

India: Accelerating Growth, Creating Well-paid Jobs for the Masses

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Abstract

Transformation of Indian economy to a modern, urban and industrial one at a fast pace requires the creation of a policy environment that would accelerate the growth of medium and large enterprises, especially in labour intensive sectors such as apparel, footwear, furniture and numerous light manufactures. Key policy reforms required for the emergence of these enterprises include opening the economy to foreign trade and investment wider, flexible labour markets, availability of land to businesses at reasonable prices and low rental housing for migrant workers taking up jobs in the enterprises. Considering the complexity of undertaking multiple reforms involving both Centre and States, an option may be to create Autonomous Employment Zones, spread over areas of 500 square kilometres or more with full autonomy to implement their own labour and land laws, as is the case in Shenzhen in China. The zones can also be designed such that imports and exports can move rapidly into and out of it. These zones may help bring many multinationals currently looking for locations other than China. The paper also lists a number of reforms in education, privatization, food procurement and public distribution system, power sector, civil service, tax administration, and fiscal and monetary policies. I discuss these reforms in detail in my recent book, *India Unlimited*.

JEL: F1, F4, J2, R3

Key Words: Economic Reforms, Growth Acceleration, Openness, Transformation.

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Introduction

Even in India, where growth used to be routinely derided, it has now come to be widely seen as essential to bringing prosperity. The view that a faster march to prosperity requires faster growth is no longer to be defended at length. An additional important but still insufficiently appreciated lesson from available evidence is that spreading prosperity over a large proportion of the population requires that growth translate into high-productivity, high-wage jobs for the masses. Therefore, in addition to the magnitude of growth, its concentration in industries that create more jobs per unit of capital matters as well.

Two recent challenges India has faced further underlined the urgency of growth acceleration and creation of decent jobs. The first of these challenges came from the New Corona Virus (NCOV) that translates in the Corona Virus Disease 2019 (COVID-19). With the vast proportion of its workforce either self-employed or employed in tiny enterprises at subsistence wages, temporary discontinuation of economic activity during the crisis exposed a disproportionately large population to extreme economic hardship. This population had no or limited savings to fall back on and therefore became wholly dependent on transfers by the government, which were also inevitably limited in scope due to tight fiscal constraints that the government faces.

The second challenge, which has arisen concurrently with NCOV challenge, is from China. China's Gross Domestic Product (GDP) at \$14.1 trillion in 2019 is now second to only that of the United States at \$21.4 trillion the same year. Given that the difference in the expected growth rates of the two countries in the coming decades will be anywhere around 3 to 4 percentage points, China sees itself closing the remaining gap between it and the United States in 10 to 15 years. Given this fact and an extremely ambitious leader at the helm, China now seeks a new global order in which it will be at the apex. A critical first step towards achieving this ambition is for China to become the undisputed regional power in Asia. It is as a part of this first step that China has begun to challenge nearly all its neighbours in South China Sea, East China Sea and most recently along its southwestern border.

If India is to guard its strategic interests in the years to come, it will need to arrest the rise of China to the status of undisputed regional power of Asia. While it can do so in the short run through closer ties with the United States, Japan and Australia, in the longer run, it will need to bridge the gap in economic size between it and China. With its population predicted to cross that of China in less than a decade, it needs to become China's economic equal or at least near equal to stand up to the challenge it poses in the long run. This strategic consideration makes the need for acceleration in the growth rate to near-double-digit level ever more urgent.

Preponderance of Tiny Economic Units

To understand what India needs to do to meet these challenges, the bottom-line question we must ask is why is it that after 70 years of development effort and substantial economic reforms since 1991, such a large proportion of Indians remains in a vulnerable state. In my recent book *India Unlimited: Reclaiming the Lost Glory*, I systematically show that the single most important factor behind our continuing woes is the preponderance of small, indeed, tiny economic units and near absence of medium and large enterprises, especially in labour-intensive sectors (Panagariya 2020).

Thus, for example, agriculture, which employed 42.5% of India's workforce in 2018-19, is populated by 70 million agricultural land holdings that are all less than half hectare in size as per the latest Agricultural Census conducted in 2015-16. The average size of these 70 million land holdings, accounting

for 48% of all holdings, is 0.23 hectare. If per-hectare value added on these farms is assumed to be the same as the overall value added per hectare, these farms cannot give a family of five more than half of India's official poverty-line income.

