

# India Development Update

May 2017

# Unlocking Women's Potential



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# INDIA DEVELOPMENT UPDATE

## *Unlocking Women's Potential*

May 2017

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The report is based on information current as of May 15, 2017.

## Abbreviations

ACH	Automated Clearing House
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
AP	Andhra Pradesh
AQR	Asset Quality Review
BE	Budget estimates
BoP	Balance of Payments
BRICS	Brazil-Russia-India-China-South Africa
BSE	Bombay Stock Exchange
C&AG	Comptroller and Auditor General
CBEC	Central Board of Excise and Customs
CDR	Corporate Debt Restructuring
CG	Chhattisgarh
C/I/S-GST	Central-/Integrated-/State-GST
CII	Confederation of Indian Industry
CPI	Consumer Price Index
CRILC	Credit Repository of Information on Large Credits
CSO	Central Statistics Office
CTS	Cheque Truncation System
DGCIS	Directorate General of Commercial Intelligence and Statistics
DRT	Debt Recovery Tribunals
DTH	Direct-to-Home
ECS	Electronic Clearing Service
EEA	European Economic Area
EPCG	Export Promotion Capital Goods
EU	European Union
FDI	Foreign Direct Investment
FIPB	Foreign Investment Promotion Board
FOB	Free on board
FRBM	Fiscal Responsibility and Budget Management
FTA	Free Trade Agreement
FTP	Foreign Trade Policy
FY	Fiscal Year
GDP	Gross Domestic Product
GFCF	Gross fixed capital formation
GFSM	Government Financial Statistics Manual
GNFS	Goods and Non-Factor Services
GNI	Gross National Income
GoI	Government of India
GSDP	Gross State Domestic Product
GST	Goods and Services Tax
GVA	Gross Value Added
HP	Himachal Pradesh
HR	Haryana
IIP	Index of Industrial Production
IMD	Indian Meteorological Department
IMF	International Monetary Fund
IMPS	Immediate Payment Service
IPR	Intellectual Property Rights
IRCTC	Indian Railway Catering and Tourism Corporation
IRFC	Indian Railway Finance Corporation Limited
IT	Information technology
JAM	Jan-Dhan-Aadhaar-Mobile
JLF	Joint Lenders' Forum
JNNURM	Jawaharlal Nehru National Urban Renewal Mission
KYC	Know-Your-Customer
LFP(R)	Labor Force Participation (Rate)
LLP	Loan-loss provision
LPA	Long Period Average

LPI	Logistics Performance Index
MAT	Minimum Alternative Tax
Mbit/s	Megabits per second
MEIS	Merchandise Exports from India Scheme
MG	Meghalaya
MGNREGA	Mahatma Gandhi National Rural Employment Guarantee Act
MHz	Megahertz
MoF	Ministry of Finance
MOSPI	Ministry of Statistics and Program Implementation
MOU	Memorandum of Understanding
MP	Madhya Pradesh
MPC	Monetary Policy Committee
MZ	Mizoram
NABARD	National Bank for Agriculture and Rural Development
NACH	National Automated Clearing House
NEFT	National Electronic Funds Transfer
NHAI	National Highway Authority of India
NIPFP	National Institute of Public Finance and Policy
NPAs	Non-Performing Assets
NSSO	National Sample Survey (Office)
OECD	Organisation for Economic Cooperation and Development
PAN	Permanent Account Number
PFM	Public Financial Management
PGAs	Partner Government Agencies
PIT	Personal income tax
POS	Point-of-Sale
PPI	Pre-Paid Instruments
PPP	Purchasing Power Parity
PSUs	Public Sector Undertakings
PTAs	Preferential Trade Agreements
RBI	Reserve Bank of India
RE	Revised estimates
REER	Real Effective Exchange Rate
RHS	Right-Hand Side
RTGS	Real Time Gross Settlement
S4A	Scheme for the Sustainable Structuring of Stressed Assets
SAD	Special additional duty
SARFAESI	Securitization and Reconstruction of Financial Assets and Enforcement of Security Interests
SDR	Strategic Debt Restructuring
SEIS	Services Exports from India Scheme
SEZs	Special Economic Zones
SFIS	Served from India scheme
SK	Sikkim
SMEs	Small-and-Medium Enterprises
SPS	Sanitary and Phytosanitary
SWIFT	Society for Worldwide Interbank Financial Telecommunication
TDS	Tax deduction at source
TFA	Trade Facilitation Agreement
TFP	Total Factor Productivity
TiVA	Trade in Value-Added
TPP	Trans Pacific Partnership
TRAI	Telecom Regulatory Authority of India
TTIP	Transatlantic Trade and Investment Partnership
UDAY	Ujwal DISCOM Assurance Yojana
UNCTAD	United Nations Conference for Trade and Development
UP	Uttar Pradesh
WDI	World Development Indicators
WDR	World Development Report
WPI	Wholesale Price Index
WTO	World Trade Organization

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# Executive Summary

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## RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

A favorable monsoon generated tailwinds to India's domestically-driven expansion. The Gross Domestic Product (GDP) expanded by 7.9 percent in FY16, the fastest pace in 5 years, supported by investment and urban consumption. The normal monsoon in FY17 boosted agriculture and rural consumption, while urban consumption remained robust. Despite renewed weakness in private investment and limited lift from external demand, India was poised to continue growing robustly in FY17 until "demonetization" dented growth, albeit moderately, causing immediate cash crunch, and affecting activity in cash reliant sectors. The cash crunch affected activity in cash reliant sectors and GDP growth slowed to 7.0 percent y/y during Q3 FY17, from 7.3 percent during H1 FY17. Such a modest slowdown can be explained by: (i) coping mechanisms (e.g. informal credit); (ii) higher rural wages and public consumption; and (iii) higher reported sales to legitimize holdings of old currency and use of formal-sector indicators to measure informal activity, which exacerbated measured growth.

The central government met its commitment to fiscal consolidation, but states increased spending and borrowing. The central government expects to meet its fiscal deficit target of 3.5 percent of GDP in FY17 as tax collection remained robust. The fiscal stance of the general government (center and states) is less clear as fiscal reporting by states, which have been undertaking a growing share of expenditure, is less reliable. There are indications, however, that state-level deficits have been on an increasing trend.

External accounts remain robust. Exports contracted for five consecutive quarters, but turned positive in the second half of FY17, supported largely by higher prices and improvements in global trade, contributing to containing the current account deficit. Capital inflows accelerated, reflecting in part reforms in foreign direct investment (FDI) policies and in part global appetite for Indian equities. Consequently, foreign reserves rose to \$360bn, worth nearly nine months of imports.

Demonetization affected poor and vulnerable households, in all likelihood having an impact on construction and informal retail, where many poor and vulnerable individuals work. While limited data is

available, there has been an increase in demand for guaranteed employment (up to February 2017 demand exceeded the full year FY16 level), and indicators of rural consumption (in particular, sales of two-wheelers) contracted sharply in November, before recovering.

Economic activity ought to accelerate in FY18. GDP is projected to grow at 7.2 percent from 6.8 percent in FY17. The revision in forecasts reflect a combination of the impact of demonetization and an investment recovery that has proven more protracted than expected. Growth increases gradually to 7.7 percent by FY20, underpinned by recovery in private investments, which are "crowded-in" by the recent increase in public capital expenditure and improvement in investment climate.

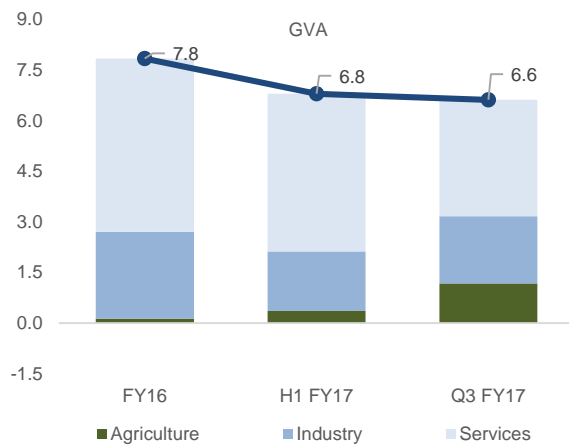
India's fiscal, inflation and external conditions are expected to remain stable. The center will continue to consolidate modestly in FY18, while retaining the push towards infrastructure spending. Inflation will stabilize, supported by stable weather and structural reforms. A normal monsoon has offset increases in petroleum prices, the government amended the RBI Act to reflect a (central) inflation target of 4 percent and established a Monetary Policy Committee (MPC), boosting the credibility of the central bank. The exchange rate has appreciated, partly reflecting expectations of a narrowing inflation gap between India and the USA and limited external vulnerability as the current account deficit is expected to remain below 2 percent of GDP and fully financed by FDI inflows.

There are significant risks to India's favorable growth outlook. First, continued uncertainties in the global environment, including rising global protectionism and a renewed slowdown in the Chinese economy, could further delay a meaningful recovery of external demand. Second, private investment continues to face several impediments in the form of corporate debt overhang, stress in the financial sector, where NPAs continue to increase, excess capacity, and regulatory and policy challenges. Subdued private investment would put downside pressures on India's potential growth. Finally, further rapid increases in oil and other commodity prices could lead to a negative terms-of-trade shock. On the other hand, smooth implementation of the Goods and Services Tax (GST) and faster resolution of banking sector stress could prove to be an upside risk to economic activity.

# The Indian Economy in Pictures

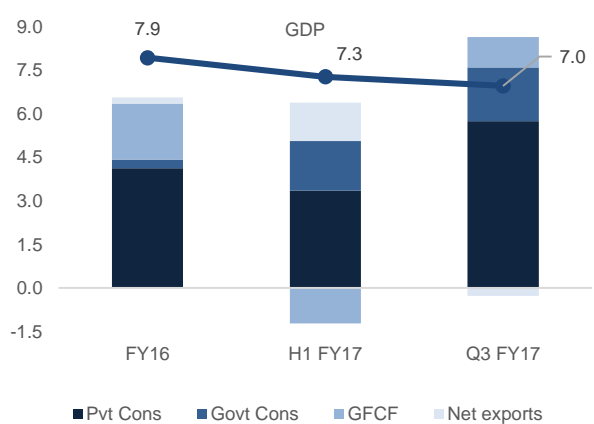
## The monsoon delivered...

Change from the previous year, percent

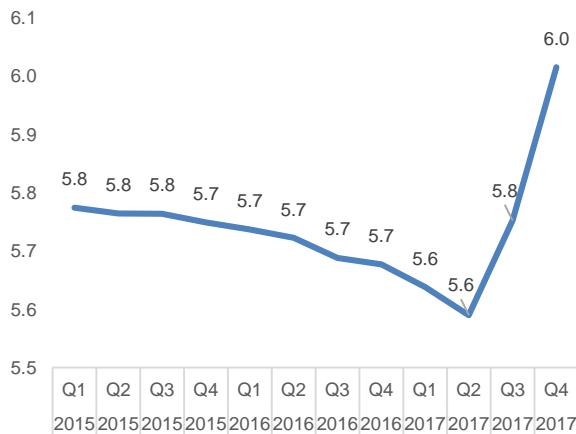


## ... and demonetization caused hardly a dent on growth...

Change from the previous year, percent

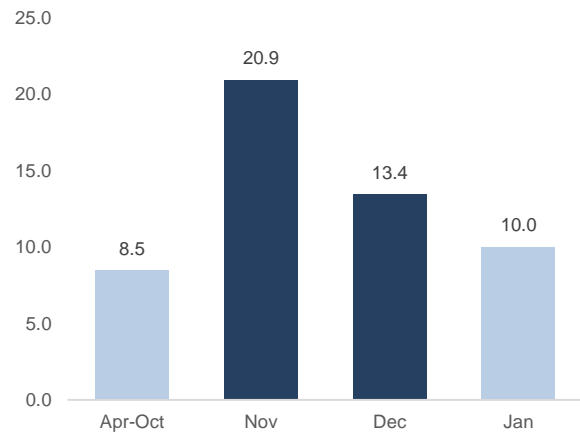


## ...partly as Indians figured out ways around using cash... M1 velocity



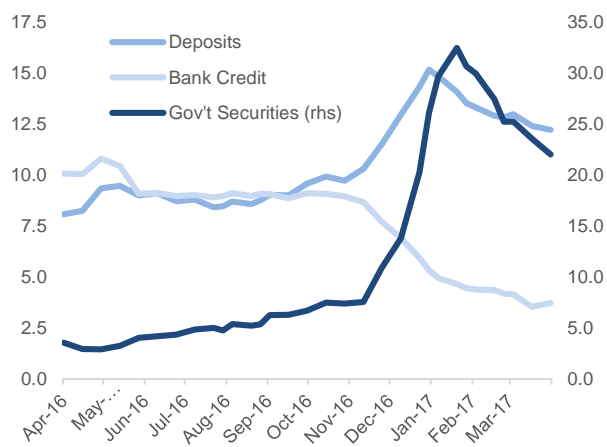
## ...and partly higher tax payments masked the impact

Sales tax collections in the 11 largest states, change from the previous year, percent



## Banks had more funds, but used them to buy government bonds while credit and investment remained sluggish

Change of the four-week moving average from the previous year, percent



## Trade has revived, offering an upside risk for investment and FY18 growth if prospects of de-globalization abate

Change from the previous year, percent



Sources: see main text

## UNLOCKING WOMEN'S POTENTIAL

India has among the lowest female labor force participation rates (LFPRs) in the world – well below what would be expected for its level of income and what is observed in neighbors such as Bangladesh, Sri Lanka and Nepal. Not only is India's female LFPR low, but it declined a further 10 percentage points between 2004-05 and 2011-12. Low female LFPRs impose constraints on a country's growth, the empowerment of its women, and the outcomes for its children.

In particular, low female LFPR is a drag on GDP growth and an obstacle towards reaching a higher growth path. One estimate suggests GDP growth could accelerate from 7.4 percent currently to over 9 percent if India closed half the female LFPR gap with Nepal. Women are also an untapped source of managerial and entrepreneurial skills. By excluding women, the pool of such talent becomes shallower and growth suffers.

What are the “proximate” or mechanistic causes of low female LFPR? **First**, some 30 percent of the decline is due to more young women staying in school longer as both secondary and tertiary enrolment rates increased substantially. **Second**, female LFP declines along the rural-urban gradation; in other words, as areas become more urbanized, women who reside in those areas become less likely to work. This leads to two related phenomena: first, as more Indians moved to cities, female LFPR converged to the (lower) urban levels; second, as areas that are classified as rural became more urbanized, female LFPR similarly declined, but this appeared as a decline in urban female LFPR. The **third** cause are retirements. Although still a minor cause, the fact that inactivity rates among older (46+) Indians have increased between 2004-05 and 2011-12 suggests that India is fast approaching an aging demographic profile.

Two observations arise from the analysis of proximate causes of low female LFPR. The **first** is that participation rates are also low and declining even among educated women. Considering that 42 percent of India's science and technology graduates are women, this is a significant ‘brain drain’ for modern services sectors. The **second** is that jobs for Indian women remain primarily in agriculture. The share of women in services and industry is less than 20 percent and lower than the overall female LFPR. In contrast to India, in Brazil, Indonesia and Vietnam, women workers take a higher share of services jobs. In Bangladesh and Vietnam, which have vibrant textile and apparel industries, women represent a larger share in the industrial sector.

Two main hypotheses have been offered to explain the deeper causes of low urban female LFPR. The first is known as the ‘income hypothesis’ and notes that some decline in female LFPR can be expected with development. At low levels of income and education, women mostly work out of necessity and in poor quality jobs, largely in agriculture. As household incomes rise when men find jobs in industry or services, women may choose to drop out from the labor market as higher household incomes allow women to stay at home, often a preferred household choice.

Supply-side explanations are likely part of the overall reason for low and declining LFPR, but cannot explain all the developments observed. In particular, higher household incomes are not closely associated with female LFPR, and the low and declining participation rate of educated women is inconsistent with an economy with a growing modern services sector.

The alternative explanation points to limited job creation overall; given social norms and other gender-specific constraints, these few jobs being created end up going to men. Supporting this hypothesis, many women who are not working say they would like to work, but they cannot find suitable jobs, which are well-paying, close to their homes, and with flexible working hours.

Concerns about women's safety are strong and often genuine, while flexibility, availability of childcare, and adequate pay are important given social norms that require women to reconcile work with household duties.

Regular, salaried jobs may also be attractive as they would provide higher and steadier income that would help women reconcile household duties with work. However, such regular, salaried jobs have been in short supply in India, especially for women.

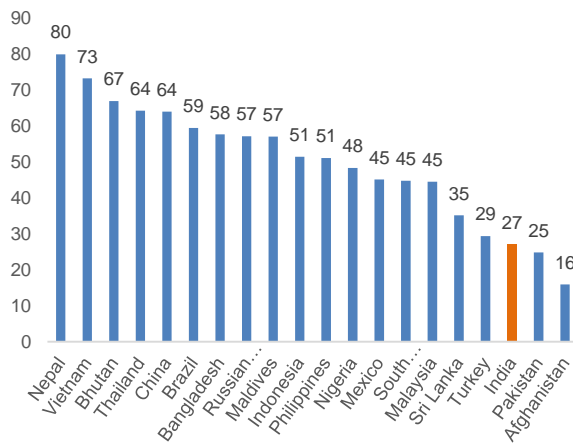
While no definitive answer has been identified, labor laws are relatively restrictive overall but especially towards women. Moreover, female entrepreneurs tend to hire more women, but there are relatively few women entrepreneurs, in part because of lack of access to capital and business networks.

If the overall lack of jobs, especially regular salaried jobs, plays a large role in India's female LFPR, only a combination of gender-targeted and broader policies towards formal job creation can sustainably raise female LFPR and accelerate India's GDP growth and broader social development. Policies that promote job creation in ‘women-friendly’ sectors such as apparel, or that help fast-growing modern service sectors absorb more educated women workers would be particularly helpful.

# Unlocking Women's Potential in Pictures

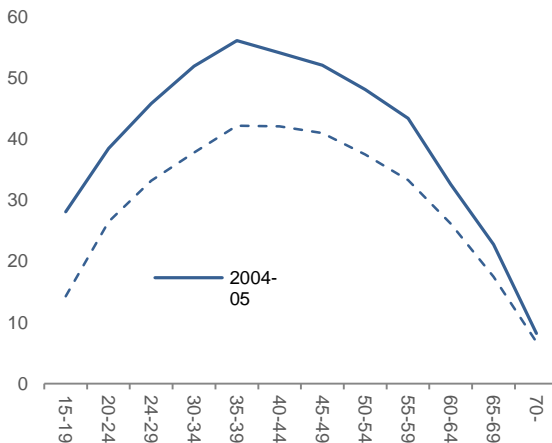
## Female labor force participation is low...

LFPR; percent



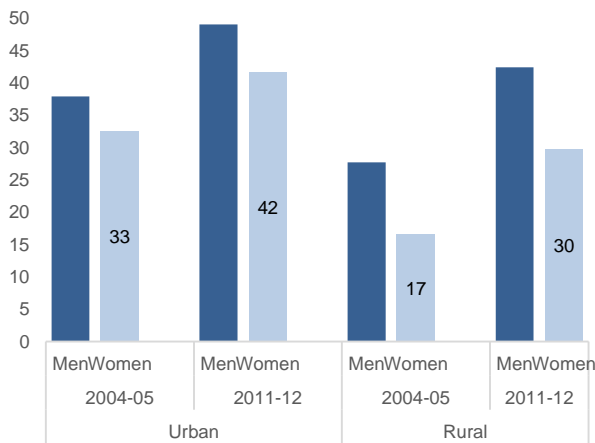
## ...and declined across all age groups

LFPR by age group, percent



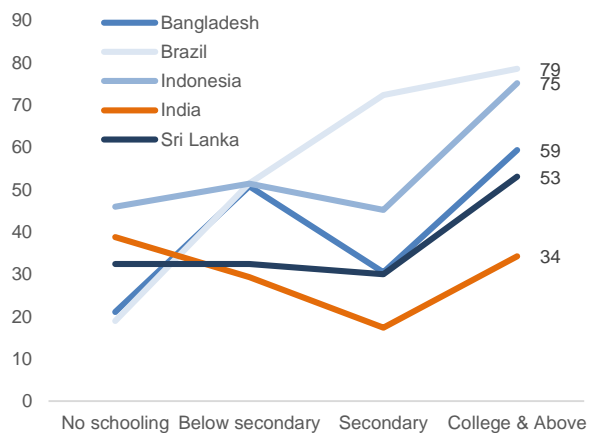
## A larger number of younger women are in school

Share of 15-25 year-olds in school, percent



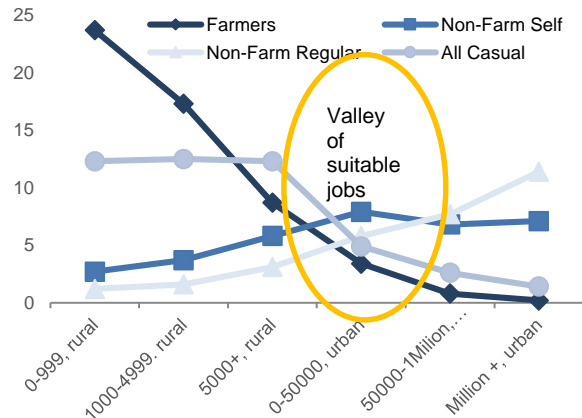
## However, even graduates are unlikely to work

LFPRs, percent



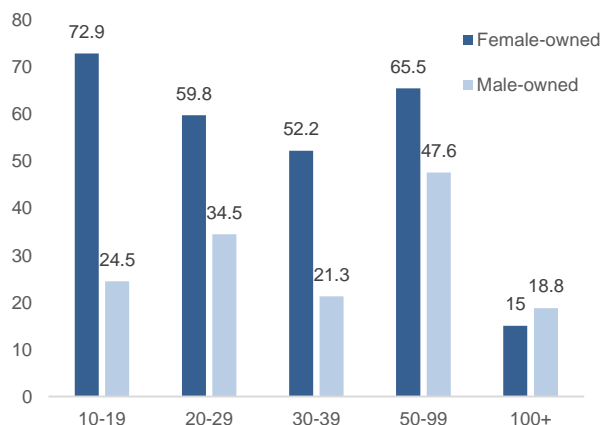
## There is a 'valley of suitable jobs' in urbanizing areas

LFPR by district size, percent



## Female-owned firms employ more women, but there are too few of them

Share of employees in the firm that are female by gender of owner, percent (y-axis); firm size, number of employees of the firm (x-axis)



Sources: see main text

## A. Recent Economic Developments and Outlook



### Favorable monsoon kept India's economy on a solid growth path

**India's economy was slowing in the first half of FY17...**

India's GDP expanded by an upwardly-revised 7.9 percent year-on-year (y/y) in FY16 (April 2015-March 2016), the fastest pace in five years.<sup>1,2</sup> Growth slowed to 7.3 percent H1 FY17, dragged down by a contraction in gross fixed capital formation (GFCF; see Figure 1A). Growth of gross value-added (GVA), considered a more reliable measure of the economy,<sup>3</sup> slowed from 7.8 percent y/y in FY16 to 6.8 percent in H1 FY17 (Figure 1B). A decline in manufacturing output was the main contributor to the slowdown, although this decline may be partly due to measurement issues – see Box 1.

**... but the favorable monsoon revived the growth momentum, which was only partly dampened by demonetization<sup>4</sup>**

The normal monsoon in June-October 2016 boosted growth of agriculture (+5.2 percent y/y in July-December 2016), farmer income, and rural consumption, shifting the economy to an upward path. In November 2016, however, demonetization caused a cash crunch that affected India's large informal economy and its financial sector, offsetting some of the gains in the rural economy. High frequency indicators pointed to a significant dent to growth, but the economy continued to expand in Q3 FY17 (October-December 2016), albeit at a somewhat slower quarterly pace (Figure 2).<sup>5</sup> GDP growth slowed to 7.0 percent in Q3 FY17, but consumption growth held up, investment growth turned positive, and trade showed green shoots. Similarly, helped by agriculture and government services (Figure 1B and Figure 3), GVA slowed only 0.2 pp in Q3 FY17, with the deceleration largely explained by a slowdown in the financial sector (specifically, financial, real estate and professional services) as banks had to focus on exchanging currency.

<sup>1</sup> "FY" refers to the Indian fiscal year, the twelve-month period ending March 31 of the year in question.

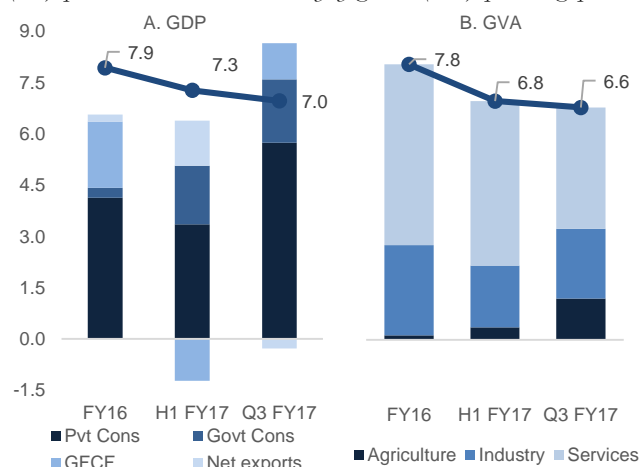
<sup>2</sup> GDP is valued at market (purchaser's) prices, whereas GVA is measured at basic (producer) prices, excluding product taxes and subsidies.

<sup>3</sup> The IMF (2017, p. SA10) notes that "due to weaknesses in estimating taxes less subsidies on products in constant prices, and as supply-side data remain of better quality than expenditure-side data, GVA is preferred as a proxy for measuring economic growth."

<sup>4</sup> Because the policy entailed the immediate demonetization of ₹500 and ₹1000 notes, it became widely known as "demonetization," although it can be best described as a currency exchange, since new ₹500 and ₹2000 notes were introduced to replace old ones. See [Note 1](#) in Part B.

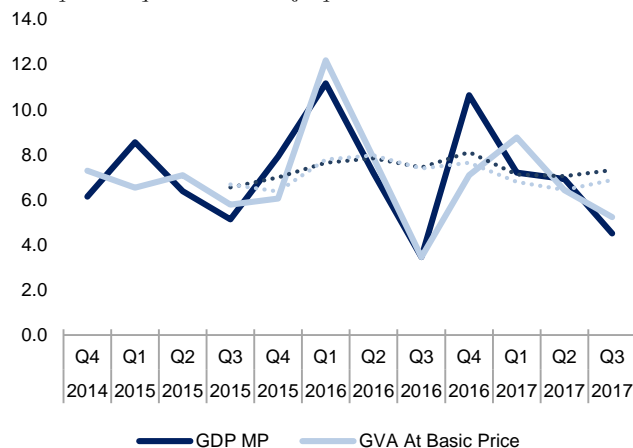
<sup>5</sup> Data are seasonally adjusted using the X13 procedure in JDemetra+.

**Figure 1. The monsoon delivered agricultural growth ...**  
 GDP and GVA adjusted for inflation; change from the previous year (line), percent; and contributions to y/y growth (bars), percentage points



Source: CEIC, CSO, and World Bank staff calculations  
 Notes: 1/ Gap between GDP and components due to contributions from changes in stocks, valuables, and statistical discrepancy

**Figure 2. ...cushioning the impact of demonetization**  
 GDP and GVA adjusted for inflation and seasonal fluctuations; change from the previous quarter, annualized, percent

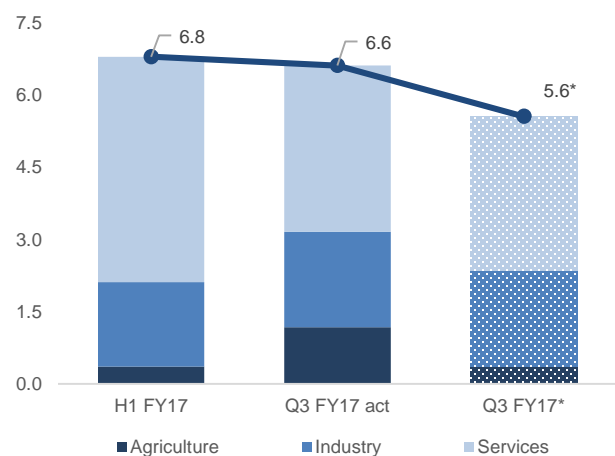


Source: CSO, and World Bank staff calculations  
 Note: Dotted lines correspond to four-quarter moving averages

**The impact of demonetization on growth was mitigated by growth in agriculture, government spending and coping mechanisms, and was partly masked by statistical issues**

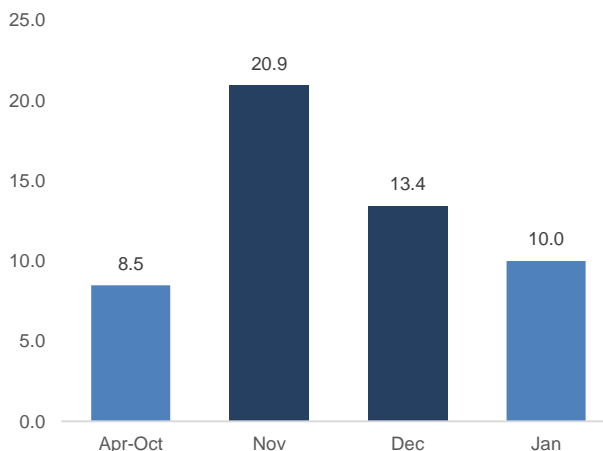
Five main factors explain the modest economic slowdown in the face of a large liquidity shock: (i) coping mechanisms; (ii) higher rural incomes; (iii) robust public consumption; (iv) a jump in reported sales; and (v) formal economy indicators used to assess the informal economy. Coping mechanisms included informal credit and the switch towards non-cash payments. Rural wages continued to rise in November and December, and the decline in food prices was not severe despite higher farm output, suggesting resilience in rural areas. Meanwhile, spending by states drove public consumption higher. A surge in sales tax collection, especially in November (Figure 4), supports a hypothesis that businesses may have reported earlier sales to legitimize holdings of old notes. Sales tax collection are used to estimate growth in wholesale and retail trade, which may have been overstated. The jump in sales tax collection also translates into higher net indirect taxes, explaining the continued gap between GVA and GDP. Finally, the Index of Industrial Production (IIP) is used to approximate activity in informal manufacturing but demonetization had an asymmetric effect on informal firms. See [Note 1](#) in Part B.

**Figure 3. Without the boost from agriculture and government services, growth would have slowed more**  
 GVA adjusted for inflation; change from the previous year (line), percent; and contributions to y/y growth (bars), percentage points



Source: CEIC, CSO, and World Bank staff calculations  
 Note: Q3 FY17\* assumes the contribution of agriculture and public administration to GVA growth remain unchanged from H1 FY17

**Figure 4. Sales tax collection jumped following demonetization**  
 Sales tax collections in the 11 largest states, change from the previous year, percent



Source: C&AG, and World Bank staff calculations

## Higher agricultural incomes and public spending boost consumption

**The monsoon delivered higher agricultural growth...**

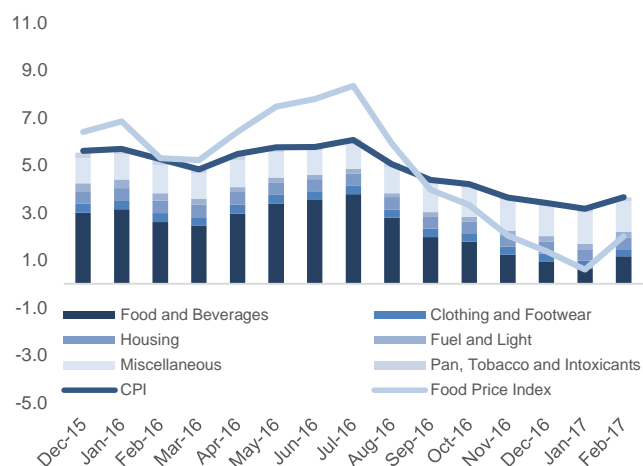
Following a normal Southwest monsoon, rain-fed crops performed well after two years of deficient rains. As of February 2017, the rainfall deviation stood at 10.1 percent of the long period average (LPA) compared to -57.9 percent of LPA in February 2016 and reservoir levels were at 46.5 percent of total capacity versus 35 percent a year ago. As a result, agriculture growth accelerated to 6.0 percent y/y in Q3 FY17 from 3.8 percent y/y in Q2 FY17. This was the highest growth in nearly five years, and probably continued into Q4 FY17 as reservoirs were recharged: the second advance estimate of production put cereal output for FY17 at nearly 250 million tons, crossing the previous record of 246 million tons harvested in 2013-14.

**...and dampened food inflation...**

The favorable monsoon and to some extent demonetization also contributed to moderating food price inflation, which drove headline inflation lower even as global commodity prices increased (Figure 5). With the exception of cereals, the pace of price rises in most food categories registered a decline. In particular, vegetable prices contracted from September, and from December, the price of pulses also declined. Considering the combination of higher production, the perishable nature of vegetables in the context of a cash shortage, and favorable base effects as vegetable prices had remained high for the previous two years, the decline in food inflation was relatively modest. Since the cash crunch was felt more in the rural economy and food forms a larger share of the basket in rural areas, rural inflation declined more than urban inflation (Figure 6).

**Figure 5. A favorable monsoon also helped contain food inflation...**

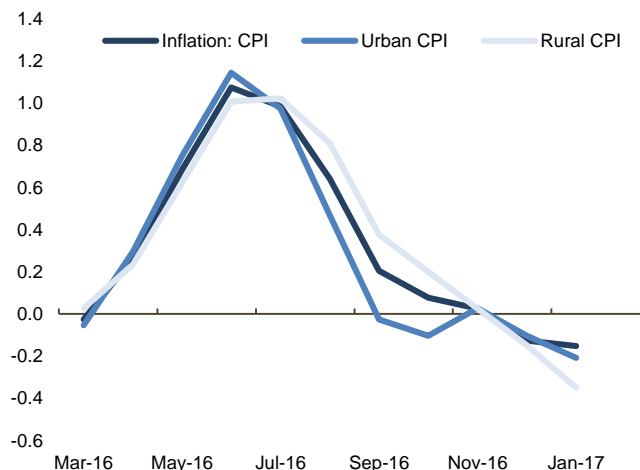
*Decomposition of CPI, changes (line) y/y percent, percentage points (bars)*



Source: CEIC and World Bank staff calculations

**Figure 6. ...leading to lower headline inflation particularly in rural areas**

*Consumer Price Index, change q/q 3mma, percent*



Source: CEIC and World Bank staff calculations

**...increasing real rural wages and leading to an early surge in rural consumption**

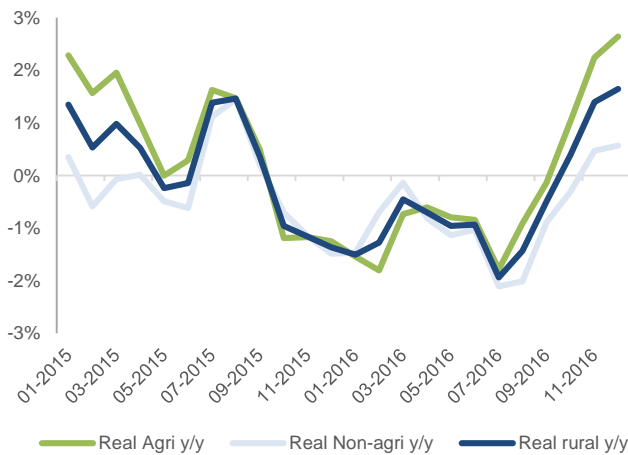
Owing to increased agricultural output, wages in rural areas have accelerated since October 2016. Further helped by declining rural inflation, real rural wages climbed 2.4 percent y/y in January, driven by wages for agricultural jobs (Figure 7). Rural consumption, as approximated by two-wheeler and tractor sales, picked up in September and October (Figure 8). Tractor sales had risen over 50 percent in October, while two-wheeler sales rose 18 percent. Demonetization then led to a sharp deceleration in rural consumption, as depicted in Figure 8, but this appears to have been temporary, as sales appear to have been recovering as of March.

**Civil servants' pay hikes and coping mechanisms helped urban consumption**

Urban consumption growth seemed less affected by demonetization as compared with rural consumption (Figure 9). This may be due to the impact of the civil service pay increases, the fact that urban households were better able to switch to digital payments and mitigate the liquidity crunch, use of informal credit, as well as the continued decline in inflation, which boosted real incomes.

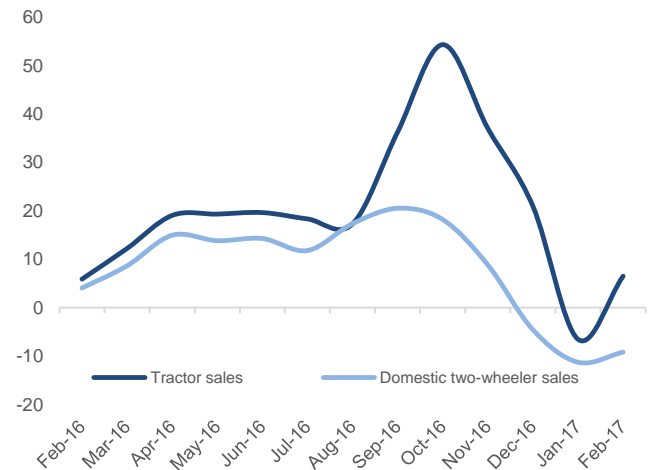


**Figure 7. Rural wages picked up after several months...**  
Rural wages and rural CPI changes from the previous year, percent



Source: CEIC, RBI and World Bank staff calculations

**Figure 8. ...leading to higher sales in rural areas**  
Growth in sales from the previous quarter, 3mma, percent

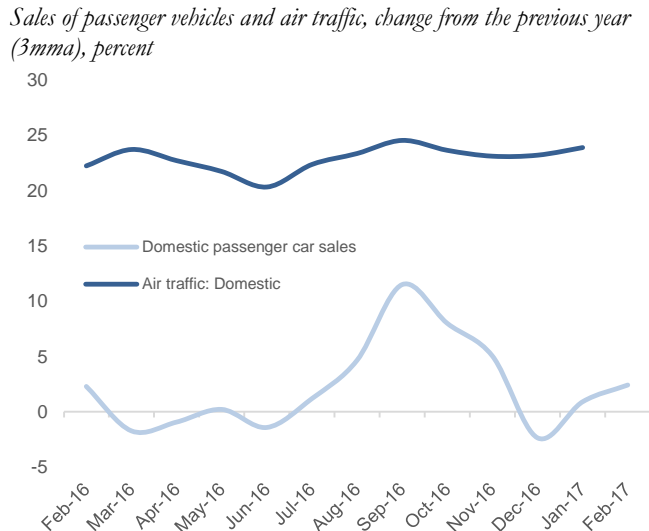


Source: CEIC and World Bank staff calculations

**The financial sector dragged down services growth, which slowed despite an expansion in government services**

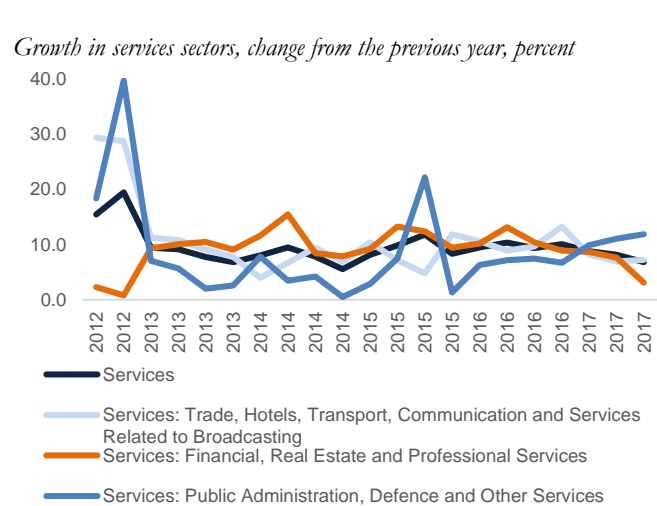
The contribution of service sector growth to overall GVA in Q3 FY17 was 3.5 percentage points (pp), the lowest in the past ten quarters. Growth of the services sector slowed sharply to 6.8 percent in Q3 FY17 as compared with 8.5 percent y/y in H1 FY17. The sectoral slowdown was largely due to a slowdown in financial, real estate and professional services (18.7 percent of GVA and a key driver of growth in recent years), which slowed to 3.1 percent y/y from 8.1 percent in H1 FY17. Given the full-time effort required to exchange old notes, it is not surprising that financial sector growth was temporarily depressed. Meanwhile, growth in public services was robust (Figure 10), reflecting the rapid increase in public consumption.

