Economic Survey of India 2015-16

New Delhi

February 26, 2016

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Strengthening the State: Fiscal Relations with Rich and Poor

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Macro Outlook & Policy

Summary

I. The world economy is becoming grim

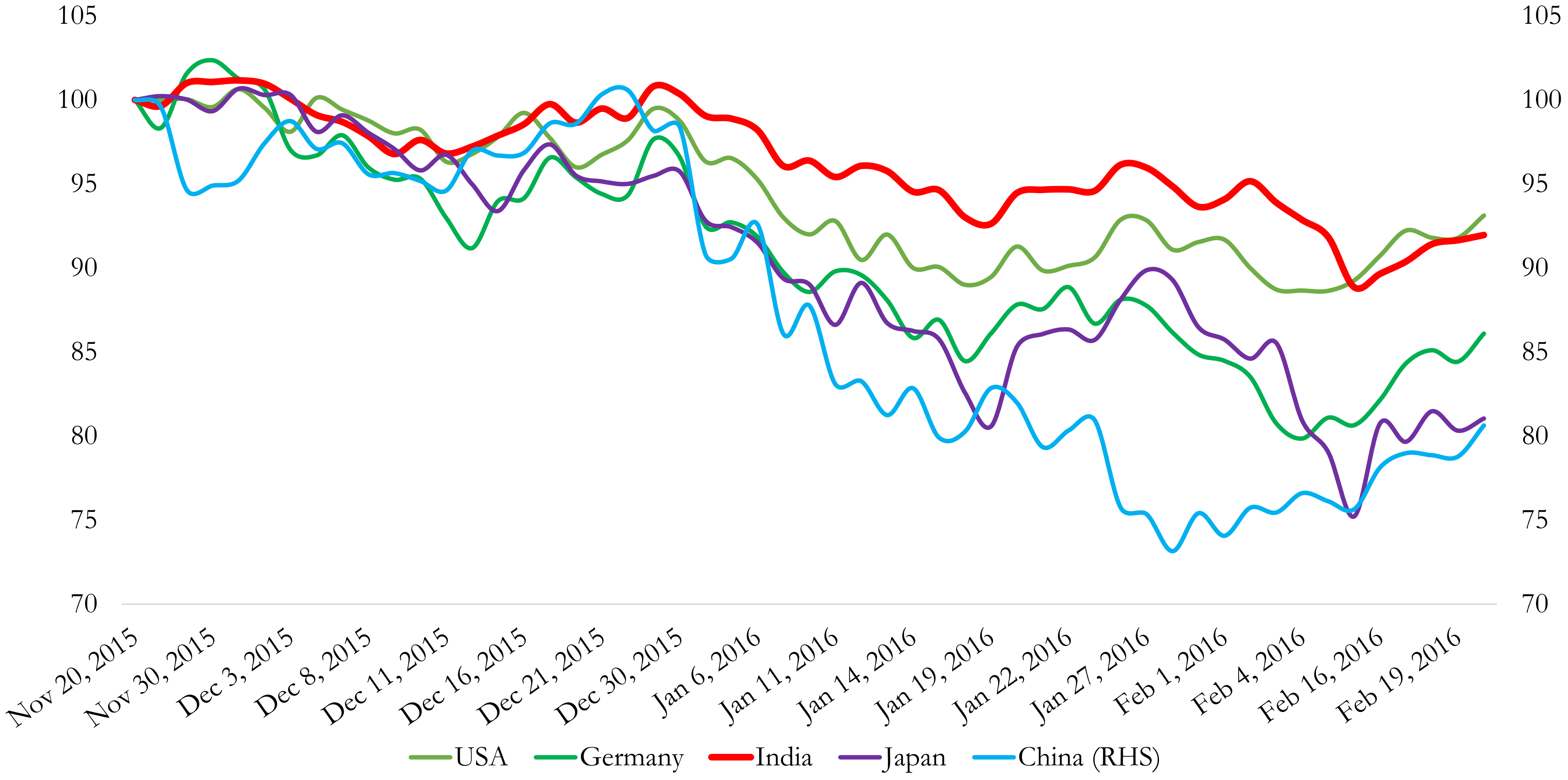
II. Recalibrate expectations about India's performance

III. Need to sustain macro-economic stability

IV. Monetary and fiscal policy must purchase insurance against growth slowdown

V. No longer a twin deficit but a "twin balance sheet" challenge

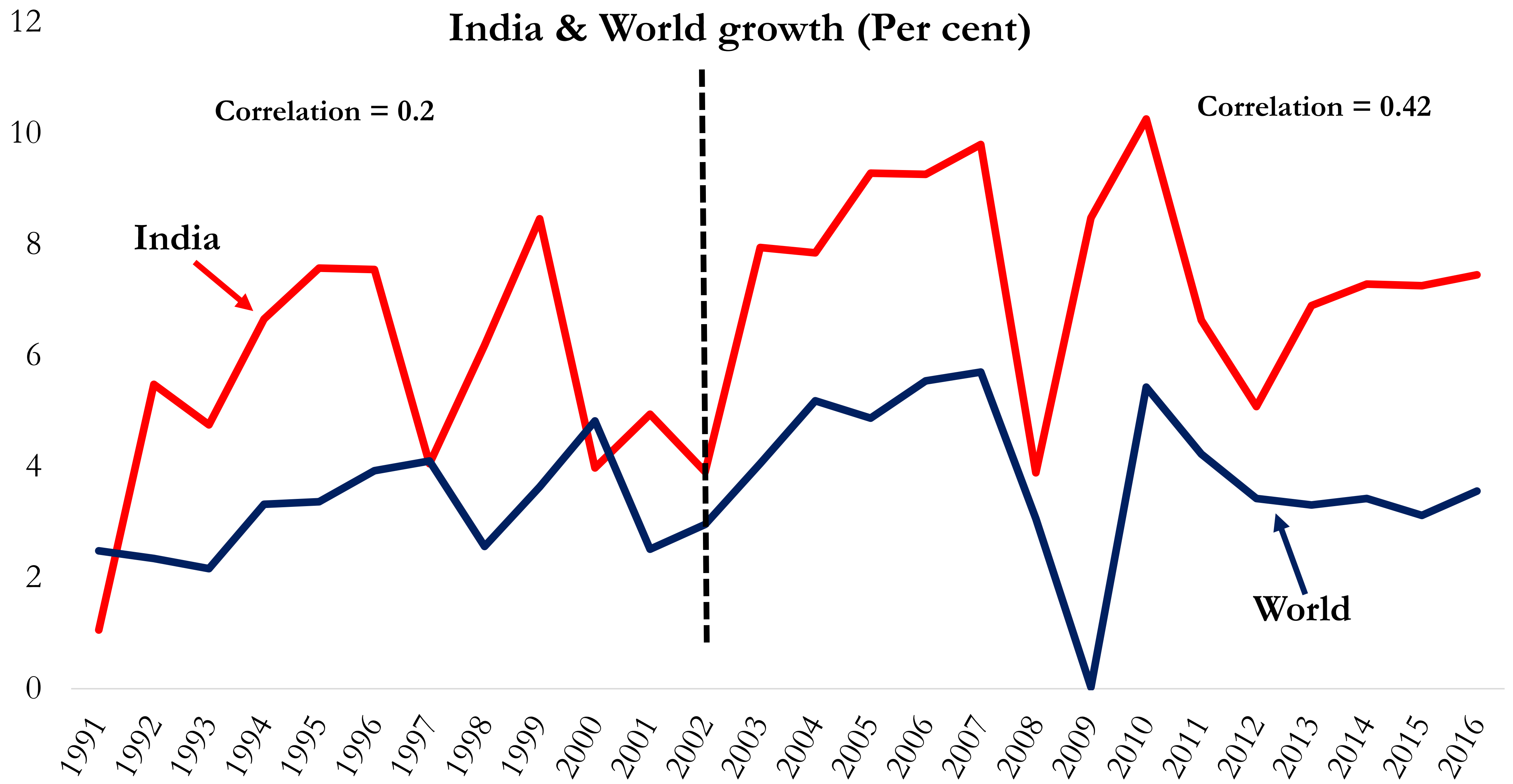
Grim External Environment: Declining Stock Markets



Taxonomy of Financial Crises: This time might be very different

Crisis Type	Originating Countries	Origin of problem	Manifestation	Trigger	Exchange Rate Regime	Remarks
Latin American	EMEs (Latin America 1982; India 1991); Small advanced country (Greece 2010 onwards)	Government borrowing	Current account deficit	Speculative attack and exchange rate collapse	Fixed rate	Greece was part of euro, so trigger was sharp rise in interest rates.
Asian Financial Crisis	EMEs (East Asia 1997-9; Eastern Europe, 2008; Fragile Five 2013); Small advanced country (Spain 2010)	Corporate borrowing	Asset price bubbles; High corporate leverage	"Sudden stop" of capital flows and exchange rate collapse	Fixed rate	Fragile Five had flexible exchange rates. Spain was part of euro.
Global Financial Crisis	Systemically Important (US 2008)	Bank and consumer borrowing	Asset price bubble in housing	Correction in asset prices	Flexible exchange rate	US dollar appreciated.
The NEXT	Systemically Important	Corporate borrowing	Rising debt, asset price bubbles	"Sudden stop" with potential for sharp exchange rate decline	Managed float	Crisis country's currency could depreciate substantially.

