

THE INFORMATION TECHNOLOGY AND INNOVATION FOUNDATION

# THE INDIAN ECONOMY AT A CROSSROADS

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Executive Summary



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## EXECUTIVE SUMMARY

India's embrace of economic and trade liberalization reforms in the early 1990s—particularly de-licensing, the privatization of state-owned enterprises (SOEs), and liberalisation of trade and foreign direct investment (FDI)—contributed to two decades of turbocharged economic growth that gave rise to the so-called “Indian Economic Miracle.” In fact, the Indian economy grew 40 percent faster per year in the two decades that followed the 1991 reforms than it did in the two decades preceding it. Unfortunately, over the past several years, Indian economic growth has stagnated, and the momentum for continued liberalization has waned. In fact, in 2012, Indian economic growth slowed to 4.9 percent—the lowest level in a decade—and while India's economy rebounded modestly to finish 2013 with 5.9 percent growth, the International Monetary Fund predicts that India's economic growth will slow to 4.3 percent in 2014. Given this, the roughly 10 percent annual growth associated with the Indian Economic Miracle of the 1990s and early 2000s appears to be an increasingly distant memory. Yet even as India's policymakers must contend with slowing economic growth, they are also concerned by a current account deficit that has reached \$325 billion, persistently high unemployment and inflation rates, and a looming “demographic dividend” that will bring over 110 million new Indian citizens into the country's workforce over the coming decade.

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*The best way for India to sustainably grow its economy is by encouraging market-based competition, including among domestic and foreign competitors, embracing an across-the-board productivity growth strategy, and investing in the innovation potential of its economy.*

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At the same time, India's economy and its enterprises face significant international competition. In particular, as the race for global innovation-based economic growth has intensified, some countries have increasingly turned to using trade-distorting “innovation mercantilist” practices such as mandating local production or technology transfer as a condition of market access, manipulating currency and technology standards, and disadvantaging foreign competitors to gain advantage.

Both pressured by and perceiving the “apparent success” of such trade-distorting practices in countries such as Brazil and China, recently India has turned to innovation mercantilist measures of its own, as evidenced by its Preferential Market Access (PMA) rules (local content requirements for public procurement of information and communications technology (ICT) products), compulsory licenses on foreign biopharmaceutical intellectual property (partly justified on the basis that those products are being inadequately manufactured in-country), and restrictions on market access and FDI in sectors such as e-commerce, retail, and financial services.

These mercantilist measures appear to be driven at least in part by a belief among Indian policymakers that the best approach to simultaneously creating jobs and reducing India's current account deficit is to maximize manufacturing growth while simultaneously restricting productivity growth in other sectors. The latter is evidenced by the restrictions on FDI in sectors, such as retail, that would boost chronically low Indian productivity. It's also evidenced by India's National Manufacturing Plan (NMP), which calls for the creation of 100 million new manufacturing jobs in India in this decade and an increase in manufacturing's contribution to Indian gross domestic product (GDP) from 16 to 25

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percent. The plan calls for Indian-owned manufacturers to produce a greater share of the manufactured products consumed in India and to contribute to increased exports. And while the NMP does contain a number of constructive and needed policy reforms—including easing regulations and investing in infrastructure, technical skills, and the productivity potential of small manufacturers—it also calls for significant use of trade-distorting policies.

To be sure, manufacturing will play an important role in generating sustained Indian economic and employment growth, but Indian policymakers are pursuing an economic growth model too one-dimensionally focused on manufacturing-based growth and not sufficiently focused on productivity-based growth across all sectors of India's economy, including also in agricultural and services sectors. Moreover, India's recent implementation of trade-distorting practices across a range of sectors will harm many Indian producers and consumers.

While such trade-distorting policies do promise to deliver some short-term gains for nations in employment and economic growth, ultimately they constitute a flawed approach because they lead to a number of adverse consequences. First, they raise the cost of key capital goods, such as for ICTs, which reduces capital goods use by the majority of industries, lowering innovation and productivity. Second, they limit countries' participation in global value chains for the production of high-technology products. Third, they can lead to broad economic inefficiencies. Fourth, they cause reputational harm that can damage a country's attractiveness as a location for foreign direct investment. Fifth, they tend to isolate nations from the global economy while often failing to achieve their intended aims. Sixth, such policies are fundamentally unsustainable, in part because they: a) reciprocally engender protectionist policies by other nations; b) can't be sustained by the global economy; and c) lead to unbalanced and unsustainable "dual economies" in countries implementing them.

Rather, a recommitted and indeed expanded embrace of competitive markets, open trade, and economic liberalization, coupled with the adoption of strong productivity- and innovation-enhancing policies—including investment in education, research, physical and digital infrastructures, and technology adoption and commercialization—will prove a far more effective path for broad and sustainable economic and employment growth for India.

