Mammoth moves

In the past 3 years, the Modi govt has tackled some elephants in the room. Relentless implementation is crucial to the next leg of growth

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Research

CRISIL

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Executive summary

On May 26, 2017, the Narendra Modi-led National Democratic Alliance (NDA) will complete the third and most eventful year so far of its five-year term.

The good part is, this hasn't been a two-steps-forward, one-step-back kind of government.

The mammoth is on the move, as it were, warts and all. But for it to charge ahead, relentless implementation would be crucial because most of the repairs and reforms remain work in progress.

The government is trying to tackle some elephants in the room such as corruption, red-tapism and entrenched inefficiencies. Given the intent and efforts, it's only fair to cut it some slack, because ecosystemic torpor takes time to overcome, especially in a multi-dimensional nation such as India.

Policy prudence and some fortuitous tailwinds have meant India's macroeconomic fundamentals are looking much better. And the decks are now clear for the implementation of the Goods and Services Tax (GST), the most fundamental and far-reaching indirect tax reform in decades. It's not optimal, but let the best not be the enemy of the good. Even with its imperfections, it could usher in significant benefits, especially through a quantum leap in transaction trails and logistical efficiencies.

India also continues to improve its global competitiveness rank, and states are getting more flexibility to spend the resources that central government transfers. Additionally, there have been concerted efforts to formalise the economy, and, last but not the least, the NDA has significantly consolidated its political position.

But challenges loom, too.

Non-performing assets in the banking system continue to increase (the flow is decelerating, but the stock remains high), and investment as a percentage of GDP is still headed south. Reversing this trend is critical if India's growth trajectory has to shift higher sustainably.

India also has to create millions of jobs – and skill its workforce – for its growth prospects to improve and to quell a lurking demographic nightmare. That won't be easy, especially given the challenges posed by technology. So incentivising and facilitating micro and small entrepreneurship will also have a large bearing on societal contentment.

Overall, we maintain that the steps taken by the Modi government do not create an immediate and strong upside to growth, but they do improve India's ability to achieve faster and, importantly, sustainable growth over the medium term.

In our report card last year, we had pointed out that while the Modi government had avoided populism and focussed on steps to raise India's potential growth rate, there was a risk that it could change course when the political cycle kicked in.

So far, there is no evidence of that. Which also means the gains made on the fiscal and monetary fronts over the past three years are unlikely to be reversed.

Coming to politics, our analysis suggests that even if NDA wins all state elections and the 2019 general elections, it would get majority in both the Houses of the Parliament only by 2020. But that's unlikely to be a spoiler.

Looking ahead, the fourth year of the Modi government has to majorly be about efficient implementation, because the next order of gains will flow from that.


INDIA

Part I

Taking stock of reforms

No taking eye off implementation

Prime Minister Modi had won the national elections on the core agenda of development. And indeed, his three years in office have seen the government announce a slew of reforms that can potentially improve the economy's growth prospects.

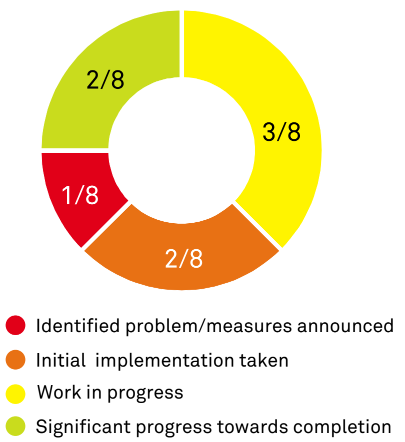
However, to what extent have these reforms been implemented? Our analysis shows that while a number of reforms have been announced, execution of most of these reforms remains work in progress.

In this section, we look at what the key reforms entail and the status of their implementation. We have grouped these reforms under eight important pillars of competitiveness (out of the 12) used by the World Economic Forum's (WEF's) Global Competitiveness rankings.

We find that the majority of reforms initiated by the Modi government are in initial and middle stages of implementation. Of the 8 pillars of competitiveness, reforms under health and education, technological readiness are in initial stage of implementation, under macroeconomic environment, infrastructure, financial market development in middle stage, and under goods market efficiency, institutions in advanced stage of implementation. In the remaining pillar of labour market, concrete reform measures are still pending.

Nevertheless, the Modi government is trying to improve implementation in many areas, especially in reforms related to the macroeconomic environment, goods market efficiency, infrastructure and institutions. This is evident in significant improvement in WEF competitiveness ranking from 2015 to 2016, which reflects the sentiments of the respondents covered in the survey. Going forward, the areas of competitiveness which should see significant improvement are goods market and institutions. However, improving the pace of implementation will be highly challenging in reforms such as those for employment generation, banking sector and power sector. Moreover, some of the earlier neglected areas for reform, such as health, education and labour market, continue to see slow progress in reforms.

Overview of progress on 8 important pillars of competitiveness



Source: CRISIL Research

Methodology for analysing implementation of reforms

In our previous Modi reports, we used a speedometer to analyse progress of reforms under the Modi government. This time, we have also added a "scale of difficulty" which gauges the challenges in implementation of some of the major reforms of the government.

How to read the speedometer which tracks reforms

For construction of the speedometer, we have used the World Economic Forum's (WEF's) competitiveness framework. This framework helps us analyse the progress of reforms on various parameters of competitiveness, relative to competitiveness of other economies. In the speedometer, we take 2016 WEF rankings as our starting point, and use the arrow to signal the current progress of reforms.

Speedometer key

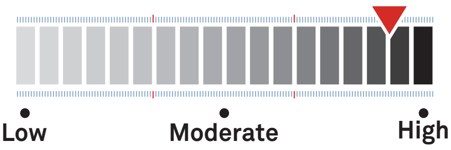
Starting point: WEF Global Competitiveness Ranking 2016

- **Dark red:** No action
- **Red:** Identified problem/ measures announced
- **Orange:** Implementation started and initial steps taken
- **Yellow:** Work in progress
- **Light green:** Significant progress made
- **Dark green:** Action completed

Interpreting the scale of difficulty in implementing reforms

Scale of difficulty is being used to analyse the extent of challenges faced by key reforms. The arrow on the scale indicates the level of difficulty the given reform faces in implementation.

Scale of difficulty



Tracking implementation under the core pillars of competitiveness

Improving macroeconomic environment

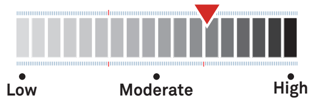
Progress on reforms

Macroeconomic environment

- Fiscal consolidation
- Low inflation and current account, stable rupee
- Measures to boost investment and manufacturing growth such as relaxed FDI limits, allocating funds for domestic manufacturing sectors such as electronics and textiles

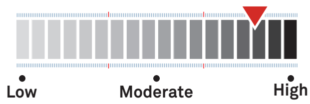
Challenges in implementation

Weak investments challenge sustainable growth



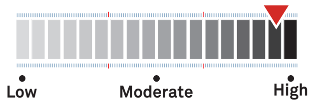
- Low capacity utilisation and weak balance sheets of companies deterring private investments
- Demonetisation's impact on consumption, even though transitory, delayed pick-up in capacity utilisation and decreased production
- Investments unlikely to pick up before fiscal 2019

Vulnerable agriculture still an inflation risk



- Low irrigation buffer, lack of marketing infrastructure, and slow diffusion of technology limit the potential of agriculture and breed inflation risk

Employment generation



- Large-scale creation of low-skill jobs difficult in an environment of tepid global trade and increasing automation in the manufacturing sector
- Mass-scale skilling needs to be done in order to improve competitiveness of Indian labour market
- Restrictive and non-uniform labour laws across states remain a significant hurdle to creation of large scale employment

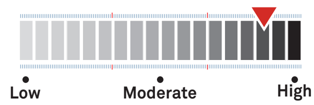
Infrastructure

Progress on reforms	Challenges in implementation

Infrastructure

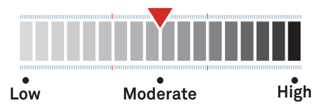
- *Improved access to electricity:* As against Modi government's target of electrifying all un-electrified villages by fiscal 2018, 72% of the un-electrified villages were electrified as of April 2017. With this, 74% of rural households now have access to electricity
- *Restoring financial health of discoms[2] through UDAY[3] :* As of April 2017, 26 states and 1 Union Territory had joined UDAY, covering almost all the states with outstanding discom debts
- Push to renewable energy generation, especially solar power
- Improved pace of road construction, especially in rural areas
- New coal linkage policy approved for efficient domestic supply of coal to power plants
- Issues that held back the construction of highways between fiscals 2012 and 2014, such as delays in land acquisition and environmental clearances, are now being actively addressed by the government
- Promoting affordable housing through increased allocation for construction and interest subvention schemes

Power sector



- Intensive rural electrification of states such as UP, Bihar, North-Eastern states remains low
- Although the financial burden from most discoms has reduced, their operational performance remains a concern
- Tariff hikes constrained by already high rates charged to industrial consumers
- Low capacity utilisation in power generation: Plant Load Factor (PLF) is estimated to remain low at around 62% till fiscal 2019. However, from fiscal 2019, given a pick-up in power demand, slowdown in capacity addition and retirement of old, inefficient projects, we expect an improvement in coal-based PLFs to about 69-70% in fiscal 2021
- Although renewable energy capacity additions are expected to rise at a break-neck speed, power off-take, payment security and aggressive bidding are key monitorables

Road connectivity

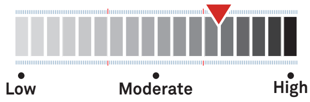


- Highway road construction, despite improvement, lags behind target. As private sector participation remains muted, the National Highways Authority of India does not have enough capacity to achieve construction targets

[2]*Power distribution companies*
[3]*Ujjwal Discom Assurance Yojana*

Progress on reforms	Challenges in implementation

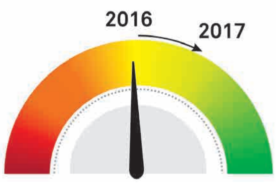
High leverage of infrastructure companies hindering financing



- India needs an estimated ~Rs 43 trillion in the five years to 2020 for its infrastructure build-out. In the past, infrastructure companies have relied primarily on bank financing. However, with the banking sector's asset quality under pressure due to large non-performing assets (NPAs), funds have been hard to get
- Speedy resolution of bad debt is critical for attracting future financing
- Growth of other modes of financing, such as the corporate bond market, besides securitisation of infrastructure assets and speedy implementation of the Bankruptcy Code are also vital for sustaining financing of infrastructure

Institutions

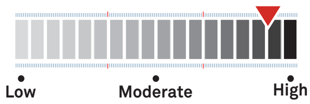
Progress on reforms	Challenges in implementation



Institutions

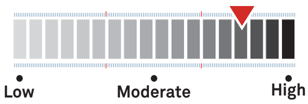
- Insolvency and Bankruptcy Code enacted, Insolvency and Bankruptcy Board of India set up
- Aadhaar Act, legalising use of Aadhaar for transferring government benefits, has come into force
- Digitalisation of government processes for transferring benefits and greater ease of doing business
- Curtailing black economy through voluntary disclosure schemes, Benami Transactions (Prohibition) Amendment Act, linking PAN with Aadhaar, etc

Formalisation of economy



- The government is trying to formalise the economy by bringing transactions under the digital infrastructure. Restrictive labour laws and taxes continue to deter small firms from entering the formal economy
- Getting smaller firms into the GST process will also pose challenges

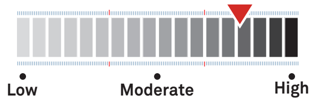
Implementing Insolvency and Bankruptcy Code



- The Insolvency and Bankruptcy Board of India is putting in place systems to implement the code
- Registration of insolvency professionals is in initial stages
- Information utilities (IUs) are yet to be set up. Banks are yet to share information of their borrowers with IUs
- Creditor banks also need to modify their systems to trigger bankruptcy resolution process under the new code. This is expected to take time

