Government of India

Rural financial stress, low job creation constrain growth potential, increase fiscal challenges

A key support of India’s [Baa2 stable] creditworthiness is its economic strength, underpinned by the size of the economy and, notwithstanding the more recent moderation in growth, broadly stable and high growth rates. However, heightened financial distress among rural households and weak job creation, two major topics during the just-completed general election, imply that the quality of growth and shock absorption capacity of the economy may be lower than GDP growth rates imply.

With the election over, we expect that the new government’s policy agenda will focus on inclusive growth that benefits rural as well as urban households, while maintaining fiscal consolidation as an objective. The effectiveness of such policies in delivering broader-based, job-rich growth that leads to a decline in the debt burden will be a key determinant in the evolution of India’s credit profile.

» Economic shock absorption capacity is more limited than growth data imply. Large segments of the population are not benefiting from India’s generally high growth rates. Financial stress among rural households has risen due to persistent low food price increases and an inefficient agricultural sector. Meanwhile, employment opportunities are not keeping pace with the rate of increase and changing demands of the working-age population. Given India’s very low per-capita income and narrow tax base, these dynamics signal more limited economic shock absorption capacity than GDP growth suggests. Restrictions on the productivity of labor and land also act as constraints on investment and GDP growth potential. If left unaddressed, these factors will weigh on India’s sovereign credit profile over the medium term.

» Improved quality of growth would make planned fiscal consolidation more achievable. In recent years, despite the central government’s stated commitment to medium-term fiscal consolidation, it has missed or delayed targets, and deficits have widened at the state level. Broader-based growth with more, higher-quality jobs would make the government’s planned fiscal consolidation more achievable by directly reducing the debt burden, raising tax revenue and reducing political pressure for higher welfare spending. Such measures would make fiscal consolidation more sustainable. In the absence of such growth, India’s credit profile is likely to weaken as our assessments of economic and fiscal strength decline.
Shock absorption capacity of India's economy is more limited than growth data imply

A key support for India's credit profile is its economic strength, which is underpinned by the scale and diversity of the economy, and its broadly stable and high growth rates. In particular, India's very large domestic market provides generally robust domestic demand, which helps to limit the economic impact of any external shocks. We expect GDP growth of 6.8% in the fiscal year ended March 2019 (fiscal 2018) and 7.0% in fiscal 2019, picking up modestly to 7.3% in fiscal 2020 (see Exhibit 1).

This forecast takes into account the recent economic slowdown, with quarterly real GDP growth falling to 5.8% year-over-year in the fourth quarter of fiscal 2018, a five-year low, from a recent peak of 8.0% in the first quarter of fiscal 2018. Moderation in private consumption and investment, driven by subdued rural and urban domestic demand, along with weaker net exports caused the decline.

While an expanding population and productivity gains have maintained high and relatively steady GDP growth over the past decade, the economy and quality of growth featured prominently in India's election campaign. In particular, two key public policy concerns point to underlying vulnerabilities in the quality of India's GDP growth: financial distress among rural farmers and broader concerns about job creation – or jobless growth.

In the absence of policies that support a more intense and efficient use of capital and labor, including land and labor reforms, potential GDP growth will be constrained, limiting the economy’s shock absorption capacity. This will ultimately weigh on India’s sovereign credit profile through a lower assessment of economic strength.

With the election over, we expect that the new government’s policy agenda will focus on inclusive growth that benefits rural as well as urban households, while maintaining fiscal consolidation as an objective. The effectiveness of such policies will become clear over a number of years.