**Figure 9. Urban consumption indicators appeared more resilient to demonetization**  
Sales of passenger vehicles and air traffic, change from the previous year (3mma), percent



Source: CEIC and World Bank staff calculations

**Figure 10. Financial sector accounted for most of the slowdown in services in Q3 2017**  
Growth in services sectors, change from the previous year, percent



Source: CEIC and World Bank staff calculations

**Higher public sector consumption likely to have come from state-level spending as the center continues to consolidate**

The acceleration in public administration services mirrors a pickup in government consumption, which started in 1H FY17 (+15.4 percent y/y; FY16: 2.9 percent) and continued into Q3 (+19.9 percent y/y). This acceleration contrasts with the central government's continued adherence to a path of fiscal consolidation partly premised on expenditure restraint. The center has cut its fiscal deficit from 3.9 percent of GDP in FY16 to 3.5 percent in FY17. Higher revenues (up

from 9.2 to 9.8 percent of GDP) and stable current expenditure<sup>6</sup> (10.3 and 10.4 percent of GDP in FY16 and FY17, respectively) drove consolidation in the period. Demonetization and the earlier tax amnesty resulted in a fiscal bounty in FY17, with tax revenues expected to be up 17.0 percent, 4.4 percent above budgeted targets. Partly thanks to a continued decline in subsidies, current expenditure has been stable even as the government implemented increases in pensions and allowances for civil servants following recommendations of the 7<sup>th</sup> Pay Commission.

Given the expenditure restraint at the center, the growth in government consumption has been the result of higher spending by the states, which are now responsible for 60 percent of general government expenditure. Transfers from the center to states increased a further 0.5 pp of GDP in FY17, while fiscal deficits of states have reportedly increased (see [Note 2](#) in Part B), both suggesting higher spending levels.

**Driven by both households and governments, consumption remained the main growth driver in FY17**

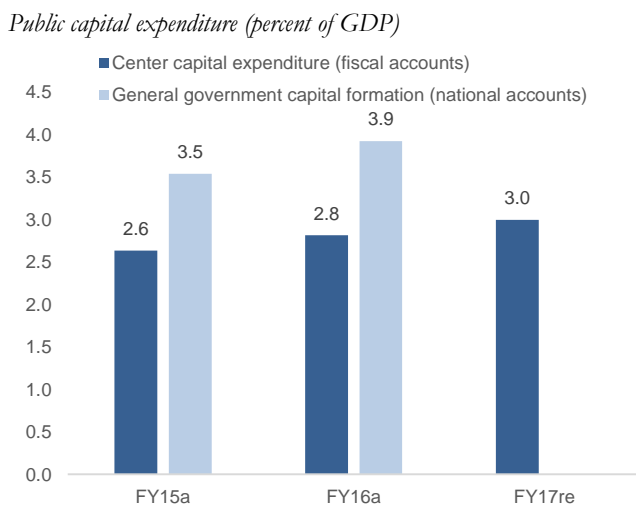
In H1 FY17, government consumption dominated while consumption by households (85 percent of final consumption and approximately 60 percent of India’s GDP), slowed (H1 FY17: 6.1 percent y/y; FY16: 7.3 percent). Private consumption growth then accelerated from a tepid 6.1 percent y/y in H1 FY17 to 10.1 percent y/y in Q3 FY17 (+12.8 percent q/q saar), which combined with the further increase in public consumption ensured that final consumption demand jumped 11.4 percent in the quarter, the fastest increase in over five years. Overall, final consumption expenditure remained the main driver of GDP growth, expanding by 9.0 percent y/y between April-December 2016.

**Investment remains tepid despite higher public capex and lower interest rates**

**Both the union and state governments stepped up capital expenditure...**

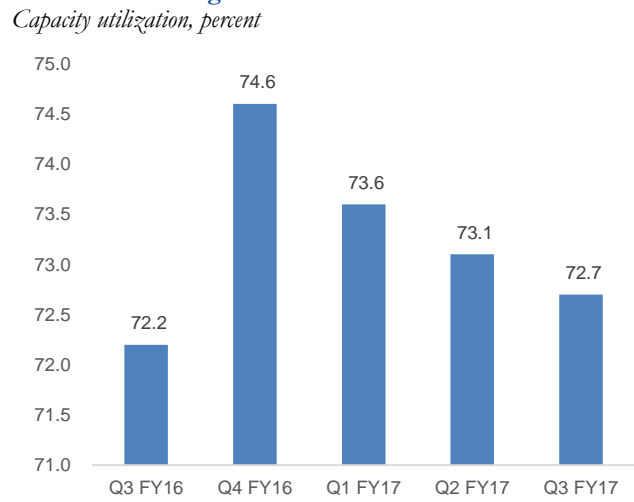
Capital expenditure by the central government has increased from 2.6 percent of GDP in FY15 to 2.8 percent in FY16 and 3.0 percent in FY17 (Figure 11). Reflecting this increase, as well as higher spending by state governments, public investment by the general government in the national accounts has increased from 3.5 percent of GDP in FY15 to 3.9 percent of GDP in FY16. Given the further increase in central capital expenditure in FY17, government investment is likely to have climbed further.

**Figure 11. Public investments have picked up since FY14**



Source: CSO

**Figure 12. Industrial capacity utilization declines despite weak investment growth**



Source: RBI

**...but fixed investment growth**

Private investment, which accounts for three quarters of total GFCF, has not been forthcoming despite the promise of crowding-in by public sector investments and government efforts to

<sup>6</sup> Revenue expenditure excluding grants for the creation of capital assets. See [Selected Issue Note 2](#) for additional details on fiscal policy.

**remained sluggish in early FY17**

improve the business environment and facilitate foreign direct investment (FDI). GFCF contracted by 1.4 percent y/y in real terms between April-September 2016. GFCF as a percent of GDP have averaged 27.4 percent between Q3 FY16 and Q2 FY17 compared to a medium term average (5 year) of 32.4 percent of GDP. This weakness in private investment has been attributed to local and global excess-capacity (Figure 12) leveraged corporate and bank balance sheets, and remaining domestic bottlenecks.

**Signs of an investment recovery have emerged...**

After contracting for three consecutive quarters, GFCF grew by 3.5 percent y/y (15.3 percent saar) in Q3 FY17. Supporting the view of an incipient pickup, production of capital goods expanded by 6.8 percent 3mma y/y in January 2017 after 13 consecutive months of negative growth, imports of machinery rose by 13.5 percent y/y in March, and FDI expanded by 10.9 percent in Q3 FY17 driven primarily by investments in the telecommunications sector.

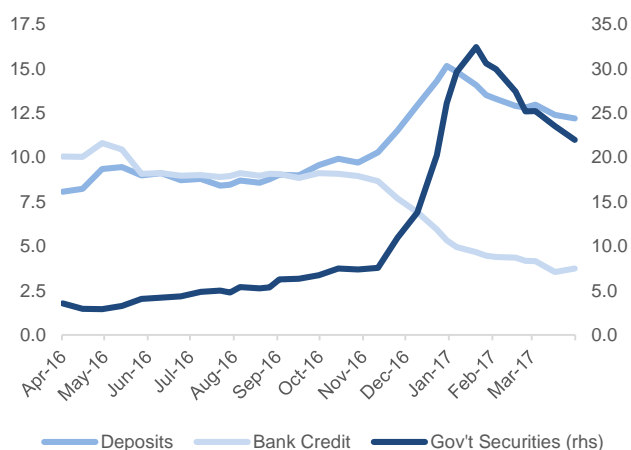
The uptick in investment may explain the relative resilience of the construction sector in Q3, considering the sector's dependence on cash payments to daily wage construction workers and material suppliers. News reports<sup>7</sup> noted that some employers front-loaded wage payments with old currency, which helps explain the performance of construction as well as consumption.

**... but remain tentative as bank credit remains subdued**

However, credit growth remains weak. Although credit data for November and December is clouded by banks' focus on exchanging old notes rather than lending, January and February data was little improved, with growth of barely 3.5 percent (y/y). Banks have used higher deposits post-demonetization to buy government securities rather than to expand credit (Figure 13). This suggests weak credit demand, as many large corporates remain highly leveraged and global capacity in key sectors such as steel is ample. Credit to industry remains in negative territory and has been the main driver of lower overall credit growth while credit growth to households and services firms has been largely stable (Figure 14).

**Figure 13. Banks preferred to invest the higher deposits in government securities rather than expand credit**

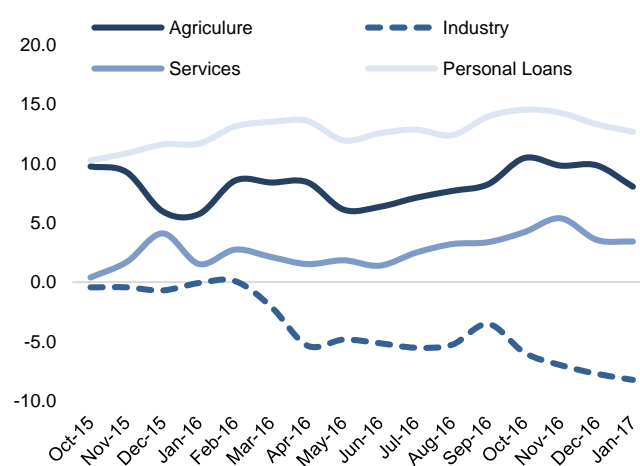
*Change of the four-week moving average from the previous year, percent*



Source: RBI and World Bank staff calculations

**Figure 14. Credit growth remains subdued, especially to industry**

*Credit growth, y/y*



Source: CSO

**The RBI has paused its interest cut cycle since October**

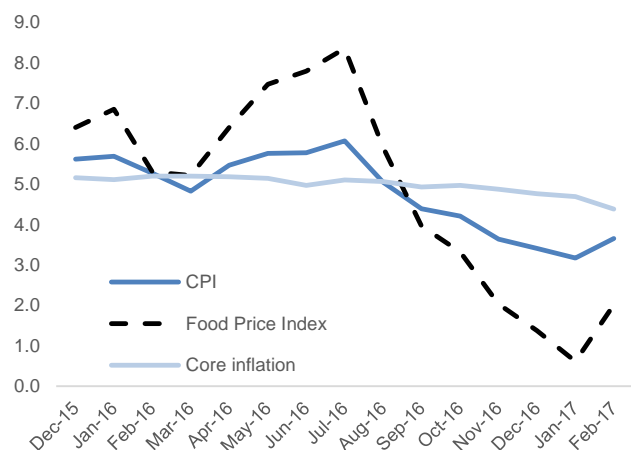
Although headline inflation has come down and the RBI met its 5 percent inflation target along the glide path, core inflation (non-food, non-oil) remained sticky above the 4 percent long-term target (Figure 15). Meanwhile, domestic liquidity has become ample following the uptick in deposits post-demonetization (Figure 16). Tightening conditions in advanced economies, especially the US, added to domestic pressures. The WPI, which is more sensitive to commodity prices, picked up to a three-year high in February, led by a firming of farm input costs.

<sup>7</sup> See for example “The bright side of demonetisation: Advance salaries, digital transactions bring about smiles” Firstpost, Nov. 24, 2016 ([link](#)).

Anticipating a pickup in inflation and activity, the MPC has kept the policy repo rate at 6.25 percent since September 2016, and shifted in February from an accommodative to a neutral stance.

**Figure 15. Core inflation has been sticky even as headline inflation declined**

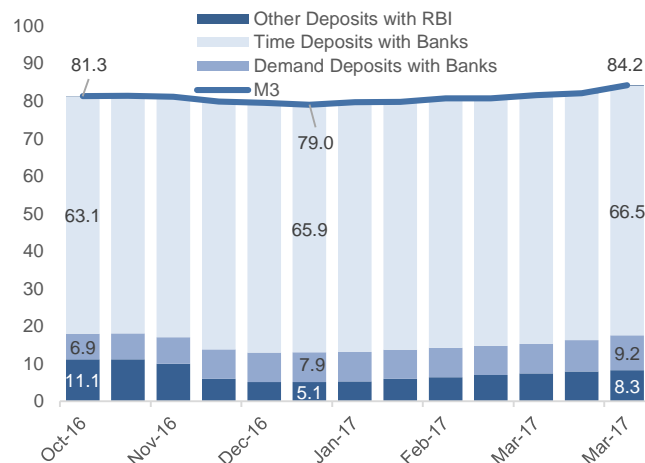
*Headline and core inflation*



Source: CEIC, RBI, and World Bank staff calculations

**Figure 16. Liquidity conditions have improved rapidly since demonetization**

*M3 as a share of FY17 GDP*



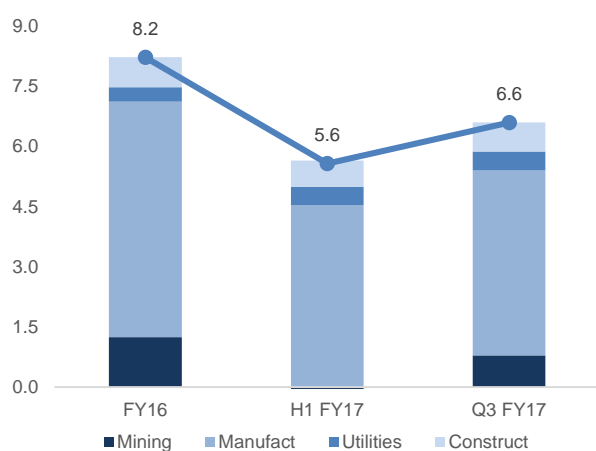
Source: CEIC, RBI, and World Bank staff calculations

**The manufacturing sector rebounded in Q3 FY17 after a weak start to the FY**

Industrial growth picked up in Q3 FY17 primarily because of improvements in mining (Figure 17 and Figure 18). Manufacturing growth, which contributes the most towards industrial growth, had weakened for the third consecutive quarter from a high of 12.8 percent y/y in Q3 FY16 to 6.9 percent y/y in Q2 FY17. This was partly because the commodity-heavy WPI used in the deflator accelerated by 5.1 pp in the period, eroding growth in real terms; growth of manufacturing value-added accelerated in nominal terms. In Q3 FY17, despite further gains in WPI and demonetization, real growth in manufacturing rebounded to 8.3 percent y/y (nominal terms: 11.8 percent y/y). Measurement issues may also be at play in estimates of manufacturing output in Q3 FY17 as they rely to some extent on reports of sales, which some firms may have inflated to legitimize holdings of old currency. Both the IIP and WPI series have been rebased in May, 2017, which may ameliorate statistical issues going forward (see Box 3).

**Figure 17. Mining led the acceleration of the industrial sector**

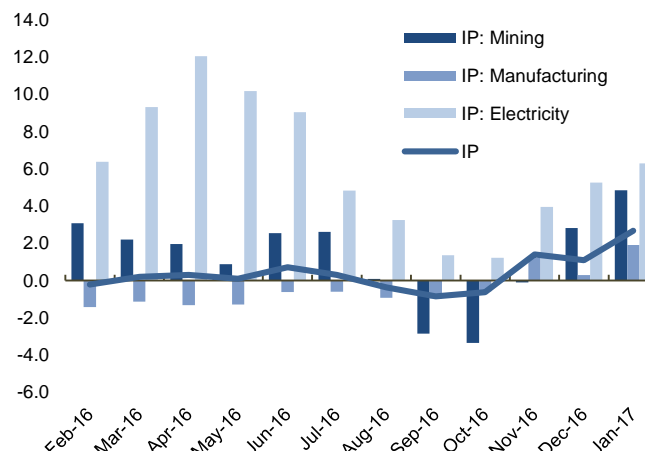
*Decomposition of industrial growth, y/y, percent*



Source: CEIC, CSO and World Bank staff calculations

**Figure 18. The index of industrial production picked up since October**

*Decomposition of the growth in the IIP, y/y, percent*



Source: CEIC and World Bank staff calculations

## Green shoots in the external sector

### Domestic demand continued to drive growth...

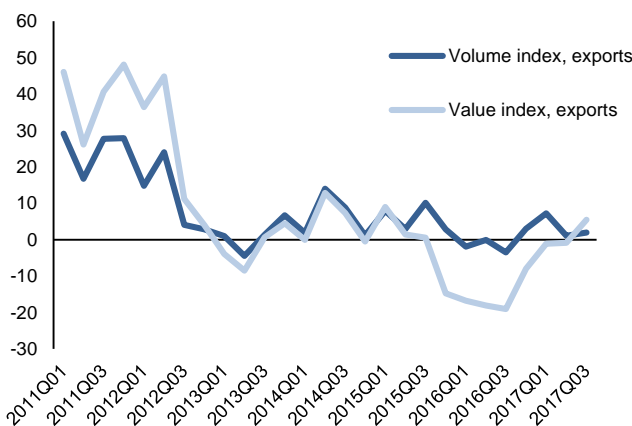
Domestic demand accounted for 87 percent of the y/y growth rate of GDP (excluding discrepancies) in 9M FY17. This compares with 97 percent for FY16, highlighting both a better performance of exports (9M FY17: +1.5 percent; FY16: -5.4 percent) but also a deceleration of domestic demand (9M FY17: 5.2 percent; FY16: 6.3 percent) that has also spilled over to slower import growth, leading to a higher contribution from net exports.

### ...but exports revived strongly in Q3 FY17...

Export performance improved in earnest in Q3 FY17, when real exports of goods and services expanded by 3.4 percent y/y. Nominal merchandise exports in USD terms grew by 5.7 percent. Commodity prices rebounded and volumes turned positive after several quarters (Figure 19), as reflected by the large contribution of non-oil exports to export growth (Figure 20).

**Figure 19. Both volumes and values turned positive...**

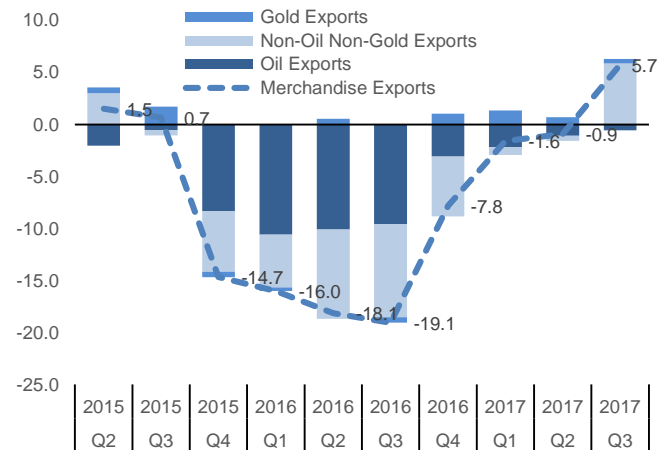
Change from the previous year, y/y, percent



Source: WTO, UNCTAD and World Bank staff calculations

**Figure 20. ... and core exports expanded**

Decomposition of export growth in USD, y/y, percent



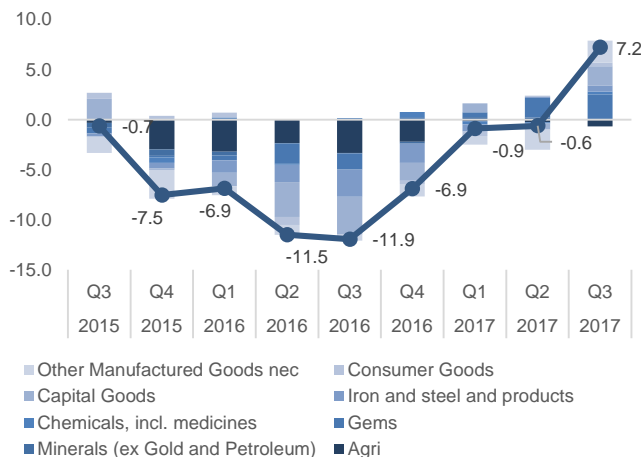
Source: CEIC and World Bank staff calculations

### ...across the spectrum of commodities...

The recovery in non-oil non-gold (“core”) exports was broad-based, with large contributions from gems, capital goods and other manufactured goods; only agricultural exports contracted (Figure 21). Services export growth also picked up, reaching 11.2 percent y/y in Q3 FY17 (Figure 22). The data for 9M FY17 suggests that both modern and traditional exports gained. Nevertheless, India’s traditional IT service exports have been subdued, growing only 0.1 percent in FY17.

**Figure 21. Core exports expanded**

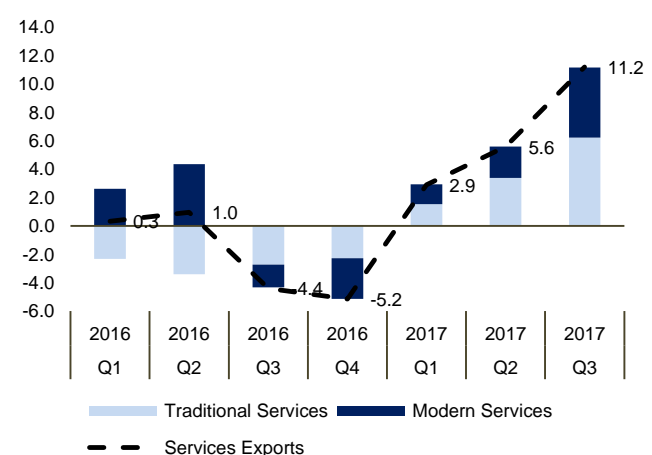
Decomposition of non-oil, non-gold export growth by type, y/y, percent



Source: CEIC and World Bank staff calculations

**Figure 22. Services exports also recovered strongly in Q3**

Decomposition of services export growth in USD, y/y, percent



Source: CEIC and World Bank staff calculations

**...and driven by US demand**

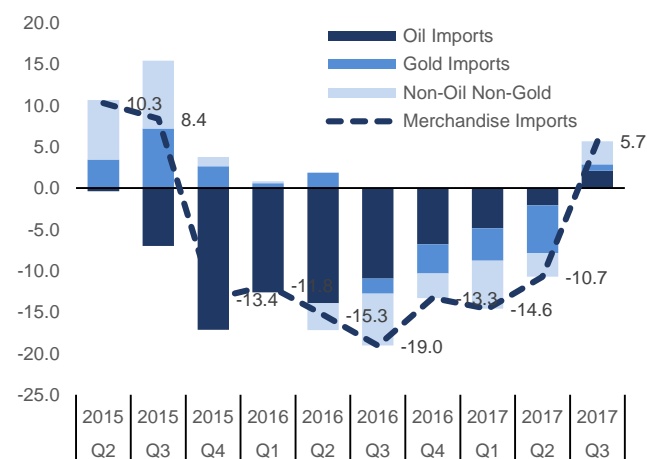
While exports to Africa, the Middle East and the UK declined, exports to the United States (approximately 16 percent of total exports) jumped by 13.1 percent y/y in Q3 FY17 from 2.3 percent in Q2, thereby driving merchandise export growth. Exports to greater China (mainland, Hong Kong and Taiwan, Province of China) also increased by a similar magnitude, suggesting that India may be more integrated in global supply chains than commonly believed. [Note 3](#) in Part B provides additional details on India's trade performance and policy.

**Imports, especially of services, also increased strongly in Q3 after contracting earlier in the FY**

Imports of goods and services (in USD) increased by 6.5 percent y/y in Q3 FY17 after contracting by 6.7 percent y/y in H1 FY17. Merchandise imports picked up in Q3 FY17, growing by +5.7 percent y/y compared to a -10.5 percent in H1 FY17 and -15.0 percent in FY16, when lower oil prices drove imports sharply lower (Figure 23). Imports of petroleum and petroleum products (22 percent of merchandise imports during FY16) increased along with prices. Core imports (excluding oil and gold), increased by 3.8 percent due to the recovery in exports through higher imports of intermediate goods. Capital goods imports jumped by 11.0 percent in Q3, reflecting the improvement in GFCF. Service import growth surged to 23.2 percent y/y in Q3 FY17 (FY16: +4.3 percent y/y). Modern services were the main driver, expanding 16.3 percent y/y in Q3 FY17 (Figure 24). In particular, insurance and financial service imports grew by 66.9 percent y/y in the period.

**Figure 23. Lower oil imports explain almost all of the decline in nominal imports, implying volumes increased**

*Decomposition of merchandise import growth by type, y/y, percent*



Source: CEIC and World Bank staff calculations

**Figure 24. Growth in services imports also decelerated, but remained positive overall**

*Decomposition of service import growth by type, y/y, percent*



Source: CEIC and World Bank staff calculations

**The current account deficit remains comfortable and financed by FDI**

The current account deficit narrowed to 0.4 percent of GDP during H1 FY17 from 1.0 percent in FY16, and widened slightly to 0.5 percent of GDP in the year up to Q3 FY17. Despite the negative (albeit small) terms-of-trade shock as oil prices increased, the oil trade balance narrowed to 2.1 percent of GDP in Q3 FY17 compared to 2.5 percent of GDP in FY16. On the back of the solid growth in merchandise exports, the non-oil balance improved by 0.5 pp between FY16 and Q3 FY17 to a surplus of 0.3 percent of GDP. Worker remittances declined in the first half of FY17, as flows from Gulf countries remained subdued<sup>8</sup>. However, the rebound in oil prices led to a 16.2 percent y/y jump in worker remittances in Q3 FY17, and for the year up to Q3 FY17 worker remittances were down only marginally. Other household transfers in the BoP declined more, however, possibly affected by demonetization, and total remittances retreated by 0.4 pp of GDP in the same period. Gross FDI inflows expanded significantly in FY17 (17.3 percent y/y for 9M FY17, in USD terms) to 2.8 percent of GDP in the year up to Q3 FY17, thus comfortably financing the current account deficit.

<sup>8</sup> Worker remittances include compensation of employees. Overall remittances to India decreased by 8.9 percent in CY 2016 from CY 2015 to USD 62.7 billion, the second consecutive yearly decline.

## Structural reforms support growth in the medium term

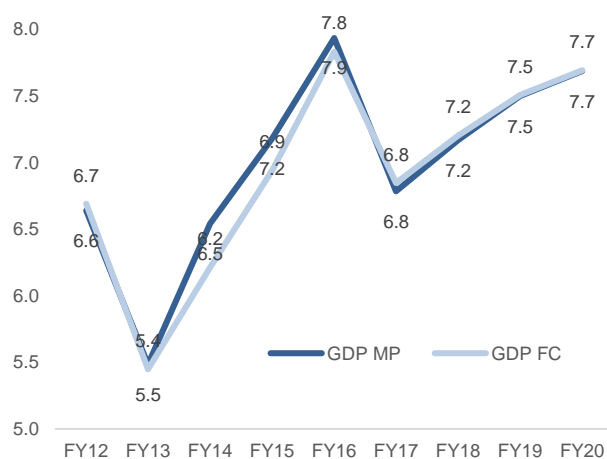
**India's fundamentals remain solid, and the economy is expected to accelerate following a temporary slow-down in FY17**

India's GDP growth is expected to slow down to 6.8 percent y/y in FY17 from 7.9 percent in FY16 as the momentum of Q3 FY17 (4.5 percent q/q saar) carries on to Q4 (Figure 25 and Table 1). On the one hand, activity will pick up with the "remonetization" of the economy. Trade indicators are also favorable: export growth was up 27.6 percent y/y in March 2017. On the other hand, some of the measurement effects related to sales taxes and use of IIP to estimate informal manufacturing are likely to revert. Sales tax receipt growth for a sample of nine large states slowed by 1.6 pp between Q3 FY17 and January-February 2017<sup>9</sup>. Finally, high frequency indicators do not yet paint a firmly bullish picture. In February, the industrial production index for capital goods contracted 3.4 y/y, while credit to industry contracted 5.2 percent y/y, suggesting that a meaningful recovery in private investments is unlikely until later in FY18.

These headwinds and tailwinds largely cancelled out each other in Q4 FY17, keeping the economy in a U-shape recovery, which gains momentum in FY18, when growth is projected to accelerate to 7.2 percent (Figure 26). Growth in private investments is likely to pick up once clarity emerges on the global outlook, as well as when implementation of the GST is more advanced. With agriculture and fiscal policy unable to provide the same boost to growth given the higher base, higher commodity prices leading to a small negative terms-of-trade shock, sluggish credit to industry, and frictions from the initial implementation of GST (see [Note 2](#) in Part B), headwinds to growth are likely to increase. On the positive side, consumption will remain robust given declining inflation and solid household credit growth, and the pickup in trade is likely to endure at least through the first half of the fiscal year, helping lift investment.

**Figure 25. The economy is expected to accelerate following a temporary set-back in FY17**

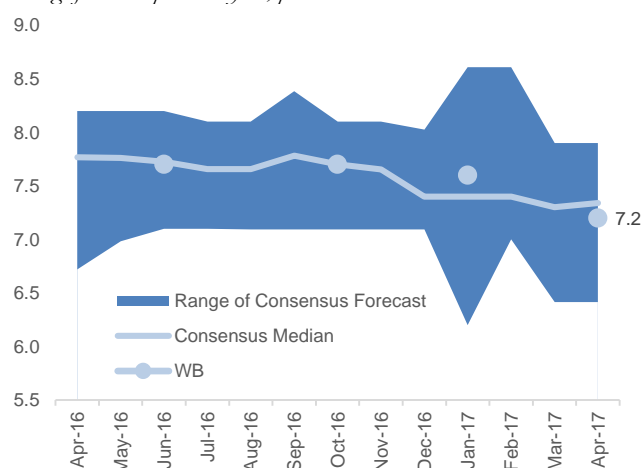
*Change from the previous year, percent*



Source: World Bank staff calculations and projections

**Figure 26. Forecasts of FY18 growth have come down as the outlook for investments remain challenging**

*Change from the previous year, percent*



Source: World Bank staff calculations and projections

In later years, growth is projected to accelerate gradually to 7.7 percent by FY20, underpinned by a more meaningful recovery in private investment following the recent push to accelerate infrastructure spending, concerted efforts to improve the business climate and (eventually) less leveraged corporate and financial balance sheets "crowd in" the private sector.

**The economy will function below full-potential in the medium-term**

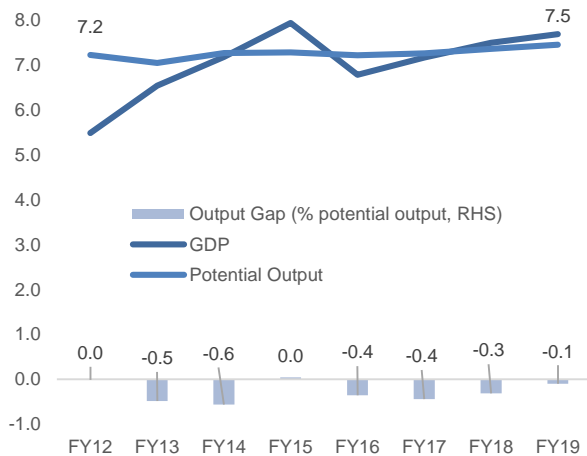
The output gap is only likely to close by 2020 (Figure 27). While data constraints make it difficult to calculate India's potential GDP with precision, we estimate potential GDP growth to converge to approximately 7.5 percent in the medium-term assuming a sustained pickup in investments. Total Factor Productivity (TFP) remains the largest contributor to potential

<sup>9</sup> State government spending tends to be revised lower, and therefore would constitute another measurement issue that would mean-revert.

growth, but rising investment levels are expected to drive a modest acceleration in the medium term (Figure 28). Achieving a higher potential would require a combination of productivity enhancements, a larger pickup in investment, and an increase in women's participation in the labor force, as India's labor force is short of its potential given the large gender gap in economic participation (see [Part C](#)).

**Figure 27. Negative output gap to close by 2020**

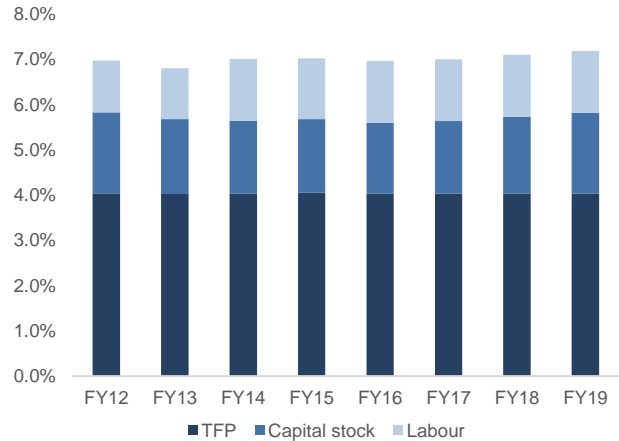
*Lines: Year-on-Year growth of GDP and potential GDP, percent; Bars: output gap, percentage points (RHS)*



Source: World Bank staff calculations and projections

**Figure 28. TFP to remain the largest driver of potential growth, capital stock gains ground in the medium-term**

*Contribution to Potential GDP growth, percent*



Source: World Bank staff calculations and projections

**While domestic and global downside risks prevail, policy reforms could bring better-than-expected outcomes**

There are several key risks to the outlook. First, private investment continues to face several domestic impediments in the form of corporate debt overhang, stress in the financial sector, and regulatory and policy challenges, as well as excess capacity globally. If these bottlenecks are not alleviated, a continuation of slow private investment would weigh down on growth and put downside pressures on India's potential GDP. Second, continued uncertainties in the global environment, notably a faster than expected tightening of monetary policy in USA could affect short-term volatility of flows, and spillovers from Brexit and USA trade and immigration policies, as well as a renewed slowdown of the Chinese economy, could further delay a meaningful recovery of external demand, which has played a critical role in India's previous growth episodes. Finally, as a net oil importer, further rapid increases in oil and other commodity prices could lead to a negative terms-of-trade shock and pressures on fiscal accounts. On the other hand, upside risks include a more sustained recovery in external demand into the second half of the fiscal year and beyond, a smooth implementation of the GST that leads to a faster-than-expected pickup in investor sentiment, as well as an acceleration in the resolution of NPAs following the recent measures to empower RBI.

**A shift in drivers towards industry and investments**

**Agriculture will continue to provide momentum to the economy in early FY18...**

Agricultural output is expected to grow at 4.7 percent in FY17 and stabilize at its long-term average of 2.6 in the successive years (Figure 29). First estimates of FY17 food grain production suggest a record high of 135 metric tons, an increase of 9 percent over the last year, resulting from both a 4 percent increase in gross-sown area and a reported increase in yields. In addition, good rains allowed for some recovery of groundwater, whereby water storage in 91 major reservoirs stood at 76 percent of total storage capacity, becoming 27 percent higher than last year. Given these favorable hydrological conditions, and that demonetization ultimately had little negative impact on sowing for the winter crop, the momentum in agriculture should carry into early FY18.

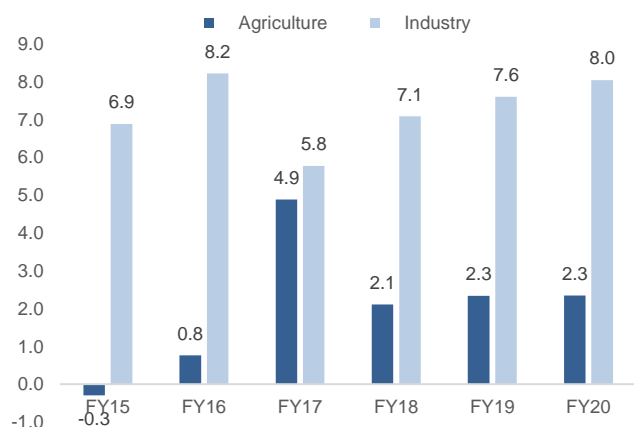


**... but industry gradually takes over as a growth driver**

Industrial growth is expected to slow down to 5.6 percent in FY17 due to (i) a slowdown in construction as the sector adjusts to the post-demonetization environment and the public sector pares back on capital expenditure growth, and (ii) mean-reversal of measurement issues in Q3<sup>10</sup>. Economic activity is expected to pick up into FY18 driven by improved trade performance, resilient consumption, and eventually higher demand for capital goods from an increase in investments. Industrial growth is expected to accelerate to 8.0 percent by FY20, pulling the overall GVA growth to 7.7 percent. Services growth will be stable at 8.8 percent in FY20 and remain the key driver of overall economic activity, supported by backward and forward linkages to the industrial sector.

**Figure 29. Agricultural rebound to drive GVA growth in FY17**

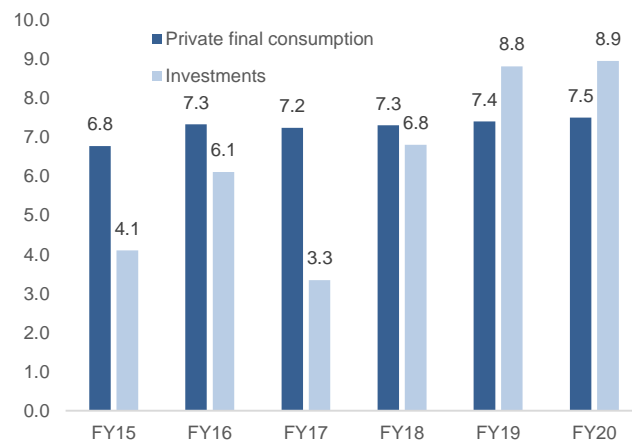
Change from the previous year, percent



Source: CEIC, World Bank staff calculations and projections

**Figure 30. ... Broad-based consumption to drive growth, followed by investments in the future**

Change from the previous year, percent



Source: CEIC, World Bank staff calculations and projections

**Private consumption will remain a stable source of growth...**

Private consumption remains a stable growth driver, ranging between 7.2 and 7.5 percent between FY17 and FY20 (Figure 30). The minor deceleration in FY17 is offset by higher rural incomes from favorable agricultural growth, revisions to civil servants' pay by an average of 24 percent, and declining inflationary expectations that boost real incomes. Inflation expectations, as measured by the RBI, have come down sharply from 10.5 percent a year ago to 7.3 percent in December 2016 and should decline further toward the RBI's inflation target of 4 +/-2 percent. Furthermore, the catch-up in rural demand following favorable *rabi* and *kharif* harvests will create significant potential for overall growth. Budget estimates of FY18 by the center and states point to limited consolidation, achieved primarily from the sale of public assets.<sup>11</sup>

**...but private investment eventually accelerates**

The government will maintain its momentum in public infrastructure spending, with government capital expenditure by the center budgeted at 3.0 percent of GDP in FY18, flat from the previous year. Private investment is expected to pick up, but only gradually as recovery may be protracted in part due to relatively longer-term effects of demonetization on cash-reliant construction activities (household investment, largely housing, accounts for approximately 1/3 of total investment), corporate leverage and the persistent weakness in credit growth, which suggest that the financial sector may require more time to adjust. Gross fixed capital formation is forecast to grow by 3.3 percent in FY17 and rise gradually to 8.9 percent by FY20, overtaking private consumption as a major growth driver. Underpinning this forecast is the impact of reforms such as the Bankruptcy law and GST, crowding-in from the recent infrastructure push, and continued inflow of foreign investments. The abolition of the Foreign Investment Promotion Board from FY18 will further support investment growth. Moreover, RBI's efforts

<sup>10</sup>Quarterly estimates of manufacturing GDP use a combination of the IIP and advance filing of corporate accounts. Such filings are subject to the same possibility of artificially high revenues in Q3 FY17 if manufacturing firms reported previously undeclared sales to legitimize old notes.

<sup>11</sup> See [Note 2](#) in Part B for further details on India's FY18 budget.

