Event
Beginning a New Era: India's Union Budget 2015-16

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Adam Posen: Good morning everyone. Welcome back to the Peterson Institute for International Economics. Today is a special day for all of us, not just those of us here which includes many good friends, all the new but also many people we hope in the subcontinent and throughout the world who are watching today’s programming live streamed on pie.com It is my privilege as President of the Peterson Institute to introduce not only Dr. Arvind Subramanian, our not so prodigal rather our very distinguished son back to home for a discussion of Beginning a New Era: India’s Union Budget 2015-16. I will come back to all that in a moment, but we are partnered today with two distinguished organizations who’ve made it possible to convene such a distinguished group for Arvind’s made in US speech as a policymaker.

We have with us today Dr. Mukesh Aghi, the new President of the US-India Business Council. He formally joined the USIBC at the beginning of this month. Prior to that appointment, he was chief executive and member of the board of directors at L&T Infotech. He’s previously been chairman and CEO of Steria Asia Pacific, president of IBM India and working with a number of high technology companies spending postings abroad in Europe, Japan, Singapore, India, and the US.

The US-India Business Council is our partner on today’s event and also in a long-term research project on US-India relations that Arvind and my predecessor Fred Bergsten have been doing and we’re grateful to them for their ongoing support of our program.

We also have with us today Ambassador Taranjit Singh Sandhu who’s a Chargé d’Affaires. Watch me mess up pronunciation in both French and Indian, in Hindi rather, excuse me. My forgiveness. He’s of course Chargé d’Affaires of the Embassy of India to the United States. Ambassador Singh Sandhu has been at the embassy here in Washington since July of 2013; previously
been Consul General of India in Frankfurt; served in the Ministry of External Affairs; the Joint Secretary at the United Nations Administration; and he’s also been the Permanent Mission of India to United Nations in New York.

These distinguished people have come out because we are seeing a change in India, a change in India’s economic policy and some true leadership from Prime Minister Modi, from the finance minister and from our colleague Arvind. To put that in context, I ask Dr. Aghi to come give us some opening remarks. Thank you.

Mukesh Aghi:

Well good morning everybody. It’s good to be—it’s my second week on this new position and I would say my first public program and I had only two-and-a-half days of work last week. I guess it snows a lot in this part of town. But I’m delighted to be here and to invite Arvind to talk about the economic reforms taking place. But I think from USIBC perspective, we feel that the budget—which are presented by the Finance Minister Jaitley and worked in partnership with Arvind and the rest of the organization—is a great budget. And the reason I use the word “great” because it focuses on a long-term perspective. It looks at a ten-year perspective and trying to deliver strong economic growth in India itself.

I think the strong aspect of the budget is, is it tends to provide a sense of transparency, predictability and opens an opportunity for the US companies, especially members of USIBC to go and invest in India. Yes, there are a lot of open issues which needs to be addressed and I think that’s why we have Arvind to talk about from that perspective. But I think what Arvind and also Governor Rajan are on the right track when the politicians like this Friday said, these are the American Indians who come to India, take difficult decisions and go back because they don’t have to execute. So Arvind, I think you’re doing something right as you move forward there.

I just want to say one more aspect from USIBC perspective. I think our members are very keen to partner in some of the projects that government has taken from [inaudible 00:04:42] itself, the digital India, making India, clean India so we look forward to a partnership with the government of India along with the US companies to take this business forward.

I would like to introduce a friend here, and a big supporter of USIBC in this town, and that’s Ambassador Sandhu. He comes with extensive experience in international diplomacy, commerce, trade and he has been to the [inaudible 00:05:11] for 25 years
itself. He has worked in geographies such as Sri Lanka, opened [inaudible 00:05:19] in Ukraine and Soviet Union and before DC, he was in Frankfurt itself. He also spent a lot of time with the United Nations and one thing about Ambassador Sandhu is absolutely approachable, very, very warm personality and whenever we come to him and ask for any help, he steps up and gives us that support itself. So Ambassador, over to you. Thank you for your help and support.

Dr. Arvind Subramanian, Chief Economic Advisor to the Government of India, Dr. Adam Posen, President of Peterson Institute of International Economics, Dr. Mukesh Aghi, President of US-India Business Council, distinguished guests, I thank the Peterson Institute and the US-India Business Council for coming together with the Embassy of India to organize this morning’s discussion on the recently presented Union Budget.

I’ve been asked to introduce to you our main speaker, Dr. Arvind Subramanian. To a group like this, and to the people in this town, Dr. Subramanian needs no introduction. Until not very long ago, he used to serve in this very institute as senior fellow. In addition, he has served with great distinction at Center for Global Development beside IMF and GATT. Dr. Subramanian has taught at Kennedy School of Government and at Johns Hopkins’ School for Advanced International Studies.

Of course, the range of his interest and expertise is not confined to one particular area. He is a widely-cited expert on economics of India, China, and the changing balance of global economic power, which he aptly portrayed in his highly celebrated books, Eclipse: Living in the Shadow of China’s Economic Dominance and before that in India’s Turn: Understanding the Economic Transformation. He has written extensively and in highly reputed journals and newspapers on growth, trade, development, institutions, aid, oil, Africa and the WTO.

Today, he’s recognized as one of the most distinguished economists globally and rightfully named by the Foreign Policy magazine as one of the world’s top hundred global thinkers. To those of us who are working to bring more dynamism into the India-US relations, including in the field of economy, it is a matter of great joy to see someone of his caliber and experience to be an important part of economic policymaking in India.

As India’s chief economic adviser since October last year, no one is better suited today to speak to this gathering about the
significance of the first full budget of Prime Minister Modi’s government than Dr. Subramanian. As a key architect of the budget, he will be able to give us a unique perspective on how the budget will contribute to long-term growth and help fulfill the expectations that the world now has of India.

