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## Limits of the Jugaad Growth Model: No Workaround to Good Governance for India


*Indian industry has gained fame in management circles for* jugaad, *or persevering despite limited resources. This skill has proven particularly important in overcoming inadequate public services. However, the economy appears to have reached the limit of using* jugaad *in the place of good government, suggesting a lower growth trajectory in the absence of a major improvement in political dynamics.*


India's economy performed exceedingly well in the past decade, averaging an impressive 7.8% growth across 10 years, even sustaining 5% growth during the peak of the financial crisis. A common refrain holds that growth occurred "despite the government," requiring India's celebrated expertise in *jugaad*, or creative workarounds to poor resources. The exceptional growth of India's service industry exemplifies this success. While the reforms of the early 1990s commonly receive credit for launching India's great growth juggernaut, in fact measures like lifting the license raj—the command-and-control regime for private industry—and facilitating cross-border trade benefited manufacturing much more than service industries. The transformational growth, however, came from services, both because India's information technology (IT) and business service entrepreneurs offered a good value proposition and, critically, because they relied very little on public services: no use of the transportation system to ship products, light power consumption, and no need for regulation. IT and business services do require an educated workforce, but at the start of the decade that was available in abundance. Because public services had been so unreliable and regulation so onerous, India required a business model that avoided government intervention to attain its high growth rates.

But as the decade closed, the air seemed to come out of the balloon. The economy weakened, with investment growth declining and inflation soaring to double digits. In the current fiscal year ending in March 2012, India's economic energy has faded to levels seen during the worst of the financial crisis—though without a crisis to blame.

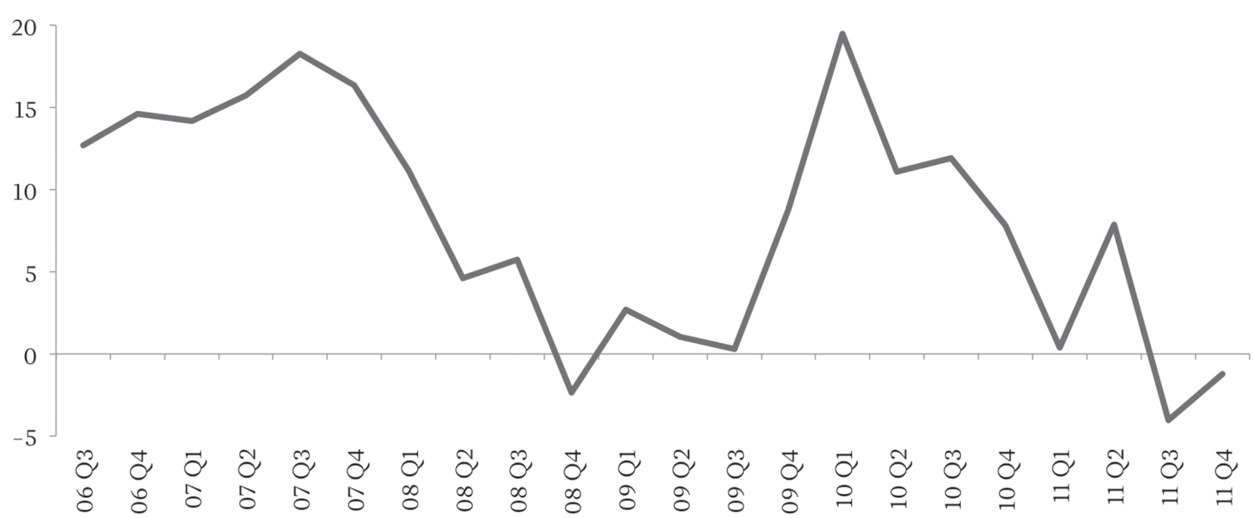
So what is the reason? Observers in Delhi and Mumbai nearly uniformly point to weak government, which has sapped investor enthusiasm for new projects. Through the lens of headline policies in Delhi, weak government means lack of action on economic reforms or the fiscal deficit. Long-pending items include addressing low infrastructure, adverse labor markets, limits on foreign participation, tax reform, and many others. Recent moves in the wrong direction, like the failure to allow foreign direct investment (FDI) in multi-brand retail and expensive new proposals like a Food Security Bill, combined with weak external markets, have given investor confidence little reason for near-term revival.[1] Through a broader lens, weak government means virtually no public service is adequate, at any level of government.