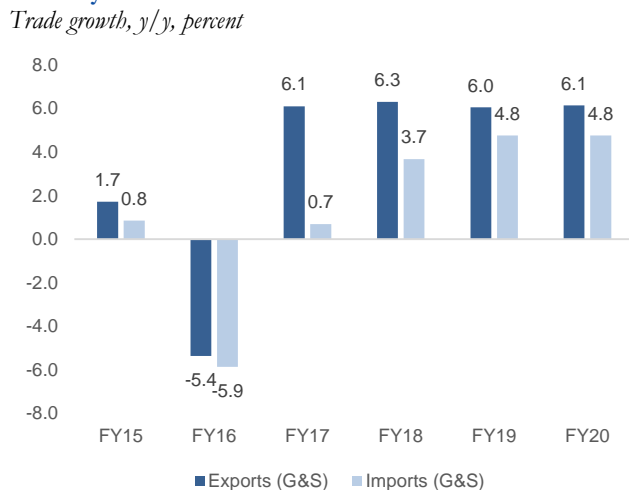
to reform the banking sector (see Box 2) in addition to a higher steady state of banking sector deposits post-demonetization will eventually allow credit growth to recover robustly and sustainably.

### Exports continue to recover, but uncertainties are high

**Exports likely to begin recovery in FY17; significant uncertainties cloud the outlook from FY18**

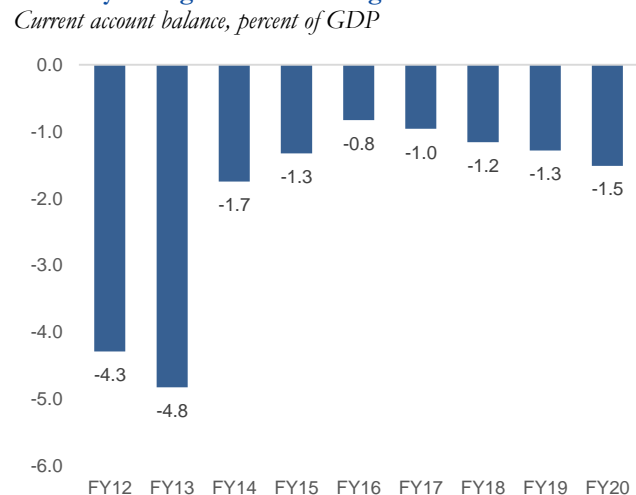
Exports are projected to expand by 6.1 percent in FY17 due to the low base in FY16 and the cyclical pickup of the global economy, led by the USA, commodity-exporting emerging markets, and China. In later years, export growth is projected to remain stable, consistent with moderate growth in global trade and a small increase in India's global market share, but well below the levels registered during the boom years before 2012. The outlook for FY18 and beyond is clouded by uncertainty about the potential increase in protectionist policies and the structural deceleration in global trade. The baseline scenario, based on the World Bank's global forecasts, assumes global trade volumes grow by 3.8 percent y/y in FY18-FY20, half of the 7.5 percent in FY01-08.

**Figure 31. Exports to improve gradually with global trade recovery**



Source: CEIC, World Bank staff calculations and projections

**Figure 32. The current account deficit will widen modestly on higher investment growth**



Source: CEIC, World Bank staff calculations and projections

**A pickup in demand for consumer goods and, eventually, capital goods will drive imports upward and widen the current account deficit modestly**

Growth in imports is expected to accelerate but remain below export growth at 4.8 percent by FY19. The initial rise in imports is predicated on higher private consumption (consumer goods account for nearly half of all merchandise imports) and a modest recovery in exports, which will lead to demand for imported consumption and intermediate goods, respectively. In later years, imports are likely to grow owing to higher demand for capital goods (which currently account for approximately 17 percent of total merchandise imports) from revived investment, as well as higher demand for intermediate inputs in response to improved manufacturing activity and exports. The current account deficit may widen gradually to 1.5 percent of GDP by FY19 (Figure 32). However, robust inflows of FDI will ensure smooth financing of the deficit as the government continues to open additional sectors of the economy and India reinforces its stance as a bright spot in the global economy

### External and domestic risks weigh on the favorable outlook

**The most substantial medium-term risks are associated with the recovery in private investments**

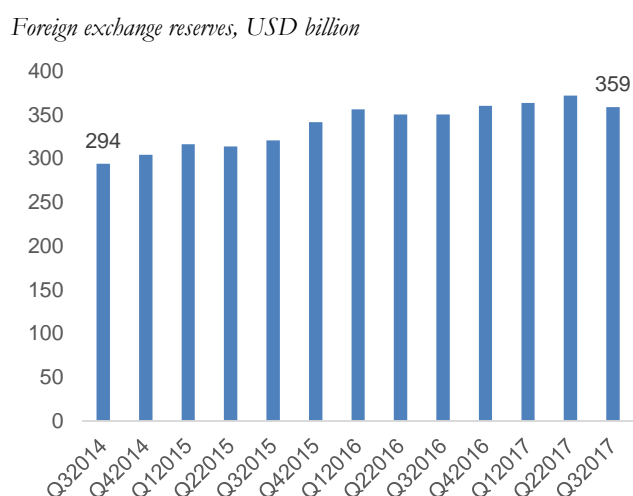
Private investment growth continues to face several impediments in the form of excess capacity, regulatory and policy challenges, and corporate debt overhang. A continuation of sub-par growth in private investment cannot be ruled out if corporate and financial sector balance sheet stresses are not alleviated, although the recently-announced measures to deal with Non-Performing Assets (NPAs) represent a potential upside risk as the baseline anticipates a protracted recovery (Box 2). The banking sector problems are likely to remain a drag on private investments to the extent the resources for required recapitalization are unavailable and diluting

government equity for raising additional resources is uncertain. Over the longer term, in the absence of investments and resulting expansion of production capacity, not only may faster growth not materialize, but macroeconomic imbalances could build up.

**External risks emanate from global volatility and broader spillovers from increased protectionism**

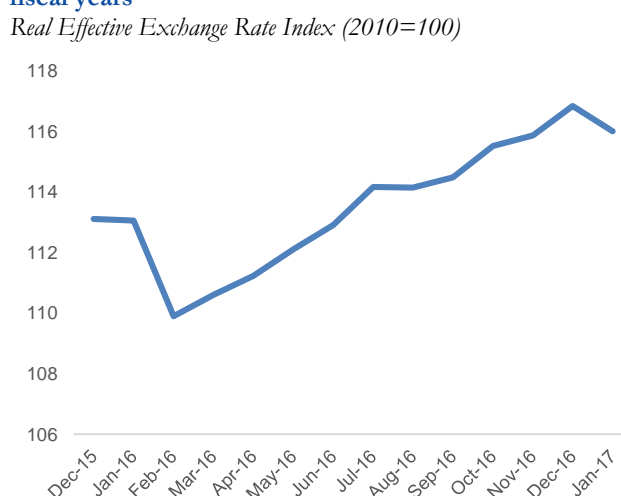
Downside risks to the global economy – and accordingly to export growth and capital flows – are also substantial given geopolitical risks, monetary policy normalization in the USA and risks of policy moves towards de-globalization. Faster than expected increases in the federal funds rate in the USA, could result in short-run volatility in capital flows and on higher yields beyond the short run. However, India is expected to manage short-term pressures on capital flows without major difficulties, due to solid foreign exchange reserves (Figure 33) and the limited financing requirements for the current account deficit, which have been comfortably filled by long-term FDI. In fact, the recent appreciation of the real effective exchange (REER) rate reflects a market perception of India’s strong fundamentals against global volatility (Figure 34), although if such appreciation continues it may pose risks to export growth. See [Note 3](#) in Part B for additional details on global trade.

**Figure 33. Foreign exchange reserves have been stable**



Source: CEIC, RBI, and World Bank staff calculations

**Figure 34. The REER has appreciated over the past two fiscal years**



Source: Bank for International Settlements

**Further increases in oil prices may be disruptive**

Consumers and the government reaped large benefits of lower oil prices in FY16. Those benefits will at best dissipate in FY17 and FY18. A sharper increase in oil prices compared to a generally stable baseline would lead to a negative impulse, assuming the government retains current excise levels, or higher fiscal deficit. Increases in inflation may reverse the RBI’s accommodative stance. Without the benefit of the growth in oil-related excises (and possible reductions if oil prices increase) the government will find it challenging to meet its deficit target without further cuts in expenditure – and usually capital expenditure is the first to be cut.

**Risks of a sub-par monsoon are not negligible as the probability of El Niño conditions developing is significant**

The Indian Meteorological Department (IMD) expects rainfall during the 2017 monsoon season (June to September) to be normal at 96 percent of the long-period average (LPA). The IMD also highlighted the risks that El Niño conditions could develop during the latter part of the monsoon season. Indeed, the Australian Bureau of Meteorology forecasts a 50 percent probability of El Niño thresholds being reached by July 2017, and monsoon rains have been below normal in nearly two-thirds of El Niño years. Finally, private weather forecaster Skymet is predicting rains to be below normal at 95 percent of the LPA. Hence, despite taking the IMD’s normal rainfall prediction as our baseline, the risks of deficient rain in FY18 are not negligible.

**Table 1. Key macroeconomic statistics and forecasts**

		BASELINE						
		2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
GDP, market prices	y/y percent	6.5	7.2	7.9	6.8	7.2	7.5	7.7
Private Consumption	y/y percent	7.4	6.8	7.3	7.2	7.3	7.4	7.5
Government Consumption	y/y percent	0.6	9.4	2.9	4.7	4.4	4.2	4.3
Gross Fixed Investment	y/y percent	1.8	4.1	6.1	3.3	6.8	8.8	8.9
Exports, GNFS	y/y percent	7.8	1.7	-5.4	6.1	6.3	6.0	6.1
Imports, GNFS	y/y percent	-8.1	0.8	-5.9	0.7	3.7	4.8	4.8
GVA, basic prices	y/y percent	6.2	6.9	7.8	6.7	7.2	7.5	7.7
Agriculture	y/y percent	5.6	-0.3	0.8	4.7	2.1	2.3	2.3
Industry	y/y percent	4.2	6.9	8.2	5.6	7.1	7.6	8.0
Services	y/y percent	7.7	9.5	9.8	7.9	8.7	8.8	8.8
Current account balance	percent of GDP	-1.7	-1.3	-0.8	-1.0	-1.2	-1.3	-1.5
Total Revenues	percent of GDP	19.6	19.9	20.7	20.7	20.8	20.9	21.3
Total Expenditures	percent of GDP	26.0	27.1	27.0	26.8	26.5	26.4	26.7
Fiscal Balance	percent of GDP	-6.5	-7.2	-6.2	-6.1	-5.8	-5.5	-5.4
General government debt	percent of GDP	68.5	68.6	69.5	69.2	69.2	68.3	66.8

Source: CEIC, Ministry of Finance, RBI, World Bank calculations and projections

### Box 1: Linking measurement and reality of economic activity

This box summarizes key statistical issues influencing the measured economic activity in India in FY16-FY18. Statistical issues are especially important at this time because demonetization brought about a new set of challenges in measuring economic activity.

High-frequency data shown in Figure 35 suggests a V-shaped recovery of the Indian economy: the indicators contracted in Q3 FY17, then expanded in Q4 FY17. However, quarterly GDP data shows a deceleration but no contraction in Q3 FY17, and the World Bank expects the same pace in Q4 FY17 rather than a stronger expansion – a U-shaped recovery. To reconcile both sets of facts, one needs to understand how GDP (and GVA) data are calculated. Estimates of GVA use quarterly filings of firms (to measure growth in manufacturing and some service sectors), and sales tax collection (to measure growth in the wholesale and retail sector and net indirect taxes, which link GVA with GDP). The methodology is not uncommon, and the administrative data, especially on tax collection, is relatively reliable, notwithstanding certain shortcomings.<sup>12</sup>

However, in an exceptional case such as demonetization, economic actors behave exceptionally. In particular, the jump in indirect tax collection in view of the drop in consumption of durable goods (such as two-wheelers and vehicles) and the fall in prices of perishable food items supports a hypothesis that traders and firms in possession of old notes may have declared earlier sales to legitimize their holdings. Sales tax collection in the states jumped, as shown in Figure 4. Meanwhile, collections of indirect (excise and service) taxes by the central government also surged in November, with indirect tax growth up 36 percent compared to 25 percent in October. Indirect tax growth has since dropped to 12.4 percent in February. These developments likely did not reflect actual sales in the quarter, but appeared in the GDP data as a jump in sales.

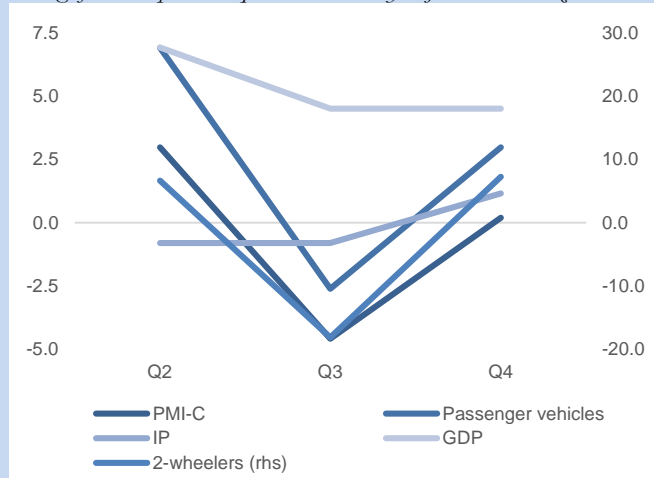
A second statistical challenge, mentioned in the 2017-18 Economic Survey, is the difficulty in measuring the informal economy, which is likely to have been most affected by demonetization: “Recorded GDP will understate impact on informal sector because informal manufacturing is estimated using formal sector indicators (Index of Industrial Production).” (p. 60). Indeed, similarly to GDP, the IIP

<sup>12</sup> See the data annex of the IMF’s Article IV report (2017) for further details.

barely changed between the second and third quarters, although in both cases growth was negative. The implicit assumption that formal and informal sectors move broadly in tandem is reasonable in normal times but broke down during the period of demonetization.

**Figure 35. Most indicators contracted in 3Q FY17 from the previous quarter, but not GDP**

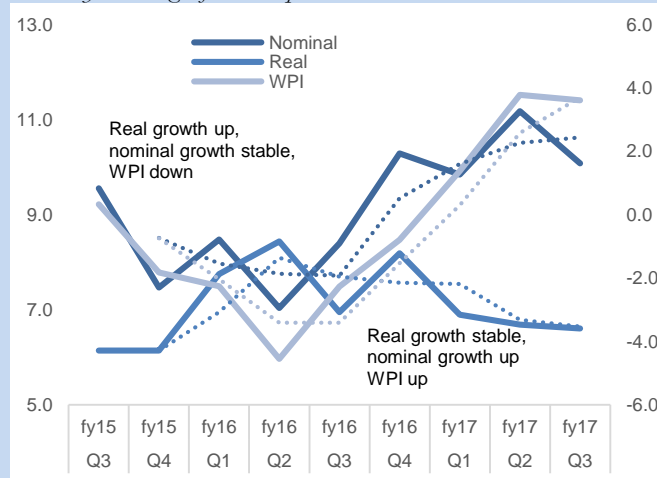
*Change from the previous quarter, seasonally-adjusted annualized rates*



Source: CEIC, RBI, and World Bank staff calculations

**Figure 36. Nominal growth has been buoyant but real growth lagged as the deflator picked up**

*Year-on-year change of GVA, percent*



Source: CEIC, CSO, and World Bank staff calculations

Finally, it was earlier highlighted that the use of the WPI in deriving the deflator, especially for manufacturing value-added, may lead to certain anomalies. The Economic Survey notes, “the large wedge between CPI and WPI inflation has created difficulties in measuring the GDP deflator”. While these difficulties may have overstated growth in FY16, when WPI was declining (Figure 36), the reversal of this trend, especially in the first half of FY17 may now be understating actual growth.

To the extent that nominal GVA is a more accurate measure of economic activity, it is noteworthy that despite the fast growth in agriculture and the statistical issues that would have led to an exaggeration of growth in wholesale and retail trade and manufacturing sectors, nominal GVA growth slowed 1.1 pp in the third quarter.

**Box 2: New measures to address banking-sector stress**

The Indian banking sector has been burdened by non-performing assets (NPAs) that constrain the sector from supporting economic growth. NPAs of Scheduled Commercial Banks stood at ₹7.0trn (8.5 percent of advances) in FY17 (year-ending March 2017), up from ₹0.9trn (2.2 percent of advances) in FY11. Together with restructured assets, total stressed assets in the banking system are currently around ₹9.6trn (11.5 percent of advances).

Banks are required to make loan loss provisions (LLPs) to cover losses stemming from NPAs. Rising NPAs therefore lower profits. Eight out of the ten largest PSBs had losses in FY16, due to provisioning for the NPAs. While FY17 results are still coming in, some banks appear to have improved performance, while some deteriorated, but none are out of the woods completely. LLPs ultimately shrink banks’ capital and reduce banks’ ability to lend, as reflected in the decline in credit growth observed.

In 2015, the RBI performed an asset quality review (AQR) with the goal of providing greater transparency regarding the scope of the NPA problem. NPAs were understated in reported numbers as for example, banks often carried out restructuring of loans to avoid classifying them as NPAs, thereby also avoiding the accompanying LLP expenses. While better recognition of the problem is a critical step to recovery of the sector (World Bank, 2016c), the AQR led to a steep increase in provisioning that had an expected short-term adverse impact on the profitability of the banks (RBI, 2016).

In parallel, over time, the RBI has introduced several tools to help banks deal with distressed assets (Table 2). Despite the availability of a wider range of instruments, their use by banks has been limited to date.

The latest among these enabling legislations is the Banking Regulation (Amendment) Ordinance, 2017, which involves RBI more deeply into asset resolution. The Ordinance makes three key amendments. First, it authorizes the central government to direct the RBI to order banks to initiate insolvency proceedings (under the recently-approved Insolvency and Bankruptcy Code) against specific defaults. Second, it allows the RBI to establish (one or more) authority(ies)/oversight committee(s), and to appoint their members.

Such committee will advise banks on the resolution of stressed assets. Third, it authorizes the RBI to issue directions to banks to resolve stressed assets. Under the Ordinance, decisions in the Joint Lenders Forum (JLF) agreed upon by a minimum of 60 percent of creditors by value and 50 percent of creditors by number are now be considered as the basis for deciding the corrective action plan, and will be binding on all lenders, subject to the exit option available in the framework.

**Table 2. RBI has introduced several tools to address NPAs**

Measure/Tools	Description
<b>Scheme for Sustainable Structuring of Stressed Assets (S4A)</b>	Allows banks to split a stressed long-term loan into sustainable debt (that can be restructured) and unsustainable debt (that can be converted into equity or long-dated securities).
<b>Strategic Debt Restructuring (SDR)</b>	Allows banks to convert stressed loans into equity shares and to provide banks with enhanced capabilities to initiate the change of ownership in accounts that fail to meet the projected viability milestones.
<b>5/25 Flexible Structuring Scheme</b>	Allows banks to fix longer amortization periods for loans to infrastructure sector and core industries (that usually have a longer gestation period, like 25 years or more), based on economic life of the project with periodic refinancing, say every five years.
<b>Credit Repository of Information on Large Credits (CRILC) and Joint Lenders' Forum (JLF)</b>	CRILC is a central database in which banks are mandated by the RBI to provide details on all borrowers with aggregate exposure of ₹50m or more, and also to highlight the probability of accounts becoming delinquent. JLF is a separate empowered group of lenders that can speed up decisions to resolve stressed assets.
<b>Corporate Debt Restructuring (CDR)</b>	The CDR is a voluntary mechanism set up by the RBI to facilitate restructuring of debts of viable corporates outside normal insolvency law process. It works through a three-tier system, the CDR standing forum, the CDR empowered group, and the CDR Cell.
<b>Lok Adalats</b>	Lok Adalat institutions help banks to settle disputes involving accounts in "doubtful" and "loss" categories and with outstanding balance of ₹5 lakh or more. Debt recovery tribunals have been empowered to organize Lok Adalat to decide on cases of NPAs of ₹10 lakh and above.
<b>Debt Recovery Tribunals (DRT) and Securitization and Reconstruction of Financial Assets and Enforcement of Security Interests (SARFAESI) Act</b>	The main instruments for the enforcement of creditor rights in India have been the DRTs and the SARFAESI Act, both of which require court-based procedures for the enforcement of creditor rights. The DRTs were created to help financial institutions recover their dues in cases of unsecured debts, while the SARFAESI was designed to support the collateral recovery efforts of secured bank lenders, but it is applicable only to banks and housing finance companies registered with the National Housing Bank.

Source: HSBC, India's Investment challenges, 16 May 2017, World Bank and RBI

From a supervisory perspective, the RBI issued a revised framework in April 2017 and specified risk based triggers for Prompt Corrective Action<sup>13</sup> by the central bank. Among others, a breach of 'Risk Threshold 3' of common equity tier 1 by a bank would identify it as a likely candidate for resolution through tools like amalgamation, reconstruction etc.

The rationale for the Ordinance is that large volumes of NPAs are concentrated on less than 50 creditors<sup>14</sup>, but the bankers are not inclined to initiate default proceedings against such companies for two main reasons – pressure by powerful corporates; and fear of investigative proceedings particularly for decisions that involve a settlement and haircut and may have been optimal from an NPA resolution perspective but could raise questions from a vigilance standpoint. The Insolvency and Bankruptcy Code is itself new, and banks and corporates may be reluctant to initiate proceedings given the legislation is untested. In the face of such disincentives for fast decision-making, the ordinance may be justified (in the short term) even if it empowers the RBI beyond its regulatory role.

Some commentators (e.g. Datta & Sengupta, 2017) point out that the Ordinance elevates the role of the central bank (and the government) from a market regulator to a market participant, proactively involved in decision-making of the commercial banks. Moreover, while the ordinance seeks to provide greater comfort for (public sector) bankers to take decisions on the resolution of impaired assets, there is a question whether RBI officials may also not be subject to similar concerns, in which case paralysis will not be resolved. Finally, the government's ownership stake in the financial sector creates broad incentives for losses to be recognized only

<sup>13</sup> Includes mandatory (viz. restrictions on dividend, branch expansion, management compensation) and discretionary actions (viz. related to Supervisory interactions, Governance, Capital, Risks etc).

<sup>14</sup> Source: "Resolution of NPAs set for radical overhaul: FM Arun Jaitley", LiveMint, May 24, 2017.

gradually (under the RBI's time-bound provisioning rules), as fiscal resources ultimately need to be allocated to recapitalize the banks for the incurred losses.

At a minimum, the Ordinance should help test the new Insolvency and Bankruptcy Code, which has been a key financial sector reform initiative. By bringing borrowers and lenders to a common platform, the Ordinance, which, among others, empowers the RBI to issue borrower specific instructions to banks to initiate resolution under the provisions of Insolvency and Bankruptcy Code 2016, would test the timeliness of resolution given the limited timeframe of 180 days (with provision of one-time extension of 90 days) under the bankruptcy code. It will be key for banks, borrowers and creditors to agree on the resolution plan to prevent liquidation of the borrower.

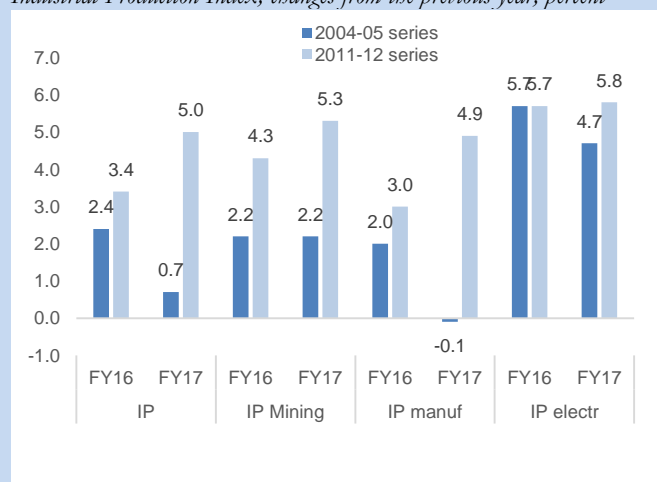
### Box 3: New IIP and WPI series

In May 2017, the Central Statistics Office (CSO) and the Ministry of Commerce revised the base year of India's wholesale price index (WPI) and index of industrial production (IIP) series from 2004-05 to 2011-12. The series have also undergone other methodological changes, including (1) adding new items and excluding some old ones to capture the changing structure of the economy; (2) including work-in-progress in estimating capital goods production in IIP; and (3) removal of indirect taxes in deriving wholesale prices.

Both series are a crucial input in estimating GVA and GDP growth. In estimating GVA, the CSO uses a combination of private sector corporate sector filings (deflated using WPI), and IIP growth (as a proxy for the unorganised sector). On account of the upward revision to IIP growth and downward revision to WPI inflation (Figure 37 and Figure 38), GVA and GDP growth could witness some upward revision when updated to reflect the new series.

**Figure 37. Growth in industrial production was revised upwards in the 2011-12 series**

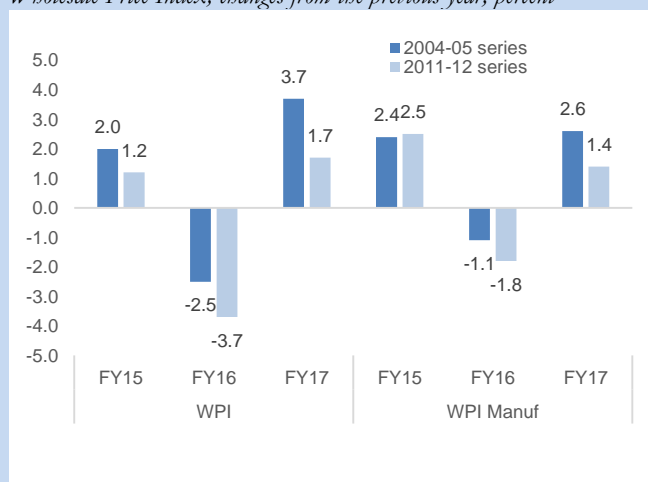
*Industrial Production Index, changes from the previous year, percent*



Source: CSO, Nomura and World Bank staff calculations

**Figure 38. Wholesale inflation was revised downwards in FY16 in the 2011-12 series**

*Wholesale Price Index, changes from the previous year, percent*



Source: Ministry of Commerce, Nomura and World Bank staff calculations

## B. Selected Issue Notes



### 1. India's Great Currency Exchange

**India's currency exchange initiative is an unprecedented development, leading to short-term disruption and potentially long-term benefits if complementary measures are adopted**

On November 8, 2016 the Government of India announced that existing ₹500 (USD 7.50) and ₹1000 (USD 15) banknotes, corresponding to 86 percent of India's currency in circulation by value, had been “demonetized,” that is, ceased to be legal tender.<sup>15</sup> Holders had 50 days to turn in the demonetized notes at banks. Although holders could initially exchange some of the old notes for new notes, or withdraw new notes from their accounts, cash shortages ensued as withdrawals were subject to limits and technical factors constrained the pace of introduction of new notes. Since more than 80 percent of purchases in India are made in cash, the shortages caused a drop in transactions and reduced economic activity in the short-term, as described in Part A. While the cash shortage has largely abated, certain sectors that disproportionately employ the poor and vulnerable may take longer to adjust, notably construction and other informal sectors. Therefore, measures announced to ramp up affordable housing construction will be important to mitigate the short-term impact on this group. In the long term, demonetization has the potential to accelerate three positive and related transformations: (i) formalization of the economy; (ii) increased tax collection and (iii) greater digital financial inclusion. However, to realize the potential benefits, complementary measures are required.

#### **A gargantuan and unprecedented exercise aimed at curbing “black money”**

**Outside of hyperinflations or other severe crises, there is no precedent for demonetization of this magnitude**

India's currency in circulation is equivalent to 12.3 percent of GDP, higher than in most emerging market and advanced economies (Figure 39). An estimated 23 billion banknotes have been demonetized, representing over 86 percent of currency in circulation by value (Figure 42), or approximately 10 percent of GDP. In January 1978, the government demonetized ₹1000, ₹5000 and ₹10000 through an ordinance to control illegal transactions. However, these high-denomination notes accounted for just 1.7 percent of the total value of notes in circulation and

<sup>15</sup> This led the initiative to be known as “demonetization,” although it is best described as a currency exchange of old ₹500 and ₹1000 notes for lower-denomination notes and new ₹500 and ₹2000 notes.

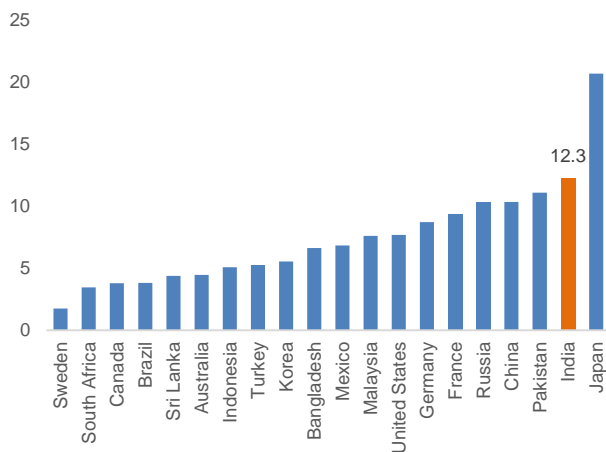


a substantial window was offered to replace them. The denominations were much larger in real terms, which did not interfere with the payment system.

Almost all other historical examples of currency exchanges occurred either in circumstances of hyperinflation (as in Brazil in the 1980s and 1990s), or provided a longer period during which new and old notes were valid. For example, the Central Bank of the Philippines initiated a demonetization exercise in 2010 to replace old notes with new ones possessing better security features; old notes remained valid for six years before losing legal tender status in January 2017. In contrast, in the recent episode legal tender of the old notes was withdrawn with immediate effect and with limited exceptions new and old notes were not allowed to circulate in parallel.

**Figure 39. Currency in circulation is higher in India than in most other countries**

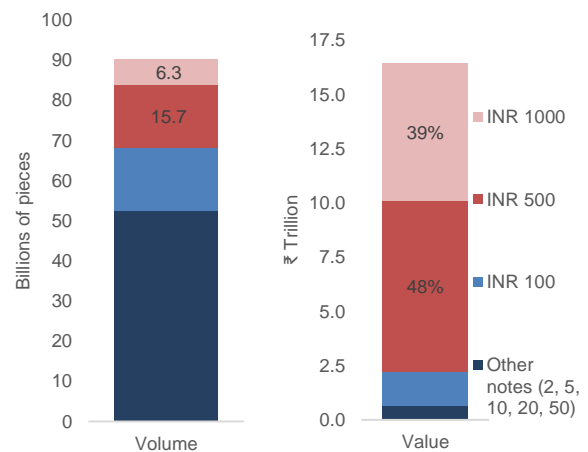
*Current in circulation as share of GDP (2015)*



Source: International Finance Statistics and World Bank staff calculations

**Figure 40. Demonetized denominations were prevalent**

*Bank notes in circulation, by denomination*



Source: RBI and World Bank staff calculations

**The stated objectives were to fight corruption, curb tax evasion and eliminate counterfeit notes**

The Indian authorities initially stated three main objectives of demonetization: (i) eliminate counterfeit notes, which were used to fund terrorism and other illicit activities; (ii) curb “black money,” wealth for which taxes were not paid; and (iii) fight corruption, which is one key source of the “black money” being targeted. The promotion of non-cash payments, primarily through digital means, emerged as an important fourth objective.

Central banks commonly undertake currency exchanges to remove counterfeit notes from circulation and introduce notes with more advanced security features to deter future counterfeiting activity. The note exchange in the Philippines is one example, while the US Federal Reserve has introduced three new designs of the USD 100 note in the past 30 years.

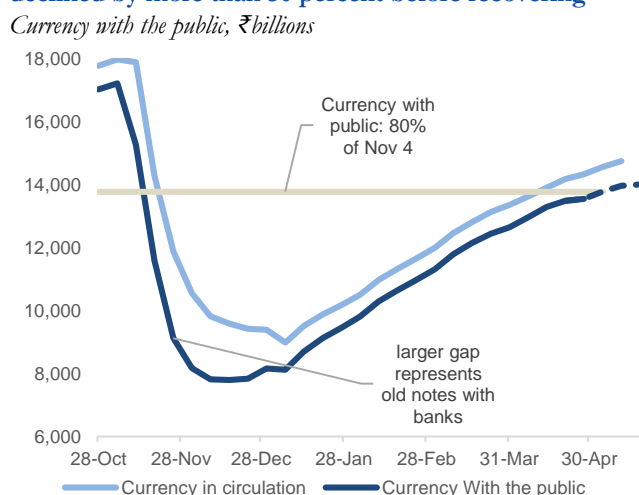
Demonetization forced individuals either to disclose their cash holdings (and thus open themselves to scrutiny and taxation), or take substantial losses and risks to keep their anonymity. When holders disclosed previously undeclared income, they faced a 50 percent tax, with 50 percent of the remaining amount retained for four years in a non-remunerated account. If tax authorities later identify deposits of previously undeclared income, they will be subject to 85 percent tax and penalty, and possible criminal prosecution. Most subterfuges utilized to legitimize cash holdings involved payments either to the government (taxes), or to third parties. Therefore, demonetization effectively acted as a tax on undeclared money.

Finally, demonetization encouraged more merchants to accept payment other than in cash, and more consumers to start using digital payments, leading to a possible network effect. Boosting digital payments reduces the use of anonymous cash and increases the public’s comfort with electronic cash, which is key to implementing direct transfer of benefits successfully.

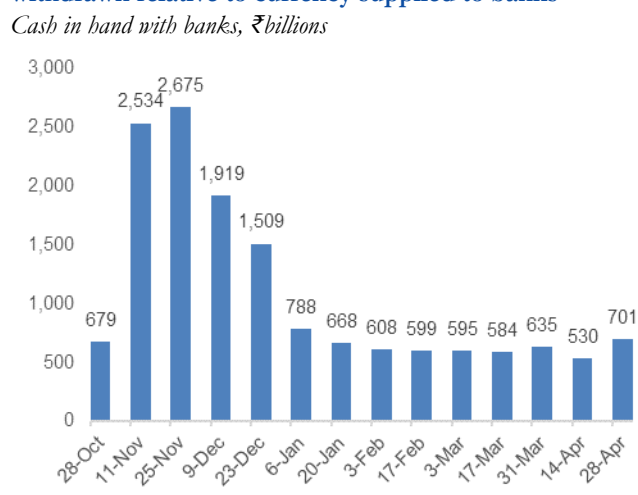
**Cash availability has normalized and a new steady-state of holdings near 80 percent of pre-demonetization appears to be emerging**

The amount of currency with the public (which includes old notes) declined sharply until early December 2016, as the amount of demonetized notes turned into banks exceeded the amount of valid notes disbursed (Figure 41). The RBI's mints started printing ₹2000 notes in September 2016 and the new ₹500 notes only after November 8, 2016, limiting the pace of new currency disbursements. Daily and weekly deposit restrictions were in place, but in many cases limited quantities of cash were the binding constraint to cash withdrawals, leading to long lines at ATMs. Currency with the public reached a low of 46 percent of the pre-demonetization value on December 9, 2016 representing a contraction of over 5 pp of GDP. Liquidity started to normalize by the second half of December 2016 by end-April 2017 had reached 80 percent of pre-demonetization levels. Cash in hand with banks appears to have returned to levels prevailing pre-demonetization (Figure 42), suggesting demand for currency matches supply to banks, and that a new post-demonetization steady state of cash holdings could be close to being reached.

**Figure 41. The amount of currency with the public declined by more than 50 percent before recovering**



**Figure 42. Less cash with banks means more currency withdrawn relative to currency supplied to banks**



**The near-term economic impact was limited but the social impact may have been greater**

**The impact on economic activity was limited given the magnitude of the exercise**

As discussed in [Part A](#), despite statistical issues that mask some of the impact of demonetization on measured economic growth in Q3, available evidence suggests that the actual impact was smaller than what the observed liquidity contraction would have suggested. A naïve model assuming constant money velocity and sticky prices would have yielded a much larger impact in FY17 GDP (Table 3). Instead, while the inflation trajectory was little-changed, money velocity accelerated strongly after demonetization (Figure 43)<sup>16</sup>.

This increase in money velocity reflects a jump in the use of electronic payments, as well as coping mechanisms, especially informal credit. As demonetization was pervasive and widely understood to be temporary, the response of informal credit probably was larger compared to a monetary shock perceived to be permanent. In addition, the government allowed the use of old notes for specific purchases until December. Importantly, old notes could be used for fuel purchases until early December 2016, and farmers were able to buy seeds with old notes, which ensured that the sown area of the *rabi* (winter) crop was barely impacted by demonetization. This, together with the liberation of tolls, prevented a breakdown of the logistics chain, which would have had a much bigger impact on activity.

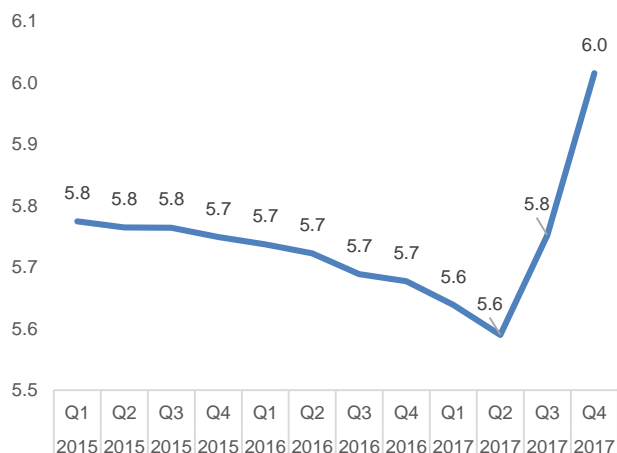
<sup>16</sup> While the numerator (GDP) may have been overstated by statistical issues in Q3, the numerator was also overstated since it includes old notes that had not been deposited but were no longer legal tender, and new notes were predominantly the relatively less liquid ₹2000 notes.

**Table 3. A naïve textbook model with constant velocity and sticky prices would have predicted flat GDP growth**  
₹billions (GDP, M1), ratio (V) and percent (deflator, growth)

	Nominal GDP (PY)	M1	V
FY16	136,753	24,114	5.7
FY17F ("textbook") ( $P*Y=M1*V$ )	141,042	25,231	5.6
Assumed Deflator	3.0%		
Real Growth	0.1%		

Source: RBI and World Bank staff calculations  
Note: FY17 velocity calculated as the average up to Q2

**Figure 43. However, in reality money velocity accelerated sharply post-demonetization**  
M1 velocity



Source: CSO, RBI and World Bank staff calculations and projections  
Note: M1 velocity calculated as the four-quarter rolling sum of nominal GDP divided by average M1 for the last four quarters. Q4 FY17 GDP is the World Bank's forecast

**Possible short-term adverse impact on low-income households**

While the macroeconomic impact of demonetization has been relatively limited, the distribution of the costs is uneven as the informal economy is likely to have been hit especially hard. Although the informal economy may account for only 40 percent of GDP (Kolli & Sinharay, 2011), it employs 90 percent of India's workers (Naik, 2009), and the disproportionate impact of demonetization on India's informal sector suggests that it would have affected those workers the most. The poor and vulnerable are more likely to work in informal sectors (farming, small retail, and construction), and are less able to move to non-cash payments. Sensitive to the potential impact on jobs in the construction sector, which is an important avenue for poverty reduction, the government announced a number of measures to boost the construction of affordable housing, which may help the sector as it transitions to a less cash-reliant model.

**Banks benefit from higher deposits, but credit growth remains limited**

The initial impact of demonetization on banks was negative, as evidenced by the slowdown in financial services in the national accounts. The longer-term impact may be more positive if the new steady-state level of deposits is higher and usage of electronic payments increases. Although a large share of the cash deposited has been withdrawn, as of April 28 deposits were up 3.7 pp of GDP compared to before demonetization. In turn, higher deposits should allow for a reduction in deposit and lending rates, and for banks to increase lending volumes while preserving profit margins. Although deposit and base rates did come down slightly, banks used additional deposits to purchase government securities rather than extend credit (Figure 13).