Before Dr. Subramanian takes you through a more sophisticated understanding of the budget, let me remark that a number of announcements made are directly relevant to the kind of concerns expressed by the US business and economic community. It reflects our leadership’s interest in making India a friendly place to do business in and with. It is aimed at making "making India" more than a slogan. In this endeavor, the US is our natural and preferred partner. It is a point that our prime minister has made amply clear during his two summits with President Obama in a span of four months and that our industry and economic bureaucracy in both countries have tried to imbibe.

I will just highlight few of the important measures announced that would be attractive to the US businesses. First, a national investment and infrastructure fund to be established with an annual flow of $3.5 billion which will be used to provide equity funding to multiple projects in infrastructure sectors. [Inaudible 00:10:01] of the applicability of the general anti-avoidance rules to April, 2017. Announced intention about implementation of the proposed GST from April next year. Commitment to reduce the top rate of corporate taxation along with phasing out of exemptions. Permission to foreign investment in alternative investment fund. Doing away with the distinction between foreign direct and portfolio investments and replacing the separate carve outs with composite gaps.

We hope to see a resurgence in investment flows from the US to India, particularly in the critical sectors like infrastructure, manufacturing, skill development and capacities. With these remarks, I yield to Dr. Subramanian. Thank you for your patience.

Arvind Subramanian: Good morning everyone. Thanks to all of you for turning up this morning. It’s a great, great privilege and honor to be—of course, to serve in India but to come back to Washington which is my home away from home because my family still lives here and come back to my professional home away from home, the Peterson Institute and of course also the Center for Global Development. I want to thank Ambassador Sandhu, Mukesh, head of USIBC, Adam, my good friend, my colleagues who I miss a lot, thank you all for coming.
I want to talk today a little bit about the Indian budget, if the slides show up. Sorry about this glitch. Sorry, sorry, sorry. Thanks, Alex. Let me run through the budget today and give you a sense of what this budget means both in itself and beyond. I’m going to try and be relatively brief, speak for about 25, 30 minutes but no doubt, we’re going to have some Q&A time afterwards, is that right? So that I don’t want to be overly comprehensive or boring at this stage.

I want to break up my presentation into four parts, you know, give you the context, because it was very important, the framing of the budget, what the expectations were and the kind of curve ball that was thrown late in the day in the form of the 14th Finance Commission. I want to talk about the content, which is the big public investment push while preserving the commitment to fiscal discipline. Talk about the risks a little bit, and finally, end up you know giving my own candid assessment of the budget.

You know yesterday, my former boss, Fred Bergsten rang me and the first question he asked me was, "Arvind, are you still maintaining your integrity while in India?" And my response, I think at the end of this, my response is going to be, “Provided you give me some limited license for responsible access and some license for reasonable spin, I think I might pass the test that Fred set for me.”

So what is the context to this budget? I think the context as you all know was very, very high expectations of the budget. This was the first full budget of the Modi government and they did present the previous budget but that was not a full budget and the government had just come into power and so even the economists, especially internationally, the expectations were running unreasonably high.

So one of the things I think you have to keep in mind is how should one assess the call that was made repeatedly for big bang reforms and the argument we made was that in our survey was that you know it’s actually a very unreasonable standard because big bang reforms as my colleagues all know and you know John Williamson has a great book on this is that usually, you see big bang reforms only during or in the immediate aftermath of a financial crisis.

And big bang reforms in robust, you know, what I say, “frustratingly vibrant” democracies such as India are the exception rather than the rule. In countries like India, power is so dispersed,
there’s so many veto centers, the center, the states, different institutions, the power to do, undo, block is so extensive that you know it’s a bit unreasonable.

So India is neither in crisis or was neither in crisis, I mean, nor is it one of those places where you can just pull these levers and expect big bang reform. So the argument that we were making was that this is just a completely unreasonable standard to apply to India. But of course, that should not be and cannot be an excuse for you know procrastination or delay. So what we said was that you know because this is a kind of sweet spot for India, it’s a moment that comes but rarely in history. And that moment, that sweet spot, is because here was a government with a political mandate, a strong political mandate for change combined with the fact that the external environment is very favorable.

India is a large importer of oil so the decline in oil prices has really given India a lot of space to undertake policies, new policies, and of course, the external environment is also benign in the sense that you know if you look around the world, India looks relatively promising compared to all the places that my colleagues study and specialize in, you know, crisis Eurozone, Russia, Brazil, Japan. And India along with the United States looks relatively promising. So that’s the sweet spot.

So what we said was that the standard by which you should assess India is that there must be a bold shift in the areas that the central government controls, the levers that it can pull, there should be decisive shifts but in other areas which are much more difficult to reform, we called for what we call a creative incrementalism, you know, just keep plugging away like Max Weber’s slow boring of hard boards and if you combine the two, reforms in area that the center controls plus plugging away, both these can cumulate to what can be quite meaningful. And at the end, I’m going to ask whether you know something like this has happened in India or not.

The second I mean really important context was—and by the way, this was I say “a curve ball” because very, very few analysts were aware that this was going to happen. It’s define the budget in a very special way, a very unique way which I’m going to come to but essentially what happened was that we have this constitutionally mandated body that, every five years, talks about the allocation of tax resources between the center, what you call the federal level and the states. So every five years they say, “How much of the tax revenue should be shared?” And this year, this
commission came along and said that an extra one percentage point, one percentage point of GDP which is—now we know my rupees and my dollars are getting confused. I’ve turned native not just in my dress but also in my numeral—so one percent of GDP that will be $2 billion, about $2 billion has now extra, has to be forked over by the center, the states.

So essentially, in itself, it’s revolutionary for Indian fiscal federalism, the relationship between the center and the states now is going much more in favor of the states and this conforms to our prime minister’s vision of you know cooperative and competitive federalism. The states are going to be much more powerful. That’s going to unleash these very dynamic forces of competition between states as the agent of change.