In a similar vein, tiny enterprises dominate in industry and services. The latest available Economic Census, conducted during 2013-14, identified 58.5 million establishments. Of these, 89.39% were private proprietorships, 0.74% private partnership and only 0.33% private companies. The remainder 9.46% establishments were government establishments including public sector enterprises (PSEs), private self-help groups, private cooperatives, non-profit institutions and private miscellaneous entities. In terms of employment, 78.50% were in private proprietorships, 2.54% in partnerships and only 3.88% in private companies. Surprisingly, at 7.24%, government establishments including PSEs were twice as large as private companies as employers.

A follow up survey conducted in 2015-16 provides further details on the nature of employment of the vast majority of non-agricultural workers (National Sample Survey Office 2017). The survey covers unincorporated enterprises only, which account for about 85% of the workforce covered by the Economic Census. The survey divides these enterprises into own-account enterprises (OAEs) and establishments. The former does not employ a single hired worker on a regular basis while the latter employs one or more such workers. In 2015-16, 62.1% of all workers in unincorporated enterprises were employed in OAEs and 37.9% in establishments. Annual value added per worker was 73,951 rupees in OAEs and 152,723 rupees in Establishments. Only 26.4% of the workers in all unincorporated enterprises taken together were hired workers with the rest being principally self-employed. Annual emoluments of the hired workers at 2015-16 prices amounted to just 87,544 rupees.

Criticality of Medium and Large Enterprises in Labour-intensive Sectors

These data confirm that workers in India are disproportionately employed in small enterprises, which exhibit low value added per worker and low wages. Larger companies that exhibit high value added per worker employ very small proportion of India's workforce. Even the few medium and large enterprises that exist are predominantly in sectors such as petroleum refining, auto and auto parts, fertilisers and chemicals in which technology forces a minimum scale. When it comes to apparel, footwear, furniture and light manufactures, micro and small enterprises dominate.

It is not that small enterprises are always characterised by low labour productivity. In fact, in many countries, they exhibit average labour productivity that is many times that observed in India. The key determinant of labour productivity in small enterprises is the presence of medium and large enterprises. Broadly speaking, small enterprises (with less than 50 workers) exhibit high average labour productivity when they operate in an environment in which medium and large enterprises (with 50 or more but fewer than 200 workers and 200 or more workers, respectively) have a sizeable presence. For instance, in 2005, approximately half of China's manufacturing workforce was employed in large enterprises and another quarter in medium enterprises. The corresponding proportions in India were 10.5% and 5.5% implying that a gigantic 84% of the workers in manufacturing were in small enterprises (Hasan and Zandoc 2013). With their large shares in the workforce, medium and large enterprises in China effectively define the ecosystem within which small enterprises operate. The latter must either become ancillaries of the former or compete against them. Either way, they must adopt technologies and cost-saving management practices necessary to survive side by side with their medium and large counterparts. Unsurprisingly, average labour productivity in small enterprises in China turns out to be many more times that in India.

If India can make the policy environment conducive to the emergence of many more medium and large enterprises, especially in labour-intensive sectors, a significant proportion of the workforce currently in the unincorporated enterprises would move to these enterprises to take advantage of higher wages that the latter would pay. That in turn would tighten the labour market for the unincorporated enterprises, forcing them to take productivity-enhancing measures. The process will also pave the way for some workers to migrate out of low value-added farming.

It deserves emphasising that for this process to work its way, production structure must shift heavily towards labour-intensive manufacturing and services. There are two critical reasons behind this proposition. First, India is a capital-scarce and labour-abundant country. Therefore, capital needs to be deployed where employment per-unit of capital is high. Today, the bulk of India's capital is deployed in highly capital-intensive sector. This leaves very little capital for the labour-intensive sectors, which crowds out medium and large enterprises that are by nature more capital intensive than their small-scale counterparts within the same sector. A swath of small enterprises in labour-intensive sectors with low labour productivity, low wages and low product quality is the end result.