Progress on reforms	Challenges in implementation

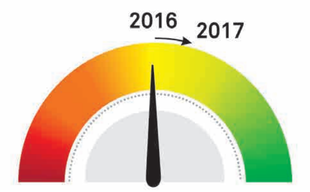
Curtailing the black economy



- While demonetisation may have temporarily reduced the stock of black money, it does not dramatically change the flow. Other avenues for hoarding of black money, such as real estate, funding of political parties, need to be rigorously monitored, too

Financial market development

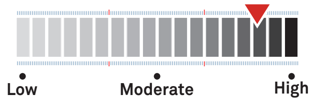
Progress on reforms	Challenges in implementation



Financial market development

- *Capital infusion into public sector banks:* The government allocated Rs 229 billion in fiscal 2017 (against initial budget allocation of Rs 250 billion) to 13 PSBs, 75% of which was infused immediately. The fiscal 2018 budget has allocated Rs 100 billion capital support to PSBs.
- Bank Board Bureau operationalised
- Notification of an ordinance to the Banking Regulation Act, 1949, which gives RBI more powers to speed up resolution of stressed assets
- Debt laws strengthened for speedy resolution
- 100% FDI in asset reconstruction companies (ARCs)

Banking sector reforms



- Revitalising public sector banks on a durable basis remains a challenge
- Capital infusion planned by the government is inadequate, given the high capital requirement to meet Basel-III norms, and the relentless rise in gross non-performing assets (GNPAs)
- The Strategic Debt Restructuring (SDR) scheme is facing hurdles in implementation such as disagreement on the terms of conversion of debt to equity between banks and companies, and lack of capacity of banks to get a new management to run a company
- The Bank Board Bureau has not been empowered to change the management at public sector banks
- Sale of stressed assets by banks to ARCs have been subdued due to inadequate capital and differences in valuation of the debt
- CRISIL Research expects loans slippages to be lower in fiscal 2018 compared with the previous two fiscals, but GNPAs are nevertheless expected to remain at elevated levels and touch 10.6% of advances by March 31, 2018, due to slower recoveries
- Banking sector will continue to stay under pressure in the near term due to weak credit quality of borrowers in the investment linked sectors. While improving prospects of some debt-intensive sectors such as metals and sugar (due to better prices) will limit the pace of fresh addition to NPAs in fiscal 2018, the pace of recoveries will remain subdued owing to a large chunk of NPAs coming from highly leveraged companies with stretched cash flows. Several investment-linked sectors such as real estate and capital goods continue to see headwinds

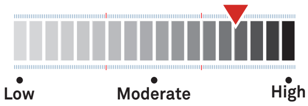
Progress on reforms

- Public Debt Management Cell set up by the finance ministry to streamline government borrowings
- Electronic auction platform for primary debt offer
- Limit for foreign investment in stock exchanges increased to 15% from 5%

Challenges in implementation

- Reduction in NPAs largely supported by high write-offs so far. In fiscal 2016 and for the nine months ended December 31, 2016, the share of write-offs in overall reductions for public sector banks increased to 45% against 37% average in the previous 5 years

Developing vibrant corporate bond markets



- Investors are mostly interested in high-rated corporate bonds. Insurance and pension funds – the largest investors in bond market – have stringent regulatory norms regarding investing in this market. Retail participation remains low
- A well-functioning Insolvency and Bankruptcy Code will help deepen the corporate bond market. While the new and simplified Code has come into force, its implementation by the Insolvency and Bankruptcy Board of India, lending institutions and other stakeholders will take time
- High government borrowing pushes up interest rate and cost of issuance in the bond market
- Lack of liquidity in the market
- Lack of a well-functioning derivatives market is also contraining further expansion of bond market

Goods market efficiency

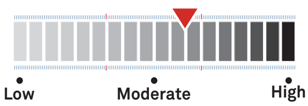
Progress on reforms

Goods market efficiency

- Passage of Goods and Services Tax Bills for uniform indirect tax system in the country
- States told to amend Agricultural Produce Marketing Committee (APMC) Acts for creation of a single national agriculture market

Challenges in implementation

Goods and Services Tax

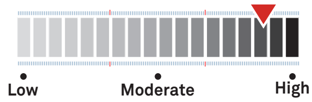


- IT compliance systems across government and corporates need to undergo significant changes to adapt to the GST regime
- Success of Goods and Services Tax Network – the central IT backbone for GST, critical for each step in GST system – is dependent on internet penetration, which still needs scaling up.
- GST is a fully online/paperless system. Authorities aim to make the entire process completely paperless and are devising multiple ways to ensure even the smallest of retailers can file their taxes online. However, basic digital infrastructure – internet penetration and electricity access – needs to be in place

Progress on reforms	Challenges in implementation

- Launch of e-NAM (or electronic National Agriculture Market), an online trading platform for agricultural produce

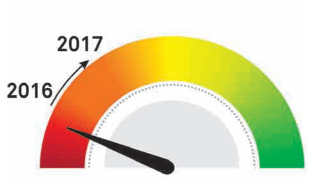
Creating a single agriculture market



- Half of the states are yet to amend their APMC Acts. Resistance from APMC committees is a major hurdle
- Even in the states where APMC has been amended, implementation of electronic trading platform e-NAM is at a nascent stage. Mandis have reported software failures and lack of capacity to handle large trade volumes
- Inadequate facilities for sorting and grading of produce
- Rural infrastructure inadequate for smooth market access

Labour market efficiency

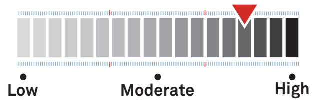
Progress on reforms	Challenges in implementation



Labour market efficiency

- Ministry of Labour & Employment working to rationalise 43 labour laws under 4 labour codes

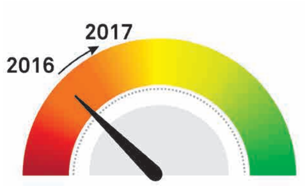
Simplification of labour laws



- Responsibility for modification of labour laws has been pushed to the domain of states. The little progress in easing labour laws, too, is limited to a few states. So far 11 states have carried out some form of labour reforms
- Absence of a uniform simplified labour law continues to deter investments in labour-intensive industries

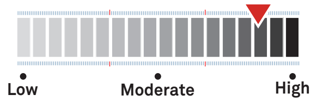
Health and primary education

Progress on reforms	Challenges in implementation



Health & primary education

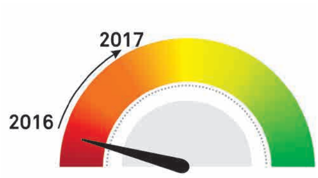
- New National Health Policy approved by Cabinet targets to increase health spending to 2.5% of GDP by 2025 from the current 1.3%
- Budget allocation for Swacchh Bharat Mission increased 44% on-year for fiscal 2018



- Measures to improve health and primary education outcomes remain inadequate
- Lack of public healthcare infrastructure
- Inadequate health workforce – more so in rural areas
- Indian government's health expenditure at 1.3% of GDP[6] remains one of the lowest in the world

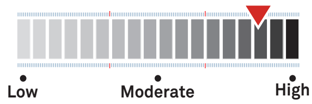
Technological readiness

Progress on reforms	Challenges in implementation



Technological readiness

- Deepening internet penetration in villages through Bharatnet
- *Innovations in payment systems to make digital payments simpler:* Launch of Unified Payment Interface and BHIM app for Aadhaar/ mobile-based payment



- Optical fibre under Bharatnet has only been laid in 38% of gram panchayats so far
- Acceptance to digital payments has not improved much
- While digital payment process has been significantly simplified, lack of continuous access to electricity and high-speed internet is a major hurdle for mass usage of digital payments. The problem is more severe in remote areas

[6]*As in fiscal 2016. Comprises health expenditure of centre as well as states*

The incipient jobs crisis

India's much-vaunted demographic dividend and efforts to ensure equitable growth will come to naught if it fails to ensure employment to millions every year. It's a staggering challenge that, worryingly has seen little concerted policy attention. Between now and 2025, India will add about 100 million people to the working-age population, tantamount to ~27% of the incremental working age population globally.

Let us assume only 58% of working-age Indians, the current labour force participation rate, will look for jobs. That's 60 million – nearly the population of Italy or France – of them looking for a job.

Inadequate low-skilled job opportunities outside agriculture, and a widening skills mismatch in the formal sphere, are disquieting. Then there is the threat of automation impacting existing jobs in many of India's high employment-generating sectors such as textiles, food processing, and information technology and information technology-enables services.

While the Modi government has taken some steps to generate employment over the past three years, these are far from adequate. The approach appears two-pronged. First, provide a safety net to the rural folk through higher spending on the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS). Second, offer durable employment opportunities by increasing allocation to sectors with large employment intensities.

Accordingly, budgetary allocations have increased. The allocation for the rural roads programme (Pradhan Mantri Gram Sadak Yojana) has seen an average increase of 40% in spending during fiscals 2015 and 2018, while that for MGNREGA is a more modest 10%. Similarly, the government has backed other high employment-generating sectors such as affordable housing, tourism, and construction, as also the 'Make in India' initiative. However, the much-needed cohesive thrust on skilling and employment is far from reality.

What else can policymakers do to ensure job growth? Some low-cost/labour-intensive sectors such as textiles offer an emerging export opportunity as wages in China rise and businesses exit these segments. Bangladesh took advantage of its low-cost structure and developed the textiles sector, creating jobs and improving social indicators. Today, Bangladesh beats India in most social indicators despite its lower per capita income.

Within services, sharper focus is needed on the labour-intensive health and education sectors. That will not only create jobs, but also raise India's growth potential by making the workforce healthy, skilled and educated.

Policy inaction will be perilous. Large-scale skilling and micro-entrepreneurship initiatives are needed on a war footing. Else, a demographic nightmare would be at hand.

The demonetisation gambit

Any discussion on reforms carried out by the Modi government would be incomplete without mentioning demonetisation. The surprise announcement at 8 pm on 8/11 was remarkable, indeed. Here's the lowdown:

Objective

- Reduce corruption
- Curb illegal activities such as terror financing
- Encourage digital payments

Economic impact: Transitory

Sudden withdrawal of 86% of currency
+
Sluggish replacement

Demand shock

- Industrial production fell to 3.8% in the second half of fiscal 2007 from 6.5% in the first half.
- Cash-intensive sectors such as real estate severely hit
- Informal sector business likely to be impacted the most

GDP

Inflation

What has worked

- 9.1 million people added to the list of taxpayers after demonetisation
- 14.3% increase in direct tax collections in fiscal 2017. Voluntary disclosure schemes further added to tax collections
- Surge in bank deposits and improved transmission lowered lending rates

What else is needed

- While demonetisation may have temporarily reduced the stock of black money, it does not dramatically change the flow. Other avenues for hoarding of black money, such as real estate, funding of political parties, need to be rigorously monitored, too
- Although electronic payments picked up immediately after demonetisation, they declined as soon as cash was replenished (See section on digitalisation, page 17). So cash-less transactions will need to be incentivised further
- It remains to be seen whether the increase in tax collections due to demonetisation can be sustained. A steady increase in India's tax to GDP ratio would indicate success

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GST is here

The Modi government's biggest victory so far in terms of reforms is the passage of the four Goods and Service Tax (GST) Bills[1] in Parliament and is slated to roll out on July 1, 2017.

A four-tier tax rate structure – 5%, 12%, 18% and 28% – has been finalised under GST, with essential items of daily use attracting the lowest rate and demerit/temptation goods the highest. Additionally, a cess above the peak rate on luxury and demerit goods such as tobacco has been proposed. The government has fixed tax rates for most goods and services. Majority of mass-consumption goods will be taxed at a lower rate, and some essential food commodities have been exempted.

