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Deceleration, Pandemic, Recession: Does India Have a Plan?

A CASI Working Paper

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CASI SPRING 2020 VISITING FELLOW

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DIRECTOR'S NOTE

I am delighted to feature Roshan Kishore's paper on the economic consequences of the COVID-19 pandemic as the first Working Paper of my tenure as Director of the Center for the Advanced Study of India (CASI). This paper knits together insights on how the economic challenges imposed by the pandemic intersect with pre-existing challenges facing the Indian economy, and evaluates the Government of India's initial economic policy response to this crisis. The author, Roshan Kishore, is Data & Political Economy Editor at *Hindustan Times*, and was a CASI Spring 2020 Visiting Fellow. To say that Mr. Kishore had a challenging experience during his fellowship would be an understatement. His arrival coincided almost perfectly with the university closing its campus and the wider city of Philadelphia issuing stay-at-home orders due to the COVID-19 pandemic. I am grateful to Mr. Kishore for his refusal to be limited by these constraints, and instead using his time at CASI to analyze how the pandemic has affected India's political economy. Initial analyses that informed this study were [presented in a piece](#) for CASI's *India in Transition* special series on COVID-19, and in a [CASI podcast and virtual seminar](#).

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ABSTRACT

India's economic pain due to the COVID-19 pandemic will be more painful because it has come on the back of a prolonged economic slowdown. The pre-COVID-19 slowdown is rooted in India's inability to find a sustainable demand side stimulus in the post-2008 period. However, the current regime has failed to grasp this macroeconomic reality and pursued policies which have only made matters worse. Because the economic pain has not translated into political pain for the ruling party, intellectual criticism of its policies is increasingly losing its influence. Persisting with such policy and politics will significantly add to the already existing economic pain and worsen social fissures. Unless the opposition reinvents its politics, things will not change on the policy front.¹

¹ The author is grateful to Milan Vaishnav, Gautam Nair, and Sharan MR for their comments on the first draft of the paper. The views expressed here and mistakes, if any, are entirely the author's responsibility.

INTRODUCTION

The COVID-19 pandemic has crippled economic activity across the globe; India is no exception. The World Bank's latest projections expect India's GDP to contract in 2020-21 by 3.2 percent. While it expects a recovery in 2021-22, it will not be enough to restore the GDP to even 2019-20 levels. Most private forecasts expect a bigger contraction in the economy, leading to enormous, perhaps unprecedented, economic pain ahead. Two factors will accentuate this pain for India in comparison to a normal economy experiencing a one-off contraction. The Indian economy was caught in a prolonged deceleration even before the COVID-19 shock; the capacity of businesses and the government to apply counter-cyclical measures is already stretched. India also has a very weak social security coverage and public health infrastructure in place, which will significantly increase the cost of coping with the economic and health crises.

How will the Indian economy cope with this shock? This will depend on the nature of policy response. In a democracy, politics primarily shapes policy. In this paper, I argue that the COVID-19 shock is the proverbial fork in the road for India's political economy trajectory. India can adopt two ways to fight this crisis. The current regime's response, at least so far, leans toward supply-side measures on the economic front and centralization and growing polarization on the political front (in keeping with its existing policy orientation). I will argue here that it is precisely this approach that has failed to arrest, and has actually worsened, India's extant economic problems. The paper will outline an alternative political economy trajectory, advocating a demand-side orientation on the economic front and rolling back centralization. Such a policy reorientation will not come without political pressure. This, I will argue, will have to come from a pragmatic reinvention of opposition politics in India.

The discussion that follows is divided into three sections. The first section will discuss the nature and cause of the economic slowdown before the pandemic and try to explain why economic policy failed to arrest it. The second section will discuss the immediate implications of the COVID-19 shock and summarize the government's response to it. The third section will develop a political economy critique of the current policy and chart out an alternative trajectory.

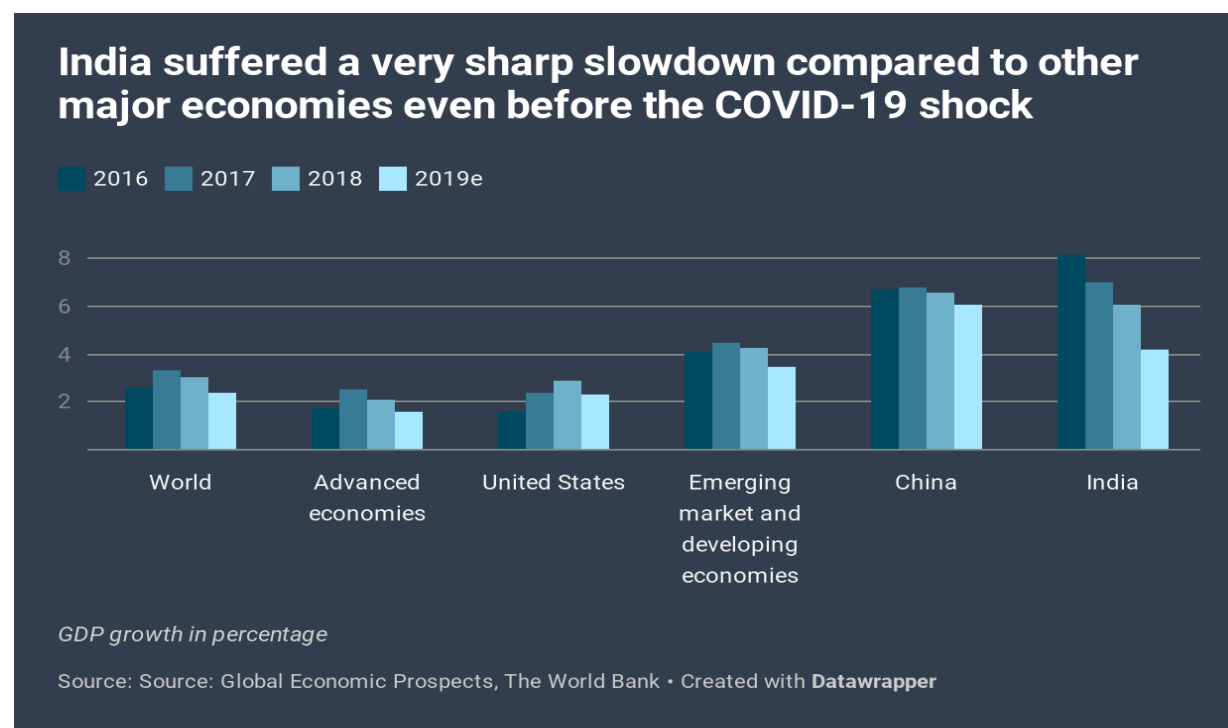
SECTION I: HOW DID INDIA GO FROM THE FASTEST GROWING TO THE FASTEST SLOWING ECONOMY?

a. The Government was Too Complacent to See the Problem

On February 1, 2019, months before the 2019 general election, India's finance minister Piyush Goyal presented the last Union Budget of the Narendra Modi government, which was elected in 2014. The Union Budget—the most important annual economic policy exercise in India—presents the blueprint of government receipts and expenditure for the year ahead. The speech to the Parliament reflected exuberance:

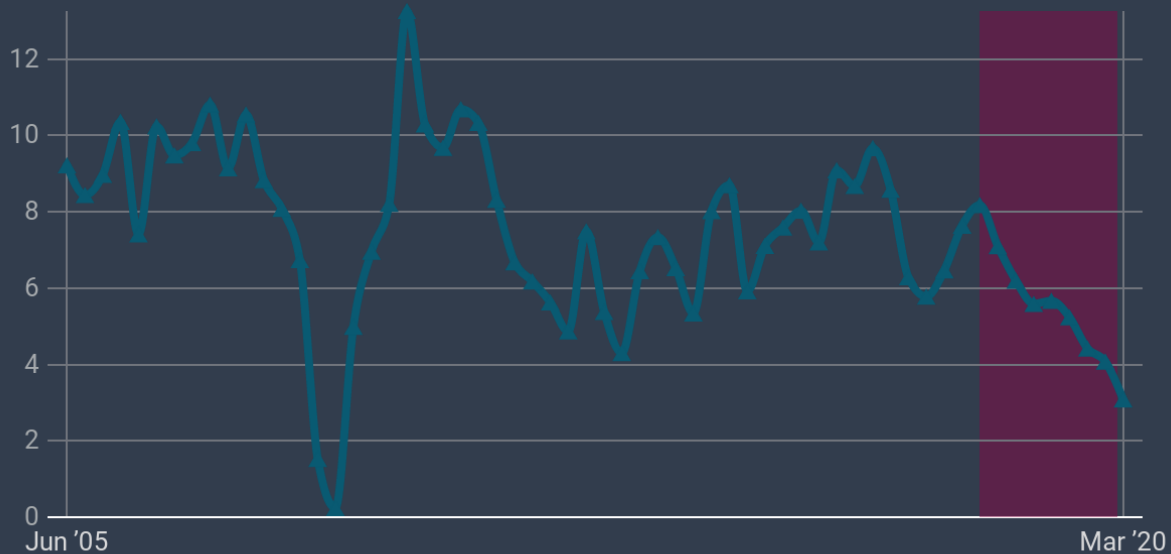
“Madam Speaker, the last five years have seen India being universally recognized as a bright spot of the global economy. The country witnessed its best phase of macro-economic stability during this period. We are the fastest growing major economy in the world with an annual average GDP growth during the last five years higher than the growth achieved by any Government since economic reforms began in 1991.”²

The irony could have not been greater. India's GDP grew at 5.7 percent in the quarter ending March 2019, 2.5 percentage points less than the GDP growth the previous year. Economic growth had been decelerating continuously. The slowdown would continue unabated. GDP growth plummeted to 3.1 percent in the quarter ending March 2020. In a span of three years, India went from being the fastest *growing* economy to the fastest *slowing* economy. The government, as the 2019 Budget speech shows, was either unaware of the economic deterioration or in denial.



² Interim Budget speech of Piyush Goyal, February 1, 2019, available at www.indiabudget.gov.in

GDP growth has been falling sharply since March 2018



Quarter-wise annual growth in GDP in percentage

Source: CMIE • Created with Datawrapper

b. Is There a Financial Sector Way to Economic Recovery?

