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COVID-19 Economic Policy Reform Memo for PMO

"You are engaged on a double task, Recovery and Reform; — recovery from the slump and the passage of those business and social reforms which are long overdue. For the first, speed and quick results are essential. The second may be urgent too; but haste will be injurious, and wisdom of long-range purpose is more necessary than immediate achievement. It will be through raising high the prestige of your administration by success in short-range Recovery, that you will have the driving force to accomplish long-range Reform. On the other hand, even wise and necessary Reforms may, in some respects, impede and complete Recovery."

- John Maynard Keynes in a letter to US President Franklin Delano Roosevelt in 1933

COVID-19 has caused the greatest global economic crisis since the Great Depression of 1929. The International Monetary Fund (IMF) estimates that the global GDP will shrink by 3.00% this year. In 2019, global debt crossed 230% of the global GDP, reaching a historic high. Today it is much higher. Trade has slowed down. Unemployment has increased exponentially. After years of decline, poverty is on the rise.

This economic crisis is leading to enormous strains in the free trade rules-based economic system created by the US at the end of World War II. Protectionism is back in fashion even in the US. As a result, global supply chains are shrinking. Keynesian economic policies have made a comeback even where people espouse hardcore free market ideas.

Emerging economies have been hit particularly hard. For some, their export-led growth model is now in question and foreign investment is drying up. Despite its relative isolation, the Indian economy has experienced a collapse in demand as per high-frequency indicators. There is the added risk of capital flight and decline in asset prices. The Ministry of Finance estimates 2% growth for 2020-21 while the Reserve Bank of India (RBI) anticipates a contraction though it does not quantify the negative growth rate. India's most industrialized states that clock over 60% of output have entered orange and red zones, color codes that signify spread of COVID-19 . As a corollary, collapse of output, employment and consumption is all but certain. A simultaneous supply and demand shock triggers risk of depression, not just recession.

Even before COVID-19, the Indian economy was in the doldrums. In 2017-18, consumer spending declined for the first time in more than four decades. Investments fell from 23.6% of the GDP in 2012 to 16.7% in 2019. Banks had high bad debts and some failed, leading to a financial crisis. Unemployment reached a record high, wages fell and growth slowed down. The lockdown has put further pressure on the economy.

To combat the unprecedented risk to its economy, India must institute key reforms. So far, many governments have made the right noises and repeatedly promised reforms but failed to deliver. For instance, barely a fraction of the ₹10,000 crore promised for Startup India has been disbursed. The country now needs a new social contract that promises citizens clear time-bound deliverables, fixes responsibilities as to who will deliver them and gives people the right to redressal when the state falls short. To forge this new social contract, the following six reforms are key.

1. **Promote Industry and Make "Make in India" a Reality**: In 2017, information and communications technology (ICT) goods comprised more than 9.7% of India's imports and less than 0.9% of its exports. These ICT goods can and should be manufactured in India just as cars are. India must set up special manufacturing zones (SMZs) with liberal industrial permissions, land policy, transparent tax regimes and sovereign guarantees of policy stability. This policy has already been tried in the car market, and players like Toyota, Honda, Suzuki, Kia and SAIC are manufacturing in the country. A decent SMZ policy would bring in more companies from abroad and unleash domestic players. In addition, India could establish a national body like National Automotive Testing and R&D Infrastructure Project (NATRIP) for ICT goods. Like NATRIP, this body would help develop the supply chain and train workers for this sector. A goal of these policies must be to make India an exporter to emerging markets in the Middle East and Africa.

2. **Reform Public Sector**: Professional management with industry experience and sector expertise must run public sector companies. The Indian Administrative Service (IAS) must stick to policy making, not running companies as diverse as Air India, the Food Corporation of India and Indian Tourism Development Corporation. Public sector boards must change too. They must have people with varied, relevant skill sets, not just politicians and IAS officers. Privatization is an option but must be used judiciously. India must learn from Russia's disastrous privatization that brought in little money to the state coffers and led to the emergence of oligarchs. The Antrix Corporation, with its numerous successes in space technologies and services, is a good model for other public sector

companies, including India's public sector banks. At the moment, lending is often arbitrary and this leads to bad debts. Recruitment to public sector banks needs urgent overhaul, middle management requires fresh blood from the corporate sector and senior management needs major changes. Boards of these banks must comprise people of high integrity with diverse skill sets to ensure prudent and professional management of the nation's capital.

3. **Institute Right of Redressal Against Government**: Stakeholders such as manufacturers, traders and professionals must have a right to redress their grievance against the government. Indian bureaucrats can and do change policies on whims with little due process or notice, causing carnage. A petty clerk can sit on a file forever, delaying a tax refund or project clearance. This "pocket veto" causes much economic damage. Every government servant must have a time limit to make a decision. If she or he fails to decide, the stakeholder's file must be deemed automatically approved. Officials not only keep stakeholders waiting, they also make terrible decisions. Rarely are they held accountable because officials in India wield far too much arbitrary power. Consequently, stakeholders suffer. They can be falsely charged under confusing laws, indefinitely dragged to courts, lose their livelihood and sometimes even their lives. Till today, the goods and services tax (GST) filing system remains glitchy. If a small trader's tax is not refunded in time, turning his or her cash flow issue into a solvency one, then the official responsible for the delay must face penalty. Just as doctors are liable for negligence, so should Indian officials be held to account by the law. Therefore, India needs fast-track, independent tribunals to resolve stakeholder complaints speedily.

