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India's Narendra Modi Wins Big: Time To Finish Economic Reforms

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Despite imposing a disastrous “currency reform” that impoverished poorer people and small businesses across his nation, Indian Prime Minister Narendra Modi won big in five state elections a week ago. His Bharatiya Janata Party’s sweep was incomplete—the BJP lost one state and will rule only in coalition in two others—but the BJP triumphed dramatically in mega-state Uttar Pradesh.

There the BJP forged a broad coalition to overcome caste politics and staged an effective grassroots campaign. Modi, rather than local leaders, acted as the BJP’s public face. The Observer Research Foundation’s Ashok Malik called it “a stupendous achievement.” Even the Congress Party’s Kapil Sibal acknowledged: “No doubt, it’s an astounding victory for the BJP.”

The result strengthens the ruling party’s influence in the Rajya Sabha, the nation’s upper house, which it still does not control, and positions the BJP for reelection in national elections for the more important lower house, or Lok Sabha, two years hence. Modi parlayed a mix of business friendliness, reputation for competence, and Hindu nationalism into a stunning national victory in 2014, humiliating the long-dominant Congress Party.

Today, with the latter’s dynastic leadership in decline, the BJP appears to be the natural governing party. No politician has enjoyed such sway for years. Observed Sandeep Shastri of Jain University: “Modi represents that national-level figure that we’ve not seen since Indira Gandhi,” the Congress Party prime minister assassinated more than three decades ago.

Modi also has made an international impact, raising his country’s profile. He represents a people on their way to greatness. Today India has the world’s fastest growing economy and second largest population—on its way to becoming the largest. English is commonly spoken and ethnic Indians are productive traders around the world. Several years ago the Cato Institute’s Swaminathan S. Anklesaria Aiyar noted that India’s diaspora, at more than 30 million worldwide, is another source of economic strength and international influence for the homeland. The number of Indian students studying at American universities is second only to those from China.

Nevertheless, Indian voters were most interested in bettering their lives domestically. Indians long languished in poverty as their leaders followed a collectivist, dirigiste economic strategy. New Delhi imposed confiscatory tax rates, employed a bureaucracy rated the worst in Asia, nicknamed the “License Raj,” and controlled the economy’s commanding heights. Indian politicians pushed industrialization, but focusing on capital- and skill-intensive industries, acting “against its comparative advantage,” explained HDFC Bank, since “India’s comparative advantage lay in an abundance of relatively low-skilled workforce.” Indeed, New Delhi was not only a political friend but also an economic mimic of the Soviet Union.

The consequences for the Indian people were catastrophic. Growth lagged behind numerous other developing nations; until 1983 the poverty rate was about 60 percent. There were brief attempts at economic liberalization in 1966 and 1985, but both elite and popular resistance remained strong. Real progress occurred in 1991, freeing Indians to be more entrepreneurial. Eric D. Dixon and Tarun Vats of the Atlas Network reported: “Within a decade, the average income in India had doubled, and nearly 250 million people—about a fifth of the population—have risen out of poverty since then.”

However, progress remained incomplete, especially compared to China, which became a global economic powerhouse. Explained Aiyar in a recent Cato Institute study, “Although many old controls have been abolished, many still continue, and a plethora of new controls have been created.” Indians’ economic liberty actually peaked in the mid-2000s.

The 2014 *Economic Freedom of the World* report, the most recent ranking, rated India a disappointing 112 out of 159 nations, down from 102 the previous year. (India did substantially better on personal freedom, coming in at 77.) The Heritage Foundation’s 2017 Index of Economic Freedom rated India at 143 of 180 countries, well behind China at 111. India’s rating dropped from the year before, and New Delhi did particularly badly on investment freedom, financial freedom, labor freedom, government integrity, judicial effectiveness, and business freedom.

Although growth increased after liberalization, India failed to overtake China as had been predicted. Since 2013 growth rates have accelerated, though pulling 86 percent of India’s money out of circulation late last year had a negative effect. The International Monetary Fund originally forecast growth of 7.4 percent this year, but recently cut the estimate to 6.6 percent.

Other caution lights are blinking. Growth has been driven by government spending rather than private investment, and India’s per capita GDP growth dropped early in the decade, a bad sign for future economic progress. Moreover, job growth remains weak. It first slowed markedly in 2012 but has not recovered under the current government, which according to HDFC Bank, indicates a “growing disconnect between economic growth, education, skilling and jobs.”

