BertelsmannStiftung

Modi's Reform Agenda: **Change You Can Believe In?**

Milan Vaishnav*

Germany and Asia
Building Bridges – Promoting Progress

November 2015 **Asia Policy Brief** 2015 | 04

Indian Prime Minister Narendra Modi entered office with a historic political mandate. For the first time in thirty years, a single party won a majority of seats in the lower house of Parliament *(Lok Sabha).* However, Modi faces sky-high expectations to fulfill his campaign promises of getting India's economy back on track. Eighteen months into his government's term and in the wake of electoral defeats in the states of Delhi and Bihar, questions are being raised about its economic performance. While the Modi government has stabilized India's macroeconomy and announced a series of incremental economic reforms, more sweeping changes have fallen victim to India's nettlesome domestic politics, including roadblocks within the ruling alliance.

Acche din

India's 2014 general election took place as the country was being buffeted by severe economic headwinds. Though the incumbent United Progressive Alliance (UPA) presided over the highest rates of economic growth in India's history during its first five years in office, the economy took a turn for the worse during its second term. In addition to the impacts of the 2008 global financial crisis, a series of policy missteps, high-profile corruption scandals and a divided political leadership created a pervasive sense of policy paralysis, leading to a collapse of the investment cycle.

By August 2013, less than one year before the general election, a Morgan Stanley research report dubbed India one of the "Fragile Five" emerging market countries likely to be hit hard as the US Federal Reserve began its gradual withdrawal of monetary stimulus. Indeed, persistently high inflation, slowing growth and twin current account and fiscal deficits made India especially vulnerable to the vagaries of the global economy.

In contrast to the prevailing order and backed by an impressive record of sustaining economic growth and

* Milan Vaishnav is an associate in the South Asia program at the Carnegie Endowment for International Peace in Washington, DC.
He is grateful to Aidan Milliff and Saksham Khosla for their excellent research assistance.

attracting investment during a decade as chief minister of the state of Gujarat, Modi positioned himself as the experienced, decisive leader who could restore *acche din* (good days) to the Indian economy. The centerpiece of his Bharatiya Janata Party's (BJP) 2014 campaign was then-candidate Modi's catchy slogan, *Sab ka saath, sab ka vikas* (Together with all, development for all). The antipathy Indian voters experienced towards the ruling Congress Party, as well as the latter's inability to provide a coherent economic message or project a convincing prime ministerial candidate, led to the BJP winning 282 (of 545) seats in the Lok Sabha and the Congress' worst ever performance (a lowly 44 seats).

Macroeconomic stabilization

After assuming office, the Modi government quickly racked up one major accomplishment: stabilizing India's macroeconomy. In truth, India's stabilization program began in the waning months of UPA's tenure when then-Finance Minister Palaniappan Chidambaram and Reserve Bank of India (RBI) Governor Raghuram Rajan championed a series of remedial steps to get India's economic house in order. The BJP government, for its part, reaffirmed this commitment to stabilization.

In the two years since India was added to the ignominious "Fragile Five" club, it has engineered a remarkable reversal of fortune (Figure 1). According to its September 2015 *World Economic Outlook*, the International Monetary Fund (IMF) reported that India is now the fastest growing major economy in the world, surging ahead of China. In 2015, the country's gross domestic product (GDP) is expected to grow by 7.5 percent as China's dips to 6.8 percent and "emerging and developing Asia" as a whole cools to 6.5 percent. Consumer price inflation, long

Figure 1: India's Macroeconomic Trajectory

Year	Real GDP Growth (% yoy)	Consumer price inflation (% avg)	Current account deficit (% of GDP)	International reserves (billion $USD)	Central government fiscal deficit (% of GDP)
2011	10.2	10.4	–2.7	273.7	–4.8
2012	6.7	8.4	–4.2	260.1	–5.8
2013	5.1	10.2	–4.8	259.7	–4.9
2014	6.9	9.5	–1.7	276.4	–4.4
2015*	7.3	5.9	–1.3	316.2	–4.1
2016*	7.5	5.0	–1.4	359.7	–3.9