While complete implementation of GST is expected to bring efficiency gains and lead to higher tax compliance in the long run, there would be disruptions and likely loss of revenue in the short run because of the transition. GST entails setting up of a huge IT ecosystem, educating stakeholders on compliance and bringing them on board, which will be a very challenging task.
However, GST will be a game changer and can usher in significant efficiencies and benefits in the transportation and logistics chains. Cost will reduce for manufacturers, though it will increase for the services sector. In addition, GST will help narrow the gap between unorganised and organised firms as input sourcing from compliant firms will be needed for tax set-off.

The GST rate for organised players in most industries will be lower than their current effective indirect tax rate, which will reduce their input costs and hence make them more competitive. On the other hand, unorganised players will see an increase in compliance cost, and will be under pressure to cut margins or lose market share to organised players.

Although GST is not being rolled out in its ideal form, it will yet mark a significant improvement over the current distorted indirect tax structure in the country.

[1] *Central GST (CGST) Bill, the Integrated GST (IGST) Bill, GST (Compensation to States) Bill, and the Union Territory GST Bill.*

Digitalisation: Its success can lend speed to reforms

In our last Modi report *(Choosing trend over cycle)*, we pointed out the potentially disruptive impact of digitalisation on the Indian economy, with benefits for government, firms as well as citizens. The importance of digitalisation has increased given that many major reforms and government functions such as the Goods and Services Tax, transfer of government benefits, and initiatives for improving ease of doing business are being done by leveraging the digital medium.

But how prepared is the Indian economy for digitalisation? As seen earlier, India's technological infrastructure is poor by international standards. India ranks 110th in WEF's ranking for technological readiness, the worst among its peers. The progress in laying optical fibre in villages for internet connectivity has been slow. Moreover, according to State of the Internet report by Akamai Technologies, while India's average internet speed doubled to 5.6 mbps in October-December quarter 2016, it still has the lowest internet speeds in Asia Pacific. The global average internet speed was 7.0 mbps in the quarter.

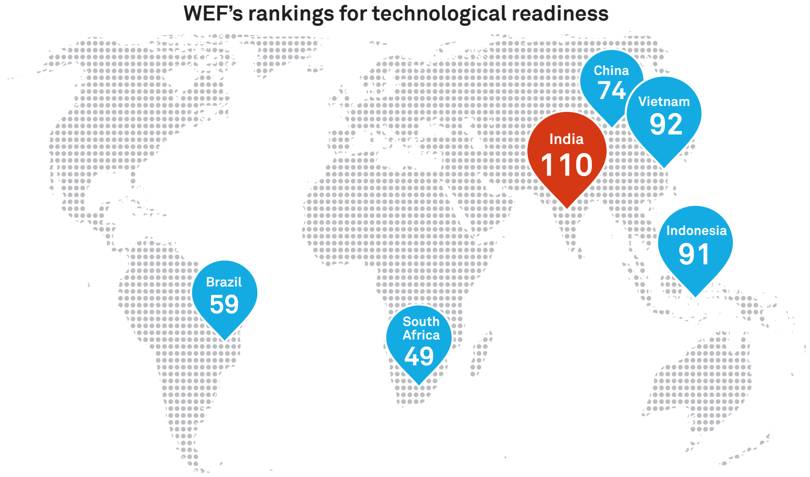
Modi government is also using digitalisation to formalise the Indian economy. The biggest move taken in this regard was demonetisation of Rs 500 and Rs 1000 notes, through which the government tried to bring various economic activities under digital infrastructure.

However, there hasn't been a significant increase in digital payments among individuals. While electronic payments saw a predictable spike in December, immediately after demonetisation, the value as well as volume of payments has not materially picked up since then. This shows the proclivity to switch to cash as soon as it got replenished in the economy.

The tepid response of citizens to digital payments may be because it has not been able to provide as much convenience as cash. Lack of technological readiness may again be a factor behind this. While the government has made big strides in financial inclusion by providing bank accounts and Aadhaar identities to majority of the Indian population, it lags in providing uninterrupted electricity and internet access.

India ranks the lowest in technological readiness

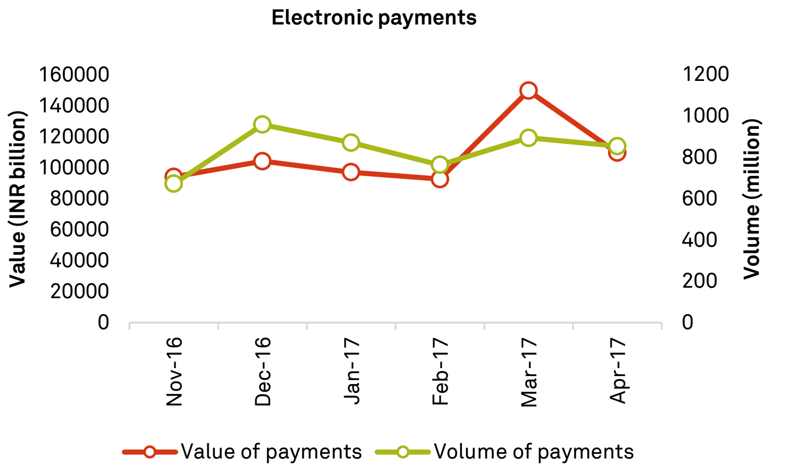
WEF's rankings for technological readiness



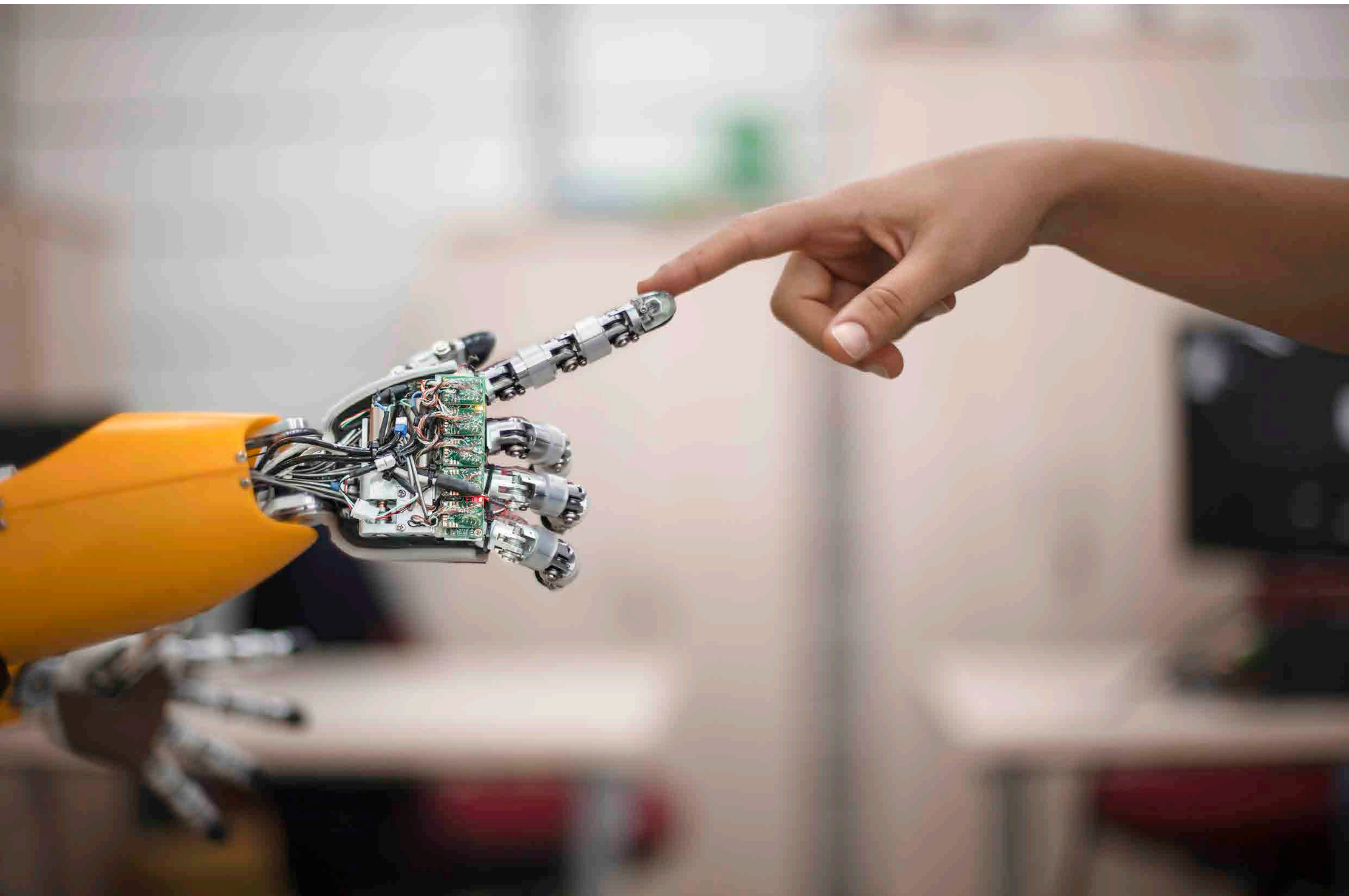
Source: World Economic Forum, CRISIL Research

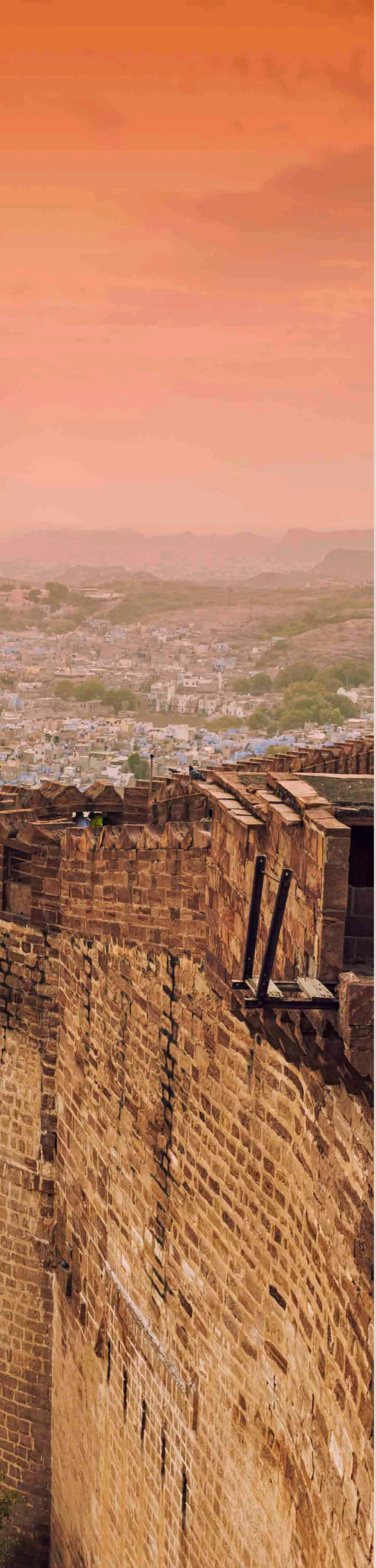
Given that some of the most important reforms of Modi government hinge on technology, having fully developed technological infrastructure is crucial for successful implementation of reforms. For this, expanding internet and electricity access must be accorded top priority by the government.