India's workarounds are reaching their limits. Potential growth, or the economic speed limit beyond which inflation picks up, might have been as high as 9%, but Reserve Bank of India (RBI) Governor Duvvuri Subbarao now pegs it at 7%. Compounding the problem is that investment, exactly the component of the economy that has been suppressed, is also the key channel to raising potential growth. To break this cycle, India requires near-term measures to indicate reform momentum and boost investor confidence. But more importantly, India requires a commitment to several fundamental reforms that can release major binding constraints on the economy. While India's pundits widely agree on the necessity for some reforms, other important measures, like reforming the bureaucracy and judiciary, receive virtually no attention.

## Investment Momentum Dissolving

Domestic investment in physical productive capital slowed dramatically in calendar year 2011, declining 1.2% of gross domestic product (GDP). As a result, forecasts of growth in fiscal year 2012 hit 6.9%, and about the same again next year. Sentiment surveys portray a sharp decline in investment outlook by Indian businesses due to a combination of high inflation (23 months with inflation at close to 9%), high nominal interest rates (hiked 3.75% since March 2010), and lack of action by the government. The government is seen to be neither implementing reforms to improve conditions, nor making basic decisions to allow projects to advance. Fear of an anti-corruption crackdown has reportedly chilled bureaucratic action. Interest rates may stop rising (more on that below), giving investment a near-term boost. But the ability of minor parties within the coalition government to thwart opening FDI in multi-brand retail and the focus on anti-corruption measures suggest no government action soon to provide a more permanent fillip to investor sentiment.

### Figure 1: Investment/GDP (% growth, year-on-year)



Investments in infrastructure have slowed in particular, dropping close to 60% year-on-year in the second quarter of 2011.[2] This can be attributed to bureaucratic holdups in environmental and other approvals, delays in land acquisition, difficulty sourcing energy in the power sector, and all the same reasons investment in general has slowed. Infrastructure experts like Vinayak Chatterjee, president of Feedback Ventures, caution that the pipeline for infrastructure projects has thinned out significantly and does not reflect the average annual value of projects needed to meet India's ambitious target of investing $1 trillion over the coming five years. Poor infrastructure, more than low investment in other areas, presents a serious obstacle to India once again exceeding 8% growth.

The power shortage described in Box 1 exemplifies the impact of infrastructure. Due to frequent outages, almost all factories (and many homes and offices) maintain their own diesel generating capacity for backup. De facto electricity costs in India are therefore among the highest in the world, mitigating the advantage of low wages and creating a high hurdle for developing manufacturing facilities. Unfortunately, the main reasons behind underperformance in infrastructure—land acquisition, low bureaucratic capacity, and poor investment climate—are some of India's most difficult issues to tackle.

## Insufficient Public Goods

India is famous for its poor infrastructure, as inadequate roads and frequent power outages cannot be missed. Despite intense government focus on meeting India's daunting infrastructure needs, infrastructure investment has recently stalled above and beyond the slowdown in private infrastructure development mentioned above. As a share of

### Box 1: Looming Crisis Due to Underinvestment in the Power Sector

India already faces peak power shortages of nearly 10%, despite an impressive amount of new generation capacity coming online this year and next. Yet lack of coal supply risks slowing the addition of new power.

In 2009, Coal India—the domestic coal monopoly—decided to guarantee only 50% of supply needs for new private power producers (from 80% previously). Since imported coal costs nearly four times more than domestic coal, developers or their financiers have been balking at new coal-based projects for the past two years. Those that were funded have been slow-rolled awaiting more certainty of supply.

