OPINION

Keys to Successful Reform in India

By Eswar Prasad

India's new Prime Minister, Narendra Modi, won a decisive mandate from an electorate yearning for effective leadership. His government's first budget due out next week will be an important indicator of how forcefully Mr. Modi intends to translate this mandate into actions to put India's economy back on track.

Of course, despite his clear mandate, Mr. Modi will not have a free hand to impose reforms by decree. He is constrained by a democratic system of government and accountability to the electorate. Hence, both the strategy and the specifics of reform will be crucial to making the program a success.

A key priority is to signal greater fiscal discipline. High levels of public deficits and debt, exacerbated by wasteful subsidies

Both strategy and specifics are crucial in Modi's first budget, due out next week.

and an inefficient tax system, have created many market distortions and contributed to high inflation. Populist sops have also reduced resources available for expenditure on infrastructure, education and other areas that could boost long-term productivity.

The government needs to commit to long-term fiscal discipline. It should move aggressively to reduce fuel subsidies, implement a goods and services tax, and step up the pace of privatization of state enterprises. These measures would not only improve the fiscal position of the government but also enhance overall economic efficiency by shifting the focus away from purely redistributive policies.

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Narendra Modi lights a lamp and gets down to setting policy.

It will also be helpful to signal that the government will not look for easy targets, such as foreign firms, to raise revenues by changing the rules whenever convenient. Policy certainty is as important for domestic investors as it is for foreign ones.

Mr. Modi needs a narrative that highlights the broad benefits of reforms. A major stumbling block to reforms in emerging market economies is the view, often a legitimate one, that such reforms largely benefit the economic and political elite.

A clear narrative will be especially relevant for major reforms, such as those to increase labor market flexibility. Rigid labor laws that make it difficult to fire workers or shut down loss-making firms have hurt job growth and the competitiveness of India's manufacturing sector. It is important to communicate that freeing up the labor market is essential for generating high-quality job growth that will benefit India's population rather than just industrialists and entrepreneurs.

The rhetoric surrounding reforms is particularly crucial in determining their political fate in a democracy. Mr. Modi could build support for his agenda by taking a frontal stand against public corruption, which has not only hurt economic efficiency but also deprived the poor of many benefits from economic growth.

Mr. Modi should also signal a willingness to embrace globalization with open arms. Reducing barriers to trade in goods and services and easing barriers to foreign investment would create more choices for consumers and more sources of financing for firms. Although increasing openness to foreign trade and capital has some risks, there can be large indirect benefits if the process is managed well. Namely, it could push domestic firms and financial institutions to up their game.

The budget should provide a down payment on reforms to help generate momentum. No one expects miracles overnight but actions are as important as words in building credibility on reforms.

Consider the actions of central banker Raghuram Rajan. On his first day in office, Mr. Rajan announced a set of financial sector reforms and signaled that there was more to come. Soon after, despite protests from industry, he raised policy interest rates. This made it clear that controlling inflation would be the first priority of the central bank and that he would not back down from this objective. This combination—a quick start on implementing reforms and a commitment to deliver on the central bank's core mandate—fended off market pressures and helped turn around sentiment about the economy's prospects during a difficult period.

Fighting inflation should be a priority for the new government since persistent high inflation can quickly erode its support. It can bolster the Reserve Bank of India's actions by emphasizing supply-side measures that boost investment and productivity. The supply and distribution of food, in particular, needs improvement through reforms of agricultural and land policies.

The budget should contain a clear message supporting the central bank's efforts to free up financial markets and develop broader sources of financing, especially corporate bond markets, to meet India's needs for long-term finance. Another RBI goal is to promote access to the formal financial system. Support from the government for this will tie in to the broader message of inclusive reforms as it will help spread the benefits of reforms more broadly through the population.

On the national stage, the complexity of the challenges Mr. Modi faces and the level of opposition to reforms will be far higher than at the state level. To be successful, he will need an iron will and a plan of action that involves quickly plucking low-hanging fruit but also getting started on more fundamental reforms. To deliver what India's electorate is hoping far, a well thought-out strategy will be as important as knowing what needs to be done.

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