Electronic payments have not picked up much



Source: Reserve Bank of India, CRISIL Research





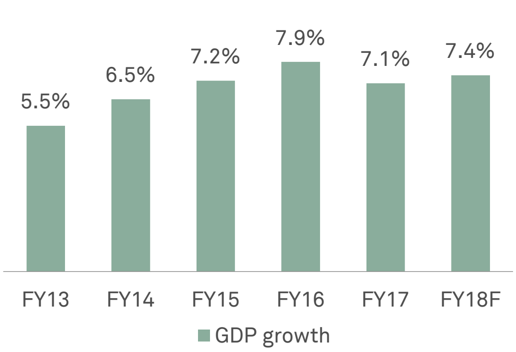
Part II
The big picture

Crucial numbers are looking good

From a global context, India stands out for three reasons – stable macros, prudent fiscal and monetary policies, and gradual but steady pace of reforms

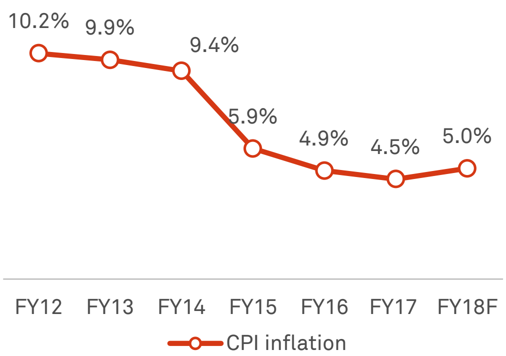
The past three years have seen a gradual improvement in India's macro story. Not only is there an improvement in the growth-inflation mix, but also it is likely to sustain. The government's focus on prudent fiscal and monetary policies is raising the ***quality of growth***, though not so much the ***rate of growth***. The government has adopted an inflation-targeting framework that provides an institutional framework for inflation control while modernising central banking. Fiscal policy has managed to stay mildly growth-focussed while managing a gradual reduction in the deficit. Yes, policies have played a big role in improving the macros, but so has good luck, mainly from a decline in global oil and commodity prices. India is a net importer of oil and commodities, so declining prices have positively impacted inflation, the merchandise import bill and the fuel subsidy burden on the exchequer. The upshot is that India's macros are a lot more stable, and this has improved resilience to global shocks.

Growth holding steady



- Over the past three years, the quality of growth has improved as it is backed by sound monetary and fiscal policies, and moderate reforms
- The demonetisation-led dip in fiscal 2017 growth is transitory
- The government has managed to keep inflation under control and bring interest rates down, which has supported private consumption, the key driver of India's GDP

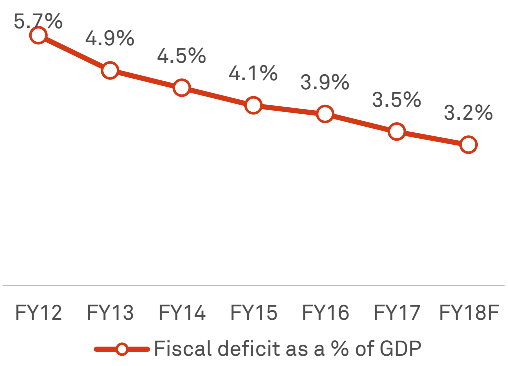
CPI inflation low and stable



- Over the past three years, CPI inflation has materially come down and stayed within the target range of the Reserve Bank of India (RBI)
- The government's initiatives to improve food supply management and lower minimum support price hikes, together with good luck on oil and commodities, have helped rein in inflation

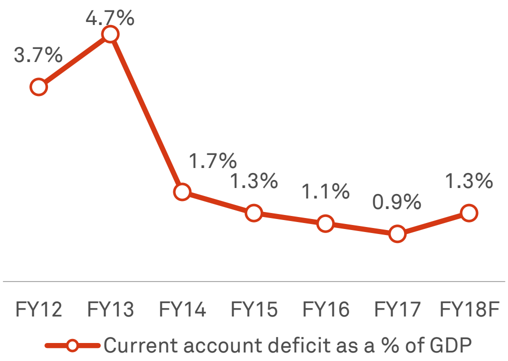
- The government's go-ahead to inflation targeting has provided an institutional framework for inflation control and also modernised central banking
- The RBI has set its medium-term inflation target at 4%, with a glide path that takes CPI-inflation to an average of 5% in the second half of fiscal 2018, and 4.6% in the fourth quarter of fiscal 2019

Fiscal rectitude helping



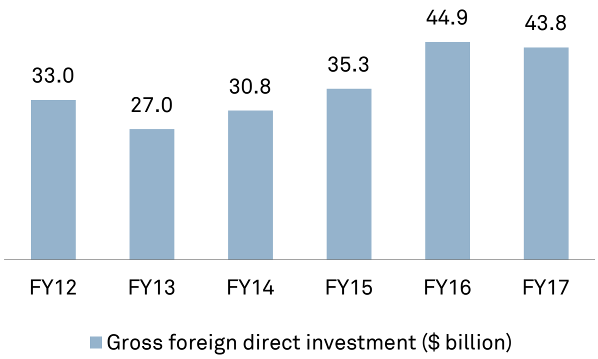
- The Modi government took forward the fiscal correction initiated by UPA government
- The dip in the global oil and commodity prices, coupled with deregulation of petrol and diesel prices, has reduced the fuel subsidy bill of the exchequer and helped bring down the deficit
- The ball is now in the government's court to reduce the fiscal deficit to 2.5% and the debt-to-GDP ratio to 40% by fiscal 2023, as recommended by the N K Singh Committee

Current account deficit narrows



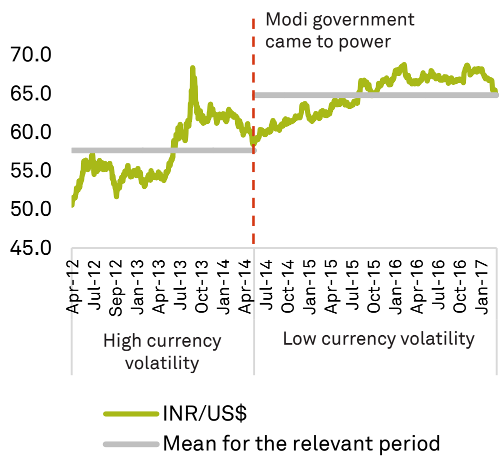
- The current account deficit (CAD) has been steadily declining and is estimated to have fallen to its lowest level of 0.9% of GDP in fiscal 2017
- The decline in CAD has been brought about by the fall in global oil and commodity prices, curbs on gold imports, and weak industrial production
- But going forward, two key risks emerge – rising global trade protectionism, which threatens exports, and increasing global commodity prices, which put upward pressure on the import bill. We expect CAD to remain within 2% of GDP over the next two fiscals

FDI inflows strong



- India ranks 10th in the world in terms of foreign direct investment (FDI) inflows, as per the United Nations Conference on Trade and Development's World Investment Report 2016
- The government has eased the norms for FDI inflows in 9 sectors, including defence, pharmaceuticals, civil aviation and single-brand retailing, which has further stimulated FDI investment
- The government has also successfully pushed through tough legislation such as the Goods and Services Tax, the Bankruptcy Code, and the Real Estate (Regulation and Development) Act, etc, boosting sentiment of foreign investors

Currency shows resilience



- From being one of the worst-performing currencies in 2013 after the 'taper tantrum' , the rupee has become one of the most stable emerging market currencies in recent past
- The coefficient of variance has reduced from 6.5% between April 2012 and May 2014 to 4.1% between June 2014 and March 2017
- Improving macroeconomic fundamentals, low CAD and proactive government policies have improved India's pull factor, keeping capital inflows buoyant

Note: F: CRISIL Forecast
Source: MOSPI, IMF, RBI, FRBM Review Committee Report (2017), CEIC, CRISIL Research

What's still challenging?

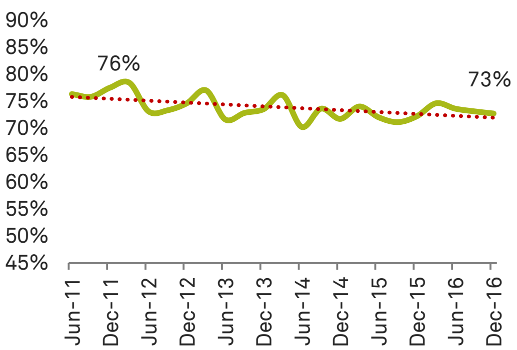
The buoyancy on macroeconomic parameters notwithstanding, there are many areas that need improvement, and slow progress is limiting upside.

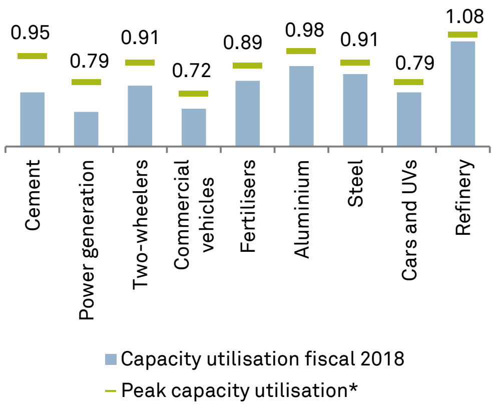
First, investments remain a drag on growth. The narrative on private investment dynamics has not changed in the past 2-3 years as factors such as weak balance sheets of companies and low capacity utilisation continue to be deterrents. The global economy is also a mixed bag. Low global growth and its falling trade intensity are adversely affecting India's exports. This, in addition to weak domestic demand, is why manufacturing capacities remain underutilised and discourage additional investments.

Second, the fiscal health of the states, which are being projected as the engines of growth, needs to improve. Over the past few years, though the Centre's fiscal deficit has fallen, that of the states has risen.

Third, the twin-balance sheet problem – of corporate indebtedness and bad loans in banking – has been curbing credit growth. Weak assets impair the ability of banks to aggressively finance growth. We expect the pace of deterioration in banking system asset quality to decelerate this fiscal, even as overall weak assets level remains elevated. In the corporate sector, topline growth for the highly leveraged ones will remain a challenge. But the implementation of GST and a pick-up in demand should help others crank it up.

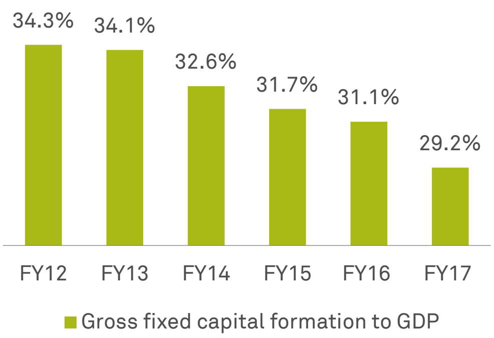
Capacity utilisation low





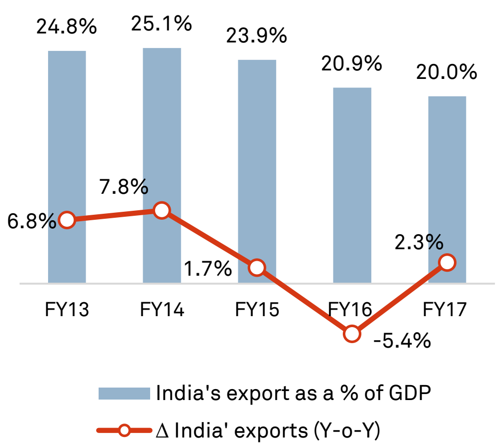
- As indicated by the RBI's Order Books, Inventory and Capacity Utilisation Survey (OBICUS), capacity utilisation has declined over the years
- CRISIL's research corroborates this, especially for key manufacturing sectors such as cement, power generation and automobiles
- Over-investments in fiscals 2011 and 2012, when the then government's stimulus boosted consumption, created excess capacity
- Capacities remained under-utilised due to weak domestic and global demand

Investment remains a drag on growth



- Investments, measured as the ratio of gross fixed capital formation to GDP, have steadily declined over the past few years
- Low capacity utilisation and weak balance sheets of companies have deterred private investment
- The government is trying to push public investment by focusing on road and rural infrastructure, etc, but this is inadequate to crowd in private investment
- Once capacity utilisation improves and companies deleverage, the ongoing reforms, coupled with India's improved global ranking for ease of doing business, will boost private investment. That is at least a year from now.