To reinvigorate sustained and robust economic growth, Indian policymakers' foremost focus should be on: 1) raising productivity across all sectors of India's economy and 2) implementing stable macroeconomic policies that create the right environment for enterprises to grow; 3) investing in the productivity and innovation potential of Indian enterprise and industries. Regarding the first priority, productivity growth—the increase in the amount of output produced per a given unit of effort (labor and capital)—is the most important measure and determinant of economic performance for any nation. Yet, in 2012, overall productivity rates in India stood at just 10 percent of U.S. levels and significantly trailed those of most peer developing countries, including Brazil, Russia,

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China, and Malaysia. Yet broadly raising productivity is the only real path to improved living standards and moving from being a developing to a developed economy.

However, too many elected officials and even some business leaders and policymakers in India believe that the key task of creating jobs for the massive numbers of citizens entering into India's labor force will be made harder, not easier, by higher rates of productivity growth. Such individuals often adhere to the "lump of labor" fallacy—the concept that there is a limited amount of work to be performed and that any increase in productivity will mean fewer jobs. But the scholarly literature is clear that strong productivity growth has no negative effect on job growth. In contrast, if India wishes to create jobs while also raising wages and incomes, productivity growth is the only path. As Badri Rath and S. Madheswaran conclude in *Productivity, Wages and Employment in Indian Manufacturing Sector: An Empirical Analysis*, "labour productivity growth [is] the only route to enhance labour welfare in the long run."<sup>1</sup>

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*Increasingly Indian policymakers are pursuing an economic growth model too one-dimensionally focused on manufacturing-based growth and not sufficiently focused on productivity-based growth across all sectors of India's economy.*

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Economies can increase their productivity levels in two ways: either through the "growth effect"—through which all sectors of an economy become more productive—or the "shift effect"—which occurs when low-productivity industries lose share to high-productivity industries. But the lion's share of productivity growth for almost all nations—especially a nation with an economy as large as India's—comes not from changing the sectoral mix to higher-productivity industries, but from all industries and organizations, even low-productivity ones, boosting their productivity.

But despite this, many Indian policymakers—just like many economists in the international development field—appear to have erroneously bought into the perception that changing a country's sectoral share from one of low-productivity industries to high-productivity industries is a better growth strategy than boosting productivity across-the-board.<sup>2</sup> This is a key reason why Indian policymakers have sought to bolster high-tech manufacturing and boost manufactured exports (incorrectly believing in the latter case that high export levels are correlated with lower rates of unemployment).

Yet while Indian policymakers are understandably concerned about creating rewarding jobs for the more than 110 million citizens who will enter India's workforce over the coming decade, the reality is that if Indian policymakers can just create the stable expansionary macro- and micro-economic conditions in which growth can flourish, the Indian economy will be able to create all the jobs it needs. In other words, an increased supply of workers will create demand for new goods and services, which in turn will create jobs. India's workers will demand more housing, transportation, education, health services, financial services, retail, groceries, entertainment, hospitality, etc., thus creating jobs across all these sectors. Those new workers will create more wealth through their work, and they will also receive payment for it that they will then spend on other goods. This additional spending creates even more demand, creating a virtuous cycle of self-reinforcing economic expansion.

## THE MODERN ECONOMY PATH

So what are the framework conditions and enterprise support policies India needs to ensure robust productivity and employment growth? Perhaps the best way to think about the needed policies is to envision a four-level pyramid (Figure ES-1). At the base level are key framework conditions such as the rule of law, ease of doing business, competitive markets, flexible labor markets, effective protection of property, including intellectual property, and a culture of trust. Without these key framework conditions, even the most sophisticated innovation and industrial policies will not succeed. The next level includes an effective tax, trade, and investment environment. Key considerations here are establishing a globally competitive tax environment and implementing policies that encourage trade and foreign direct investment. Regarding FDI, India wins if it plays an attraction strategy, not a compulsion strategy, especially since many global corporations are actively seeking an alternative investment location to countries such as Brazil and China which have embraced innovation mercantilist policies.

After these factors are in place, nations need to focus on supporting the kinds of external factors firms need in order to succeed. These include robust physical and digital infrastructures; a skilled workforce with broad-based general capabilities as well as the specialized skills matching the needs of key industries; and robust knowledge creation (e.g., investment in science and technology). But even these are not enough. Indeed, with more nations realizing that mastery of these three levels is needed just to “be in the game,” success requires going to a fourth level that includes effectively crafted innovation and productivity policies specifically tailored to a country’s competitive strengths and weaknesses. Policies here include provisions such as R&D tax incentives, support for regional innovation clusters, and support for innovative small businesses.