Low productivity, high concentration of labor in agriculture constrain economic opportunities

Structural constraints in the agriculture sector weigh on India’s economic strength. Although agriculture contributes only about 17% of India’s GDP, around half of the country’s labor force is employed in the agricultural sector and rural demand constitutes a large share of total consumption. As such, India’s rural economy has a greater sway on public well-being and the overall economy than agriculture's contribution to GDP suggests.
Productivity in the agricultural sector is weak, due to multiple long-standing factors: relatively stringent land acquisition laws, which prevent the consolidation of smaller plots for large-scale farming; generally poor infrastructure and supply chain connectivity; distortive government food procurement and pricing policies; and limited use of irrigation technology (almost half the country’s farmland is unirrigated and relies on monsoon rainfall). This constrains productivity and opportunities for investment. In addition, it exposes the rural population to fluctuations in monsoon rain cycles and climate change risk, which impact consumption and the ability of households to absorb financial shocks.1

In the past, these inefficiencies contributed to high food and overall consumer price inflation. However, food price gains have slowed significantly in recent years, due to increased government intervention in food markets. Since 2013, food price inflation has fallen from a high of nearly 17% to five successive months of deflation from October 2018 through February 2019. Since productivity gains in the agricultural sector have remained elusive, farmers have been left with lower overall profit margins (see Exhibits 2 and 3). This sustained decline in food price increases, while positive for the urban population, has contributed to financial stress among rural households that are dependent on agriculture.

Exhibit 2
Food price inflation has been on a downward trend since 2013 ...
(Annual CPI inflation rates, %)

Exhibit 3
... leading to a significant decline in consumer price inflation
(Percentage point contribution to CPI inflation rate)

Farm household incomes and consumption are vulnerable to periods of financial stress caused by weaker sales prices and income growth, due to their relatively low wealth and limited savings buffers. Despite high and broadly stable GDP growth, per-capita income is low throughout India, including relative to comparably rated sovereigns. While India's per-capita income increased to about $7,200 on a purchasing power parity (PPP) basis in 2017, from about $3,200 in 2006, it is the lowest among Baa-rated countries, for which the median is about $22,000 (see Exhibit 4).

Poverty rates and income inequality are also relatively high, indicating that many households earn far below the average per-capita income. Despite marked declines in poverty rates over the past two decades, as of 2015 about 176 million Indians (13.4% of the population) were living in extreme poverty at or below the International Poverty Line ($1.90 at 2011 PPP per day per capita), according to the World Bank, and about 660 million (50.4% of the population) were living at the higher poverty line for lower middle-income countries ($3.20 at 2011 PPP per day per capita). There is a higher prevalence of extreme poverty within the rural compared with the urban population (15% versus 9%).2

The persistent decline in food price inflation since 2013 has further pressured the economic well-being of rural households and had political and fiscal implications for the government. In response to farmers’ economic distress, politicians have called for and provided financial relief through farm loan waivers in some states and have considered a federal-level scheme. Farmer distress featured prominently as an issue in both Indian state elections and the recent national general election. It also contributed to the government’s decision to implement a new Minimum Support Price (MSP) formula in the 2018 budget,3 although that did not result in any material rise in food prices, and an income support scheme for farmers4 in the 2019 interim budget.5
**Exhibit 4**

India’s per-capita income is the lowest among Baa-rated countries

(PPP basis, 2017)

<table>
<thead>
<tr>
<th>Country</th>
<th>Per-capita Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>$3,000</td>
</tr>
<tr>
<td>Philippines</td>
<td>$5,000</td>
</tr>
<tr>
<td>Indonesia</td>
<td>$7,000</td>
</tr>
<tr>
<td>South Africa</td>
<td>$9,000</td>
</tr>
<tr>
<td>Colombia</td>
<td>$11,000</td>
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<tr>
<td>Thailand</td>
<td>$13,000</td>
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<tr>
<td>Bulgaria</td>
<td>$15,000</td>
</tr>
<tr>
<td>Mexico</td>
<td>$17,000</td>
</tr>
<tr>
<td>Uruguay</td>
<td>$19,000</td>
</tr>
<tr>
<td>Romania</td>
<td>$21,000</td>
</tr>
<tr>
<td>Panama</td>
<td>$23,000</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>$25,000</td>
</tr>
<tr>
<td>Russia</td>
<td>$27,000</td>
</tr>
<tr>
<td>Hungary</td>
<td>$30,000</td>
</tr>
<tr>
<td>Portugal</td>
<td>$35,000</td>
</tr>
<tr>
<td>Bahamas</td>
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</tr>
<tr>
<td>Slovenia</td>
<td>$45,000</td>
</tr>
<tr>
<td>Italy</td>
<td>$50,000</td>
</tr>
<tr>
<td>Spain</td>
<td>$55,000</td>
</tr>
</tbody>
</table>