Source: World Bank; Citigroup

*Forecast estimates

above 10 percent, has been cut in half. India's current account deficit averaged 3.5 percent of GDP between 2008 and 2012, but is expected to approach 1 percent this fiscal year. While the Modi government has slightly eased the pace of fiscal consolidation, the fiscal deficit as a share of GDP is expected to be below 4 percent – a sharp reduction from nearly 6.5 percent in 2009–2010. According to an index drawn from daily news reports, economic uncertainty in India has also dropped markedly since the tumultuous period of 2011–2012.

Green shoots?

The rosy picture presented by India's macroeconomic data is complemented by evidence that India's moribund investment cycle is showing renewed signs of life. Consider three indicators. First, one of the most visible signs of economic malaise over the past few years has been the rising number of capital investment projects that had been formally inaugurated by both public and private firms but ran into implementation challenges. As a share of overall GDP, this stock of "stalled" investment projects peaked at 8.5 percent in March 2014. In every quarter since (barring the most recent), this share has steadily dropped.

Furthermore, the flow of new investment projects has increased steadily, if not slowly, in recent months. One underlying driver responsible for reviving the investment cycle has been an infusion of infrastructure spending engineered by the Modi government in its 2015 budget. The government extended its previous fiscal consolidation timeline in the hopes that increased public expenditure – with a heavy emphasis on roads and railways – would stimulate growth and "crowd in" private investment. In the immediate term, that plan appears to have worked. Over the past year, India has seen steady growth in the production of capital goods and a modest uptick in the index of industrial production.

A dose of good luck

While it would be churlish to deny the Modi government credit for macroeconomic stabilization and resuscitating the investment cycle, it would be equally shortsighted to dismiss the role of relatively benign global economic conditions. For starters, India has benefited from historically low commodity prices. As a net oil importer, India's fiscal woes are relieved by depressed oil prices, which have slashed its import bill and reduced the overall subsidy burden.

India's recovery also benefits from the fact that many of its peers are encountering severe economic troubles. Of the other BRIC economies, Brazil has been contracting since government bonds were downgraded to junk status; Russia, stung by low oil prices and economic sanctions, is experiencing *negative* growth; and China's growth is expected to slow considerably as it rebalances its economy away from investment and toward domestic consumption. The setbacks experienced by India's peers make the country's economic success shine even brighter in comparison.

Creative incrementalism

Many observers have been surprised by how cautiously the government has proceeded on the economic reform front, given the government's unique electoral mandate and Modi's campaign promises that he would administer "bitter medicine" to the country by taking tough economic decisions to right India's economic affairs. Indeed, the Modi government has consciously adopted a policy of "creative incrementalism," rather than move to implement a series of "big bang" economic reforms that would mark a sharp break with the status quo.

The government's gradualist approach has produced a number of important achievements (Figure 2). The government lifted caps on foreign direct investment in the defense, insurance and railways sectors. It deregulated the price of diesel, opened up coal mining to

Figure 2: Status of Key Reforms to Date

Implemented / in progress	Pending
Raised FDI caps in defense, insurance, railways, etc.	Goods and Services Tax (GST)
Energy reforms (diesel deregulation; natural resource auctions)	Labor market reforms
Adoption of monetary policy framework	Development of common agricultural market
Banking/financial sector reforms	New PPP/infrastructure regulatory framework
Employing *Aadhaar* for Direct Benefits Transfer	Privatization of public sector undertakings

Source: Author

private companies and legislated that all new mining licenses be subject to auction. Despite initial skepticism about the UPA-designed unique biometric identification program known as *Aadhaar*, it has doubled down on the initiative, using the platform to replace graft-prone public subsidies with direct cash transfers to beneficiary bank accounts. On financial matters, in addition to launching a new financial inclusion scheme to ensure every Indian household has a bank account, the government ratified a new inflation-targeting framework and continued the UPA government's efforts to revamp the legal and regulatory framework for India's financial sector. Although ultimately unsuccessful, the government also attempted to amend a contentious 2013 law governing land acquisition in order to ease the path for industry to obtain land.