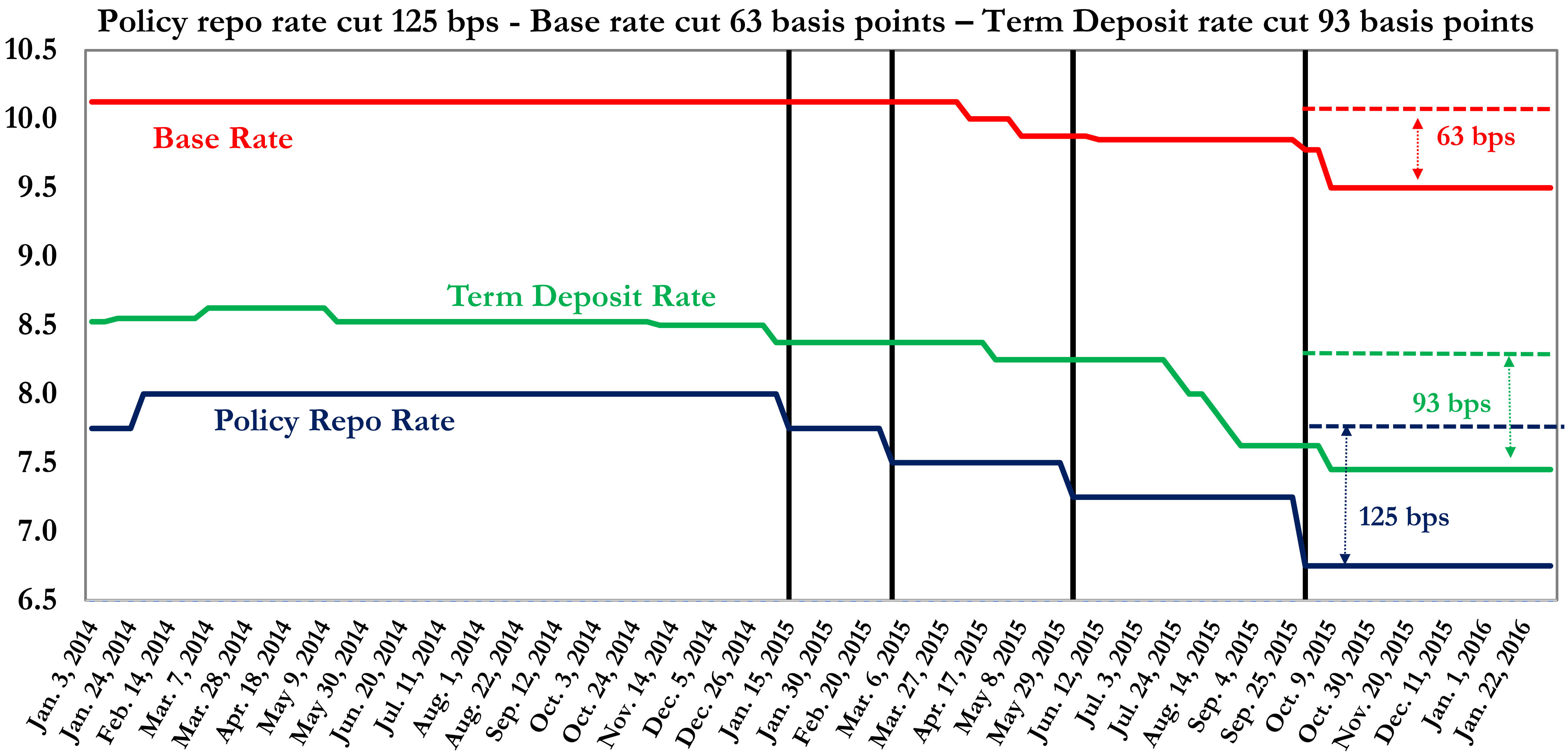
Why Recalibrate Expectations? India “so entwined” with world



Outlook for growth and inflation

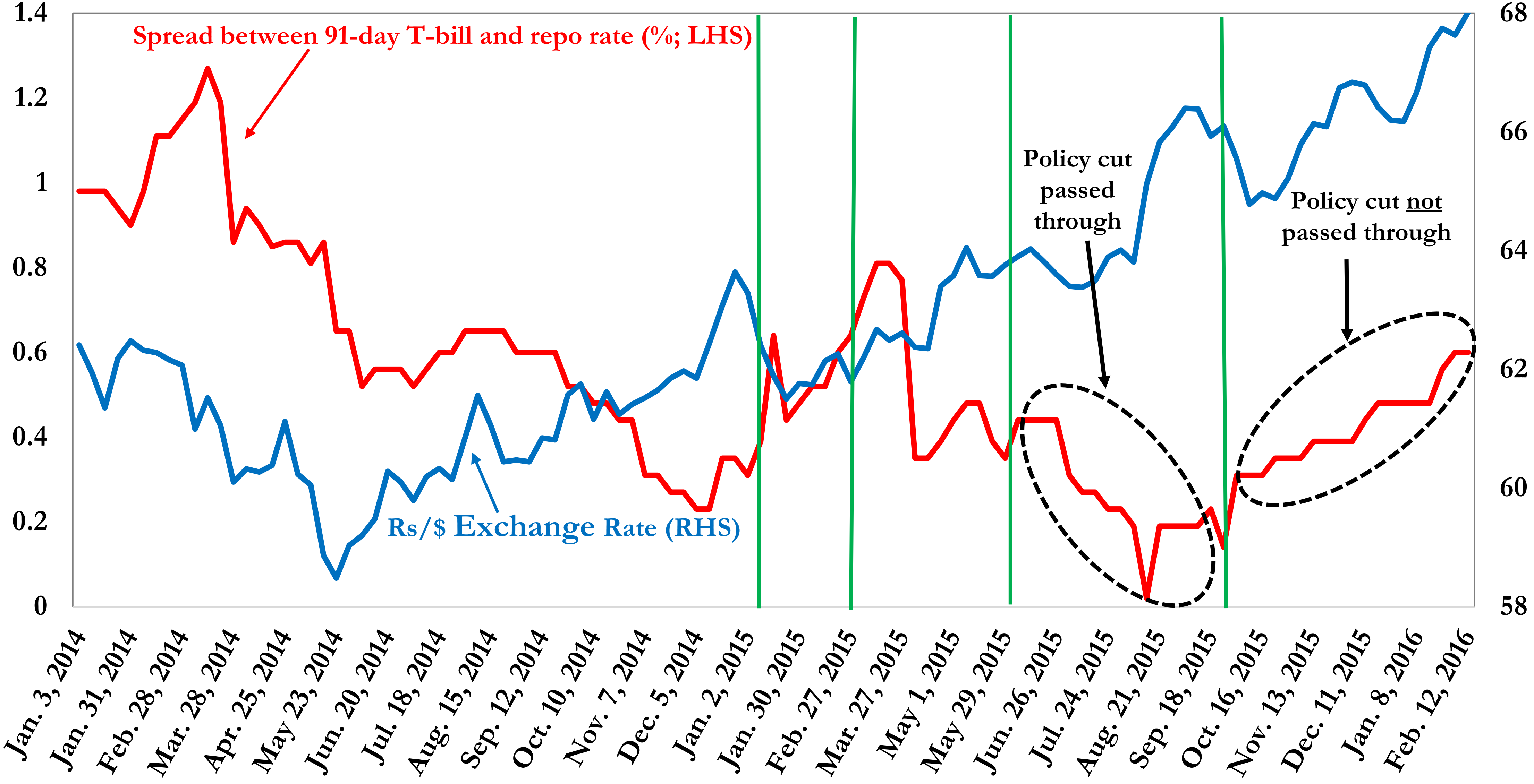
- Real GDP growth projection for FY2017: **7-7.75** per cent
  - The wider range reflects the range of exogenous: from a rebound in agriculture to a full-fledged international crisis.
  - Uncertainty arising from the divergence between growth in nominal and real aggregates.
- CPI inflation projection for FY2017: **4.5 – 5.0** per cent
  - Minimal effect of 7th Pay Commission
  - Below-potential growth and rising excess capacity
  - Balance sheet stresses of private sector
  - Deflationary world environment
- Downside risks
  - The most serious risks are global: faltering world growth, extreme financial events, and rising oil prices.

Monetary policy— Limited Interest Pass-through



** Vertical Lines in all these boxes refer to dates when repo rate changes were announced.*

Liquidity has tightened after October rate cut



Fiscal: To consolidate aggressively or gradually ?

- Fiscal policy must balance maintaining stability (through steadily declining debt and deficit) with purchasing insurance against growth slowdown

Pros

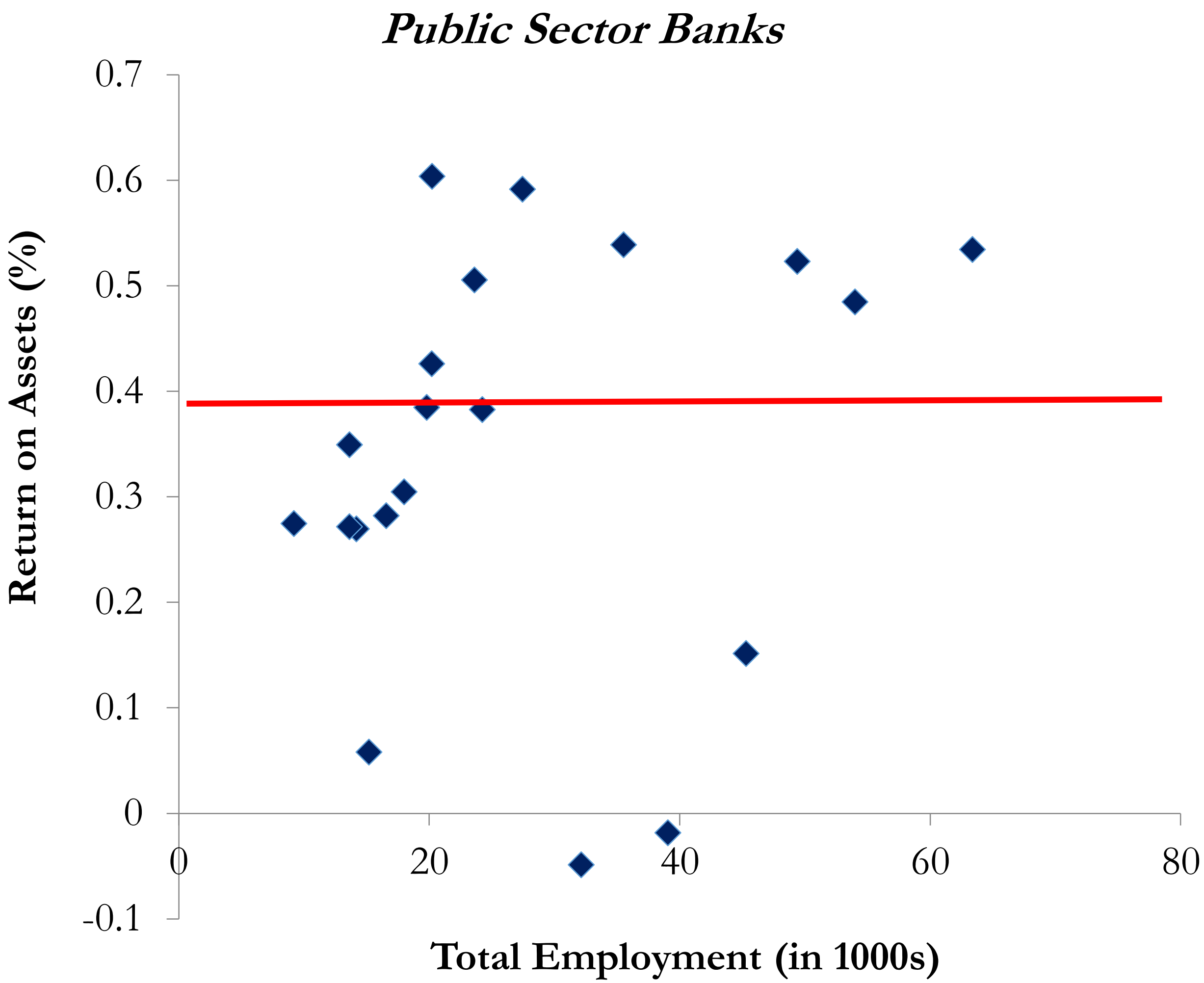
i. Government keeps commitment, reinforcing credibility
ii. Debt and deficit on declining path
iii. Robust growth right time to consolidate

