



UNRAVELLING INDIA

By Jeff Glekin and Hugo Dixon

Preface

How is political paralysis hurting the Indian economy? Can endemic corruption be effectively brought down? Is India's long-term growth story is still intact? The so-called India Shining story appears to be unravelling. The latest e-book from Breakingviews breaks this down in three parts:

- **Political Paralysis**

India is wasting a good economic crisis. Key reforms tend to follow economic slowdowns. Not this time. Instead of springing into action, the political system is paralysed. The best it can offer are handouts and subsidies, which will further exacerbate the country's problems.

- **Corruption**

What's the best way for India to slay corruption: punish the culprits or make government so transparent that it is hard for bribery to find places to latch onto in the first place? The answer is both.

- **Demography**

It's common in India to say that, even if the country suffers from short-term political paralysis, the long-term growth prospects are great because of its burgeoning population. But is that really so?



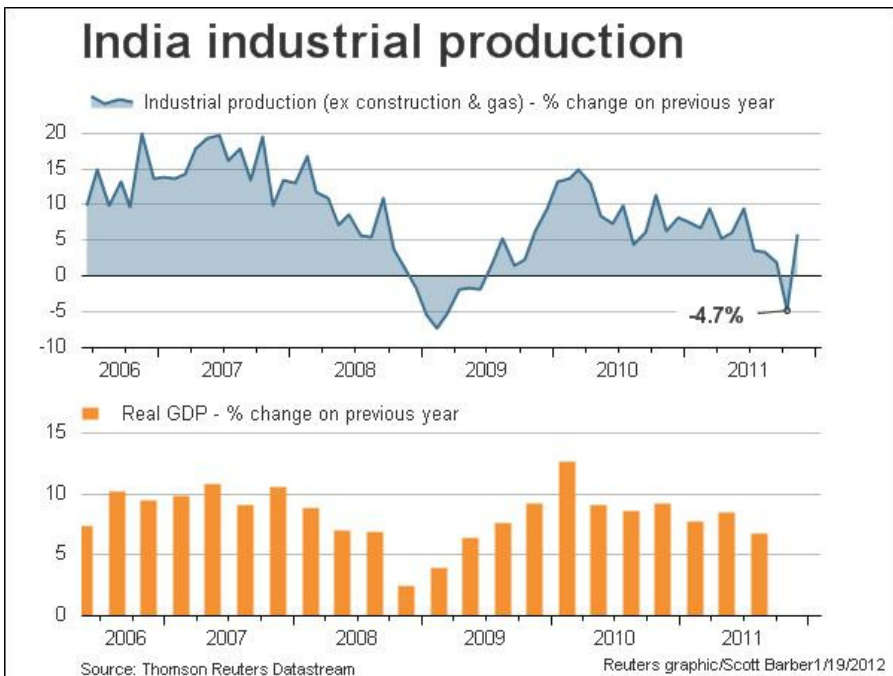
Source: [REUTERS/ B Mathur](#)

Chief of India's ruling Congress party Gandhi gestures in front of the portraits of Singh and Rahul during the inauguration ceremony of the "National Convention on Empowerment to Tribal Women" in New Delhi.

Political Paralysis

Half way into Manmohan Singh's second term as prime minister, the so-called India Shining story is unravelling. Having weathered the 2008 financial crisis better than almost anyone predicted, projections that the country would soon be growing faster than China at 10 percent or more a year had become the norm. That confidence has come hurtling back to reality with a thump.

Admittedly, GDP is still expanding at around 7 percent, a rate the developed world can only dream about. But big new investment projects have virtually dried up, the fiscal deficit is heading towards 6 percent of GDP and the rupee was Asia's worst performing major currency last year while India's Sensex stock market index fell 25 percent. What's more, inflation remains stubbornly high despite 13 interest rate hikes over the past year and a half. Some even joke that the "I" in BRIC, the club of rapidly developing economies, should now be Indonesia rather than India.



Political infighting and inertia bear much of the blame. Singh, who launched the economy on the road to liberalisation when finance minister 20 years ago, has lost the will and the ability to reform. His government's energy has been sapped by corruption

scams. And he has been unable to push through even those reforms that he promised because coalition partners keep threatening to pull the rug from under his government. How badly will this political paralysis hurt the economy's immediate prospects? What's the best way of tackling the endemic corruption? And is India's long-term growth story still intact? These are the questions addressed in Breakingviews' three-part Unravelling India series.