4. **Liberate Supply-Side Activity**: The Indian state apparatus is British-designed and retains a colonial mindset. Its default principle is that activities not explicitly permitted are often automatically deemed illegal. In much of the world, if an activity is not expressly forbidden by the law, the citizen has the freedom to engage in it. In India, an activity not expressly permitted by law or regulation can be shut down anytime. The fact it might be of much economic or social value, provide employment or essential services to a community is irrelevant. Fines, long-drawn inquiries and even closure are real consequences if even a petty bureaucrat takes umbrage. Many argue that changing the default setting is a prelude to chaos. The reality is that small businesses are increasingly crushed by compliance requirements of innumerable regulations. If a trader fails to clarify, say, subclause three of clause 30 on the 10th page, then she or he can spend an eternity running from pillar to post. The government has to simplify forms and

stop interfering in economic activity if it wants jobs, incomes and growth to increase.

5. **Rationalize "Sin" Industries Policy**: India has inherited British Victorian attitudes towards "sin" industries. Ironically, many state governments derive a significant percentage of their revenues from taxing liquor or tobacco and running lotteries. Yet both central and state follow moralizing, inconsistent and incoherent policies for these "sin" industries that do not make any sense at all. While known carcinogens like khaini — the Indian version of fermented, dried tobacco — can be sold freely, too many relatively innocuous activities such as live entertainment are either illegal or under restrictive regulations. As a result, these activities are pushed into the black economy. This benefits criminal rackets and deprives states of revenues, increasing the tax burden on more socially desirable activities. A more mature approach that formalizes and taxes "sin" industries instead of driving them underground will boost the Indian economy immensely. India can take inspiration from its past. The Khajuraho Temples still draw in tourists and continue to benefit the local economy centuries after their construction.

6. **Ensure Liquidity Crisis Does Not Become Solvency Issue**: COVID-19 is putting tremendous pressure on micro, small and medium enterprises (MSMEs). Demonetization and GST put many of them out of business. Quite a few had to downsize. Now, MSMEs face an existential crisis. They need longer loan repayment tenures. Therefore, existing MSME loans could be converted to longer term debt. Also, suspending the Insolvency and Bankruptcy Code (IBC) for six months might give stressed MSMEs much-needed relief. The government must process tax refunds faster. Loans for working capital needs at subsidized interest rates of 4-5% would help MSMEs survive this crisis. To improve access to both working capital and long term capital, India must relieve pressure on its banks that have a high percentage of bad debts. A bad bank could take over distressed assets and existing banks could be recapitalized. To come up with optimal policies, the RBI must recruit those with experience in the financial sector. This infusion of talent will allow the RBI to analyze how countries like Sweden, Germany, the US and others have tackled their banking crises. The best of these policies applicable to India must then be implemented efficiently. Some policies to help MSMEs have been announced already and are a step in the right direction. Implementation and further steps are critical.

Appendix: MSME Policy Suggestions

1. The recent changes in the definition of MSMEs as noted in the tables below is the right step forward.

Table 1: Existing MSME Classification			
Criteria: Investment in Plant and Machinery/Equipment			
Classification	Micro	Small	Medium
Manufacturing Enterprises	Investment < ₹25 lakhs	Investment < ₹5 crores	Investment < ₹10 crores
Service Enterprises	Investment < ₹10 lakhs	Investment < ₹2 crores	Investment < ₹5 crores

Table 2: Revised MSME Classification			
Composite Criteria: Investment and Annual Turnover			
Classification	Micro	Small	Medium
Manufacturing and Service Enterprises	Investment < ₹1 crore and Turnover < ₹5 crores	Investment < ₹10 crores and Turnover < ₹50 crores	Investment < ₹20 crores and Turnover < ₹100 crores

2. The next step would be to classify micro enterprises separately from small and medium enterprises (SMEs). The nature of micro and SMEs is different as are the demands they face.
3. It follows then that Small Industries Development Bank of India (SIDBI) must be split into Micro Industries Development Bank of India (MIDBI) and Small and Medium Industries Development Bank of India (SMIDBI). The management and board of both these institutions must comprise finance and industry professionals, not bureaucrats or politicians.
4. In the light of the liquidity crisis for MSMEs, setting up two investment funds on the lines National Investment and Infrastructure Fund (NIIF) run by finance

professionals with rich experience would be a good idea. One would invest in micro enterprises while the other would invest in SMEs.

5. The two investment funds could invest directly in companies as well as funds that provide equity or debt to micro enterprises and SMEs.
6. The various financial institutions must coordinate, instead of working in silos, to optimize results. These include non-banking financial companies (NBFCs), micro-finance institutions (MFIs), MIDBI, SMIDBI and others.
7. A rigorous analysis of the more than 5.5 crore MSMEs is the order of the day. For investment decisions, MSMEs need separate consideration and classification. An analysis of various sectors such as pharmaceuticals, ICT hardware and chemicals is essential to determine which of the MSMEs are most strategic. Furthermore, defining the parameters for classifying MSMEs in each of the micro, small and medium segments is most critical. Some criteria for selecting the top 40-50% companies in each segment could be revenue, profitability, tax contribution and strategic importance.
8. Excluding startups from the MSME category is the prudent policy measure because they have alternative access to capital. Venture capital funding already flows to startups in India. Furthermore, the government has allocated ₹10,000 crores of capital for startups. In addition, many startups are consumer-facing businesses that do not have the same multiplier effect as MSMEs on the economy.