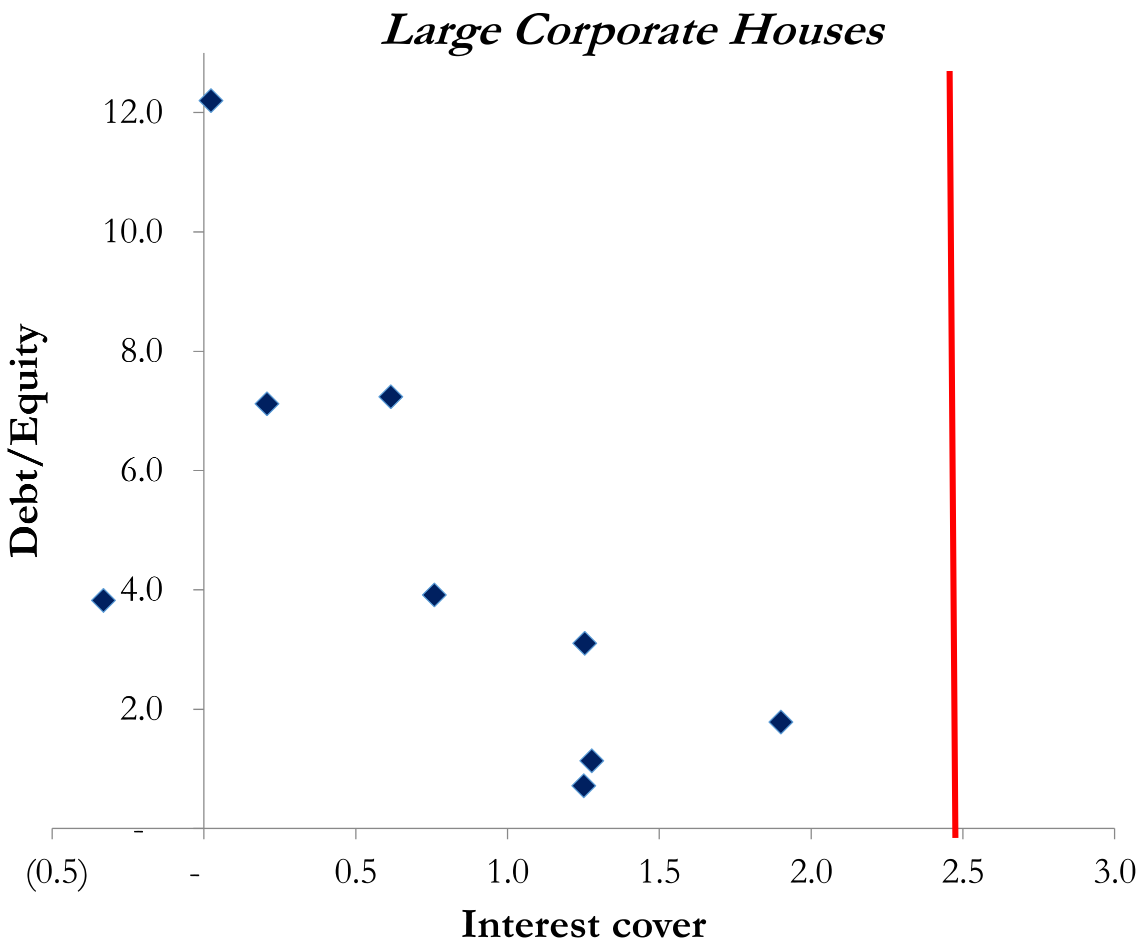
Cons

i. Feasibility when large Pay Commission and infrastructure obligations loom
ii. Could weaken economy when growth outlook uncertain

From twin deficits challenge to Twin Balance Sheet challenge

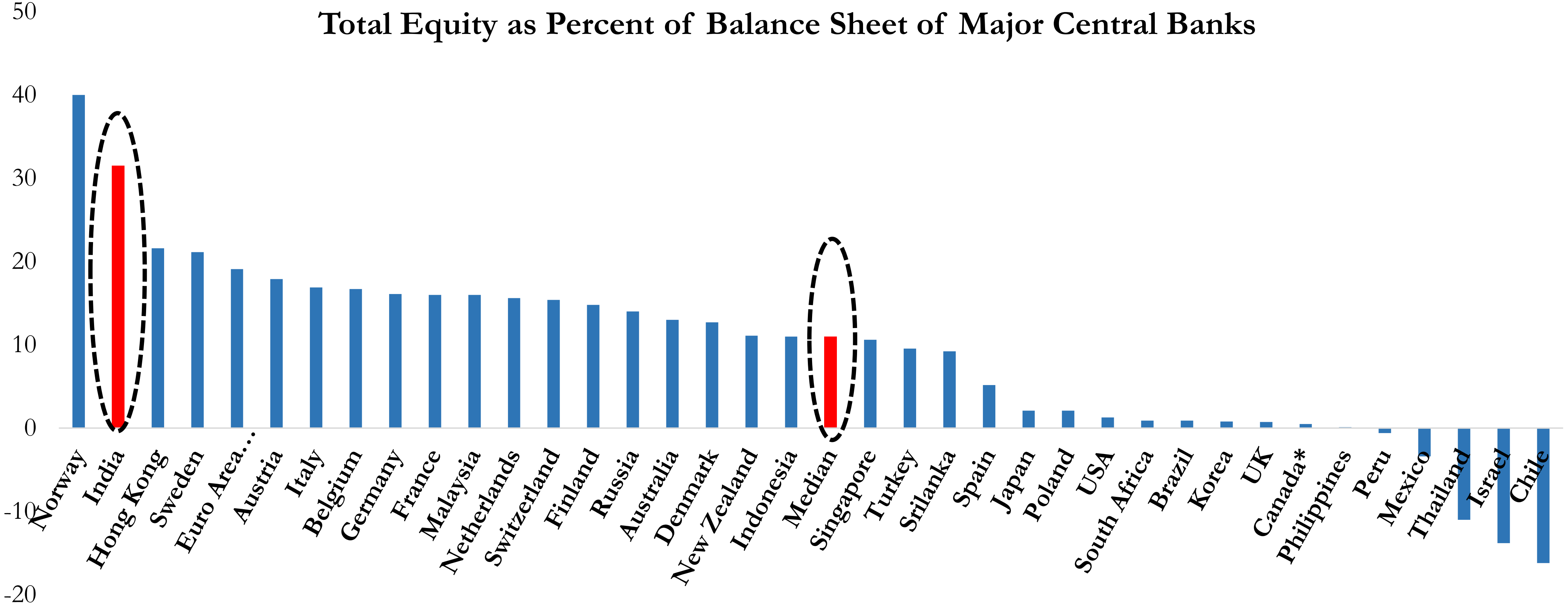
- Large and rising stressed assets in banks
- Profitability and indebtedness of corporates worsening





Addressing India's 'Twin Balance Sheets'

- Resolving the TBS challenge comprehensively would require 4 R's: *Recognition*, *Recapitalization*, *Resolution*, and *Reform*
- Can resources for recapitalization come from public sector – including RBI – balance sheet ?



Structural Reforms viewed through lens of ***Exit***

The *Chakravyuha* or Exit Challenge: *From socialism with limited entry to "marketism" without exit*

Impeded Exit is pervasive, costly but fixable..

Sector	Inefficiency Measure/Cost
PUBLIC SECTOR	
Fertilizers (Inefficient firms)	Total subsidy based on economic cost Rs. 23,013 crore.
Public Sector Banks (a few banks)	Capital infusion between 2009-10 and 2015-16 (H1): Rs. 1.02 lakh crore.
Discoms (major loss-making states)	Accumulated losses over 2008-09 and 2013-14-15 about Rs. 2.3 lakh crores.
Central Public Sector Enterprises	Accumulated losses of sick units as of 2013-14: Rs 1.04 lakh crore.
Administrative Schemes	Number of central sector and centrally sponsored schemes increased from 908 in 2006-07 to 1086 in 2014-15.
PRIVATE SECTOR	
Steel	Cost of production 50-75% higher for few inefficient firms in comparison to global norms.
Infrastructure (few large groups)	As of FY15 the average interest cover is about 0.3.
Small Savings	Implicit subsidy to well-off: Rs 11,900 crore.
ECONOMY WIDE	
Trade Liberalisation	Nearly highest restrictions on imports; gains from liberalisation of goods and services estimated at 1% of GDP
Labour	Not enough big firms and too many small and inefficient firms (Hsieh & Klenow, 2014; Bloom and van Reenen (2010)

Why is Exit Difficult?