Source: [REUTERS/Pawan Kumar](#)

Chief of India's ruling Congress party Sonia Gandhi and its General-Secretary Rahul Gandhi wave to their supporters at Rae Bareilly

Wasting a good crisis

In India major reforms tend to follow economic slowdowns. It was a balance of payments crisis in 1991 that kicked off Singh's original reforms. Yet this time, instead of springing into action, the political system is paralysed. The best it can offer is handouts and subsidies, which will further exacerbate the country's economic problems.

The failure to enact structural reforms in Singh's first term as prime minister from 2004-2009, as well as since he was re-elected, is one of the reasons the country's productive potential has not grown as fast as it might have. Demand, though, has been strong – driven both by the growing middle classes and deficit-financed cash handouts to the

rural population. The snag is that, with demand outpacing supply, inflation remained above 9 percent throughout 2011.

The Reserve Bank of India has tried, only partly successfully, to tackle the inflation by pushing interest rates up to 8.5 percent. While demand has slowed down, it's investment that has been hit more than consumption – and that's an unhealthy mix for the future. For the moment, investment - which was 35 percent of GDP last year – doesn't look too bad. But large new investment proposals fell to a five-year low in 2011, according to data from the Centre for Monitoring Indian Economy. Unless investment picks up, the country's productive potential won't rise as rapidly as it could and it will face renewed inflation whenever it tries to press on the accelerator.



The hike in interest rates isn't the only factor restraining investment. Many new projects, especially anything to do with infrastructure or exploitation of natural resources, require government approval – and the machinery of government is operating at a snail's pace. That, in turn, is partly because several people have been thrown into jail in connection with a telecoms scam, where radio spectrum was awarded to mobile phone companies at a fraction of its value costing the state an estimated \$39 billion in lost revenue. Officials across government are reluctant to sign off on new projects because they are afraid they may get incarcerated too. Hopefully, the bureaucratic stasis will only last until government transitions to a cleaner way of operating. But, in the meantime, it is gumming up the economy.

Business confidence has also taken a hit. Industry is worried about the paralysis in Delhi. The government's habit of spending more than it raises in taxes – and then mainly on

things that boost consumption rather than infrastructure – is also crowding out the private sector. Business has in recent years tapped foreign sources of capital to help plug the gap. But the euro crisis has made it harder to borrow from abroad. Indeed, some companies such as Reliance Communications and Tata Motors are rueing the day they loaded up with dollar loans only to find that the plunge in the rupee means their debts are bigger in their home currency.

Power is an example of how a cat's cradle of government policies is messing up a vital sector. The main source of energy is coal, which is abundant in India and made available to generators at about 45 percent less than global prices. So private-sector groups such as Tata Power, Sterlite and Reliance Power started investing in new coal-fired power stations, financing them mostly with borrowed money. The snag is that new coal mining projects have been delayed by environmental concerns and so the power producers don't have enough cheap local coal. Buying expensive imported coal, on the other hand, is uneconomic because the price at which they are allowed to sell electricity is capped by the state. Some of the power producers look like they will need a debt restructuring. India may soon have insufficient electricity to drive growth.



Source: REUTERS/Danish Siddiqui

Smoke rises from a depot of state-run Indian Oil Corp (IOC) in Talaja

All this is happening when the global economy is slowing and the euro crisis is raging. India isn't as much exposed to trade as, say, China is. But its reliance on foreign capital makes it vulnerable to any seizing up in financial markets such as the one which followed Lehman Brothers' bankruptcy. What's more, if the euro did explode, the government's own deficit means it wouldn't have many ways of cushioning the blow.

Political games

Ideally, the government would respond to the slowdown by launching supply-side reforms to boost investment and the country's productive potential. Top priorities would include curbing the fiscal deficit, rooting out subsidies, liberalising the power sector, simplifying regulations on land use without which few enterprises can get going or expand – and, of course, combating corruption.

In fact, the government's only significant liberalisation move – a relatively modest plan to open up the country's retail sector to foreign investment – has fallen flat on its face. Just days after announcing the move in November, which would not only have brought in foreign money from the likes of Tesco and Wal-Mart but also helped modernise the supply chain and curb inflation, Singh had to shelve the plan. The reason? Mamata Banerjee, the powerful chief minister of West Bengal on whose support Singh's government relies, refused to back it. She also incidentally torpedoed an anti-corruption bill in the dying days of 2011.