A number of other reforms remain pending but are cause for optimism. The most consequential is arguably the creation of a new Goods and Services Tax (GST), which would reduce barriers to trade and commerce occurring across states. Other reforms on the anvil include legislation to create a common market for agricultural produce, a new regulatory reform bill for infrastructure, and the streamlining of onerous labor laws into four "labor codes" on wages, industrial relations, social security and working conditions.

Obstreperous democracy

Given its impressive list of accomplishments to date, the Modi government cannot be accused of failing to pursue reforms. The question for debate is why its reform program has been incremental in nature – far short of the "maximum governance, minimum government" Modi promised during the 2014 campaign. The most obvious answer concerns the multiplicity of veto points that act as a check on major policy shifts. For instance, while the BJP alliance earned an outright majority in the Lok Sabha, it is a distinct minority in the upper house (Rajya Sabha), whose assent is necessary for most legislation. Because members of the various state assemblies select Rajya Sabha members, the composition of the house changes at a glacial pace. For the BJP and its allies to control a majority of Rajya Sabha seats by the end of the Modi government's first term, it will have to perform exceedingly well in upcoming state elections. The imperative to improve the party's performance at the state level, however, imposes a cost on policy-making as it heightens the pressures imposed by the electoral calendar.

Another check on the executive is India's independent judiciary. In two recent high-profile cases, judicial rulings have curtailed the government's reform impulse. First, in 2014, Parliament and a majority of state assemblies ratified an important (though controversial) institutional reform, amending the Constitution to create a new National Judicial Appointments Commission (NJAC) to replace the opaque collegium system that is presently responsible for the appointment of the higher judiciary. While the government touted the NJAC as a way of fixing a broken appointments process, the Supreme Court struck the amendment down on constitutional grounds. A second high-profile case involves the government's desire to use citizens' *Aadhaar* numbers to deliver subsidies and welfare benefits. The Supreme Court has balked at making the biometric scheme mandatory for any benefits transfers, although a recent interim ruling permits its voluntary use for a narrow set of government programs.

Internal constraints

The veto points inherent in Indian democracy are widely acknowledged. The many impediments to economic reforms that exist *within* the ruling alliance itself, however, have received less attention. At least four merit mention.

For starters, it is not clear that Modi believes sweeping policy reform is necessary. As chief minister of Gujarat, Modi consistently emphasized two important, but less dramatic priorities: efficiency and infrastructure creation. Rather than dismantling public sector units (PSUs) in Gujarat, Modi sought to professionalize their management and make them more efficient. He also earned plaudits for overhauling Gujarat's infrastructure and providing "single window" clearance for businesses looking to make large capital investments. Modi has demonstrated both proclivities in his first eighteen months in Delhi.

Second and related to the point above, it is not immediately obvious that Modi or his closest advisors have a clearly defined reform strategy. As a result, there is a tendency to change tack when opposed. For example, many Finance Ministry officials have long advocated for the government to establish an independent debt management agency to separate debt management from monetary policy management, thereby resolving an inherent conflict of interest faced by the RBI. The government had included such a provision in its 2015 Finance Bill and publically announced its intention to push for it, but changed course just days later when objections were raised.

Even if one dismisses the notion that the government does not have a well-articulated reform vision, Modi's own statements suggest a third possible constraint: a belief that his government has plenty of time. Indeed, Modi has openly dismissed talk of "100 day" agendas or even one or five-year agendas, remarking that he will need ten years (or two, five-year terms) to "bring India into the 21st century." If Modi is operating with a two or even three-term time horizon, it makes more sense that he has chosen not to front load drastic changes into his first years in office, but instead pursue gradual change spread out over the long haul. This inclination is likely further strengthened by the widespread perception that the BJP's unexpected loss in the 2004 general election was a result of moving too quickly on reforms while in office.