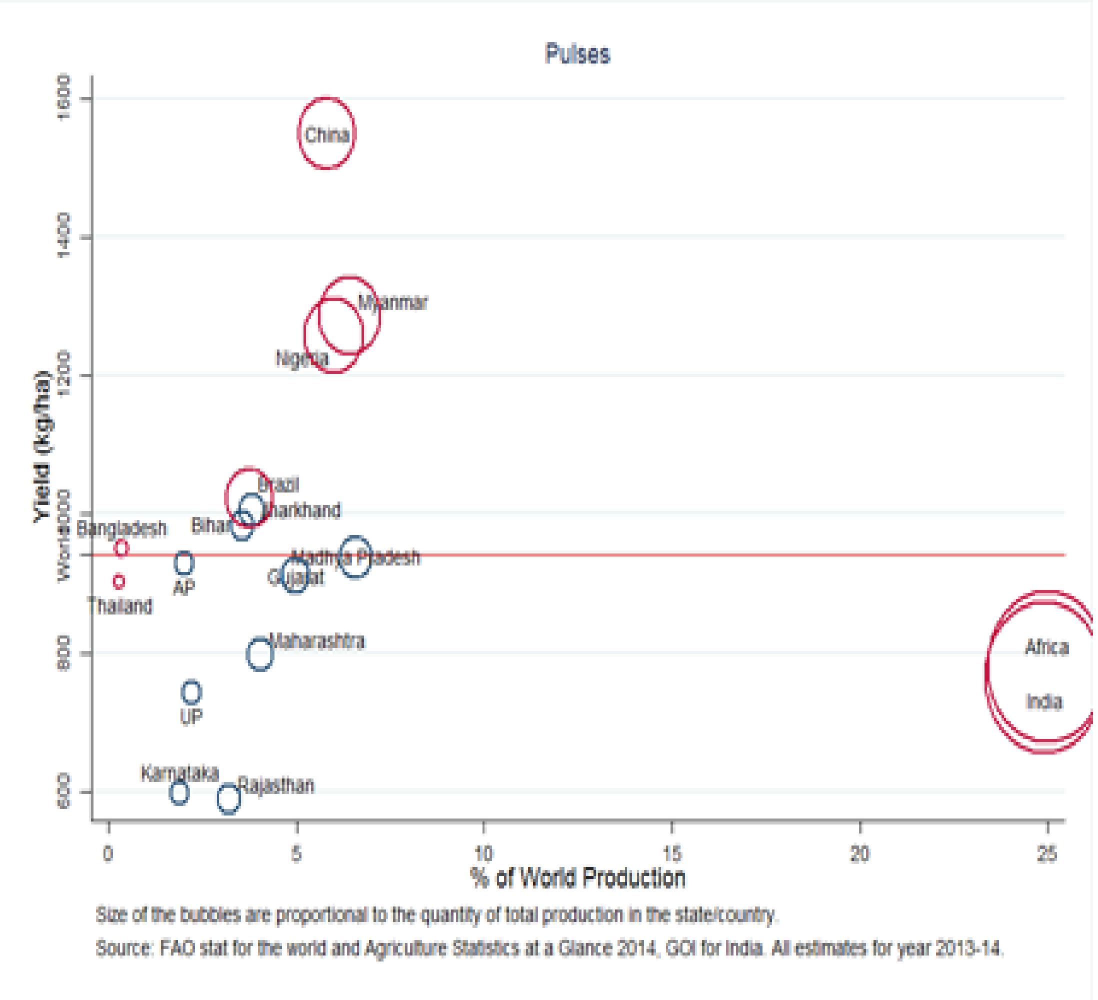
- Interests: Diffused beneficiaries, concentrated losers

- Institutions—weak and strong
  - Weak: Wilful defaulters
  - Strong: Bureaucratic paralysis created by referee institutions

- Ideas/Ideology
  - Protecting vulnerable in a poor economy
  - "Sanctification of the small"

Agriculture: Diversify to pulses and greater market integration

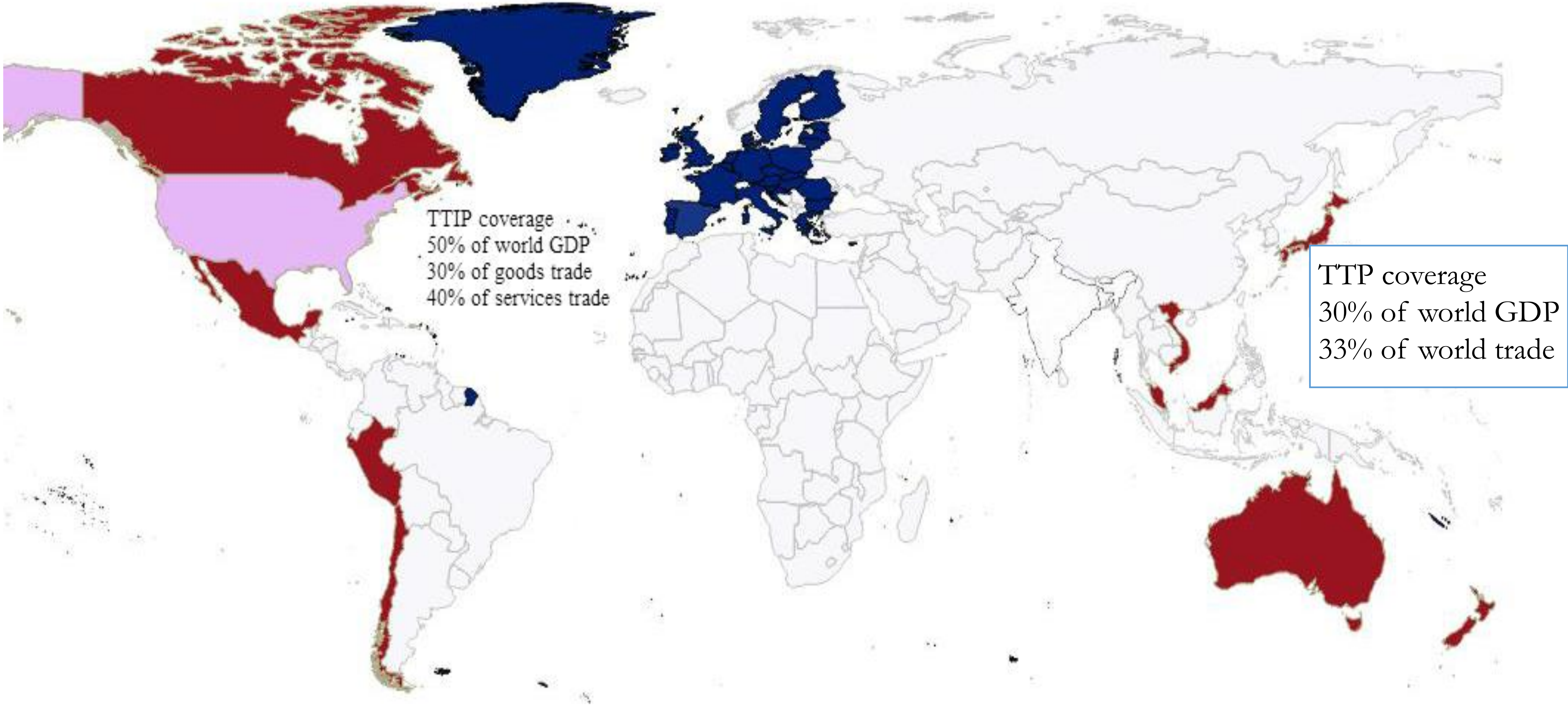
Average Yield of Pulses



From cereal-centric, regionally-concentrated, and input-intensive policies to…

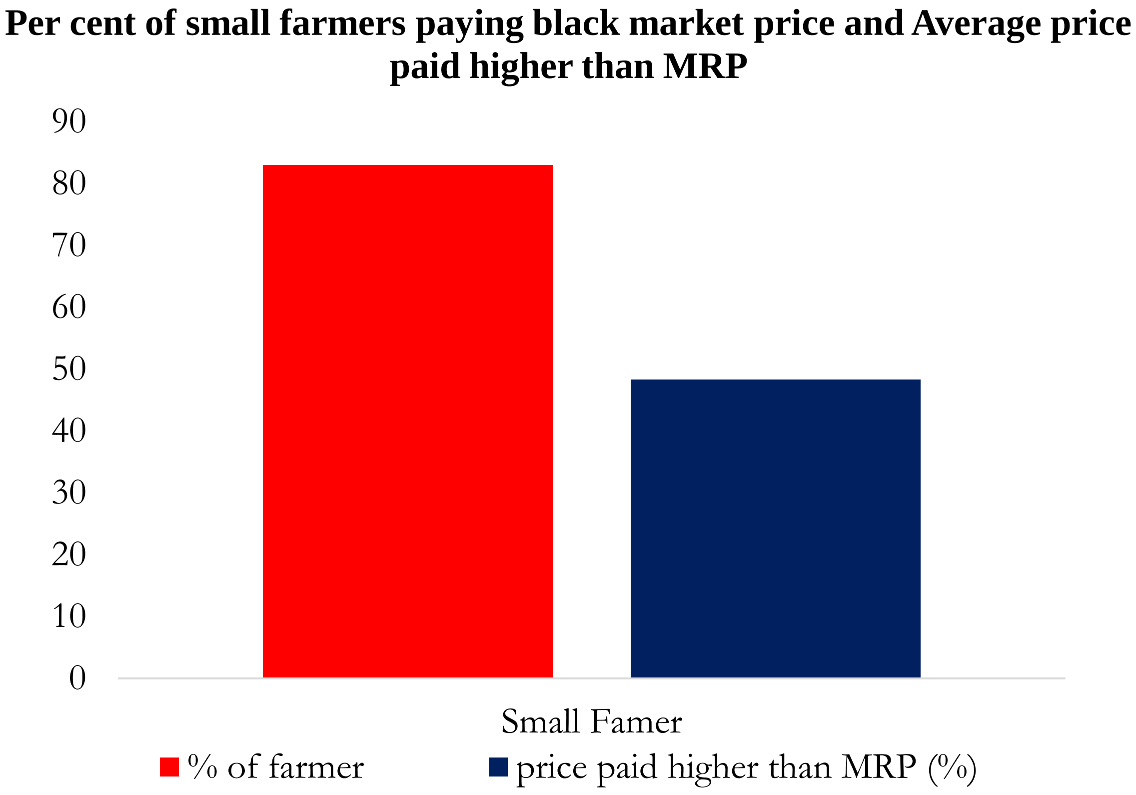
…..pulses & oilseeds, regionally-spread, "more for less from inputs," and "better price for farmers"