So the fact that the states are going to get more tax revenues is going to further this. So in itself, it’s a major, almost a tectonic shift in Indian federalism but also in terms of the public finances. It’s going to mean that chart on the right hand side shows that now, about 62% of tax revenues is actually going to be spent by the states and no longer by the center which has implications for how one should evaluate this budget.

So unreasonably high expectations. One has to kind of calibrate what should be expected of India and this kind of googly which was bowled late in the process—notice I’m mixing my sporting metaphors between baseball and cricket—but that was really very important. That framed the background to the budget.

Now, what about the budget itself? I think it has a lot of features. I don’t want to go into all of them. I want to stress for this audience a couple of things and we can get into questions later on. The two I would say key things about the budget amongst many are one is, hang on, Ted, don’t be impatient. I’m coming to that.

One, a big push for investment, first public as a catalytic role and second private investment. I’ll speak about that briefly. So a push for public investment. While I would adamantly argue—and you know I will debate the austerity brigade until kingdom come—that we’ve done this while maintaining our commitment to fiscal discipline. So I want to stress these two things very strongly.

And why public investment? I think it’s really important to understand why we made this push and, in our midyear analysis, we came out very strongly—we called this “the balance sheet syndrome” with Indian characteristics. Essentially, Indian private
investment suffers from the problems that Japan suffered in the late ‘80s. So one way of looking at private investment is to look at the stock of stalled projects and on that first chart here, you can see that, is there a pointer? There is a pointer.

So the stalled projects as a fraction of GDP in the latest split is about 7% of GDP, 80% in the private sector. The Indian private sector is therefore hobbled. Its debt equity ratio is very high, amongst the highest in the world and rising. The profitability of private sector companies is actually quite weak. Nearly one-third of companies do not generate enough cash to even pay interest and as a result, the banking system is highly stressed.

So this combination of weak private sector and stressed assets in the balance sheet means that private investment in India could arguably remain weak for some time. And exit in India is not easy. We don’t have efficient Chapter 11-type bankruptcy procedures so this hangs over the Indian economy like a kind of shadow and so private investment is going to be slow going forward hence the push for public investment not to replace private investment but in the interim to catalyze private investment. So that’s one of the big thrusts of the push that we’ve made in the budget and in the budget we have an extra I would say something like between 0.3 and 0.5% of GDP more to invest in especially roads and railways which are going to be the two sectors which are going to kick start the economy.

So, of course we haven’t neglected private investment. And the key measure there in the budget is to announce corporate tax reforms beginning next year and I can talk about why next year and not this year so for the tax rates to go down from 30 to 25% progressively and while simultaneously removing all the exemptions going forward. So India is aiming very much to create a competitive tax environment, a clean tax environment, a predictable tax environment, but that’s going to take time, and hence, in the interim, the need for public investment.

Now, this is a very important issue because all market participants expected us or wanted us calling upon us to consolidate by 0.5 percentage points of GDP. This year, India’s budget deficit is going to come in at 4.1% and everyone wanted us to go down by another 0.5 percentage points and the government chose not to go down to 3.6 but to go down to 3.9, i.e., to continue the fiscal consolidation but not to accelerate it.
So how do we justify this, given that to the extent that it needs justification? There are three or four important points to remember. So our medium-term target is still three percentage points of GDP but that’s been deferred by a year. It’s going to be reached within three years not two years and to those in the markets who might view this as Augustinian, “Lord give me chastity and penitence but not yet,” Augustinian procrastination, we would insist that that’s not the case. We would say that you know this year, the 4.1% target was met under very difficult circumstances so the commitment to discipline demonstrated.

Moreover, we said that 3.9 rather than 3.6 was justified because one, the 3.6 target was set when the macroeconomy was in really bad shape. At that time, inflation was 12% or 11.5%. The current account deficit was at 4.5%. Growth was decelerating. So now I think we say that the need for accelerated consolidation has lessened; that’s one thing. And second—something that I’m going to talk about in a second—is that India is still very much a recovering economy, not a surging economy. So we don’t want to follow pro-cyclical fiscal policy at this stage and that’s another reason. And the third reason, of course we wanted to find space for public investment.

So the argument is therefore that we don’t need as much fiscal consolidation. We need space for other things and moreover, our envelope was shrunk by the fact that you know the fiscal finance commission reduced resources to the center by about one percentage point of GDP.

Now finally, I think the argument that we made—which is also something that the RBI used when it cut interest rates quite recently—was one consequence of this devolution, fiscal devolution that’s taking place is that now whenever and this is my call to all my market friends here, who are sitting here assessing the budget is that increasingly given that 62% or more of tax revenues are going to be collected and spent by the states, you have to assess Indian public finances at the consolidated level, not just at the level of the center.

And it turns out that the states on average have been twice as fiscally prudent as the center so that at the margin, this transfer of resources to the states is actually going to make India a more fiscally prudent state than the headline number might indicate. I don’t know what I did to that chart but so if you look at the consolidated financing center and state, the fiscal consolidation is now about 0.4 or 0.5 percentage point of GDP—just what market
analysts wanted of the central government—and similarly, the capital expenditure is going to be much bigger than the headline number suggests.

The final point, I think, is that, again, this is something that the RBI invoked in cutting interest rates is that the quality of fiscal consolidation has dramatically improved. For example, you see that blue line there, that’s revenue expenditure broadly public consumption actually in this budget, if you draw the line to this budget, there’s going to be a dramatic decline in public investment and the dotted line at the bottom you know, public investment has been languishing, that’s going to go up.

So there’s been fiscal consolidation combined with some very important steps in the quality of fiscal consolidation. Revenue expenditures, public consumption down by something like 0.6 percentage points of GDP and capital expenditures, public investment up by 0.3 percentage points of GDP. So we’re pushing growth via public and private investment. It is not coming at the cost of fiscal consolidation and it’s accompanied by an improvement in the quality of fiscal consolidation. So this is, I think, a big part of the budget and I think we can talk about a little bit other things in a moment.