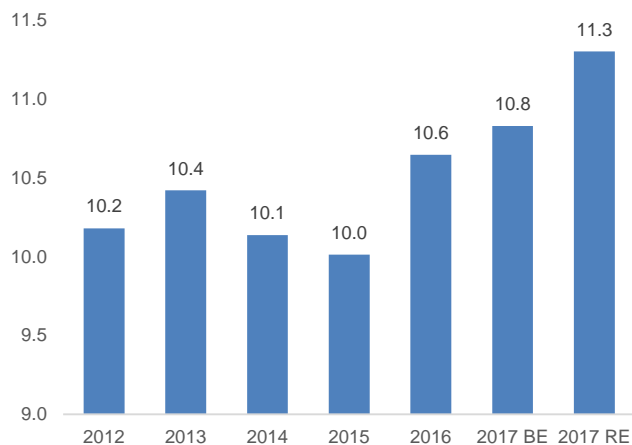
**Gains to government's collections this FY, with possible long-term benefits**

In FY17, the taxation of previously unreported cash (including the amount identified via the tax amnesty and demonetization) generated additional tax revenues. Gross tax revenues (including the states' share) exceeded the budgeted target of 10.8 percent of GDP and came in at 11.3 percent (FY16: 10.6 percent; Figure 44), mostly reflecting higher-than-expected excise collections on petroleum products.<sup>17</sup> Meanwhile, demonetization had a neutral effect on direct taxes, which were in line with budget targets (5.6 percent of GDP). Moreover, as banks bought government bonds, funding costs initially fell, lowering the interest bill at least temporarily (Figure 45). Going forward, revenues may increase permanently if demonetization is successful in raising the amount of income reported to tax authorities.

<sup>17</sup> Indirect tax revenue, particularly excise, came in higher than the budgeted 5.2 percent of GDP at 5.7 percent of GDP during FY17.

**Figure 44. Tax collections exceeded budgeted targets**

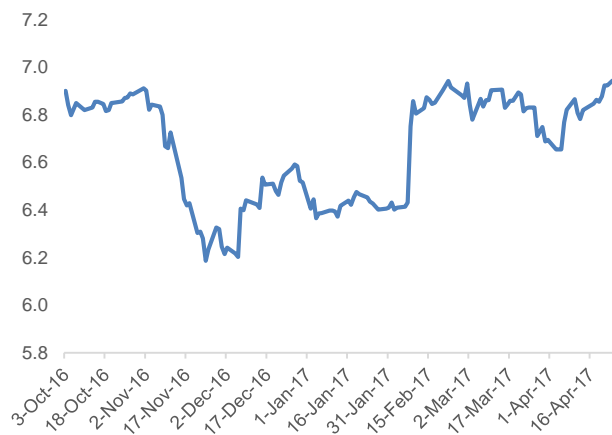
Gross tax revenue, percent of GDP



Source: MoF and World Bank staff calculations

**Figure 45. Government borrowing costs declined post-demonetization**

10-year government Bond Yields (percent)



Source: RBI and World Bank staff calculations

## Complementary reforms will ensure the achievement of positive transformations

### Formalization of the economy

#### Demonetization can accelerate the formalization of the economy

The informal economy accounts for over half of India's GDP (as of FY09) and 82 percent of non-agricultural employment (as of FY12; Table 4). Demonetization promotes a reallocation of resources from the informal to the formal economy. First, informal traders and credit providers felt the brunt of the withdrawal of liquidity. If informal credit providers, who serve individuals and informal businesses, faced losses related to cash that they had not previously declared, their capital base and future ability to lend declined. On the other hand, liquidity flowed to banks, which can channel it as credit – largely to formal enterprises. Second, formal merchants and businesses were better able to switch to non-cash forms of payment during the liquidity crunch, thereby minimizing disruptions. Many firms that had been reluctant to formalize now adopted digital payments, moving a step closer to formalization, thanks to the demonetization exercise.

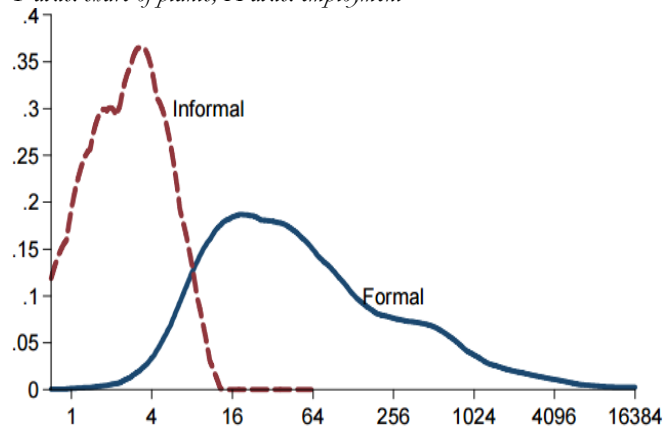
**Table 4. Jobs are concentrated in the informal sector...**

Unorganized share of, percent	GDP (FY09)	Jobs (FY12)
Agriculture	92.4	99.6
Manufacturing	32.0	74.8
Mining, utilities	9.3	41.0
Construction	55.9	67.0
Trade, hotel & restaurants	74.1	94.9
Transport, storage & communications	63.1	87.2
Services other than trade or transport	36.6	74.5
<b>All industries</b>	<b>54.4</b>	<b>82.4</b>

Source: Kolli (2011) and Srijia & Shirke (2014)

**Figure 46. ... where firms are smaller and less efficient**

Y axis: share of plants; X axis: employment



Source: Hsieh and Klenow (2012)

Formalization is ultimately a positive transformation that can lead to greater efficiency, and India's low aggregate productivity is in part due to the prevalence of a large number of informal,

unproductive firms (Figure 46). Complementary measures related to the ease of doing business (notably labor market regulations) are needed to ensure that the new equilibrium of higher formalization prevails. Moreover, given that the informal sector is a large source of employment, especially for poor and vulnerable groups, the shift requires mitigation measures for those groups as well as strengthening India’s safety net and expanding skilling programs.

**Formalization of the economy will be supported by improving the “ease of doing business” and GST implementation**

Complementary measures to promote the formalization of the economy include the “ease of doing business” agenda to reduce the cost of firms operating in the formal economy. The key measures in this regard are: (i) implementation of the new Insolvency Act, which allows a more orderly reallocation of resources from less to more productive firms; (ii) improvements in tax administration that balance the need for enforcement of tax laws with the burden of compliance; and (iii) further improvements in licensing and registration procedures for businesses. The smooth implementation of GST will be another major complementary reform to promote formalization, as firms have a strong incentive to register with GST to obtain input tax credits.

**Mitigating the impact on the poor will be important in this accelerated transition towards formalization**

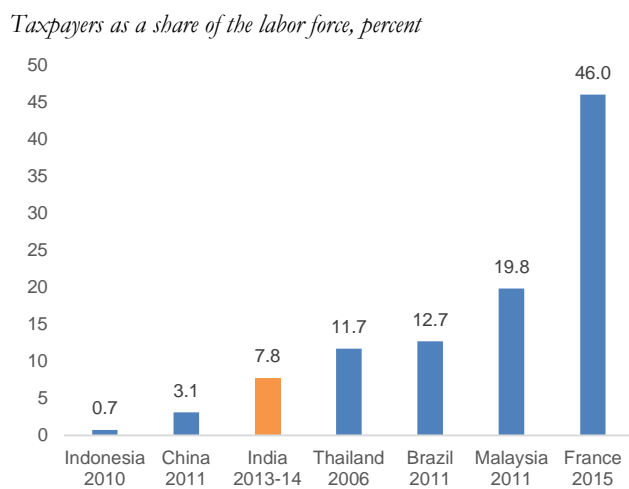
Recent global events have highlighted the importance of mitigating the impact of economic shifts on the groups that will be most disrupted. As noted, in India, the poorest and most vulnerable work in the informal sector. The construction sector in particular has been an important pathway out of poverty for many rural households. Policies that facilitate the absorption of construction labor force by larger firms, including as part of the announced expansion of investment in public infrastructure and in affordable housing, are helpful in this regard. Similarly, policies that promote hiring by formal firms, including through review of burdensome or complex labor legislation, would be important to ensure that the losses in the informal sector are significantly compensated by gains at the formal end.

**Increasing tax collections**

**Greater formalization also implies higher tax collections**

The main stated objective of demonetization was to penalize holders of cash related to income that has avoided (or evaded) taxation, and curb its creation. Indeed, few individuals pay tax (Figure 47) and India collects little in personal income taxes. Although this may be expected by its current income level (Figure 48), as income rises, income tax collections would be expected to increase.

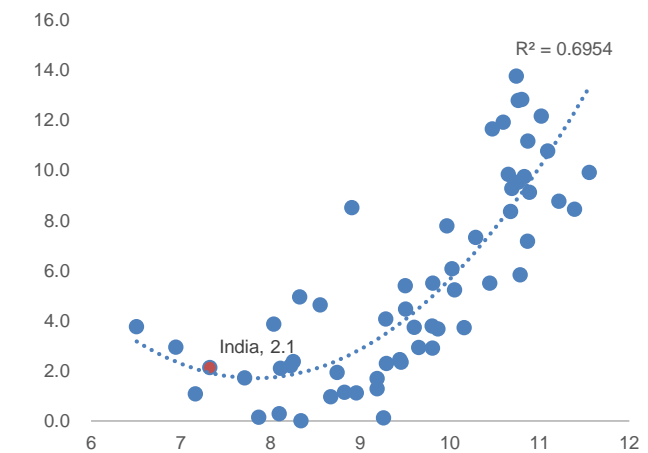
**Figure 47. Too few Indians pay personal income tax compared to similar countries**



Source: OECD, MoF, and World Bank staff calculations

**Figure 48. India collects little in direct taxes...**

Personal income tax revenue as a share of GDP (x-axis); Log of GNI per capita (current USD) (y-axis)

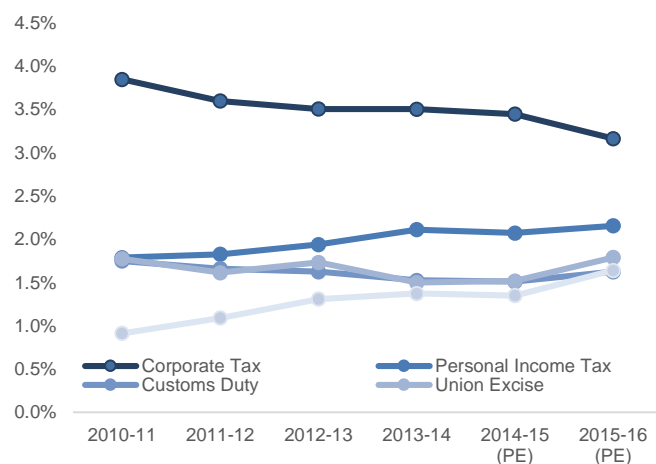


Source: OECD, MoF (India), National Bureau of Statistics of China

Furthermore, corporate tax collections have been declining (Figure 49), a trend whose impact on the budget has been offset by increased reliance on indirect taxes. Demonetization affected the stock of “black money”, and the government succeeded in raising additional tax revenues from

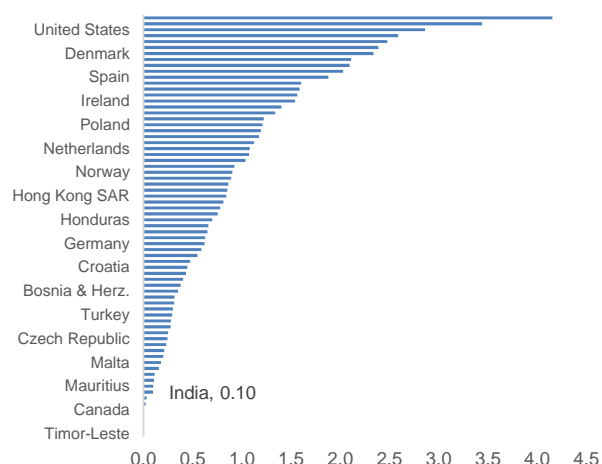
the money unearthed by the exercise. However, in order to capture the flow of “black money” going forward, additional measures related to tax policy and tax administration will be required.

**Figure 49. Corporate income tax collections have been declining, with increased reliance on indirect taxes**  
Percent of GDP



Source: MoF and World Bank staff calculations

**Figure 50. Property tax collections are low compared to other countries**  
Taxes on property, percent of GDP



Source: OECD, MoF, and World Bank staff calculations

**India can raise more revenues from the taxation of property, a major store of unaccounted wealth**

A 2012 study by the National Institute of Financial Management<sup>18</sup> found that investments in real estate is the most common method to hold unaccounted income. Real estate has reportedly been purchased largely in cash, in order to avoid stamp duty and registration fee, and to minimize property tax, even as very few municipalities enforce meaningful and regular taxation of properties. As a result, India is an outlier in the collection of tax on property (Figure 50), which limits resources at the level of state and local governments.

One factor accounting for this development is the relatively high costs of property registration, which creates incentives to under-report the underlying sale value of the property, thereby creating “black money”. Under the Jawaharlal Nehru National Urban Renewal Mission (JNNURM), states agreed to reduce stamp duty rates, which were often 10 percent or higher, to five percent. While the rates have thus come down, they remain high in many states in comparison to levels in other countries. Once registration fees are added, the overall cost of registering property increases by an average of 1 percent surging to 10 percent in Bihar, where a 2 percent additional stamp duty in urban areas leads to an effective stamp duty rate of 8 percent. At the same time, some states have raised the circle/administrative rates closer to market levels. Nevertheless, between 2005-2006 (when the JNNURM was launched) and 2013-2014, the ratio of stamp duty collections to GDP increased only modestly from 0.70 to 0.78 percent of GDP, suggesting that underreporting of transaction values remains a challenge.

**The government has taken several measures to curb “black money” and improve the enforcement of tax collection**

In the past two and a half years, the government enacted a law regarding undisclosed foreign income and assets, amended the Double Taxation Avoidance Agreement with Mauritius and Cyprus, and implemented a Voluntary Income Disclosure Scheme earlier this year. Moreover, the Benami Act, which targets property held in the name of third parties, came into effect on November 3<sup>rd</sup> 2017. These are welcome measures, but collections of personal and corporate income tax and property taxes can be further enhanced by (i) better coordination among tax agencies to increase number of companies with tax deduction at source (TDS); (ii) introducing a minimum alternative tax based on a firm’s assets (or individual wealth); and (iii) rationalizing land taxation to incentivize truthful reporting of property values.

<sup>18</sup> NIFM (2012), see Figure 3.18.

**Greater coordination between central and state tax agencies, and among central tax agencies can lead to improved enforcement**

There is limited information exchange between state and the central revenue departments, as well as between the Central Board of Excise and Customs (CBEC) and the Income Tax Office (ITO), curbing the ability of different tax authorities to cross-reference information and better enforce tax collection. Although information exchange has picked up since the signing of an MOU between the CBEC and the ITO, collaboration between the agencies can be deepened further, which is likely to bring significant benefits with the launch of GST

Since firms have an incentive to register for GST to claim input tax credits, GST provides an avenue to cross-reference filings of GST and corporate income tax, thereby ensuring consistency in reported turnover, as well as using this information, first to alert companies of any possible mismatch and, subsequently, for audit purposes. This requires increased collaboration and data sharing not only between the departments overseeing direct and indirect tax collection but also between state and central revenue departments.

Besides, GST can help in providing additional information on firms' corporate incomes, as well as increasing the number of firms that deduct personal income tax at source; this can be similarly verified or audited based on mismatch between the firms' reported turnover and filing of TDS.

**A minimum alternative tax based on individual and corporate assets can secure higher revenues and allow the simplification of the tax code**

India's taxation system for businesses is complicated because of numerous exemptions that allow certain firms to pay no taxes. Many of these businesses deliberately keep idle assets on their balance sheets, using these assets for speculative purposes or as conduits for tax avoidance or evasion. A Minimum Alternative Tax (MAT) on book profits at a rate of 18.5 percent is currently applied when the amount paid on book profit is higher than the amount resulting from a regular tax rate of 30 percent applied on taxable profit. However, this helps mainly in the case public sector enterprises that have the incentive to accurately report profit. Most corporations have no such incentive, leading to MAT being ineffective as a tool to improve compliance. In the recent past, further exemptions have crept into MAT, reducing its ability to serve as a minimum tax. Lastly, MAT does not apply to non-corporations, hence further limiting its effectiveness.

**Taxation of land transactions can be rationalized to increase revenues and transparency**

The advent of GST would be an opportunity to consolidate stamp duty and other property registration and related fees into the GST, possibly at the low rate applicable to gold (5 percent). This would bring many transactions to light, especially as developers would have more incentives to report, given the facility to claim input tax credits. Notwithstanding these steps, improved collection of land-related taxes also requires fine tuning and modernizing land cadasters, besides frequently updating circle rates to create a better check on reported transaction prices. Finally, keeping the land value updated would allow state governments to moderate stamp duty rates.

**Digital financial inclusion**

**India has been a pioneer in digital financial inclusion**

Since the 1990s, India began developing the technology infrastructure to facilitate the creation of a payments and settlement ecosystem. Legislation and policy initiatives have been key to promoting wider acceptance and deeper penetration of electronic payments, including through the *JAM (Jan Dhan, Aadhaar and Mobile)* trinity. India now has a robust, diversified and efficient retail payments framework, comparable to that in advanced countries, to meet the diverse requirements of users. These include bank accounts, checks, debit and credit cards and prepaid payment instruments. A variety of remittance channels are in place to suit the needs of users based upon their time criticality and cost sensitivity: National Electronic Funds Transfer (NEFT), Immediate Payment Service (IMPS), Aadhaar Enabled Payment System and recently the Unified Payments Interface. Systems such as the Electronic Clearing Service (ECS), the National Automated Clearing House (NACH) and the Aadhaar Payment Bridge System meet the need for making bulk and repetitive payments. The RBI Committee Report on *Medium Term Path on Financial Inclusion (2015)* articulated the vision.

**Table 5. Cash transactions still very popular in India**

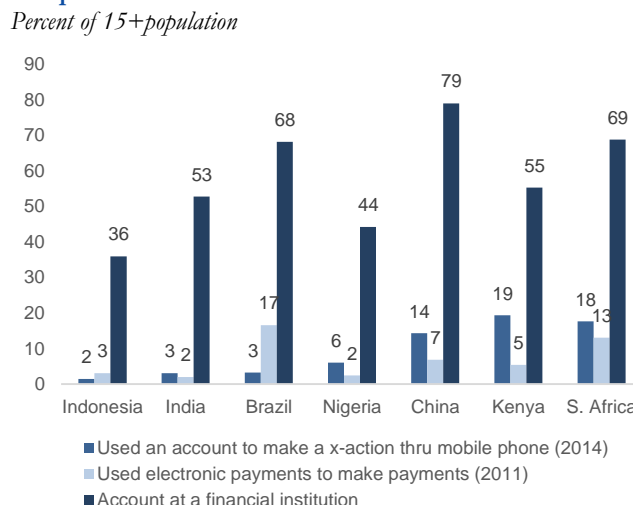
Payment Type	2007	2008	2009	2010	2011	2012
Card Payment Transactions (Excluding Commercial)	2.8	3.1	2.9	2.8	3.5	4.1
Electronic Direct / ACH Transactions	2.6	3.0	3.8	4.5	5.6	6.8
Cash Transactions	90.6	90.0	89.7	89.5	87.9	86.6
Other Paper Transactions (Checks, Demand Drafts)	4.1	3.9	3.6	3.2	2.9	2.5

Source: Euro monitor Passport 2013

**Yet cash transactions remain pervasive**

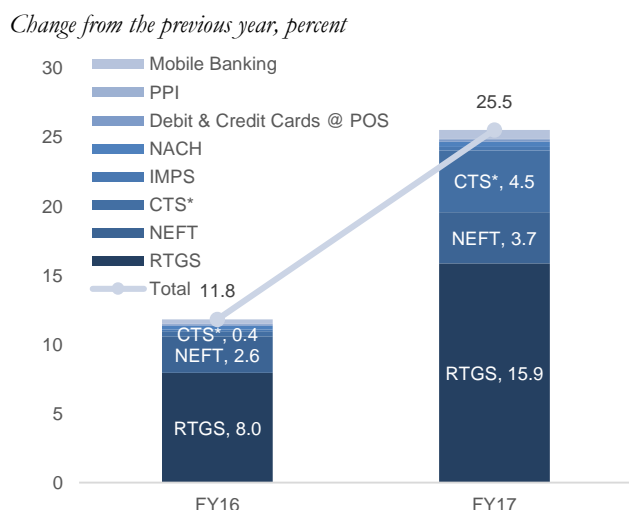
Cash transactions are still very prevalent, however (Table 5), and few individuals used electronic payments or mobile banking prior to demonetization (Figure 51). After the demonetization decision in early November 2016, there has been a large jump in digital payments (Figure 52). These include debit cards (92 percent y/y in FY17 vs. 31 percent in FY16) and pre-paid instruments such as e-wallets (71 percent y/y in FY17 vs. 128 percent in FY16). High growth comes from a low base, however, which explains why the contribution to growth of these categories is negligible.<sup>19</sup> On balance, the extent to which demonetization succeeds in universalizing electronic payment will depend on the implementation of supporting arrangements and capacity building interventions.

**Figure 51. Prevalence of cashless transactions was low compared to other countries**



Source: RBI, World Bank staff calculations

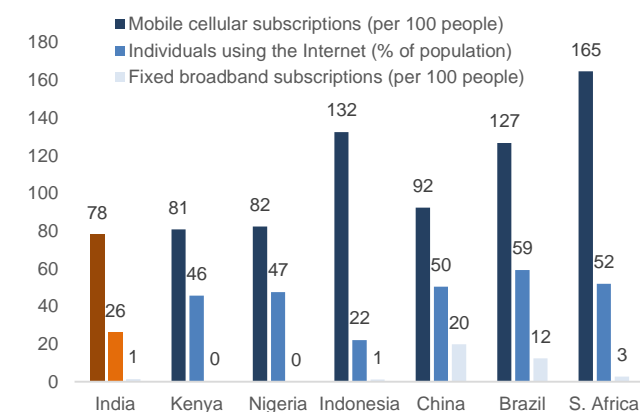
**Figure 52. The growth of electronic payments jumped post-demonetization**



Source: RBI, World Bank staff calculations  
Note: See [Abbreviations](#) for acronyms

**Figure 53. Access to the internet remains limited**

Share of the population (individuals using the internet) and number per 100 people (others), 2015



Source: WDI

<sup>19</sup> Following the RBI's reporting on electronic payments, this figure includes RTGS, which is largely an inter-bank system for large value payments. RTGS saw huge spurt during demonetization because of an increase in ePayments in other payment systems, which use the RTGS to do the final aggregate settlement, and because of the increase in liquidity in the banking system that led to more inter-bank money market transactions and placements with RBI.



**Mobile penetration can increase further, and the internet needs to be more accessible, reliable, affordable, open and safe for all Indians**

The adequacy of a stable, reliable digital payments infrastructure suited to transaction volumes is paramount. Enhancements in network connectivity, financial infrastructure and reliability of banking websites and applications relative to transaction demand are needed for customers to feel confident in utilizing them. The cost of smartphones is relatively low by international standards, but India’s mobile penetration rate lags behind most other emerging economies, while only half the population has a mobile connection (Figure 53 and Table 6). Overall teledensity (which includes subscribers with multiple accounts) was 93 percent as of February 2017, but Bihar, Assam, Madhya Pradesh, Uttar Pradesh and Odisha have teledensities below 80 percent, while rural teledensity is only 56 percent, suggesting unequal access.

India lags further behind with respect to data connections. India has approximately 432 million internet subscribers (of which about half are still on narrowband 2G connections) compared with 731 million in China. Nearly half of Indian businesses had an online presence in 2014 compared to two-thirds in China two years earlier. The cost of a 1 Mbit/s residential broadband service in India is 6-10 times more expensive than in China.

**Table 6. India has considerable scope to improve its digital connectivity relative to China**

Indicators (as of 2016, except as noted)	India	China
Unique mobile subscribers, share of the population 1/	51.4	76.1
Mobile broadband (3/4G), share of unique mobile subscribers 1/	18.6	64.6
Spectrum allocated to mobile communications (MHz) 2/	256 (2015)	687 (2013)
Internet users (millions) 3/	432	731
Firms with their own website (percent) 4/	48.9 (2014)	66.1 (2012)
Price of a 1 Mbit/s residential broadband service (PPP USD) 5/	56.5 (2013)	4.4 (2013)

Sources: 1/ GSMA Intelligence; 2/ GSMA Intelligence and China Academy of Telecommunication Research; 3/India: TRAI; China: S. China Morning Post; 4/ World Bank Enterprise Surveys; 5/ WDR 2015

**Even with the right infrastructure, changing consumer and bank behavior will require additional effort**

While the demonetization experiment moved a large number of individuals to digital payment, sustainable changes in consumer behavior will require additional measures. Rao et al (2016) point to a few key challenges. Individuals need to make two key changes in their behavior. First, they must move from tangible means that they can see and feel, to means that are less tangible or not at all tangible. Second, they have to rely on technologically advanced tools to undertake regular day-to-day operations. The latter requires users to be literate and educated to the extent of comprehending the content of transactions. Supporting and sustained investment in digital financial literacy is needed for this purpose. Complementing that baseline need is accessibility in the local language: if the bulk of the population needs to come on board, it would be important to make these facilities available in the principal Indian languages to ensure that users comprehend the transactions they enter into.

In addition, the banking sector will need to move from account opening to account usage. The challenges for the banking sector include adjusting to the cash preferences of customers who start using credit or electronic advances, and translating the increase in the number of bank accounts from the Jan Dhan Yojana into actual usage of those accounts. Increasing the use of direct benefit transfers to provide further benefit through electronic transfers would be an important step in this regard.

**Interoperability between different systems will also have to be resolved**

Advances in the retail payments infrastructure and overall policy framework have brought about a number of developments including (i) full interoperability for payment cards; (ii) initiation of transactions from various digital payment channels; (iii) fast developing interoperability for agent networks through the “MicroATM” and Aadhaar payments bridge; and (iv) de-coupling of mobile wallets from the underlying bank account through the Unified Payments Interface.

Customers of Pre-Paid Instruments (PPI) however do not get the full benefits of interoperability. There are several transaction channels available for moving funds from a linked

bank account to PPI and vice versa. However, it is not possible to move funds between PPIs. This difficulty arises because of lack of full access for PPI issuers to the retail payments infrastructure in the country and restrictions on the “cash out” feature for PPI given AML/CFT considerations. In the context of proposed changes to PPI guidelines, the RBI has suggested further strengthening the KYC requirements for opening PPI accounts – this could pose challenges to issuers and customers, but on the other hand could pave the way for PPI instruments getting fully integrated into the retail payments infrastructure.

**The government can also introduce more incentives and mandates for digital payments**

From a user perspective, the cost of cash as a means of payment is (nearly) nil, as the RBI and the government cover the costs involved in supplying the medium of payment. However, digital payments services are provided by commercial operators and user costs can therefore be higher. Therefore, the government can continue to support the switch to digital payments by introducing mandates and incentives (such as the service tax exemption on card payments provided during demonetization). Moreover, the government can accelerate its push to digitize all government transactions, including tax filings and payments. In particular, the introduction of GST allows doing this on a national scale.

## 2. Fiscal Policy Update

### FY18 Budget: Everything in Moderation

#### Budget largely achieves the objectives of building fiscal credibility

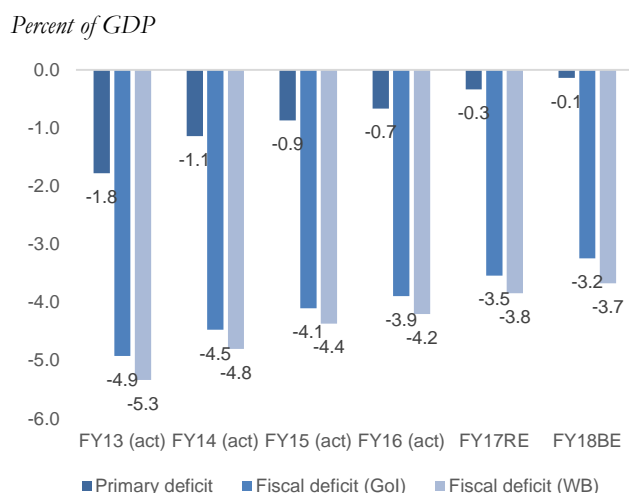
**Fiscal consolidation continues, at a measured pace** The government announced the FY18 fiscal deficit target at 3.2 percent of GDP, lower than the expected 3.5 percent deficit in FY17 and the 3.9 percent achieved in FY16 (Table 7 and Figure 54), but 0.2 pp higher than the previously announced fiscal path. This stance is broadly neutral: excluding disinvestment receipts (which are treated as financing items under GFSM 2001), the ‘strict’ fiscal deficit (“World Bank/IMF definition” in Table 7 below) is expected to come down by only 0.1 percent of GDP. The primary deficit contracted by 0.4 percent of GDP in FY17 and is expected to decline further to 0.1 percent in FY18, supporting a declining path for the debt of the Central government. However, what appears to be the materialization of contingent liabilities (“residual” in Figure 55) has kept debt ratios above what the path of fiscal deficits would imply. The combined debt stock of the center and the states has been declining since 2004 and has stabilized close to 69 percent of GDP since FY16.

Table 7. The deficit has been on a consolidation path

Percent of GDP	FY15 (act)	FY16 (act)	FY17RE	FY18BE
<b>Total receipts</b>	9.3	9.2	9.8	9.5
<b>Revenue receipts</b>	8.9	8.7	9.4	9.0
<b>Non-debt capital receipts</b>	0.4	0.5	0.4	0.5
<i>of which divestments</i>	0.3	0.3	0.3	0.4
<b>Total expenditure</b>	13.4	13.1	13.4	12.7
<b>Revenue expenditure</b> (excl. grants for capital assets)	10.7	10.3	10.4	9.7
<i>of which interest</i>	3.2	3.2	3.2	3.1
<b>Capital expenditure</b> (incl. grants for capital assets)	2.6	2.8	3.0	3.0
<b>Primary deficit</b>	-0.9	-0.7	-0.3	-0.1
<b>Fiscal deficit</b> (GoI definition)	-4.1	-3.9	-3.5	-3.2
<b>Fiscal deficit</b> (WB/IMF definition)	-4.4	-4.2	-3.8	-3.7

Source: Ministry of Finance and World Bank staff calculations

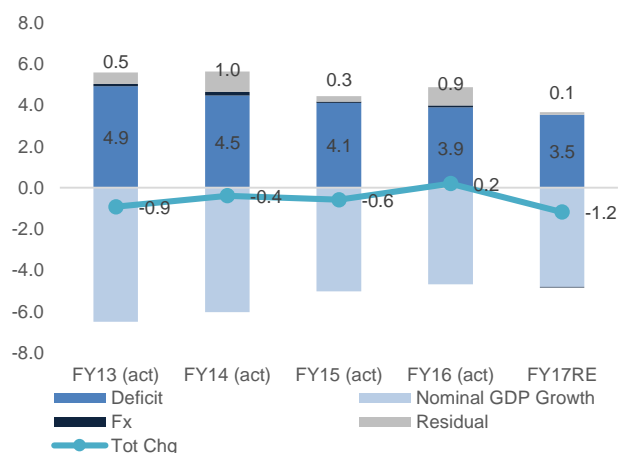
Figure 54. The government remains on a path of fiscal consolidation



Source: OECD, MoF, and World Bank staff calculations

Figure 55. Debt levels of the center have not declined in line with the deficits

Decomposition (bars) of changes in the center's debt-to-GDP ratio (line), percentage points of GDP



Source: MoF, RBI

**The budget targets are largely aligned with the recommendations of the FRBM review committee**

In May 2016, the government commissioned a group of experts to review the Fiscal Responsibility and Budget Management (FRBM) Act, which embodies India's fiscal rule. During preparations of the FY18 budget, the committee delivered its report to the government, which published it in April 2017. Its key recommendations include (i) introducing a medium-term debt target of 60 percent of GDP for the center and states combined (vs. 69 percent currently); (ii) adopting an explicit escape clause for when deficits can deviate from the target; and (iii) gradually lowering the fiscal deficit targets. The government is currently reviewing the recommendations, although it has already accepted some of them in the budget. Importantly, for FY19 (the year of the next general election), the fiscal deficit is targeted at 3 percent of GDP. Box 4 has additional details of the report's recommendations.

**Box 4: The FRBM Committee Report**

The FRBM Review Committee submitted its report in January 2017. The Committee proposed a draft Debt Management and Fiscal Responsibility Bill, 2017 to replace the Fiscal Responsibility and Budget Management Act, 2003 (FRBM Act). Key recommendations are summarized below:

1. The committee suggested using general government debt-to-GDP ratio as the primary anchor for medium-term fiscal consolidation. A debt-to-GDP ratio of 60 percent should be achieved by no later than FY23, with a 40 percent limit for the center and 20 percent limit for the states.
2. The fiscal deficit (GoI definition) should be adopted as the key operational target consistent with achieving the medium-term debt ceiling.
3. The path of fiscal deficit to GDP ratio consistent with achieving the debt targets, according to a majority of the committee was set at 3.0 percent in FY18-FY20, 2.8 percent in FY21, 2.6 percent in FY22, and 2.5 percent in FY23.
4. The committee has included certain escape clauses to provide fiscal flexibility. These can be invoked in situations resulting in (i) matters of national security, war, calamities resulting in collapse of agricultural output (ii) sharp decline in real output growth of at least 3 pp below the average for the previous four quarters (iii) far-reaching structural reforms in the economy with unanticipated fiscal implications. However, deviations from the stipulated fiscal deficit target should not exceed 0.5 pp in a year.
5. It has also complemented this with a buoyancy clause according to which the fiscal deficit must be lowered by at least 0.5pp below the stipulated target if the growth of real GDP is 3pp higher than the average of the previous four quarters.
6. The revenue deficit to GDP ratio should decline steadily by 0.25 pp each year with the path specified as follows: 2.3 percent in FY17, 2.05 percent in FY18, 1.8 percent in FY19, 1.55 percent in FY20, 1.30 percent in FY21, 1.05 percent in FY22, and 0.8 percent in FY23.
7. The committee also recommended the setting up of a three-member Fiscal Council that would: (i) provide macroeconomic forecasts to the government; (ii) independently assess the central government's compliance with the recommended fiscal targets; (iii) advise the central government on invoking the escape clause along with the action plan for returning to the stipulated fiscal trajectory; and (iv) prepare an annual fiscal strategy

**Revenue performance improving; most assumptions for FY18 realistic**

**Tax revenues exceeded targets in FY17**

As seen in [Note 1](#), gross tax revenues exceeded the budgeted target of 10.8 percent of GDP, coming in at 11.3 percent, mostly reflecting higher-than-expected excise collections (especially on petroleum products) as well as higher-than-budgeted service tax collection (Figure 56). The increase in collection may be linked to demonetization, as businesses had to legitimize their holdings of old currency. Meanwhile, demonetization had a neutral effect on direct taxes, which were in line with budget targets (5.6 percent of GDP); in effect, the measure boosted income disclosure, but the liquidity crunch dampened economic activity.

**Outturn from tax revenues expected to be stable; no**

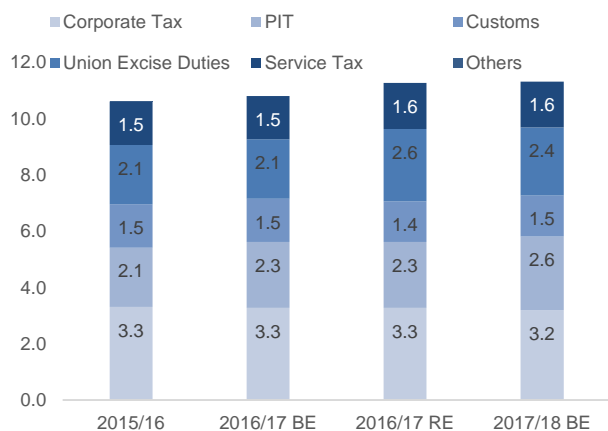
Tax revenue targets in FY18 are flat as a percentage of GDP compared with FY17 i.e., they assume a buoyancy of one. On the one hand, there will be some significant headwinds, including the reversal of favorable oil prices, the voluntary income disclosure schemes, and the

**estimates for receipts from GST**

demonetization-induced pressure to legitimize existing cash holdings. On the other hand, the ambitious target for Personal Income Tax (PIT) collection (+25 percent in FY18 and +23 percent in FY17) may be feasible considering that India has one of the lowest PIT/GDP ratios in the world, and government has increased the rates for individuals in high-income brackets,<sup>20</sup> whereby compliance may improve due to the information gathered from demonetization. Excise collection is projected to grow by 5 percent, accounting for higher oil prices, which may necessitate lower tax rates, while corporate tax is expected to grow by 9 percent due to a reduction in corporate taxes to 25 percent for SMEs. No projections for GST have been provided, although it is the stated government policy to introduce the GST in July 2017, and at the latest by September 2017.

**Figure 56. Tax collection improved thanks to higher excise duties**

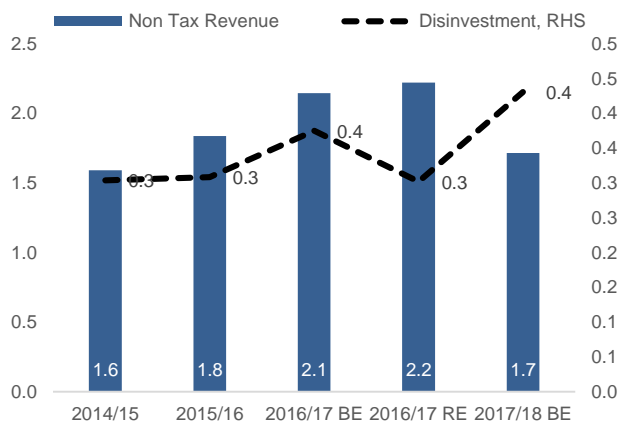
Percent of GDP



CEIC, Ministry of Finance, and World Bank staff calculations

**Figure 57. Receipts from one-time asset sales are expected to increase**

Percent of GDP



CEIC, Ministry of Finance, and World Bank staff calculations

**Disinvestment receipts to increase, with possible strategic significance for railroads**

Divestments came in lower than budgeted at 0.4 percent of GDP in FY17, the same level as in FY16. Budget estimates for FY18 peg disinvestment receipts at 0.4 percent of GDP (compared to 0.3 in FY17; Figure 57). Notably, the divestment list includes some key rail sector PSUs (IRCTC, IRFC, Ircon), which could be a key structural reform in the sector. The government also plans to divest ₹110 billion worth of stakes in PSUs, starting with general insurance companies. Total non-tax revenues, including disinvestments, are expected to decrease by 0.4 pp in FY18.

**The quality of expenditure continues to improve**

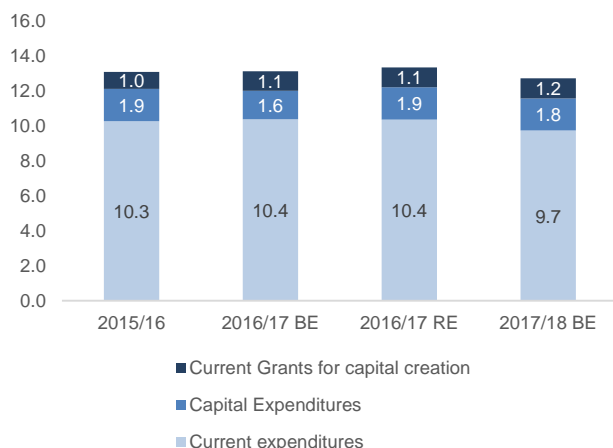
**The majority of the consolidation is expected on account of rationalization of current expenditure**

Revenue (current) expenditure, excluding grants for capital formation by states, has remained largely stable in FY17 (10.4 percent vs. 10.3 percent attained in FY16). Increases on account of implementation of the 7<sup>th</sup> Pay Commission recommendations offset the reduction in subsidies (food, fertilizer and petroleum subsidies declined by 0.3 pp of GDP). In FY18, revenue (current) expenditure excluding capital grants is expected to contract to 9.7 percent of GDP (Figure 58), with savings spread among interest payments (given lower interest rates), subsidies (especially fuel-related, as the push to improved management continues), current expenditure on defense, and pensions (as pay and pension arrears arising from the 7<sup>th</sup> Pay Commission have been largely disbursed).

<sup>20</sup>A surcharge of 10 percent of tax payable was added for individuals with income between Rs5 million and Rs10 million.

