SBM).

First is the issuance of a biometric identity card to all residents of the country. Begun under the previous government in 2010, the Aadhaar project, as it is known, has today distributed 1.2 billion such cards, and nearly all Indian residents except those in a few states on the border are in possession of one. The government issued 8.65 million cards in August 2017 alone.

As a part of its effort to increase financial inclusion, the government launched the Jan Dhan bank account program and opened 18 million bank accounts for citizens in just one week in August 2014, a feat that qualified for inclusion in the Guinness Book of World Records. Today, the total number of Jan Dhan bank accounts stands at 316 million.

Finally, under SBM, the percentage of rural households with toilets has risen from barely 38 percent to 84.2 percent. The number of states with no open defecation has risen from none when Modi took office to 17 currently. Modi is now within striking distance of achieving his declared objective: an open-defecation-free India by Mahatma Gandhi's 150th birthday on October 2, 2019.

STRUCTURAL REFORMS

When Modi came to office, momentum for structural reforms had been lost, and little progress had been made during the preceding five years. During his tenure, substantial progress has been made in a large number of areas. Although the full list is too long to be fully covered, some key reforms are worthy of note: deregulation of gasoline and diesel prices, further opening to foreign direct investment (FDI), greater labor-market flexibility, the shift to Direct Benefit Transfers (DBT), the Goods and Services Tax (GST), and the Insolvency and Bankruptcy Code (IBC).

Under Modi, India has deregulated gasoline and diesel prices. For too long, state subsidies held down the prices paid by consumers, thereby encouraging wasteful consumption of the products and adding to the fiscal deficit. These subsidies have now been fully eliminated. During the recent rise in crude prices, which led to large increases in retail gasoline and diesel prices, voices were raised from nearly all quarters to lower the prices but the government has refrained from restoring subsidies. During the last four years, the subsidy on liquid petroleum gas, used in cooking, has also been considerably reduced.



MUKESH GUPTA / REUTERS

Indian Prime Minister Narendra Modi speaks during the inauguration of hydro power and infrastructure projects in the state of Jammu and Kashmir, May 2018.

Modi has also opened India up to greater levels of foreign direct investment (FDI). At the time he came to office, foreign investors considered a relaxation of the FDI cap in the insurance market from 26 percent to 49 percent as a litmus test of his resolve to place India back on the path of reforms. The Modi government has not only delivered on this reform but gone further by opening up defense to FDI. It has also permitted 100 percent FDI in marketing of food products produced in India; high-tech and capital-intensive activities in the railways; manufacturing of medical devices; and the e-commerce marketplace. The last of these items has led to the entry of Amazon and Walmart in India's e-commerce space. Total FDI flow, which averaged \$35 billion during the last two fiscal years of the outgoing government, has risen to \$60 billion in the fiscal year ending in March 2017 and \$48 billion during the nine-month period of April-December 2017.

According to one of the labor laws, a manufacturing firm with 100 or more workers cannot terminate workers for any reason without permission from the relevant regulatory authority, which is almost never granted in practice. Consequently, firms in India have tended to stay small, especially in labor-intensive sectors where margins per worker are small. To alleviate this problem, the government has now introduced fixed-term employment in all sectors, whereby firms will be able to hire workers for a specified term, after which they will have no claim to staying on. This will give the firms greater flexibility in hiring than in the past.

To improve the efficiency of distribution of benefits under social programs, and curb waste, fraud, and abuse, the government has been channeling more and more of its benefits through the Direct Benefit Transfer (DBT) mechanism, which requires beneficiaries to produce their biometric Aadhaar identity cards. A vast number of benefits, including such major ones as the subsidy on cooking-gas cylinders, the sale of food grain at subsidized prices, and the payment of wages for employment under the National Rural Employment Guarantee Act, are now being implemented through the DBT mechanism. This has allowed the elimination of tens of millions of ghost beneficiaries. Savings attributable to the DBT mechanism cumulatively exceed \$10 billion.

The GST, meanwhile, had been a reform in the making for over a decade. The government has finally successfully completed this complex reform, requiring consensus across 29 states, a constitutional amendment, and multiple legislations. Although the reform has been criticized for maintaining as many as four different tax rates and for poor implementation, its principal benefit is the replacement of numerous central and state level indirect taxes by a single tax on each product nationwide. Already, a major logistics company, Rivigo, reports that with the GST leading to the removal of checkpoints at state borders, travel time for trucks on highways has decreased on average by 15 percent.

Despite the passage of nearly 70 years since independence, India still lacked an effective bankruptcy law when Modi took power, leaving creditors, including banks, at the mercy of borrowers. Large borrowers have traditionally exploited this situation by forcing lenders to renegotiate the terms of loans. There have also been repeated episodes of large accumulations of non-performing assets (NPAs) by banks, requiring the government to recapitalize the banks using taxpayer money. At long last, in May 2016, the government enacted the IBC, which introduces a time-bound bankruptcy process in case of default. The Reserve Bank of India is now successfully deploying this law to systematically clear the existing NPAs. Using the IBC, it has also laid down strict rules of repayment of loans, thereby cutting the scope for banks to accumulate a large volume of NPAs in the future.

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THE FUTURE OF THE INDIAN ECONOMY

For all the Modi government's economic accomplishments, there is one important area in which it has fallen short: international trade. A process of concerted reduction in trade barriers beginning in 1991 had brought the top industrial tariff (with some exceptions, such as textiles, apparel, and auto) down from 355 percent to 10 percent by 2007. The average industrial tariff had correspondingly fallen from 113 percent to 12 percent. But recently, the government has returned to the discredited policy of import-substitution industrialization, which promotes industrialization by replacing imports by domestic production and raised tariffs on a large number of products.

Currently, approximately 45 percent of India's workforce remains in [agriculture](#), which produces just 15 percent of GDP. Economic transformation requires the creation of well-paid jobs in industry and services so that a significant proportion of the current agricultural workforce may migrate out of its current low-productivity employment. If this migration is to take place speedily, India must achieve substantial expansion in its share of global exports, especially in the labor-intensive products. With China withdrawing from these products due to its high wages, this is a feasible proposition, but only if India's own policies favor outward orientation over the inward-looking policy of import substitution.

Over the past four years, the Modi government has made great progress in reforming the economy to deliver greater growth and prosperity. Although many of its policies have already had a marked effect, most will yield their full impact only in the longer run, so unless the next government turns populist, prospects for further acceleration in growth and prosperity are excellent. 