**Pathfinder Economic Flash**

# Setting the Strategic Direction for Faster Growth: a Challenge for Both India and Sri Lanka.

## Unrealistic Expectations

Prime Minister Modi's elections were hailed as a resounding victory for his pro-growth/pro-business agenda. There was an expectation among pro-market economists and business_that Finance Minister Arun Jaitley's maiden effort would lay out a vision for five years; introduce major structural reforms; and administer some necessary but bitter medicine in pursuit of fiscal consolidation. Instead, critics claimed that the budget seemed to have been prepared by incumbent bureaucrats and represented unimaginative continuity rather than a bold new vision.

## Stop Gap Budget?

One can argue that such criticism is based on unrealistic expectations. First, in democracies like India and Sri Lanka it is not possible to move too far away from the mixed economy approach that has commanded bipartisan support. It has to be so in a country which still has widespread rural and urban poverty and accounts for the largest number of poor people in the world. Furthermore, it has been argued that having to present a new budget one month after assuming office did not provide sufficient time to understand, analyse and plan for major change. Anyway, the new government will be presenting another budget in February 2015 as part of the usual cycle of fiscal management. In addition, with the weak monsoon and an uncertain global recovery there are uncertainties which may have tempered the inclination for aggressive change.

## Vision for Growth Strategy

Despite all this, Mr. Jaitley's budget has set out indicative policy action for strengthening the growth framework of the economy. The budget emphasised the state's catalytic role in the four key areas of the budget: infrastructure, urbanization, manufacturing and education/entrepreneurship. It is also noteworthy that high priority has been attached to employment creation. During its previous tenure, the BJP's 'shining India' delivered jobless growth. A conscious effort seems to have been made this time around to address this problem. Prioritization, sequencing and managing trade-offs are key for successful implementation. With its strong mandate the current Indian government needs to execute effectively.

In this respect, it is important to understand Mr. Modi's acclaimed approach in developing Gujrat. It was not 'flashy'. Instead, he first focused on developing infrastructure and streamlining policy and administrative processes i.e. he focused on strengthening fundamentals rather than offering 'quick fixes'. One can argue that his Union Government's first budget speech and other measures already introduced to reduce red-tape and strengthen delivery reflect a similar approach to that he followed in Gujrat. Some analysts expect a more detailed vision of the Modi agenda to emerge in the coming months through policy modifications culminating in the next budget speech in February 2015. It is expected that there will be a carefully managed shift from populism and untargeted (unaffordable) subsidies towards more growth and business-friendly policies.

**Setting the New Direction: The Growth Agenda- India following Sri Lanka and vice a versa**

Though the Mr. Jaitley's budget speech was not as radical as expected in some quarters, it laid out clearly the priorities of the Modi government.

**Fiscal Consolidation**

As in Sri Lanka, the budget deficit has been a major source of systemic instability in India by fuelling excess demand that flows through into price and balance of payments pressure. Mr. Jaitley re-affirmed the fiscal deficit target of 4.1% of GDP set by his predecessor, Mr. Chidambaram, in his Interim Budget of February 2014 – though he described it as a daunting challenge. The roadmap for fiscal consolidation envisages deficits of 3.6% of GDP (2015/2016) and 3% (2016/2017). Some analysts have contended that the budget arithmetic is somewhat optimistic, with insufficient detail on how future deficit targets would be met. However, the Indian economy seems to be picking-up some growth momentum which should assist Mr. Jaitley in meeting his targets. On the other hand, a week monsoon and higher oil prices could work in the opposite direction in the short-term.

On the expenditure side, Mr. Jaitley undertook to make food and petroleum subsidies better targeted. The Mahatma Gandhi National Rural Employment Guarantee Scheme would become more focused on asset creation. This intention of shifting the scheme in a more productive direction provides useful insights for strengthening Sri Lanka's Samurdhi Program. On the revenue side, the General Sales Tax has been deferred till December 2014. In the meantime, there were sharp increases in the imposts on cigarettes, alcohol and aerated waters. Mr. Jaitley argued that these were 'healthy' measures. It is noteworthy that India may well be the first country to put carbonated drinks on the same tax platform as cigarettes.