Now, with the new GDP growth, this is a detour I have to take which is very important. When new India provided new GDP growth numbers at the end of January and the number, the growth number for 2013-14 was bumped up by some 1.8 percentage points to 6.9% and my colleagues sent me emails saying this is the Arvind Subramanian jigging of statistics effect. And what I would say, I would like to say a few things about this.

One, the calendar, the timing, all of these were absolutely pre-set, pre-determined years ago. We have a statistical agency that is fiercely independent, technically high quality, of unimpeachable integrity and they’ve brought us up to world class standards in terms of GDP estimation. But remember—so what I’m saying is that process is fantastic but like many processes such as democracy, outcomes can be somewhat puzzling. And here, what happened was that while the methodology, the data coverage and everything improved, the number that actually came out, 6.9 and I said this publicly was puzzling because 2013-14 was in fact a crisis year in India.

So how could you have growth accelerating by almost two percentage points and going to 6.9%—so both the level and the
change were really quite mysterious—and so what do we do with this? So essentially what we said is that the level number is puzzling but what we’re going to do—and we have no choice because these are the only numbers that are going to be produced and we have to go with these official numbers—so the way to treat these numbers is to say that you know, “We’re projecting a growth next year of between 8 and 8.5 which relative to 6.9 of two years ago represents a steady acceleration in growth.”

So one can justify the change from 6.9 to 8 and 8.5 next year and we’re saying this acceleration is going to be based on four factors going forward—one, the cumulative impact of reforms; two, the fact that oil prices are going to kick in about 30% lower next year than this year assuming all goes well so that’s going to be like a tax cut which is going to boost both consumption and investment; three, interest rates are coming down. The RBI has already cut interest rates by 50 basis points so that should also provide boost to growth. And finally next year, the monsoon is meant to be better than this year. So four growth impulses which we can confidently defend as justifying the change but still puzzled about the level of the number.

So the bottom line we say is that the balance of evidence shows that India is a recovering, not a surging economy. So don’t look at 8 to 8.5 in absolute terms and say, "Wow, this is East Asian tiger rates of growth" but focus more on the change and the numbers seem less puzzling.

Now, what are the risks to this scenario going forward? I would argue that there are external risks and domestic risks. Oil—I mean, all of you know this better than I do—it could go up, but I think as long as it doesn’t go up beyond 70 or 75, I think the Indian economy can withstand that shock. Eurozone and Fed risks, it is something that we have to be watchful about because a lot of the capital inflows that came in this last year have been interest-sensitive, about two-thirds so if there’s a reversal of Fed turmoil in the Eurozone, there will be some pressure but compared to 18 months ago, the macroeconomic situation is much better, reserves are much higher, inflation is much lower. There’s a certain solidity to the economy that wasn’t there some time ago. So I think we’re going to be relatively well-cushioned in the event of external financial shocks.

The last one I think is on the external side the trade challenge. It’s something that I think is more worrying. Something that we discovered while doing the economic survey, the chart on the left
shows India’s services and manufacturing exports as a share of GDP and what you find is that after a big surge in the 2000s, it’s actually stabilized and even declined to some extent. And the lower line is services exports and that’s a little worrisome. The fact that, because the “making India” challenge—which the prime minister has thrown out—I think the flip side of that is the export challenge not just making India but making India competitively which is I think quite a challenge.

I mean, my sense is that the external environment is also getting a bit more adverse. There’s a very nice paper by the World Bank recently co-authored by [inaudible 00:33:21] and some people which shows that the elasticity of global trade with respect to world exports has been declining. And something like that has been happening in spades for Indian exports both services and manufacturing. You find the export buoyancy of Indian exports relative to foreign growth again surging in the 2000s but declining very dramatically.

So trade has stagnated. The external environment has deteriorated in a kind of economic sense and of course the subtext here is it’s also kind of threatening in a policy sense because you know these big mega regionals are being negotiated by US and Asia, US and Europe and India is, for the moment at least, excluded from them. So selling into markets that are going to have barriers not just tariff but also in terms of standards, labor environment, et cetera is going to aggravate the trade challenge for India.

So on the external side, I see this as the bigger challenge than anything on the financial side or oil prices. But I think the bigger challenge is, of course, domestic. It’s implementation, implementation, implementation. I mean, I say this not just in terms of a sound bite, but if you think about this budget and the push for public investment, one key thing all of you should watch out for is, is the public sector able to spend, spend quickly and spend reasonably effectively? I think that’s going to be, I think, one big challenge going forward because the impulse to growth has to come in the short run, as I said, from public investment, and that’s going to depend to a great extent on implementation capacity in the public sector.

So just to bring it altogether, think for example of the standard that I set, you know, not big bang but something else. What would my assessment be? I think that a kind of realistic—and the Fred Bergsten standard if I might invoke—I would say that this budget maintains and accelerates the reform momentum that’s been
underway since this government took into power. I say that with kind of realism and moderation and not to hype things up too much, but here’s what struck me though … supposing I were to take you back 18 months. Imagine that you’re in 2013 sometime in the fall and if I want to tell you that we’re going to have macro stability. Inflation is on a downward trend. Wholesale price inflation is actually negative to industry. If I were to tell you that we’re going to have macro stability, if I were to tell you that we were going to have an investment focused budget without compromising fiscal discipline, if I were to tell you that monetary policy was going to be eased already 50 basis points and more, if I were to tell you there’s going to be a new impetus to unleash competitive and cooperative federalism, and if I were to tell you that the government is going to enact a game changing goods and services tax, raise the limits, FDI and insurance, conduct transparent call actions and put behind the legacy of scandals and corruption, where to enact new land laws and it were to make progress in direct benefit transfers, if I were to say—if you had been told 18 months ago that all this was going to happen on the horizon, would these constitute big bang meaningful whatever reforms, what would you have answered? You tell me. Thank you very much.