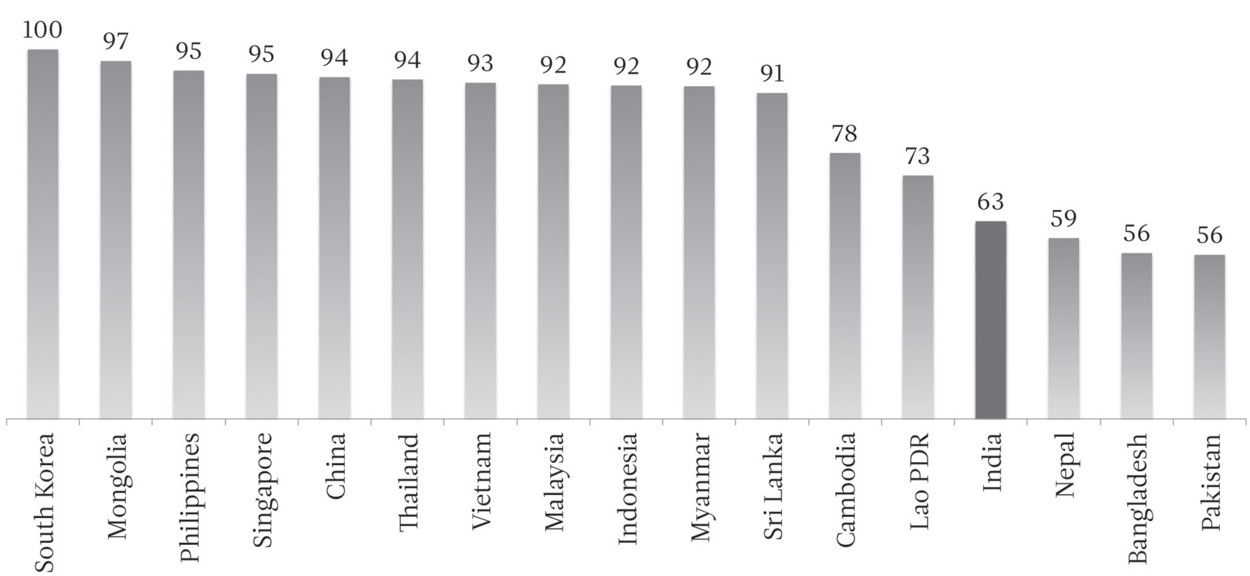
Coal-based projects represent the preponderance of new projects and typically take three years to complete. Hence, after the current pipeline of active projects comes on board over the next one to three years, India may face an unwelcome slowdown in electricity generation growth.

total infrastructure investment, public sector infrastructure spending fell from an average of 50% in the past four years to 20% in the past two quarters.[3] India has almost met its targets for aggregate infrastructure development outlined in the Five-Year Plan that ends in 2012, but a closer look reveals that the booming private sector-led telecom sector made up for serious shortfalls in government-led sectors like roads, railways, mining, and ports.

Education represents another critical element of development—for economic growth and so many other outcomes. Enrollment rates have shown hopeful improvements, with near-universal primary school enrollment in most parts of India. This is in part attributable to the choice of private sector schools, even among the poor, as public sector schools so clearly provide little value. Unfortunately, it is not clear how far the private schools raise the bar. India's educational achievement can be gauged from recently released internationally comparable Programme for International Student Assessment (PISA) scores, where India ranked 73rd out of 74 regions in reading, math, and science. Another indicator of poor education is a literacy rate much more like an economic laggard than an economic leader. Poor education impacts employability and limits the ability of India's youth to transition out of the low-wage informal and agricultural sector of their parents, into higher-wage formal sector jobs. As a result, labor quality presents a major hurdle for firms across industries.