Source: Moody’s Investors Service

**Government policies have contributed to the decline in food price inflation**

Cereals (wheat and rice) and vegetables have been the main drivers of the decline in food price inflation. Since 2013, the fall in cereal price inflation has reflected more active food management policy following implementation of the National Food Security Act. This resulted in the release of government cereal stocks into the open market at highly subsidized rates, along with higher wheat imports.

Since cereals play a very important role in the Indian economy, the government actively manages their procurement, storage and distribution, along with their prices by setting MSPs. The price of cereals influences other food prices and wages, because it can incentivize greater production of cereals and to a less of other agricultural products, and rural wages are often linked to cereal prices.

The decline in vegetable prices is also a result of changes to state government food policy. Historically, India’s vegetable supply chain was fragmented and used inefficient middlemen, adding to mark-up costs and contributing to higher spoilage and waste. Starting in 2012, some Indian states began to address this by amending the Agriculture Produce and Marketing Committee Act (APMC), which stated that farmers had to sell their product through “mandis” (wholesale market middlemen) instead of directly to consumers, giving farmers the freedom to sell to other markets. Starting in 2012, several states began to deregulate vegetables (and fruits) from the APMC, resulting in a sharp decline in prices.

These changes should benefit the average Indian household through lower prices. However, given the very high share of employment in the agriculture sector, many rural households are ultimately hurt by persistently low food prices when their own production costs do not slow at the same pace. Meanwhile, measures to reduce rural families’ reliance on agriculture and provide better job opportunities have been limited by structural challenges in the labor market.

**Pace and quality of job creation lags working-age population’s needs**

Another constraint to economic strength relates to relatively limited job creation outside the informal, very low-skilled sector – at odds with the country’s high GDP growth.

India’s young and growing working-age population will exacerbate this challenge. The United Nations estimates that the working age population (15 to 64 years old) will continue to rise from about 66% of the total today to about 68% in 2030-40. As a result, India
will need to generate around 16 million “new and better jobs” to fully absorb its surplus labor by 2030, according to India’s Institute for Human Development (see Exhibit 5).\(^7\)

India’s dearth of reliable employment data make it difficult to determine the pace at which jobs are being created today. However, a number of indicators suggest that formal job creation is lagging working-age population growth (see Exhibit 6).

Unemployment stood at 4.9% in 2013-14, according to the Ministry of Labour and Employment. Although the release of the National Sample Survey Office’s (NSSO) Periodic Labour Force Survey (PLFS) for 2017-18 was delayed, limiting the availability of more recent official data, private sources suggest that employment conditions are weaker today. For example, the Center for Monitoring the Indian Economy (CMIE) estimates that India’s unemployment rate reached 7.4% in December 2018, and the Center for Sustainable Employment at Azim Premji University estimates that India’s youth unemployment stands at 16%.\(^8\) According to Brookings India’s analysis of a government survey of households\(^9\) before demonetization and the implementation of the goods and services tax (GST), as of 2016 Indian unemployment hovered around 5% and labor force participation stood at an unusually low 50% (i.e., only half the working-age population was actively working or seeking employment), compared with rates of around 77% in Vietnam (Ba3 stable), 70% in Indonesia (Baa2 stable), 69% in Thailand (Baa1 stable) and 57% in Bangladesh (Ba3 stable).\(^10\)

In addition, unemployment rates vary greatly between regions, with states that are actively increasing the ease of doing business through elimination of red tape and investment-friendly policies (including Gujarat, Karnataka and Chhattisgarh) registering much lower overall and youth unemployment rates and higher female workforce participation.