Adam Posen: Dr. Subramanian, esteemed CEA, that was fantastic. Before we go to questions, I just want to say a note of appreciation. There was the question of integrity. I don’t think Arvind’s integrity was ever in question. The question was always, “Would Arvind be Arvind if he got to government?” He used a marvelous line I have here about “frustratingly vibrant democracy.” Which, of course, also represents, as we saw with Ted’s interjection, the Institute’s internal discussions: a frustratingly vibrant democracy. And I hope that trained him well. But joking aside, we have a long tradition of people taking off from the Institute and serving as economic advisors and policymakers on leave and at the time he was appointed, I said, a number of us said this speaks incredibly well of the Modi government that they want someone as independent thinking and substantive as the ambassador said in this role and continues to speak well of that government that he’s been allowed to play this role but it also speaks incredibly well of our dear friend and colleague Arvind that he’s been effective despite remaining Arvind so thank you very much.

We are going to open it up for questions in a moment. I was just going to put one or two things to Arvind and [inaudible 00:38:55] as well. One conceptual thing and then one very specific thing. So conceptually, Arvind, as a good classically educated person, you
made reference to Augustinian forms of restraint—save me but not yet—with your budget. But underlying the budget, as you put it out, seems to be the message that if we have a more stimulative macro environment, more supportive from the center, we can encourage more reforms elsewhere. And as you know in the vibrant democracy at the Peterson Institute but also in the vibrant democracies of Europe, this has been a point of huge debate. Do you promote reform and progress best by tightening your macro policies so as to force people into reform? Or do you promote reform best by moderating your austerity and loosening monetary policy as RBI just did to make more room for reform? How much since you’re coming in and actually making this decision in this case, how do you think about that issue that affects all of us?

Arvind Subramanian:

Adam, I think that’s really a great question because I have been thinking about the parallels with Europe and also I think the parallels with the United States after 1870, you know, I think that’s to me etched in my mind and I would say two things, Adam. One is that unlike in Europe now where the periphery is "profligate" and the core is more tight, as I said, in India that’s not been the case. The states on average have ran a deficit of about 2.4% of GDP. The center has run a deficit of 4.1% of GDP.

So luckily for us, that choice has not been so stark as it is in Europe. So in that sense, we don’t have to fear for macro stability with this transfer of resources. But I think the second point is where the analogy with United States after the Civil War comes in is that you know reforms and change are going to happen in India of course some by the center pulling these levers but a lot more through competition between the states.

So to give you one example, Gujarat has been a model of good reforms under the prime minister and experiments like Gujarat have acted both as models and magnets for reform in other parts of India. As models because you know they showed that this can be done elsewhere and no longer can you say, “Well, politics is very difficult and my state is much more …” whatever left or whatever. But importantly in terms of the convergence dynamic that we know about, the growth, as magnets because if one state does well, it attracts capital, talent, labor from the other states and this is what happened as you know in the US in 1870.

So that competitive process which really I feel is one of the strongest agents for change, fiscal devolution and the transfer of resources actually accelerates and facilitates that process. So for
both these reasons, the fact that the "periphery" is actually fiscally prudent [inaudible 00:42:20] not profligate and the agent for change in India is going to be bottoms up competition between states, I think this would be a desirable dynamic in India going forward.

Adam Posen: Great. Let me now turn to something very specific which is, you know, you gave us the Union budget and as you just argued, you have a [inaudible 00:42:38] concept, a real strategic drive behind it but obviously for many of the business people and people working on US-Indian relations through the years, it’s the specifics of reforms that matter a great deal. I’ll turn in a second to Mukesh to follow up on this, but it was sort of in your last slide. We have this last bullet list on GST, direct benefits, the land sales, cool.

Can you give us a sense of particularly—at least starting in the financial sector—where do you see the change coming in? So you mentioned the FDI opening up in insurance, we know there’s been some things in the other direction on the banking system, you mentioned the fact that there is this debt overhang for much of the private sector and you know I kind of hoped and maybe our mutual friend Simon Johnson would want to say something to this that you all would do more radical debt restructuring that the Americans were scared to do that delayed our recovery. Where’s the agenda for example in financial reform more specifically?

Arvind Subramanian: Yeah, so I think three or four things on financial sector reform, right? One, there’s the FDI and insurance. It was passed as an ordinance which is kind of slightly legislative limbo. So in this session, if it gets translated into legislation, the financial sector, insurance sector opens up. In the budget we have a number of measures to improve regulation of the financial sector. We’re now going to have a unified regulator in some areas. Debt management is going to move from the RBI to an independent institution so the number of institutional changes on the horizon in finance.

On the banking system, I think what’s going to happen is that it’s going to be a relatively slow and steady progress on that because exit, as I said, is quite challenging in India. So the way I think it’s going to happen is that there’s going to be some ad hoc slow clearing of the debt overhang through case-by-case negotiation. The RBI extending some maturities, a little bit of forbearance, but at the same time, some banking sector reform as well.

So I think we’re kind of recapitalizing the banks and importantly, the government has said that banks should be able to raise
resources by going to the market because the government is now committed to allowing its share in the public sector banks to come down to 52%. So that’s going to open up a lot of space for public sector banks too.

But to be honest, it is going to be a slow process. And the way I think things are going to change in the banking side is really with interest rate cuts, with growth picking up. I think some of the loans are going to look less bad going forward. So you’re going to get a combination of an endogenous improvement in balance sheets via growth and interest rate cuts and some modest action to address the problem itself.

Adam Posen: Fabulous, Mukesh. You want to put a question to Arvind?