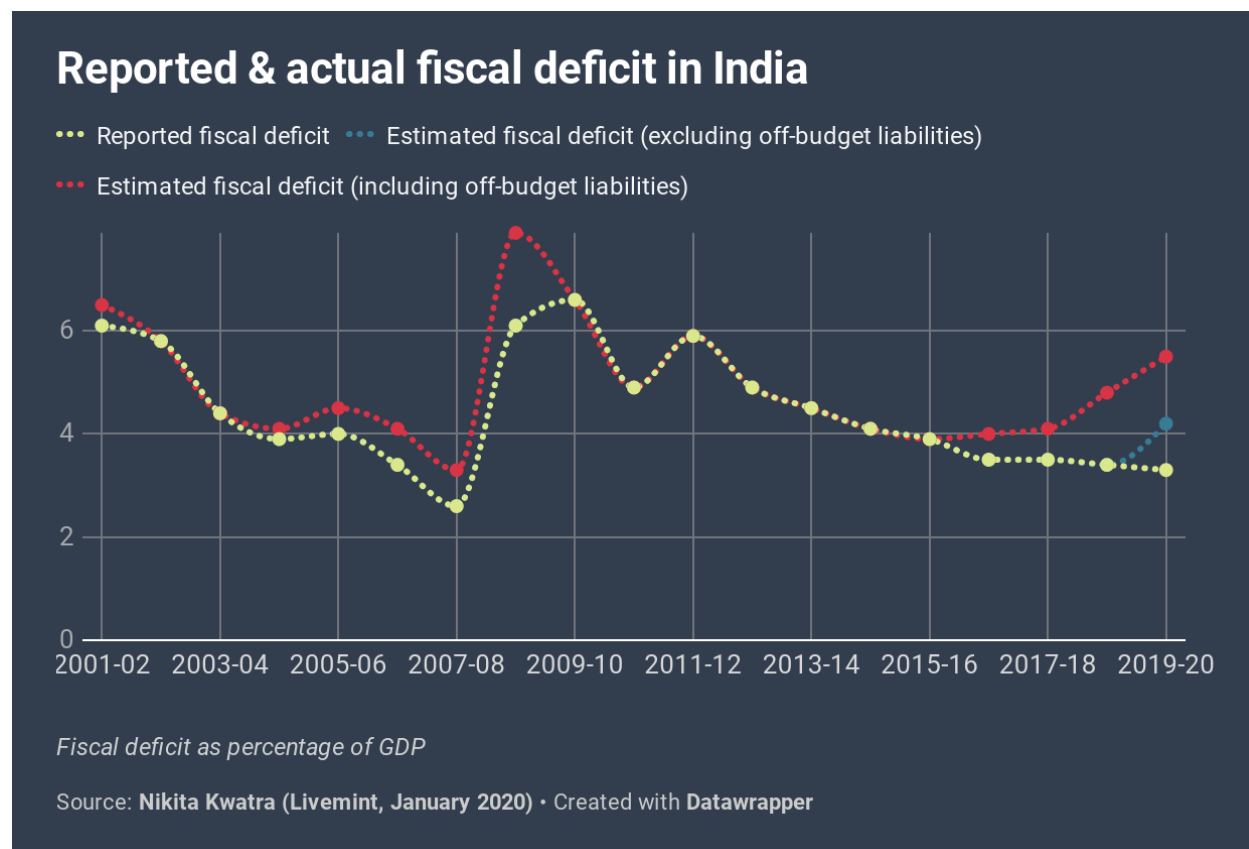
What created this economic slowdown in India? Given its severity, the question has attracted a lot of intellectual attention.

In a December 2019 paper, Subramanian and Felman (2019) provide a useful summary of the literature so far along with their own diagnosis of the problem at hand.³ The authors argue that a worsening of India's financial sector mess, from a twin balance sheet problem to a four balance sheet problem, is the biggest reason for the current deceleration in the Indian economy. India experienced an unprecedented export-led economic boom before the 2008 financial crisis. This created an irrational exuberance among entrepreneurs and encouraged high levels of debt in even non-export sectors, especially infrastructure. The 2008 shock burst this bubble, creating a burden of unserviceable debt for firms and bad loans for commercial banks, something that has been described as the twin balance sheet problem.

The subsequent economic recovery was led by external tailwinds from low oil prices since 2015 and a non-bank financial company (NBFC)-led credit boom, especially in the real

³ "India's Great Slowdown: What Happened? What's the Way Out?" Arvind Subramanian and Josh Felman, CID Faculty Paper No. 370, December 2019

estate sector.⁴ The NBFC credit bubble went bust in 2019 and growth collapsed. The authors argue that because the slowdown is rooted in a problem in the financial sector, conventional policy tools such as interest rate reduction have not been working due to a breakdown of transmission mechanism. Even though the Reserve Bank of India (RBI) has brought down policy rates, banks have been unwilling to lower interest rates, as risk premiums have gone up. They also question the efficacy of a fiscal stimulus, arguing that actual government deficit levels are anyway much higher than the official numbers, and yet, growth has not revived.



Their paper argues for immediate steps to clear up the financial sector mess by rejuvenating the process of recognizing bad debt and taking steps to get rid of it at the end of both borrowers and lenders.

The importance of resolving India's financial sector mess notwithstanding, the argument by Subramanian and Felman (2019) leaves an important question unanswered. While

⁴ NBFCs lend and make investments and hence their activities are akin to that of banks; however there are a few differences between banks and NBFCs according to the RBI: NBFC cannot accept demand deposits; NBFCs do not form part of the payment and settlement system and cannot issue cheques drawn on itself; deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFCs, unlike in case of banks.

credit bubbles encouraged by banks and NBFCs are to blame for the previous and current downturn, the fact remains that they did create periods of high growth before the bubble burst. This also means that India's growth performance would have been significantly worse in the absence of such exuberant lending. Given her low per capita income levels, India cannot afford to settle for a low but stable growth trajectory. While fixing the financial sector's problems could provide temporary relief, it does not guarantee a return to a high growth path.

A recently published paper has looked at this question. Dasgupta (2020) argues that the financial fragility in the Indian economy is a compulsion for the current policy trajectory rather than an accident.⁵ The paper agrees with the sequence of events drawn by Subramanian and Felman (2019) about the origins of the financial sector mess and its adverse impact on growth. However, it argues that in the absence of an exogenous stimulus, increase in financial fragility has been crucial in ensuring a high growth rate in the Indian economy. This view is supported by two books released in July 2020 by Urjit Patel and Viral Acharya, who served as the Governor and Deputy Governor, respectively, of the RBI: "The government wanted to go for liquidity and credit-led short run boost to growth, not much unlike the kind of push that we saw for generating higher growth in the last decade. We felt that we could not allow the system to repeat its mistakes while we were still trying to clean up the previous leverage boom and bust cycle," Acharya said in an interview with this author.⁶

The exogenous stimuli to growth, Dasgupta argues, have been drying up for the Indian economy. The Fiscal Responsibility and Budgetary Management (FRBM) Act, passed in 2003, rules out pursuing an effective counter-cyclical fiscal policy.⁷ India's export growth has not been able to regain its pre-2008 mojo. Crude oil prices reversed their falling trend from 2016 onward.

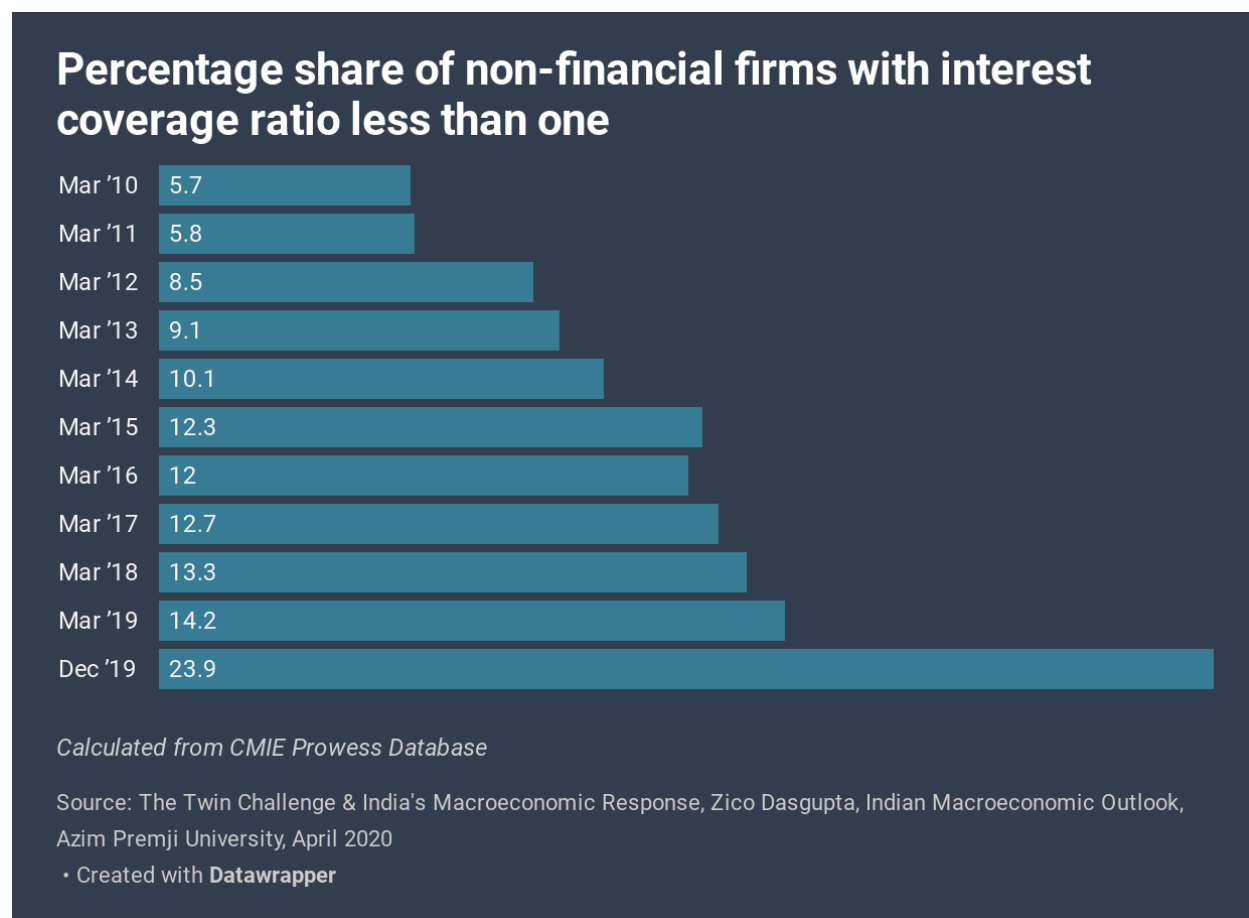
Dasgupta states that "in the absence of any effective policy instrument which can boost demand, credit supply becomes a policy lever to keep firms afloat despite being insolvent or retain private investments by increasing leverage ratios." This strategy, the author says, is unlikely to work in a modern capitalist economy "since investment decisions are affected by present output, whereas output remains constrained by demand, relaxing balance sheet constraints or finance constraints hardly increases investment or output." Because the strategy also entails worsening financial health of firms, the paper argues that

⁵ "Economic Slowdown and Financial Fragility: The Structural Malaise of India's Growth Process," Zico Dasgupta, *Economic and Political Weekly*, March 2020

⁶ See "[Important to Deal with Non-performing Assets: Viral Acharya](#)," Roshan Kishore, *Hindustan Times*, July 29, 2020

⁷ The FRBM Act requires the government to limit the fiscal deficit to 3 percent of the GDP by March 31, 2021 and the debt of the central government to 40 percent of the GDP by 2024-25, among others. It was adopted in 2003, and requires that the fiscal deficit be brought down gradually in keeping with a glide path. To be sure, the Act provides room for some deviation from the annual fiscal deficit target under certain conditions.

it makes them more vulnerable to any future shock. This is evident from the sharp rise in share of non-financial firms whose profits were not enough to even cover interest payments.