**Figure 58. Current spending rationalized, while capex maintained**

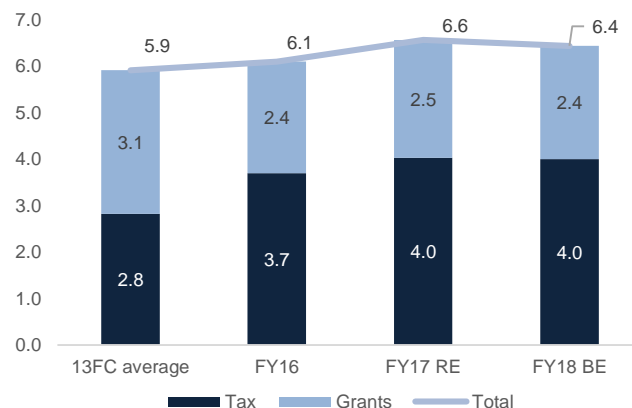
Percent of GDP



CEIC, Ministry of Finance, and World Bank staff calculations

**Figure 59. Transfers to states remain high**

Devolution to states, percent of GDP



CEIC, Ministry of Finance, and World Bank staff calculations

**Transfers to states set to remain high**

Tax devolution to states has been budgeted at 4.0 percent of GDP in FY18, same as the previous year (Figure 59). This is slightly higher than 1 percent of GDP, as compared with the 13<sup>th</sup> Finance Commission period, though grants to the states have been reduced to 2.4 percent of GDP, compared with 3.1 percent on the average during this period. Overall, transfers to the states are budgeted at 6.4 percent of GDP in FY18 vs. 5.9 percent on the average for FY11-FY15. By comparison, the central government transfers approximately 30 percent of expenditure to the states, against an average of 9.8 percent in the Organization for Economic Co-operation and Development (OECD), although this is partly due to low own-tax collections in the states, especially the municipalities.

**A marginal increase in capex is budgeted**

Capital expenditure, including grants-in-aid for capital formation by the states, is budgeted to increase from 2.9 percent of GDP in FY16 to 3.0 percent of GDP respectively in FY17 and FY18. In fact, all deviation of budgetary targeted expenditure in FY17 was due to higher capital expenditures (FY17 budget: 2.7 percent of GDP). Most of the increase in capital outlay can be attributed to infrastructure sectors, such as roads and bridges. The revised estimates of capital expenditure on roads and bridges at 0.26 percent of GDP for FY17 exceeded the budgeted target by 0.16 percent of GDP. This level of expenditure for roads and bridges has been increased slightly to 0.3 percent of GDP in FY18.

**Allocations to the social sectors increased, albeit modestly**

In FY 17, the revised estimates of total expenditures on social services (current + capital + loans and advances) exceeded the budgeted amount by a substantial 0.38 percent of GDP coming in at 5.3 percent of GDP. Social sector spending has been further enhanced to 5.7 percent of GDP in FY18. Some of the projected increase (in both FY17RE and FY18BE) is attributed to the “Mahatma Gandhi National Rural Employment Guarantee Act” (MGNREGA) scheme, which became particularly important to absorb unskilled labor displaced by the demonetization exercise. In contrast to the overall decline expected for current expenditures, expenditures on education and health (which are largely current in nature) have increased modestly. Current expenditures on education exceeded budgeted targets in FY 17, and are budgeted to remain flat (up 0.01 pp in FY18). Current expenditures on health largely met budgeted targets in FY17 and have been maintained at the same level in FY18. Substantial increases in capital expenditures on health and education are envisaged in FY18, although they remain a small percentage of total expenditure in the sectors (17 percent and 1 percent in health and education respectively) is the first to be cut.

**Important measures were taken to mitigate the impact of demonetization on poor and vulnerable through stimulus to construction**

Construction has been an important gateway out of poverty in India. Therefore, policies that promote construction are likely to have dual effects of creating jobs at the low-end of the income distribution, and providing conditions for crowding in private investments and sustaining growth. Demonetization's continued impact in FY18 is expected to be felt primarily in the construction and real estate sectors, therefore the focus on infrastructure investment and protecting allocations for MGNREGA are important for the poor. In this context, the budget: (i) granted infrastructure status to affordable housing, which could mean lower tax rates on project development and potentially lower funding costs; (ii) reduced the holding period for considering gains on immovable property to be long-term from three to two years; and (iii) focused on rural areas and increased allocation for irrigation and water (~₹300 billion), interest subsidies, and e-NAM (national agricultural markets).

**Some notable public finance management (PFM) and governance reforms introduced**

**A few important PFM reforms implemented, but much remains to be done**

PFM reforms included: (i) the budget date has been brought forward by a month, which, on the one hand, this gives parliament more time to deliberate and allows for more timely execution. On the other, estimates are based on less information than before. (ii) Consolidation of the railway budget into the union budget. In this initial year the measure is mostly aesthetic as the information has simply been aggregated to the union budget presentation. (iii) Elimination of plan vs. non-plan distinction. The plan vs. non-plan distinction, associated with five-year development plans, has been eliminated and the budget has adopted a more standard classification of expenditures between current and capital. A breakdown of expenditure on schemes, which are largely implemented by states, has been provided instead. This is helpful in identifying the expenditures implemented by central agencies vs. states. (iv) Off-budget funds and overall budget transparency. Special-purpose vehicles, and off-budget borrowing remain pervasive, but limited information is provided in the budget. In FY17, some of the infrastructure push was accomplished through nearly ₹600 billion borrowing by NHAI; the FY18 budget brought a ₹20 billion fund for the dairy sector under the National Bank for Agriculture and Rural Development (NABARD).

**Reforms to reduce corruption and the creation of "black money", were introduced**

Reforms were introduced in the areas of: (i) Digital economy, no transactions above ₹200,000 will now be permitted in cash; further incentives are being provided for using digital payments. (ii) Election funding – Enhanced transparency for political funding is expected to be brought about by imposing a limit of ₹2,000 on individual cash donations and all payments above that restricted to checks and digital modes.

**State finances: higher deficits, higher capex**

**State deficits have climbed in recent years, but by how much?**

**State deficits have been increasing, but caution is warranted with respect to recent trends**

States' deficits have been on the rise since FY13 (Figure 60) and market borrowing by states reached 2.0 percent of GDP in FY17 compared to 1.7 percent of GDP in FY16; in contrast, the union reduced borrowing from 3.2 percent to 2.7 percent of GDP. The increase in state deficits is partly due to a sharp deceleration in the growth of own revenues and an acceleration of capital expenditures (Figure 61). However, two caveats apply when looking at the two most recent years. First, the sharper increase in deficits and market borrowings in FY16 includes the effects of UDAY, a scheme whereby state governments took over liabilities of their electricity distribution companies and which were essentially debt of states. Second, fiscal reporting by states face challenges in timeliness and quality. In particular, an analysis of ten major states shows that states tend to overestimate current-year deficits during budget period (see Box 5). While states overestimate revenues, revenue expenditures tend to come even shorter of revised estimates.

**Figure 60. Deficits have been on the rise...**

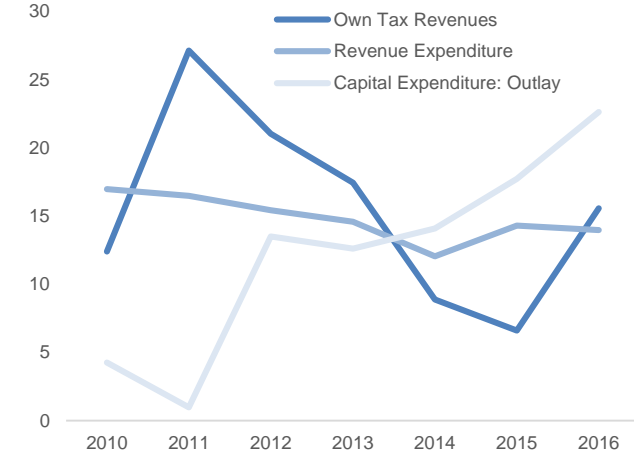
Combined state fiscal deficit, percent of all-India GDP



CMIE, state budget documents, and World Bank staff calculations

**Figure 61. ... primarily because growth of own revenues decelerated in recent years**

Change from the previous year, percent



CMIE, state budget documents, and World Bank staff calculations

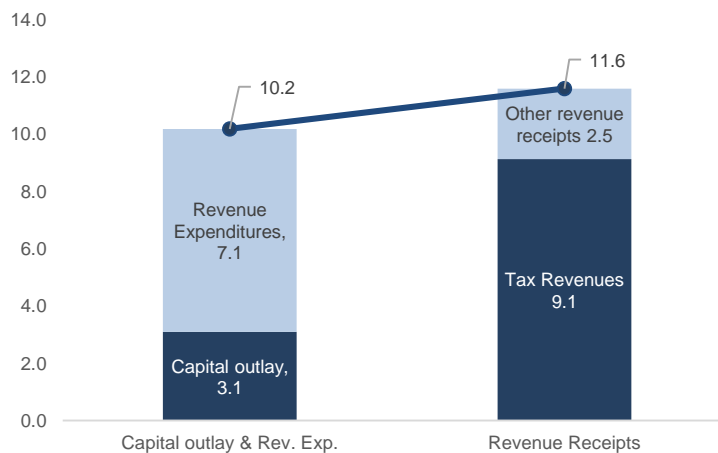
**State FY18 budgets project a continuation of capex push and fiscal consolidation**

**FY18 budgets promise lower deficits as UDAY expenditures are phased out**

The combined fiscal deficit of a sample of major states<sup>21</sup> is budgeted to decline by 12.2 percent in FY18 from FY17RE, partly as states phase out the UDAY debt transfers that increased deficits in FY16 and FY17. For example, Rajasthan’s deficit is expected to decline by 6.4 percent of Gross State Domestic Product (GSDP) in FY17. States have budgeted an increase in total expenditures (revenue expenditure and capital outlays) of 10.2 percent y/y (Figure 62), driven largely by capital outlays (+21.4 percent y/y). Revenue expenditure is projected to grow by a more moderate 8.3 percent despite the implementation of recommendations from the 7<sup>th</sup> Central Pay Commission in a number of states. States expect revenue growth to exceed expenditure growth, thus leading to lower deficits. Budget documents target revenue receipts growth of 11.6 percent y/y in FY18, driven by a healthy growth in tax revenues (+12.8 percent y/y), primarily states’ own tax revenues (+13.7 percent y/y). These projections are in line with the guarantee given by the center, that under the GST revenues would increase by at least 14 percent nominally.

**Figure 62. Consolidation in FY18 relies on contained revenue expenditures and tax revenue growth**

Composition of growth rate of revenues and expenditures, percentage points



Source: CMIE, states’ budgets, World Bank staff calculations

<sup>21</sup> Due to lack of data, excludes UP, Uttarakhand, Punjab, Manipur, Meghalaya, Mizoram, Tripura, Telangana, Assam, Arunachal Pradesh and Goa.



### Box 5: Revised estimates and actual budget execution outcomes

With a larger share of expenditure and borrowing in India now undertaken by states, interest has grown in state finances. However, the quality and untimeliness of state-level fiscal information creates a major hurdle to state-level fiscal analysis. This Box presents a comparison between the revised estimates and actual fiscal deficit in selected states to understand whether revised estimates (RE) of fiscal deficits of states are reliable guides to actual outcomes. We base our observations on a sample of 10 states<sup>22</sup> for a period of 10 years from 2006 to 2015.

**Table 8. States have systematically overstated deficits in revised estimates**

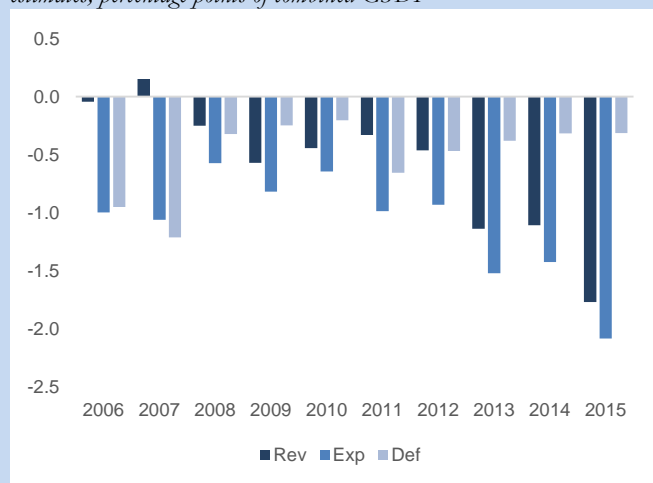
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Total Number of States	10	10	10	10	10	10	10	10	10	10
<b>...for which Actual &lt; RE</b>										
Fiscal Deficit	9	10	7	6	6	10	8	8	7	5
Revenue	5	2	4	7	8	7	7	10	10	10
Expenditure	9	8	8	9	6	10	9	10	10	10
Revenue Expenditure	9	9	8	9	6	10	9	9	10	10
Capital Outlays	7	5	6	4	7	8	7	8	9	8

Source: CMIE and World Bank staff calculations

Data shows that in the last ten years, on average, eight out of ten states in our sample have overestimated their fiscal deficits (Table 8) and actual deficits were 0.5 pp of GDP lower than the revised estimates suggested (Figure 63). In other words, the audited fiscal deficit turns out to be systematically lower than the revised estimate of the fiscal deficit announced within two months of the end of the fiscal year. An increasing number of states have overestimated their receipts over the last 10 years, while almost all states have overestimated expenditures as well. Overestimation of expenditures vis-à-vis in revenues drives most of the overestimation of fiscal deficit. Notably, the execution of revenue expenditures drives the underestimation of expenditures with a smaller contribution from capital outlays (Figure 64), although there is some variation across states.

**Figure 63. Actual state deficits were lower than revised estimates by 0.5 percent of GSDP...**

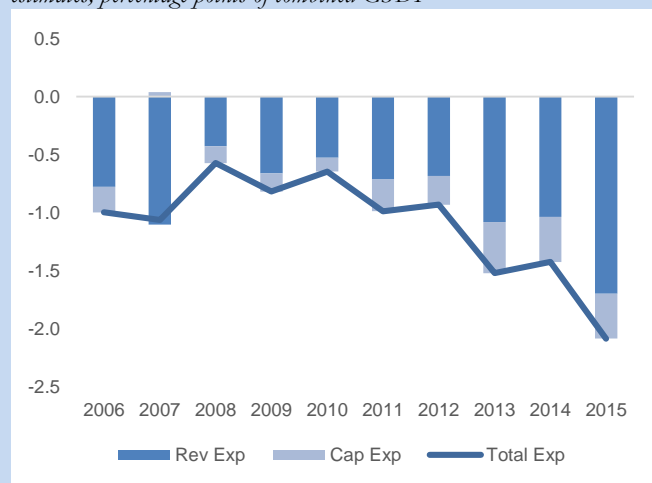
*Fiscal deficit of 10 major states, difference between actual and revised estimates, percentage points of combined GSDP*



Source: CMIE and World Bank staff calculations

**Figure 64. ...as the execution of expenditures (especially revenue expenditures) came short of revised estimates**

*Expenditures of 10 major states, difference between actual and revised estimates, percentage points of combined GSDP*



Source: CMIE and World Bank staff calculations

<sup>22</sup> Rajasthan, Bihar, Uttar Pradesh, Jharkhand, Madhya Pradesh, Kerala, Karnataka, Punjab, Tamil Nadu and Gujarat

## GST on the verge of implementation

### Government makes progress on GST implementation

**The GST is on track for implementation in Q2 FY18, but key policy and administrative challenges remain**

Following the approval of the Constitutional amendment to enact the Goods and Services Tax (GST) in September 2016, the Union Cabinet has in March 2017 approved four bills<sup>23</sup> to implement the new tax. The GST would be levied on all transactions involving supply of goods and services except those that are exempt or kept out of the purview of the GST, primarily electricity, and alcohol, as well as petroleum products, which can be added later.

The model adopted by India for the GST is unique and reflects the country's federal structure. First, the central government and the States will levy parallel taxes on goods and services simultaneously through a dual GST model. The first component, Central GST (C-GST) will be levied and collected by the central government, and the second component, namely, the State GST (S-GST) will be levied, collected and appropriated by each of the States. A third variant of the GST, the integrated GST (I-GST), will be set at a rate equal to the C-GST plus S-GST, and will apply to interstate transactions instead of C-GST and S-GST. The states and the Center will split the administration of the GST. The second unusual feature of India's GST is that it will have a number of rates – from exempt, to low-rated, to standard-rated with additional cesses.

The GST Council is currently working on the final operational rules, and the Fitment Committee has recently announced GST rates on all goods and services, a challenging task given the need to harmonize rates across 29 states that in some cases had different rates for the same commodity (Figure 65 and Figure 66).

**Figure 65. Although some items receive similar tax treatment in most states...**

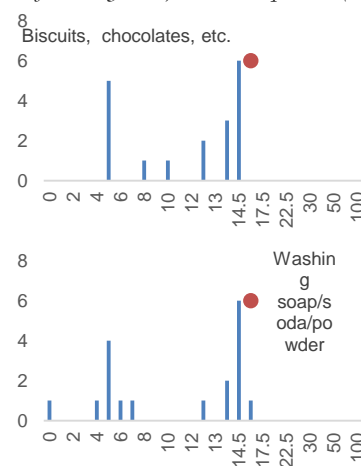
*Frequency, number of states (y-axis) and rates, percent (x-axis)*



Source: State tax schedules, World Bank staff calculations

**Figure 66. ... others are treated differently in different states; these will need to be aligned under GST**

*Frequency, number of states (y-axis) and rates, percent (x-axis)*



Source: State tax schedules, World Bank staff calculations

To be ready for the GST, State governments will need to re-engineer and align their processes with the GST processes, no matter whether a state decides to adopt its own IT systems (Model 1), or use the IT system developed by the GST Network (Model 2). Due to the integrated nature of commerce across the country, and the potential of widespread disruptions if some states move to GST and some do not, it is critical that all states ensure their preparedness, including the majority of Model 2 states, which would still require significant capacity building. Notwithstanding the challenges, the GST is expected to be rolled out in the second quarter of FY18.

<sup>23</sup> In particular, the Central GST bill, Integrated GST bill, Union Territory GST bill and Compensation bill.

## Impact on growth and revenues expected to be positive in the long term

**GST is expected to yield substantial growth dividends, but their magnitude is hard to quantify**

GST will play an important role in transforming the Indian economy and will lead to substantial economic gains, through at least four channels. First, it will affect business processes, strategies, investments and profitability in all segments of the economy. Firms that optimized production and logistics at least in part to arbitrage different taxes across states will re-optimize for greater efficiency of serving the consumer market. Second, GST will reduce costs of doing business for firms. By replacing a large number of taxes levied by the center and the States, GST would integrate the tax base and allow seamless flow of input tax credit across the value chain of goods and services. This would eliminate the need to file and pay multiple taxes, reduce cascading, and result in an overall simplification of indirect taxation regime. Third, GST will reduce logistics costs of moving goods across states, since the current regime had a number of barriers to trade across states, from inspections at state borders, to limits on claiming input tax credit, and the central sales tax, which was not eligible for input tax credit, effectively acting as a tariff. Fourth, investment may gain as the distinction between goods and services is eliminated and capital goods used as an input in provision of services will also be eligible for input tax credit.

While the mechanisms are clear, estimating their impact on economic growth is challenging. In one recent study, Van Leemput and Wiencek (2017) estimated a positive impact on real GDP between 3.1 to 4.2 percent. However, due to lack of data, the authors can only calibrate the model to inter-state trade that takes place through rail, which represents less than 40 percent of domestic trade. Moreover, the model appears to result in a reduction of overall tax burdens, which is unlikely to be the case given the objective of revenue neutrality of the policy. Regardless, the impact is likely to be positive and significant, given the highly inefficient nature of the current indirect tax system.

**The GST is intended to be revenue-neutral in the short-term, but may eventually increase collections as the economy formalizes**

A key design feature of the GST is that it should be revenue neutral. As of FY15, states and the center raise approximately 13 percent of private consumption expenditure in indirect taxes that the GST is expected to incorporate. Given the large number of exemptions on over half of the consumer basket, GST rates are expected to be relatively high, with a standard rate of 18 percent and a number of products taxed at a higher rate through cesses. The multi-rate structure of the GST in fact mimics in some respects the existing system, possibly as a means to provide greater certainty on revenue projections and ensure revenue neutrality is achieved.

Revenue neutrality also (approximately) ensures that the impact on inflation will be minimal. A lower tax burden in one segment (e.g. higher provision of input tax credits for manufactured items) would need to be offset by increases in other categories (e.g. services, which are currently taxed at 15 percent and are likely to be taxed at the standard 18 percent rate). States are guaranteed revenue growth of at least 14 percent y/y; should actual GST revenues fall short of the guaranteed target, the center will compensate them.

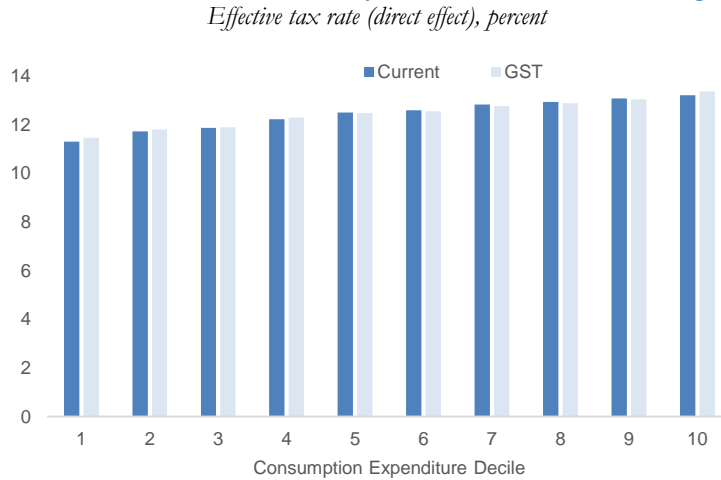
In the long term, the GST will help increase formalization of the economy and may lead to higher revenues. Sellers who are not in the GST chain will be unable to claim input credits, putting them at a disadvantage vis-à-vis registered vendors. As the credit chain will function only if all the transactions are recorded, the post-GST environment would lead to improved disclosure of economic transactions, which in turn, may also have a strongly positive impact on direct tax collection.

**The large number of exemptions and rates does not accomplish progressivity in the GST**

The multi-rate structure of GST is justified primarily on the grounds of protecting the poor: since poor households consume certain items more intensively, equity considerations may suggest exempting those items from GST. However, international experience and analysis of the Indian data suggest that even with extensive exemptions on over half of the consumption basket (largely food products), neither the current indirect tax system nor the GST are very progressive tax instruments (Figure 67). This is because the cascading effects of GST on

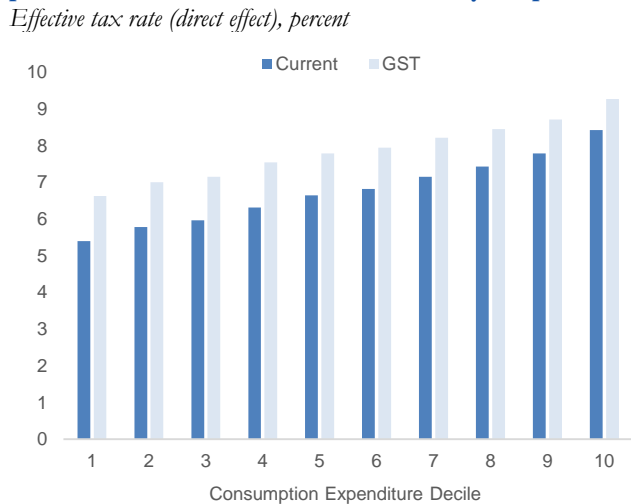
standard-rated inputs to exempt items, as well as cascading of taxes outside of GST (especially those on petroleum products), lead to a significant “tax content” of many exempt and low-rated products (Figure 68 and Figure 69). This suggests that simplifying the GST by reducing the number of exemptions and rates would likely improve efficiency without a significant loss of progressivity, which is best achieved through cash transfers and broader use of progressive personal income taxes.

**Figure 67. The incidence of the GST is very similar to that of the existing indirect taxes**



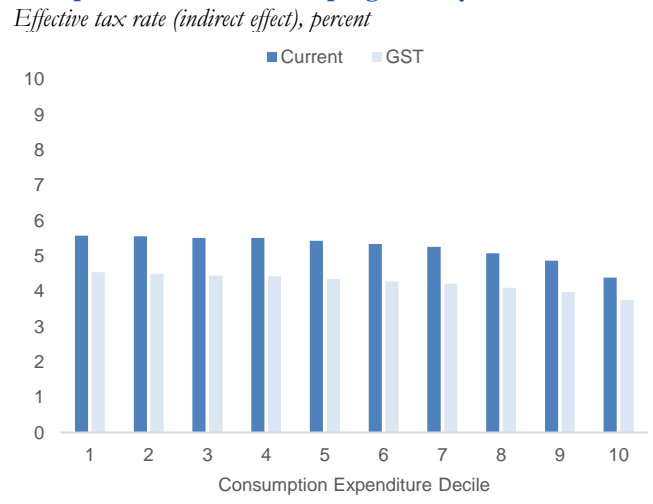
Source: World Bank staff calculations

**Figure 68. The current indirect tax system and the GST provide lower rates on items consumed by the poor...**



Source: World Bank staff calculations  
 Note: Direct effect means the effective tax based on application of the statutory rate

**Figure 69. ...but cascading effects are more prevalent in exempt items and diminish progressivity**



Source: World Bank staff calculations  
 Note: Indirect effect captures the cascading effects of taxes that are passed to the consumer because they are not credited to the producer

**Overall, implementing GST will be a major achievement**

Nevertheless, the fact that India can achieve a major reform of indirect taxes without increasing the burden on the poor is in itself an achievement. Adding to this the efficiency gains that the tax will achieve and the fact that the information generated through the GST on spending patterns will facilitate enforcement of personal and corporate income taxes, the impact of the GST introduction on equity and poverty should be positive.

### 3. Trade Policy and Performance Update

**In line with the global slowdown in trade, India's growth in imports and exports has been declining**

This note examines recent trends in international trade and outlines developments on the policy front, both globally and in India. In particular, India has not been immune to the global slowdown in trade of the past three years, as growth rates in exports and imports have been decreasing. Two recent significant global policy developments, namely the formal initiation of the process of exit by the United Kingdom from the European Union and the New Trade Policy Agenda for 2017 announced by the USA, contributed to the uncertainty surrounding trade openness from the two major economies. On the domestic front, India laid out its new Foreign Trade Policy (FTP) for five years (2015-20), ratified the WTO trade facilitation agreement and implemented the Single Window Interface for Facilitating Trade. India also introduced several trade remedy measures, other export and import measures, and FDI reforms.

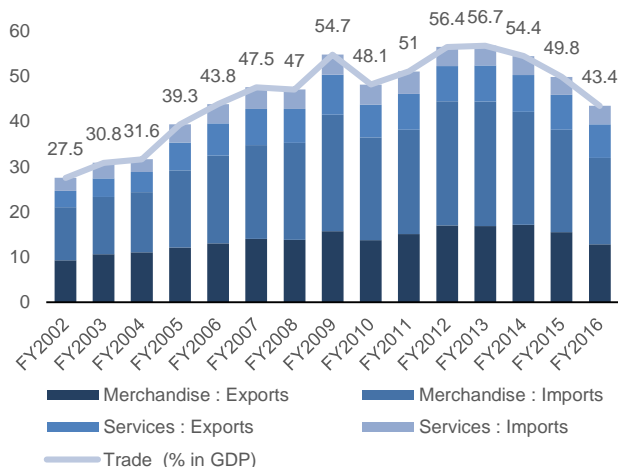
#### Before the recent pickup, trade went through a multi-year decline

**The trade-to-GDP ratio has declined in recent years...**

In the past 20 years, India has become more integrated with the global economy. The trade-to-GDP ratio more than doubled from 27.5 percent in FY 2002 to 56.7 percent in FY 2013, as service exports and merchandise imports climbed (Figure 70). However, the trade-to-GDP ratio declined to 43.4 percent in FY 2016, the lowest since FY 2005, as India has experienced an export slump in the previous four years.

**Figure 70. Trade has declined as a share of GDP**

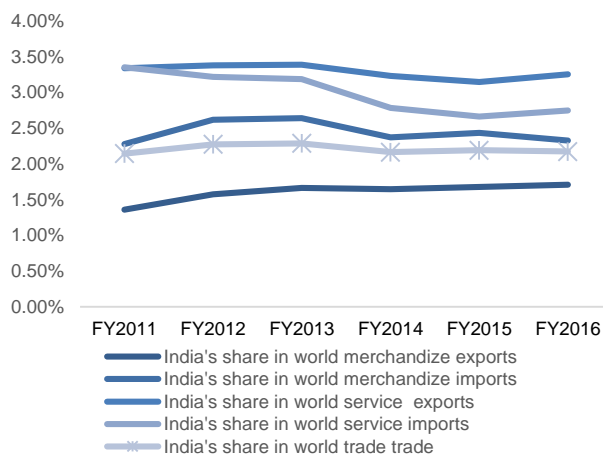
Trade in GDP, percent



Source: WDI and World Bank staff calculations

**Figure 71. India's share in world trade has remained stable**

India's share in world trade



Source: WTO and World Bank staff calculations

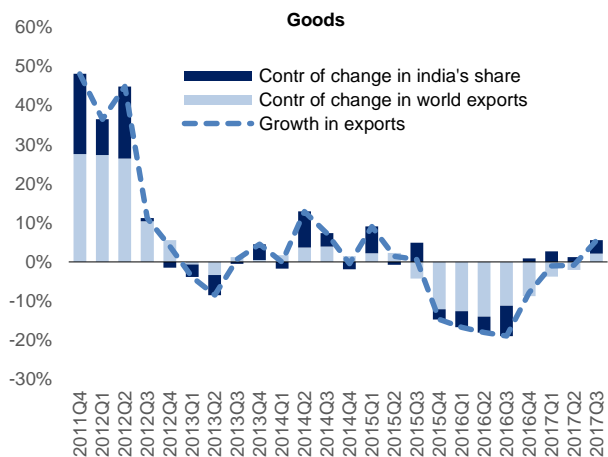
**...reflecting global trends more than a loss in competitiveness<sup>24</sup>**

However, the share of India's trade in world trade has been relatively unchanged (Figure 71), suggesting that India's experience is part of a broader global trend. A decomposition of Indian merchandise export growth into global demand (world export growth) and India's competitiveness (India's market share) confirms that weakening world demand conditions have been driving the decline in Indian merchandise export growth (Figure 72). A similar decomposition of Indian service export growth (Figure 73) reveals that between Q3 of FY 2013 and Q3 of FY 2015, the low growth rates was largely because of a loss in India's competitiveness. Contracting world demand was responsible for the declining growth rates since Q4 FY2015 and gains in India's market share have contributed to the pickup in services growth in recent quarters.

<sup>24</sup> In this section, "competitiveness" refers to India's share in global export markets. Due to data constraints, market shares are based on value terms.

**Figure 72. The recent decline in India's exports has been mostly due to weakness in demand conditions...**

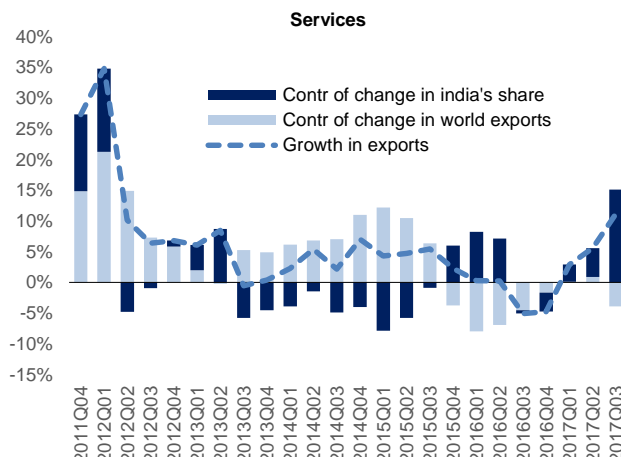
Decomposition of nominal USD y/y export growth (line), light bars are percentage point difference of country growth minus global growth



Source: WTO and World Bank staff calculations

**Figure 73. ... and in the case of services market share has increased.**

Decomposition of nominal USD y/y export growth (line), light bars are percentage point difference of country growth minus global growth



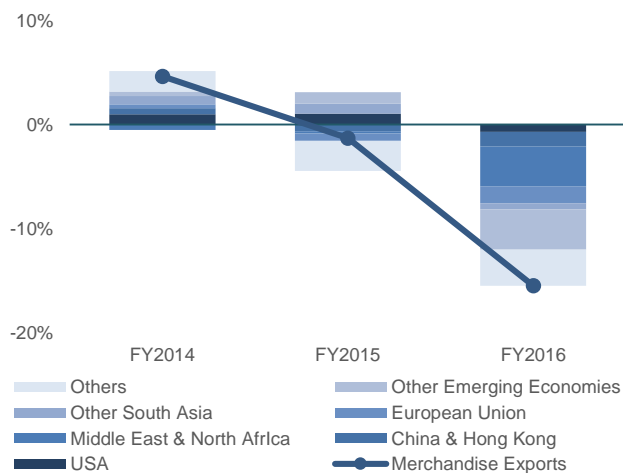
Source: WTO and World Bank staff calculations

**Demand was weak across destinations**

India's exports have declined across markets. Driven by lower commodity prices and slowing growth in China, exports to the Middle East and emerging economies, including China, fell substantially in FY16, and explained almost 60 percent of the decline in export in the fiscal year (Figure 74). Only 25 percent of the drop in FY 2016 can be attributed to a loss in India's competitiveness. Conversely, the revival of merchandise exports in FY17, particularly Q3, was due largely to improvement in India's competitiveness. Besides, there was growth in world demand during Q3 of FY17, the first since Q2 of FY15

**Figure 74. Lower shipments to emerging economies was a key driver of India's export slowdown**

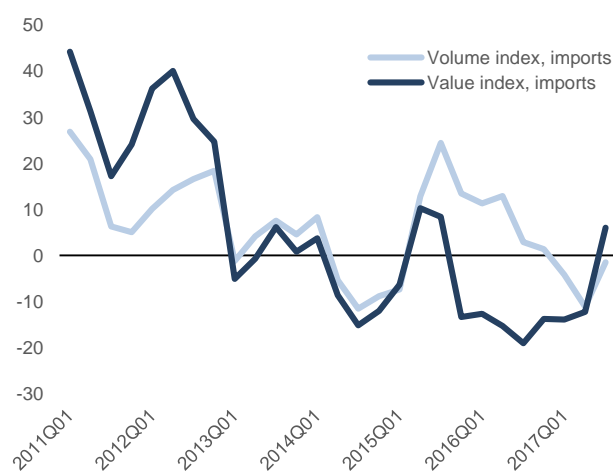
Decomposition of export growth by market share, nominal



Source: DGCIS, GoI and World Bank staff calculations

**Figure 75. Imports also contracted until recently**

Import growth rate y/y, percent



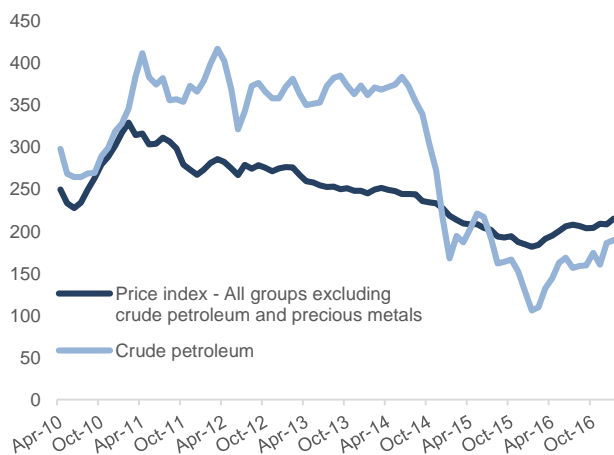
Source: WTO, UNCTAD and World Bank staff calculations

**Imports also contracted in the same period**

Merchandise imports have experienced negative growth rates over the last three years (Figure 75). Initially this was driven by a sharp decline in oil prices (Figure 76), but in 2017 both volumes and values of imports contracted. The divergence between import value and volume growth rates from Q3 of FY 2015 until the end of FY 2016 can be explained by the decline in oil prices. With the downward trend in commodity prices halted, import values have begun rising, particularly in Q3 of FY 2017.

**Figure 76. The downward trend in commodity prices has been arrested in recent quarters**

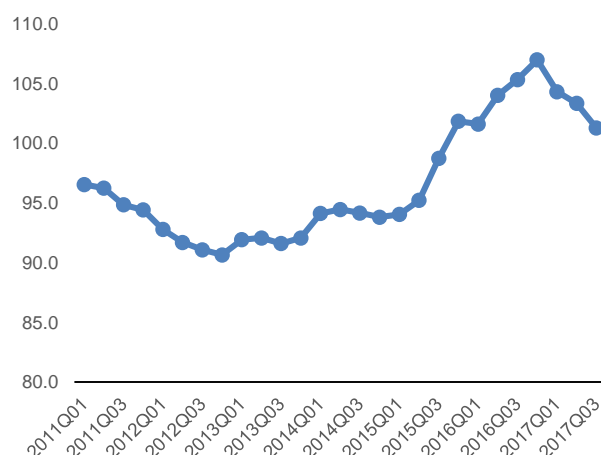
*Commodity price indices, world*



Source: UNCTAD and World Bank staff calculations

**Figure 77. As oil prices recovered, there has been a decline in terms of trade in recent quarters**

*Terms-of-trade, merchandise*



Source: WTO, UNCTAD and World Bank staff calculations

**Terms of trade deteriorated as oil prices rose**

The terms of trade improved, particularly from Q3 of FY 2015 to Q4 of FY 2016. This coincided with the decline in world prices of oil and other commodities. Since March 2016, the downward trend in world commodity and oil prices has halted and this was reflected in the fall in the terms of trade in the first three quarters of FY 2017 (Figure 77).

**The policy environment for trade may be changing globally**

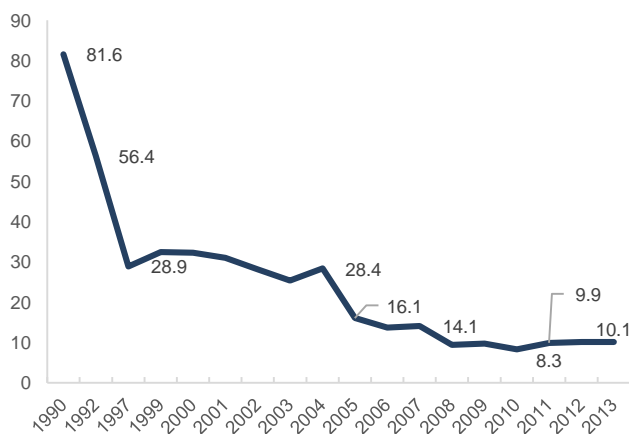
**Recent developments have highlighted risks of reversal in economic globalization, but developing countries continue to be cautiously supportive of trade**

In the 1990s and early 2000s, most developing countries, including India, in the context of broad range reforms undertaken in 1991, significantly reduced their external tariffs and simplified tariff structures (Figure 78 and Figure 79). Global services trade has also been significantly liberalized, although mainly in the context of regional negotiations and less so in that of multilateral negotiations.

There were several developments on the trade policy front at the global level that have increased the risk of a halting or reversal of the move towards freer trade.

**Figure 78. India has lowered tariff rates dramatically since the 1990s...**

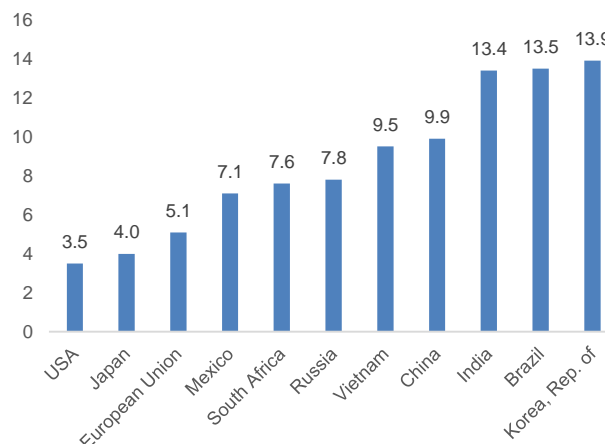
*Tariff rate, applied, simple mean, all products; percent*



Source: WDI, World Bank

**Figure 79. ... a trend followed by other countries**

*Tariff rate, applied, simple mean, all products; percent*



Source: WDI, World Bank

In the United States, President Donald Trump signed an executive order to withdraw the United States from the Trans Pacific Partnership (TPP). Britain, meanwhile, initiated the process of exit from the European Union on March 29<sup>th</sup>, 2017.