Nevertheless, India could pull ahead with better policies. The *McKinsey Quarterly* contended that deregulation would kick growth rates up to ten percent. Inflation is lower than in other “emerging markets” and the Economist Intelligence Unit rates New Delhi’s “country risk” below that of China. Growing wealth is spurring domestic demand: India’s “consuming class” is expected to treble during the coming decade. Democracy provides a political safety valve not present in China.

Modi's 2014 triumph reflected his pro-business record as chief minister of the state of Gujarat and the widespread belief that he would transform national economic policy as well. However, despite his big win and large parliamentary majority, his government has moved only slowly to free the economy. For instance, the *Times of India* (New Delhi) complained about the slow "implementation of projects" and that "the government hasn't pressed the pedal hard on reforms." *Business Standard* (New Delhi) columnist Shankar Acharya warned: "Economic reforms have clearly lost momentum and there is a sense of drift in economic policy."

In part this reflects opposition control of the Rajya Sabha, whose membership changes only with state government control. However, New Delhi's failure to liberalize more also appears to reflect the fact that Modi believes not so much in free markets as in better managed markets. So, too, do other members of the BJP. Milan Vaishnav of the Carnegie Endowment for International Peace noted the party's "nationalist, protectionist wing will also demand a pound of flesh" after the UP victory. Moreover, Sebastian Mallaby of the Council on Foreign Relations argued that Modi "seems stuck in the mindset of a provincial executive: he is more interested in projects than in policies; he is a modernizer, not a reformer."

The demonetization project is a dramatic example of a Modi policy expanding government control over people's economic lives. Other counterproductive initiatives include agricultural price controls and attacks on "hoarding." Worse, according to the *Telegraph* (Calcutta): "the Modi government has started to drum up the virtues of creating large state-owned assets in a throwback to a Nehruvian era of creating state monopolies in strategic areas." This is a prescription for economic stasis.

Still, the Modi government has restrained spending, sped environmental regulatory approvals, eliminated capital and certification barriers for new businesses, streamlined distribution of welfare benefits, improved sanitation, and attempted to move poorer Indians into the financial system. New Delhi also has begun to improve the electrical grid and transportation infrastructure. Perhaps most important have been passage of a new bankruptcy code and a uniform goods and services tax (GST) to replace a complex and confusing hodge-podge of regional and national taxes (though the new levy itself seems more complicated than necessary). In January the government eased limits on foreign direct investment, including in the aviation, defense, and pharmaceutical sectors.

These are important steps. However, much more remains to be done. Eswar Prasad of Cornell argued that the government must demonstrate its commitment "to deep-rooted reforms including reducing labor regulations, unshackling businesses from red tape and bureaucracy, reducing government control of banks and clearing up their bad loans, developing capital markets, revamping the government's tax and expenditure systems and improving infrastructure."

For instance, New Delhi should end the web of government controls over business hiring and firing. Companies with at least 100 employees generally require government permission to cut staff, which is one reason nine out of ten Indians work in the informal economy. Noted the OECD: "In labor markets, employment growth has been concentrated in firms that operate in sectors not covered by India's highly restrictive labor laws." In contrast, in regulated areas employment has been falling. Moreover, contract employees account for almost half of the workforce at large industrial firms, compared to under nine percent in service enterprises.

The American Enterprise Institute's Derek Scissors observed that such restrictions "essentially guarantee mass underemployment and an India that, unlike its neighbors in East Asia, cannot benefit from global demand for manufactured goods." Yet one unnamed BJP official told the *Telegraph* (Kolkata): "if it's a conflict between a corporate entity and its workers, we have to be on the side of the workers." Even though those workers would most benefit from new and better positions in place of their current jobs.

Modi also should dismantle the state economic sector which has expanded dramatically over the last couple of decades. Losses from public enterprises run billions of dollars annually. Among the biggest problems are public-sector banks. Profits are down and negative overall. These institutions hold 70 percent of the nation's financial assets: alas, more than a sixth of the loans are "stressed," many unable to even pay interest. Problem loans total roughly \$200 billion, reducing credit for productive enterprises and increasing chances of a financial crisis.

In fact, many companies fear the future. Sales growth and capacity utilization are low compared to the past, and business confidence is the lowest in two years. Reported the *Economist* in early March: "If India is indeed the world's fastest-growing big economy, as its government once again claimed last week, no one told its bankers and business leaders. In a nation of 1.3 billion steadily growing at around seven percent a year, the mood in corner offices ought to be jubilant. Instead, firms are busy cutting back investment as if mired in recession. Bank lending to industry, growth in which once reached 30 percent a year, is shrinking for the first time in over two decades."

