Global Counsel

Mr Singh's 'legacy' and the state of the Indian political economy

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Summary

- Two weeks after high profile reforms to fuel subsidies and rules on inward investment were pushed through the Indian cabinet by Prime Minister Manmohan Singh and Finance Minister Palaniappan Chidambaram, the likely impact of the proposed changes is now clearer. In finally pushing through some reform measures, Singh has successfully united the BJP, most of the Indian left and even some of his own party against him. While not unexpected, this leaves big questions over the package's actual implementation.

- Mr Singh described the package as his 'legacy'. In many ways it reflected his inheritance – the structural features of the Indian political economy that have defined his Prime Ministership. For investors in India, the nature of the measures tell us a lot about what worries senior policymakers in India and how they see their freedom of action.

- On fiscal reform, the reduction in fuel subsidies is an attempt to stabilise a system spending money badly and raising insufficient revenue to spend well. The delegation to state governments of decision-making on inward investment in the retail sector was an explicit concession to the intractable deadlock at the national level and the shifting power balance between Delhi and the states.

- At worst, the Singh package provokes an early election and an even more business-sceptical government. At best, it provides a few new incremental steps in the long process of turning the Indian political and economic supertanker.

It was the politics of the big gesture. Just when just about everyone outside India and many in the Indian business community had given up on Indian reform, at least until the next general election, the government of Manmohan Singh appeared to have rediscovered its sense of purpose. On Friday 14 September, the government announced a package of reforms to reduce fuel subsidies and open Indian markets for foreign investment in retail. It also widened the scope for FDI in airlines and broadcasting and proposed the part-privatisation of some of India's national energy companies. Money flowed into Indian equities and the rupee bounced. Manmohan had, one commentator said, got his mojo back.

The subsequent fortnight has tempered expectations somewhat. On the domestic political front, the announcement was greeted with condemnation from the opposition BJP and parties of the Indian left. West Bengal's Mamata Banerjee announced on 21st September that she and her 19 MPs of the Trinamool Congress were leaving the government, and thereby removing its majority. If the measures were in part a signal of intent to the ratings agencies that have been growing increasingly restive about India and threatening a downgrade, it is unlikely to work. India remains on negative outlook one notch above junk.

Singh described the package as his ‘legacy’. In many ways it reflected his inheritance – the structural features of the Indian political economy that have defined his Prime Ministership. The fact that the wider freedoms for inward investment were not imposed nationally, but delegated to Indian State governments for decision, may have been a way of sidestepping national disagreement, but it also conceded the bigger problem of national political deadlock. Clearly, trimming fuel subsidies makes economic sense, but it points to the much bigger problem of India’s fiscal sustainability. This Global Counsel Insight looks at these deeper structural features of the Indian political economy.

Retail politics

The biggest headlines for the Singh package, at least internationally, have been reserved for the decision to allow foreign retailers to take controlling (51%) shares in the Indian multi-brand retail sector. This is a move which the government attempted to take in November 2011 before being forced into a humiliating retreat under pressure from its Trinamool Congress coalition partner and its leader Mamata Banerjee, who claimed that it would prove fatal to India’s millions of small retail stores.

This time around the government is standing behind the measure despite Ms Banerjee and her 19 MPs leaving the governing coalition. But the liberalisation comes with caveats. Foreign retailers will be limited to cities of over 1mn people. They will have to use 50% of the investment to create “back end infrastructure” such as cold storage facilities. Critically for large multinational supply chain businesses, they will have to source 30% of produce from small Indian business. The key change is the removal of requirements that every individual store be established in India as a separate legal entity.

The biggest and most important concession in the September 14 package goes right to the heart of the Indian political economy. Delhi delegated the decision on whether to implement the measures to state governments. At time of writing, nine of India’s 28 states have announced that they will, and a number of states have stated that they would not, including Uttar Pradesh which has a population of over 200 million, and where the governing Congress Party – in the form of Rahul Gandhi – lost a decisive election earlier this year.