While there is concern about the effects of a shift towards more protectionist trade policies in the global economy, some studies indicate that India, and the South Asia region more broadly, under certain policy scenarios, may be little affected. On the contrary, India should seize the opportunity and deepen its participation in the global economy (World Bank, 2017).

On the other hand, developing countries more broadly and India in particular have continued to push for gradual opening. The government of India laid out the new foreign trade policy for 2015-20. India also took important steps taken on the trade facilitation front. These include the ratification of the WTO trade Facilitation Agreement, the submission at the WTO of a Trade Facilitation in Services Agreement proposal, paralleling the existing similar agreement for trade in goods, and the introduction of the Single Window System for Customs clearance. The GoI also introduced several trade remedy measures and other trade policy measures as well as undertook important liberalization reforms in FDI.

### Heightened uncertainty about political support for trade openness

#### **The USA will not move forward with the Trans Pacific Partnership (TPP)**

The USA has recently presented its trade policy agenda for 2017. The agenda is based on the notion that trade should be free and fair for all Americans and that these goals can be best achieved through bilateral rather than multilateral negotiations. The USA has called for strengthening national sovereignty over trade policy, more strictly enforcing US trade law, and negotiating better trade deals. Accordingly, the United States President Donald Trump signed an executive order in January, 2017 to withdraw the USA from the TPP. Twelve countries, namely Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the USA and Vietnam had signed this trade deal in February 2016. These countries accounted for 36 percent of world GDP and 23 percent of world export in 2014.

The TPP aimed at eliminating tariffs with the exclusion of sensitive items, lowering non-tariff barriers, enforcing more stringent environmental and labor standards, strengthening intellectual property rights (IPR) protection, increasing transparency in public procurement and limiting advantages to state-owned enterprises. According to a World Bank (2016b) estimate, the agreement could have raised the GDP of its member countries by an average of 1.1 percent and member country trade by 11 percent by 2030.

Several studies estimated that the TPP could have led to some losses in Indian exports, particularly to the US market, due to trade diversion (Kumar and Krishna, 2015, Banga and Sahu, 2015, among others). The United States is the single largest destination for Indian exports. Around 16.2 percent of the total merchandise exports and 15.75 percent of the total service exports from India are to the United States.<sup>25</sup> The remaining eleven countries account for around 13.4 percent of the merchandise export market and 10.65 percent of the service export market (Figure 80).<sup>26</sup> The greatest impact from the TPP was expected in the textile sector, given that Vietnam would have gained zero duty access to US markets while India would face duties of 14-32 percent on readymade garments. In addition, Vietnam presently imports yarn and fabric from India and exports readymade garments to the US. The 'Yarn forward rule' under the TPP would have made it mandatory to source yarn from TPP member countries to avail duty preference and could potentially have impacted exports of Indian yarn to Vietnam.

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<sup>25</sup> Merchandise export data pertains to FY 2016 and service export data to 2011.

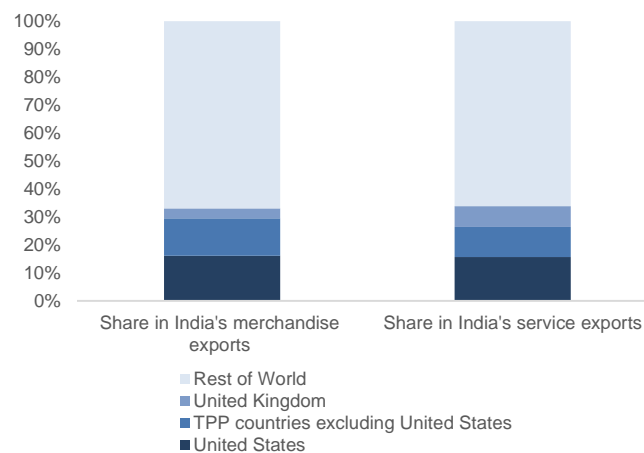
<sup>26</sup> Among the TPP economies, Singapore, USA, Japan and Malaysia are also an important source of foreign direct investment. These four countries accounted for over 51 percent of FDI inflows in FY 2016 (RBI, World Bank staff calculations)



Given the withdrawal of the United States from the TPP, the TPP will not go ahead in its current form. The member countries met in March 2017 in Chile to assess future steps. However, no clear consensus emerged on the way forward. The member countries are scheduled to meet again in May 2017. Given these recent developments, where the future of TPP, as well as that of other trade agreements the US is party to or is currently negotiating, such as the Transatlantic Trade and Investment Partnership and the Trade in Services Agreement, is unclear, it is difficult to ascertain the likely impact on Indian exports.

**Figure 80. India's exposure to the UK and TPP countries is limited**

*Export market share: TPP countries and United Kingdom*



Source: Source: DGCIS, TiVA OECD, World Bank staff calculations

### The United Kingdom voted in June 2016 to exit from the European Union (Brexit)

The United Kingdom is an important global player, with the European Union (EU) accounting for over half of its trade. Several emerging economies in Eastern Europe and Central Asia and Sub-Saharan Africa have a high trade exposure with the UK. As part of the EU, the UK had clear commitments and rights, in several areas including competition policy, investment and movement of capital. As an EU member, the UK was part of 36 preferential trade agreements (PTAs). Brexit has increased trade and investment policy uncertainty for the UK and the impact of Brexit on trade flows and investment would depend on the type of trade relationship that the UK will have with the EU.

World Bank (2016a) considers several post-Brexit scenarios assuming varying degrees of economic integration with the EU. These include the “Norway Scenario” (the UK is a non-EU European Economic Area – EEA – member part of the European Single Market); the “Swiss Scenario” (the UK is a not a member of the EU or the EEA, but negotiates bilateral treaties with the EU), the “FTA scenario” (the UK negotiates FTAs with the EU and other countries), and the “no-agreement scenario” (UK trade is governed by the WTO). The study concludes that the weaker the trade deal negotiated with the EU, the more negative could be the post-Brexit outcome for the UK. Thus, the Norway scenario dominates the FTA scenario, which dominates the no-agreement scenario. The study also suggests that Brexit may have a negative impact on trade with countries that have strong trade linkages with the UK, which include Hungary, Poland, Czech Republic, Ireland, Netherlands and Cyprus in the EU, as well as non-EU countries such as South Africa, Nigeria and countries in the Caribbean.

The UK accounts for around 3.6 percent of India's merchandise export market share and 7.5 percent of service export market share. (Figure 80). Between 2011 and 2016, approximately 5.6

percent of total FDI inflows were from the UK.<sup>27</sup> The impact of Brexit on India would depend on the post Brexit trade policy that emerges as well as the agreements India negotiates with the UK, going forward.

## Trade policy developments in India show continued but cautious engagement in global trade

### The new Foreign Trade Policy (FTP) 2015-20 aims at promoting exports

Enacted in April 2015, the policy aims to promote exports, encourage domestic procurement of inputs and capital goods and improve trade facilitation. Two new schemes, the Merchandise Exports from India Scheme (MEIS) and the Services Exports from India Scheme (SEIS) have been introduced. Duty scrips are granted as rewards under the MEIS and SEIS. These scrips can be used to pay customs duty on imports of inputs and capital goods, excise duty on domestic procurement of inputs and capital goods and service tax for procurement of services. Under the MEIS, countries have been categorized into three groups (traditional markets, emerging and focus markets and other markets) and the rates of rewards range from 2 – 5 percent of realized FOB value of exports. The rate of rewards under SEIS range between 3 – 5 percent on exports of notified services.

In order to incentivize domestic procurement, the government has reduced the export obligation under the Export Promotion Capital Goods Scheme (EPCG) for capital goods sourced domestically. The scheme allows for imports of capital goods at zero customs duty. The importer is subject to a normal export obligation of six times the duty saved over and above the average exports of the applicant in the preceding three years. In the case of indigenous procurement of capital goods, duties are calculated as notional customs duties and the export obligation set is lower than when capital goods are sourced from abroad. The new MEIS scheme also proposes higher rewards for items with higher domestic content and value addition as compared to items with high import content and less value addition.

With a view to improve the ease of doing business, the government reduced the number of mandatory documents for exports and imports to three. The new FTP will be valid until March 31<sup>st</sup> 2020 and is due for a mid-term review in October 2017. See Table 9 for key changes to the foreign trade policy.

**Table 9. Highlights of Key changes in the Foreign Trade Policy**

Old FTP Policy	New FTP 2015-20
Five separate schemes- Focus Product Scheme, Market Linked Focus Product Scheme, Focus Market Scheme, Agriculture Infrastructure Incentive Scrip, Vishesh Krishi and Gram Udyog Yojna and the Incremental Export Incentive Scheme for merchandise exports	The five schemes have been merged into the MEIS
Served from India scheme (SFIS) applied to Indian service providers	SEIS applied to service providers located in India
Varying conditions (sector specific or actual user only) attached to the use of scrips	Scrips issued under MEIS and SFIS and goods imported or locally procured against these scrips are freely transferable and can be traded in the market.
Benefits not available to units in SEZs	Benefits of MEIS and SEIS extended to units in SEZs
Only additional duty on customs, excise duty or service tax allowed as duty drawback.	Basic Customs Duty paid in cash or through debit under Duty Credit Scrip can be taken back as duty drawback if imported inputs are used for exports
Export Obligation for domestic procurement under the EPCG scheme at 90 percent of normal obligation	Export Obligation for domestic procurement under the EPCG scheme reduced to 75 percent of normal obligation

Source: Foreign Trade Policy 2015-20, Ministry of Commerce, GoI

### The WTO Trade Facilitation

The WTO TFA agreement aims to expedite the movement, release, and clearance of goods, including goods in transit. It carries measures for effective cooperation between customs and other authorities on trade facilitation and customs compliance issues. It also contains provisions

<sup>27</sup> RBI, World Bank staff calculations

**Agreement (TFA) has come into force**

for technical assistance and capacity building. Negotiations between WTO members on the TFA concluded at the WTO's 2013 Bali Ministerial Conference. The Government of India handed over the instrument of the TFA to the WTO in April 2016 and was the 76<sup>th</sup> country to ratify the TFA, now signed by over 110 countries and having come into force on February 22<sup>nd</sup>, 2017.

OECD (2015) estimate that the TFA could potentially reduce trade costs by 12.6 -16.5 percent for low income countries, 13.7 -17.4 percent for lower-middle income countries, 12.8 -14.6 percent for upper-middle income countries and 10.4 -11.8 percent for OECD countries. WTO (2015) use a computable general equilibrium model and predict an increase in world exports from the TFA of between USD 750 billion to USD 1 trillion dollars per annum. The actual gains would depend on the implementation time frame and coverage. Between 2015 and 2030, the implementation of the TFA is expected to add more than 2 percent per year to world export growth and approximately half a percent per year to world GDP growth. Their estimates from a Gravity model suggest even larger gains.

**The Central Board of Excise and Customs of the GoI introduced the Single Window Interface for Facilitating Trade (SWIFT)**

The SWIFT, operationalized on April 1, 2016 enables importers and exporters to electronically lodge their customs clearance documents at a single point with the customs authorities. The required permission, if any, from Partner Government Agencies (PGAs) such as Animal Quarantine, Plant Quarantine, Drug Controller, Food Safety and Standards Authority of India, Wild Life Control Board and Textile Committee is obtained online. The importer does not have to approach these agencies separately and instead only submits the "Integrated Declaration" electronically to a single entry point, that is the Customs Gateway (ICEGATE). The Integrated Declaration incorporates all information required for import clearance by the PGAs in the electronic format of the Bill of Entry and replaces nine separate forms that had to be filed earlier. An Integrated Risk Management facility for PGAs has been introduced to ensure that consignments are selected by agencies for examination and testing based on the principle of risk management.

**India improved its ranking in the Logistics Performance Index**

In the 2016 edition of the Logistics Performance Index (LPI), India ranked 35<sup>th</sup> out of 160 countries (Table 10), moving up 19 places from 54<sup>th</sup> in 2014. While China is ranked 27<sup>th</sup>, India outperforms several upper-middle income countries and BRICS members: Brazil (55); Indonesia (63); and Russia (99).

Logistics connect firms to domestic and international markets through a network of supply chains whose performance is critical to trade integration and growth. The LPI measures the efficiency of supply chains across the world. It is prepared by the World Bank every two years based on a survey of over 1,200 logistics professionals worldwide. In a large country like India, the LPI is biased towards the performance of the main economic gateways (e.g. Mumbai), and may not capture the full extent of costs and inefficiency in moving goods internally.

**Table 10. Logistics Performance Index India**

	2014		2016	
	Score	Rank	Score	Rank
<b>Overall LPI</b>	3.07	54	3.42	35
The efficiency of customs and border management clearance	2.72	65	3.17	38
The quality of trade and transport infrastructure	2.88	58	3.34	36
The ease of arranging competitively priced shipments	3.2	44	3.36	39
The competence and quality of logistics	3.03	52	3.39	32
The ability to track and trace consignments	3.11	57	3.52	33
The frequency with which shipments reach consignees within scheduled or expected delivery times	3.51	51	3.74	42

Source: Logistics Performance Index, World Bank available at <http://lpi.worldbank.org/>

The LPI is based on six components which capture main inputs to the supply chain (customs, infrastructure, and services, which are all areas for policy regulation) and supply chain performance outcomes (timeliness, international shipments and tracking and tracing). India improved its score and rank in all six components of the LPI.

### FDI policy measures have been mostly towards increasing access

**FDI regulations have been relaxed** India has introduced a number of amendments in the FDI policy in recent months. Changes introduced in the policy included increase in sectoral caps, bringing more sectors under automatic route and easing of conditionalities for foreign investment. See Box 6 for details on FDI policy changes.

#### Box 6: Recent FDI Policy Measures

##### Abolition of the Foreign Investment Promotion Board (FIPB)

- The government announced the scrapping of the Foreign Investment Promotion Board (FIPB) in the Budget 2017 presentation. The FIPB is an inter-ministerial body responsible for making recommendations on FDI proposals under the government approval route. On May 23 the FIPB was abolished.

##### Food products manufactured/produced in India

- 100 percent FDI permitted under government approval route for trading, including through e-commerce.

##### Defense

- FDI beyond 49 percent permitted through government approval route, in cases where it results in access to modern technology.
- FDI limit for defense sector now also applies to manufacturing of small arms and ammunitions covered under Arms Act 1959.

##### Broadcasting carriage services

- FDI up to 100 percent permitted through automatic route in teleports, DTH, Cable Networks, Mobile TV and Headend-in-the-Sky Broadcasting Services
- FIPB approval is required for infusion of fresh foreign investment, beyond 49 percent in a company not seeking license/permission from sectoral ministry, resulting in change in the ownership pattern or transfer of stake in existing investor to new foreign investor.

##### Pharmaceuticals

- FDI up to 74 percent permitted under automatic route in brownfield pharmaceuticals. Government approval route required beyond 74 percent.

##### Civil aviation

- 100 percent FDI permitted under automatic route in Brownfield Airport projects, from 74 percent previously
- Foreign investment in Scheduled Air Transport Service/Domestic Scheduled Passenger Airline and regional Air Transport Service has been raised to 100 percent, with FDI up to 49 percent permitted under automatic route and FDI beyond 49 percent through government approval.

##### Retail

- 100 percent FDI in single brand retail trade is permitted (above 49 percent permitted under the government route). However, if the FDI exceeded 51 percent, additional conditions, including the condition on sourcing 30 percent of the value of goods from India, were imposed. This sourcing requirement now has to be met in the first instance as an average of five years total value of the goods purchased beginning on the financial year where the first store was opened. Thereafter it has to be met on an annual basis.

##### Private security agencies

- FDI up to 49 percent is permitted under automatic route and FDI beyond 49 percent and up to 74 percent would be permitted with government approval route. Earlier, only up to 49 percent FDI was permitted under the government route.

##### Animal husbandry

100 percent FDI in Animal Husbandry (including breeding of dogs), Pisciculture, Aquaculture and Apiculture is allowed under Automatic Route

Source: Press Information Bureau, Government of India

## India raised some tariffs and extended the use of trade remedy measures

### A number of tariffs were increased

The government introduced a number of import and export measures in 2016. Import tariffs on several agricultural commodities including rice, wheat and edible oils were increased. Temporary tariffs were imposed on imports of sugar, rubber and silk. Tariffs on golf carts were increased from 10 to 60 percent and on soy extract and groundnut oil cakes from zero to 30 percent. The exemptions and concessional custom duties granted on 73 specified drugs were eliminated. See Box 7 for details on recent trade policy measures.

### Box 7: Recent Trade Policy Measures

#### Elimination of import tariffs

- Braille paper (from 10 percent); electrolyzer membranes and their parts (from 2.5 percent); wood in chips or particles for manufacture of paper (from 5 percent); medical use fission molybdenum-99, polypropylene granules/resin (from 7.5 percent), iron ore pellets, technetium-99m, certain goods required for medical, surgical, dental or veterinary use.

#### Reductions in import tariffs and duties

- In import tariffs (from 5 to 2.5 percent) on denatured ethyl alcohol, silica sand, fibers, filaments/yarns, brass scarp, anthracite, bituminous coal, briquettes, ovoids and similar solid fuels manufactured from coal, lignite, peat, oils and other products of the distillation of high temperature coal tar, pulp of wood, acyclic hydrocarbons, cyclic hydrocarbons ; on aluminum oxide, super absorbent polymer (from 7.5 percent to 5 percent); on refrigerated containers (from 10 percent to 5 percent); on raw materials, parts or accessories for use in manufacture of instruments or appliances required for medical, surgical, dental or veterinary use (from 5 to 2.5 percent).
- In special additional duty (SAD) (from 4 to 2 percent) on orthoxylene when used in the manufacture of phthalic anhydride

#### Increases in import tariffs, minimum import prices and additional duties

- Import tariffs on wheat (from 10 to 25 percent); on certain medical devices (from 5 percent to 7.5 percent); on de-oiled soya extract and groundnut oil cake/oil cake meal (from zero to 30 percent); on nuts, solar tempered glass (from zero to 5 percent); natural latex rubber (from zero to 10 percent); plans, drawings and designs (from zero to 10 percent); imitation jewelry (from 10 to 15 percent); primary aluminum products, industrial solar water heater (from 5 to 7.5 percent); golf cars (from 10 to 60 percent); on certain metal products, and certain iron and non-alloy steel (to 10 percent); certain flat-rolled products of iron or non-alloy steel (to 12.5 percent); on semi-milled or wholly milled rice (0 to 70 percent); soya-bean oil, ground-nut oil, olive oil, palm oil) (up to 20 percent); certain articles of marble (to 40 percent)
- Minimum import price (from ₹110/kg to ₹162/kg) for areca nuts
- Special additional duty (SAD) on populated printed circuit boards (from zero to 4 percent)

#### Export Measures

- Export duties on iron ore lumps and fines below 58 percent iron content, chromium ores and concentrates eliminated
- Export duties on bauxite (natural) reduced from 20 percent to 15 percent
- Export duties on non-agglomerated iron ores and concentrates set at 10 percent
- Establishment of an online system for the instant generation of export (and import) code
- Minimum export price of onions increased to USD700/MT

Source: WTO trade monitoring database

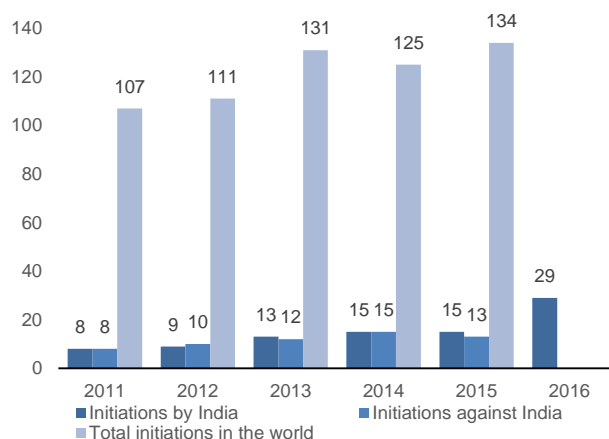
### India has initiated more remedy measures in 2016

Governments use trade remedy measures such as anti-dumping duties, countervailing measures and safeguard actions to take remedial action against imports that could cause injuries to domestic industry.<sup>28</sup> Countries have been increasingly resorting to such measures. There was a

<sup>28</sup> Anti-dumping duties are imposed by an importing country to combat dumping, i.e., when an exporter sells at a lower price in the foreign market than it sells in its domestic market. Countervailing duties are imposed by importing countries to counter artificially low prices that are a result of subsidies offered by governments to exports. Anti-dumping and countervailing duties are discriminatory measures applied to the particular trading partner to combat 'unfair' trade practices, which is shown to cause harm to domestic industry. Safeguard measures are temporary import restrictions or duty increases to protect a specific domestic industry from an increase in imports of any product which could cause serious injury to the industry. These measures are non-discriminatory and are applied to all trading partners. Unlike anti-dumping and countervailing measures, safeguard measures do not require a finding of an 'unfair' practice.

25 percent jump in anti-dumping investigations initiated in the world between 2011 and 2015. (Figure 81).

**Figure 81. The number of antidumping measures initiated has increased**  
*Antidumping measures initiated*



Source: WTO Trade Monitoring Database last updated as of 9<sup>th</sup> Dec 2016, World Bank staff calculations

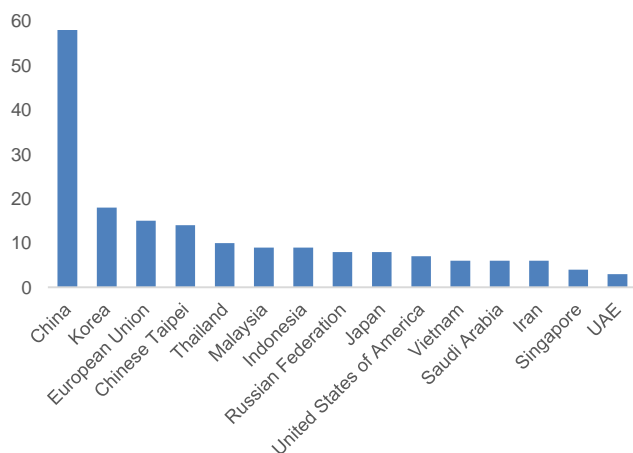
**India is one of the most active users of anti-dumping measures**

Between 2011 and 2015, approximately 10 percent of the total anti-dumping investigations in the world were initiated in India, increasing from 8 in 2011 to 15 in 2015. In 2016, 29 investigations have been initiated.

A single case may involve the investigation of imports from several countries. The largest number of investigations by India were initiated on products imported from China, followed by Korea, EU, Taiwan and Thailand. Between 2011 and 2016, there were fifty-eight new investigations initiated against China. (Figure 82). Not all investigations result in the imposition of a duty. From 1992, when anti-dumping investigations began to be carried out by the Directorate General of Anti-Dumping & Allied Duties, to June 2014, duties were imposed in over 75 percent of the cases investigated.

**Figure 82. India's anti-dumping investigations have primarily targeted China**

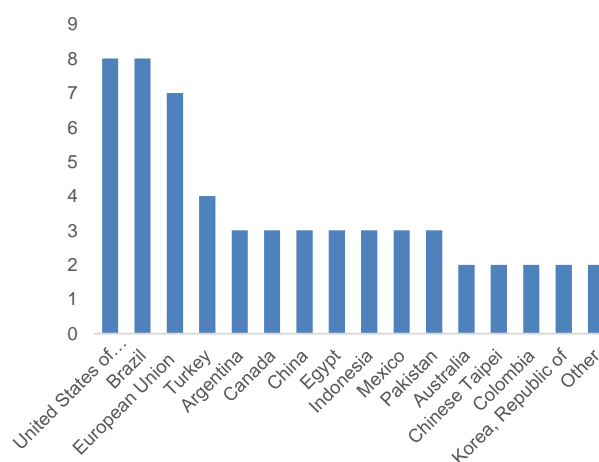
*Anti-dumping investigations initiated against countries by India, 2011-2016*



Source: WTO Trade Monitoring Database, World Bank staff calculations

**Figure 83. The US and Brazil have initiated the most investigations on Indian products**

*Countries initiating anti-dumping investigations against India 2011-2015*



Source: WTO Trade Monitoring Database, World Bank staff calculations

**Indian products have been the subject of anti-dumping investigations in other countries**

Between 2011 and 2015, 10.6 percent of the 548 investigations initiated in the rest of the world involved products exported from India. The largest number of investigations on Indian products were initiated in the United States and Brazil, followed by EU and Turkey. Canada, China, Egypt, Indonesia, Mexico and Pakistan are some of the other countries that have initiated anti-dumping investigations on Indian products. (Figure 82 and Figure 83).

**The largest number of safeguard investigations have been initiated in India**

There were a 113 new safeguard investigations launched in the world between 2011 and 2016. Of these, 18 were initiated in India, followed by 16 in Indonesia. The two countries together accounted for over 30 percent of total investigations initiated in the world.<sup>29</sup> No safeguard duties were imposed in 7 of the cases initiated in India, but safeguard duties were levied on imports of a number of products.<sup>30</sup>

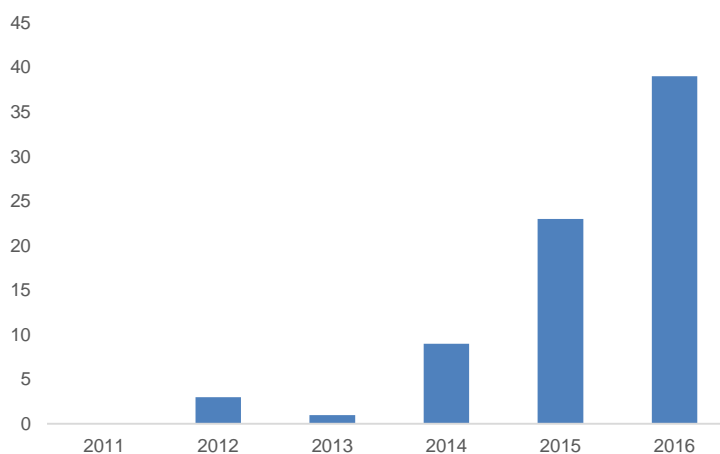
**India imposed its first countervailing measure in January 2016**

A definitive duty was imposed on the imports of castings for wind operated electricity generators from China. There is also one countervailing duty/ anti-subsidy case currently under investigation concerning imports of certain Hot Rolled and Cold Rolled Stainless Steel Flat Products from China.

**The number of SPS measures initiated in India has been on the rise in recent years**

Sanitary measures (relating to humans and animals) and phytosanitary measures (relating to plants) are non-tariff measures applied to ensure food safety and plant and animal health. While they are meant to be based on science, they often act as market access barriers. The number of SPS measure initiated in India increased from 3 in 2012 to 39 in 2016 (Figure 84).

**Figure 84. The number of phytosanitary measures has increased**  
*Phytosanitary measures initiated*



Source: WTO Trade Monitoring Database last updated as of 9<sup>th</sup> Dec 2016, World Bank staff calculations

<sup>29</sup> Safeguard duties were levied on imports of phthalic anhydride, carbon black, electrical insulators, dioctyl phthalate, hot rolled flat products of stainless steel 304 grade, sodium nitrate, seamless pipes and tubes of iron and steel, sodium citrate, saturated fatty alcohol, hot rolled products of steel and of hot rolled flat sheets and plates of steel as per notifications issued by the Ministry of Finance, GoI.

<sup>30</sup> <http://www.dgsafeguards.gov.in>

## C. Unlocking women's potential



*Kavita holds a postgraduate degree in commerce and stays with her family in an informal settlement in Indore, Madhya Pradesh. She told a World Bank team in 2015 that she wanted a job, and even managed to obtain one as a teacher. However, the salary was a “pittance”, not commensurate with the effort she put in. Next, she invested in a specialized course for accountancy and registered in an employment exchange. Her efforts bore fruit and she secured a job offer for an accountant’s position in a textile firm. There, her prospective employers expected her to work long hours, and her parents forbade her to return home late from work. As a result, Kavita was not working. Her mother, a home-based worker stitching small garments on a piece rate basis, spoke of finding “a suitable match” for her daughter.*

### i. Women represent an untapped source of growth for India

#### **Increasing women’s participation in the labor market is one of the key challenges of India’s development**

Low female labor force participation rates (LFPRs) impose constraints on a country’s growth, the empowerment of its women, and the outcomes for its children. Greater involvement from women in the labor force has both an economic and a social impact. Paid employment is known to increase women’s agency and empowerment (World Bank, 2011 and 2012). Money gives women a sense of empowerment within their marriage and their households, higher levels of decision-making power, and greater mobility. At the household level, women who participate in the labor force marry and have children later, and their children stay in school longer. Even the sisters of women who work marry later (Sivasankaran, 2014). Moreover, there is evidence that women’s earnings can have a beneficial impact, not just on their own health and nutrition, but the health and education outcomes of their children. Women are more likely than men to invest a large proportion of their household income in the education of their children (Qian, 2008).

In sum, an increase in women’s labor force participation (LFP) and earnings can lead to faster growth, reduced poverty and more widely shared prosperity. Women benefit from their economic empowerment, and so too can their men, children and society as a whole. The case for India getting more of its women in the labor force is thus not only “the right thing to do” but also “smart economics” (World Bank, 2006).



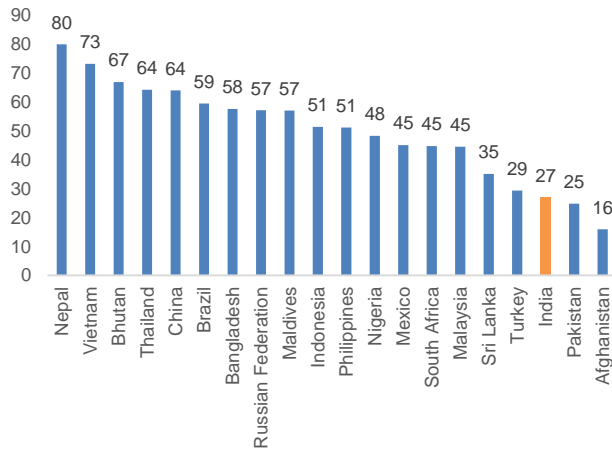
## Compared to other countries, very few Indian women are at work

### India has among the lowest female LFPRs in the world

Less than a third (27 percent) of women 15 years or older are working or actively looking for a job. Three of every five prime working age Indian women (26-45 years) are not economically active, meaning that they are neither working on a farm or in businesses nor are they earning any wage. Only few countries such as Afghanistan, Pakistan and Saudi Arabia rank lower than India, which is an outlier with far lower female LFPRs compared to most countries at the same level of income (Verick, 2014; Figure 85 and Figure 86).

**Figure 85. The LFPR of women in India is low compared to most countries**

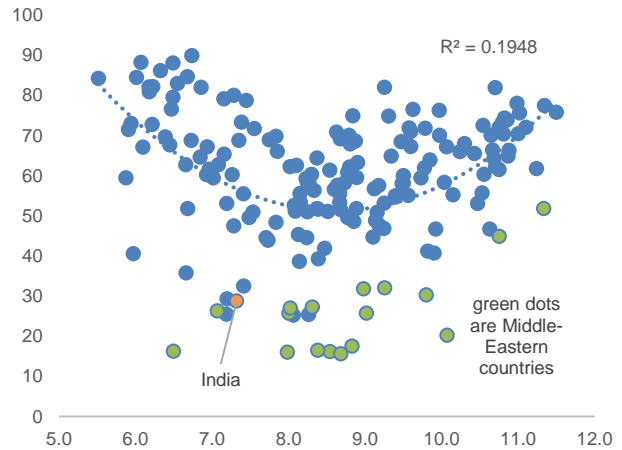
Females ages 15+ who are either working or unemployed, percent of total



Source: World Development Indicators (WDI)

**Figure 86. Participation rates are also low when controlling for income levels**

Log of GDP per capita (x-axis); female LFPR, percent (y-axis)



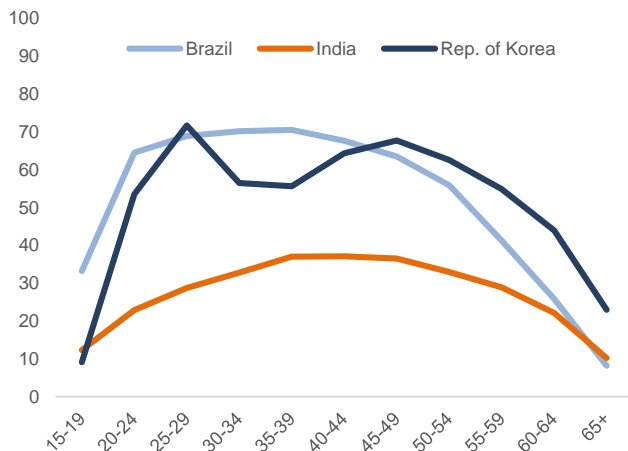
Source: WDI and World Bank staff calculations

### Indian women enter the labor force late and exit early

Unlike Indian men, or women in other countries, Indian women enter the workforce at older ages and exit early (Figure 87 and Figure 88). India's female LFPR curve is 'single-peaked', similar to Brazil but unlike advanced economies such as the Republic of Korea, where female LFP increases, then declines when women exit the labor force to care for children, and then increases again once children are in school. In India, LFP of women peaks at a low 37 percent between the ages of 35-39, and then starts to decline.

**Figure 87. Women enter the labor force late and exit early...**

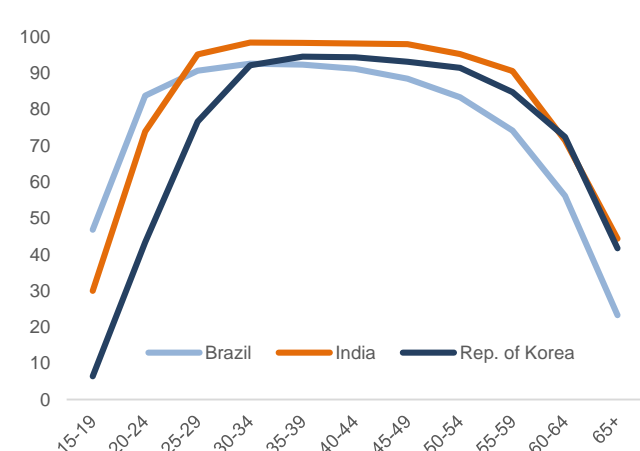
Women's LFPR by age (2011-12)



Source: ILOSTAT

**Figure 88. ... while nearly all men 24-49 are in the labor force**

Men's LFPR by age (2011-12)



Source: ILOSTAT

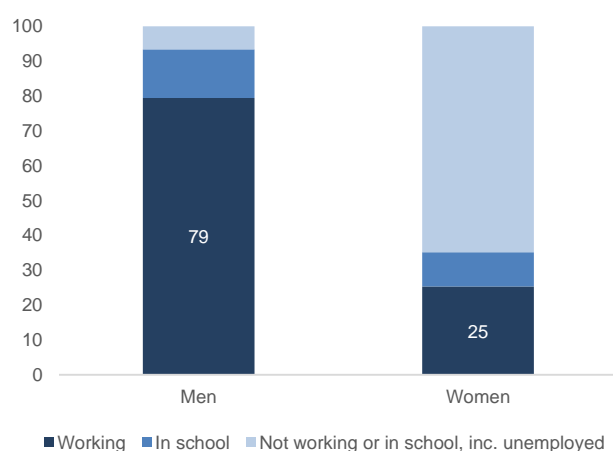
## India's low female LFPR has declined further

### India's female LFPR declined 10 pp between 2004-05 and 2011-12

India's female LFPR is not only low compared to other countries or that of Indian men, but has declined between 2004-05 and 2011-12 (the latest available National Sample Survey or NSS). At 37 percent in 2004-05, India's LFPR was already some 15-20 pp lower than what would be expected given its income level. This rate declined further between 2004-05 and 2011-12, reaching 27 percent<sup>31</sup>. Among the working age (15+) population, 25 percent of women had a job in 2011-12 (two percent were unemployed), compared to 79 percent of men (Figure 89). While 92 percent of men who were not in school had a job, only 28 percent of women did. Considering only those of prime working age (25-46), the figures are 99 percent for men and 29 percent for women. This gap increased from 2004-05. The share of men either in school or in the labor force has been stable, with a modest decline among men above the age of 46 (suggestive of net retirements). For women, however, a number equivalent to 4.4 pp of the total working age population was neither working or in school, and this decline affected both women in prime working age as well as those above 46 (Figure 90).

**Figure 89. Only 25 percent of working age women work, compared to nearly 80 percent working age men**

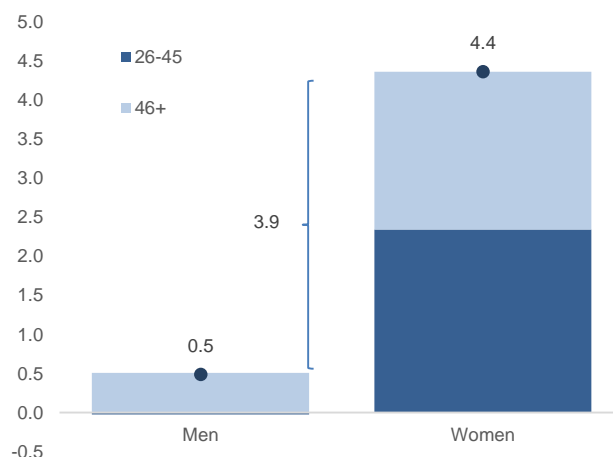
Shares of the working age (15+) population as of 2012, percent



Source: NSS, and World Bank staff calculations

**Figure 90. The number of women not working or in school increased significantly between 2005 and 2012**

Changes in the shares of the adult (26+) population not in school or employment between 2005 and 2012, percentage points



Source: NSS, and World Bank staff calculations

## Reconciling census and NSS views of female LFP

### Possible mis-measurement cannot explain the decline

One proposed explanation for the decline in female LFP is that of mismeasurement of women's work. The analysis in this chapter is based on India's NSS. Hirway (2012) argues that the NSS does not capture a sizeable part of female employment that is related to home-based subsidiary work. The work most women in India are engaged in does not match the image of a regular, salaried, nine-to-five job. Many women have marginal jobs or are engaged in multiple activities, including home production, which is difficult to measure adequately.

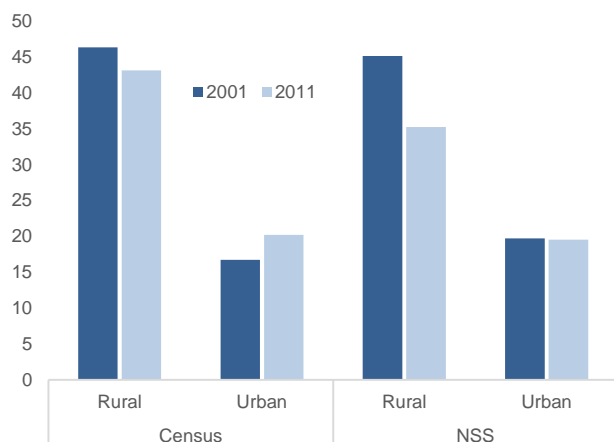
Female unemployment may be underestimated as well. Under the NSS Principal Status definitions, a person is only considered part of the labor force if he or she has been looking for a job for at least six months during the survey year – a very stringent criterion. For example, in the case of the MGNREGA, a number of people who work or seek work under MGNREGA, or who are registered with a placement agency, are counted by the NSS as being out of the labor force. If their number is included, the female LFPR is higher by about 3 pp and 5 pp in rural and urban areas, respectively.

<sup>31</sup> This figure is based on 'principal status' but the pattern is similar when considering different definitions. Andres et al. (2017) report a decline from 43 percent to 31 percent under the latter definition. See the Technical Appendix for details on how labor force participation is defined.