Even basic law and order lags behind the needs of a modern economy. Corruption—and new policies to counter it—dominate the agenda in Delhi for good reason. But the lack of law and order goes beyond corruption. The Indian Bar Association cites a 30 million-case backlog in the judicial system, which helps India attain its second-to-last ranking (182 of 183) in the World Bank's 2011 Doing Business

**Figure 2: Adult Literacy Rates Across Asia (%)**




Source: World Development Indicators

Indicators for contract enforcement. Indians jokingly say that real negotiations do not begin until after the contract is signed, but the truth behind the quip is no joke. Indeed, India's Doing Business Indicators subcomponents reinforce the impression of the modern economy outpacing its government. India's highest score (40) is in the "getting credit" subcomponent, arguably the only category in which there is meaningful private sector competition.

### Table 1: India's Rank in World Bank Ease of Doing Business Indicators 2011 (out of 183)

| | |
|---|---|
| Overall Rank | 132 |
| Starting a Business | 166 |
| Dealing with Construction Permits | 181 |
| Getting Electricity | 98 |
| Registering Property | 97 |
| Getting Credit | 40 |
| Protecting Investors | 46 |
| Paying Taxes | 147 |
| Trading Across Borders | 109 |

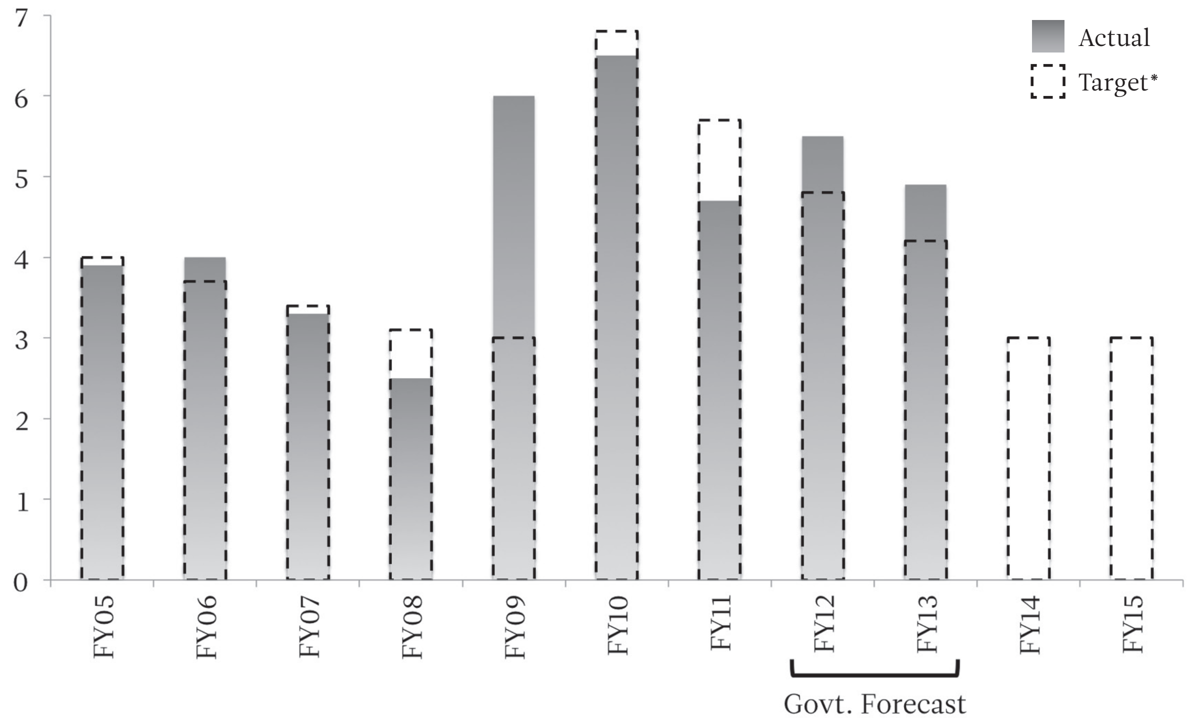
## Domestic Pressures Mounting

India's fiscal deficit has blown out this year, marking another indicator of policy weakness and deterring businesses from investing in new projects. The deficit will likely miss the budgeted target of 4.6% of GDP this fiscal year. The Ministry of Finance expects the deficit to widen to 5.5% of GDP because of higher-than-anticipated subsidies and weak revenue collection. When state-level budget deficits are added to calculate a whole-government deficit, Morgan Stanley expects India to have the highest deficit among all major emerging markets in 2012.