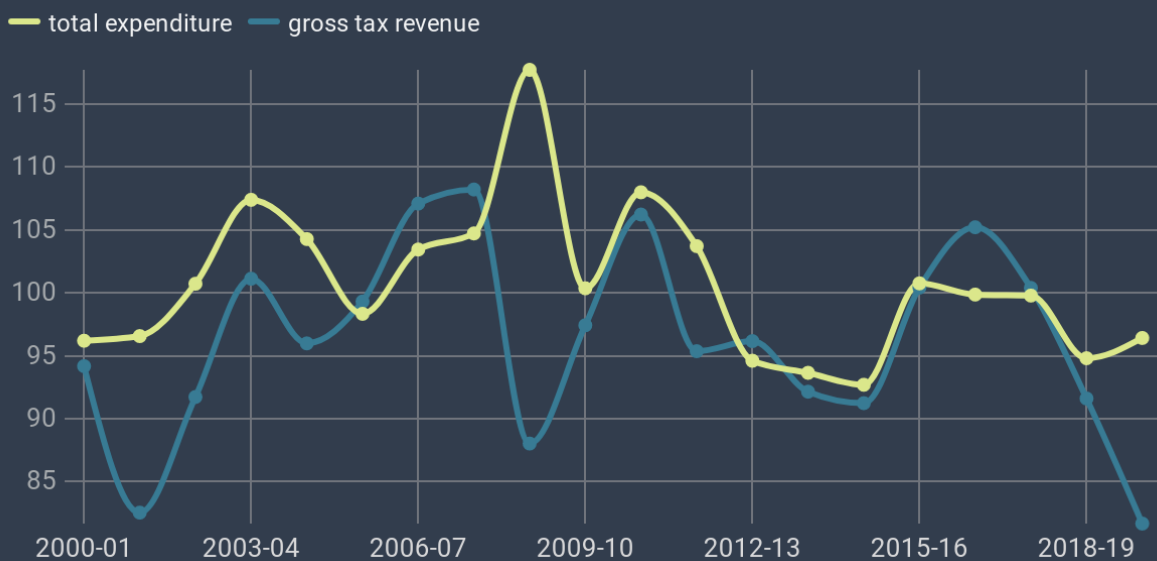


c. The Curious Case of Rising Fiscal Deficits But No Growth Revival

There is one question, however, that Dasgupta (2020) does not answer. If actual fiscal deficit levels have indeed been rising, as Sunbamanian and Felman (2019) point out, then why did this fiscal stimulus not revive demand?

An increase in fiscal deficit does not necessarily entail a fiscal stimulus. A significant shortfall in revenue targets can force the government to cut back on its committed spending, and yet leave a bigger fiscal deficit at the end of the year. This is exactly what has been happening in India for the past few years. Even though the fiscal deficit has been higher than budget estimates, central government expenditure has been falling short of budget estimates too. The biggest reason for this has been a growing shortfall in tax collections, which collapsed to just 82 percent of budget estimates in 2019-20.

Central government expenditure & gross tax revenue as percent of budget estimates



Source: CMIE & Ministry of Finance, Government of India • Created with Datawrapper

Two factors explain the shortfall in tax collections. First is a sharp fall in tax buoyancy over the last three years. This means that even for similar levels of GDP growth, growth in tax collections has been coming down. The second is a fall in nominal GDP growth. This has put a squeeze on the base of revenue collections, as taxes are a fraction of nominal, not real GDP.

What explains these two developments? Tax buoyancy in 2019-20 fell to -0.05 in 2019-20, the lowest level since 1962-63. Negative tax buoyancy means that tax collections go down despite an increase in GDP. What explains this? India's tax regime has seen multiple disruptions under the Narendra Modi government. In November 2016, the government announced demonetization, scrapping Rs 500 and Rs 1,000 currency notes as legal tender. These denominations constituted 86 percent of the value of currency in circulation, leading to a huge liquidity squeeze and disrupted economic activity. The stated objective at the time of announcement was to purge unaccounted incomes held in cash. The post-facto justification came on the lines of using data on bank deposits—99 percent of the scrapped currency came back to the banking system—to widen the income tax net.

In July 2017, India implemented the Goods and Services Tax (GST), arguably the single biggest tax reform since independence. GST abolished a plethora of central and state indirect taxes on domestic activities for a national tax, barring a few exceptions such as

taxes on petroleum, alcoholic beverages and real estate transactions. Both demonetization and GST were expected to lead to widening of the tax-base and, therefore, improve tax buoyancy.

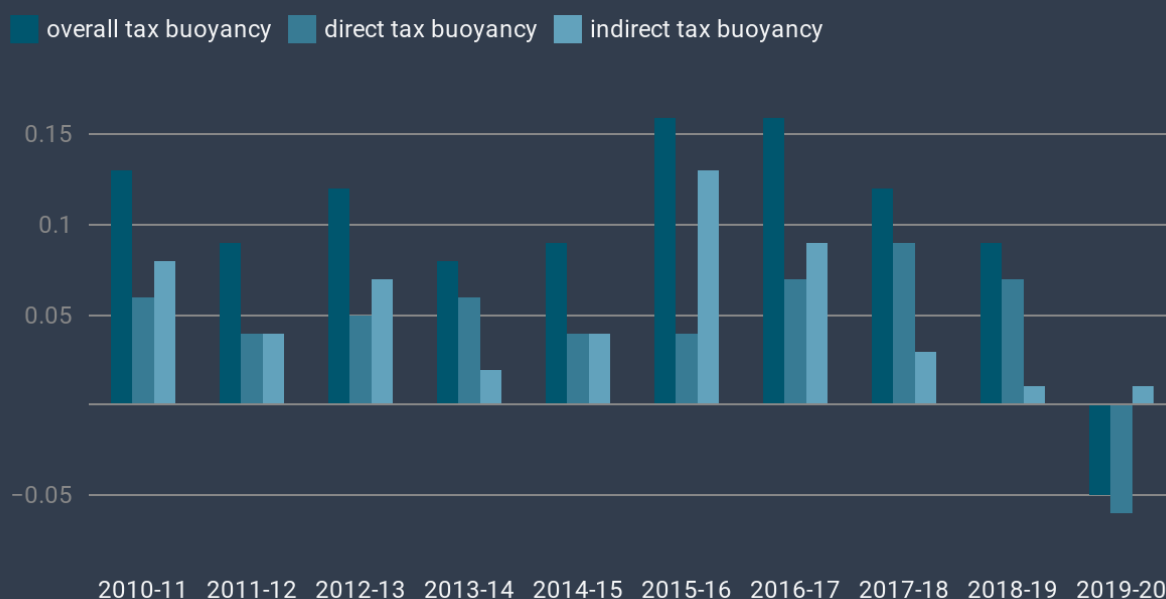
Two years later, in September 2019, the government announced a large reduction in corporate tax rates. According to news reports, the entire proposal was finalized in less than 36 hours.⁸ Corporate tax rates for domestic manufacturers went down from 30 percent to 22 percent, while for new manufacturing companies, the rate was reduced from 25 percent to 15 percent, provided they do not claim any exemptions. The corporate tax reduction was expected to lead to a revenue loss of Rs 1.45 trillion (\$19 billion) but boost economic activity.

None of these expectations have materialized, borne out of an examination of direct and indirect tax buoyancy trends. The former increased between the period from 2015-16 and 2017-18, came down in 2018-19, and fell sharply in 2019-20. While the 2019-20 reduction is largely because of corporate tax reductions announced in September 2019, even personal income tax collections, which were supposed to benefit from demonetization, have not impressed. Income tax collections have been falling short of budget estimates by an increasing margin since 2017-18. Indirect tax buoyancy increased sharply between 2014-15 and 2015-16, mainly due to a tax windfall from the fall in petroleum prices.⁹ It fell slightly in 2016-17, as oil prices started increasing, and has plummeted since 2017-18 onward, which is also the post-GST period. The point is, the government's policies have actually created a revenue generation crisis instead of improving it. While the demonetization decision was purely a political move, it can be argued that not all the blame for the GST's failure can be laid at the level of the central government, as its details were finalized after prolonged negotiations between the centre and the states.

⁸ See [“₹1.45 Lakh Crore Corporate Tax Cuts Finalised by Gov't in 36 Hours,” Shishir Gupta & Rajeev Jayaswal. *Hindustan Times*, September 22, 2019](#) for details.

⁹ The government did not pass on the benefits of lower oil prices to consumers, and increased ad valorem taxes on petrol and diesel. See [“Why Oil Can Spoil India's Budget Math,” Tadiit Kundu. *Livemint*, January 27, 2017](#) for a detailed discussion.