Global and domestic challenges constrain exports@

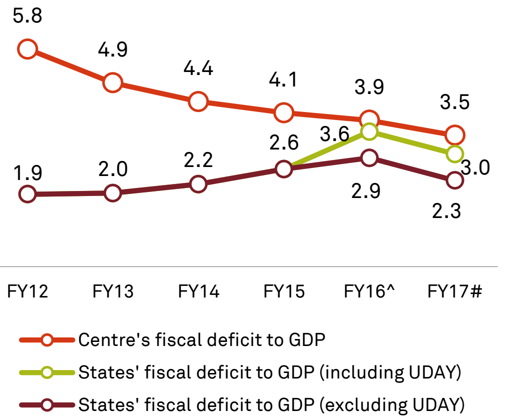


- Sluggish global growth and falling trade intensity pose a challenge to India's exports. As per IMF's database, in calendar 2016, growth in world trade (2.2%) was slower than world GDP growth (3.1%). However, in calendar 2017, the IMF has projected world trade to grow 3.8%, faster than world GDP (3.5%), although global political uncertainty and protectionism continue to pose a risk
- Besides global factors, several domestic challenges have constrained India's export competitiveness, such as continued lack of market access, limited adaptability to changing global demand, small scale of operations, and low labour and machinery productivity
- The Modi government has taken several initiatives to boost exports, including:
  - Duty-free entitlement to garment exporters for import of raw material, 24/7 customs clearance facility to promote textile exports
  - Make in India to promote manufactured goods export

– Unified tax regime under GST to eliminate entry tax and improve price competitiveness

- However, these initiatives are at nascent stages, with their impact on exports yet to be realised

Fiscal health of states weakening relative to Centre

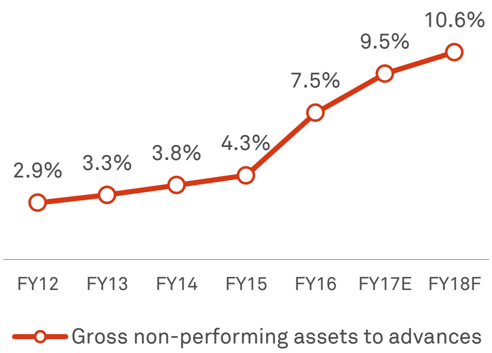


- Although the Centre's fiscal deficit has dipped, that of the states has bumped up

- States' deficit has worsened due to multiple factors, including an increase in social infrastructure expenditure and underachievement of their own-tax collection targets

- Moving forward, the implementation of the Pay Commission revision and Ujwal Discom Assurance Yojana (UDAY) bonds would further worsen the fiscal deficit of the states

Bad assets rising

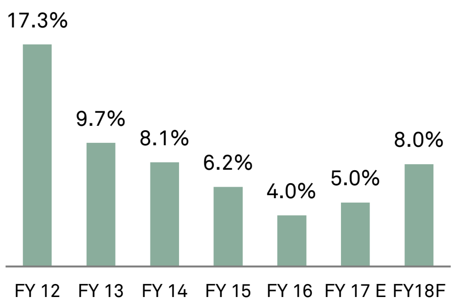


- NPAs of scheduled commercial banks have been rising

- CRISIL believes that while slippages into non-performing assets (NPAs) for the banking system will begin to decline in fiscal 2018, overall, NPAs would remain elevated

- Since rising NPAs impair banks' ability to aggressively finance growth, resolution of NPAs is the key near-term challenge for the government

India Inc revenues$ stuck in low gear



- The topline of India Inc is expected to improve after remaining weak during the initial three years of the Modi government

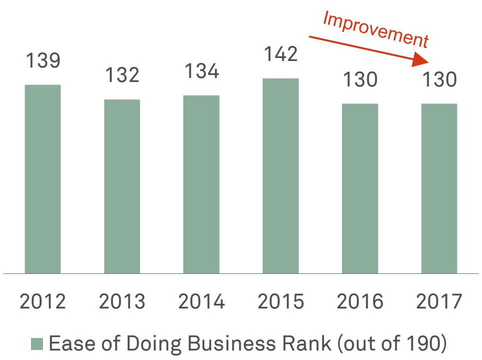
- The government's policy initiatives such as GST will aid gradual recovery in topline growth

*Note: *Annual average peak capacity utilisation in last 10 years; @Export data includes exports of goods and services at constant prices (2011-12 series); ^Actual for Centre's fiscal deficit and the revised estimate for states' fiscal deficit; #Revised estimate for Centre's fiscal deficit and budget estimate for states' fiscal deficit; $Includes data for key NSE-listed companies excluding financial and oil companies; E: Estimate; F: CRISIL forecast*
Source: MOSPI, IMF, RBI, FRBM Review Committee Report (2017), CEIC, CRISIL Research, Colors of growth – CRISIL's India Outlook report for fiscal 2018

Globally, India stands tall in many respects

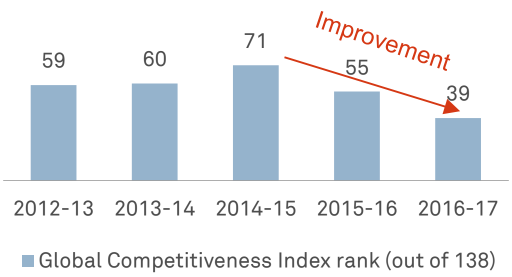
The improvement and stability in India's macros, certainty in policies and continued focus on raising the growth potential of the economy are being noticed favourably globally. The past few years have seen improvements in India's global position on many a parameter. Naturally, the country's attractiveness as an investment destination is increasing. However, India has a long way to go in achieving balanced and equitable growth.

Ease of doing business ranking has improved



- India's ease of doing business rank, as assigned by the World Bank, improved a tad in 2016 and has been maintained at that spot
- The reasons for the improvement in rank are:
  - *Getting electricity:* streamlining of the process of getting electricity connection
  - *Paying taxes:* introduction of electronic payment system for employee insurance contribution
  - *Reducing trade barriers:* launch of an e-commerce portal (ICEGATE) and simplification of procedure for intra- and international trading
  - *Enforcing contracts:* creation of dedicated judicial divisions to resolve commercial cases

Global competitiveness index ranking has improved significantly

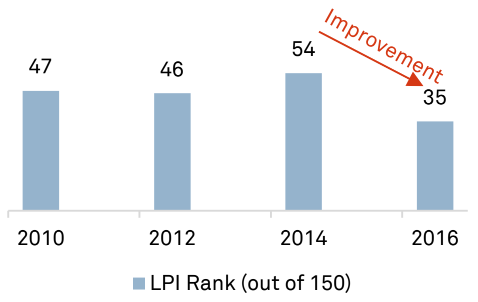


- India's global competitiveness index ranking, assigned by the World Economic Forum, has seen significant improvement in the past two years
- Steps taken by the Modi government that improved the ranking include:
  - *Infrastructure:* increased public investment and speedy approval procedures; electricity distribution through UDAY scheme, rural road construction through Pradhan Mantri Gram Sadak Yojana,

affordable housing provision through Pradhan Mantri Awas Yojana

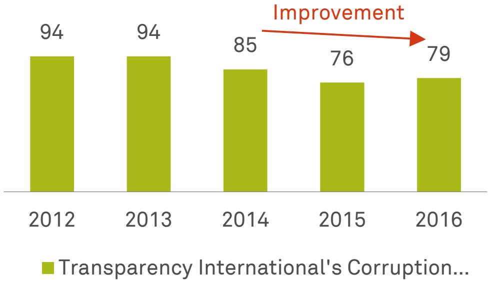
- *Institutions:* introduction of voluntary disclosure scheme, Benami Transactions (Prohibition) Act, digitalisation of government processes
- *Macroeconomic environment:* fiscal consolidation, inflation targeting
- *Goods market efficiency: APMC Act, e-NAM initiative and progress on GST*

Logistics performance index ranking has improved



- As per the World Bank's Logistics Performance Index, a biennial measure of international supply chain efficiency, India's ranking improved from 54th in 2014 to 35th in 2016
- Of the six components analysed in LPI, India outshined in four, namely efficiency of customs and border clearance, quality of logistics services, ability of tracking and tracing consignments, and quality of trade and transport infrastructure
- The government's Make in India initiative and improvements in infrastructure have helped in improving the logistical performance

Corruption perception ranking has improved

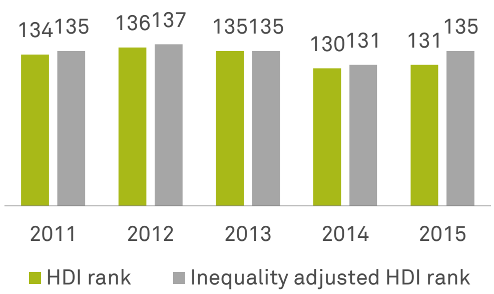


- While India's corruption perception index ranking as assigned by Transparency International improved from 85th in 2014 to 79th in 2016, the study suggested India has a long way to go in its battle against corruption
- As per the study, 53% of the citizens believe the government is doing well in fighting corruption, while 35% believe it has fared badly
- However, India posted the highest bribery rate of all the countries surveyed, where nearly seven in 10

people who had accessed public services had paid a bribe

- The government's demonetisation move, passage of GST Bills, and a push towards digitalisation may translate into a better score in the corruption perception index moving forward

But, HDI ranking dipped



- India's HDI ranking, as assigned by UNDP, fell from 130th in 2014 to 131 in 2015
- What dragged down the score?
  - Persistent inequality reflected in low human development attainments of the most marginalised groups, including Scheduled Castes, tribal and rural populations, women, transgenders, people living with HIV and migrants, have brought down India's HDI score
  - The Government has introduced various schemes to bring about inclusive growth, but its impact has not been fully realised
- The following steps initiated by the government can improve the HDI score if followed vigorously:
  - Financial inclusion through Pradhan Mantri Jan Dhan Yojana
  - Education and skill development through introducing schemes like 'Padhe Bharat, Badhe Bharat', 'Skill India' and continuing with the UPA government's 'Sarva Shiksha Abhiyan' and Mid-Day Meal Scheme
  - Sanitation improvement through Swachh Bharat Mission

Source: World Bank, IMF, Transparency International, UNDP


PAKISTAN
Lahore
New Delhi
NEPAL
Katmandu
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Bangalore
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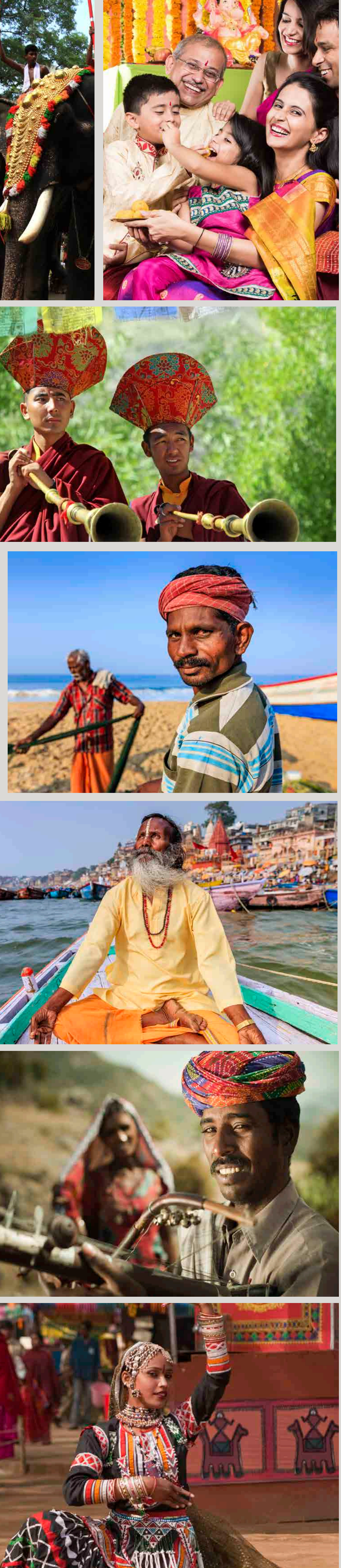


Part III

Over to the states now

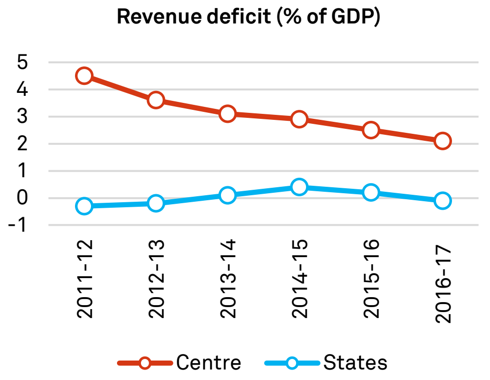
Two key things have happened on the fiscal front – more aptly, in Centre-state fiscal relationship – under the present regime. First, the dismantling of the Planning Commission has meant that fiscal transfers from the Centre to the states, which was earlier the remit of implementing agencies, is now the job of the states. Second, the acceptance of the 14th Finance Commission recommendations have led to increased devolution of the central divisible pool of taxes – from 32% to 42% – starting fiscal 2016. Essentially, these moves have meant greater flexibility for states on the money's usage.