<table>
<thead>
<tr>
<th>Exhibit 5</th>
<th>Exhibit 6</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>India’s working-age population will continue to grow through 2040</strong>&lt;br&gt;(Working-age population as a percentage of total population)</td>
<td><strong>Recent growth in the labor force has not kept up with the working-age population</strong>&lt;br&gt;(Thousands of persons)</td>
</tr>
<tr>
<td><img src="graph1.png" alt="Graph showing working-age population growth" /></td>
<td><img src="graph2.png" alt="Graph showing labor force growth" /></td>
</tr>
</tbody>
</table>

At the same time, the quality of jobs being created is often below what would support a material increase in labor productivity. Brookings’ analysis points out that there is a higher unemployment rate among Indian youth who possess graduate degrees and above (nearly 35%), compared to only about 6% among relatively uneducated young workers. This highlights that the quality of jobs being created tends to be relatively low and indicates that skill sets are out of sync with those jobs that are available.

This apparent skills mismatch has led analysts to suggest that India would benefit from both better quality job opportunities for educated graduates and skilling of less educated workers through vocational training. For example, the World Bank notes that India’s vocational education stream is small, enrolling less than 3% of students at the upper secondary level. Meanwhile, the vocational stream is not meeting the needs of the labor market, as less than 40% of its graduates find employment. The World Bank highlights that industry’s limited involvement in vocational training is a key constraint to matching demand for labor with relevant skills, while public training institutions also need greater incentives to improve performance.\(^11\)
According to the Indian government, the country is facing a severe shortage of well-trained, skilled workers, with large segments of the educated labor force having few or no job skills. The government has estimated that only about 2.3% of India’s workforce has undergone formal skill training, compared with 52% in the US (Aaa stable), 68% in the UK (Aa2 stable), 75% in Germany (Aaa stable), 80% in Japan (A1 stable) and 96% in Korea (Aa2 stable).

At the same time, a large proportion of India’s workforce is employed in the informal sector, which is generally less stable, and more difficult to draw into the government’s tax net. Although the IMF estimates that, at 24% of GDP, India’s informal economy is smaller than the average of about 32% among a group of 158 advanced and developing countries, the International Labor Organization calculates that the large majority of workers, more than 80% of nonagricultural employees, are in the informal economy.

One of the main drivers of the large degree of informality in the workforce is India’s rigid labor laws, which disincentivize hiring at scale. For example, the Industrial Disputes Act of 1947 requires industrial establishments that employ 100 or more workers to seek permission from the government before laying off employees or closing down establishments, limiting the ability of companies to respond to changing business conditions. Meanwhile, the Contract Labour Act of 1970 limits the use of contract labor to address uncertain demand conditions. More broadly, India’s systems for securing registrations and licenses, submitting information, and maintaining records are often cumbersome. As a result, labor in India is less competitive than in some other low cost production centers in Asia, including Bangladesh, Cambodia (B2 stable) and Vietnam.

**Government policies have started to focus on labor market constraints and job creation, with limited progress to date**

The Indian government has taken some steps to increase labor market competitiveness and boost job creation in recent years, but with limited success.

For example, there have been efforts to liberalize labor laws, but such measures continue to meet staunch resistance from labor unions and strong political forces within Indian society. More recently, some states have implemented reforms that have increased the flexibility of labor laws. But these reforms have been incremental in nature and many fundamental challenges remain. Prospects for significant labor reforms at the national level appear very low.