New Delhi should respond by accelerating reforms. A foreign investor told *Open Magazine* last year; "The BJP underestimated the extent of the problem" and concentrated on "low-hanging fruits." However, spurring manufacturing and reviving banks required more than "a few quick fixes." India also needs a change in economic philosophy, as public support for statism if not old-fashioned socialism endures. Economist Mohan Guruswamy of the Center for Policy Alternatives observed that "There is still a distrust of private capital and foreign capital, and a consensus on state control of industries that cuts across parties. People still want a lifetime of employment, a lifetime of assured income."

Finally, government must perform better when it acts. India remains a poor nation, so government welfare is no surprise. However, there are nearly 1000 national programs, supplemented by various state initiatives. The result, said Aiyar, is "a bewildering variety of freebies," many to the well-off. Complained the *Economist*: "the plethora of schemes in place for Indians to claim subsidized food, fuel, gas, electricity and so on are inefficient and corrupt." Better to consolidate the in-kind benefits into individual cash payments. The latter would reduce inefficiency and corruption and return decision-making to the poor.

Moreover, observed Aiyar in his Cato study: "With almost no exceptions, the delivery of government services in India is pathetic, from the police and judiciary to education and health. Unsackable government staff members have no accountability to the people they are supposed to serve, and so callousness, corruption, and waste are common." A mix of privatization and better management are necessary.

Unfortunately, India's economy may suffer from the ongoing surge in Hindu nationalism. Modi got his start in the Rashtriya Swayamsevak Sangh, or RSS, which promotes Hindu nationalism.

While in Gujarat he was blamed for mob violence that killed hundreds of Muslims, though his responsibility was never proved. Religious persecution and intolerance, long present in India, have worsened with his 2014 victory. Warned the U.S. Commission on International Religious Freedom in a report issued last month: “threats, hate crimes, social boycotts, desecration of places of worship, assaults, and forced conversions led by radical Hindu nationalist movements have escalated dramatically under the BJP-led government.”

Most violence occurs at the state level, beyond the prime minister’s direct reach. However, the BJP has pandered to Hindu nationalists. For instance, in last week’s election Modi accused the ruling local party of favoring Muslims. After the BJP victory he appointed as UP’s chief minister a parliamentarian who doubles as Hindu priest and violent provocateur. Indeed, Yogi Adityanath was briefly jailed for his incendiary rhetoric against Muslims. He also has pushed for building a Hindu temple on the site of a mosque destroyed years ago by a mob, which triggered deadly sectarian violence.

To the extent these violent currents ripple outward, foreign investment could suffer. Warned Manu Bhagavan of Hunter College, such “regressive identity politics ... are more about the last century than the next.”

India is gaining economically. But continuing liberal reform is necessary to sustain strong economic growth. Modi is India’s most popular politician and dominates the national political landscape. So far he has only cautiously pushed economic reforms, but voters have credited him with making an effort, even forgiving the bungled currency reform since it was targeted at the well-off. He has two years left before the next national contest.

After last week’s election Jain University political scientist Sandeep Shastri predicted that Modi “will likely try for some measures in the coming months that will capture the imagination of voters that will help him win in 2019.” But that won’t necessarily be economic liberalization. After being accused of running a “suit-boot” administration too friendly with corporate elites, he turned more populist. Novelist Pankaj Mishra argued that Modi relied on *ressentiment* by “presenting himself as a relentless scourge of elites and sentinel of the upwardly mobile.” The Brookings Institute’s Tanvi Madan predicted that Modi will move forward on the anti-corruption front, which “is something that resonates with people.”

Does Modi want free the economy? Madan contended that “It’s been established that he is not a free-market guy.” Indeed, Modi looks ever less like Ronald Reagan, to whom the prime minister once was compared, and more like Donald Trump, argued Ruchir Sharma of Morgan Stanley Investment Management. Polls indicate that Indians increasingly want a strong leader, and Modi is “concentrating power in his own hands, thus shifting the driver of economic growth from the private sector to the state.” The ironic result may be a better managed but not much freer economy.

India has come far. Extreme poverty still afflicts millions of people across this complex and diverse nation, however. Much more economic work remains to be done. If Narendra Modi desires to be a truly transformational leader, he will press market reforms to fully release the extraordinary economic talents of the Indian people.

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