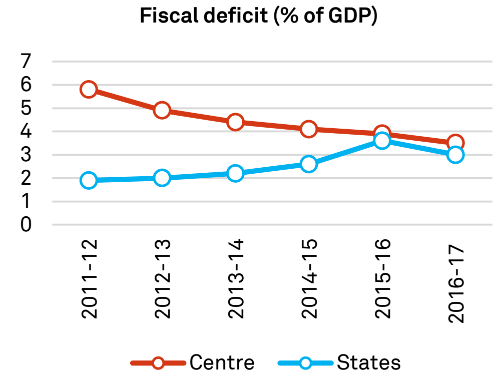
In the following sections, we cover how the fiscal situation in the country has evolved over the past few years and what has been the impact of the above mentioned moves on state finances.

Centre-state dichotomy

Over the past few years, there has been a trend reversal in the fiscal health of the Centre and the states. The central government has been improving its fiscal health since fiscal 2012. The trend has continued in the current regime, which took the fiscal consolidation agenda forward. The Centre's fiscal deficit ratio (FDR), i.e. fiscal deficit as a percentage of GDP, has been brought down from 5.8% in fiscal 2012 to 3.9% in 2016 and further to 3.5% in 2017. Likewise, the revenue deficit ratio (RDR) improved from 4.5% to 2.5% and further to 2.1%.

Centre-state fiscal health dichotomy





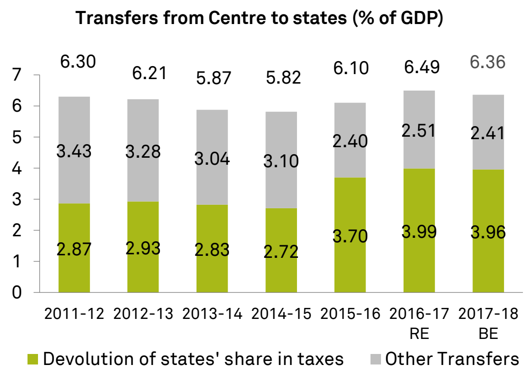
Source: RBI, Note: 2016-17 data for states are budget estimates (BE). Revised estimates are likely to be higher

On the other hand, states have been less prudent, racking up a combined revenue deficit in fiscal 2014 from a surplus situation in the past. On fiscal deficit, the picture is no better, with the combined number rising 100 bps from 2.6% in fiscal 2015 to 3.6% in 2016, after 75%[1] of the discom debt were taken over by states in accordance with the UDAY scheme. Shorn of UDAY, the ratio would have risen to 2.9%. While states budgeted a lower fiscal deficit of 3% (including UDAY) in fiscal 2017, the recent study on state finances by the Reserve Bank of India[2] (RBI) suggests a slippage of 0.4 percentage points on the basis of information available for 25 states. Broadly, the trend shows a worsening in the fiscal health of states with or without UDAY. Further pressure is expected next fiscal on account of increased interest payments for UDAY bonds, implementation of the Seventh Pay Commission recommendations, and farm loan waivers in select states.

Paradigm shift in central transfers

Based on the recommendations of 14th Finance Commission, the states' share in the divisible pool of taxes was increased from 32% to 42%. As a result, overall transfers from the Centre to the states have seen a marginal uptick since fiscal 2016. To compensate for the higher outgo from the tax kitty to the states, some of the transfers that earlier used to go towards centrally sponsored schemes were withdrawn. Therefore, the net gain for the states was not much. But interestingly, a greater part of the transfers that states receive from the Centre became unbound in this new regime, which has meant greater flexibility to use the money. The share of taxes in overall transfers since fiscal 2016 has exceeded the share of other transfers[2].

Nature of central transfers to states has undergone a change



Source: Ministry of Finance, CRISIL Research

But expenditure mix seems to be improving

However, more unencumbered money from the Centre hasn't exactly translated into better fiscal health of the states. Those that were running revenue deficits continue to do so. In fact, some states with revenue surplus (Andhra Pradesh, Rajasthan and Tamil Nadu) now have revenue deficit *(see appendix for details).*

As for fiscal deficit, we have already seen that at the aggregate level, the situation has worsened in the past few years. Even as the FDR – sans UDAY – of all states combined has remained below 3% (the Fiscal Responsibility and

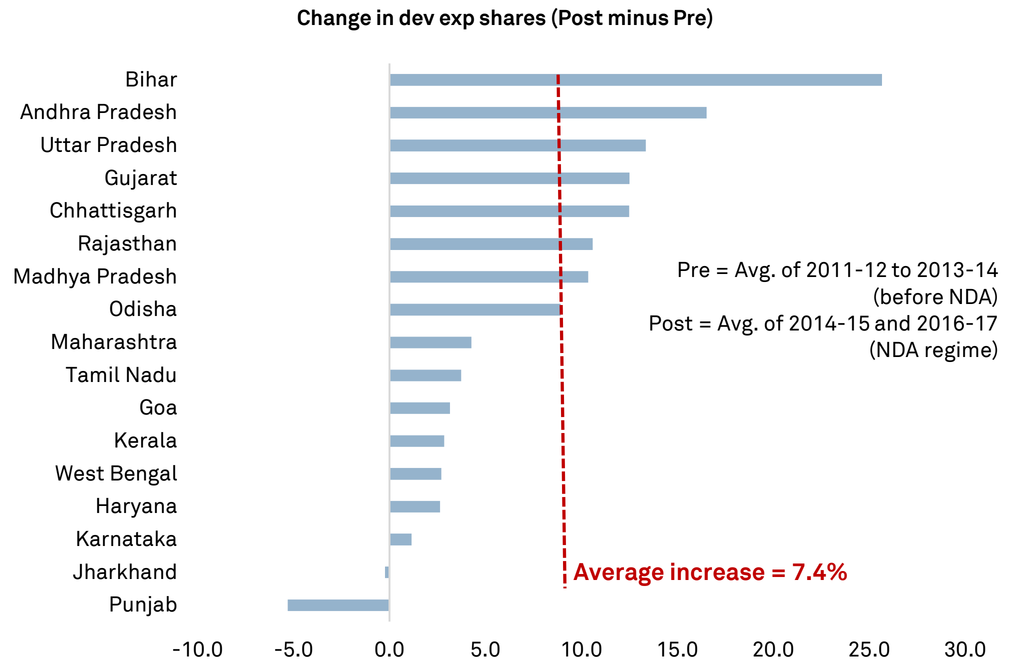
[1]This is to be done in two tranches – 50% in fiscal 2016 and 25% in fiscal 2017.
[2]State Finances: A study of budgets of 2016-17, RBI, May 2017

Budget Management Act-based target for the states), many individually have been above that mark for some time *(see Appendix).* States which are vulnerable on this count are Bihar, Kerala, Rajasthan, Jharkhand, Andhra Pradesh, Goa, Haryana and Uttar Pradesh.

Even as the fiscal deficit of many states has increased and is above the 3% mark, the greater quantum of unencumbered money flowing from the Centre to the states has resulted in the expenditure mix of the states improving. An analysis of expenditure shows the share of developmental expenditure (revenue and capital combined and including loans and advances) rising for almost all states under the Modi regime *(see chart).* While it is true that increased loans and advances to power projects on account of UDAY jacked up the share of development expenditure for some states, it was not the only reason. They also spent more on areas such as irrigation, roads, health and education. States where development expenditure reduced were Karnataka, Jharkhand and Punjab.

To be sure, the practice of giving money directly to the implementing agencies was done away with in fiscal 2015 and from fiscal 2016, higher tax devolutions were also put in place. So, in the chart below, we have plotted the difference in the share of developmental expenditure before and after fiscal 2015. Pertinently, some states such as Goa, Karnataka, Haryana already had large development expenditure shares and hence didn't show a big increase *(see chart)*. Bihar is a good example where local leadership plays a key role on spending for the right causes.

Share of developmental expenditure for most states has risen



Source: Ministry of Finance, CRISIL Research

Also, states are doing their bit to push the reforms agenda

While the central government exercises greater control over policies at a broader level, including areas such as market access, taxation, trade liberalisation, etc, it is the states whose role becomes dominant when it comes to creating a conducive environment for doing business or attracting investments. Broadly speaking, the task of implementation of reforms is entrusted more with the states. This is so because, first, the central government may not always be in a position to undertake reforms which require legislative actions, and second, many key areas of reforms (agriculture, land, etc) are state subjects. As such, creation of basic physical (water, electricity, etc) and social (health, education, etc) infrastructure depends on effective implementation by state level agencies.

The NDA government has, therefore, deftly made a conscious effort to push the states to undertake key reforms in the spirit of competitive federalism. And to track the implementation of this agenda, the government, through Department of Industrial Policy and Promotion (DIPP) and NITI Aayog, has asked for states to be ranked on various reform/ implementation related parameters. We look at four key reform areas – agriculture, real estate, land and labour – and try to assess the progress different states have made under each of these.