Trade Policy and FTAs : How should India respond to mega-regional agreements



Fertiliser (Urea): The black market and leakages

- Policies lead to black-market and hurt the small farmer
- **80 per cent** of small farmers buy urea at prices greater than MRP
- They pay 50% greater than the administered price



Of total urea subsidy (Rs 50,300 Cr)

1. 24% goes to inefficient firms (Rs 12000 Cr)
2. of the remaining 41% get diverted (Rs15,700 Cr)
3. of the remaining 24 % goes to large farmer (Rs 5400 Cr)
4. only 35% goes to small farmers (Rs 17100 Cr)

Time is ripe for liberalizing imports of urea and for implementing JAM…..

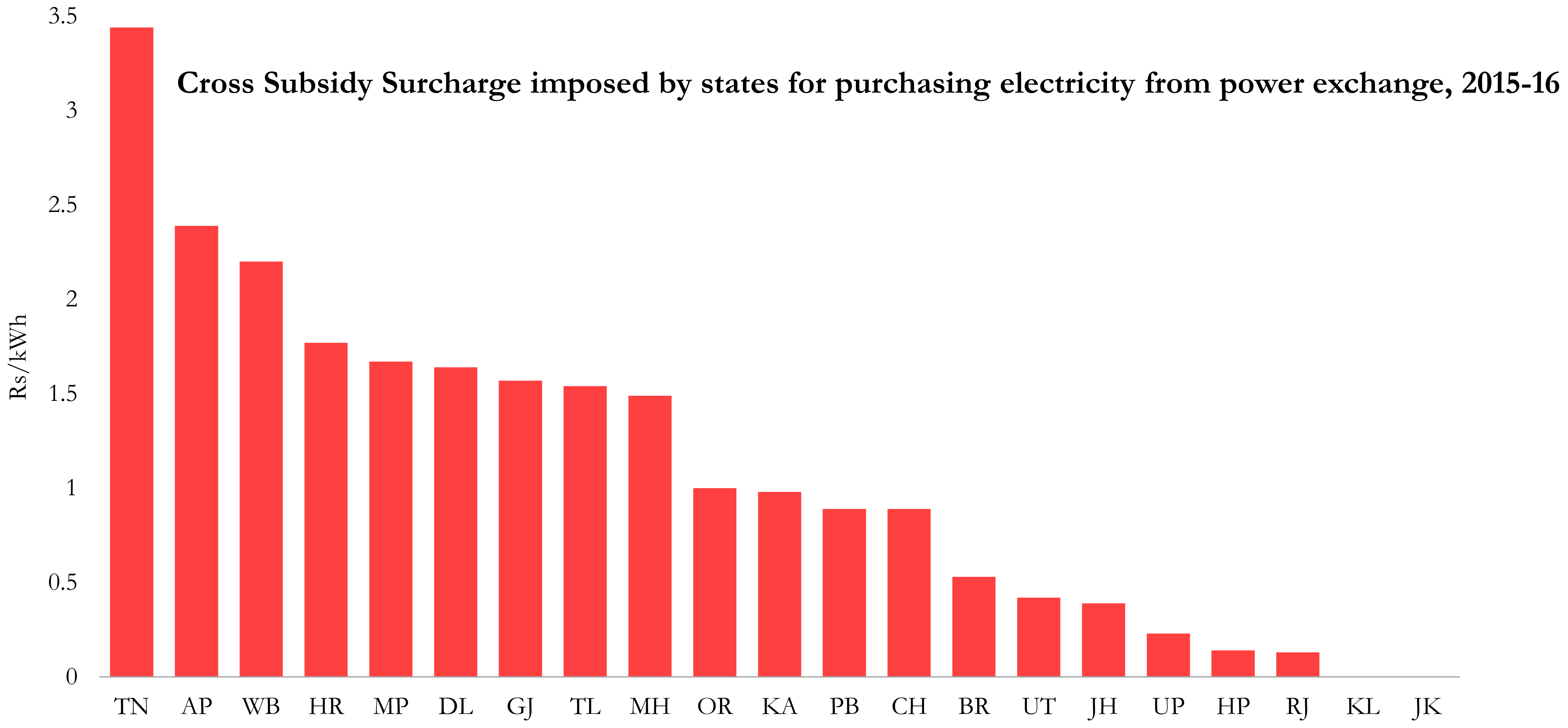
Power: Complex tariff schedules; One price for petroleum but 100 prices for power

Consumer Category	Energy Charge (Rs /Unit)
LT-I:DOMESTIC (Telescopic)	
LT I(A):Upto 50 Units/Month	1.45
LT I(B):>50 and upto 100 Units/Month	
First 50 Units	1.45
51-100 Units	2.60
LT I(C):>100 and upto 200 Units/Month	
First 50	**2.60**
51-100	**2.60**
101-150	**3.60**
151-200	**3.60**
LT I(D):Above 20 0 Units/Month	
First 50	**2.60**
51-100	**3.25**
101-150	**4.88**
151-200	**5.63**
201-250	**6.70**
251-300	**7.22**
301-400	**7.75**
401-500	**8.27**
Above 500	**8.80**
LT-II:NON DOMESTIC/COMMERCIAL	
LT II(A):Upto 50 Units/Month	**5.40**
LT II(B):Above 50 Units/Month	
First 50	**6.63**
51-100	**7.38**
101-300	**8.54**
301-500	**9.06**
Above 500	**9.59**
LT II(C):ADVERTISEMENT HOARDINGS	**11.58**
LT-III:INDUSTRY	
Industry (General)	**6.38**
Seasonal Industries (off season)	**7.09**
Pisciculture/Prawn culture	**4.63**
Sugarcane crushing	**4.63**
Poultry farms	**5.63**
Mushroom & Rabbit Farms	**5.63**
Floriculture in Green House	**5.63**
LT-IV:COTTAGE INDUSTRIES & OTHERS	
a) Cottage Industries upto 10 HP	**3.75**
b) Agro Based Activity upto 10 HP	**3.75**

Consumer Category	Energy Charge (Rs /Unit)
LT-V:AGRICULTURE **	
LT-V(A):AGRICULTURE WITH DSM	
Corporate Farmers & IT Assesses	2.50
Wet Land Farmers (Holdings >2.5 acre)	0.50
Dry Land Farmers (Connections > 3 nos.)	0.50
Wet Land Farmers (Holdings ≤ 2.5 acre)	0.00
Dry Land Farmers (Connections ≤ 3 nos.)	0.00
LT-V(B):AGRICULTURE WITHOUT DSM MEASURES	
Corporate Farmers & IT Assesses	3.50
Wet Land Farmers (Holdings >2.5 acre)	1.00
Dry Land Farmers (Connections > 3 nos.)	1.00
Wet Land Farmers (Holdings ≤ 2.5 acre)	0.50
Dry Land Farmers (Connections ≤ 3 nos.)	0.50
LT-V(C):OTHERS	
Salt farming units upto 15HP	3.70
Rural Horticulture Nurseries upto 15HP	3.70
LT-VI:STREET LIGHTING AND PWS	
LT-VI(A):STREET LIGHTING	
Panchayats	5.64
Municipalities	6.16
Municipal Corporations	6.69
LT-VI(B):PWS SCHEMES	
Panchayats	4.59
Municipalities	5.64
Municipal Corporations	6.16
LT-VI(C):NTR Sujala Padhakam	4.00
LT-VII:GENERAL	
LT-VII(A):GENERAL PURPOSE	6.86
LT-VII(B):RELIGIOUS PLACES (CL ≤ 2 KW)	4.70
LT-VIII: TEMPORARY SUPPLY	9.90
HT-I:INDUSTRY	
HT-I(A): INDUSTRY GENERAL	
11 kV	6.02
33 kV	5.57
132 kV & Above	5.15
INDUSTRIAL COLONIES	
11 kV	5.96
33 kV	5.96
132 kV & Above	5.96

Consumer Category	Energy Charge (Rs /Unit)
SEASONAL INDUSTRIES (off season Tariff)	
11 kV	7.25
33 kV	6.59
132 kV & Above	6.33
TIME OF DAY TARIFFS (6 PM to 10 PM)	
11 kV	7.07
33 kV	6.62
132 kV & Above	6.20
HT-I(B):FERRO ALLOY UNITS	
11 kV	5.68
33 kV	5.23
132 kV & Above	4.81
HT-II:OTHERS	
11 kV	7.25
33 kV	6.59
132 kV & Above	6.33
TIME OF DAY TARIFFS (6 PM to 10 PM)	
11 kV	8.30
33 kV	7.64
132 kV & Above	7.38
HT-III:AIRPORTS,BUS STATIONS AND RAILWAY	
11 kV	6.91
33 kV	6.31
132 kV & Above	6.01
TIME OF DAY TARIFFS (6 PM to 10 PM)	
11 kV	7.96
33 kV	7.36
132 kV & Above	7.06
HT-IV: Govt., LIFT IRRIGATION, AGRICULTURE	
Govt. Lift Irrigation & Agriculture	5.64
Composite Water Supply Schemes	4.61
HT-V:RAILWAY TRACTION	6.68
HT-VI:TOWNSHIPS AND RESIDENTIAL COLONIES	5.96
HT-VII:GREEN POWER	11.32
HT-VIII:TEMPORARY	
RURAL ELECTRIC CO-OPERATIVES	
Kuppam	0.24
Anakapally	1.38
Chipurupally	0.22