This explanation also coheres with employment indicators from the population censuses of 2001 and 2011, which show only a small decline in female LFP in rural areas compared to the decline reported in the NSS. The difference lies mostly in the manner in which the Census and NSS define unemployment: the Census does not require a person to have been searching for a job for at least 6 months during the year, as the NSS does. This less stringent definition results in a much higher unemployment rate in rural areas in the Census in 2011. If unemployment was indeed high in rural areas, it suggests that not all decline in female LFP was voluntary.

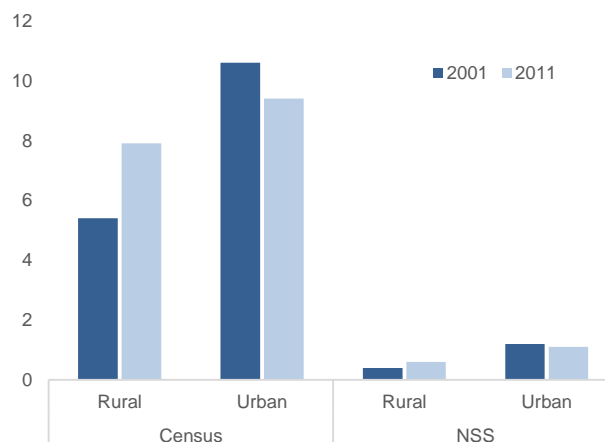
**Figure 91 The Census and the NSS tell different stories on rural employment**

Female Employment, percent of working-age females (15+)



**Figure 92. In the Census, female unemployment is high and it increased substantially in rural areas**

Female Unemployment, percent of working-age females



Source and Notes: estimates from the NSS are from 1999-2000 and 2011-12 survey rounds and based on the Usual Status definition. Estimates from the Census are based on the All Workers definition, which combines both main and marginal workers

## Costs to growth are estimated to be large

**GDP growth could accelerate to over 9 percent if India closed half the female LFPR gap with Nepal**

Women outside of the labor force represent underused human capital and reduce India's potential economic growth. A number of studies have estimated the potential impact of a higher female LFPR in the economy. While estimates vary significantly, the direction is unequivocal.

One approach to estimate the effect of higher female LFP on the economy is to use standard growth accounting models to simulate the impact of a higher path of labor inputs on the growth of potential GDP. Assuming that productivity growth and capital per worker remain as in our baseline model described in Part A, closing half the female LFPR gap with Sri Lanka within the next five years (a gain of 5 pp in India's female LFPR), would accelerate potential GDP growth by 0.4 pp (Table 11). Closing half the gap with the level of the female LFPR expected for India's level of income (which is similar to that of Bangladesh or Indonesia) could increase potential GDP growth by up to a full percentage point.

**Table 11. Increasing women's LFPR would be a boost to growth**

Simulations of changes in potential GDP based on India closing half the gap in LFPR with the following:

	Women's LFPR, percent	Women entering the labor market per year, million	Potential GDP growth by 2020, percent
Baseline (India today)	27	2.0	7.5
Sri Lanka	39	6.2	7.9
Indonesia, Bangladesh (expected for income level):	53-59	12-14	8.4-8.5
Brazil, China	65-70	17-19	8.8-8.9
Nepal	83	25	9.3

Source: WDI, World Bank staff calculations

Note: Simulations assume the same productivity growth as the baseline, and higher growth in gross fixed capital formation to keep the capital-per-worker ratio at the same level as the baseline

**A number of studies confirm that low women's LFPR is a drag on GDP growth**

Aguirre et al. (2012) find potential economic gains from equalizing male and female LFP at 27 percent of GDP per capita. This is after accounting for temporary drops in labor productivity and average hours worked as more women with limited work experience and other obligations on their time enter the workforce.

Agenor, Mares, and Sorsa (2015) develop a model that simulates policies expected to influence women's choices in how they allocate their time between household chores and childcare, investing in their human capital, and work. Policies include both pro-growth and pro-gender policies, such as investment in infrastructure, improving efficiency of government spending in health and education, increasing family benefits per child, and affirmative action policies for women in the labor market. The authors estimate that such policies would boost India's growth rate by 1.5 to 2.4 pp per annum in the long term.

Khera (2016) links the issues of gender inequality and informality in the labor market within a unified framework. Her model allows her to quantify the impact of gender-based policies on aggregate economic activity and on labor market indicators of gender inequality. Khera argues that policies to reduce informality and facilitate women's participation in the labor market are complementary, and shows that increasing the level of education of women by 5 percent raises the female LFPR by 1.5 pp and GDP by 1.25 percent. Higher education also increases the number of women in formal employment and consequently reduces inequality. She estimates that closing the gender gap would lead to a 6 percent increase in India's GDP.

**Women are also an untapped source of managerial and entrepreneurial talent**

By excluding women from the labor force, the pool of such talent becomes shallower. Gender gaps in entrepreneurship adversely affect both labor income and aggregate productivity as the average talent of entrepreneurs is weakened. Cuberes and Teignier (2016) estimate that the long-run income loss in India due to the occupational gender gaps in "employership" and self-employment (the entrepreneurship gap) is over 10 percent. The income loss when adding the gap in LFP, is over 30 percent.

## ii. What are the proximate causes of low and declining women's LFPR?

**Women's LFPR has declined further with more education and urbanization**

Two patterns stand out as proximate causes of changes in the LFP of Indian women. First, a larger share of young women is outside the labor market because they are in school. Second, there has been a dramatic drop in female LFP in rural areas (from 41 to 29 percent), while female LFP in urban areas has stagnated at very low levels (20 percent). The combination of a larger number of girls in school, a declining female LFPR in rural areas, a stagnant female LFPR in urban areas, and urbanization together account for the overall drop in the female LFPR.

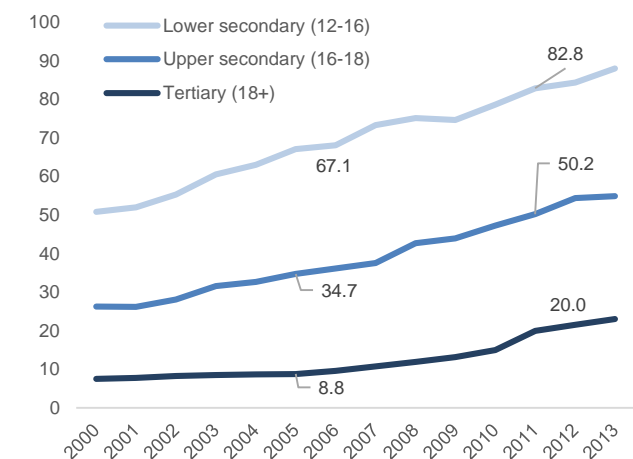
## More young women in school is a "good" cause of the recent decline in female LFP

**About 30 percent of the decline in the female LFPR is due to more young women staying in school longer**

Both the male and female LFPR declined between 2004-05 and 2011-12, to some extent as more young Indians stayed longer in school. Secondary enrolment increased from 48.7 to 67.4 percent, while tertiary enrolment increased from 8.8 to 20.0 percent (Figure 93). Accordingly, the share of women in school increased significantly (Figure 94). The decline in the number of women aged 15-25 working (expressed as a share of the adult population) almost exactly matches the increase in women of the same age group who are in school. For this age group, the increase in female enrollment can explain the drop in female LFP (Andres et al., 2017). As a result, out of a total decline in the female LFPR of close to 10 pp, approximately 3 pp are explained by a larger number of young women who might have previously been at work but are now in school. Similarly, Rangarajan, Iyer, and Kaul (2011) estimate the share of women who withdraw from the labor force in order to improve their education at over 40 percent.

**Figure 93 Secondary and tertiary enrolments have increased**

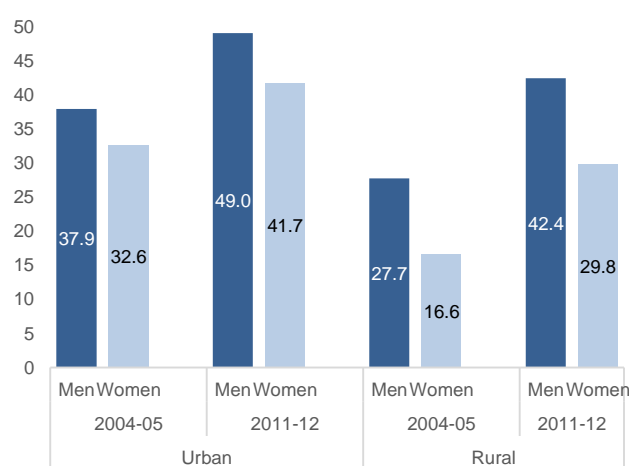
Gross enrolment ratios, females, percent



Source: Unesco Institute for Statistics

**Figure 94. More young women are in secondary and post-secondary education**

Population 15-25 in school, percent of total



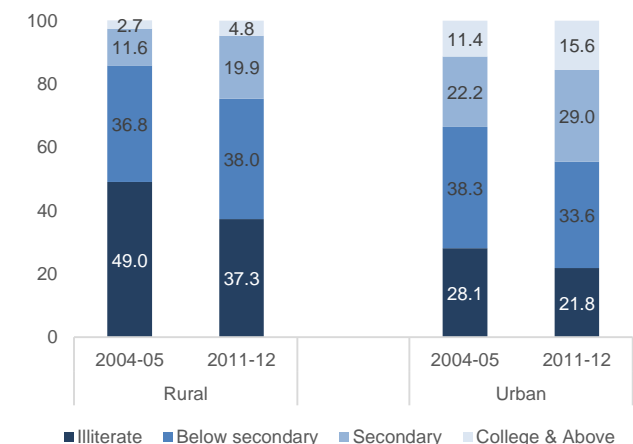
Source: NSS, and World Bank staff calculations

**Participation rates among educated women are also relatively low...**

Not only were there more young women in school in 2011-12 compared to 2004-05, but those in the labor market had a higher level of education (Figure 95). However, the effect of higher levels of education on female LFP is not linear. While college-educated women do have a higher propensity to work, women who have only completed a secondary education are the least likely to work (Figure 96), in large part because an increasing number are continuing their studies (Figure 97). However, even for college graduates, the female LFPR in India is only around 40 percent compared to 59 percent in Bangladesh and over 75 percent in Indonesia and Brazil.

**Figure 95. The level of education of India's working-age women has increased**

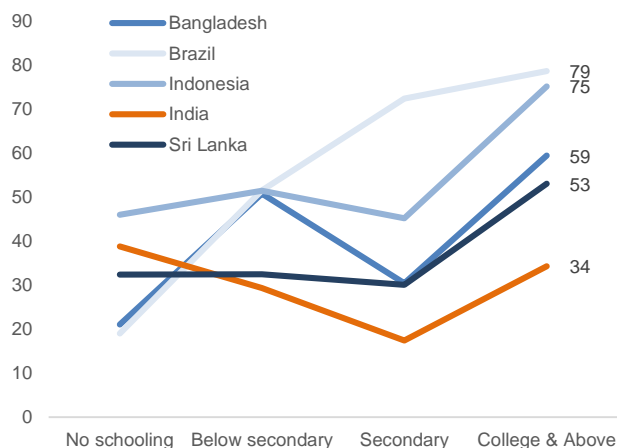
Level of education of working-age women (15+), percent



Source: NSS and World Bank staff calculations

**Figure 96. India's LFPR among highly educated women is much lower than in comparable countries**

Female LFPR by level of education attainment, percent



Source: ILOSTAT; figures for 2013 except India (2011-12)

**... and declined for all age and educational groups**

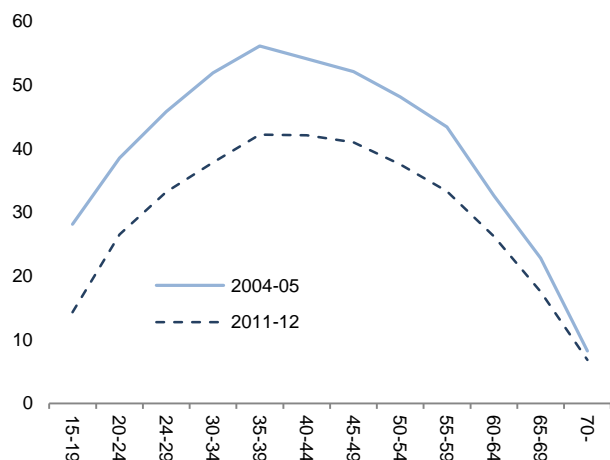
The discussion so far suggests that approximately 30 percent of the decline in women's LFPR is due to more young women being in school. However, the LFPR declined for women of all ages (Figure 97). As shown also in Figure 90, there was a significant increase in the number of women who are neither in school nor working, which went well beyond the decline in the share of (older) men in the labor force (and which might be attributable to an aging society). On the contrary, the decline is concentrated among those of prime working age (26-45).

In addition, the female LFPR fell across all levels of educational attainment, and even after taking into account school enrolment (Figure 98). Female LFPR declined the most for the group

with no schooling (12 pp). Increased schooling does not explain lower LFPR for this group, or the group with less than a secondary education. The decline in LFPR among women with a complete secondary education (7 pp) and college or diploma (8 pp) can be partly explained by continued education. The fact that continued education explains half the decline in LFPR among college graduates and diploma holders may indicate disguised unemployment, as young women delay entry into the labor markets, possibly due to poor job prospects.

**Figure 97. LFPR declined for women of all ages**

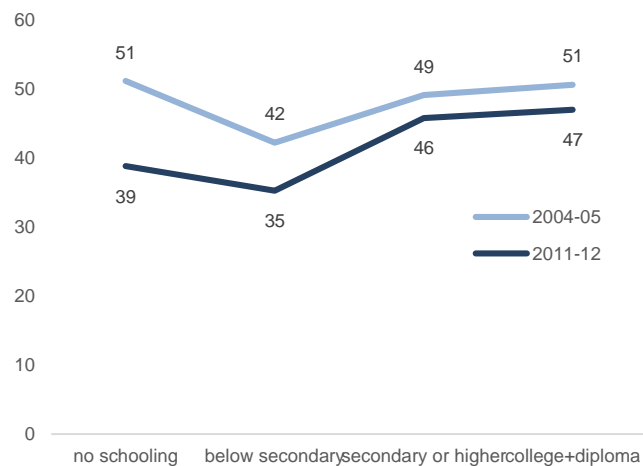
Women's LFPR by age, percent



Source: NSS and World Bank staff calculations, based on usual status

**Figure 98. Women of all levels of education dropped out**

Women in school or the labor force as a share of all adult (15+) females, by level of education attainment, percent



Source: NSS and World Bank staff calculations, based on usual status

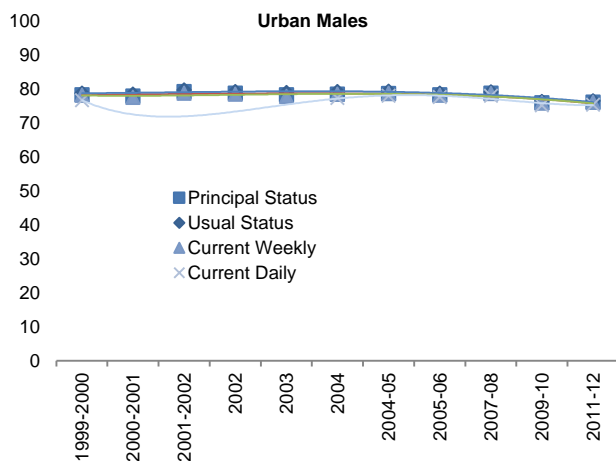
## Urbanization and stagnant urban female LFP drive the overall decline

### Urbanization and a low urban female LFPR drive decline in overall female LFPR

While men's LFP in urban and rural areas is similar and relatively stable at around 80 percent (Figure 99 and Figure 100), female LFP varies considerably across geographic areas. As of 2011-12, 36 percent of women in rural areas, but only one in five working age women in urban areas, were in the labor force. India has become more urban between 2004-05 and 2011-12, with a net shift of about 3 percent of the working age population from rural to urban areas according to the NSS. Since urban female LFP was unchanged in the period (Figure 101), urbanization is linked to a lower overall female LFPR.

**Figure 99. Men's LFPR in urban areas is high and stable**

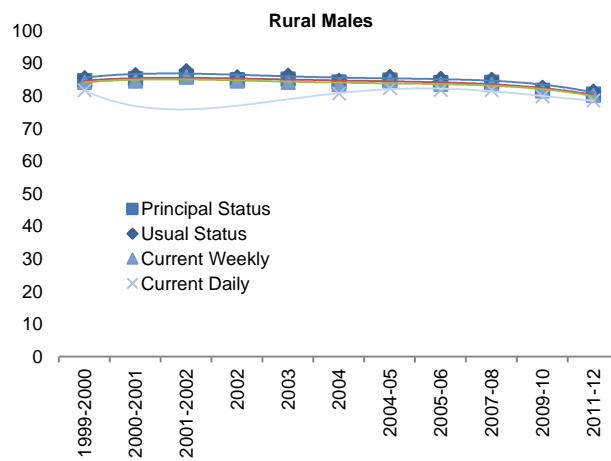
LFPR (15+), percent



Source: NSS and World Bank staff calculations. Employment definitions are discussed in the Technical Appendix

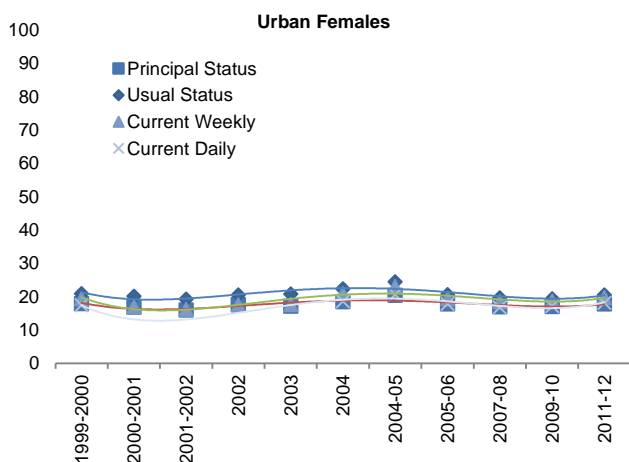
**Figure 100. Men's rural LFPR is comparable to urban LFPR and similarly stable over time**

LFPR (15+), percent



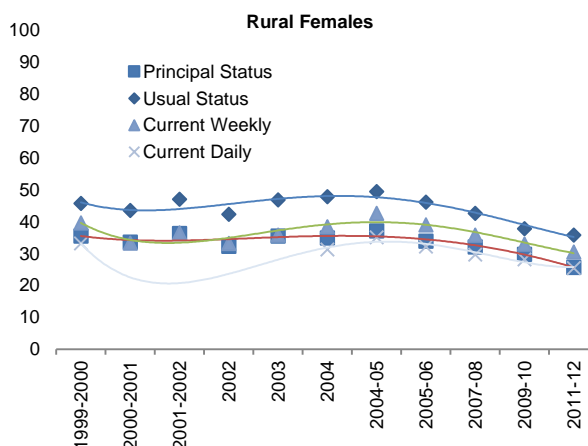
**Figure 101. Female LFP has stagnated at low levels in urban areas**

LFPR (15+), percent



**Figure 102. Female LFP in rural areas is higher than in urban areas, but has declined significantly since 2004-05**

LFPR (15+), percent



Source: NSS and World Bank staff calculations. Employment definitions are discussed in the Technical Appendix

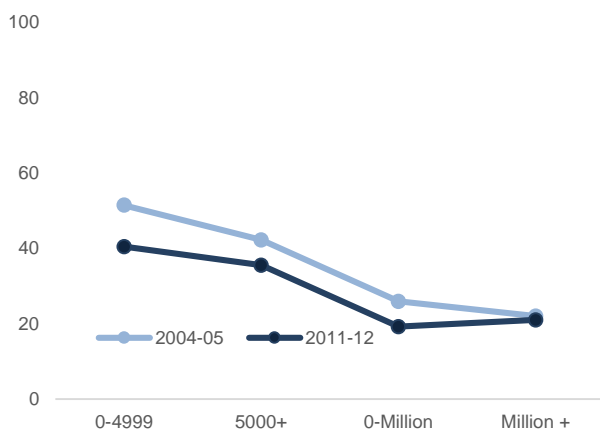
In rural areas, the LFPR for men declined by approximately 5 pp over this period, which may be explained by additional schooling and, to a lesser extent, retirements. Meanwhile, the magnitude of the decline was much larger for rural women, with their LFPR falling by nearly 15 pp to 36 percent in 2011-12 (Figure 102); the decline is similar regardless of the measure of employment used. Andres et al. (2017) argue that the drop in the overall female LFPR was mainly due to this development.

**Female LFP declines along the rural-urban gradation**

One factor contributing to the decline in rural female LFPRs may be a de facto urbanization of rural areas and the fact that movements across the urban-rural gradation may not be captured in the binary rural/urban designation. As rural areas become less agricultural, the female LFPR there may increasingly resemble the (lower) female LFPR in urban areas. Lending support to this view, female LFPR strongly declines along the rural-urban gradation. Women living in India's smallest villages (with population below 5000 people) are twice as likely to be in the labor force as those living in big (million plus population) cities (Figure 103). For men, on the other hand, the LFP is roughly the same (Figure 104).

**Figure 103. Female LFP is declining strongly along the rural-urban gradation...**

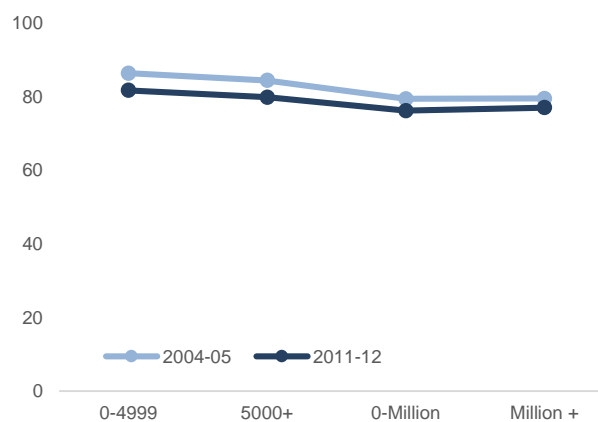
Female (15+) LFPR by location



Source: Chatterjee et al. (2015)

**Figure 104. ... while male LFP is relatively constant**

Male (15+) LFPR by location



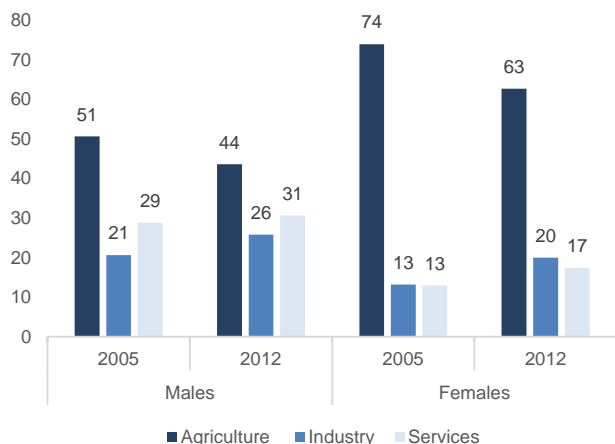
Source: Chatterjee et al. (2015)

## Women's jobs remain primarily in agriculture

While less than half of Indian men are now employed in agriculture, nearly two-thirds of working women remain tied to farm-based work (Figure 105), typically “self-employed” on the family farm. In fact, the share of agricultural employment in a state or district is a good predictor of the female LFPR (see Box 8). The decline of female LFP along the urban gradation is linked to the fact that women’s participation in services and industry, which are urban sectors, is very low (Figure 106) compared to other countries. The decline in the share of women working in agriculture seen in Figure 105 is largely explained by women dropping out of the labor force, rather than a large shift to other sectors. In most sectors, with the exception of utilities and construction, the share of women was stable or declined.

**Figure 105. Women remain much more likely to work in agriculture compared to men**

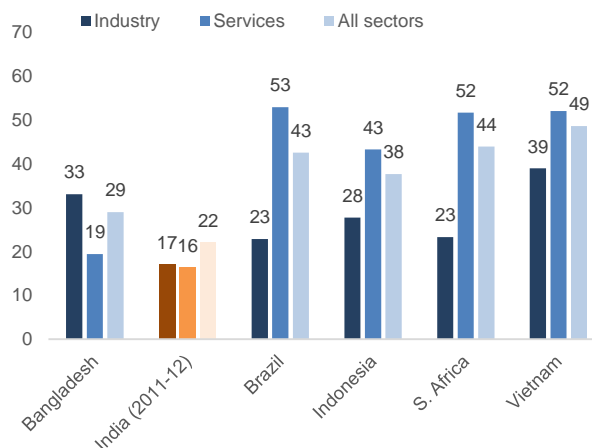
*Distribution of employed women by sector of work, percent*



Source: NSS and World Bank staff calculations, based on usual status

**Figure 106. India is an outlier in terms of the share of women employed in sectors outside of agriculture...**

*Share of women aged 15+ in each sector, percent*



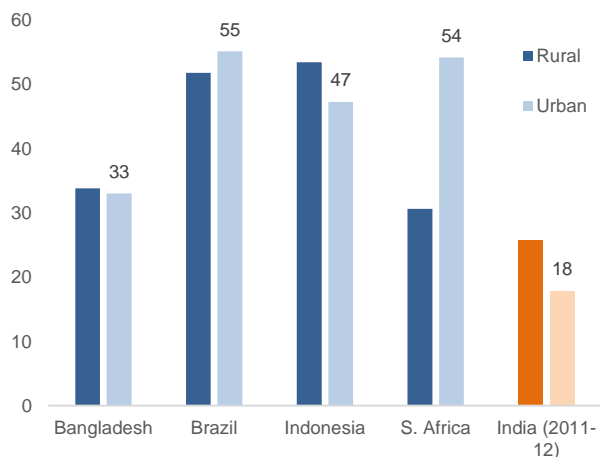
Source: ILOSTAT; data are for 2013 except India

## Few women are working in industry and services

Figure 106, Figure 107 and Figure 108 summarize the nature of the puzzle of India’s female LFP: women in urban areas are less likely to work compared to their peers, and related to that, the share of women employed in both industry and services is low relative to the overall female LFPR. Textiles in Vietnam and Bangladesh accounts for a large share of jobs for women; in Brazil, Indonesia, South Africa and Vietnam, the share of women in services is higher than the overall female LFPR. Bangladesh has a share of women in services sectors comparable to India, but this is compensated by a relatively high share of women in manufacturing.

**Figure 107. ...as well as in terms of urban female LFPR**

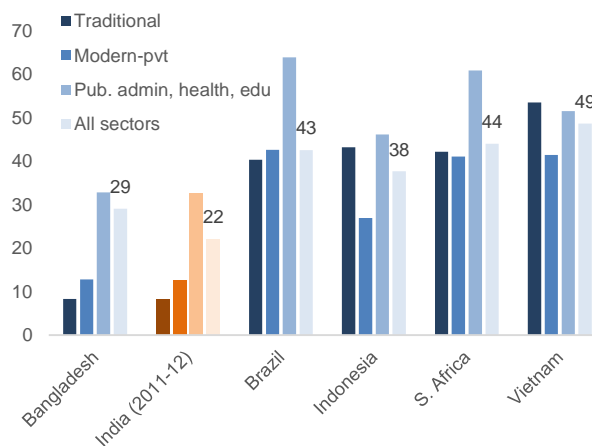
*Female LFPR (15+), percent*



Source: ILOSTAT; data are for 2013 except India

**Figure 108. The share of women in service sectors, except for public administration, is less than 20 percent**

*Share of women employed in each sector, percent*



Source: ILOSTAT; data is for 2013 except India



Indian women are underrepresented in traditional services such as trade, hotels and restaurants, as well as modern services such as finance, real estate and other business services, which includes the IT industry. The only exceptions are public administration, education and health, but even in those sectors the share of women is lower than in other countries.

### iii. Deeper causes: why is urban female LFP so low?

**Why are there so few women in industry and services?**

The main challenge is therefore to understand the deeper causes of the low number of urban Indian women working, and, relatedly, why there are so few women in the industry and service sectors. The main explanations that have been put forward can be sorted along two broad sets focusing either on labor supply or on demand. The decision to participate in the labor market (labor supply) depends on women's individual preferences or her family circumstances. On the other hand, women may be willing to participate in the labor market, but do not because of insufficient demand, represented by a scarcity of jobs that women find suitable.

### The income hypothesis: women prefer not to work when household income increases

**As income increases, some women may choose to drop out of the labor force**

Some decline in female LFPR can be expected with development. Female LFP is often seen as exhibiting a U-shaped relationship with income and education (Figure 86 above): at low levels of income and education, women mostly work out of necessity and in poor quality jobs, largely in agriculture. As household incomes rise when men find jobs in industry or services, women may choose to drop out from the labor market as their reservation wage increases. Higher household incomes may allow women to stay at home, often a preferred household choice in a predominantly patriarchal society in which working outside of the home is stigmatized.

Another argument proposed by Andres et al. (2017) is that women are often secondary workers who work temporarily to smooth family income. With increasing share of regular wage earners and declining share of casual labor in the composition of family labor supply, women may drop out of the labor force. Women may also move out of the labor force to spend more time on care duties, more so in urban areas where lack of childcare and family child support with increasingly nuclear families leave them with little choice but to stay at home.

Meanwhile, higher levels of education may interact with the marriage market, since education increases both employment and marriage prospects in the Indian context. Moreover, higher levels of education may also lead to lower female LFP if social stigma is associated with low-skilled jobs or work in general increases with women's education (Klasen and Pieters, 2015).

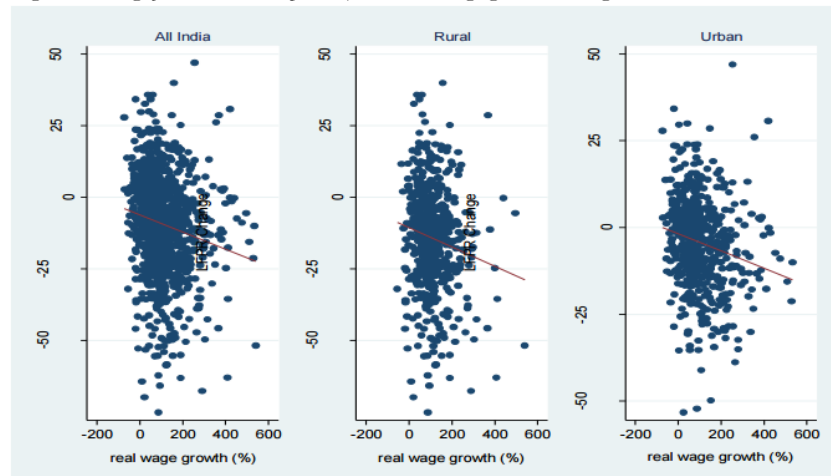
A large body of academic work has explained the decline in the female LFPR in India using such supply-side explanations; see for instance, Olsen (2006), Chowdhury (2011), Neff, Kunal, and Kling (2012), Himanshu (2011), Rangarajan et al. (2011), and Klasen and Pieters (2015).

**Supply-side explanations cannot explain all the developments observed**

However, there is evidence that higher household incomes are not closely associated with female LFP. Based on a comparison at the district level, a doubling of real wages between 2005 and 2012 has been associated with only a modest (3 percent) decline in the rural female LFPR, not with the much larger 13 pp fall that occurred during this period (Figure 109). In addition, households with similar living standards are still characterized by varying female LFPR depending on whether they live in rural or urban areas.

Moreover, some of the "supply-side" explanations such as the lack of childcare may help explain some of the decline in the LFPR of women 26-45, but can hardly account for the decline in LFPR of women over 45. Among the latter group, a number equivalent to two percentage points of the working age population dropped out of the labor force, compared to half a percentage point for men.

**Figure 109. Higher wages are associated with only a modest decline in female LFPRs**  
*District-level changes in average female LFPR (y-axis) and real wage growth during the 2004-05 to 2011-12 period, percent*



Source: Chatterjee et al. (2015)

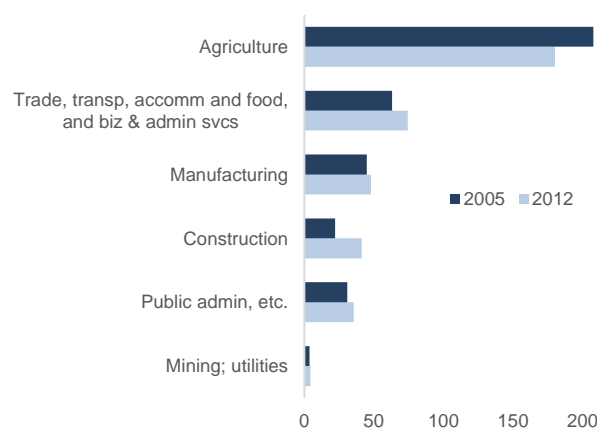
**The jobs hypothesis: there are not enough jobs suitable for women in urban areas**

**There is a scarcity of suitable jobs for women**

Chatterjee, Murgai and Rama (2015) argue that beyond the income effect, the key fundamental driver of the decline in female LFPR in India is the lack of “suitable” jobs for women. Between 2005 and 2012, the number of farm jobs dropped substantially, without a parallel increase in jobs in offices and factories (Figure 110). Casual work in construction absorbed some of the women exiting agriculture, with a significant contribution from MGNREGA, which in 2012 accounted for over a third of the female construction workers. However, job creation was insufficient overall, particularly in the rapidly-expanding areas that are neither truly rural nor fully urban. Farm jobs have declined particularly in the small villages, whereas regular employment expanded significantly only in large cities. The combination of these two trends created a “valley” of suitable jobs for women along the rural-urban gradation (Figure 111).

**Figure 110. Farming jobs dropped, but few industry and service jobs took their place**

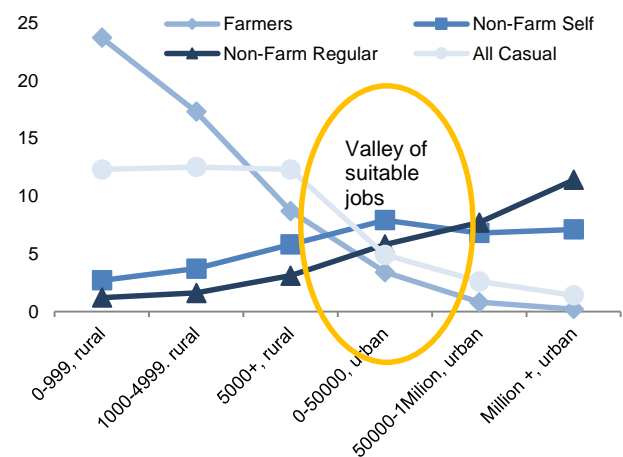
*Number of jobs, millions*



Sources: NSS and World Bank staff calculations

**Figure 111. There are not enough suitable jobs for women along the rural-urban gradation**

*Type of jobs, 2012, percent of female adults*



Source: Chatterjee et al. (2015)

In a traditional society where women’s work is considered acceptable only if it takes place in environments perceived as safe, female LFPR can be expected to depend on availability of jobs which are “at home” or “close to home”. Jobs in agriculture offer that advantage. With a decline in the kind of subsidiary farming jobs that women do and rapid growth in what may be called

“peri-urban areas” or densification of “officially rural areas”, the challenge may be not that of urbanization per se, but that of finding suitable job opportunities for women in India’s rapidly growing small towns (large villages), which can replace the comfort of farming. Chatterjee et al. (2015) find that once local job opportunities are taken into account, the place of residence along the rural-urban gradation loses relevance as an explanation of female LFP. What matters for women’s employment is job opportunities around where a household lives; not so much whether the household is based in a rural or urban area.

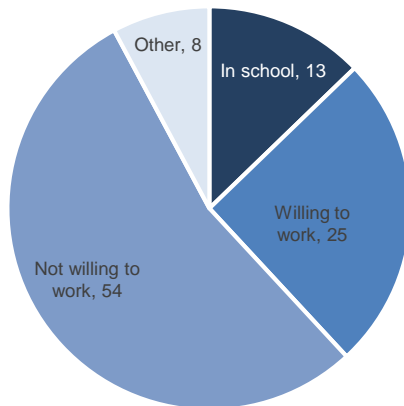
The importance of demand-side factors, and that the availability of suitable jobs matters, has also been highlighted by many authors (e.g. Rogers, 2012; Klasen and Pieters, 2015; Kannan and Raveendran, 2012; and Chand and Srivastava, 2014).

### Women say they would like to work

Nearly one-third of women not in the labor force and engaged in domestic duties as of 2011-12, corresponding to a quarter of the women out of the labor force, were willing to accept work (NSSO, 2014; Figure 112). If all women engaged in domestic duties who are willing to work had a job, the female LFPR would increase by nearly 20 pp.

**Figure 112. Many women not in the labor force are willing to work**

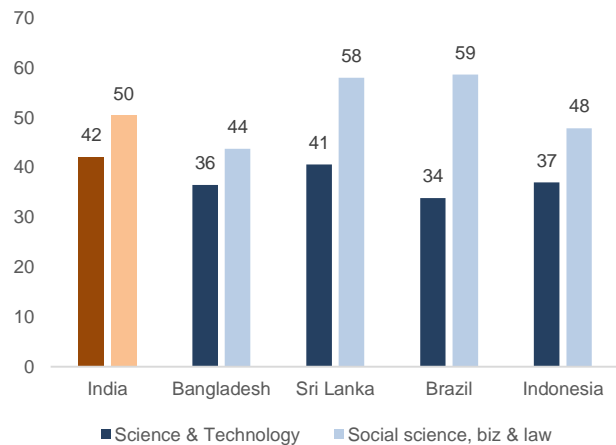
Shares (2011-2012), percent



Source: NSSO (2014) and World Bank staff calculations  
Note: Based on principal status

**Figure 113. Little evidence of gender streaming: women are a large share of science and technology graduates**

Share of graduates who are female, percent



Source: World Bank Edstats

### The jobs hypothesis helps explain the puzzle of education

One of the puzzles of India’s low female LFP is the low LFPR of college graduates compared to other countries. In a developing economy with a dynamic and modern service sector such as India, the demand for skills would be expected to be large and growing, leading employers to create jobs that attract an increasing number of educated women. In particular, India’s women comprise a large share of science, technology and business graduates (Figure 113), and in theory should have highly sought-after skills. Therefore, it appears that factors other than a lack of skills is restricting job creation. Indeed, a 2014 World Bank Enterprise Survey<sup>32</sup>, only 9.4 percent of firms identified an inadequately educated workforce as a major constraint, compared to 15.7 percent in Bangladesh and 21.7 percent globally.

#### iv. What kinds of jobs do women consider suitable?

##### Women prefer jobs that are well-paying, close to their

Women’s decision to enter the labor force is influenced by the type of work available and by the perceptions of their relatives. It is therefore important to understand what women are looking

<sup>32</sup> See [www.enterprisesurveys.org](http://www.enterprisesurveys.org).

## **homes, and with flexible working hours**

for in a job, how they perceive existing jobs, and what are the characteristics of available jobs that prevent women from taking them.

To unpack perspectives of women and the factors that influence their decisions around labor force participation, a World Bank team conducted interviews with more than 400 women and girls in two cities – Bhopal and Indore – in Madhya Pradesh<sup>33</sup> (for more details see Fruttero, Mehta and Schmidt, 2014). Respondents had different socio-economic backgrounds and education levels. Some lived in informal settlements while others were students enrolled in engineering colleges. The researchers probed them about their aspirations, the jobs they considered “suitable”, the barriers they faced in accessing the labor market, and more specifically the decision-making process they followed while thinking about which job to take up and which one to forego.

The picture that emerged was surprisingly uniform. While nearly all women and girls expressed a desire to work, and some were even offered work, the terms of employment were not always considered favorable. Women wanted jobs that were well-paying, close to their homes, and with flexible working hours. Underlying the need for proximity and flexibility were strong social norms around women’s chastity, marriage, work, and household duties.

## **Women need jobs that are safe, pay adequately, and offer flexible working hours**

### **Concerns about women’s safety are strong and often genuine**

In some cases, the need to ensure safety was driven by actual incidents of crime against women. The settlement where Kavita lived, for instance, was relatively new, comprised largely of migrants who worked in brick kilns. It had no street lights, youth unemployment was high and an alcohol shop in the area was perceived by residents as having further escalated violence against women and girls. In other cases, the girls felt that the powerful imagery of violence against women created by popular media also played a role in their parents forcing them to take up jobs in the vicinity of their neighborhood and/or those with flexible working hours.