The second reason why a substantial shift to labour-intensive sector is required is that the bulk of India's workforce lacks skills necessary for employment in high-tech manufacturing or services sectors. It is heroic to think that at least half of the 42.5% of the workers currently in agriculture, who need gainful employment, can be absorbed in sectors such as pharmaceuticals, information technology, petroleum refining, chemical and machinery sectors. Instead, it will have to be sectors such as apparel, footwear, furniture and other light manufactures, for which workers with no or limited skills can be trained in relatively short time, that have the ability to employ these workers at decent wages.

Export Orientation, Not Import Substitution

A robust empirical regularity is that medium and large enterprises operate in the global marketplace. Today, even India's \$2.7 trillion economy does not offer a large enough market for most products to fully exploit scale economies. For instance, India has promoted its auto industry through prohibitive trade barriers. Yet, after 70 years, it has not been able to achieve the quality and cost to be competitive in the world market. Its share in global auto exports remains less than 1%. An argument can be made that the industry got a free ride on other sectors that helped increase incomes that generated steadily rising demand for automobiles. For comparable cars, Indian auto industry charges Indians customers prices that are one and a half times those prevailing in other countries. If the infant industry argument had any merit, by now this infant should have been ready to face foreign competition. It is not.

The story is not very different in electronics industry. The efforts to build up this sector via import substitution had begun in 2014-15. But trade data do not offer much comfort in this sector either. In 2011-12, exports of electronic items in current dollars had stood \$8.85 billion. In real terms, this value was larger than the exports of these items in 2018-19 at \$8.88 billion. In the meantime, imports have gone up from \$34.13 billion to \$55.63 billion over the same period. A genuinely flourishing electronics industry that can capture the global markets has simply not emerged.

To create enterprises that are competitive in the global marketplace, India needs a clear strategy of outward orientation. That means rolling back tariff increases introduced in the past three to four years and cutting them further. The commitment should be to bring all tariffs down to 7% in five years or sooner. Any protection to domestic goods against foreign goods should be provided through depreciation of the rupee, which helps equally domestically produced exportable and import-competing goods.

India also needs to pay particular attention to trade facilitation. Imports and exports require a large number of permissions from different ministries, which slows slowdown their movement. This is particularly problematic in the case of exports since exporters must in any case meet the demands of their customers and governments in the destination countries. There is no reason for the exporting country government to heavily regulate the movement of exports. There also remain many bottlenecks at Indian ports translating into significantly slower movement of goods into and out of India.

When it comes to trade, so far, India has always gone for a war room for monitoring imports. What we need instead is a war room for exports. Such a war room should be overseen directly by the Prime Minister in the way President Park Chung-hee, the maker of modern South Korea, did in the 1960s and 1970s. Beginning in 1965, Park held monthly meetings of all parties responsible for export performance including exporters, industry associations and various government agencies and oversaw the progress. If exports were not moving forward, he probed what the obstacles were and made sure that those obstacles were removed.

Factor Market Reforms

Rigidities in labour markets as an obstacle to the emergence of medium and large enterprises in labour-intensive sectors in India have been discussed at length and I need not go into their details here. Sadly, however, lately land markets have appeared as an additional major obstacle. Large enterprises need large chunks of urban land and this has become progressively difficult over time. With no conclusive land titles, disputes on the ownership of land are endemic in India. Therefore, creating a large piece of land by purchasing and pooling a number of smaller contiguous parcels of land has always been a challenge for private entrepreneurs in India. But in the past, it was relatively easy for the government to acquire land on behalf of the industry. But the Land Acquisition Act of 2013 put an end to that flexibility. This law makes it nearly impossible for the government to acquire land on behalf of industry. Indeed, it has made land acquisition for even public projects difficult as well as costly. As a result, even building roads has become excessively costly in India.

The government can alleviate the land constraint to some degree by bringing on the market unused land it owns. Many of public sector enterprises including those designated as “sick” own much more land than they need. Many educational institutions also own land far in excess of their needs. Many government ministries including defense, railways and civil aviation own unused urban land. State government may similarly own land that they do not expect to use. All this land can be brought on the market through auction. State governments can introduce additional flexibility in land markets by liberalizing the rules for conversion of agricultural land for alternative uses on the periphery of cities. A final important step towards greater flexibility will be to relax the floor space index to allow for significantly taller buildings in and around the city centres of different cities.