Like in most countries, some unpopular measures preceded the budget speech, including the increase in railway fares.

As mentioned above, the growth agenda focuses upon four pillars: infrastructure, urbanization, manufacturing and education/entrepreneurship. In each of these areas there is a heavy emphasis on an important role for the private sector.

Priority had been attached to **infrastructure development** (roads, railways, power and airports). Major initiatives include formal approval of the Eastern Freight Corridor with industrial parks around it; high-speed rail links; clean-up and development of the Ganges waterway for transport; massive investment in the sanitation sector to improve public hygiene in a country where an estimated 600 million people defecate outdoors; and completion of a number of ongoing but slow-moving projects. There is strong commitment to PPPs in implementing this ambitious infrastructure development program, while containing the adverse impact on India's budget deficit and debt dynamics. This should have significant resonance for policy-makers in Sri Lanka as well.

India, like most developing countries, is experiencing rapid **urbanization**. The budget speech recognizes the importance of managing this process effectively with priority attached to the development and efficient delivery of basic services. Money has also been allocated for the development of 'smart cities'. Here again, an important role is envisaged for private investment in a constrained deficit and debt environment. Sri Lanka's important urban development program faces similar financing challenges and would benefit from greater private sector involvement.

Mr. Jaitley's budget speech prioritizes the **manufacturing sector** at a time when capacity is being relocated away from China due to domestic cost escalation, including wage pressures, and appreciation of the Yuan. The National Manufacturing Policy proposed by the previous Congress government has yet to be implemented. This seeks to boost manufacturing from 15 %-25% of GDP and create 100 million employment opportunities in the next 10 years. It would be a game-changer if the Modi government can meet this target. The budget has set aside $1.66 billion for a Fund to finance start-up ventures. The operational details of this Fund are yet to be announced. Commentators have stressed that the government should not become a venture investor. Instead, the Fund should be managed by independent professionals. The budget also included various cluster initiatives in the biotech sector. In addition, manufacturing companies have been permitted to sell their products on e-commerce platforms without further approvals. This recognizes the role of e-commerce in the growth of the manufacturing sector. There has been some disappointment that there was a lack of incentives for R&D and innovation which have an important role to play in creating an eco-system which is conducive for India becoming a world class manufacturing centre.

India's young population is both an opportunity and a challenge. The opportunity is derived from the enormous potential demographic dividend it enjoys in an aging world (China, Europe and Japan). However, there is a major challenge to be met in terms of **education, training and skills development** if this potential is to be realized. The budget provides for the establishment of five new IITs/IIMs and the opening of four new All India Institute of Medical Science Centres (AIIMS). It also proposes a national program branded 'Skill India' which is intended to provide training with a focus on employability and entrepreneurship. Sri Lanka has exhausted its demographic dividend and the potential benefits were severely eroded by the peak years coinciding with the 30-year conflict. It is important to realize that human resources are likely to be the binding constraint in implementing the Sri Lankan government's five hubs + tourism strategy. Like India, this country needs to attach high priority to developing its human capital to meet its development objectives.

**Investment Climate: Learning from a Debacle and Moving Towards Predictability**

Much of the policy paralysis associated with the previous Congress government was related to deterioration in the business environment. The new Modi government has already initiated action to address bureaucratic inertia. The notorious Vodafone case increased uncertainty among investors, both domestic and foreign, by undermining the credibility attached to the consistency and predictability of the Indian government's policy-making. There is an important lesson for Sri Lanka in this. The Indian budget (2011/12) imposed a retrospective tax liability of $2.2 billion on Vodafone. It has been the single biggest deterrent to FDI flows to India. Mr. Jaitely, in his budget speech, stated 'this government will not ordinarily bring about any changes retrospectively which creates a fresh liability, 'while pointing out that the 'sovereign right of the government to undertake retrospective legislation is unquestionable.' The Modi government should settle the Vodafone matter expeditiously to provide a positive signal of the direction in which it wants to move in terms of its pro-growth/pro-business agenda. This would provide greater certainty regarding the predictability of policies in order to give a further boost to investor confidence. The Vodafone episode provides important lessons for all countries, including Sri Lanka, regarding the negative impact on investor confidence arising from a lack of consistency and predictability in policy-making.