This report comprehensively addresses how India fares vis-à-vis key competitor nations across each of these policy areas, and notes both where Indian policies are either strong or have opportunity for improvement.



Figure ES-1: The Economic Growth Pyramid

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## POLICY RECOMMENDATIONS

ITIF recommends Indian policymakers implement the following policy recommendations to reinvigorate robust, sustained economic growth. The recommendations are grouped into three categories: 1) overarching domestic; 2) specific domestic; and 3) international.

### 1) Overarching Domestic

- Improve the process of Indian interagency communication and coordination in the development and promulgation of administrative and agency rulemaking, including increased transparency and mechanisms for soliciting stakeholder input.
- Bring increased clarity and certainty to India's regulatory environment across national, state, and regional levels.
- Appoint a National Productivity Commission (modeled on Australia's).
- Establish a Best Public Policies Practices Council that identifies effective economic growth policies and practices in India's states and promotes them at the national level across India.

### 2) Specific Domestic

- Fully repeal the Preferential Market Access (PMA) policy.
- Replace proprietary conformity assessment regulations on ICT products with a policy that accepts reports from reputable international laboratories regarding ICT certification.
- Implement the Goods and Services Tax (GST) and bring stability to the corporate tax code.
- Reform labor market laws to allow greater labor market flexibility.
- Implement "single window clearance" to streamline the 70-odd clearances investors currently need into a single form.
- Reform business registration procedures to allow businesses to use the Internet to register a business in one day.
- Allocate additional resources to IPR enforcement activities.
- Improve efficiency in ports by introducing a digital customs process to ensure easy and streamlined movement of goods across Indian borders.
- Allow 100 percent foreign ownership in more industries including accounting, banking, legal services, life sciences, and retail trade, among others.

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### 3) International

- Join international negotiations seeking to expand product coverage of the Information Technology Agreement (ITA).
- Complete a U.S.-India Bilateral Trade and Investment (BIT) Agreement to promote foreign direct investment in India.

### VISION OF THE FUTURE

Despite what some economists might say, there is no reason why India cannot regain the economic growth rates it enjoyed in the 1990s. If Indian policymakers are able to implement the needed reforms, including those listed in this report, what could Indian citizens expect their economy to look like within a decade?

- India increases its average annual labor productivity growth rate from the 4.9 percent it achieved over the past 15 years to 7.3 percent.<sup>3</sup>
- Real Indian GDP per capita grows by 300 percent over the coming decade. In 2002, Indian GDP per capita in current U.S. dollars equaled \$485.60; by 2012 it had grown to \$1,489.20, an increase of 207 percent. India should aspire to at least triple that level of per capita income over the coming decade, pushing per capita incomes close to \$5,000.
- India creates gainful employment for the over 100 million citizens entering its workforce as part of the demographic dividend.
- India reverses its \$325 billion trade deficit and runs a balanced current account.
- In a decade, India becomes the one of the top ranked developing economy in the World Bank's "Doing Business" index.
- India raises its national R&D intensity from the 0.85 percent of GDP to 2 percent.
- India surpasses China in terms of annual FDI as a share of GDP.

If India is to realize its extraordinary economic potential, lift hundreds of millions out of poverty, and successfully address the looming demographic dividend, policymakers need to think anew and adopt a bold economic growth strategy: a modern economy path based on robust across-the-board productivity growth across all agriculture, manufacturing, and service sectors achieved by applying a comprehensive growth pyramid of policies.

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## ENDNOTES

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1. Badri Narayan Rath and S.Madheswaran, “Productivity, Wages and Employment in Indian Manufacturing Sector: An Empirical Analysis,” (Bangalore, India: Institute for Social and Economic Change, 2005), [http:// www.hss.iitb.ac.in/ties07/paper/ts5/psB/2.doc](http://www.hss.iitb.ac.in/ties07/paper/ts5/psB/2.doc).
2. Such thinking has a long tradition, including going back to Albert O. Hirschman’s *Strategy of Economic Development*.
3. The Conference Board, “Total Economy Database, Summary Statistics 1966-2013,” (New York: The Conference Board, January 2013), 10, <http://www.conference-board.org/data/economydatabase/>.



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## ABOUT ITIF

The Information Technology and Innovation Foundation (ITIF) is a Washington, D.C.-based think tank at the cutting edge of designing innovation strategies and technology policies to create economic opportunities and improve quality of life in the United States and around the world. Founded in 2006, ITIF is a 501(c) 3 nonprofit, non-partisan organization that documents the beneficial role technology plays in our lives and provides pragmatic ideas for improving technology-driven productivity, boosting competitiveness, and meeting today's global challenges through innovation.

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