India has made considerably more progress in reforming financial markets than labour and land markets. Even then, much remains to be done in this area. While the immediate concern is with restoring the health of banks and non-bank financial companies, the key longer-term reform is privatisation of banks. In addition to the fact that private sector banks outdo public sector banks along all major parameters of efficiency, public ownership of banks gives rise to serious governance issues. Public sector bank employees are subject to vigilance investigation, which ties the hands of their senior staff in ways that is costly to the taxpayer. The regulatory powers of the Reserve Bank of India over public sector banks are far weaker than over private sector banks, which creates an undesirable asymmetry in regulation. At the same time, public sector banks are subject to one set of regulations by the RBI and another set of

regulations by the government. Finally, with the ownership of public sector banks, the government ends up being the policy maker, regulator and service provider. This is not a feature of a good governance system.

Urbanisation

I noted earlier that 70 million or 48% of all Indian land holdings are less than half hectare with average size of these holdings being less than a quarter hectare. These holdings yield such low income to families dependent on them that even doubling or tripling that income cannot make them prosperous. Many of these farmers would like to migrate to better jobs in industry and services. In so far as such job opportunities exist in cities, their migration will require greater urbanisation.

Unfortunately, Indian cities have not been friendly to migrant workers. Much of the focus of policy has been on owner-occupied housing, which is inevitably aimed at families already in the cities. Migrants who come looking for a job from rural areas need low-rent housing. Such housing is rarely available. As a result, the lucky among the migrants find housing in slum and not so lucky sleep on footpath. During the recent pandemic, this problem has finally come to the fore and has got some attention of the government.

But the policy action by the government at present is minimal and can hardly make a dent. The only effective way to help this migration smoothly and systematically is to create conditions for the emergence of low-rent commercial housing. This in turn requires a considerable fall in land prices. At the current land prices, rental yields are a tiny fraction of the interest rate, making investment in rental housing a losing proposition. This fact makes the reforms in land markets including bringing unused urban land with different entities on the market critically important.

One other reform concerns the reform of rental laws. Except in the state of Rajasthan, rental laws disproportionately favour tenant over the landlord. Given the absence of conclusive land titles in India, these laws place even the ownership rights of the potential landlord at risk. Indeed, there is a history of many owners losing their residential units to tenants because they could neither raise the rents nor get the latter to vacate those units. The result of these lopsided rental laws has been that according to 2011 Census, 11.09 million or 12.3% of a total of ninety million residential units remain vacant in India. If states will reform their rental laws bringing better balance between the rights of tenants and owners, a large proportion of these units could become available on rent considerably alleviating the shortage of rental housing.

Autonomous Employment Zones

Given the difficulty of implementing wide-ranging reforms across the entire nation within a short period, I have argued that India could speed up the creation of good jobs by creating half dozen or fewer zones in which the business environment will be highly flexible.¹ I refer to these zones as Autonomous Employment Zones (AEZs). Two or three of these zones may be located near the coast in Gujarat, Andhra Pradesh and Odisha to take advantage of deep dredge ports in these states. These AEZs would be along the lines of Shenzhen in China. Unlike the Special Economic Zones (SEZs) with which India experimented during the past one and a half decades with at best limited success, AEZs would be spread

¹ The following discussion in this section is taken from Panagariya 2020.

over large areas in excess of 500 square kilometres. They will also be far fewer in number—no more than half dozen, perhaps only two or three, in the beginning—than SEZs. Since suitable unused land areas of this size are unlikely to be available, especially near the coast, the zones may include existing habitations and establishments.

The key feature of AEZs would be to define the boundaries of the zone and then give virtually all powers to frame the rules of economic engagement including labour and land laws and administration of customs within the zone to the local administration. The zones will offer a highly flexible environment with respect to labour and land laws allowing rapid reallocation of these factors from one activity to another. They will also allow exporters to import inputs with minimum friction, process them and re-export. But there will be no export requirement for firms locating in the zones.

