JOINT ECONOMIC COMMITTEE

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RESEARCH REPORT #110-7
May 2007

CHALLENGES TO SUSTAINED ECONOMIC GROWTH IN INDIA

After India initiated comprehensive reforms in 1991, economic growth accelerated. In 2006, India's real GDP grew by 9.2 percent.

This research report (1) reviews India's economic reforms; (2) compares India's economy with a peer group of large developing economies in Asia – the People's Republic of China, Indonesia, Malaysia, the Philippines, and Thailand – that compete with India both in export markets and for inward foreign direct investment; and (3) assesses the challenges that India must overcome to sustain rapid economic growth and reduce poverty over the long term. If India meets these challenges, it will become a far more important trade and investment partner for the United States.

Economic Reform

From 1947 to 1984, India had a development policy of import substitution industrialization. This policy promoted domestic manufacturing by discouraging imports through international trade and investment barriers, domestic regulations, and subsidies. To implement this policy, India instituted Soviet-style central planning, established many government-owned enterprises (GOEs), and granted monopolies to GOEs in energy, telecommunications, and transportation.

Unlike China, India retained a significant private sector. To enforce compliance with its five-year economic plans, India instituted comprehensive controls, known as the *license raj* (regime). Under the license raj, both private firms and GOEs needed government approval to (1) establish new facilities, (2) expand production capacity, (3) launch new products, or (4) close or relocate existing facilities. India also limited the manufacturing of certain goods to small firms.

This policy produced anemic economic growth. In 1984, Prime Minister Rajiv Gandhi began economic reform by abolishing the licensing system for twenty-five industries and substantially liberalizing it for others.

An economic crisis prompted Prime Minister Narasimha Rao to initiate sweeping reforms in 1991. India progressively abolished licensing for all industries except atomic energy, defense equipment, alcoholic beverages, and tobacco. India slashed its average applied import tariff rate from 79.2 percent in 1991 to 16.0 percent in 2005, phased-out quantitative restrictions on almost all imports by 2001, and eased restrictions on foreign investment.

Since 1991, the leaders of India's two major parties, the Bharatiya Janata Party (BJP) and the Congress Party, have supported further liberalization. Given India's fractious multiparty parliamentary system, opposition from minor parties has forced both BJP- and Congress-led governments to delay or weaken proposed reforms during the last fifteen years. While the direction of economic policy is clear, the liberalization has been slower than many policymakers would like.

Bifurcated Economy

India is the world's second most populous country. In contrast to China, India's working age population (ages 15 to 64) is projected to grow by 53.9 percent from 691 million in 2005 to 1.064 billion in 2050.

India favored developing internationally competitive colleges, universities, and technical institutes for a limited number of students. Because of India's linguistic diversity, English remained the preferred language of instruction. Hence, India developed a large pool of educated, highly skilled, English-speaking managerial, professional, and technical workers compared with the peer group.

In contrast, competing Asian economies favored expanding the availability of primary education to all children. Consequently, India's adult literacy rate of 61.0 percent compares unfavorably with literacy rates of the peer group.

During the last two decades, the peer group followed a development strategy of export promotion industrialization that encouraged export-oriented labor-intensive manufacturing of apparel, footwear, sporting goods, and toys as well as final assembly of consumer electronics.

In contrast, India encouraged knowledge-intensive business services and software industries and capital-intensive manufacturing of capital goods and high-tech goods to exploit its comparative advantage in educated, highly skilled, English-speaking workers. This strategy created a developed sector of India's economy that supports 190 million Indians in middle-class lifestyles.

Another sector of India's economy is underdeveloped. In the peer group, the economic importance of agriculture declined as workers left the countryside and took more productive, better paying jobs in labor-intensive manufacturing and final assembly in cities. This transition has been slow in India.

Agriculture still accounted for 18.4 percent of India's GDP in 2006 and 54.2 percent of India's total employment in 2004, both higher than competing Asian economies. Manufacturing accounted for only 15.4 percent of India's GDP in 2006, lower than competing Asian economies.

As a result, India suffers from far more extreme poverty than the peer group. In 2003, 340 million Indians or 30.7 percent of India's population each lived on less than $1 per day.

Challenges to Long-Term Growth

India must create millions of new jobs for unskilled and semi-skilled workers that are currently unemployed or underemployed in subsistence agriculture. Although employment in India's knowledge-intensive and capital-intensive industries is soaring, these jobs generally require a higher education or specialized skills. In competing Asian economies, export-oriented labor-intensive manufacturing and final assembly created the first urban jobs for unskilled and semi-skilled workers moving from farms to the cities. A number of policies have contributed to the relatively slow growth of labor-intensive manufacturing and final assembly in India.