Mukesh Aghi: Yeah. Arvind, from a member’s perspective, especially the company’s itself, it’s all about implementation as you said. But as you [inaudible 00:46:10] down dealing with the bureaucracies and the processes of trying to come into India, investing, creating jobs, a sense of transparency, that still doesn’t exist. And so the formal question I have is: how do you bring that predictability and transparency to US companies as they invest in India? And what happens is it’s very interesting, my first week on the job, I’m dealing with issues which came in almost 40 years ago and they still have not been sorted out. So how do we take this forward?

Arvind Subramanian: Yeah, you know, part of the moderation of expectations I would argue is that some of the things like tax administration reform or easing the cost of doing business, I mean, these are not things, levers that are easily pulled. I mean, remember, these are levers that exist both at the national level and at the level of the states, at the level of the regulatory institutions. So this is going to be a slow tough grind going forward.

What the center can do is two or three things I think. One, very important, there’s a line in the budget speech of the finance minister which says that you know the era of scams, scandals and corruption is behind us. And there, I think bringing transparency to selling public assets, to selling spectrum extra, I think the call auctions that have happened recently are really a step in that direction.

In fact, it was fascinating to see these call auctions you know, bids all online, you can see what’s happening and so on. So I think a transparency is going to be a big part of it, one. Second, I think that you know we have to change, make regulation much simpler and
much more business friendly. The land law again is going to be passed in Parliament in this—no, going to be discussed in Parliament. What happens? We’ll wait and see.

But remember on the tax side, the government has made it clear that no more tax terrorism and I think in a sign [inaudible 00:48:22] foreign investors. In the Vodafone and the Shell cases which were a source of such problem, the high court decisions have not been contested by the central government which is a clear indication that this is the way we want to go forward.

And finally, I would say that, I mean, on the tax side which is so important, some people say in India that you know tax administration is tax policy. I would say almost exactly the opposite. I would say tax policy is tax administration because if we can bring tax rates down to internationally competitive levels, say we could get to 20% going forward, 70, 80% of transfer pricing cases disappear. The incentive to game the system get diminished. So I think we have to work on multiple fronts and working on policy plus patience on—you have to be patient on many of these other things, that’s India for you.

Adam Posen: Arvind, no one on this stage has ever made incrementalism sound so sexy. Well done. We’re now going to open it up to questions. For those of you who are unfamiliar with our procedures, we have Jessica with a roving mic up front. For people in the back, you can go stand at the back mic. When I recognize you, please identify yourself and please pretend you’re asking a question rather than making a speech. Thank you. The gentleman there, if you just want to go to the back mic and then these two at this table.

Jeff Kemprecos: Good morning. Jeff Kemprecos with Merck & Co., a pharmaceutical company. I was curious about the life sciences sector. You’ve done a very good overview with kind of the macro picture but in terms of the micro sectoral issues, do you have any early thinking about how to stimulate more innovation in the medicine sector, how to take advantage of the tremendous human capital in the country? How can we boost India over the next few years into the global top 20 in innovative medicines and vaccines? Thanks.

Arvind Subramanian: Yeah. I have to say, first of all, that I’m not an expert on many of these sectoral issues, but on life sciences, let me say just a couple of things. One is that you know the Indian government is undertaking its review of intellectual property policies, so I think that’s something that people are going to watch with keen interest.
And I’m hoping that that will come out in a way that can straddle many, many objectives, innovation, the need to maintain affordable access to medicine. It’s a challenging thing, but I think India is aware of the innovation side of this piece so I think it’s going to try and straddle these competing objectives.

The second thing I would say is, if you look at the experience of the last, what? Six or seven months ago. All these FDA investigations into many of the top Indian companies, I think that’s had a very salutary impact on India. India which is quite prickly about foreign intervention and you know especially foreign regulatory intervention, in the case of the FDA and in fact the FAA, when these institutions came along and said Indian practices were kind of somewhat short of world standards and actually exposed huge deficiencies. In the case of the pharmaceutical sector, safety standards were seriously compromised.

So I think that’s had a very positive impact in India. So I think this whole—the innovation puzzle, the affordable access and maintaining quality because after all, this is—we export generics to the United States and we want to make sure that that’s not compromised in any way. So I think on the life sciences, I think all these objectives are in play and you know, we’re going to have to straddle these going forward.

Adam Posen: Thank you. I have two people at this table then the gentleman at the back and then Ambassador Wesner.

Lorenzo Giorgianni: Thank you, Arvind. Lorenzo Giorgianni from Tudor Investment Corporation. Wanted to first congratulate you on a great document, readable, lots of depth, very well done, Arvind. One comment and two quick questions, a comment on the expectations that the markets had about the budget, these were really driven by the government’s own plans that were announced last year, right? So I think some of us might have felt that there was, using your terminology, a curve ball thrown at us in the same way as the change in the transfer was to the states was introduced late in the game. So what matters is really consistency of policies over time.

The two questions, one is where do you assess we are in the fight in lowering inflation, in particular, the role the structural policies have in reducing inflation as opposed to the role that the Central Bank has? Clearly, if there is more progress in reducing rural wage pressures, the Central Bank probably will feel more comfortable cutting rates. How do you assess the two aspects of these inflationary policies? And the second quick question is: can you
tell us something more about the disinvestment plans of shares in state companies going forward? Thank you.

Arvind Subramanian: Thanks, Lorenzo. I think on the expectations point, maybe you’re right and I think as long as there’s consistency going forward and the momentum is maintained, I think that’s very important. On inflation, we said about four or five months ago that—and we still maintain that there’s been a structural shift in inflation in India—I think it did catch markets, and frankly, also I think policy making institutions, by surprise. And I think there are now three pieces to why I think there’s been a structural shift.

One of course is the whole oil picture and you know if that’s going to be maintained, that’s going to have benefits going forward but that’s a bit unpredictable. But I think that’s there. That’s there going forward. The second, I think the key thing is that you know the inflationary impulse coming from agriculture has changed quite dramatically. Global prices have come down, right? But over and above that, the government through a series of I would say kind of non-actions because a lot of the inflation was also reinforced by very high increases in the support prices for agricultural products. Those have been moderated significantly and that’s going to be maintained going forward.