Alongside Modi's agenda, it is important to keep in mind that the BJP is a big tent party. It contains free marketeers who advocate for liberal economics, nativists who endorse the principles of *swadeshi* (self-sufficiency) and preach the gospel of *gau raksha* (cow protection), and people at every position in between these poles. The Modi government is constantly walking a tightrope. If it pushes too hard on reforms, its nationalist supporters – many of whom are affiliated with the BJP's ideological parent, the Rashtriya Swayamsevak Sangh (RSS) – threaten to launch protests or sit out the next election. But if the government leans too far in a nationalist direction, it risks losing its pro-business adherents. By splitting the difference, it aims to keep everyone happy.

Looking ahead

In 2015, the BJP's electoral juggernaut encountered serious roadblocks. After losing February's state election in Delhi to the upstart Aam Aadmi Party, in November the party was decimated by the opposition in the state of Bihar. The BJP's inability to wrest control of the state – in spite of Modi leading the campaign – accentuates the internal and external constraints the prime minister faces in at least three ways.

First, Bihar has an important role to play in India's federal power structure, not least because it has sixteen seats in the Rajya Sabha, control over which the BJP desperately needs. In addition, Bihar also serves as the literal and metaphorical gateway to eastern India, a tract of Indian territory into which the BJP is eager to expand. Finally, the outcome is personally damaging to Modi's prestige, given how intently he campaigned for the party. This loss of face could complicate his control over the party apparatus and imperil future attempts to rein in nationalist elements of his base, whose actions distract from a sharp focus on the economy. In sum, the Bihar result increases the likelihood that Modi will adhere to his gradualist reform course. But even within the framework of incrementalism, there remain several unrealized opportunities.

First, the Modi government has adopted a new and refreshing approach on federalism. This approach emphasizes center-state cooperation as well as heightened interstate competition. To facilitate the former, the government scrapped the decades-old Planning Commission and increased the share of central revenue devolved directly to the states. For the latter, the government launched a new initiative to rank the "ease of doing business" within states. It also used its authority under Article 254(2) of the Indian Constitution to allow states to experiment with legislative changes on issues concurrently governed by the states and the center. Exercising this authority essentially devolves rule-making to the state level on thorny issues of labor and land reform in the hopes that successful policy experiments will attract copycat reforms. To date, the BJP-ruled states of Rajasthan and Madhya Pradesh have both used this opening to ease rigid labor laws. Using his bully pulpit, Modi can go even further by exhorting BJP states to adopt a "common minimum program" on economic reforms, moving in lockstep to amend legislation under state or concurrent jurisdiction.

Second, in the coming years the government faces a financial dilemma: it needs to consolidate its fiscal position to please markets, but will simultaneously be pressured to increase public expenditures, both on infrastructure and to cover new fiscal burdens imposed on it by the recent report of a government pay commission that sets government salaries. One obvious solution, as articulated by economist Sajjid Chinoy, is to sell government assets and channel some of the proceeds of this disinvestment into public spending. This would essentially act as an asset swap by redirecting public monies from PSUs to productive public infrastructure. The government could use this externally imposed dilemma as a politically convenient alibi to make such changes. To date, the government has announced ambitious plans to sell government assets, but implementation has been fitful.

Third, the goal of returning India to a sustainable high rate of growth implicitly requires upgrading the quality of public sector institutions. Unfortunately, the government is guilty of both sins of commission and omission on this front. Regarding the former, upon taking office Modi moved quickly to centralize power within the Prime Minister's Office (PMO). While reinstating the authority and legitimacy of the PMO was necessary after its credibility had badly eroded under the previous government, centralizing power within the PMO runs the risk of creating new bottlenecks and distortions. Second, the government has often exerted political influence in places where it should not, such as intervening in the functioning of higher-education institutes and rewarding political cronies with plum positions in government or quasi-government entities. Nearly every Indian government in recent memory has followed a similar playbook, but this is also why they have all done a disservice to governance.