Looking ahead, India's finance minister has already forecast missing the Finance Commission deficit target of 4.2% in fiscal year 2013; his forecast does not include a number of additional fiscal burdens that may arise. New entitlements are expected, such as the proposed Food Security Bill, estimated to add anywhere between 0.3-3.0% of GDP to expenditures. Losses in airlines and the state electricity boards that run electricity distribution, and capital infusions into public sector banks loom as potentially large unbudgeted expenditure items. With national elections coming in 2014, pressure will mount for additional populist surprises, as happened with a farm loan waiver (1.3% of GDP) announced before the 2009 election. On the revenue side, two major tax collection reforms—a new direct tax code and the introduction of a goods and services tax—appear less and less likely to begin next fiscal year because of political gridlock; neither is expected to bring additional revenue in the near term.

Lack of fiscal contraction or structural reform has kept pressure on inflation as well. The deficit remains above its pre-crisis level, continuing to add stimulus to the economy. The RBI has used monetary policy to fight inflationary pressures by raising interest rates, and inflation finally appears to be heading below 7% levels. This may allow the RBI to loosen monetary policy to give the economy more breathing space—indeed, the loosening has already begun. However, inflation remains above the RBI near-term comfort zone of 5.5%, set because research shows inflation above 6% inhibits growth.

**Figure 3: Fiscal Deficit (% GDP, year-on-year)**




* FY05–09: Fiscal Responsibility and Budget Management Act targets; FY10–15: 13th Finance Commission targets

More worryingly, the structural drivers of inflation remain. Low infrastructure has always caused bottlenecks and, as discussed above, will remain a contributor to supply constraints in the medium term. Though the level of food inflation has come down recently, agricultural policy continues to leave India vulnerable to new episodes of high food inflation. Agricultural policy in the central government continues to promote excess production of subsidized staples at the expense (literally) of higher-value products. With higher incomes among consumers, demand for fruits, vegetables, and dairy products is rising, making them a prime driver of inflation. State-level policy introduces unnecessary rigidity to agricultural supply chains, whether through taxing interstate commerce or requiring sales to monopolist middlemen. Another price shock could easily occur, forcing the RBI back into tightening mode.