Tax buoyancy has been falling in the recent period



Source: CMIE & Ministry of Finance, Government of India • Created with Datawrapper

What about the reduction in nominal GDP growth? In 2019-20, nominal GDP growth was 7.2 percent, the lowest since 1975-76. This is 4.8 percentage points less than the 12 percent figure the 2019-20 Union Budget had assumed.¹⁰

Simply speaking, a fall in the nominal growth component means a lower rate of inflation in the economy. A collapse in nominal growth leading to a revenue squeeze in India is ironic, in a way. Inflation is generally seen as a vice by both policy makers and common people in India. In 2016, India officially adopted inflation targeting as the guiding anchor of its monetary policy.¹¹ The policy has been widely celebrated as having been successful in keeping inflation under control. However, the associated collapse in nominal growth highlights an unforeseen cost of inflation targeting. If India were to move permanently to a significantly low inflation regime, which is a stated policy goal now, it will take much

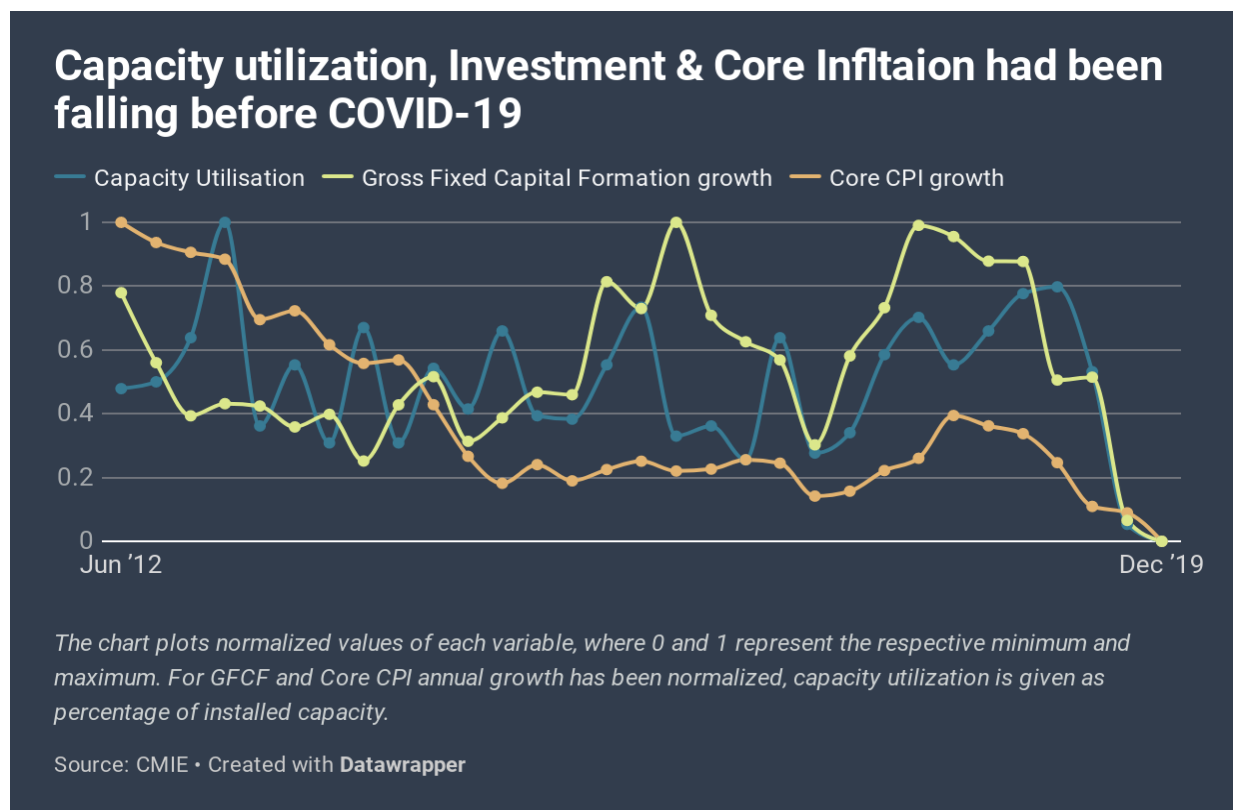
¹⁰ Union Budgets in India assume a nominal GDP growth rate. This assumption is crucial for projecting revenues and expenditure.

¹¹ The amended Reserve Bank of India Act, 1934, which came into effect in June 2016, paved the way for a flexible inflation targeting (FIT) framework in India by specifying the primary objective of monetary policy as maintaining price stability while keeping in mind the objective of growth. To operationalize this mandate, the Government of India notified a medium-term inflation target of 4 percent, with a band of +/- 2 percent for the period from August 2016 to March 2021. The inflation target has been fixed in terms of all-India CPI-Combined published by the Central Statistics Office (CSO).

higher real growth rates to generate similar levels of nominal growth, and therefore, revenue growth.

The discussion so far brings out the following: India's pre-COVID-19 slowdown was the result of atrophying of external tailwinds from a reversal in falling oil prices and a worsening of the twin balance sheet crisis to a four balance sheet crisis. The latter rendered monetary policy ineffective, as reductions in policy rates were not passed on to retail borrowers because of heightened risk premiums. The fiscal policy route, *prima facie*, also appears ineffective, as growth did not recover despite a rise in the fiscal deficit. I have tried to resolve this paradox by arguing that the rising fiscal deficit was driven by a growing shortfall in revenues, which forced a reduction rather than an increase in government spending, and therefore did not entail a stimulus to the economy.

Does the Indian economy need a fiscal stimulus? A fiscal policy intervention is justified when the economic slowdown is a result of deficient demand. The recent slowdown has been characterized by a sharp fall in private investment along with falling capacity utilization levels. This has happened alongside a sharp fall in core inflation.¹² This means that even as firms have been cutting down on production and investment, there has been no scarcity in the market, which clearly underlines the primacy of the demand side aspect to the slowdown.

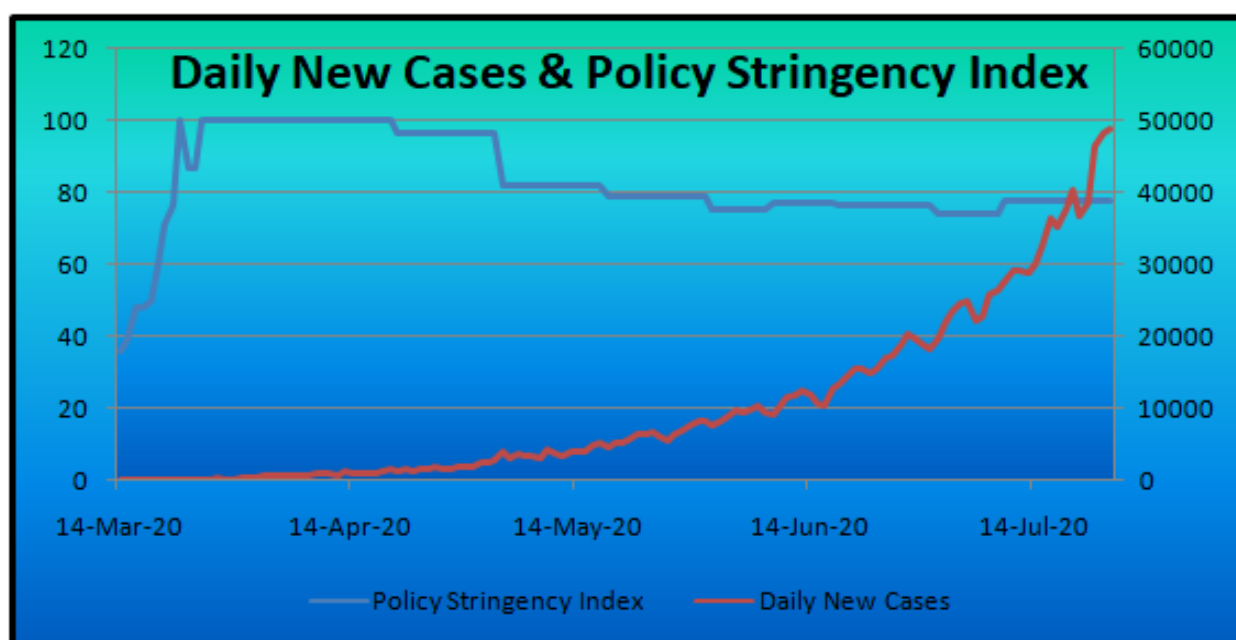


¹² Core inflation is the non-food, non-fuel component of Consumer Price Index, India's benchmark inflation measure. It is more immune to seasonal fluctuations in food and petroleum prices.

SECTION II: THE COVID-19 SHOCK

a. The Lockdown Flattened Economic Activity, Not the Virus

The World Health Organization (WHO) declared the COVID-19 epidemic as a pandemic on March 11, 2020. On March 24, Prime Minister Narendra Modi announced a nationwide lockdown at an advanced notice of just four hours. The lockdown was among the most draconian in the world. Between March 25 and April 18, India scored 100, the maximum possible value, on the policy stringency index prepared by University of Oxford. Lockdown restrictions continued to be significant even after April 18, though the lockdown did not succeed in containing the spread of the virus. New daily cases continued to increase during the lockdown and have shown a sharp spike after restrictions were eased.



Source: Oxford University and *Hindustan Times* Database

The lockdown restrictions have dealt a huge blow to economic activity. GDP data for the quarter ending in June will only be available by the end of August. However, high frequency indicators capture the extent of economic disruption. One such indicator is the Purchasing Managers' Index (PMI). PMI indices capture hiring activity in the manufacturing and service sector. Any value above (below) 50 signifies expansion (contraction). These indices fell to their all-time low in April and continued to be way below 50 in May, suggesting a complete collapse in economic activity. While the manufacturing PMI did recover to 47.2 in June, it fell again in July. Other high frequency indicators also suggest that the economic recovery seen until June might have started

plateauing with the pent-up demand getting exhausted and new cases continuing to rise.¹³ As COVID-19 cases and deaths continue to rise in India, prospects of an economic revival are pretty grim. In its Global Economic Prospects, published in June, the World Bank expects India's GDP to contract by 3.2 percent in 2020-21. 2021-22 will see a moderate recovery of just 3.1 percent, which means that India's GDP will not reach 2019-20 levels in the next two years. Most private forecasts expect a bigger contraction in GDP.



b. COVID-19's Labor Market and Income Shock in India

Given that Modi announced the nation-wide lockdown with only four hours' notice, there was practically no time for people to prepare for it. Both private and public transport came to a halt. Most economic activity was not allowed. This had a devastating impact on India's migrant workers. They could neither earn a living in the cities, nor go back to their native places. Weeks after the lockdown, anecdotal reports of migrant workers and their families walking back hundreds of kilometers to their native places started appearing. Many of them perished on the way from either accidents or sheer exhaustion. Thousands suffered immense trauma. After widespread criticism, the government made arrangements for transporting migrants through special trains. Because there was no streamlined

¹³ [“Economic Recovery Hits July Plateau, Shows Data,” Roshan Kishore. Hindustan Times, August 4, 2020](#)

procedure for transporting back migrant workers, estimates of the actual magnitude of reverse migration vary drastically.¹⁴ While the human cost of the tragedy has caught the attention of many, its economic implications are equally grave.