In July 2015 the government launched the National Skill Development Mission. A new Ministry for Skill Development & Entrepreneurship was created to oversee and direct the initiative by coordinating and consolidating skilling efforts across sectors and states. The mission seeks to provide institutional capacity to train a minimum of 300 million people by 2022. Government efforts like this, in coordination with those of schools and private sector employers, can increase the competitiveness and employability of India’s labor force. However, progress is likely to be gradual and success will largely depend on the extent to which private sector employers partner with these programs to match employment opportunities with skill sets.

On the labor demand side, the government is promoting development of the manufacturing sector as a potential source of larger scale and better quality job creation. Expansion of labor-intensive manufacturing jobs (such as in textiles, gems and jewelry) would contribute to labor productivity gains by transferring jobs from the highly inefficient agriculture sector. However, despite ongoing government attention to the issue (which spans multiple administrations), there has been little tangible progress to date. The combination of relatively rigid labor laws and skill constraints, with falls in the relative cost of capital investments due to technological progress, has contributed to a substantial decline in labor intensity in manufacturing over the past three decades.

To address this, in 2014 the government launched its “Make in India” campaign with the intent of making the country a global manufacturing hub, by encouraging multinational and domestic companies to produce their goods in India. The government aimed to expand the size of the manufacturing sector to 25% of GDP by 2022 from about 16% in 2014, while creating 100 million new jobs. It has subsequently shifted the target date to 2025, and while foreign direct investment flows have risen somewhat, the manufacturing sector constitutes a similar share of GDP as at the time the initiative was announced.

These examples highlight the scale of India’s challenge and relatively limited impact of government measures to date.

Moving forward, we believe that potential GDP growth and employment generation will remain constrained unless reforms are advanced to directly reduce restrictions on the productivity of labor and land, and stimulate private sector investment in physical
infrastructure. In the absence of such policy actions, these fundamental constraints on productivity will continue to weigh on India’s labor and export competitiveness, and relative attractiveness as an investment destination.

**Improved quality of growth would make planned fiscal consolidation more achievable**

India’s weak fiscal position, underscored by its high debt burden and low debt affordability, is one of its main credit challenges. To tackle this issue, the government convened a committee of fiscal policy experts in 2016 to develop recommendations for new amendments to the Fiscal Responsibility and Budget Management (FRBM) act that would provide a framework for credible fiscal consolidation. The FRBM Review Committee presented the government with its recommendations in January 2017, suggesting a debt rule and fiscal deficit glide path that would lower the general government (combined central and state) debt-to-GDP ratio to 60% by fiscal 2022, with a target ratio of 40% of GDP for the central government and 20% for states (see Exhibits 7 and 8).

Higher quality growth that raises GDP growth potential and formal job creation would make the government’s planned fiscal consolidation more achievable by directly lowering the debt burden, augmenting government revenue collection through increased tax buoyancy, and reducing political pressure for higher government welfare spending.

The most direct impact of GDP growth on a sovereign’s debt burden is through the denominator for the debt-to-GDP ratio. Sustained higher nominal GDP growth results in a higher denominator which deflates the ratio when GDP grows faster than general government debt. This dynamic was a major contributor to the decline in India’s debt burden to about 67% in fiscal 2010 from about 85% in fiscal 2003, driven by both high real GDP growth and inflation (which averaged around 7.7% and 7.0%, respectively, during this period). However, the reverse occurs when growth and inflation slow. Lower nominal GDP growth makes cutting the debt burden even more reliant on proactive fiscal deficit reduction, which can be politically challenging and, when it implies restrictive fiscal policy, weigh on growth.

As a baseline, we expect India’s general government debt-to-GDP ratio to slowly fall to about 64% in fiscal 2022 from about 67% in fiscal 2018, supported by a decline in the general government fiscal deficit to 6.0% from 6.4% and average nominal GDP growth of just below 12% during this period.