The budget has increased the **FDI** limit in the lucrative defence and insurance sectors from 26% to 49%. This constitutes a good beginning and potential Indian joint venture partners are keen to pursue prospects in these sectors. However, foreign defence firms may be reluctant to transfer sensitive technology unless they have majority ownership. In contrast, the insurance sector is likely to have greater potential as India is one of the most underinsured markets in the world. Less than 5% of their population has life insurance coverage.

**Foreign Institutional Investors** have invested more than $130 billion in India. There has been some uncertainty regarding the characterization of their income for tax purposes. The budget has clarified that income arising for foreign portfolio investors from transactions in securities would be classified as capital gains. This is intended to encourage some foreign fund managers to shift to India.

**Sharing the Benefits of Growth**

As mentioned above, a major weakness in BJP's performance during its previous period in office was that it was characterized by a lack of employment and inclusion. This time around, the Modi government's first budget has placed high priority on employment creation and SME development to address this.

The budget has sought to promote **employment creation** by attaching priority to five key dimensions: physical (infrastructure and urbanization); sectoral (boosting manufacturing employment and shifting labour out of low productivity agriculture); education and training (IIT/IIMs/AIIMS and the 'Skill India' program) and enterprise development (creation of more productive companies by improving the ease of doing business and strengthening access to credit for entrepreneurs via small banks and the Start-up Fund). On the fifth legislative pillar, though there was nothing major in the budget speech, action was initiated earlier on Labour Law Reform. A key message in Mr. Jaitley's budget speech was that skilling and creation of higher value employment will be at the heart of policy-making. He was clear that this was an idea whose time had come. This has great resonance for Sri Lanka as well as it moves forward to implement its 5 hubs plus tourism strategy.

The Indian budget speech also recognized that SMEs formed the backbone of the economy. Creating a conducive eco-system for the development of this sector is, therefore, crucial as it is an important means of transmitting the benefits of growth more widely. In this connection, Mr. Jaitley has proposed the appointment of a Committee with representatives from the Ministry of Finance, Ministry of Small, Medium and Micro Enterprises and the Reserve Bank of India to provide specific recommendations within three months. The budget speech also attached priority to increasing enterprise ownership among disadvantaged groups. There could well be insights that could be gained for the Divineguma Programa from the measures being initiated in India for this sector.

**Just the Beginning not the End**

Mr. Jaitley pointed out 'this is the beginning of the journey, not the end.' It is expected that the first full budget of the Modi government to be presented in February 2015 will build on the start made to pull the Indian economy out of its low-growth phase. Many analysts expect a major program of disinvestment of public assets.

The measures contained in the recent budget speech as well as various other indices indicate that Sri Lanka is further down the road of economic reform. This is reflected in Sri Lanka's higher rankings in global indices, such as the World Bank's Doing Business Index and the World Economic Forum's Competitiveness Index. However, reform is a dynamic process. No country can afford to rest on its laurels. The stalling of the growth momentum and the sluggish investment performance (domestic and foreign) highlight the need for continued reform in the Sri Lankan context. Sri Lanka, like India, needs a concerted effort to strengthen the growth framework of the economy. This would need to be high on the agenda at the beginning of the next political cycle following the major elections expected in early 2015. There are important insights that can be gained not only from Mr. Jaitley's maiden budget speech but also from other reform measures that are being/will be implemented to revive growth, generate employment and share prosperity.

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