Migrant workers play an important role in the Indian economy. The 2016-17 Economic Survey estimated the size of India's migrant workforce to be around 100 million in 2016—almost 25 percent of the total workforce in India. The Survey also cited studies that show at least 10 percent of India's rural household received remittances from domestic migrant workers that financed 30 percent of the consumption of households that received them.¹⁵ The Survey's assertions are backed by findings from field-based studies which underline the growing importance of non-farm jobs outside Indian villages in rural incomes. For example, Himanshu et al (2018) show that 60 percent of income in Palanpur village (Uttar Pradesh) came from non-cultivation activities. 60 percent of non-farm jobs were located outside the village and at least 60 percent of these jobs were located at a distance of at least 50 kilometers from the village.¹⁶ The massive reverse migration to villages has disrupted this income flow to rural areas. Anecdotal evidence after the lockdown suggests that remittances were actually moving from rural to urban areas, suggesting a large-scale disruption to earnings of migrant workers.¹⁷

The reverse migration due to lockdown has also created a situation where there exists surplus labor in villages and labor scarcity in cities. Given the trauma these workers had to face in coming back to their villages, there is now extreme reluctance to go back to the cities. This has created a scarcity of workers to resume economic activity after the easing of restrictions.¹⁸ The rural labor market was not in the best shape even before the pandemic struck; real rural wages had been contracting since September 2019. The huge addition to the rural labor supply, thanks to the reverse migration from the lockdown, will generate additional headwinds for rural wages and, therefore, incomes.

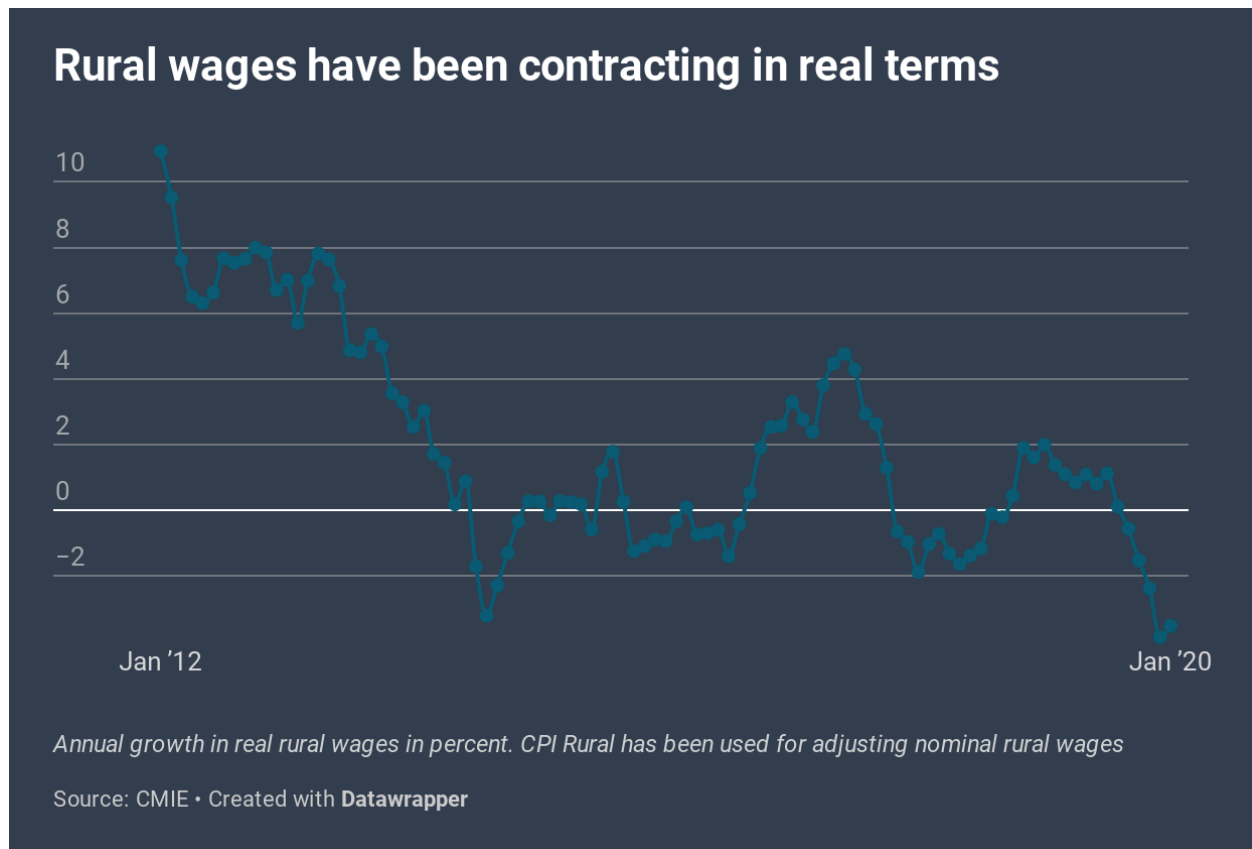
¹⁴ For example, Nomaan Majid estimates this to be 5 million, Chinmay Tumbe expects it to be 30 million. A recent *Indian Express* report says that 6.7 million workers returned to 116 districts in 6 states

¹⁵ See "India on the Move and Churning: New Evidence," Economic Survey, Ministry of Finance, Government of India (2016-17) for a detailed discussion

¹⁶ See *How Lives Change: Palanpur, India and Development Economics*; Himanshu, Peter Lanjouw and Nicholas Stern, Oxford University Press (2018) for details

¹⁷ See "[Remittances Return, but from Rural to Urban](#)," Saloni Shukla & Ashwin Manikandan. *The Economic Times*, May 18, 2020 for details

¹⁸ See "[No Way Back: Indian Workers Shun City Jobs After Lockdown Ordeal](#)," Roli Srivastava & Anuradha Nagaraj. *Reuters*, May 27, 2020 and "[As Migrant Workers Return Home, Lack of Workforce Hits Businesses in Delhi](#)," Vatsala Shrangi. *Hindustan Times*, June 2, 2020 for examples



The interruption of remittance income from cities and an additional squeeze on rural villages is likely to bring down income and, therefore, consumption in rural areas. The contraction of rural demand will adversely affect resumption of normal economic activity in the cities as well. According to the 2011-12 Consumption Expenditure Survey (CES) conducted by the National Sample Survey Office (NSSO), more than 50 percent of India's consumption expenditure came from rural areas. To be sure, this was due to higher population share of rural areas. In terms of average per capita expenditure, urban consumption levels were almost twice the rural levels. While the share of the rural population has been declining in India, rural areas will continue to have a significant share in total consumption expenditure in India. Because India does not have a CES after 2011-12, there is no official data on the pattern and structure of consumption spending in the country.¹⁹

c. Economic Package Without Fiscal Spending

As the lockdown started taking a toll on economic activity, clamor for government support started growing. On May 12, Modi announced that the government was coming up with an economic package worth Rs 20 trillion (\$263 billion)—around 10 percent of India's

¹⁹ To be sure, a CES was conducted in 2017-18, but the government scrapped its findings. This was done after media reports claimed that the report showed a drop in average consumption expenditure between 2011-12 and 2017-18.

GDP. The actual details of the package were announced by finance minister Nirmala Sitharaman over the course of five days. While the package does add up to the promised amount, there was very little in terms of a fiscal stimulus. A research note by Pranjul Bhandari at HSBC securities calculates the additional fiscal spending in the package to just 1 percent of GDP. More than two-thirds of the package is focused on credit supply measures, including liquidity injection by the RBI and loan guarantees to Micro, Small, and Medium Enterprises. That the package focused on easing credit supply and improving liquidity shows that the government had adopted a supply side approach to responding to the crisis. The government response is not in keeping private expectations. Bhandari's research note says, "while markets were expecting a more demand-side stimulus...a large part of the attention has been towards medium-term supply side measures." RBI Governor Shaktikanta Das also highlighted the primacy of demand side challenge to economic revival in the RBI Monetary Policy Committee Meeting held after the announcement of the government's package. "Even as the supply side is expected to ease gradually as the lockdown related restrictions are phased out, it is the demand side, which will continue to weigh heavily on economic activity for some time to come," Das said, according to the minutes of the meeting, published in June.²⁰

Break-up of the Central Government's Economic Package				
Economic Package	Size of Package (Rs billion)	Fiscal Cost (Rs billion)	Total as % of GDP	Fiscal Cost of % of GDP
Increase in MGNREGS Budgetary Allocation	400	400	0.2	0.2
Viability Gap Funding for Social Infrastructure	81	81	0.0	0.0
Agriculture & Allied Activities	1,500	30	0.7	0.0
Migrant and Farmers	3,100	160	1.5	0.1
MSME, NBFCs etc.	5,946	168	2.9	0.1
Welfare & Health	1,928	1,296	0.9	0.6
RBI	8,016		3.9	
Total	20,971	2,135	10.1	1.1

Source: HSBC Research Note by Pranjul Bhandari • Created with Datawrapper

²⁰ See [Minutes of the Monetary Policy Committee Meeting, RBI, May 20-22, 2020](#)

The package also included certain policy changes in addition to the measures listed above. Among the most important has been a deregulation of agriculture markets. This has been done via taking out food items from the ambit of the Essential Commodities Act (ECA) and abolishing the monopoly of Agriculture Product Market Committees (APMC). The former will remove restrictions from private trade, storage and movement of food items. The latter is expected to give farmers greater freedom in selling their produce, and hence receive better prices. While the policy change has been celebrated as a radical reform by the government and a section of commentators, a careful examination of the facts suggests otherwise.²¹

SECTION III: TOWARD A NEW POLITICAL ECONOMY TRAJECTORY

a. What Explains the Political Immunity of the Modi Government from its Policy Mistakes?