Ironically, BJP-led Gujurat may actually be one of the early liberalisers of multi-brand retail, although its huge constituency of small shopkeepers makes the BJP an opponent of the measures at the national level. Indeed the BJP-led, NDA coalition has already stated that if elected in 2014 they would revoke the measure, which is unlikely to encourage state governments to take the leap.

The basic concession to national deadlock can be seen in two ways that are not necessarily contradictory. The first is that it provides an opportunity for competitive reform among India’s states. If FDI in retail is successful in Maharashtra, for example, then other states will be more inclined to relax their own restrictions. Investors have long found state governments – at least those who agree with them - a more natural partner than Delhi and this enables these states to move faster with inward capital.

The second is that it is simply a political reality in India that the balance of power between Delhi and the states is increasingly playing out in favour of the latter. A succession of powerful and charismatic Chief Ministers, including Nitish Kumar of Bihar state and Narendra Modi of Gujarat, have helped reinforce a very strong residual sense of regional over national political identity in India. After the 2009 elections, 70% of Indians reported that they saw their regional identity as more important than their national one. The hold of the Congress-BJP duopoly has consistently weakened since 1991 and regional parties now account for just over half the Indian national vote – up ten percentage points in the last two decades.

Not only has the persistent bias in the national political system towards coalition become a check on decisive action, but the fractious nature of national coalition politics has allowed regional parties like Ms Banerjee's to extract regional benefit from participation in national government. West Bengal has seen a 166% rise in grants from the centre since Trinamool Congress joined the government in 2009 – the largest rise in India by some distance. She has managed to translate support at the centre into financial support to her heavily-indebted state.

Fuel subsidies and fiscal sustainability

Before the cuts in fuel subsidies announced on September 14th, the expected fuel bill for this financial year in India was $35 billion. Economic growth has increased fuel consumption and rising oil prices have been exacerbated by the weakening of the rupee, which has lost over 25% against the dollar since the start of 2011. This fuel bill is a major contributor to India's 8% fiscal deficit (Fig 1).

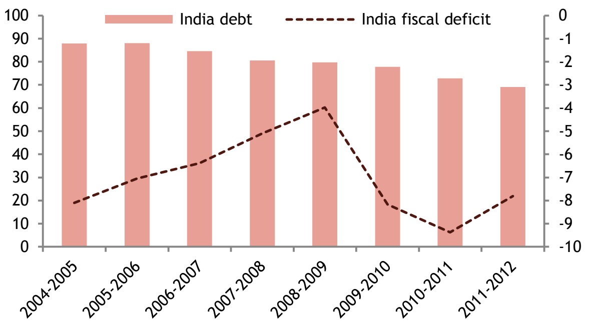

Fig 1: India's European-looking fiscal profile

Source: RBI 2012

As in a number of developing markets, reforming fuel subsidies in India remains both fiscally critical and politically toxic. As in Indonesia (see GCI 12/11 *Chasing the Scooter Vote*), subsidised fuel is regarded by many in India as an integral part of the social safety net. Even the modest trim proposed by the Singh government will raise prices by 12-14% for the millions of poorer Indians who use gas for cooking and diesel for transport and inefficient electric power generators. The simultaneous liberalisation of retail markets will ultimately help counter rising household costs by lowering food costs to consumers. But these reforms will take time to lower prices, whereas the fuel price rise will hit consumer wallets now.

The Singh government has rightly tried to take the long view on fiscal sustainability, not least because it is India's fiscal position that is at the forefront of threats to downgrade India's credit rating. But this is a revenue problem as well as a spending problem for India. Despite rapid economic growth government, fiscal revenues represent only 18.5% of GDP in India – a figure which has risen only marginally in the last twenty years. By way of comparison, China's government revenue growth during the same period has risen from 14.6% to 22.3% (Fig 2).