Power: Tariff and non-price regulations impeding one market for Indian power



Structural Changes in Labour Markets

- Challenge is to create "good"—safe, productive, well-paying, dignified—jobs
  - These tend to be in formal sector

- Three developments
  - Contractualisation of labour
  - Competitive federalism
  - Relocation of labour-intensive manufacturing to second tier cities and towns

- Mandatory deductions from employees' salaries higher for poor than rich workers (15% versus 0.5%)

Strengthening the State:
Fiscal Relations with Rich and Poor

Does India Under-tax and Under-spend ? Yes, …..Actually No

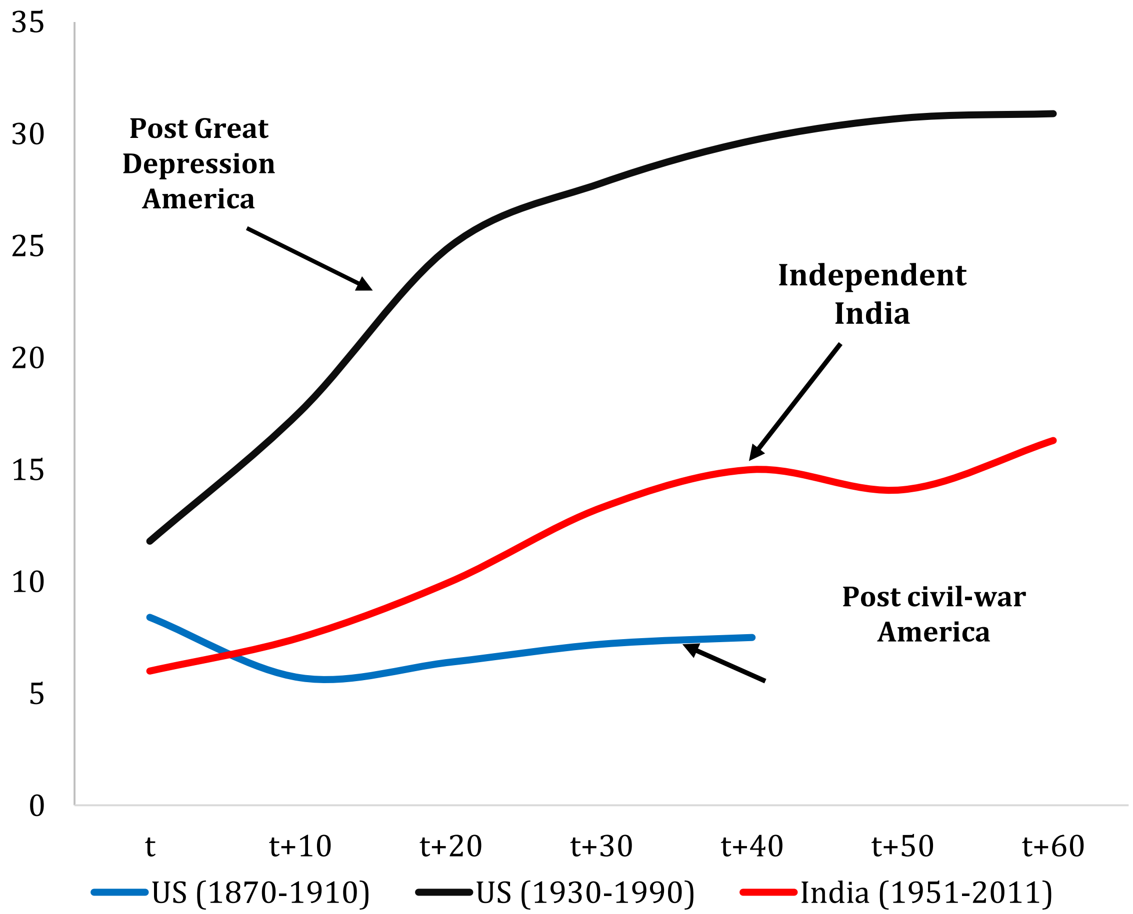
Yes, in a simple comparison

Share as per cent of GDP

Country	Total Tax	Total Expenditure	Expenditure in human capex*	Income tax	Individual Income tax	Property tax	Indirect Tax
China	19.4	29.7	7.2	5.3	--	2.0	12.7
India	16.6	26.6	5.1	5.6	2.1	0.8	10.1
Brazil	35.6	40.2	11.0	7.3	2.3	2.0	15.7
Korea	24.3	20.0	8.4	7.1	3.7	2.5	7.5
Vietnam	22.2	28.0	8.8	8.4	--	--	--
South Africa	28.8	32.0	10.7	15.0	--	1.4	10.2
Turkey	29.3	37.3	7.2	5.9	4.1	1.4	13.5
Russia	23.0	38.7	7.2	7.2	--	1.1	7.1
UK	32.9	41.4	13.4	11.7	9.1	4.0	10.8
US	25.4	35.7	13.3	12.0	9.8	2.9	4.4
EMEs Avg	21.4	30.9	7.5	7.4	2.2	1.0	10.8
OECD Avg	34.2	42.8	11.6	11.5	9.5	1.9	11.0

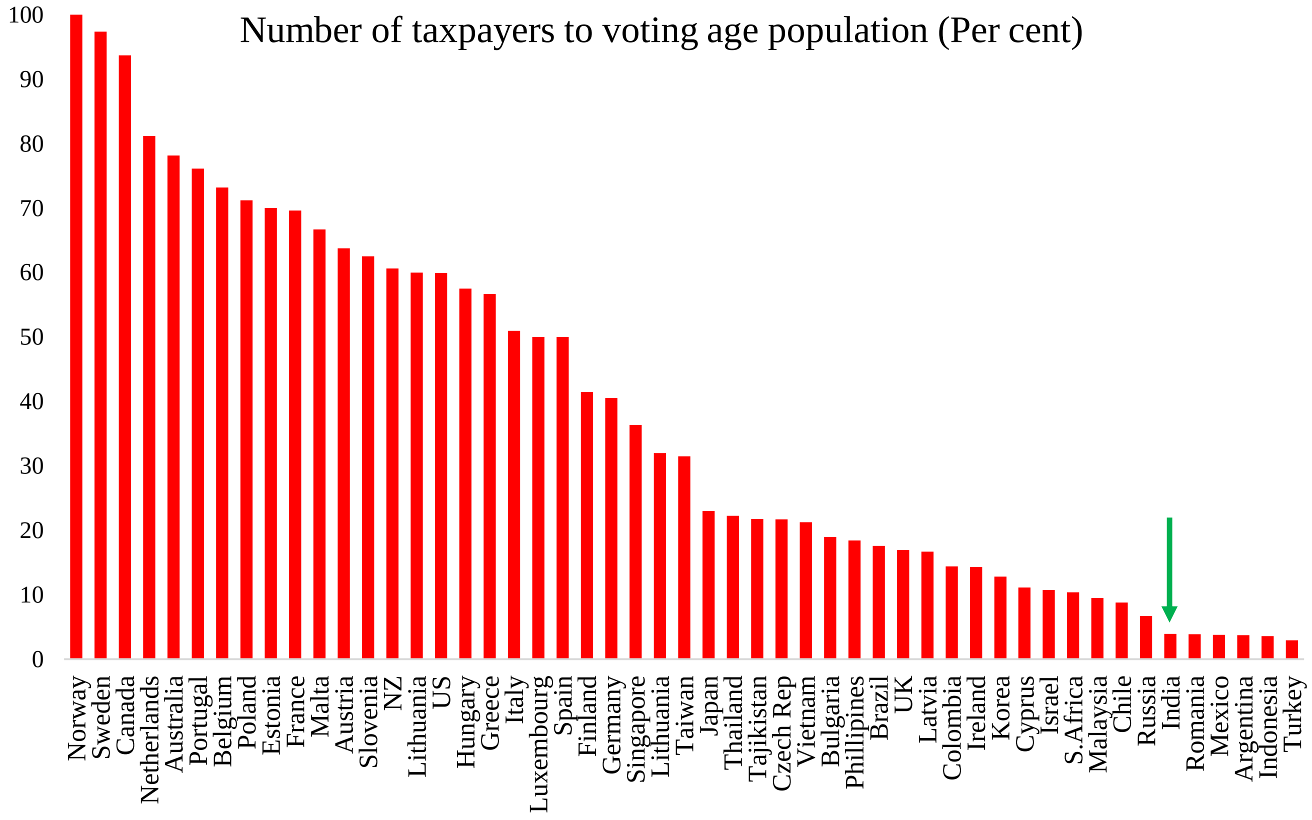
Actually, No because India is a young democracy which did not experience upheavals (war)