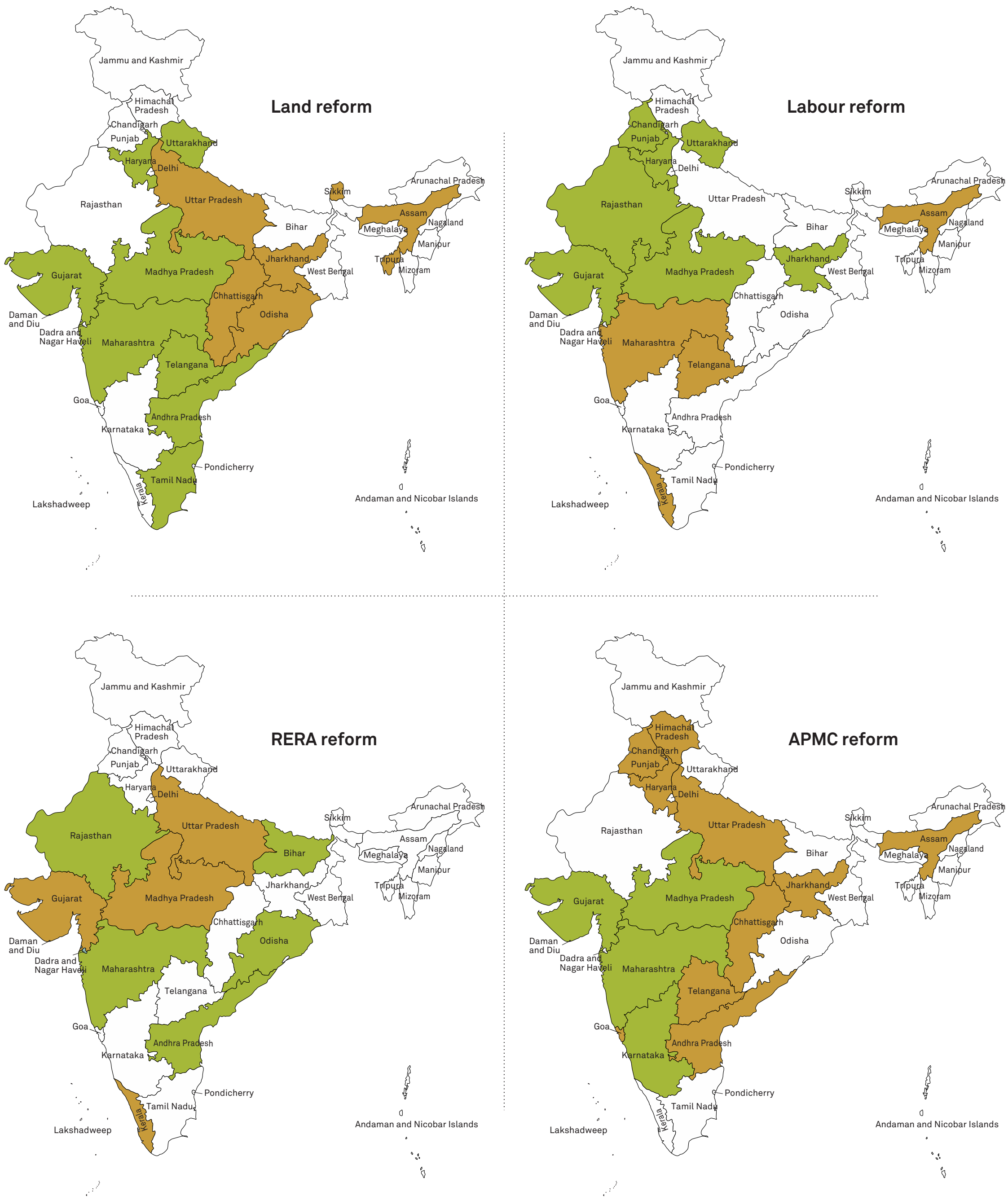
Which states are leading on reforms?

	Per capita income* (Rs.)	Land	Labour	Rera	Agri
Goa	205,185				
Chandigarh	192,951				
Sikkim	177,441				
Haryana	124,092				
Uttarakhand	116,557				
Kerala	115,848				
Maharashtra	113,378				
Gujarat	109,846				
Karnataka	108,908				
Tamil Nadu	106,034				
Telangana	105,488				
Himachal Pradesh	105,269				
Punjab	96,638				
Andhra Pradesh	79,441				
Chhattisgarh	64,841				
Rajasthan	64,001				
Tripura	58,888				
Odisha	54,926				
Assam	45,692				
Jharkhand	48,549				
Madhya Pradesh	44,110				
Uttar Pradesh	35,693				
Bihar	25,399				

States with maximum reforms *States with some reforms* *States with minimal or nil reforms*

Source: CSO, CRISIL Research Note:States marked in red are NDA led
**2014-15 current prices*

Status of various reforms across India



States having undertaken most reforms

States having undertaken some reforms

States having undertaken negligible or no reforms

Source: DIPP, NITI Aayog, various ministry websites, CRISIL Research

It is important to keep in mind that there isn't one key step or action that would determine whether a particular reform has happened, rather a combination of steps and relentless follow-through.

Also, not all states – the ones which have undertaken reforms – can be painted with the same brush. For instance, 15 states have varying degrees of land reforms and are at different stages of implementation. In the map, we colour the states which have been aggressive with the reforms in green and those which have taken some steps in yellow. The states that are not coloured are laggards or have hardly initiated any steps.

What is evident is that the NDA-led states have been more aggressive on pushing reforms. Which, perhaps, explains the victories in state polls such as the recent one in UP, where NDA didn't have the popular mandate for a long time. Interestingly, it's not just the richer states that are stepping up on reforms. The table, which lists states based on per capita income, shows this is happening across strata. Clearly, it is the strong Centre-state relationship that is driving the reforms agenda.

Agriculture reforms

Agricultural reform is a key agenda for the NDA government, which aims to double farm incomes by 2022. Even though the Centre cannot implement policies related to agricultural marketing – since it is a state subject – it has been pushing the states to amend their respective Agricultural Produce Market Committee (APMC) Acts to give more flexible market access and fair prices to the farmers. Broadly, the state governments are being advised to modify their APMC Acts in order to have a single licence and single point of levy of market fee at the state level, and gradually move towards a single licence and single point of levy of market fee at the national level. To buttress these objectives, the government in April 2016 also launched eNAM, a pan-India electronic trading portal that networks the existing APMC mandis to create a unified national market for agricultural commodities.

Despite the thrust from the central government, the response of different states to reform agriculture – mostly in terms of amending their APMC Acts – has been varied. According to a National Institute of Transforming India (NITI) Aayog report[7] , Maharashtra has implemented most of the marketing reforms and offers the best environment for doing agribusiness amongst all states. Karnataka, too, is considered very progressive in implementing agricultural marketing reforms and is the first and only state to have its own electronic unified market platform (ReMS) having all the provisions envisaged under the NDA government's eNAM. Gujarat, Rajasthan and Maharashtra closely follow. On the other hand, some of the big states, such as Uttar Pradesh, Punjab and West Bengal, which have a large share of agriculture in their GDP, remain laggards in agricultural reforms.

The NDA government came out with a new draft model law – the Agricultural Produce and Livestock Marketing (Promotion and Facilitating) Act, 2017 – in April 2017 to further liberalise trade in farm produce and ensure better price realisation for farmers. The new model Act takes care of some of the anomalies still prevalent in different states, especially with regard to removal of middlemen in the APMC markets and freedom for the farmer to sell his produce directly as per his discretion

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[7] *Agricultural marketing and farmer friendly reforms across Indian states and UTs, Ramesh Chand and Jaspal Singh, October 2016*

by encouraging entry of private players, development of wholesale markets and direct marketing, etc. While most states have applauded the new law and shown interest in amending their own APMC Acts on the same lines, it remains to be seen how well and how many actually do so.

Real estate

Real estate has been a big revenue generator for the government. However, the sector does not have a regulatory body and there have been many instances of people falling prey to fraudulent practices of some real estate developers. To reduce the vulnerability of buyers and to put in place a regulatory body (Real Estate Regulatory Authority) to protect home buyers as well as help boost investments in the real estate industry, the NDA government passed the Real Estate (Regulation and Development) Act – RERA Act – in March 2016.

The RERA Act came into force on May 1, 2017. But the progress of states has been tardy – most don't seem to be ready for the Act whether because of lack of infrastructure or the resources/ willingness to implement it. Only 13 states and union territories have notified the rules so far. Unless a state notifies the rules and sets up its own Real Estate Regulatory Authority, the law will not become operational.

The states that have notified the rules are Andhra Pradesh, Bihar, Gujarat, Madhya Pradesh, Maharashtra, Odisha, Rajasthan and Uttar Pradesh. Of these, only three states – Madhya Pradesh, Maharashtra and Rajasthan – have appointed a regulator. Besides Maharashtra, no other state has yet come up with a website for developers and brokers to register or apply for new projects under the new Act.

Not only have the states given a lukewarm response to RERA, but also most of those that have notified the rules have done so in a diluted form and are a departure from the Central RERA Act. For instance, many states have not brought the ongoing projects under RERA, while for some, there is lack of clarity in the rules governing the payment schedule. In a nutshell, while RERA is a welcome move and a step in the right direction, it would take a while and strong commitment from the state governments for it to yield the desired results.

Land

It is well known that firms find it difficult to acquire land in India and this often results in a tussle between farmers, industrialists and the government, leading to projects getting delayed, relocated or even shelved. According to a recent CPR report[8], inaccurate land records, undervaluation of sale deeds and the absence of land markets in rural areas have led to lower compensations and more litigation.

To mitigate the issue, the NDA government introduced the Right to Fair Compensation and Transparency in Land Acquisition, Rehabilitation and Resettlement (Amendment) Bill in Parliament in February 2015. The Bill was an amendment to the Right to Fair Compensation and Transparency in Land Acquisition, Rehabilitation and Resettlement Act, 2013 (LARR Act, 2013). But due to lack of support in the Upper House, the amendment Bill could not get through. The NDA government then, after consultation with the NITI Aayog in July

[8]*Land acquisition in India: A review of Supreme court cases 1950-2016, Namita Wah,i et al, Centre for Policy Research, 2017*

2015, encouraged States to draft and pass their own laws for land acquisition and get them approved by the President.

Post this directive, many states such as Gujarat, Tamil Nadu and Rajasthan took the lead in easing their own land acquisition laws. Other states such as Andhra Pradesh, Telangana and Haryana followed. The areas addressed by these states are primarily availability of land, land allotment and registration of property. While allowing the states to amend their respective land Acts may not be the best solution as it leads to dilution of the Central Act, it nevertheless gives a positive signal to the investors.

Labour

Labour reform is another priority area for the NDA government, especially in the context of making laws flexible to aid its ambitious Make in India programme. Like land and agriculture, the Centre has pushed the labour reform agenda, too, to the states. But barring Rajasthan, Haryana, Jharkhand, Maharashtra and Telangana, not much action has been seen from the states on this front.

The extent of reforms by different states has been varied. Rajasthan has been the pioneer in labour reforms. It relaxed the provisions of the Factories Act, Industrial Disputes Act, Apprentices Act and Contract Labour Act. Following Rajasthan was another BJP-led state, Madhya Pradesh, which amended at least 20 labour laws, including 17 central ones, such as the Industrial Disputes Act, Factories Act and Shops and Establishments Act. Maharashtra amended the Contract Labour (Regulation and Abolition) Act to make it applicable only to establishments in which 50 or more workers are employed. Flexibility to retrench without seeking the government's permission is a key feature of labour reforms initiated by different states.

Meanwhile, the NDA government plans to compress many labour laws (around 40) into a set of four or five to help achieve better compliance and enforcement by the states.

The upshot

While increasing the share of expenditure on the development head is a healthy trend, it is also important to keep the overall fiscal deficit in check. The increase in indebtedness of states on account of UDAY bonds (which would start reflecting in their books from fiscal 2018) and the implementation of the Seventh Pay Commission hikes at the state level would mean that even states with FDR below 3% currently would start feeling the strain, not to mention those above it.

The Centre has acted responsibly in gradually reducing its fiscal and revenue deficits, and it is now for the states to follow the fiscal consolidation path. In a positive trend, states are being pushed to undertake reforms by amending their own Acts, be it agriculture, labour or land. While as of now it is the NDA aligned states which are spearheading the reform agenda, the other states should not stay away for long and embrace the competitive federalism spirit.

Part IV

Legislative math augurs well for NDA

A more favourable political landscape will help surmount legislative hurdles

One of the most important lessons from the demonetisation drive of last year was that it is possible for a government to take hard decisions without eroding political capital. The recent election wins of the National Democratic Alliance (NDA) in key states of Uttar Pradesh, Uttarakhand and Goa bears this out.

The political developments have two major implications for the government at the Centre:

1. **Thumbs-up to reforms:** A clear majority for NDA in the Upper House of Parliament can smoothen the reform process. And better Centre-state coordination can improve the ability to push hard decisions on land and labour reforms across states.

2. **More muscle for 2019 polls:** If political strength continues to build up at the state level, it can obviate the need for populist measures as the political cycle kicks in before the 2019 general elections. It also means that gains made on the fiscal and monetary front over the past three years are unlikely to be reversed.

The key takeaway therefore – the government can now dare to go beyond the political cycle and take hard decisions with far-reaching implications without worrying too much about the adverse political consequences.

Rajya Sabha seat arithmetic can change dramatically...

...provided the NDA replicates recent state wins elsewhere

Recent state election wins directly translate into more seats for the NDA in the Rajya Sabha in coming years.