## Shaky Market Support

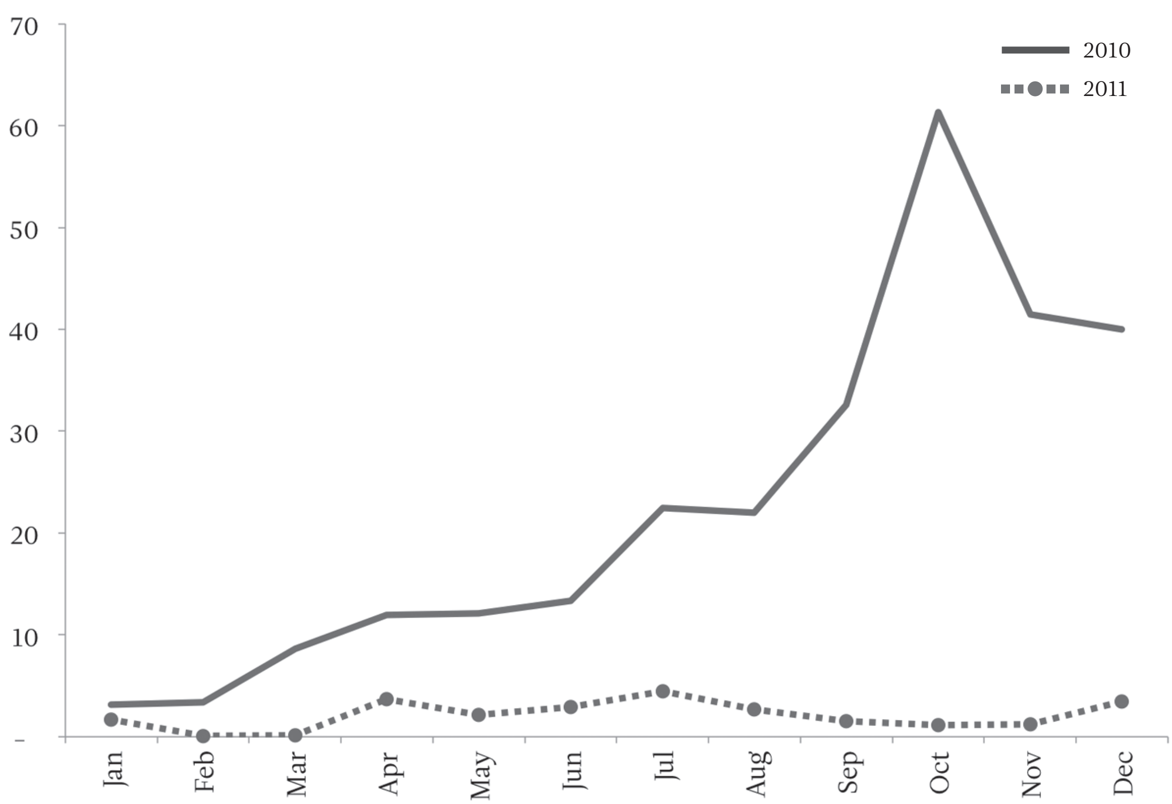
India's exchange rate and equity markets experienced a strong January 2012 rally, gaining 6.7% and 11.3% respectively. Yet the rally does not appear to reflect fundamental improvement in India's economic condition. Rather, both were moving in tandem with global markets, highly correlated with the VIX index used to measure global risk aversion.[4] India's current account deficit—distinct from other Asian economies that have surpluses—raises concern among foreign investors. Nervous investors amplify the impact of global sentiment on Indian markets and can move markets with little regard for domestic conditions. From August to December 2011 the exchange rate and stock market both fell sharply, more reflective of the prevailing pessimism on economic reform than recent months.

Concerns about financing India's current account deficit through capital inflows have not abated much with the market rally. India ended 2011 essentially flat on foreign portfolio equity inflows, versus an inflow of nearly $40 billion (2.5% of GDP) in 2010. Foreign direct investment has slowed more moderately, helping cushion faster declines elsewhere. FDI could have been much stronger on a net basis except that outward FDI by Indian firms now offsets about two-thirds of gross inflows.

With equity markets unfriendly to raising new funds, Indian corporations had been borrowing abroad. This has become more difficult recently because European banks, major lenders to emerging markets, have cut back.[5] Unhedged offshore borrowing has also highlighted a vulnerability for Indian corporations, whose dollar-denominated debts rose in rupee terms by as much as Rs 150 billion when the rupee was at its low in December 2011, according to the Business Standard Research Bureau.

India continues to loosen its capital controls to bolster inflows, but like domestic investment, these measures would be facilitated by measures to improve investor sentiment. The most successful measures have required the least investor commitment;

**Figure 4: Cumulative Net Portfolio Flows ($ Billion)**



freeing deposit rates for nonresident Indians (NRIs) attracted significant new inflows. But bank deposits from overseas epitomize "hot money" that can flow out quickly, and do not go very far to improve the robustness of flows underwriting the current account deficit.

## Breaking the Downward Cycle

While none of the challenges described above constitute a crisis, they leave India far too vulnerable to bad surprises. For instance, if the world confronts another Lehman-style credit freeze, much of India's trade and external finance will quickly disappear. India's two main crisis response tools, monetary and fiscal policy, remain constrained by high inflation and the high fiscal deficit.