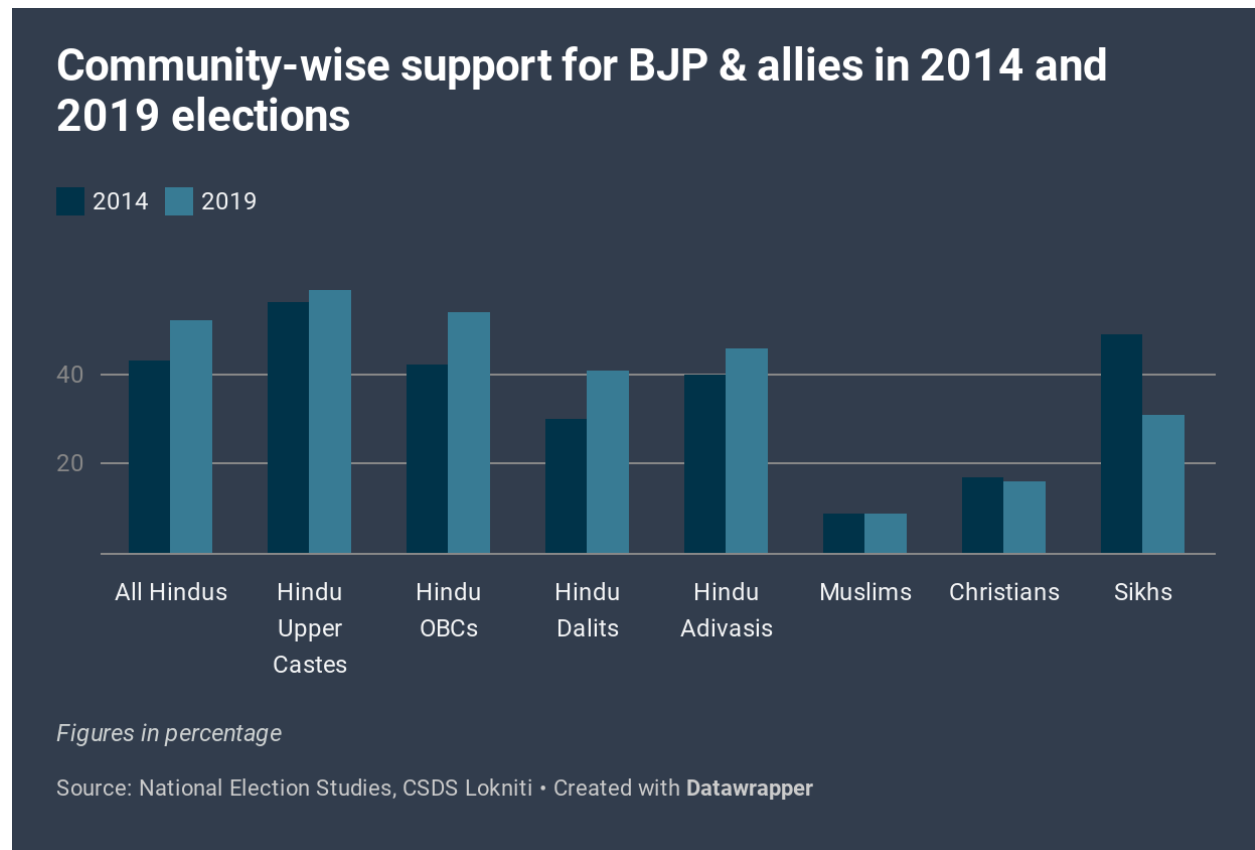
Why was the Narendra Modi government unable to arrest the pre-COVID-19 slowdown in time? Why did it implement policies such as demonetization, GST, and corporate tax reduction in a tearing hurry without carefully considering their pros and cons? All of them have contributed toward worsening the economic and fiscal situation. Why did it not think of the 100 million migrant workers before announcing a draconian national lockdown with just four hours of notice? Its own policy document had underlined the size of the migrant workforce. What explains the decision to not provide a demand side boost to the economy, despite compelling evidence of large-scale economic distress? And most importantly, why has the Bharatiya Janata Party (BJP) not paid or is not scared of paying a political price for the economic pain these policies have brought?

The answers to these seemingly perplexing questions are found in the political economy approach of the current regime. This approach has two guiding principles. The first is a strategy of ensuring electoral victories through a highly centralized and polarizing political rhetoric. The second sees a solution to India's economic problems by pursuing a policy which combines intermittent welfare measures along with policies the current regime thinks of as enhancing the ease of doing business. The latter are often implemented irrespective of their potential collateral damage in the name of bold initiatives.

The political success of the BJP under Narendra Modi has two distinct characteristics. The first is a sharp polarization between majority Hindus and India's religious minorities. National Election Studies conducted by Lokniti at the Centre for the Study of Developing

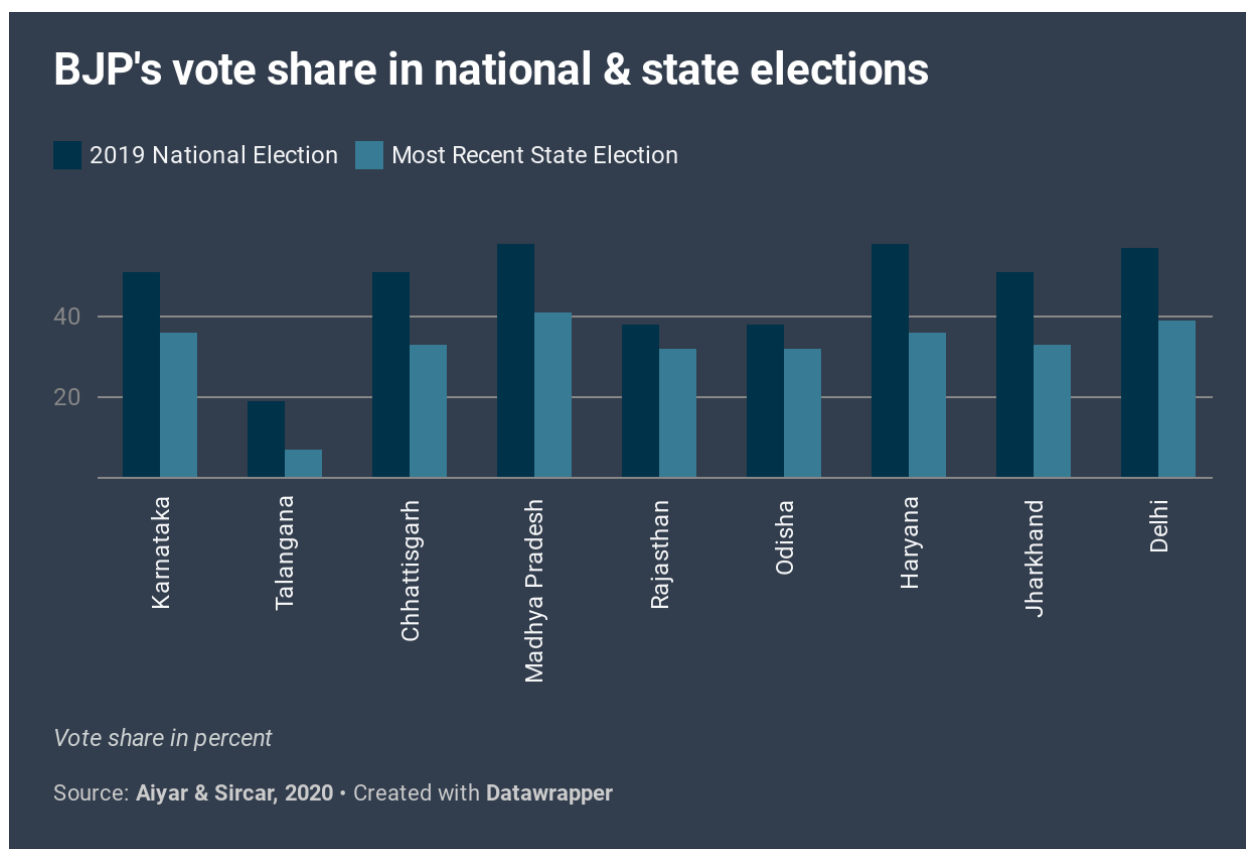
²¹ See [“Freeing Up the Farmer: Gov't to Ease Curbs on Trade, Open Up Markets,” Harish Damodaran, *The Indian Express*, May 16, 2020](#) for a favourable commentary on the agricultural policy reforms. For a critical perspective see [“Problems Farmers Face are Rooted in Structural Constraints, Require Regulatory Intervention,” Mekhala Krishnamurthy, *The Indian Express*, May 22, 2020](#) and [“Will Farmers Get a Better Deal After Recent Reforms?” Roshan Kishore, *Hindustan Times*, May 18, 2020](#)

Societies (CSDS) shows that this polarization actually became sharper between the 2014 and 2019 elections. In the 2014 elections, 43 percent of Hindus voted for the BJP and its allies. This increased to 52 percent in the 2019 polls. The BJP's support among India's religious minorities—Muslims, Christians, and Sikhs, especially the first—is significantly lower compared to Hindus, and either remained constant or went down during this period.



The second characteristic feature of the BJP's political success post-2014 has been a growing hiatus between its performance in national and state elections. While it remains vulnerable to upsets or setbacks at the state level, especially when faced with anti-incumbency, these reverses do not seem to matter at the national level. This is borne out by the vote share premium the BJP enjoyed in various states at the national level in the 2019 elections over its performance in the preceding assembly elections. Such a mismatch between state and national election performance is against earlier electoral trends in India.²²

²² See [“Lok Sabha Elections 2019: Can BJP Retain Dominance in Hindi Heartland?” Gilles Verniers, Hindustan Times, April 29, 2019](#) for a detailed discussion



How has the BJP been able to achieve this? Aiyar and Sircar (2020) attribute the BJP's national advantage vis-à-vis regional parties to three factors: the Modi government putting into place an administrative environment where state governments, and therefore regional parties, are not seen as critical for delivery of welfare benefits; a technology enabled welfare regime which claims to be more efficient and also leads to further centralization of welfare handouts; and the use of ground-level BJP cadre to popularize these schemes, and, by extension the Prime Minister's popularity.²³

This, the authors note, is in addition to the BJP's ability to push its Hindutva agenda. Anecdotal evidence from field visits during elections seem to substantiate these claims.²⁴ That the state governments have had to surrender a large part of their fiscal autonomy after the implementation of GST, and have suffered disproportionately due to the growing fiscal crisis has not helped them in dealing with the centralized political push by the BJP.²⁵

²³ "Understanding the Decline of Regional Party Power in the 2019 National Election and Beyond, Yamini Aiyar & Neelanjan Sircar, *Contemporary South Asia* (May, 2019)

²⁴ See ["How RSS, Technology are Helping BJP's Welfare Push | Analysis," Roshan Kishore. *Hindustan Times*, October 14, 2019](#) for example

²⁵ For a detailed discussion on the growing fiscal problems of state governments see ["State Finance Minister's Job an Unenviable One," Roshan Kishore. *Hindustan Times*, February 17, 2020](#)

To be sure, the BJP's political success since 2014 also has a growing intra-Hindu polarization element to it, especially in the key states of Uttar Pradesh and Bihar.²⁶ Faced with regional political adversaries who used a formula of leveraging the support of socially backward caste groups among Hindus along with Muslims, the BJP has focused on creating fissures within the socially backward Hindus by othering the dominant caste groups in the same social strata as well as Muslims.²⁷ This fragmentation in the opposition's vote bank, along with a completely united upper caste support base, has given it a decisive edge in the elections.

Strengthened by its enhanced popularity among the poor by a refashioning of welfare programs and a deeper and growing social polarization, the BJP has managed to delegitimize and deflect any economic criticism of its policies by terming it as either anti-poor or even being against national interest.²⁸ The strategy seems to have worked for the BJP on the ground.²⁹

b. "Gujarat Model" and the Fetishism for Pro-Business Policies

An important question remains: while the BJP has managed to deflect pain for its bad economic decisions via polarization, why did the Modi government implement these counter-productive policies in the first place? The only rational answer can be that it expected such policies to deliver.

What explains its misplaced optimism? India's basic economic challenge can be described as the following: there exists a large asymmetry between the income (15 percent) and employment (40 percent) share of agriculture. This is the main reason for low per capita income and living standards. In order to get rid of this asymmetry, India needs a period of sustained high growth which generates a large number of well-paying non-farm jobs, especially in manufacturing. The question is how this growth is to be achieved.