In the initial phase, say, during the first ten years, the government may provide a waiver on either GST or corporate profit tax to any single employer employing ten thousand workers or more. This will incentivise the early entrants to the zones who must function within an area that would still be developing. Later entrants would be entering a well-developed area and therefore would not require similar benefit. The government must proactively court multinationals currently active in China and other countries, especially in labour-intensive manufacturing, in the early phase of the zones.

The government's other contributions to the zones may be limited to building first-rate infrastructure and dormitory housing, which migrant workers can rent. When seen in national context, resources for building infrastructure and dormitory housing in AEZs are relatively small. They can be drawn out of general pool of resources devoted to infrastructure and urban housing.

Once success is demonstrated in a handful of AEZs, more of them may be considered. What is important, however, is that the numbers are kept in proportion to available resources to build such zones. A key flaw of many government initiatives in India is that they are multiplied too rapidly, which spreads limited resources too thinly to produce any successes.

Concluding Remarks

Whether we consider industrial countries or developing countries, economic transformation has always involved shrinking shares of agriculture in output and employment and rising shares first of manufacturing and then services. The main difference between industrial countries and developing one that have achieved the transformation is that the latter could do in three decades what took the former almost a century. But in all case, when transformation was complete, output and employment shares of agriculture had fallen into single digits.

If India is to similarly modernise itself, there is no escape from this process. The only issue is whether it wants to accomplish it in the next two to three decades or take more than hundred years like the industrial countries. If the former, it must create high-productivity jobs in industry and services that would then pave the way for the migration of workers out of agriculture into these sectors. Though India has made some progress in this direction, its pace has been extremely slow. The key factor behind it is the preponderance of employment in tiny, low-productivity enterprises in industry and services, which remain unattractive to rural workers in agriculture. The latter find their meagre income complemented by government provided benefits a better deal than these jobs.

Therefore, creating high-productivity, high-wage jobs in industry and services is the only road to speed up the transformation. This in turn requires an environment conducive to the emergence of medium and large enterprises, especially in labour-intensive industries. It is preponderance of these enterprises that

creates an ecosystem in which small enterprises are also forced to become productive lest they become uncompetitive.

Medium and large enterprises in labour-intensive sectors flourish by operating in the global marketplace. As such, the first and foremost condition for their emergence and sustainability is an open economy. If India maintains high protection, only small enterprises that can make assured profits in the domestic market even when they supply low-quality products with little risk of investment going bad would emerge. Openness requires lowering protection, improving the speed at which goods move into and out of ports and cutting down on permissions from ministries to import or export a given product.

In labour-intensive sectors, large enterprises also require flexible labour markets. There needs to be a balance between the rights of employers and employees. Currently, Indian labour laws are disproportionately tilted in favour of employees, which discourages enterprises from hiring workers to become larger. This too needs to change.

Next set of reforms for the emergence of medium and large enterprises in labour-intensive sectors relate to land markets. Large enterprises require a substantial chunk of contiguous land at a reasonable price. In India, existing national and state laws have made excessively expensive. This must change. It is also the case that workers who migrate from rural to urban areas to take up jobs with new or expanding enterprises need low-rental housing. But low-rental housing is also constrained by high land prices. Once again, land prices must come down to align rental yields to the interest rates so that commercial rental housing can emerge in Indian cities. An additional area of reform is rental laws that currently favour tenants disproportionately thereby driving even empty dwelling units out of rental markets.

Given the difficulty of implementing multiple reforms falling under multiple jurisdictions, one option is to create Autonomous Employment Zones. Spread over areas of 500 square kilometres or more, such zones can be given full autonomy to implement their own labour and land laws, as is the case in Shenzhen in China. The zones can also be designed such that imports and exports can move rapidly into and out of it. These zones may help bring many multinationals currently looking for locations other than China.

In addition to these key reforms discussed in greater detail in the paper, we will need reforms in several additional areas to achieve and sustain a double-digit growth for two or more decades. They include, notably, reforms in areas such as school and higher education; privatization of public sector enterprises; land leasing in agriculture and sales of agricultural land; food procurement, public distribution system and the Food Corporation of India; fertiliser subsidy; civil service; fiscal and monetary policies; power sector; trade negotiation; tax administration; and Centrally Sponsored Schemes. I discuss these reforms in detail in *India Unlimited*.

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