Based on our debt sensitivity analyses (see Exhibit 9), we observe that a slowing of the nominal GDP growth rate to 10% in fiscal 2019-22 from an estimated 11.5% in fiscal 2018 would result in a gradual increase in the debt burden over the next four years. Nominal growth of 11% would keep the debt burden around 66% over this same period. However, to achieve fiscal consolidation in line with the government’s revised FRBM debt target of 60% by fiscal 2023, nominal GDP growth would need to rise to 13%. By comparison, over the past five years nominal GDP growth has averaged about 11.5%.15
Higher quality growth would support greater job creation and formalization of economic activity, increasing government revenue and tax buoyancy, and facilitating fiscal deficit reduction.

India’s large low-income population limits the government’s tax revenue base. At about 21% of estimated GDP in 2018, general government revenue was lower than the 29% median for Baa-rated sovereigns (see Exhibit 10). In addition, the large proportion of workers in the informal sector hinders tax reporting and collection. Increased formalization of employment through higher quality growth would help to address this challenge.

Looking forward, in the absence of broader, more job-rich growth, India’s credit profile will likely weaken through the lowering of our assessments of economic and fiscal strength.

Without an increase in the breadth and job intensity of growth, the tax base and tax buoyancy – the responsiveness of tax revenue to growth – will be constrained. Moreover, less inclusive growth puts pressure on the government to provide direct tax relief or raise expenditure to support households and consumption, reducing tax revenue and potentially pushing some taxpayers out of the tax net.
For example, the government’s fiscal 2019 interim budget announced tax relief measures for the middle class, including rebates and a higher standard deduction, while iterative changes to the GST in 2018 lowered tax rates on certain goods and raised the income threshold for businesses that need to pay GST, reducing the overall number of businesses that fall within the tax net. Similarly, a priority of the government’s fiscal 2019 interim budget was increased rural welfare spending through a direct cash transfer scheme to provide income support to small farmers – a response to financial distress from prolonged low food price inflation.
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Compilation

» Inside India, February 2019

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Endnotes

1 See “Environmental Risks – Sovereigns: Credit profiles of small, agriculture-reliant sovereigns most susceptible to climate change risk,” May 2018

2 See “Poverty & Equity Brief South Asia India,” World Bank, October 2018


4 The farmer support program, Pradhan Mantri Kisan Samman Nidhi (PM-KISAN), is a direct cash transfer scheme providing INR6,000 (about $85) annually for small farmers with cultivable land holdings of fewer than two hectares. The cash transfer is paid in three equal installments of INR2,000 and is effective retroactively from 1 December 2018, with the first installment to be paid during fiscal 2018. The government estimates the cost at INR200 billion (about 0.10% of GDP) in fiscal 2018 and INR750 billion (about 0.35% of GDP) in fiscal 2019. The government also announced an interest rate subvention on the timely repayment of farm loans.

5 See “Cross-Sector – India: Interim budget measures aimed at boosting growth pose risks to fiscal consolidation,” February 2019

6 The National Food Security Act, or Right to Food Act, was signed into law in September 2013. It aims to provide up to 75% of India’s rural population and 50% of the urban population with access to highly subsidized rice, wheat and millet.


9 Survey of over 150,000 households across India between April and December 2015.

10 See “The debate over jobs in India is missing the point,” Ravi, April 2019.


12 See Medina & Schneider, “Shadow Economies Around the World: What Did We Learn Over the Last 20 Years?,” IMF Working Paper 18/17, January 2018

13 See “Informal economy in South Asia,” International Labour Organization

14 The ratio of workers to real fixed capital has declined by a factor of five. See “Where Have All The Workers Gone? The Puzzle of Declining Labour Intensity in Organized Indian Manufacturing,” Sen & Das, Institute for Development Policy and Management, April 2014

15 This analysis assumes a GDP deflator that gradually rises to 5.0% in fiscal 2022 from about 4.0%, in line with our projections for CPI inflation, which we expect to remain within the Reserve Bank of India’s flexible inflation target range of 4% (plus or minus two percentage points).

16 See “Government of India: A lower goods and services tax rate will weigh on fiscal consolidation efforts, a credit negative,” July 2018
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