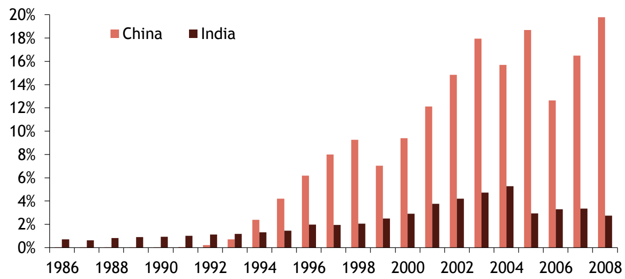

Fig 2: Share of population paying income tax, China and India

Source: Piketty and Qian 2009

The problem here again is essentially politics. China has progressively widened its tax base over the last ten years as its middle class population has grown. Yet currently only 33 million Indians out of a population of 1.2 billion pay any income tax at all. Partly this is simply a function of poverty. But partly it is political caution in the face of public resistance to tax rises.

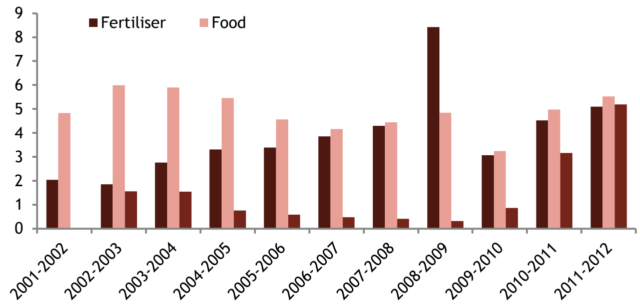

Fig 3: The subsidy safety net: subsidies as a % of total national government spending

Source: Indian Finance Ministry 2012

India's problem is not that it needs less state *per se*. In some respects, India needs more state: the financing and construction of infrastructure; improved education; provision of health services. These will all be required to enable economic growth and unlock domestic demand. What is required will be a move away from a welfare system based on direct subsidies to one based on implicit support systems and a widening of the tax base to fund it – a transition which amounts to a rewriting of the Indian political contract established during six decades of democracy.

Small steps

The Singh reform package and the reaction to it is part of the working out of a more fundamental question of how India is going to manage a period of economic transition. India's economy has reached a point where it needs reform to continue expansion. But its expansion to this point has not created a constituency for further reform which is either large enough or powerful enough to effect the necessary changes.

Indian politics is nothing if not sensitive to the demands of the electorate. The problem for advocates of reform is that the electorate is predominantly poor, rural, and resistant to tax or any dismantling of the systems of subsidised fuel, fertilizer and food that are the basis of the social contract in the Indian system (Fig 3). This system that has been reinforced by the guiding hand of Sonia Gandhi through schemes such as the National Rural Employment Guarantee Act. It will prove difficult to dismantle.

Like the EU in many respects, Indian policy is defined by the tension between technocratic reform and the limits of the politically possible. Also like the EU, or at least the Eurozone, the defining of 'national' priorities in Delhi or Brussels is ultimately hostage to more parochial interests in Paris or Madrid or Ahmedabad or Kolkata.

Mr Singh is clearly shaped by his experience as Finance Minister in 1991 when the reform package he steered through Parliament alongside Narasimha Rao fundamentally changed external perceptions of India and encouraged a steady flow of investment into the country. To some degree, he would obviously have liked to pull off the same trick again. The decision by Singh and his reformist Finance Minister, Palaniappan Chidambaram, to gamble on a high profile package of reforms could easily backfire if political dissent provokes an early election which in turn produces an even more foreign business-sceptical coalition. This may still happen even if the Parliament runs its course until 2014.

The reforms are only a small step on a path that includes big ticket items like telecoms licensing, environmental protections for energy and resources development, and, critically, reforms to the tax system – all of which will require significant outlay of political capital, of which the Singh administration has diminishing reserves.

The outcome, especially for inward investors, is most likely to be the kind of incrementalism that will probably be the final result of the September 14 measures. Piecemeal tweaks to the fiscal base. Tactical moves to outflank national political deadlock by handing decision-making power to state governments. A heavily-laden political supertanker very gradually changing course.

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