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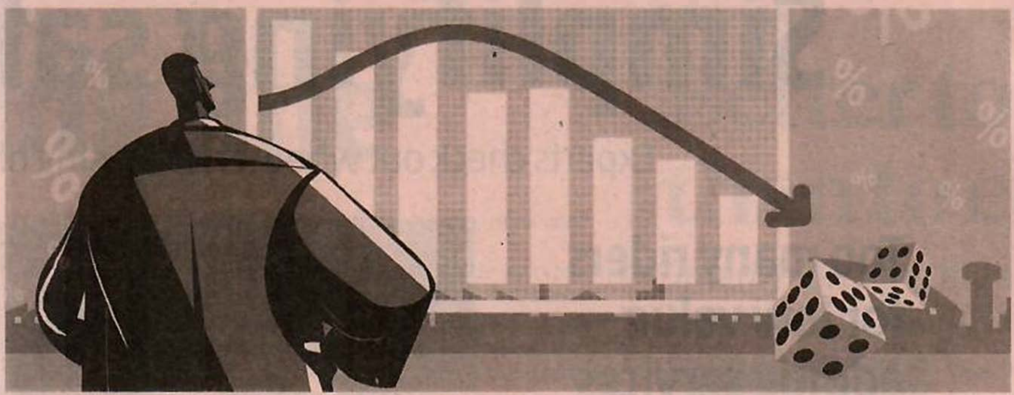

Firms are fearful as uncertainty goes up

We run the risk of 2017-19 being consumed by the GST just as 2016-17 suffered on account of demonetisation

GDP measurement in India is weak, and micro datasets are showing signs of stress. Where did we go wrong? One element of the picture is an upsurge in uncertainty. In some areas, we have had policy mistakes. The quality of policy implementation is generally weak. The old ways through which firms solved roadblocks don't work as much, but new ways have not come about. This makes firms feel powerless. This new level of uncertainty and powerlessness is holding back private investment.

A former head of the Central Statistics Office (CSO) memorably said: "If you come into my kitchen, you will not eat my meal." In recent years, we have had an extended look inside the CSO's kitchen, and have been reminded of the limitations of four pillars of official statistics — the NAS (National Accounts Statistics), the NSSO (National Sample Survey Organisation), the ASI (Annual Survey of Industries), and the IIP (Index of Industrial Production). When micro datasets disagree with the CSO, generally the micro datasets are right.

SNAKES & LADDERS
AJAY SHAH

What do the micro datasets say? We construct indexes covering all non-financial non-oil listed companies. Annual sales growth was above 20 per cent nominal from 2002 to 2012. This has dropped to 5 per cent nominal from 2012 to 2017. Annual operating profit growth was also above 20 per cent nominal per year from 2002 to 2012. From 2012 till 2017, this has also dropped to 4 per cent nominal per year. Expressed in real terms, both measures declined slightly over this five-year period.

The CMIE Capex database tracks all investment projects. From 2012 to 2017, the nominal growth of the value of projects under implementation is 0. Expressed in real terms, this is negative growth.

The most important question in Indian economics today concerns diagnosing this growth collapse. Why did India do remarkably well from 2002 to 2012, and after that, why have we fallen on hard times?

Macroeconomic phenomena always have multidimensional explanations. In my opinion, one element of this story is an upsurge of fear. From 2002 to 2012, firms were presented with an environment of risk, which they understood and could manage. The range of possibilities was known, and if bad things happened, one knew what to do. From 2012 onwards, things which were not on anybody's radar have started happening. Further, even for old style problems, the old style remedies have stopped working. Firms are now faced with a new environment of stronger uncertainty and weaker tools for dealing with roadblocks. This has made firms fearful.

We in India suffer from many weaknesses of the rule of law. Firms routinely encounter roadblocks of two kinds: Sometimes a firm is denied fair treatment, which is its right under the rule of law, and sometimes a firm wants to bend the rule of law. Let's look back at the sociology of economic policy in the good years (2002-2012). There was a certain level of dispersion of power amidst a certain policy elite. In that old environment of dispersed power, firms knew how to solve problems. Some of this was outright corruption, and some of this was a valuable set of workarounds when faced with a broken system.

That world has broken down. Part of this is well understood. Enforcement institutions asserted themselves in some famous scandals. The fear of enforcement actions has frightened officials, who are now on strike with 'work to rule'.

The new sociology of policy making is one that is inaccessible to firms, not just on questions of transactions but also on questions of policy. In the old world, power was dispersed, and there were numerous touch points in the policy elite where firms could express opinions about difficulties. Those lines of communication have broken down. The old policy elite has been swept away, but it has not been replaced by a new one. The new arrangement has weak capacity within, and is unmoored from the private sector. This mixture of low capacity and low engagement is giving policy errors, such as the reversal of the Mauritius treaty or demonetisation. This flow of erratic behaviour, which the private sector has zero influence upon, has created fear.

The design and administration of the GST is going to exert a far-reaching impact upon the private sector. However, in the journey to the GST, decisions about policy and administration have been made too often without the involvement of the private sector. This has given myriad flawed decisions. What should have been a glorious reform, and a source of confidence in the Indian reforms process, is seen with dread by the private sector. We run the risk of 2016-17 being consumed by demonetisation and then 2017-19 by the GST.

The old world of non-rule-of-law was a disgrace and needed fundamental reform. A sound government is one which has predictable frameworks, sophisticated thinking in public economics, and the rule of law. Our highest priority in the Indian policy process should be to reshape the working of government departments, regulators, enforcement agencies, and courts. Building this is not a simple matter of being moralistic, putting a few people in jail, and announcing actions every day. We require deep intellectual capabilities in designing complex institutional change, and sustained expertise in execution of policy reforms.

Economists make an important distinction between risk and uncertainty. Risk is about bad events coming about in a known worldview. For example, you roll the dice, and sometimes you get a 1. Uncertainty is about being caught completely by surprise, where things happen that you had never thought about. The Indian private sector has suffered from an increase in uncertainty. The old tools of engagement with a policy elite that would solve problems, in good ways and in corrupt ways, are degraded, so adverse shocks are more problematic.

Firms have a finite supply of adjustment. Time and money are spent in dealing with shocks. Unanticipated shocks, and policy mistakes, demand the most by way of firm adjustment. Greater uncertainty and weaker engagement have given a feeling of powerlessness for private persons. This is one factor that helps explain the zero nominal growth in projects under implementation from 2012 to 2017.

The writer is a professor at National Institute of Public Finance and Policy, New Delhi