(A) Inadequate infrastructure.

(1) Electricity. Three central GOEs generate most of India's electricity, while state electricity boards (SEBs) distribute electricity. State policymakers require these boards to provide electricity selectively to some farms and lower caste households for free or at subsidized prices. This encourages other households to steal up to 50 percent of the electricity generated through illegal connections to the grid.

Subsidized or stolen electricity costs state governments the equivalent of 2.5 percent of India's GDP a year. To offset these losses, state electricity boards overcharge industrial firms. On average, Indian manufacturers pay 60 percent more for electricity than their Southeast Asian competitors and 100 percent more than their U.S. competitors. The central government has recently required SEBs to reduce their subsidies to agricultural and household customers gradually and limit the maximum rate differential among various customers to no more than 20 percent by 2011.

Electricity demand exceeds supply by 7 percent on average and by 12 percent at peak usage. Chronic shortages cause frequent outages. Manufacturers lose power about once every two days, seven times more frequently than in China. Outages reduce the output of Indian manufacturers by 8.4 percent, four times the output loss rate in China.

The Investment Commission of India (ICI) estimated that India must spend $200 billion (equal to 25.7 percent of 2005 GDP) over the next seven years to build 90 gigawatts of generating capacity. India needs foreign direct investment (FDI) to supplement central government plans to increase generating capacity by 67 gigawatts. The inability of cash-strapped SEBs to guarantee payments to private generators and the bitter controversy over FDI by three U.S. firms in a large generation project near Dabhol during the 1990s discouraged large-scale FDI in electricity.

(2) Transportation. India's airports, ports, railways, and roads are grossly inadequate.

Inefficient ports slow turnaround time to 3.5 days.[1] Manufacturers pay about 35 percent more to ship an identical cargo to the United States from India than from China. The ICI reported that India must spend $19 billion (equal to 2.5 percent of 2005 GDP) over the next nine years on port facilities to increase efficiency.

The ICI estimated that India must spend $15 billion (equal to 2.1 percent of 2005 GDP) over the next five years on civil aviation to alleviate congestion. After years of delay, India has finally begun the expansion of the existing airports in

[1] Turnaround time is less than 6 hours in both Hong Kong and Singapore.

Delhi and Mumbai and the construction of new airports in Hyderabad and Bangalore in 2005.

Policymakers require a central GOE, Indian Railways, to charge substantially below market fares for passengers. To recoup these losses, Indian Railways charges firms above market freight rates. Extremely high rail costs have caused manufacturers to shift the bulk of their domestic freight to trucks. Unfortunately, India's road system cannot accommodate this demand.

The ICI estimated that India must spend $60 billion (equal to 8.2 percent of 2005 GDP) over the next five years to improve its roadways. India is currently building two major multi-lane highway projects, the 5,864 km Golden Quadrilateral project and the 7,300 km North-South and East-West corridor project. However, India's expenditures on rail and road transportation compare unfavorably with the peer group.

(B) Workforce Quality. Soaring demand for English-speaking managerial, professional, and technical workers from India's booming knowledge-intensive and capital-intensive industries is now outstripping its previously plentiful supply. Skilled labor shortages have ignited a bidding war. Some firms are recruiting from the United States, while others are outsourcing jobs to subsidiaries or contractors in the United States.

Widespread adult illiteracy prevents many Indian workers from securing jobs in knowledge-intensive and capital-intensive industries. India is expanding the access of its children to primary education. As a result, the literacy rate among Indians ages 15 to 24 has increased to 76.7 percent in 2004. Nevertheless, India's primary school enrollment and young adult literacy rates still compare unfavorably with the peer group.

(C) Incomplete Economic Reforms.

(1) Remnants of License Raj. In 2006, the World Bank found that India ranked 134th of 175 economies as an overall place to do business. Among the peer group, only Indonesia fared worse. India's ranking in opening new facilities, paying taxes, trading across borders, enforcing contracts, and closing a bankrupt business were lower than the peer group.

(2) Rigid Labor Market. India's rigid labor laws are a major impediment to labor-intensive manufacturing. These laws slow the transition of the 93.6 percent of Indian workers who are employed in agriculture or the informal urban sector into generally higher productivity jobs in the formal urban sector.[2]

India's labor laws apply to employers with ten or more workers, become more stringent as the number of employees increase, encourage unionization, and generally favor workers over employers. Any seven workers can form a union and bargain collectively with their employer. Government officials may intervene in collective bargaining on the behalf of "general economic interests." Firms with 100 or more employees need state government permission, which is almost never given, to fire or lay-off permanent employees.