Instead of reform, the government's main proposal has been for a new food security bill which involves giving about 800 million out of the country's 1.2 billion people access to virtually free rice, wheat and coarse grains. There's nothing wrong with a plan to curb malnutrition. After all, India has worse rates of child undernourishment than sub-Saharan Africa. But the new plan is badly targeted, covering two-thirds of the population. It may double the cost of food subsidies, taking them to 2 percent of GDP, at a time when the deficit is already too high.



*Source: REUTERS/Dani
sh Siddiqui
Prices for various
vegetables are
displayed as people
shop in the fresh foods
section of a Reliance
Fresh supermarket in
Mumbai*

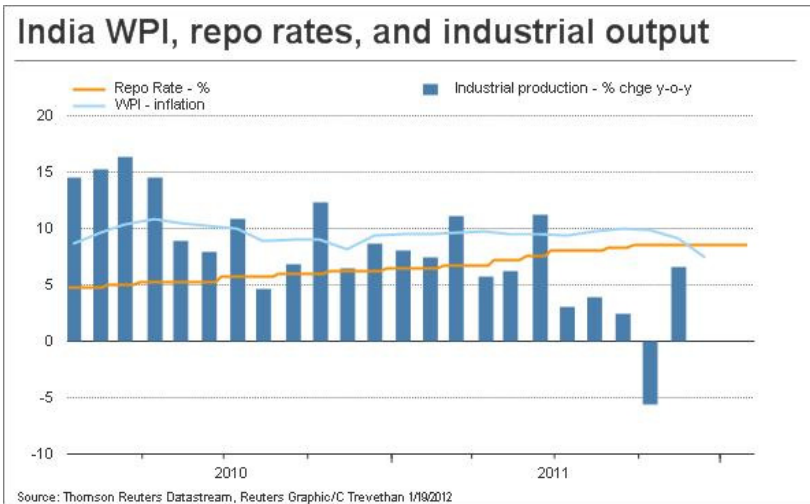
The scheme also looks like a fertile new ground for corruption. What's more, the government's need to acquire huge quantities of grain will push up food inflation. It's

hardly surprising that many observers think the main motivation for the plan isn't to combat malnutrition but to buy votes ahead of the 2014 general election.

It's not at all clear that 79-year-old Singh really believes in what the government is doing. But he is hemmed in from two sides. One is his fractious coalition partners; the Congress Party, which he is part of, has only 206 out of 543 seats in parliament. The other is Sonia Gandhi, the standard-bearer of the Nehru/Gandhi dynasty who runs the Congress Party. She is considered to be less of a reformer and more of an old-fashioned socialist. A common quip in New Delhi is that Gandhi has power without responsibility; whereas Singh has responsibility without power.

Spring hopes

Amidst all this gloom, industrialists and political pundits cling to the hope that things could get brighter in the spring. Part of the hope derives from the fact that inflation is at last falling. It is expected to come down to between 6 and 7 percent by the end of 2012, according to UBS estimates. Though that's still high, it should allow the central bank to ease interest rates a bit which, in turn, could encourage business to invest.



But the bigger hope hangs on elections in five key states in March. If Congress does well, it could reassert itself. There's a particular focus on Uttar Pradesh (UP), the largest state with over 200 million people. Congress is not in a position to win this state. But it may be able to form a coalition in UP with the local Samajwadi Party (SP). As a quid pro quo, the SP may then be prepared to support Congress in New Delhi, allowing it to dispense with Mamata Banerjee as an ally. Because Congress and SP would each have a hold on the other, such a coalition might be more stable than the current one.

In this rosy scenario, Singh would then be free to re-launch his reform agenda. He'd bring back the plans for opening up the retail sector to foreign investment and combating corruption; he'd push through draft bills on mining and land acquisition; he'd get the machinery of government moving again; and he'd rein in the fiscal deficit. The main way of doing the latter would be to curb fuel subsidies, which cost the government 3.5 percent of GDP according to the OECD. Such a move, which was heavily hinted at by Singh in his New Year's address, would help pay for the new food subsidies.