Yet India's upward potential is vast. Between working age population growth of 3.5% per year and productivity growth of 2.5% per year, Saumitra Choudhury, a member of the Planning Commission, likes to point out that 6% growth almost comes guaranteed. Given this underlying strength, changing the investment sentiment cycle may not be as difficult as in other economies. Action should take place at the central and state level, and progress can come through bureaucratic as well as legislative measures. A number of near-term reforms are sitting on the docks at the central and state levels, waiting for the political winds to allow them to launch. These could provide meaningful improvements in the investment climate, and just as importantly, signal forward momentum on the reform agenda that can bolster confidence in the direction of the economy. The deeper reforms are the measures that will truly improve structural conditions to allow India to reach its potential. In particular, the deeper reforms are needed to support a shift to a higher level of manufacturing, which is probably India's best hope to provide employment for, and hence reap the benefits of, the massive growth in its young labor force currently underway.

***Near-term reforms***

- **Fiscal:** A politically and economically credible plan to introduce greater fiscal discipline could arrive with Finance Minister Mukherjee's budget announcement in March 2012. Lowering subsidies and holding the line on new spending must take priority, as tax measures may not show revenue gains for several years.
- **Taxes:** The goods and services tax reform would greatly simplify taxes across states, unleashing a small wave of cross-state border and national network growth in the medium term. While it may have little immediate impact on the budget, even announcing political consensus to move forward could alter investment sentiment.
- **Governance:** Anti-corruption initiatives may have hijacked the conventional reform agenda in the government, but attention to this critical problem can pay off in the long run. Meaningful measures will be painful to implement, and will slow government functioning for a period. But if transparency becomes a more common practice, government will produce higher quality services more efficiently, yielding wide-ranging benefits.
- **Agriculture:** States need to cut out the middlemen mandated through the current agricultural marketing laws. They then need to remove barriers to interstate trade. Rajiv Kumar, head of a major business group, rightly says India needs a trade agreement with itself. These measures would make a bigger difference than multi-brand retail FDI in improving the plight of small farmers and reducing the pressure on

food prices that fuel inflation spikes. The central government should also reformulate the price floors it provides for certain staple products to allow greater market influence in agricultural output.

- **Debt Collection:** Much-needed bankruptcy procedures are outlined in the Companies Bill, introduced in the Parliament in December 2011. The bill is not perfect, but improves borrowers' confidence in collecting debts, an essential component of developing a more robust corporate bond market. Accordingly, amendments to strengthen the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act to facilitate bank and other creditor collections would help improve the lending appetite of banks and other direct lenders.

*Deeper reforms*

- **Judiciary:** The need for additional court capacity to try more cases cannot be more obvious. Other aspects of the judiciary need adjustment, such as more specialized courts for technical matters like taxes or bankruptcy, but simply raising output would reassure investors—among many others—that enforcement of laws and contracts will occur within a reasonable time frame. This could revolutionize the perception of India's business climate.
- **Bureaucracy:** Bureaucrats may move from a state-level urban planning job to a position leading national banking policy, and then to state-level livestock programs. Such a generalist approach may have worked in the 1920s when the British designed India's civil service, but it demands modernization today. India benefits from amazing talent in top positions, but they are too few, paid too little, and allowed too little specialization. An indicator of reform success would be regularly attracting mid-career private sector talent into the bureaucracy.
- **Labor:** A number of antiquated laws and regulations make hiring and firing workers in the formal sector difficult, especially in larger firms. This has the unfortunate impact of shifting employment to the informal sector, limiting firm size, and pushing large firms toward more capital-intensive production. This and inadequate human capital from a poor education are the two main reasons India cannot capitalize on its low-wage structure to expand its manufacturing base.
- **Education:** As in many countries, teachers are both the solution and the barrier to improving education. Teachers unions often resist reforms, and teachers' critical role in India's election machinery makes their opposition formidable. Yet without better instruction, getting more children into schools will not improve outcomes.
- **Land:** Land acquisition problems plague business, perhaps most critically by limiting the development of infrastructure. The Land Acquisition Bill that sets terms for compensating landholders is important, but the harder state-by-state job of cleaning up land records remains.[6]