To gain flexibility, firms engage in avoidance and evasion behaviors that are inefficient and reduce the potential size of India's economy. For example, small firms avoid labor regulation by limiting their output and hiring nine or fewer workers. An estimated 57 percent of medium-size firms with ten to ninety-nine workers do not register to evade labor laws. Firms invest in costly labor-saving equipment and use temporary workers whenever possible to avoid hiring permanent workers. As a result, the share of temporary workers increased from 12 percent of all manufacturing employment in 1990 to 23 percent in 2002.

(3) Inefficient Government-Dominated Financial System. India's central government-controlled financial system is highly inefficient in channeling India's saving into productive investment. India has an impressive saving rate of 32.5 percent of GDP, but only one-half of household saving is channeled through banks and other financial institutions. One-third of household saving is invested in housing, and most of the remainder is invested in 44 million low-productivity micro-enterprises.

Indians bought $10 billion of gold in 2005. Over time, Indians have accumulated over 15,000

[2] Workers in the formal urban sector receive higher real wages than workers in the rural and informal urban sectors. Moreover, workers in the formal urban sector have old-age pension and health insurance benefits that are unavailable to workers in the rural and informal urban sectors.

tons of gold that are worth $272 billion. Because banks cannot lend gold bars and jewelry, a large portion of Indian savings cannot be intermediated into economically productive investments through banks and other financial institutions. This reduces the potential size of India's economy.

Government-owned banks control more than 74 percent of India's banking assets. India limits foreign direct investment to 74 percent in private banks, 20 percent in government-owned banks, and 26 percent in insurers.

India strictly regulates asset allocation. Because of these policies, the central and state governments and their government-owned enterprises absorb 70 percent of all credit from banks and other financial institutions.

Excessive regulations have stunted India's corporate debt and equity markets as external financing sources for large private Indian firms. Consequently, these firms must rely on bank loans to a larger extent than similar firms elsewhere, crowding out small- and medium-size firms.

The McKinsey Global Institute reported that reforming India's financial system would increase the current size of India's economy by $47.3 billion and would boost India's potential real GDP growth rate to 9.4 percent a year over the next decade.

(4) International Trade and Investment Liberalization. In 2007, India reduced its peak import tariff rate on most non-agricultural goods to 10 percent. Nevertheless, import tariff rates on agricultural goods remain extremely high. India also retains significant non-tariff trade barriers including cumbersome customs procedures and weak enforcement of copyright protection for recordings and software.

India's international trade flows do not compare favorably with competing Asian economies. India's two-way goods trade as a percent of GDP was only 32.0 percent in 2005, lowest among the peer group. Despite its size, India accounted for only 1.3 percent of world goods exports and 1.6 percent of world goods imports in 2005.

Likewise, India trailed competing Asian economies in attracting foreign direct investment. From 1991 to 2005, India's average annual FDI inflows were equivalent to 0.7 percent of GDP. During the same period, China's average annual FDI inflows were equivalent to 3.6 percent of GDP. As a result, India accumulated a stock of FDI equivalent to 5.8 percent of GDP in 2005, the lowest among the peer group.

(D) Corruption. India ranked 70th of 163 countries in the *2006 Corruption Perceptions Index* compiled by Transparency International, tied with China. In *The World Bank Investment Climate Survey*, 38.1 percent of Indian firms cited corruption as a major obstacle to economic growth.

(E) Chronic Large Fiscal Deficits. In fiscal year 2006-07, the consolidated deficit for both the central and state governments was 6.3 percent of GDP. The relatively high fiscal deficits compared with the peer group limit the ability of central and state policymakers to fund education and necessary investments in infrastructure. High fiscal deficits may also deter some central policymakers from deregulating financial services.

Conclusion

Although its economy is booming, India must confront a number of challenges to sustain rapid economic growth over the long term. India's knowledge-intensive and capital-intensive industries cannot provide the millions of jobs that India's rapidly growing workforce will need in the future. India should encourage labor-intensive manufacturing to create jobs for these workers.

India must overcome a number of challenges to foster labor-intensive manufacturing and broaden economic prosperity. India's electricity supply is costly and undependable, and its transportation system is woefully inadequate. High adult illiteracy prevents many workers from benefiting from India's boom. Government-dominated banks and financial institutions are inefficient and allocate too much of India's saving based on political criteria. While India has liberalized its international trade and investment regime since 1991, India's economy is still too insulated from international competition. Corruption remains widespread.

Since 1991, the Indian people have supported an economic transformation from socialism toward capitalism through their democratic institutions. If central and state policymakers exercise leadership and address these remaining challenges, India will become a far more important trade and investment partner to the United States in the future than India has been in past decades.