Source: REUTERS/Rupak De Chowdhuri

Activists from the Socialist Unity Centre of India (SUCI) hold placards while shouting slogans during a protest against a recent hike in petrol prices in Kolkata

All this would be great if it happens. But it does rely on the state elections going the way Congress wants, as well as the government deciding that it really wants to push through another dose of reforms which would be unpopular and involve overriding vested interests. And, of course, it depends on Singh or another reformer being prime minister – which, given Gandhi remains the power behind the throne, cannot be guaranteed.

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Unravelling Corruption



Source: [REUTERS/Danish Siddiqui](#)

Anti-corruption activist Anna Hazare drinks as he ends his fast at the Bandra-Kurla Complex Mumbai

What's the best way for India to slay corruption: punish the culprits or make government so transparent that it is hard for bribery to find places to latch onto in the first place? The answer is both.

Corruption finds its way into pretty much every nook and cranny of public life. There's high-level corruption, such as the telecoms scam that cost the government an estimated \$39 billion in revenue when mobile licences were awarded to companies too cheaply between 2007 and 2008. There's the petty corruption, such as middlemen taking a cut as they distribute subsidised food to the poor. And there's the corruption at the heart of the electoral system: candidates pay voters to attend their rallies and sometimes shower them with cash, often of unknown origin.

Over the past year, India has been transfixed by a campaign led by Anna Hazare to force the government to create an ombudsman which would prosecute corrupt politicians and bureaucrats. Hazare's initial hunger strikes brought millions of sympathisers out on the streets and forced the government into a series of humiliating U-turns. But "Team Anna" has lost some steam. When 74-year-old Hazare launched his third hunger strike just before the New Year, hardly anybody turned up – and he had to call it

off prematurely because he was ill. Team Anna is now taking a pause for reflection, and the legislation creating such an ombudsman has yet to be instituted. One early conclusion is that it will have to find other tactics apart from hunger strikes.

Even if Team Anna fizzles, the broader anti-corruption movement has a life of its own. A more youthful, wealthy, tech-savvy and educated middle class is unsettling the balance of Indian politics. The media is hot on the trail of corruption. Parts of the business community – notably, Azim Premji, chairman of Wipro, the IT services giant, and Deepak Parekh, chairman of banking group HDFC – have campaigned against graft, arguing it is one of the greatest threats to India’s economy.



*Source: REUTERS/Raj Patidar
BSP President and Uttar Pradesh Chief Minister Mayawati receives a garland in the central Indian city of Bhopal*

In the current Uttar Pradesh elections, the powerful incumbent Chief Minister, Mayawati, has just sacked around half her cabinet for corruption. When the opposition BJP which had been supporting the Anna campaign welcomed some of the sacked politicians into

its fold, it faced a backlash. What would once have been seen as smart politics is now viewed as hypocrisy.

Some public servants have also taken steps to shine a spotlight on corruption. The Comptroller and Auditor General produced a series of critical reports including one on the telecoms scam. The chief justice has played a big role in pushing for a proper investigation of this case, free from political interference. And the former number two at the Securities and Exchange Board of India (SEBI), the financial watchdog, has alleged that the Finance Ministry exerted undue pressure on SEBI in support of businesses including Reliance Industries, run by multi-billionaire Mukesh Ambani.

There's no cause for complacency. Even if the chief justice is doing a good job, the overall judiciary has stacks of cases that have been backing up for years. Meanwhile, nobody has acted on the SEBI whistleblower's allegations. Indeed, the Finance Ministry removed SEBI's boss last year, arguably undermining its independence.

India clearly needs a strong ombudsman. When this comes back on the agenda, probably in the next few months, there will be much wrangling over exactly what form the legislation will take. The main dispute will be over whether the Central Bureau of Investigation, which carries out probes, should report to the ombudsman or the government. Team Anna, unsurprisingly, wants the investigators to report to the ombudsman arguing that otherwise the government could interfere with probes into its own corrupt activities.

Let there be sunshine

A strong ombudsman is only part of the answer to India's corruption problem. The other part is to make the whole system of government more transparent. A big step in this direction was taken with a Right to Information Act in 2005. Journalists and other campaigners have been successfully using this act in pursuing corruption investigations.

Another big step would be the use of electronic auctions to allocate state resources – such as land, minerals and radio spectrum – as advocated by Premji and Parekh. A similar approach could be taken with government procurement. The more things are done in the open, the less chance of bribes changing hands.

