Growing Hot And Cold

The Telegraph, August 4, 1997
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India has deregulated massively since mid-1991. Market liberalization has been encouraging, both in the growth of gross domestic product and the rise in exports. This has been accomplished with moderate inflation and sustainable foreign exchange and balance of payments conditions. The first stage of India's market liberalization must be judged a success. When compared to fast growing east Asia, however, it is clear much remains to be done.

The relatively slow growth is the result of continuing shortcomings in India's market institutions. India is still trapped by preconceptions of the Fifties, especially by vested interests fostered by state led industrialization, rather than the global economic realities of the Nineties. Key political parties still resist foreign direct investment, despite east Asia's experience that FDI does not threaten sovereignty or national culture.

Trade unions still veto crucial labour law and exit policy reforms. New regional and caste based movements support populist platforms. India's government spending is already high and its deficit already large. Programmes that increase public spending will be destabilizing.

India's prospects given current policies can be gauged by an equation relating a country's per capita economic growth to its initial income level and several policy indicators. This predicts a per capita growth rate for India of 3.6 per cent per year with current policies. If each policy variable were to take on east Asia's average value, India's growth rate would be 7.2 per cent per year. These results are crude but help establish that further reforms would give a significant, medium term boost to India's growth rate.

Eleven priority areas need attention.

One is openness. India's tariffs are among the highest. They block India's attractiveness as an export platform for labour intensive manufacturing. Foreign investment restrictions are still pervasive. Controversies like Enron and KFC hinder FDI flows. Recommended: reducing tariffs to east Asian averages, improving export processing zones, deregulating FDI in industry and simplifying FDI procedures in infrastructure.

New policies are needed for India's export processing zones. China's five economic zones exported $ 6.99 billion in 1991 compared with just $ 478 million from India's six zones. India's zones lack dynamism because of their limited scale, official ambivalence towards FDI, unclear incentive packages and central regulation of the zones. In China, such zones are run by local government.

Two is fiscal reform. With government in India near zero, the overall national savings rate is 23 per cent. East Asia averages 30 per cent or more, China 43 per cent. Government saving could be increased by reducing subsidies. A revamped tax system - value added taxation rather than turnover taxes, tariffs and octroi - could raise revenues while lowering taxes. Receipts from privatization
could help pay off India's government debt. This would cut the heavy debt service burden: interest amounted to 5.4 per cent of GDP in 199495.

Three is deregulating and privatizing state monopolies. India's public sector enterprises are damaging in two ways. First, many are inefficient and lose money. Second, they tend to be protected monopolies. Ending state monopolies will let private firms introduce competition and higher productivity. Privatization is also desirable because the government has no comparative advantages in running these enterprises. Instead it has severe disadvantages, like the politicization of key investment and employment decisions by the firms.

Four is labour law reform. India's greatest irony is that a huge shortfall of job creation in the formal economy is combined with restrictive labour laws that jack up the cost of hiring new workers. Formal sector employment is a shockingly low six per cent of the workforce. Barriers against dismissing unwanted workers in Indian firms with over 100 employees ensure firms hire no new workers. Labour intensive manufacturing exports require enterprises that can vary employment according to changes in market demand and technology India is an unattractive base for such production in part because of the obstacles to flexible labour force management.

Small steps can be taken. Some export processing zones could be exempted from sucks labour laws. Formal sector workers already employed could be protected, while the hire and fire of new workers could be liberalized. Most desirable would be changing the Industrial Disputes Act. Instead let hire and fire decisions be made as part of collective bargaining between enterprises and company unions, sans government interference.

Five is decentralizing economic policymaking. Though the Constitution allows some economic decisions by the states, in practice key fiscal, infrastructure and regulatory decisions are with New Delhi. Trends suggest economic and political authority will become more decentralized. In China this benefited economic growth. It promotes deregulation, especially as states compete to attract investment, and foster infrastructure more in tune with local needs.

Six is an exit policy for enterprises. A system is needed to allow firms to enter and exit freely from the market. While reforms have helped remove entry barriers, exit barriers remain in place. It must be recognized that badly designed safeguards turn into barriers which damage firms. Present regulations disallow firms from restructuring. Large firms are not allowed to retrench workers, or close down a unit without state government permission. In effect this means job security in large private firms, similar to that enjoyed by public sector employees. India needs to put in place a bankruptcy code.

Seven is social policy. Centre and states need to spend more on primary education and primary health. Primary education should be made compulsory. Existing subsidies for higher education should be retargeted to primary education. Food subsidy programs can be retargeted. One way is through larger school meal programmes. Spending on girls' education has a high social return: better family health, lower infant mortality and lower population growth. The Centre could offer states matching grants as an incentive to increase social outlays.

Eight is infrastructure. Infrastructure constraints can only be overcome if a regulatory environment conducive to large scale inflows of foreign investment in critical areas is set up. The Centre must
empower states to negotiate infrastructure projects with foreign investors according to basic norms- without New Delhi’s time consuming interference.

Nine is urban land use. The 1976 Urban Land (Ceiling and Regulation) Act prevents enterprises from selling surplus land without state permission. The act blocks rational land use by placing an upper limit on the size of landed property that can be privately owned. Excess land is bought by the state at well below market value. These arbitrary limits, and effective confiscation of property, hinder property development.

Ten is agricultural sector reform. Deregulating pricing and procurement of agricultural commodities is necessary to raise farmgate prices to farmers, to stimulate productivity growth in farming and to provide income to sustain rural investments in industry. Restrictions on farm land use need to be relaxed so that rural areas can shift from agricultural activities to small scale industry. China's village enterprises are crucial to its economic boom. India must unleash its rural industrial potential.

Eleven is financial market reform. Like Mexico, China and France, India nationalized its banking and insurance sectors two decades ago. Other countries have given up this policy. India, nearly alone among market economies, still relies on a state owned banking sector and insurance monopoly. The results: heavy losses and inefficient delivery of financial services. The sector urgently needs new domestic and foreign firms and less public financial institutions.

The prospects for continued reforms are perplexing. India's already opened the economy substantially with positive results: restored growth and macroeconomic stability-though not yet guaranteed. All political parties claim adherence to market reforms. But the precise commitment of various parties to real market reforms is unclear: The 1996 elections saw parties campaign do populist platforms. The growth of regional parties and concerns about corruption are positive signs. Yet if Indian politics becomes a bidding war for a fragmenting electorate, the orderly process of reform will be jeopardized. What reforms are needed is clear. But the challenges in India are mostly political rather than economic.