This list does not attempt to dive into the complexities involved in each of these reforms, since they have all benefited from analysis by government-commissioned expert committees. An underrecognized strength of the Indian policy process, these expert committees draw blueprints for reforms that usefully frame political discussion. Partially as a result of their generally high quality, realistic, and—importantly—homegrown recommendations, one would be hard pressed to find resistance among elected leaders in the current government to the list of near-term measures above (with the exception of agriculture, where market-based reforms threaten too many vested interests). Yet, despite consensus on some key measures, substantive laws rarely make it out of Parliament. A handful of good sector-specific laws have been passed in recent years, but the last act that qualifies as a major reform for the economy was the Competition Act passed in 2007.[7]

The deeper reforms enjoy less consensus, but could arguably make a more significant impact. Lack of consensus requires public dialogue to seek solutions, yet major issues like the structure of the government's bureaucracy and judiciary, or the need for labor reform, occupy very little space in the national discourse.

## It Comes Down to Politics

The key point is the necessity of government progress in addressing gaping deficiencies in public services. India's industry should not be so famous for *jugaad*. Better infrastructure, better basic education, and more access to foreign investment will allow India to unleash inherent strengths. Hence, any medium-term forecast of India's growth depends crucially on the ability of the Indian government to break the current logjam. Politics have become the linchpin of the economic trajectory. Perhaps the central question for India's economy, then, is how the central government and states can shift to more productive political dynamics.

Almost any other country would envy India's current growth rate of about 7%, but India should aim higher. Achieving its potential for double-digit growth does not imply blind devotion to the altar of economic growth. Economic growth underpins India's ability to alleviate poverty, and consistently hitting 9% versus 7% growth advances that achievement by many years. In a country with more poverty than the continent of Africa, meeting India's economic potential means a great deal to a great many people.

### Box 2: Silver Linings in the Bureaucracy: Learning-by-doing in Public Private Partnerships

It's important to recognize that bright spots can be found. For instance, under the surface an important learning-by-doing process is underway in the various state and local bureaucracies as they gain experience with putting up infrastructure in public-private partnerships (PPPs). PPPs allow governments to share capital expenditures with the private sector, and theoretically entice the builder to produce a quality product. However, they require more sophistication and market savvy to attract the builder than standard contractor arrangements. So while a state like Orissa may only have 30 or so PPPs under its belt and still rely largely on consultants to structure deals today, each project educates new staff inside the state government and creates greater internal capacity. The steep learning curve implies an exponential snowballing pattern of infrastructure development, which appears too slow in the early phases, but ramps up quickly with more experience.

## Endnotes

1. Multi-brand retail refers to firms that stock multiple brands of goods, like Wal-Mart, as opposed to IKEA, which only sells its own brand. India's Cabinet approved up to 51% foreign ownership (previously banned) on November 25, 2011, only to be forced by the opposition and members of its own coalition to “suspend” the policy two weeks later. The Food Security Bill proposes to increase food distribution to the poor.

2. See the Centre for Monitoring the Indian Economy (CMIE) at http://www.cmie.com.

3. Ibid.

4. The VIX captures implied variation in S&P 500 options, and hence indicates that markets expect big swings, but do not know if they will be up or down.

5. Chanda Kochhar, chief executive officer of ICICI Bank, estimates $140-150 billion, or 60%, of India’s private offshore debt originates with European banks.

6. Many states have no effective land title records, leading to frequent disputes that hold up projects. While the Land Acquisition Bill primarily impacts cases of eminent domain, poor land records impact all land transactions.

7. The Right to Education Act of 2008 could constitute a major reform if accompanied by resources to implement it meaningfully.

## Acknowledgments

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James A. Baker III
Institute for Public Policy
P.O. Box 1892
Houston, Texas 77251-1892

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