Meanwhile, an ambitious scheme to give Indians a biometrically-validated electronic identity could help combat low-level corruption. At present, about half the babies born in north India aren't even registered. But once it's clear who everybody is - and fingerprints and images of irises held in a central database aren't simple to fake – it should be easier to make sure that the right goods and payments get to the right people with less leakage to corrupt middlemen.

The unique identity (UID) scheme could also be the basis for bringing bank accounts and mobile phones to the hundreds of millions of people who don't have them. And as more

people have access to electronic banking, it will then be easier to get rid of universal subsidies such as cheap diesel and replace them with targeted payments to those really in need.



*Source: [REUT ERS/Krishnen du Halder](#)
A villager uses a fingerprint scanner during the Unique Identification (UID) process in Patancheru*

Nearly 200 million Indians have so far registered for a UID. The scheme has got off to a cracking start, in part because the government brought in Nandan Nilekani, ex-chairman of Infosys, the IT services group, to run it rather than rely on the established civil service. Nilekani is used to the IT ecosystem – where application developers, financiers, business partners and other talent are pulled together behind a common enterprise.

But that hasn't meant things have been plain sailing. The initiative risks becoming stalled in a turf war with the Home Ministry, which has a rival identity card scheme. The matter is due to be fought out in cabinet next month.

If UID initiative can survive, it won't just provide a way of cutting low-level corruption. It could also be a model for sorting out other massive problems in the public sector. The gummed-up judiciary would be a good place to start. Why not assign cases unique identity numbers, pop them into a central database and then track how rapidly they are moving through the system?

If Team Anna gets its mojo back, its priority will be to fight for a strong ombudsman. But, after that, it could do a lot worse than turn its attention to the transparency side of the anti-corruption agenda.

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Malthus Redux

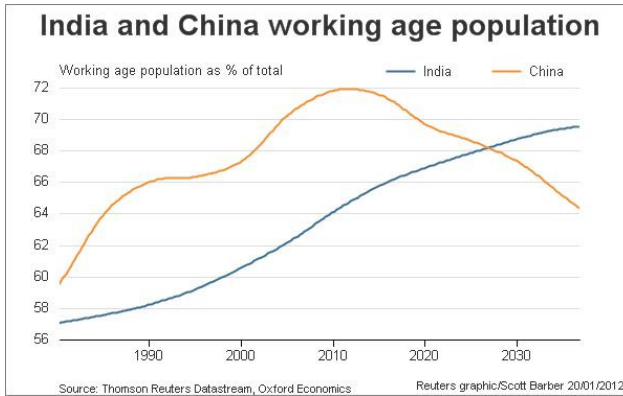


Source: *REUTERS/Pawan Kumar*

Newly born babies rest inside a ward in a hospital in Lucknow. Pawan Kumar / Reuters

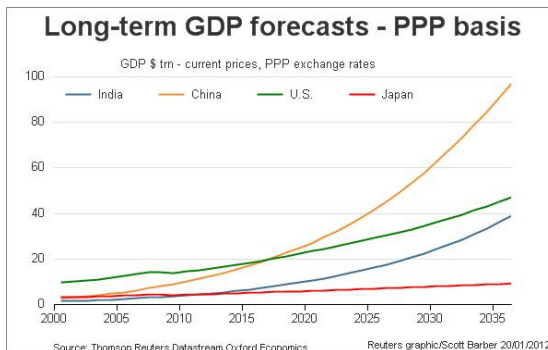
It's common in India to say that, even if the country suffers from short-term political paralysis, the long-term growth prospects are great. But is that really so?

The bull case relies on two factors: demography and catch-up. Look at demography first. India's population, currently 1.2 billion, will reach 1.7 billion in 2050. China's, by contrast, will stay stuck at 1.3 billion. What's more, China's population is greying whereas India's working-age population is still swelling. By 2040 the average age in China will be 46 whereas in India it will be 34. This means that workers and consumers will be growing faster in India than on the other side of the Himalayas — and that should, all other things being equal, be good for growth.



Now look at catch-up. India's GDP per capita in 2011 was \$1,527 - compared to \$5,184 in China and \$48,147 in America, according to the International Monetary Fund. If there is adequate investment in both physical and human capital (such as education and health care), there's no reason why India shouldn't close the gap on China just as the Middle Kingdom is catching up with America.