When Modi launched his 2014 campaign, he championed the "Gujarat Model" as a solution to this basic economic challenge. The campaign celebrated Modi's success in attracting growth-enhancing investment in the state by running a centralized and pro-business administration. That the BJP was invested in this idea was vindicated when the newly elected Modi government launched an ambitious "Make in India" program to promote manufacturing activity in India as one of its first major policy decisions in 2014. Given the politics around it, the "Gujarat Model" attracted a lot of academic debate in India. The nuances of this debate notwithstanding, the basic claim that Modi's regime in

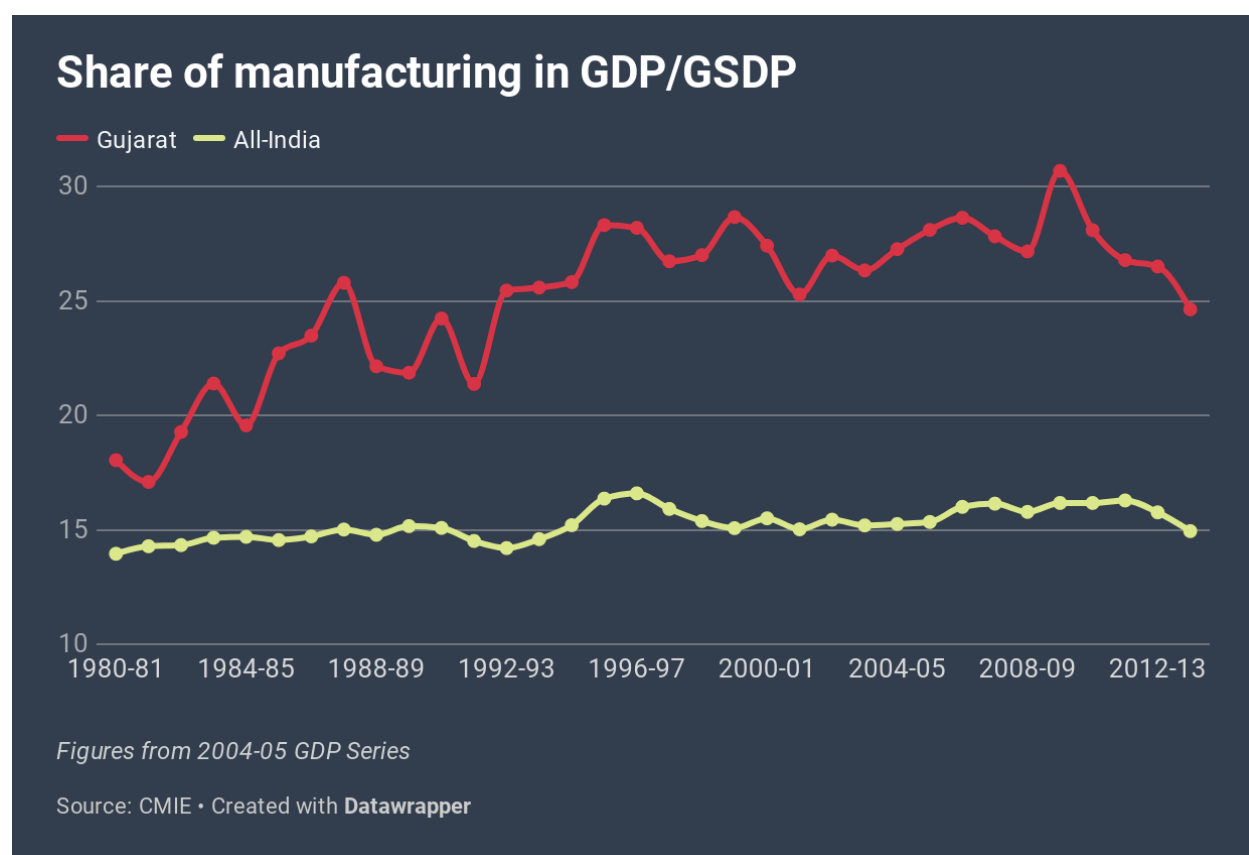
²⁶ Uttar Pradesh and Bihar account for 120 out of the 543 Lok Sabha seats in India

²⁷ For a useful summary of this argument and its contemporary relevance see ["The Waning of Subaltern Solidarity for Hindutva," Sajjan Kumar, *The Hindu*, June 1, 2020](#)

²⁸ See ["What PM Narendra Modi has Said on Demonetisation So Far," *Livemint*, November 28, 2016](#) and ["Those Opposing Demonetisation Anti-National: Maharashtra CM Devendra Fadnavis," Surendra P. Gangan, *Hindustan Times*, November 22, 2016](#) for example

²⁹ See ["Karnataka Elections: Hindutva Could be BJP's Insurance Against Anger Over Demonetisation," Roshan Kishore, *Hindustan Times*, May 12, 2018](#) for example

Gujarat could achieve what he wanted “Make in India” to accomplish at the national level does not stand up to scrutiny. Gujarat has always had a higher share of manufacturing in its economic output than all-India average. It augmented its lead after economic reforms of 1991 liberalized private investment. This gap did not change significantly in the 2000s, when Modi assumed chief ministership in the state. In fact, a comparison of manufacturing’s share in output and growth rate in Gujarat with all-India figures shows that the state was adversely affected by the shock of the 2008 financial crisis and actually saw a decline in manufacturing’s share in total output until 2013-14, the last year when Modi was the chief minister.



That even Gujarat was adversely affected by the demand shock that came with the 2008 crisis should have driven home the centrality of demand side factors for the Modi government. Gujarat’s economic success before the 2008 crisis was not the result of an alternative development model, but external tailwinds to growth giving an additional advantage to what was already an industrially developed state in India. However, the self-serving dogma of having perfected an alternative development model, which sought vindication from political victories aided by increasing polarization, has prevented this from happening. That the political opposition in India has failed to evolve political praxis to counter both the BJP’s polarization tactics and exploit the economic pain from its harmful economic decisions has only encouraged the BJP to follow this strategy.

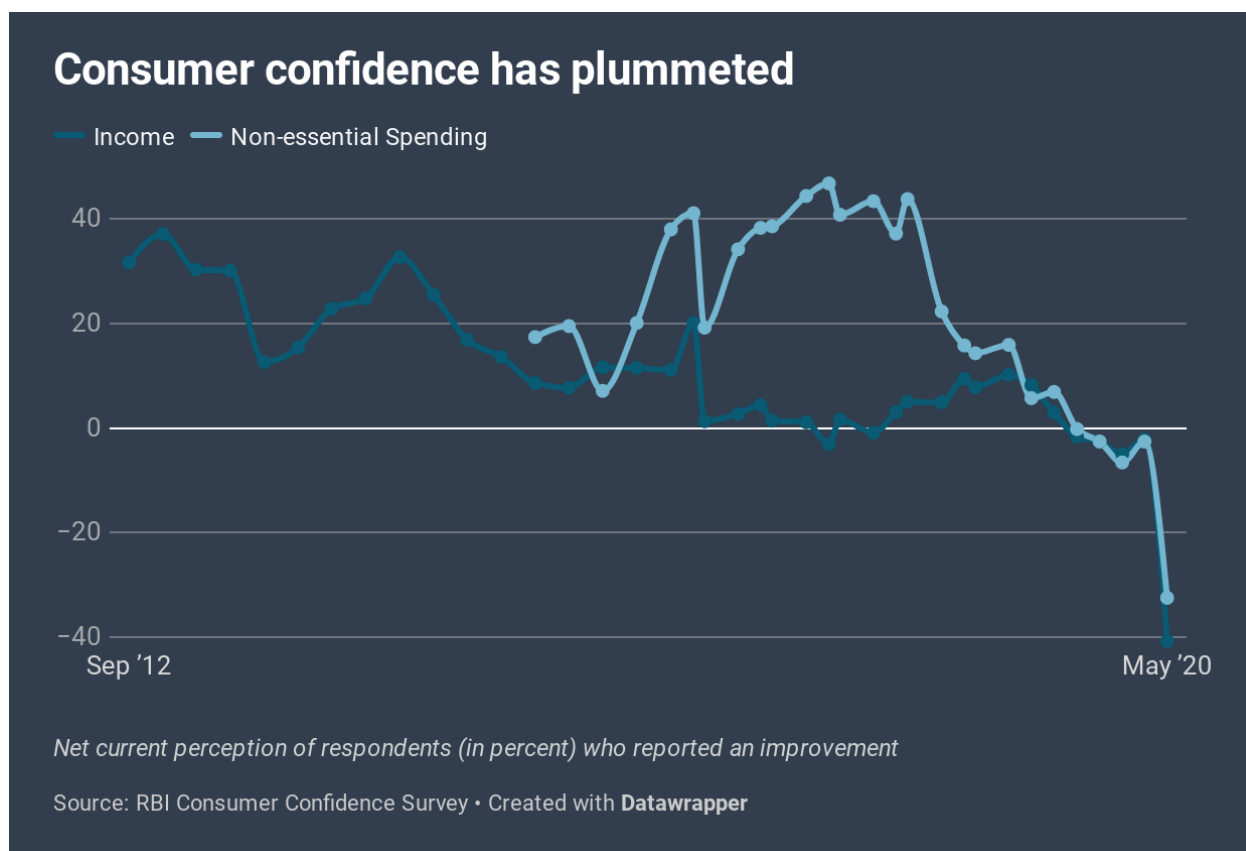
c. The Elephant in the Room: What Will Bring Demand?

India needs to have a sustained high growth phase, something it enjoyed before the 2008 crisis, in order to improve per capita income and living standards. The pre-2008 high growth phase was built on export demand and an unsustainable credit boom. The rise of protectionism across the world, a crisis-ridden international trade regime and global demand shock from the COVID-19 pandemic, any export boom is unlikely in the future. The credit boom has come back to bite the economy and ought to be avoided in the future. Given the fact that these two important drivers of demand have stalled, what will propel future growth in India?

India's growth story in the post-2008 period has been driven by private consumption. This consumption boom is driven by the rich. In 2011-12, the top 20 percent of Indians were responsible for almost half of total consumption spending. These figures are from the 2011-12 CES conducted by the NSSO, and likely to be underestimates. Income tax data for 2017-18 suggests that among the 50 million people who filed tax returns, income reported by the top 5 percent had a share of 15 percent in India's GDP.