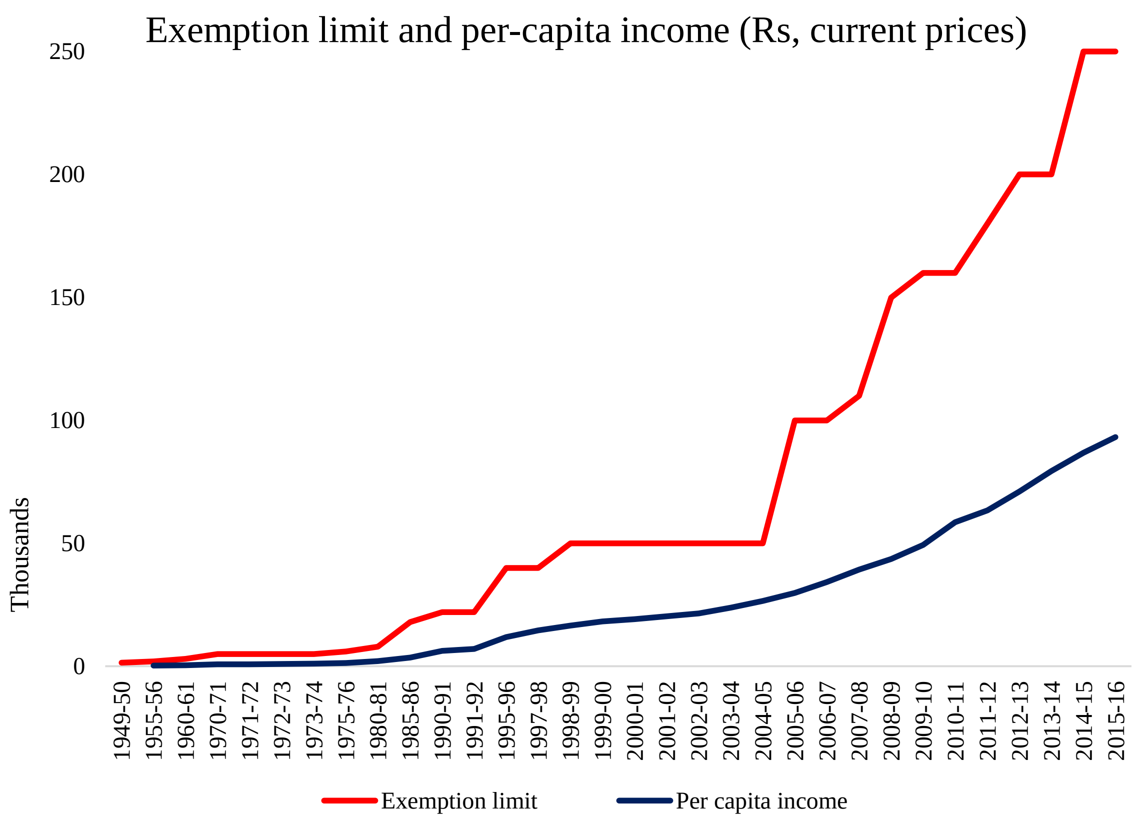
Path of tax ratios-India and US (2 periods)



Fiscal capacity: But number of taxpayers unusually low

- The ratio of tax payers to voters is **~ 4 per cent** while it should be **~23 per cent** for a country at its level of economic and political development
- Solutions: Not increasing exemption limits
- Building legitimacy in state: Delivering public goods for all; reducing bounties for well-off; and taxing well-off regardless of source of income





Piketty in India: Growing concentration of incomes at the top (till 2013)

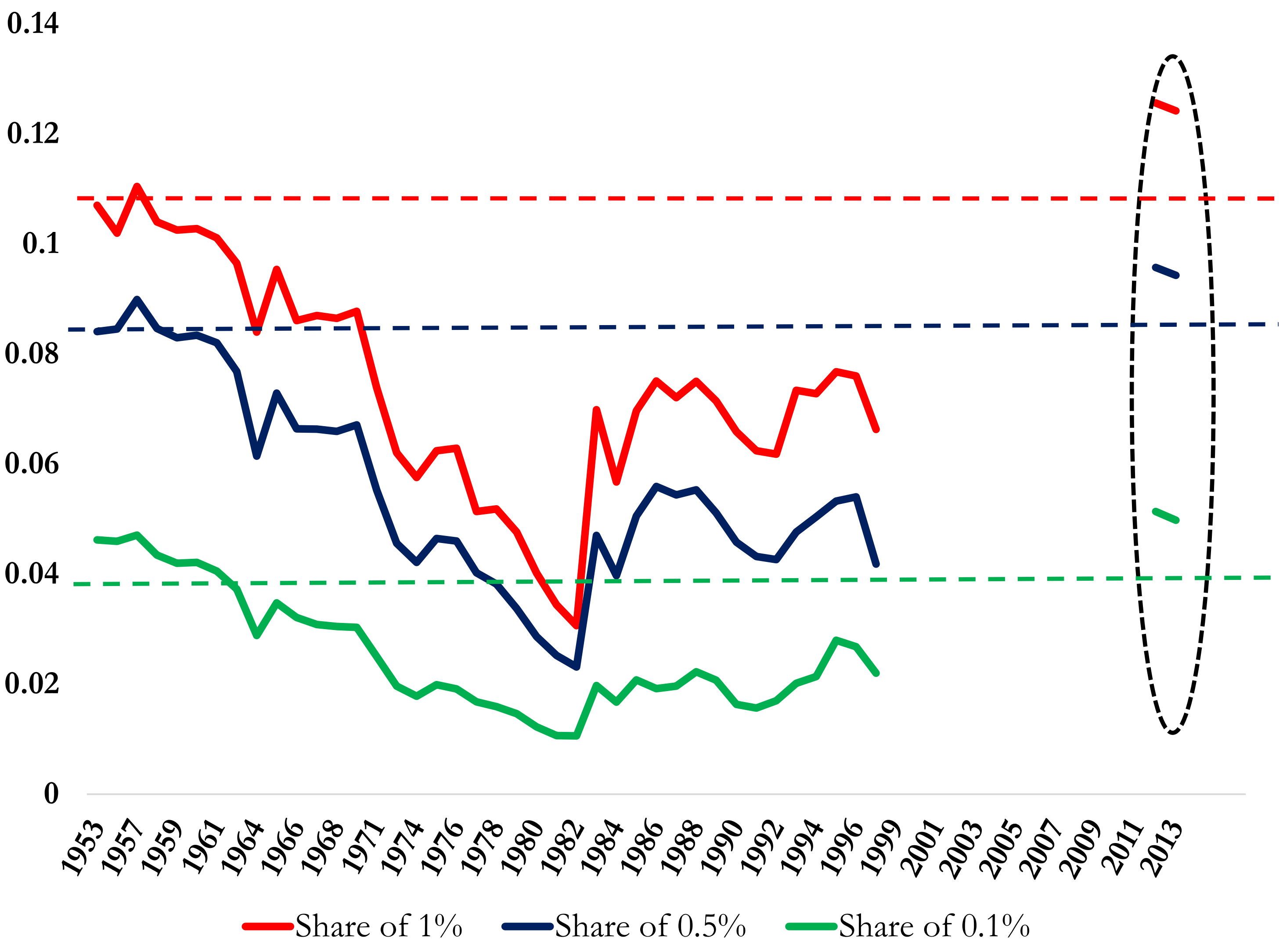


Table: Top Personal Income Distribution						
	Share of top 1 percent		Share of top 0.5 percent		Share of top 0.1 percent	
	1998	2012	1998	2012	1998	2012
USA	15.2	18.9	11.6	14.7	6.2	8.4
UK	12.5	12.7	9.1	9.2	4.4	4.6
India	9.0	12.6	7.0	9.6	3.6	5.1

Bounties for the Well-off

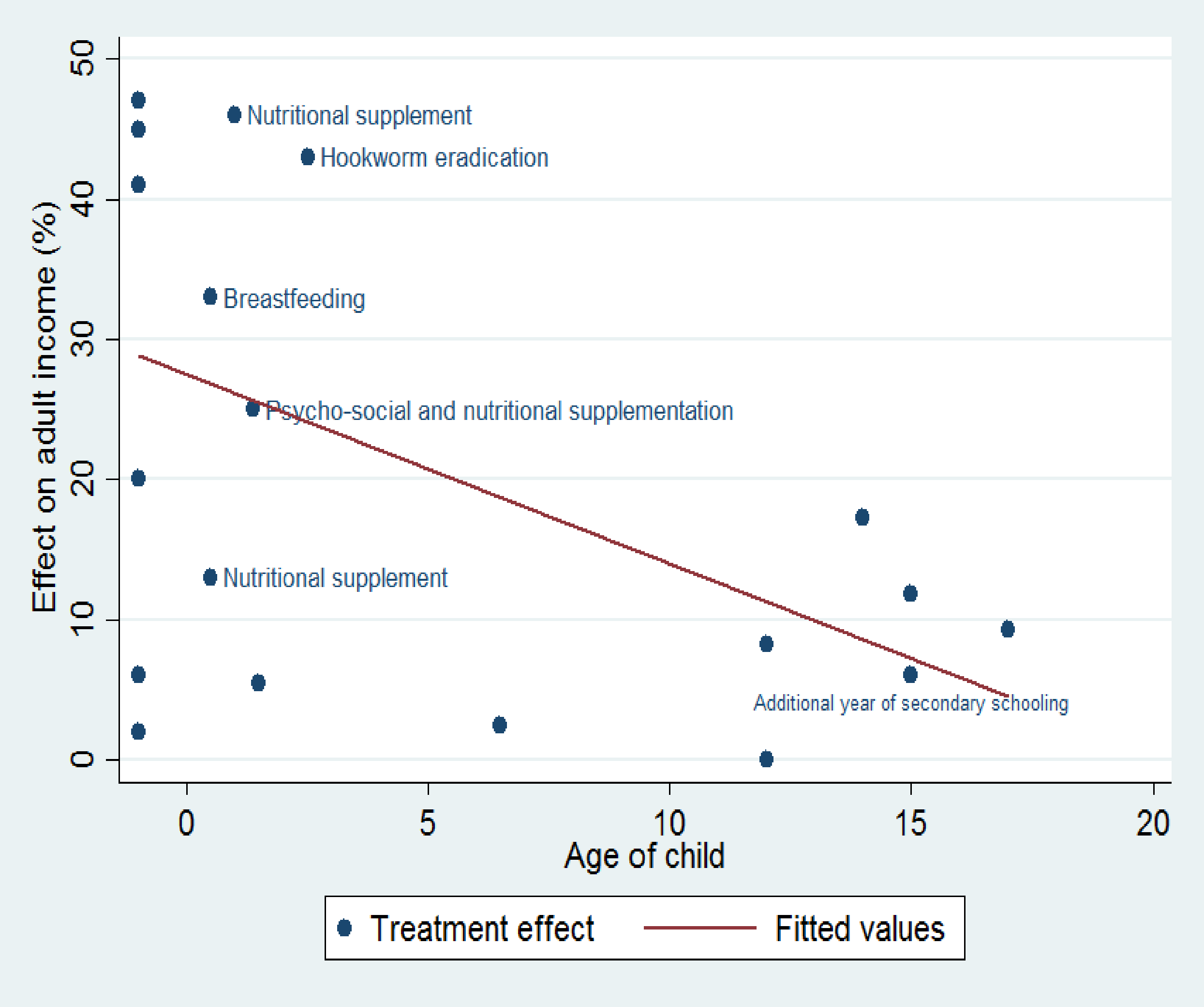
- 7 areas where the "Well-off" are subsidised:
  - Kerosene (**Rs. 5,501 crore**)
  - Railways (**Rs. 3,670 crore**)
  - Electricity (**Rs. 37,170 crore**)
  - LPG (**Rs. 40,151 crore**)
  - Gold, (**Rs. 4,093 crore**)
  - Aviation turbine fuel (**Rs. 762 crore**)
  - Small Savings (**Rs. 11,900 crore**)

TOTAL: ~Rs. 1 lakh crore

Who Benefits from Tax Benefits?