So the agriculture terms of trade shifted in favor of agriculture over the last decade have reversed and the moderation government actions have been responsible. RBI gets credit for gaining more credibility but I think part of the agricultural piece also is that you know this is a graph that we put out in our midyear analysis. You know rural wages which were growing at about 20, 25% even 26% two years ago, they’re down to about 3% now. So there’s something happening in rural agriculture that’s really tempered inflation [inaudible 00:55:44] and that’s going to be maintained going forward and so that’s big.

And the third thing that’s happened very recently is that household inflation expectations have collapsed. Maybe there was some backward looking nature to this, but the importance is that it’s both signal and also could be effect going forward because it’s going to moderate wage pressures going eight to nine percentage point drop in inflation expectations. So I think all three of these are going to [inaudible 00:56:14].

On disinvestment, the budget foresees a big increase in the disinvestment revenues and there is a clear policy statement in the budget that next year, disinvestment is going to include strategic
sales sale of loss making units. So that’s the policy vision and that’s what underpins these more ambitious targets going forward.

Adam Posen: Great.

Sai Yoshida: Good morning. I’m Sai Yoshida of Toyota Motor North America. Because I’m from automotive industry, I’d like to ask about your energy policy because I remember that your economy is quite much dependent on the imported crude oil, and even though the price of the oil is going down, still I think energy security is very important. So my question is that do you have any plan to promote the environmental friendly technology or alternative fuels in Indian market?

Adam Posen: And just following on Yoshida’s question linking it back to your previous response, Arvind, to Lorenzo, there is a worldwide tendency to be taking down energy subsidies in the current environment. The IMF has made some calls in that direction and that obviously complements what Sai is talking about.

Arvind Subramanian: Yeah. I’m glad you raised that question because in our survey actually, we deal with this extensively. So what has happened is that energy prices have come down, right? But I think the Indian government has acted very aggressively in raising taxes, excise taxes on diesel and petrol. So in fact what we say is that we have gone effectively from a carbon subsidy regime to actually high carbon taxation regime in petroleum. So our calculation, which actually the World Bank helped us do, is that now on petrol, the implicit carbon taxes, something like 160 dollars per ton and on diesel something like 70 dollars per ton which is much higher than the call that Nick Stern and all have made to start with the 25 dollar per ton of CO2.

So compared to most countries I think, I mean, I don’t want to be disingenuous here because I mean, the impulse, the imperative is mostly fiscal but you know we could have said, “We’ll just pass all these gains to the consumer,” but we didn’t do that. Even macroeconomically it made a lot of sense. I think we passed on about one-third or 40% in the form of, you know, to private consumption and the rest was public savings which we kept in the form of higher taxes and so one. Two, we’ve increased the coal cess in India by—we’ve doubled the cess on coal and third of course, the prime minister has a big plan to ramp up solar energy just kind of the target for solar energy by 2022 has been upped by a factor of four or five. Now, it’s 100 gigawatts of solar is what we’re aiming at 2022.
So in fact, so the combination of the petroleum taxation, the coal cess and the renewable energy program means that you know one of the things I’ve argued in the survey with—the Center for Global Development will be happy—is that we can go into the Paris negotiations having actually addressed this subsidy problem that Adam referred to and in fact you know we can make very positive contributions to the climate change negotiations going forward.

Adam Posen: I wanted to make sure that got in since you guys didn’t feature that in the PowerPoint but it’s huge. It’s huge. Gentleman at the back, please.

Ken Silverman: Thank you. My name is Ken Silverman. I’m head of North America for a company called Sannam S4 Consulting. We are India market entry specialists. We bring corporations, universities into India. I just came from two days at the India conference at Harvard which was very, very bullish on India. One of the panels I attended was on e-commerce in India which is booming and expected to go through the roof. The speakers identified an unusual circumstance which we don’t have here in the US, which is many, many customers who use e-commerce want to pay cash. They don’t want to use credit cards because they don’t want anyone to know what their affluence or net worth is. So the question is, and I’m not an economist, but what will the government of India do to motivate more people to pay taxes, particularly high net worth individuals who avoid paying taxes?

Arvind Subramanian: For a moment, I was puzzled by your question. I thought you wanted me to answer the e-commerce piece and then it became a taxation piece. So let me speak to both, yeah? I think on e-commerce, actually I’ve been surprised at how dynamic you know companies Flipkart and all these have come in and really challenging Google and places like that. But one of the challenges there for India is to improve financial regulation because a lot of these companies find that it’s actually better to locate in Singapore both for regulatory reasons and for tax reasons. So I think that’s something that we’re going to—the government is very aware of and the financial sector reforms are kind of geared to actually addressing the problem.

The second is I think there is actually things in the budget trying to encourage non-cash payments. There is in fact something in the budget, something very specific. So I think going forward, you know, India will be looking to encourage you know electronic payment as opposed to cash payment both because it’s desirable
but also because to tackle the problem of black money and things like that. So that’s very much on the agenda.

Adam Posen: Great. Here at table one, I have Frank and then Chris.

Frank Wisner: Frank Wisner from the law firm of Squire Patton Boggs. I wanted, first of all, to say thank you very much, the way you managed the discussion this morning, your intention to lower expectations, the sobriety of your remarks, I can assure you’re much appreciated. My question goes to—

Arvind Subramanian: I hope it’s all not just sober, I mean …

Frank Wisner: Wise, wise. My question goes to the risks that you outlined and the third risk if my memory of counting is correct was the trade risk. You talked about two aspects, the sagging exports and the risk that India faces in being excluded from major world trade zones. What is the government’s trade strategy? How do you describe where India is and wants to be in taking on an international trade regime?