Currently, the NDA enjoys majority in the Lok Sabha, with 339 of the 543 elected seats. However, in the Rajya Sabha, it has just 74 of the 245 seats (including 233 elected and 12 nominated members) – well short of the 123 seats required to secure majority.

Lack of majority in Rajya Sabha can be an impediment to strong legislative actions, though not a necessary condition. Key Bills related to Goods and Services Tax (GST), Bankruptcy Code and Aadhaar did see the light of the day despite NDA's lack of seat majority in the house. But a majority can ensure smoother passage of key legislations.

Going by the current seat metrics in the Rajya Sabha, the NDA will take till at least 2020 to cross the 100 seat mark, and until 2022 to reach majority. And this will depend significantly on whether their recent state victories are replicated in other states, too.

It will especially be important for the NDA to secure wins in Karnataka, Kerala, Tamil Nadu and Odisha, where it currently has no stronghold. These four states alone can add 33 seats to the NDA's tally over the next five years, the bulk of them from Karnataka and Odisha. This is the best case scenario[9] and therefore illustrates the maximum seats the NDA can get based on electoral victories at the state level.

The worst case scenario assumes the NDA does not get the required majority in any of the forthcoming state elections and even fails to retain some of its existing seats. In this case, too, there is an increase in seat count to 103 by 2022, mainly resulting from state wins seen so far. The actual seat count is likely to be somewhere between these two extremes.

The year 2020 will be the big game changer in the seat count math as 72 members will see their terms expire, and many of them will either get to retain their seats or give way to others. Of these 72 seats, 10 are from Uttar Pradesh where the NDA will clearly find entry. For the rest, replicating recent wins in upcoming state elections will be crucial in the lead up to 2020.

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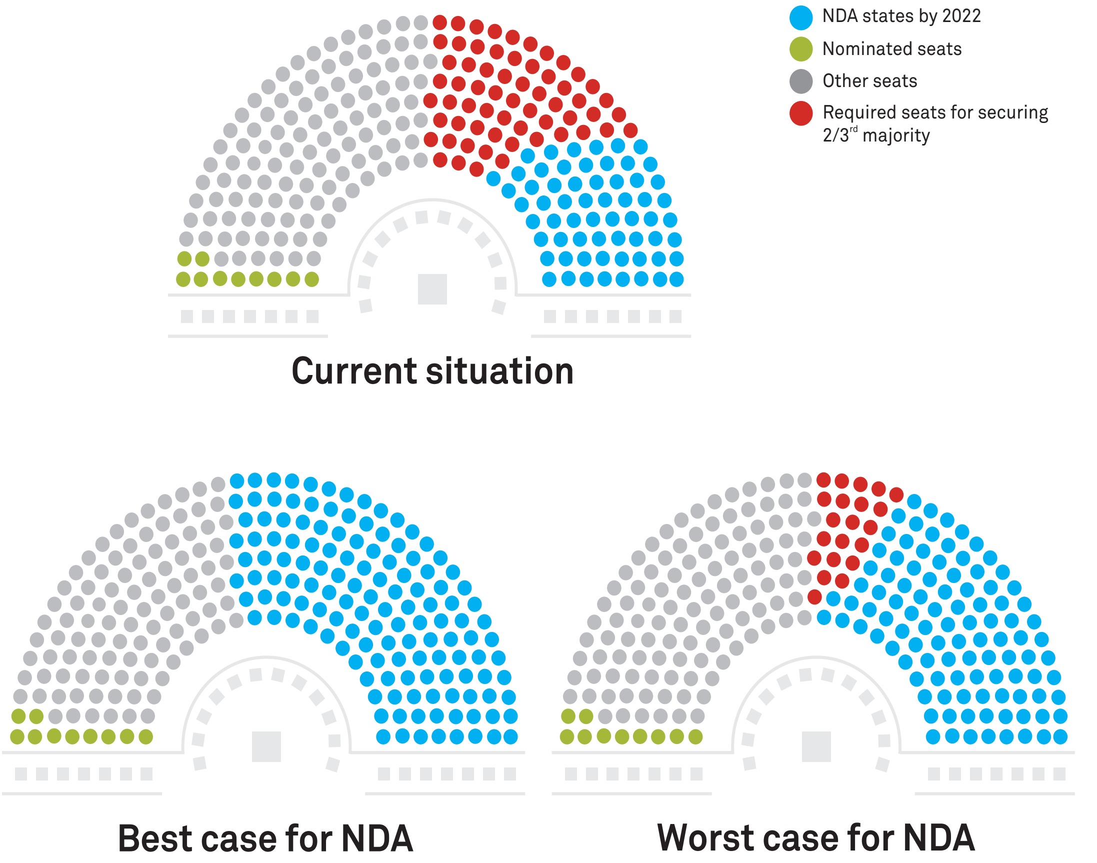
[9]Best case assumes all forthcoming state elections are won by NDA with 2/3rd majority. The worst case assumes elections are not won. The number of seats expiring each year for each state is taken from Rajya Sabha. In each state, the minimum number of votes required by each candidate to win a seat in RS is computed using the given formula; Min # of votes required = ((# of seats in state assembly / (Seats expiring +1)) +1). Based upon the number of NDA members in state assembly, the votes that they can give each RS candidate from their party is computed. The rest go to non-NDA Rajya Sabha candidates.

Rajya Sabha seat scenario over the next five years



Source: Rajya Sabha, CRISIL Research

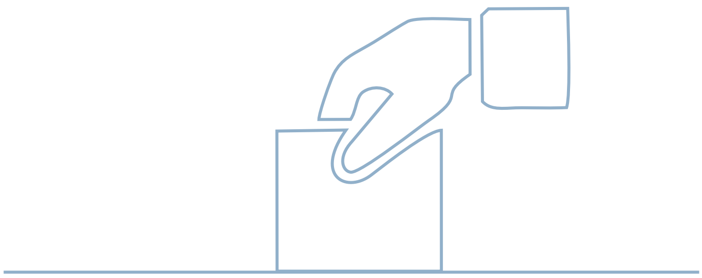
Victory in state polls can aid policy rollouts

The least this will facilitate is Centre-state coordination on difficult decisions

State election wins are also important because they allow for better coordination with central policies. They will also give the current government the muscle to take difficult reform decisions, to be implemented across states.

Today, the two key structural impediments to improving the investment climate in the economy are unavailability of land and inflexible labour laws. Though a few states have embraced land and real estate regulation and eased labour laws (see table 'Which states are leading on reforms' in Part III), a pan-India approach across states is missing. Similarly, while building transport infrastructure is a key focus area for the Centre, the progress at the state level has been tardy. Also, efforts that support initiatives like the 'Make in India', building of industrial corridors and smart cities can be fast-tracked and the decision making hastened as states work together with the Centre on more cordial terms.

Today, 17 of the 31 states are led by the NDA government, and in the run up to the next general elections, 6 non-NDA ruled states will face elections. It is crucial for the NDA to secure victory in at least some of these states to increase its presence and power.



Upcoming state elections

2018	2019	2020	2021	2022
1. Chhattisgarh*	1.Andhra Pradesh*	1. Bihar	1. Assam*	1. Goa*
2. Madhya Pradesh*	2. Arunachal Pradesh*	2. Delhi	2. Kerala	2. Manipur*
3. Nagaland*	3. Haryana*		3. Tamil Nadu	3. Uttar Pradesh*
4. Rajasthan*	4. J&K*		4. West Bengal	4. Uttarakhand*
5. Karnataka	5. Jharkhand*		5. Puducherry	5. Punjab
6. Meghalaya	6. Maharashtra*			
7. Mizoram	7. Sikkim*			
8. Tripura	8. Odisha			
	9. Telangana			

**Where NDA is in power currently*
Source: CRISIL Research

More muscle for NDA going into 2019 polls, too

Growing political strength at the state level is a reflection of the NDA government's growing political backing. This should give the government firmer muscles going into the 2019 general elections.

The upshot

2016 ended with a historic economic event in India – demonetisation – a move that saw the bulk of cash in the hands of people vanish overnight. What followed was a mix of uncertainty and fear, and also abundant criticism questioning the timing and need of such a move, and the efficacy of its implementation. Yet, the government's narrative on the benefits of the action – curbing black economy, stamping out illegal funding of activities (including funding of terrorism), elimination of counterfeit notes and pushing the economy towards transacting electronically – struck a chord with the masses.

Now, our best case shows, and if NDA also triumphs in the 2019 general elections, it would mean a single party majority in both the Houses of Parliament. The last time this was witnessed was around 1975. But even in the worst case possibility, the NDA government will see a larger representation in the Upper House as well as at the state level compared with where it started in 2014.

All in all, the acceptability of reforms is much higher now as the political landscape changes. This suggest the government must now dare to go beyond the political cycle and take tough decisions that structurally address the key concerns facing the economy – the need to raise employment, boost growth potential, improve investment climate and tame inflation.

Appendix

Fiscal deficit (% of GDP)

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Andhra Pradesh	2.4	2.3	2.1	6.0	2.8	2.9
Bihar	2.4	2.2	2.4	3.0	6.9	3.4
Chhattisgarh	0.6	1.6	2.7	3.4	2.6	2.8
Goa	2.5	2.7	2.8	2.3	6.8	6.8
Gujarat	1.8	2.5	2.4	2.0	2.2	2.2
Haryana	2.4	3.0	2.1	2.9	4.3	6.6
Jharkhand	1.4	2.2	1.3	3.0	4.7	2.1
Karnataka	2.7	2.8	2.8	2.1	2.0	2.2
Kerala	4.1	4.3	4.3	3.5	3.0	3.5
Madhya Pradesh	1.9	2.6	2.3	2.4	3.9	3.9
Maharashtra	1.7	1.0	1.7	1.8	1.9	1.6
Odisha	-0.3	0.0	1.7	1.7	2.9	3.8
Punjab	3.3	3.3	2.8	2.9	3.0	2.9
Rajasthan	0.9	1.8	2.9	3.1	10.0	5.6
Tamil Nadu	2.6	2.2	2.4	2.5	2.7	3.0
Uttar Pradesh	2.3	2.5	2.8	1.8	2.9	3.6
Telangana	-	-	-	3.1	5.6	3.9
West Bengal	3.3	3.2	3.6	3.4	2.7	2.0

Source: RBI
Note: 2015-16 figures are revised estimates (RE) and 2016-17 are budget estimates (BE)

Revenue deficit (% of GDP)

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Andhra Pradesh	-0.5	-0.2	0	4.6-	0.7	0.7
Bihar	-2	0.2	-1.9	-1.6	0.4	-3.1
Chhattisgarh	-2.3	-1.3	0.4	0.7	-1.5	-1.7
Goa	-0.8	0.9	0.7	-0.7	0.3	-0.3
Gujarat	-0.5	-0.6	-0.6	-0.6	-0.4	-0.3
Haryana	0.5	1.3	1.0	1.9	2.2	2.2
Jharkhand	-1	-2.6	-1.6	0.1	-2.2	-2.6
Karnataka	-1	-0.2	-0.1	-0.1	-0.1	0.0
Kerala	2.5	0.9	2.9	2.6	1.8	2.0
Madhya Pradesh	-3.2	-1.8	-1.4	-1.3	-0.1	-0.5
Maharashtra	0.2	0	0.3	0.7	0.5	0.2
Odisha	-2.6	-1.1	-1.2	-1.8	-2.0	-1.0
Punjab	2.6	1.6	2.1	2.1	1.8	1.8
Rajasthan	-0.8	-0.2	0.2	0.5	0.8	1.1
Tamil Nadu	-0.2	-0.1	0.2	0.6	0.8	1.2
Telangana	-	-	-	-0.1	0.0	-0.6
Uttar Pradesh	-1	-0.7	-1.2	-2.1	-1.6	-2.2
West Bengal	2.7	2.1	2.7	2.1	1.0	0.0

Source: RBI
Note: 2015-16 figures are revised estimates (RE) and 2016-17 are budget estimates (BE)

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