We do not have recent consumption data to confirm what has been happening to consumption trends across class. But anecdotal evidence suggests that the consumption demand of the well-off sections has been decelerating in India. For example, domestic sales of passenger cars have been contracting continuously since the quarter ending September 2018. This trend gels well with the sharp collapse in consumer sentiment, especially regarding spending on non-essential items, as reported by the RBI's Consumer Confidence Surveys. The spending by the rich is likely to suffer further moderation as the economic uncertainty due to the pandemic will encourage them to increase precautionary savings, leading to a decline in the marginal propensity to consume.³⁰ This will further complicate the problem of restoring demand in the economy.

³⁰ See [“The Covid Shock Could Alter People's Financial Priorities,” Niranjan Rajadhyaksha, *Livemint*, May 5, 2020](#) for a detailed discussion



So, what is to be done? The only logical alternative is to boost the consumption of the non-rich population. What is the best way to achieve this? I argue for a two-pronged policy approach.

A large part of India's population spends the bulk of its income on food. Food items have a share of almost 40 percent in the Consumer Price Index, India's benchmark inflation index. As is to be expected, the share of food in household budgets will be more than 50 percent for the poorer population. *Ceteris paribus*, this means that any increase in food prices will squeeze non-food consumption spending and, therefore, demand; non-food demand is what drives GDP growth in the country. The share of agriculture in India's GDP has been continuously falling and is less than 15 percent now. However, low food prices are not an unambiguous blessing for the Indian economy. More than 40 percent of India's workforce is engaged in agriculture, and their incomes are directly linked with food prices.

The continuous tension between maintaining low food prices and protecting farm incomes is the central political economy faultline in India. Given its political importance, the Indian state has put in place a policy to deal with this contraction. This works through a procurement based public distribution system (PDS) in which the government buys food grains at remunerative prices from the farmers and provides them at heavily subsidized prices to the program's beneficiaries. According to government statistics, more than 800 million Indians benefit from this program. Food subsidies required to run this

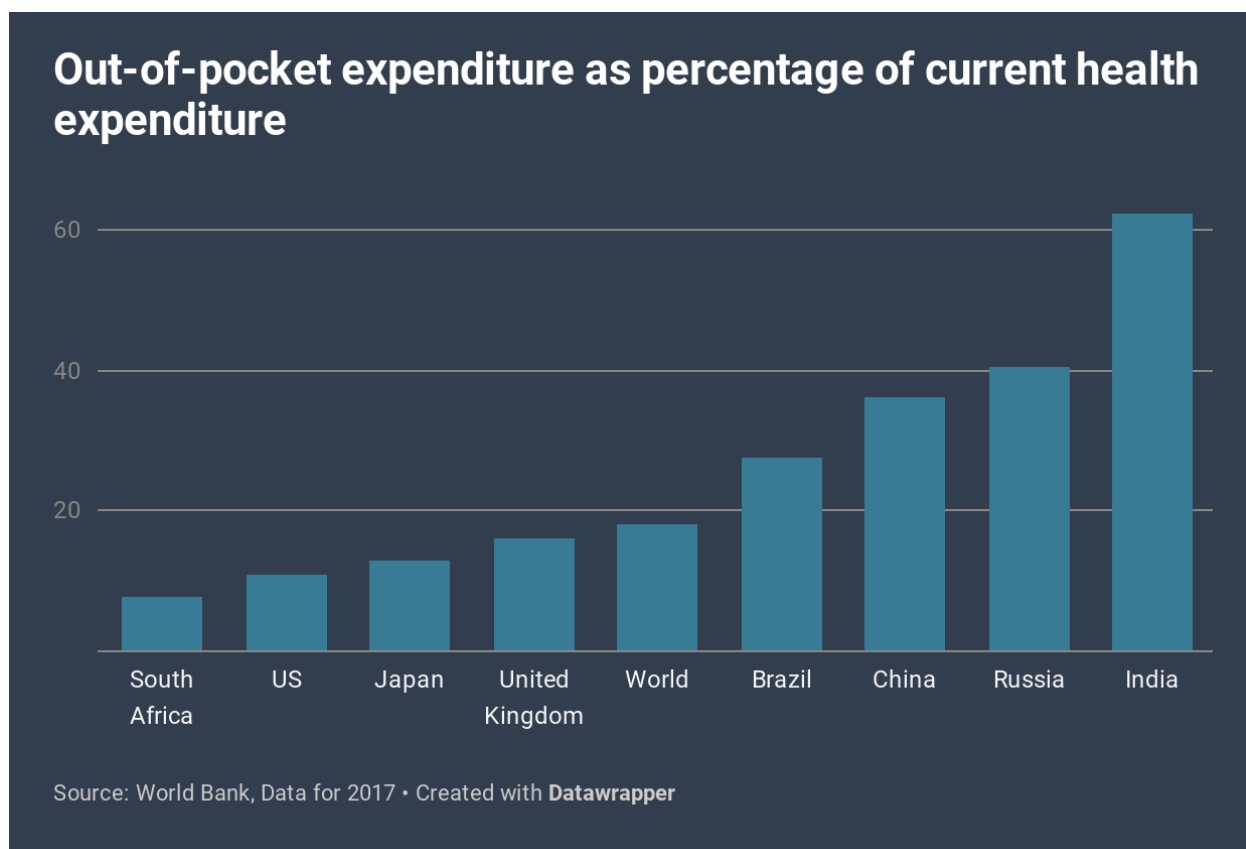
program in 2020-21 are expected to be 3.8 percent of the total budgetary spending by the central government.

While the PDS has been instrumental in safeguarding India's food security by encouraging the production of food grains and providing cheap food to those who cannot afford it, it has been losing its erstwhile importance in the food economy. This has happened due to a qualitative shift in India's food basket, both on the production as well as consumption side. The procurement-based PDS focuses on India's two most important cereals: rice and wheat. Overtime, they have lost their importance in the food economy to vegetables and fruits, which are clubbed in the horticultural product category in India's farm statistics. Data from the ministry of agriculture shows that horticultural production was just 68 percent of food grain production in 2001-02. This figure has been continuously increasing and increased to 111 percent in the triennium ending 2017-18. Relative weight of fruits and vegetables in different inflation indices captures this shift from the consumption side. The Consumer Price Index for Industrial Workers (CPI-IW), which has 2001 as its base year, gives a weight of 13.48 percent to cereals and products and 6.05 percent to fruits and vegetables. The urban component of Consumer Price Index (CPI), which has 2012 as its base year, gives a weight of just 6.59 percent to cereals and 7.3 percent to fruits and vegetables. It is to be expected that the share of cereals would have gone down further in the recent period. These statistics tell us that while the PDS is still capable of avoiding a major food security crisis, its role in protecting farm incomes via procurement and cushioning household budgets via reducing food spending has been coming down. This could change if the government were to expand the scope of the PDS to cover horticultural products, especially some key vegetables. While this will require improvising on the existing policy design—a procure-store-distribute model will not work for perishables—if implemented properly, it will provide a big relief to both farm incomes as well as household budgets. Because these income gains will accrue to the poorest sections of society, who are expected to have a much higher marginal propensity to consume than the rich, the positive impact on aggregate demand will be much greater than similar income gains for the rich.

The other way to boost mass demand is a significant enhancement of public provisioning of health in India. According to World Bank statistics, the share of out of pocket health spending in total health expenditure is among the highest in India. This means that a large part of India's population is extremely vulnerable to adverse income shocks in case of a health calamity.³¹ The high burden of health costs has also led to underreporting of illnesses in India, which translates into economic losses via a higher morbidity burden.³²

³¹ See [“Indian Households’ Healthcare Woes,” Pramit Bhattacharya, *Livemint*, December 20, 2016](#) for a discussion on this

³² See [“India’s Missing Patients,” Pramit Bhattacharya, *Livemint*, August 7, 2015](#) for a detailed discussion



The COVID-19 shock has highlighted the importance of strong intervention on both these counts. As incomes contract across the board, the government will have to deal with the dilemma of cushioning household budgets without hurting farm incomes. Any squeeze on farm incomes will only make matters worse, as it will generate additional headwinds for non-food demand by those dependent on farming. As the number of COVID-19 cases rise rapidly in India, health infrastructure in even the biggest cities has proved to be grossly ill-equipped to deal with the crisis. Because controlling the pandemic requires treating both the rich as well as poor, the high cost private facilities, which are affordable for a handful of people, cannot guarantee an effective response.

To be sure, doing both these things will entail higher fiscal spending. There is a strong view in economics that a higher fiscal deficit is counter-productive to growth as it can lead to higher inflation and also crowd out private investment. This argument has been critiqued.³³ These theoretical disagreements notwithstanding, there has always been a large consensus on using the fiscal route at times of large economic shocks.

Even the FRBM Review Committee Report, which was submitted in 2017, highlighted the problem with adhering to an FRBM kind of framework. “One disadvantage of headline fiscal balance rules is that they do not have counter-cyclical properties. For example,

³³ See [“The Fiscal Deficit,” Jyotirmoy Bhattacharya, *Macroscan*](#) for a simple discussion

when growth—and therefore revenues—are above potential, policymakers should ideally be reducing fiscal deficits, and thereby creating fiscal space that can be used in downturns. However, adhering to a fiscal deficit target necessarily results in those extra revenues being spent. Similarly, during downturns, as automatic stabilizers work, one would want the fiscal deficit to expand, but that is precluded by adherence to a headline deficit rule, thereby making fiscal policy pro-cyclical,” it said.³⁴ The extent of the economic shock due to the pandemic clearly makes a fit case for a counter-cyclical fiscal push.

CONCLUSION

The global financial crisis of 2008 dealt a body blow to the Indian economy by interrupting the export boost to economic growth. The subsequent slowdown created a twin balance sheet problem as investments became unsustainable, rendering past debt unserviceable. While there was a period of brief recovery aided by a sharp fall in oil prices, the crisis has only become bigger with deeper slowdown and proliferation of the financial sector mess from banks to NBFCs.

The policy response, thanks to the dogma of seeing pro-business reforms as the route toward recovery, has failed to grasp the severity of the macroeconomic challenge, especially the demand side of it. The policy failure has gone unpunished politically, as the opposition has failed to counter the BJP’s politics of selling Narendra Modi as the harbinger of centralized welfare benefits on the one hand and sharpening social polarization on the other.

The COVID-19 shock will significantly add to the already existing economic pain. As the fiscal crisis deepens, the government’s ability to even maintain, let alone expand, welfare benefits will come under serious strain. Because the fiscal space for state governments has been shrinking, providing additional relief at the level of the states will get increasingly difficult. These constraints will make it more tempting for the BJP to ensure political gains via the polarization route. Such efforts, in an already fragile economic situation, will only worsen the socio-economic scenario. A sustained recovery will require a decentralized demand side intervention. Whether or not such a policy change happens, however, will depend more on the political resistance the current regime faces on the ground rather than intellectual criticism from economists outside the policymaking apparatus.

³⁴ [FRBM Review Committee Report: Volume I](#)