- Not Middle Class, not Rich but the Mega Rich
  - 10% tax bracket starts at top 5.8 percentile of the income distribution
  - 20% tax bracket starts at top 1.6 percentile of the income distribution
  - 30% tax bracket starts at top 0.5 percentile of the income distribution

Large returns on early life investments in Mother & Child



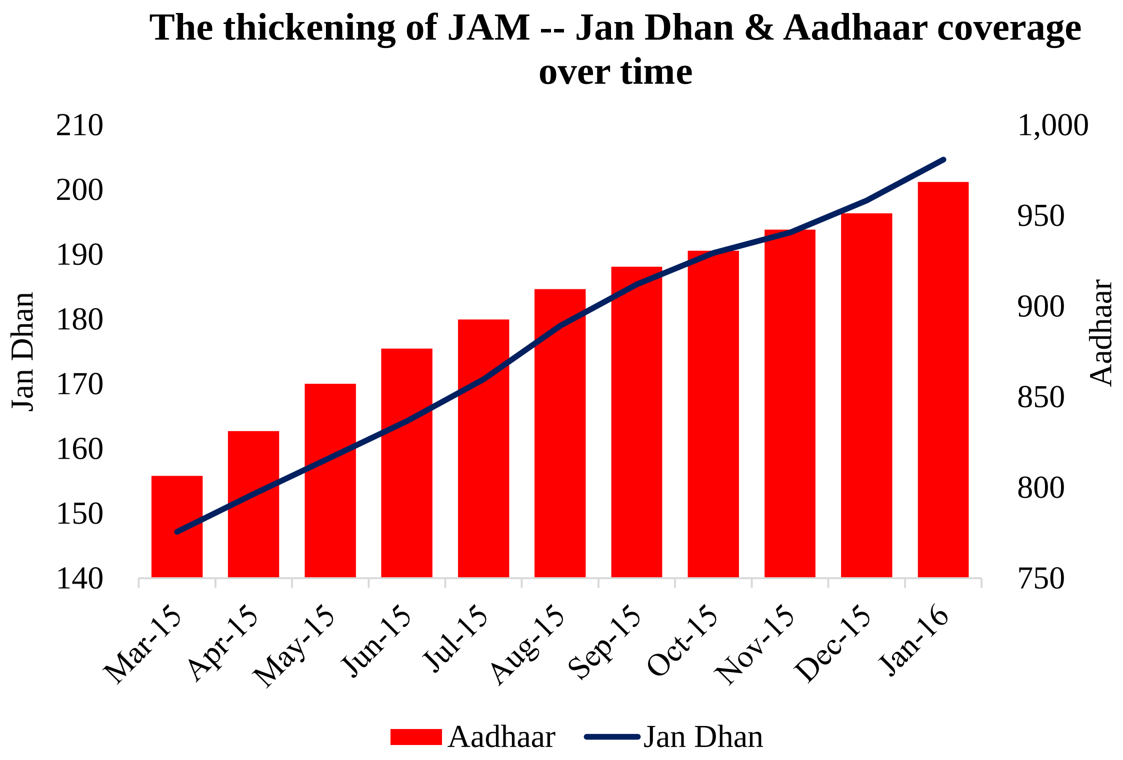
- **Tomorrow's worker is today's child or foetus:**
  - Maternal and early-life health investments have very high long-run (growth) returns

- **Effective interventions include**
  - Providing nutrition to pregnant mothers
  - Reducing open defecation (Swachh Bharat) mission key to reducing malnutrition

- **Increasing effectiveness of interventions requires changing social norms and behaviour**

Spreading JAM across India's economy

- **JAM (*Jan Dhan-Aadhaar-Mobile)* has spread over the past year**
  - Jan Dhan & Aadhaar respectively created 3 lakh & 5 lakh accounts per day in 2015

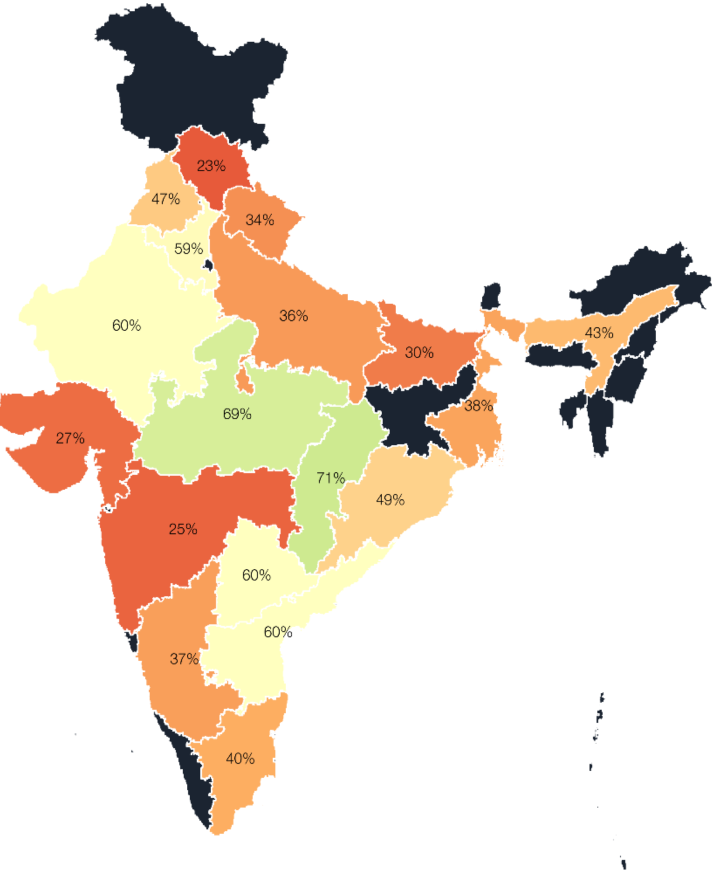


- **DBT in LPG has been a big success**
  - 24% fiscal savings
  - Limited exclusion of the poor

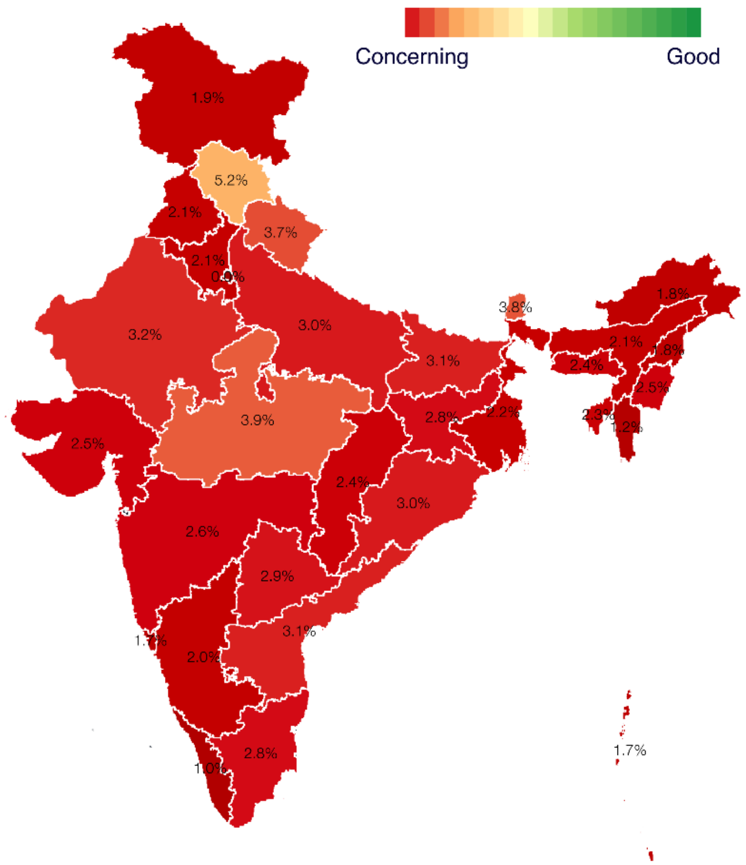
Where Next to JAM?

How prepared are states to JAM? See JAM preparedness indices

Urban



Rural



- **Way Forward for JAM?**

- Improve financial connectivity in rural areas by developing BCs and mobile banking
- Meanwhile move forward on important sectors which center controls:
  - ➢ Fertiliser
  - ➢ Government programs (eg. MGNREGA)

Conclusion

- **Last year's Survey**: Robust, decentralized democracies outside of crises will undertake "incremental" reforms
- **Achievements**: A number of individually incremental but collectively meaningful reforms have been enacted
- **Pending agenda**
  - GST
  - Strategic disinvestments
  - Twin Balance Sheet
  - Subsidy rationalization (rich and poor)
- **The promise of India**
  - Accelerated structural reforms at the center
  - Competitive federalism at the states
  - Good economics becoming good politics all over India

For now,

But not indefinitely,

The Sweet Spot

Created by a Strong Political Mandate,

But Recalibrated to account for a Weaker External Environment,

Is Still Beckoningly There.