Adam Posen: Before you respond, Arvind, I just want to remind everyone in our audience that not only is USIBC, of course, very concerned with this, but Arvind has been writing seminal works on trade not just about India for many years. And of course we had that very exciting summit of Modi and Obama which, again, with Frank’s wise cautions about not getting too excited, certainly seem to be a change in atmosphere and mutual expression of positive progress. So please, tell us. What should we hope for?

Arvind Subramanian: Frank, it’s the one question I was hoping you wouldn’t ask and I know if you hadn’t asked, Fred would have or Adam would have. So … I think India is making up its mind on how to deal with the whole changing trade environment. It’s negotiated all these agreements in East Asia, it’s part of RCEP, and then there’s the domestic piece of the puzzle that, in order to be more ambitious in its integration efforts, it has to create the “making India”, the manufacturing capability, the product standards, the development standards and so on.

So I think this is a dossier that’s going to evolve over time and you know there is no—I don’t have an easy answer for you but I think India’s aware of this, or at least I think it’s being sensitized to these challenges going forward very importantly. How it will come out? I don’t know. I think it’s going to be something that we just have to wait and watch going forward.
I mean, I think there is an appreciation, acute appreciation in India that the whole global value added chains are very important and India is not quite as integrated into them as it ought to be especially in goods. In services, we’re doing slightly better. I also think that the whole—the impetus for India will be shaped also by what is going on outside for example, how China reacts to these similar challenges as well.

So just one, to be a little bit more positive, I think one of the things, Adam, that came out of the president, the Obama-Modi visit was a renewed interest in the bilateral investment treaty. So I think India wants and is seeking FDI, and also wants to clearly send a message that we want investment and we will do all we can by way of the regulatory agenda to create a climate for FDI, attracting FDI going forward.

So the bilateral investment treaty a bit off this larger question that you’ve raised is very much moving forward. We have a draft law domestically which we are looking at. We’re kind of trying to improve and you know and I think that I’m hoping will provide the basis for even closer cooperation between India and the United States going forward.

Adam Posen: Just normally, those of you who are familiar, I plug institute work at various intervals. Since Arvind embodies so much of what we do at the Institute, I haven’t had to do that explicitly. But in this case, I just want to tout the fact that in the work Fred Bergsten and Arvind were doing prior to Arvind’s taking office was included some very serious studies on the BIT, and we will be continuing to develop that, but this takes place in the context of the excellent work that Sean Miner, Jeff Schott and co-authors did on the US-China BIT which has moved forward and which we’re presenting again in Beijing next week, I believe.

And perhaps there is a bit of competitive liberalization, Fred, if you’ll allow me to use that term that we can use on India there but also we have some exciting work being done by Lindsay Oldenski on the positive impact of bilateral investment treaties. So although I would have also wanted to be more optimistic than Arvind was, I’m very glad at least to hear we’re on that stepping stone and the Institute can make a contribution there as well. Chris.

Chris Padilla: Chris Padilla with IBM. Arvind, I want to go back to your comments about the relatively anemic level of private sector investment, and you talked about the need therefore at least for a while for public sector investment to make up for that. One of the
reasons I would argue private sector is relatively low is because of some of the transparency issues that Mukesh referred to, uncertainty. The budget didn’t deal with tax administration reform and did not deal with labor market reform to areas that I would argue are critical to creating long-term incentives for private sector investment in the economy. So my question is: why didn’t the budget go to those areas and do you anticipate that we might see more on those in the future?

Arvind Subramanian: Yeah, thanks, Chris. I think on labor market reform, remember that labor is a subject that’s addressed both at the central level and the state level and this is an area where again, the competitive liberalization dynamic is going to be at play. So for example, Rajasthan has enacted these laws but the center has facilitated this by providing presidential assent to these laws. They have to be approved by the center and the center has sent out a signal, unambiguous signal, that it will encourage and facilitate all these things that are taking place at the state level.

Now, the Rajasthan initiative is now being matched by what Gujarat is doing, Madhya Pradesh is doing so again, this is something that you should look at in India, not just what’s happening at the center but also at the states and what the center is doing to facilitate state action.

At some stage, also the center is looking very seriously at cleaning up the central bit of these labor laws. So there are only so many things that the budget can do and this is—it’s not a hardcore budgetary issue but the broader reform agenda is in that direction. And also, in the budget there’s actually something very important on labor market reform which is that it’s more on the savings side. Employees’ contribution to their provident funds and the insurance thing, now they’re going to have a choice of where to invest these things so that’s going to facilitate greater savings and all of that. So I think there is a component of labor market reforms on this.

On tax administration, I mean, I think the complexity of tax administration, of improving it is just you should not underestimate India. It is not a lever that you can pull. The Shome Committee has made these recommendations which the government is going to look at very carefully. I think that what the government can do signaling that you know Vodafone and [inaudible 01:10:38] type cases will not be contested. That principle will apply going forward. There will be no retroactivity in taxation going forward, that’s clear. And, as I said, if we can reform policy to get tax rates
down, that will be the best contribution we can make to tax administration going forward.

Adam Posen: Well, I’m afraid we’ve come to the end of our time. I think this has been the superb event we all hoped and expected it would be, just as the first budget, in many ways, is a superb achievement we all hoped it would be. I’m very grateful to our colleagues, to Mukesh and everyone here from the US-India Business Council, the member companies who supported not only this event, but a large amount of our ongoing research by Arvind, by Fred, by others and we look forward to continuing to work with them and convene on these issues.

I’m very grateful to the Embassy of India, Ambassador Sandhu for joining us today, gracing us with that official blessing and helping us arrange Arvind’s schedule to join us. But most of all, I’m grateful to Arvind. We miss you a lot but you’re doing God’s work so we’re very proud of you, sincerely, and it’s worth it to us to miss you for a couple years while you improve the world. But do come back and do keep us going, and again, praise to the Prime Minister and Finance Minister that they let Arvind be Arvind. It’s obviously working very well. Thank you very much.