The perceived need for safety at work is confirmed in other studies. In a recent survey conducted by the Evidence for Policy Design initiative, 62 percent of unemployed female youth said they would consider migrating for a job. However, while they were willing to migrate in similar measure as men (68 percent of unemployed male youth said they would migrate), nearly two-thirds reported it to be unsafe to live away from home, compared to 32 percent of males.

Similarly, the Breakthrough Index for Women in the Workplace by the Center for Strategic and International Studies finds that states that have high female workforce participation (e.g. Sikkim, Karnataka, Andhra Pradesh and Tamil Nadu) are also states that have fewer restrictions on women’s working hours and high conviction rates for workforce crimes against women.

### **Flexibility, availability of childcare, and adequate pay are important given social norms that require women to reconcile work with household duties**

A majority of women and girls interviewed for the qualitative study considered marriage and child-bearing as a significant factor on whether or not they could take up work. Marriage came with an attendant set of responsibilities which impacted women’s decision to participate in the labor force. While expressing their desire to work, most women interviewed said they could only work after attending to household chores and childcare duties. Many girls who were not married said that although they wanted to work, their families were hesitant to send them out for work.

Childcare was a significant constraint, more so in urban areas where families tended to be nuclear. Das and Zumbyte (2017) for instance find that having a young child in the home depresses mothers’ employment, a relationship that has intensified over time. The quality and affordability of childcare also came up frequently in the qualitative discussions, with many

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<sup>33</sup> Madhya Pradesh (MP) has a lower female employment rate in urban areas compared to the rest of the country (15 percent vs. 19 percent), and very few working age women in urban MP are in regular jobs (6 percent).

women saying that the facilities available (even paid ones) were not of good quality and the responsibility of tutoring and supervising children came down entirely to mothers.

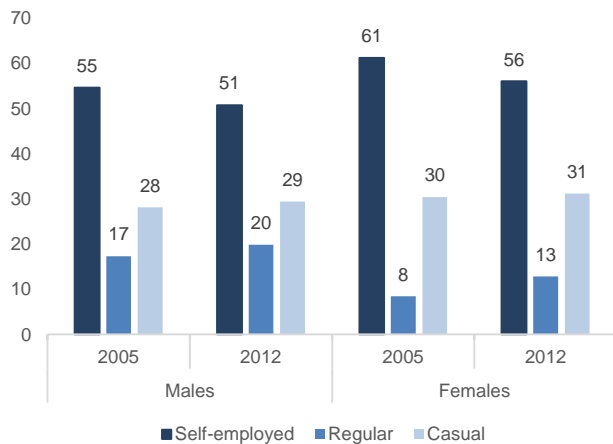
An enterprise survey undertaken by the World Bank in Madhya Pradesh (MP)<sup>34</sup> confirmed this perception and revealed that very few enterprises (40 of the 618 interviewed) offered maternity leave. Among those that did, only two in every five paid salaries during leave. The provision for childcare was even lower – only 7 firms offered such facilities. Of the firms that provided either maternity leave or childcare facilities (46), the average share of female employees was 20.5 percent, slightly more than the share of those that did not (14.7 percent; Sutra Consulting, 2016).

**Few regular, salaried jobs were created for women**

Regular, salaried jobs tend to be relatively inflexible, but they provide stability and sufficient income for women to afford some level of household help and childcare. While the share of women holding regular wage jobs increased more than that of men between 2005 and 2012 (Figure 114), this is primarily because of the decline in overall female LFPR.

**Figure 114. Women are less likely to hold regular, salaried jobs**

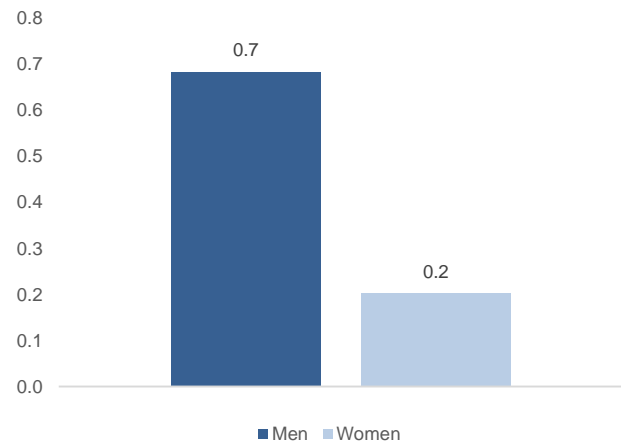
*Employment shares by type of work*



Source: NSS and World Bank staff calculations

**Figure 115. The share of adults with a regular-wage job increased, but men took 77 percent of those jobs**

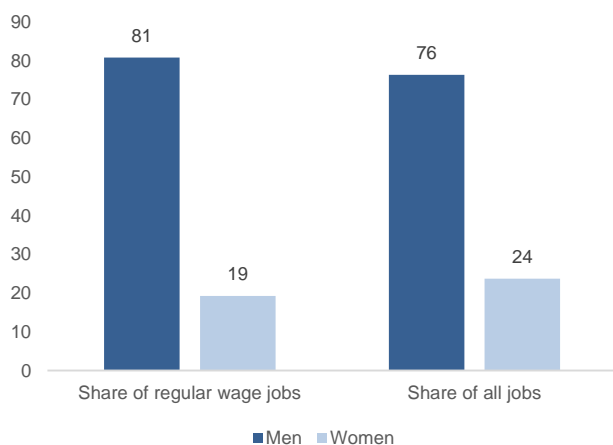
*Regular wage jobs created (2005-2012), shares of the 15+ pop., percent*



Source: NSS and World Bank staff calculations

**Figure 116. Men hold a disproportionate share of regular jobs**

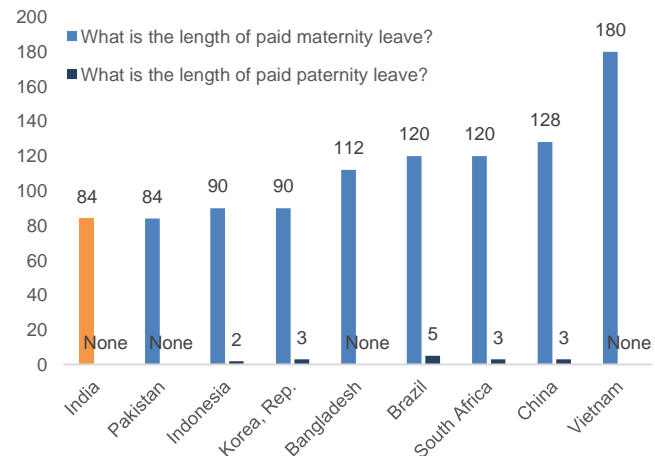
*Employment shares (2011-12), percent*



Source: NSS and World Bank staff calculations

**Figure 117. Labor laws provide for maternity leave, but for fewer days than other countries**

*Length of maternity/paternity leave, days*



Source: Women, Business and the Law (wbl.worldbank.org)

<sup>34</sup> The survey was fielded to 618 employers spread across three main cities and centers of employment in the state – Bhopal, Gwalior and Indore.

Relatively few regular salaried jobs were created between 2005 and 2012, and four of every five such jobs went to men (Figure 115), who continue to hold a disproportionate share of regular jobs (Figure 116).

**Labor laws are relatively restrictive towards women**

Part of the reason women do not take up a higher share of regular wage jobs may lie with Indian labor laws. First, they do not afford the same levels of maternity benefits as other countries (Figure 117). Second, in many cases they prevent women from taking up certain types of jobs in the formal economy (Table 12). And third, labor laws reduce the flexibility of regular wage jobs: while in the Republic of Korea parents are entitled by law to flexible or part-time work schedules, the same is not available in India. More broadly, S. Das et al. (2015) find that more flexible state labor markets are associated with higher female LFPRs. The authors also find that the chance of being employed in the formal sector is higher in states with more flexible labor laws.

**Table 12. India's labor laws restrict women's work**

	Can women do the following in the same way as men?						
	work in jobs deemed hazardous?	work in mining?	work in factories?	work in construction?	work in metalworking?	engage in jobs requiring lifting weights?	do the same job-related tasks?
Bangladesh	No	No	No	Yes	Yes	Yes	No
Brazil	Yes	Yes	Yes	Yes	Yes	No	Yes
China	Yes	No	Yes	Yes	Yes	No	No
<b>India</b>	<b>No</b>	<b>No</b>	<b>No</b>	<b>Yes</b>	<b>No</b>	<b>No</b>	<b>No</b>
Indonesia	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Korea, Rep.	No	No	Yes	Yes	Yes	Yes	Yes
Pakistan	No	No	No	Yes	Yes	Yes	No
South Africa	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Vietnam	No	No	Yes	No	No	No	No

Source: Women, Business and the Law (wbl.worldbank.org)

**Employers seem increasingly open to hiring women, although certain biases remain**

Nearly all women and girls interviewed for the qualitative study in Madhya Pradesh were of the opinion that employers were more open to hiring women in regular salaried jobs than 10 years ago, and particularly so in urban areas. However, they felt that the appreciation of female employees differs among industries and services and is high especially in the retail industry and in services like accounting, catering, beauty parlors – in sum, areas that require customer interface.

This perception is confirmed by the World Bank enterprise survey undertaken in Madhya Pradesh. The employers answering to the survey held positive and supportive attitudes to women's work. Around 85 percent of them agreed that women should work after marriage. Furthermore, 90 percent of employers said that men and women deserve equal wages and benefits for the same job. In general, there was little variation in these responses by firm sector or size. It is possible though, that employers with such perceptions are more likely to respond to the survey and some may have wanted to be seen as having adopted a "politically correct" stand on these issues.

When asked whether men have a greater right to a job than women, especially if jobs are scarce, employers were more divided: 53 percent agreed with the statement, while another 34 percent refrained from offering an opinion. This result was similar to findings from the World Values Survey, where 52 percent of all respondents and 43 percent of women respondents agreed men had priority over jobs (Figure 118; for more details, see Kapoor-Mehta et al., forthcoming)<sup>35</sup>.

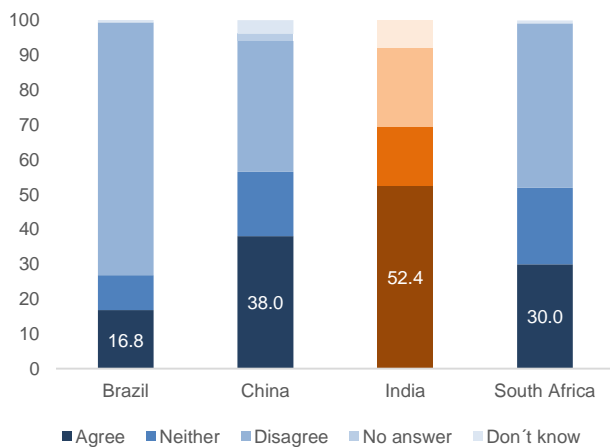
<sup>35</sup> In another survey, Pew Research found that 84 percent of Indians agree with the statement, "when jobs are scarce, men should have more right to a job than women" (Pew Research Center, 2010).

Similarly, when asked whether men made better employees than women, 42 percent of the employers interviewed responded in the affirmative, while 30 percent did not have a view (the rest disagreed). There was no significant variation on this subject by firm size, sector or city.

A majority of the employers interviewed for the enterprise survey in Madhya Pradesh also considered men as better suited for jobs in most functional areas, except for customer services and care. In general, employers perceived men to be more suited for jobs in the production/technical/operational domain (82 percent said so); and slightly lesser so for jobs involving procurement/purchase (71 percent); business development, marketing, sales and HR (62 percent) and IT support (57 percent) (Figure 119). In contrast, they were indifferent about hiring men or women for finance and accounting jobs, and in fact preferred women for jobs involving customer service or customer care: 62 percent of employers interviewed found women to be better suited for such jobs.

**Figure 118. More than half of Indian respondents believe men have priority over jobs**

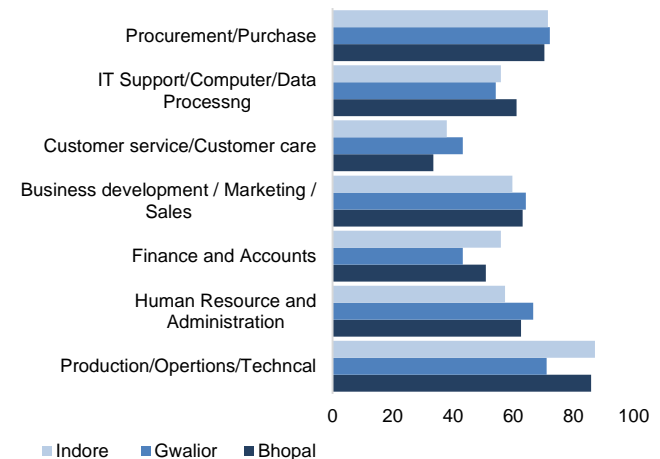
Responses to the statement “When jobs are scarce, men should have more right to a job than women”, percent



Source: World Values Survey ([www.worldvaluessurvey.org](http://www.worldvaluessurvey.org))

**Figure 119. Employers consider women suitable for jobs with customer interaction**

Share of respondents who say that jobs are better suited to men, by functional area and city, percent



Source: Kapoor-Mehta et al. (forthcoming)

The attitudes and opinions that employers hold about women appear to influence women’s employment outcomes. Across all firms interviewed for the enterprise survey, women comprised a small proportion of total workers (under 16 percent) with service sector enterprises employing a slightly higher share of women than manufacturing (18 percent compared with 15 percent). Interestingly, firms where employers are more open to hiring women in technical functional areas such as production and operations, also tend to hire more women. The average share of women in the workforce in firms where respondents opine that women are better suited to work in production/operations/technical areas is 28 percent compared to 12 percent when they think that men are better suited. Overall, larger shares of women are seen in industries that traditionally tend to employ female employees (e.g. manufacture of food products, apparel) or in services which involve a client interface (e.g. tuition centers, wholesale trade, health and social work, beauty parlors, tailoring units and photo studios).

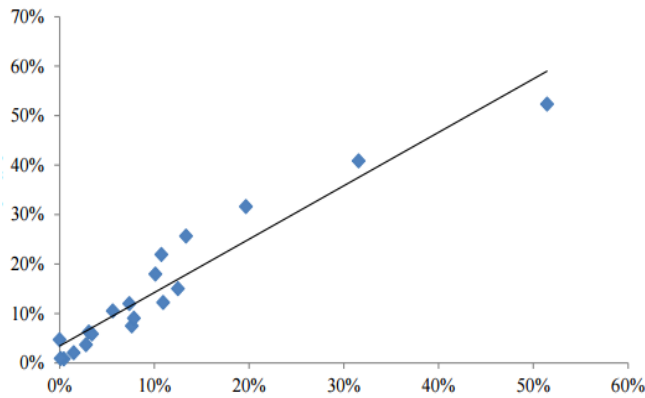
### Are there too few women entrepreneurs?

#### Female entrepreneurs tend to hire more women

Firms in which the employer is a woman tend to hire more women. For example, in the unorganized manufacturing sector, approximately 90 percent of employees in female-owned businesses are female, while this share is 81 percent in the case of services (Ghani et al., 2016). Figure 120 shows the high correlation between the share of employees in a given service industry that are female, and the share of establishments in the industry that are female-owned. This is partly because most firms have a single owner-worker, which mainly reveals that there are

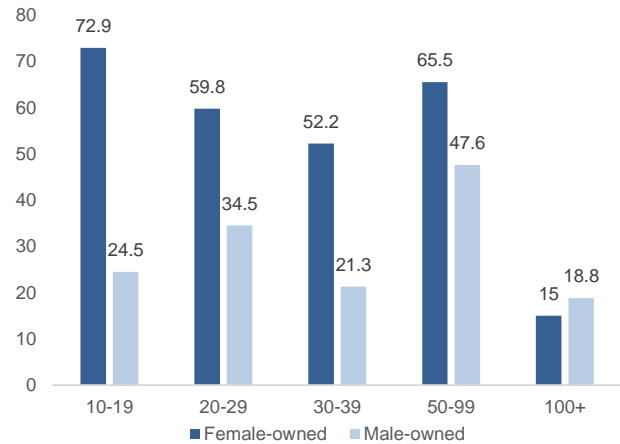
relatively few women entrepreneurs relative to men. However, as Figure 121 shows, medium-sized firms in the services sector owned by women also tend to hire more women compared to firms of similar size owned by men.

**Figure 120. There is a high correlation between female ownership and female employment in services**  
*Share of employees in the industry that are female, percent (y-axis); share of establishments in the industry that are female-owned, percent (x-axis)*



Source: Ghani et al. (2016); Note: service industries only

**Figure 121. Medium service-sector enterprises owned by women tend to hire more women**  
*Share of employees that are female, percent (y-axis); firm size, number of employees (x-axis)*



Source: Ghani et al. (2016); Note: service industries only

**However, relatively few women become entrepreneurs**

While a large share of women is self-employed in agriculture, most men also tend to be self-employed but are more likely than women to have non-farm businesses. According to the economic census (MOSPI, 2014) only some 14 percent of all Indian establishments are owned by women, over 80 percent of which are single-worker firms. The remaining firms provide employment to over 13 million persons of which approximately 90 percent are employed in establishments with less than 10 workers. Out of the establishments owned by women, about 35 percent are involved in agricultural activities with livestock dominating. Manufacturing and retail trade account for 30 percent and 18 percent of the establishments respectively.

Less than 10 percent of the firms interviewed for the enterprise survey in Madhya Pradesh had a woman working as an owner or a director.<sup>36</sup> Those run by a woman, were mostly micro units run as sole proprietorships, with a majority having only one to two employees. Most of these enterprises offered services such as tailoring or were salons; the manufacturing firms operated by women were engaged in dyeing of apparel, and some produced food and beverages.

The female employers interviewed held more positive attitudes about women’s work, and did have a higher share of women in their workforce. More female employers agreed that women should work after marriage compared to male respondents (96 percent compared to 84 percent). Women’s positive opinions about hiring female workers reflected in their workforce composition. Enterprises where the owner or Managing Director (MD) was a woman had a significantly higher likelihood of hiring more women: of the 61 enterprises where a woman was the owner/MD, in 49 the share of women in the workforce was more than half. However, such enterprises also tended to hire more women given the nature of their production or service (e.g. food production, beauty salons which tend to employ more women). In other words, female headship of firms may not be the sole factor influencing female employment in formal jobs.

<sup>36</sup> In the remaining firms, only in 10 did women rise to the level of a manager. Thus, it was not very clear if any of the women in top managerial positions were breaking the glass ceiling within organizations; the ones that were, were operating as owners of very small, self-run enterprises.

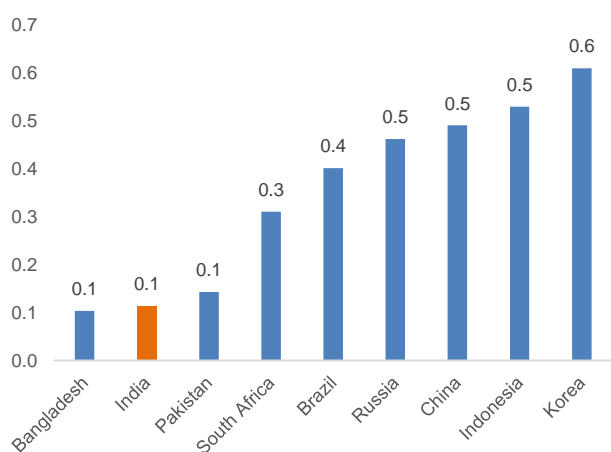


**Lack of business networks is a potential constraint**

Ghani et al. (2012) show that female business networks are important for promoting female entrepreneurship. The authors argue that there are strong agglomeration economies in both manufacturing and services, where higher female ownership among incumbent businesses within a district-industry predicts a greater share of subsequent entrepreneurs will be female. Moreover, higher female ownership of local businesses in related industries (similar labor needs, input-output markets) predicts greater relative female entry rates. Business networks are thus important for women’s economic participation. Similarly, Fields et al. (2015) find in an experimental setting that women who took a course on business skills with a friend were more likely to take a loan, and to use the loan specifically for business purposes. However, there is evidence that such networks are not strong in India. The Female Entrepreneurship Index (where India ranks 70 out of 77 countries) suggests that networking is one of the weaknesses of the Indian entrepreneurship ecosystem (Figure 122).

**Figure 122. Networking is important for entrepreneurship, but India lags**

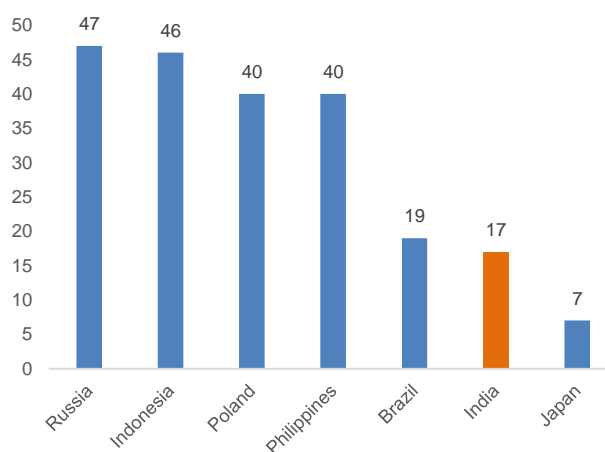
*Networking index*



Source: Global Entrepreneurship Index, 2017

**Figure 123. Few women serve on management positions in India**

*Proportion of senior management team that is female*



Source: Grant Thornton (2017)

**And very few women are in high management positions**

According to a global survey by Grant Thornton (2017), only 17 percent of senior roles are held by women in India (Figure 123). Among senior management roles, the figure is even smaller, with only 7 percent of the senior management (CEO/ Managing Director) roles held by women. Conversely, 41 percent of the Indian businesses surveyed have no women in leadership roles. As of 2010, a survey by Banerji et al. (2010) suggests that out of a total of 1,112 directorships on the BSE (Bombay Stock Exchange)-100, 59 (or 5.3 percent) were held by women. Less than half of the companies have women on their boards, and of a total of 323 executive directorships on the BSE-100, only eight are held by women. As argued by Cuberes and Teignier (2016), gender gaps in entrepreneurship and management positions negatively affect both income and aggregate productivity, since they reduce the average talent of pools of managers and entrepreneurs.

**v. Policy considerations**

**A combination of gender-targeted policies and formal job creation is needed**

This chapter identified a scarcity of suitable jobs as a key explanation for the low and declining female LFP in India. First and foremost, remedy needs to come from creating new job opportunities, including regular part time jobs, especially in newly-urbanizing areas. Three-quarters of women who were willing to accept work, if made available, favored such jobs (Chatterjee et al., 2015). “Supply-side” interventions can also be helpful and the suitability of existing employment opportunities for women needs to improve.

Ultimately, only a combination of gender-targeted policies that lower constraints on female labor force participation and reforms that boost formal job creation are likely to improve gender

equality in the labor market substantially and lead to considerable gains in GDP and employment (Khera, 2016). While gender-targeted policies can boost female labor force participation to some extent, due to the presence of labor market rigidities, these policies may not generate sufficient job creation in the formal sector, so that many of the additional women in the labor force may end up in low paying informal jobs or even remain unemployed.

Increasing formal labor market flexibility by simplifying and reducing regulation would allow more women (and men) to be employed in the formal sector. A resulting decline in aggregate informality and unemployment would boost GDP in the long run. However, with unchanged constraints on female labor supply and demand, such policies would lead to a smaller increase in female formality compared to male formality (Khera, 2016). Hence what is needed is a combination of gender-targeted policies and formal job creation.

**More jobs suitable for women need to be created and more jobs need to become suitable**

The sectors that draw in female workers the most have expanded the least in India, and related constraints need to be overcome. Employment opportunities in labor intensive manufacturing and white-collar services have not expanded sufficiently to absorb enough women (Klasen and Pieters, 2015). A different example is provided by Bangladesh, where a combination of higher education of women and a rising garment sector provided many new job opportunities. As a consequence of the high demand for women's work, female LFP in Bangladesh is much higher than in India, and driven almost entirely by the manufacturing sector (Figure 106 and World Bank, 2012). A more female- and labor-intensive export-oriented growth strategy can contribute to creating the missing employment opportunities (Klasen and Pieters, 2015).

In addition, firms can harness educated women to meet their skills needs by making existing jobs more suitable for women. In particular, childcare facilities and maternity leave granted by urban enterprises provide women with the flexibility they demand and thereby can increase the share of women in formal employment. Similarly, improved safety for women – such as through hiring more police-women – may be helpful. Infrastructure investment may not only be fundamental to India's growth agenda, but improved connectivity would also make more jobs suitable for women. For example, women in India face barriers in using transport facilities often related to safety that can be reduced by increasing lighting and establishing safe waiting areas.

Das and Zumbyte (2017) note that change in norms often follows strong policy interventions. The government could signal a more enabling vision for women and mothers through public information campaigns that value women as workers and project an image of child care as a shared responsibility in the home. Such campaigns have been effectively used in India and elsewhere to encourage literacy, or to achieve health outcomes such as immunization.

Finally, supporting female entrepreneurs can be an important way to create jobs for women and to enlarge further the talent pool of India's entrepreneurs. Women's access to networks of information and capital need to be strengthened, for example through stronger involvement of industry bodies like CII or a propagation of new online information portals. Ghani et al. (2012) argue that better local infrastructure is also linked to higher relative entry of female entrepreneurs in both manufacturing and services.

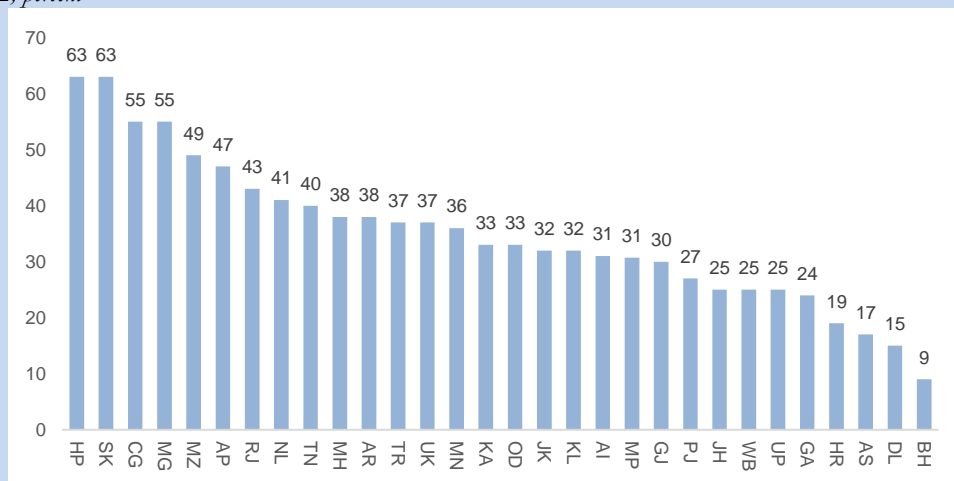
The qualitative study described in this chapter revealed that the aspirations of younger women are increasing. While one-third of the women between the age of 15 to 19 years engaged in domestic work said they would like to work at their home, daughters of women who are involved in home-based work no longer want to be employed in piece meal paying jobs. In fact, older women engaged in home based work in many cases encourage their daughters to step out and get formal jobs, provided they are close to their homes and have reasonable working hours. "I do not want my daughter to do as much physical work as I have to do," said one older woman who rolled papads for a living in Indore. "I do not want her to do home based work. I want a good and proper job for her".

### Box 8: State- and district-level variation of female LFPRs in India

Women's labor force participation differs significantly across states and districts in India. A handful of states – mountainous states such as Himachal Pradesh (HP) and those in the North-East such as Sikkim (SK), Meghalaya (MG) and Mizoram (MZ), or states with higher tribal populations such as Chhattisgarh (CG), have high participation rates (Figure 124). Women in HP, for example, are six times as likely to be in the labor force as those in Bihar, which has the lowest female LFPR at 9 percent.

**Figure 124. There is substantial variation in female LFPRs in Indian states**

*Female LFPR, 2012, percent*

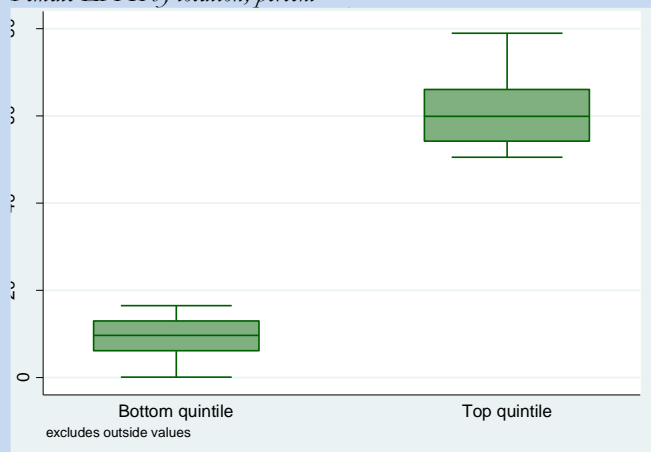


Source: NSS and World Bank staff calculations

M. Das et al. (2015) identify a combination of factors that appears to drive high female LFP in HP. First, HP has had the tradition of a large public sector which gave jobs to citizens as part of an implicit social contract after the state was carved out from Punjab. Almost half of urban men and 20 percent of urban women in HP had regular salaried jobs in 2011 (which is above average for India), with one in three jobs being in the public sector, which would be generally regarded as suitable jobs. Second, women in rural areas in HP were more than twice as likely as their male counterparts to report themselves as being self-employed in agriculture, which remains the mainstay of HP's largely rural economy. Predominantly agricultural economies tend to have higher female LFPRs. HP is a state that has invested considerably in agricultural processing industries and in expanding cultivation of crops that are locally grown (e.g. apples, mushrooms, tomatoes, bell peppers, ginger etc.). Besides being involved in their cultivation, women play an active role in agribusiness, floriculture and dairy farming (M. Das et al., 2015). Finally, HP has some of the best gender indicators in India, suggesting an elevated level of women's empowerment in the state. For example, it is the only state in northern India with a child sex ratio (in age group 0-6) above 900 (as of the 2011 census), and the Breakthrough Index of Women's Empowerment (Rossow and Watson, 2016) ranks Himachal Pradesh 5<sup>th</sup> among states.

**Figure 125. Female LFPRs vary considerably across districts**

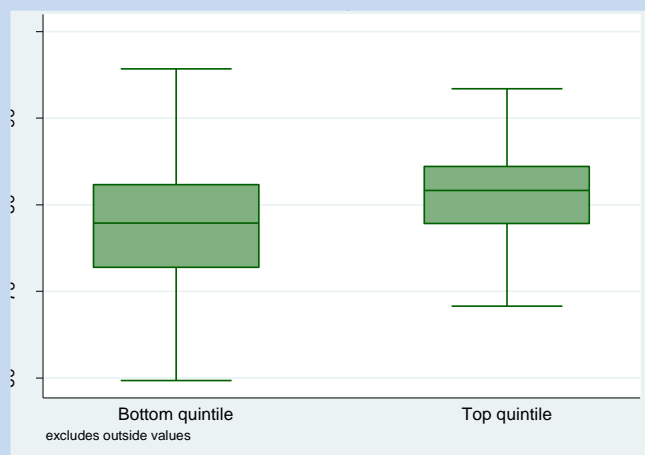
*Female LFPR by location, percent*



Source: NSS and World Bank staff calculations

**Figure 126. Male LFPRs are similar across districts**

*Male LFPR by location, percent*



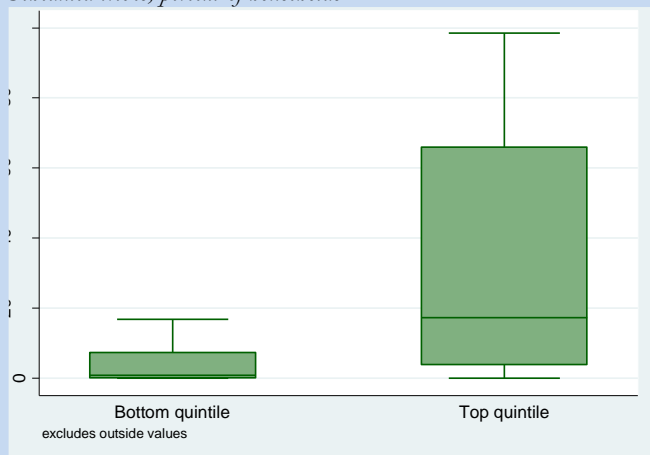
Notes: Districts arrayed into quintiles by female LFPRs based on usual status (US) definition. Box plots are shown without outside values

There is also large variation in female LFPRs across districts. Those in the top quintile of female LFPRs have median participation rates that are six times the participation rates in districts in the bottom quintile of the distribution, although with a larger variance (Figure 125). For men, on the other hand, the difference is minor (Figure 126).

Broadly, at both the state and district-level, a few features tend to be clearly associated with higher female LFPR. Places with a larger share of scheduled tribes and where agriculture is the mainstay of the economy stand out as areas where women are more likely to work (Figure 127 and Figure 128). Patterns are less clear-cut when it comes to infrastructure (Figure 129 and Figure 130).

**Figure 127. Female LFPR is higher in districts with a larger number of scheduled tribes...**

*Scheduled tribes, percent of households*

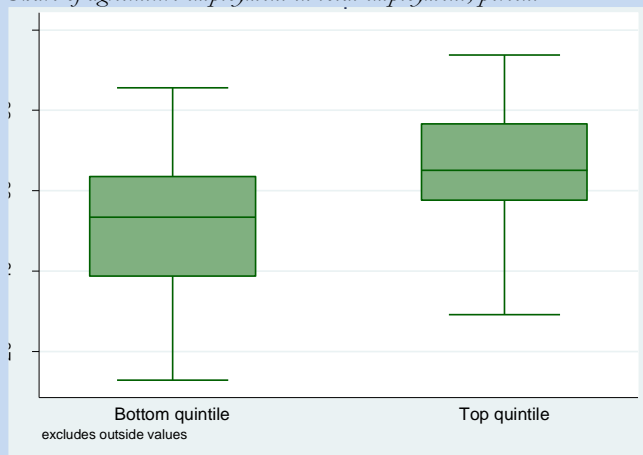


Source: NSS and World Bank staff calculations

Notes: Districts arrayed into quintiles by female LFPRs based on usual status (US) definition. Box plots are shown without outside values

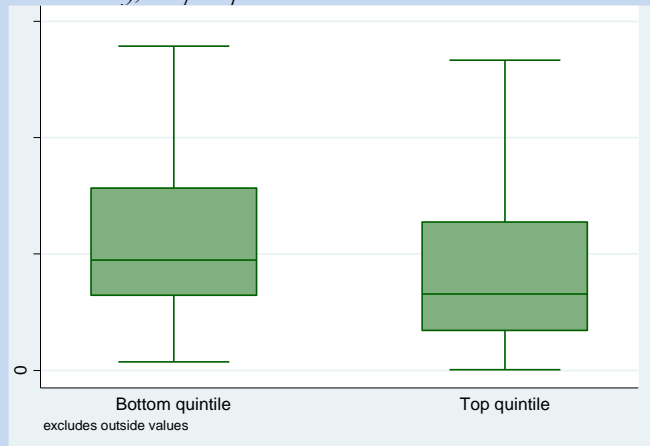
**Figure 128. ... are where agricultural employment predominates**

*Share of agriculture employment in total employment, percent*



**Figure 129. Better infrastructure at the district level, such as greater road intensity...**

*Road intensity, km per sq. km*

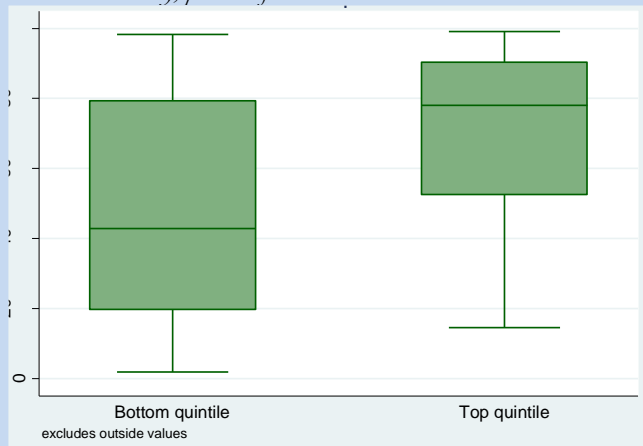


Source: NSS and World Bank staff calculations

Notes: Districts arrayed into quintiles by female LFPRs based on usual status (US) definition. Box plots are shown without outside values

**Figure 130. ...and improved access to electricity on the district level appear unrelated to female LFPRs**

*Access to electricity, percent of households*



## Technical Appendix: Definitions of Labor Force Participation

The persons surveyed by the NSS are classified into various activity categories on the basis of the activities pursued by them during three reference periods namely, (i) one year, (ii) one week, and (iii) each day of the reference week. Based on these three periods, three different measures of activity status were arrived at, which are termed as “usual status” (principal and subsidiary), “current weekly status” and “current daily status” respectively.

*Usual Principal Status:* The activity status on which a person spent relatively long time (i.e. major time criterion) during the 365 days preceding the date of survey was considered as the usual principal activity status of the person. To decide the usual principal activity of a person a two stage dichotomous classification was followed. At the first stage, persons were first categorized as those in the labor force and those out of the labor force depending on the major time spent during the 365 days preceding the date of survey. At the second stage, for persons belonging to the labor force, the broad activity status of either “working” (employed) or “not working but seeking and/or available for work” (unemployed) was ascertained based on once again the time criterion.

*Usual Subsidiary Status:* A person whose principal usual status is determined on the basis of the major time criterion could pursue some economic activity for a relatively shorter time during the reference period of 365 days preceding the date of survey or for a minor period, which is less than 30 days (not necessarily for a continuous period) during the reference year. The status, in which such economic activity is pursued, is the subsidiary economic activity status of that person.

*Usual Status:* The usual status, determined on the basis of the usual principal activity and the usual subsidiary activity of a person taken together, is considered as the usual activity status (principal + subsidiary status) of the person. According to the usual status, workers are those who perform some work activity either in the principal status or in the subsidiary status. Thus, a person who is not a worker in the usual principal status is considered as worker according to the usual status, if the person pursues some subsidiary economic activity for 30 days or more during 365 days preceding the date of survey.

*Current Weekly Status:* The broad current weekly activity status of a person is decided on the basis of a certain priority cum major time criterion. A person was considered working (or employed) if, while pursuing any economic activity, had worked for at least one hour on at least one day during the seven days preceding the date of survey. A person was considered “seeking or available for work (or unemployed)” if, during the reference week, no economic activity was pursued but he/she made efforts to get work or had been available for work any time. A person who had neither worked nor was available for work any time during the reference week was considered as out of the labor force. After the broad current weekly status of a person was determined using priority criterion, the detailed current weekly status was derived from the intensities<sup>37</sup> (time disposition during the week) assigned for the daily activities performed by a person during the seven days of the reference week.

*Current Daily Status:* The current daily activity status for a person was determined on the basis of his/her activity status on each day of the reference week using a priority-cum-major time criterion. A person is considered “working full day” if he/she had worked for four hours or more during the day, considered as “working half day” if he/she had worked for one to four hours in a day and “unemployed or not in the labor force “for the other half of the day. If a person had not worked for even one hour in a day but was seeking/available for work for four hours or more, he/she would be considered “unemployed” for full day and if he was seeking/available for work for less than 4 hours, he would be considered “unemployed” for half day and “out of labor force”.

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<sup>37</sup> Intensity is calculated for up to a maximum of two economic activities per day. Thus, on a day, a person may either have only one activity with 'full' intensity or two activities with 'half' intensity for each. If the activity is pursued with intensity 'half' on a particular day, the entry will be 0.5 against that activity and if that is pursued with intensity more than half, 1.0 will be recorded against that activity. Generally, an activity, which is pursued for more than 1 hour but less than 4 hours is considered to have been pursued with 'half' intensity. If it is pursued for 4 hours or more, the activity is considered to have been pursued with 'full' intensity.

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