Aside from these missteps, the government has also missed obvious opportunities to take action on public sector reform. In 2013, Parliament passed a bill to create a national anti-corruption ombudsman, or *Lokpal*, but the Modi government has yet to implement the legislation. The Central Information Commission (CIC) ruled that political parties are subject to the Right to Information Act, which would, for the first time, introduce a modicum of transparency into the opaque affairs of India's parties. The present government, despite Modi's pledges to reduce corruption and malfeasance in politics, has refused to accept the CIC's ruling. Indeed, the BJP joined five other national parties in refusing to even appear before the CIC.

Conclusion

The Modi government is eighteen months young. It wisely prioritized macroeconomic stabilization in its initial period in office to stem the economic malaise it inherited, and the decision to do so has paid off handsomely: while India's economy still has its vulnerabilities, it is in markedly better position to weather global economic headwinds than was the case just two years ago. On the broader economic reform agenda, however, the government's record is open to constructive criticism. While its attempt to ease stringent land acquisition legislation failed, the government has successfully implemented important, albeit incremental, changes with respect to the investment climate, subsidy reform, natural resource policies and finance/monetary reforms.

Given the array of external and internal constraints on the government, further enhanced by recent election defeats, the Modi government is unlikely to deviate from its gradualist path. Even operating within its comfort zone, the Modi government can use India's federal system to push reform at the state level and leverage externally imposed constraints to alter its public finance priorities. In truth, the most fundamental reforms – those relating to administration and governance – represent the most efficacious long-term investment the government can make. If Modi were to embrace this agenda, it would truly mark the arrival of *acche din*.

Further reading:

Bibek Debroy, Ashley Tellis, and Reece Trevor. "Getting India Back on Track: An Action Agenda for Reform" Washington, DC, 2014: Carnegie Endowment for International Peace.

Suhas Palshikar, K.C. Suri."India's 2014 Lok Sabha Elections: Critical Shifts in the Long Term, Caution in the Short Term" Economic and Political Weekly 49, no. 39 (September 27, 2014): P. 39–49.

Suyash Rai, Milan Vaishnav."Narendra Modi's One-Year Ledger" Mint, May 25, 2015, http://www.livemint.com/Opinion/Ls2dvmNymwP6yH0vynZyrM/Narendra-Modis-one-year-ledger.html.

Milan Vaishnav. "Understanding the Indian Voter" Carnegie Endowment for International Peace, 2015, http://carnegieendowment.org/2015/06/23/understanding-indian-voter/iawy.

Ashutosh Varshney. "Hindu Nationalism in Power?" Journal of Democracy 25, no. 4 (2014): P. 34–45.

Latest editions:

Asia Policy Brief 2015 I 03
China's Confidence Issue:
Hard or Smart Landing – What Can We Expect?
Bernhard Bartsch

Asia Policy Brief 2015 I 02
The Coup One Year on: Thailand's "Ugly German" Constitution
Serhat Ünaldi

Asia Policy Brief 2015 I 01
Japan Again under Abe – Fresh Start or More of the (not so Great) Same?
Axel Berkofsky

If you have any questions or if you wish to subscribe to the "Asia Policy Brief" please write to **asien@bertelsmann-stiftung.de**.

All "Asia Policy Brief" editions can be downloaded from **www.bertelsmann-stiftung.de/asien**.

ISSN 2364-8562

Responsible according to German press law

Bertelsmann Stiftung
Carl-Bertelsmann-Straße 256
D-33311 Gütersloh

Stephan Vopel
stephan.vopel@bertelsmann-stiftung.de

Dr. Peter Walkenhorst
peter.walkenhorst@bertelsmann-stiftung.de