

Modi Govt to shift gears from incremental reforms to innovative ones

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A

slew of recent reports on India from International Monetary Fund (IMF) should reinvigorate Modi Government's political will to take up reforms with focus on medium and long terms prospects for inclusive growth.

The Government has so far relied on incremental reforms and exploited the persisting trends in commodities market especially oil for short-term fiscal consolidation. It has taken benign external environment to defer expenditure reforms, labour reforms and other structural reforms. There is hardly any indication from the Government that it would make the reforms broad-based and thus growth more wholesome and sustainable.

BJP-led NDA has flaunted the increase in growth of gross domestic product (GDP) during the last two years as solely due to it being in the saddle. The fact is that growth momentum and fiscal improvement is primarily driven by slump in global prices of petroleum, fertilizers and other commodities.

IMF has estimated that favourable terms of trade especially for imported crude oil has resulted 2.5% of GDP gain for India.

As put by IMF Staff Report on India,

"following the U.S. oil revolution, with oil prices falling by 51 percent in the first year, Indian growth increases by about 0.3 percentage point after one year-either directly through higher urban consumption spending and lower input cost for corporate sector or indirectly from trade with the rest of the world (as global growth increases by 0.2â€"0.4 percentage point). The oil glut also creates a moderate temporary disinflation pressure in India (80 basis points on an annualized basis over 4 quarters) and boosts equity prices over the medium-term."

What IMF has refrained from stating is that growth would have been higher had the Government not resorted to successive hikes in excise duty on petroleum products to manage its fiscal deficit. The Government must utilize the additional tax revenue from petroleum sector to create a price stabilization fund (PSF) whose corpus can be used to manage volatility in global oil prices in future.

India's dependence on imported oil would have been less if successive regimes had ploughed back about Rs 100,000-crore proceeds of cess on indigenous crude levied since 1974 into the sector. A very small fraction of this amount has been used for development hydrocarbons and petrochemical industries.

It is here pertinent to quote Asian Development Bank's (ADB's) working paper (WP) on Norway's experiences with managing petroleum revenues starting with its first oil discovery in 1969. The paper, released last week, notes that Norway created in 1990 the Norwegian Petroleum Fund as a fiscal policy tool to underpin long-term considerations in phasing in of petroleum revenues into its economy. The Fund's name was changed to Government Pension Fund-Global (GPFG) in 2006.

WP says:

"GPFG is one of the biggest sovereign wealth funds in the world, amounting to 4,397 billion NOK, equal to USD 733 billion."

The Fund acts both price stabilisation mechanism and as a tool for long-term wealth accumulation for future generations.

The Finance Ministry should draw a lesson from Norway and other countries (both oil exporting and importing countries) that created dedicated funds for petro-products price stability and long-term growth.

Modi Government must thus utilize accumulated cess money to give a big push to oil & gas exploration and production. Simultaneously, it should set aside additional excise and customs revenue from oil sector to create petroleum products PSF. It should do so keeping in mind that global oil price would remain subdued over a couple of years.

As regards other delayed initiatives, expenditure reform is an area that is crying for attention for long. The UPA's policy paralysis typified by repeated deferring of urea price hike for years and delaying its inclusion in the nutrients-based subsidy persists. It has prevented balanced fertilization of crops and increase in crop yields, apart from subsidy savings.

The Government must unveil an expenditure reforms agenda by keeping in mind that expenditure efficiency as important as revenue collection efficiency in management of fiscal deficit.

IMF's staff report has rightly reminded about delayed or slow-paced tax reforms including direct tax code by stating that **"India's revenue-to-GDP ratio remains considerably below its emerging market peers."**

The Government should also give requisite importance to IMF's concern over **"anemic exports as well as headwinds from weaknesses in India's corporate financial positions and public bank balance sheets."**

Another IMF report on India's "Selected Issues" has underscored the prospects of rise in corporate loan defaults and the consequent need for additional recapitalization of banks.

The report projects: "The stress tests of corporate balance sheets confirm that exposure to potential shocks continues to be high. In extreme stress conditions-captured by the unprecedented combination of extreme adverse shocks calibrated to India's experience in the aftermath of the global financial crisis and the 2013 "taper tantrum"-the corporate sector's debt-at-risk could reach 42 percent."

This calls for fiscal cushion by the Finance Ministry to manage the impact of three potential risks on NPAs. The risks are: rise in domestic & foreign interest rates, depreciation of the Indian rupee and further decline in corporate profitability.

Modi Government also has to do much more than what it has done so far in realm of sector-specific reforms and labour reforms. An IMF working paper on admitted the challenges in implementing labour reforms.

WP captioned "Macroeconomic Impact of Product and Labor Market Reforms on Informality and Unemployment in India" has concluded **"that less regulation increases GDP, and reduces both informality and unemployment in the long run. The effects of labor market deregulation are stronger than those of product market deregulation."**

The reduction in the informal nature of a large chunk of economy and labour market can also lead to increase in tax revenue.

WP says:
"by adding the tax evasion and corruption aspects of informality, it might be interesting to quantify the impact of deregulation reforms on improvements in tax receipts of the government, and thus on fiscal deficits in emerging economies. This would require a more detailed modeling of the fiscal side of the economy in our framework."

To sum up, the Government should shift gears from incrementalism to innovative reforms.