So much for the theory. In practice, to achieve such potential, India will need to navigate three bottlenecks. The first of these is actually getting all that investment into the system. Investment has risen from 25 percent of GDP in 2000 to 35 percent last year. The current five-year plan, which runs until this March, will virtually hit its target of investing \$500 billion in infrastructure. The next plan calls for a doubling to \$1 trillion, much in the form of partnerships between the public and private sectors. If that happens, it will be great. But large new investment projects have ground to a halt as a response to the political stasis and the loss of business confidence (See part 1 of this series). Delhi's latest effort to kick start investment – forcing cash-rich state-owned firms such as Coal India to invest up to \$35 billion in infrastructure this year – may help. But the real challenge is to unlock commercially-motivated private investment.



Go for decentralisation

This brings one to the second bottleneck: politics. The fact that India is a democracy means it is less likely to face a disruptive revolutionary upheaval than China. But India's democracy is a raucous one. In the 65 years since independence from Britain, power has become increasingly fragmented. Initially, the Congress Party – which led the independence struggle – pretty much dominated political life. There are now multiple opposition parties both at a national and state level.

This is not surprising in such a vast country with 28 states and 7 union territories, 22 official languages, 6 major religions, 645 scheduled tribes and a multiplicity of castes – all of which offer the potential breeding ground for political parties. Coalition government is here to stay. Regional parties may be happy to join national coalitions, but they make difficult bedfellows. Even in times of crisis, their main interest is in seeking spoils for their states. They are prepared to hold the national interest to ransom to get their way.

One silver lining is better governance in some states. Nitesh Kumar in Bihar and Narendra Modi in Gujarat are cases in point. In Bihar, Kumar is credited with reversing the fortunes of a failed state of 100 million people by improving law and order and investing in infrastructure, so boosting its growth rate to 14 percent in 2011. Modi, meanwhile, has fought against corruption, improved efficiency and sucked in investment with the result that Gujarat, always a relatively strong state, now enjoys a per capita income 37 percent above the national average.



*Source: [REUTERS/](#)
[Amit Dave](#)
A BJP supporter wears
a mask of Gujarat's
Chief Minister Modi at
a rally in Balasinor*

Such successes point to a possible solution to India's chronic political paralysis: decentralise more power from the centre. It is easier to reach sensible conclusions on what to do in relatively homogenous units with average populations of 40 million than in

one sprawling polity of 1.2 billion going on 1.7 billion.

Sustainable growth

The environmental impact of that growing population is the final bottleneck. India is going to struggle to get enough land, water and power to satisfy the increasing consumption of an expanding population.



Source: [REUTERS/Babu Babu](#)

Students in Chennai make a tree formation during a programme to create awareness to save trees

India already imports more than three quarters of its oil requirements. And though the country has the world's fourth largest coal reserves, environmental restrictions mean production is struggling to keep up with demand from coal-hungry power stations. A year ago the then environment minister declared a third of coal reserves "no-go" areas. Although the policy has since been reversed, regulatory clearances for new mining projects remain hard to come by.

There are two main concerns: reserves are predominantly located in densely-forested areas; and these areas are often inhabited by poor tribal communities. A new mining bill, which is yet to be passed, proposes firms share 26 percent of their earnings with the tribal communities they displace. That may help persuade the local people that development is in their interests but it won't resolve the question of deforestation.

More generally, India is going to have to strike a balance between development and ecological sustainability. As the prices of resources rise and more of the costs of environmental destruction are born by business, the country's potential growth rate is bound to suffer. Sure, the environmental challenge may at the margin spur innovations

that allow Indians to live richer lives without consuming lots more stuff. But there is only so much that can be done when 1.7 billion people are crowded on 2.4 percent of the planet's land. The population explosion isn't an unadulterated blessing.

India's long-term prospects are linked to its current performance. Most of today's grand projections come off the back of some impressive rates of growth over the past decade.



*Source: REUTERS/Jiendra Prakash
Farmers protest against the takeover of their land for two proposed power plants, Karchana*

The problems of today – a decline in investment, a bulging fiscal deficit, rampant corruption and environmental roadblocks – are also the key challenges of the future. And a youthful population is only an asset if it can be employed productively. The economic solutions have been written down many times before but decisive action is in short supply. A change in politics driven by more state-led decision making could be the key that unlocks a sustainable high-growth trajectory. Otherwise, the India Shining story will continue to unravel.

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