A Failure on the Policy Front

*Nirupam Bajpai and Jeffrey D. Sachs say we need to rethink everything*

INDIA could have achieved what China has achieved in export growth, but India failed in basic policy strategy: China's export growth was based on core policy and economic management decisions, carried out beginning in the early 1980s.

These can be summarized as follows. First, China understood that the root of export growth would be diversification away from traditional sectors, especially raw materials, into non-traditional sectors, especially manufactured goods.

But China lacked the technology by itself to be an effective competitor in manufactured goods. Therefore, it invited foreign direct investors to provide the capital and the expertise to achieve export competitiveness in a wide range of sectors, including electronics, apparel, plastic toys, stuffed animals, ceramics, and many other labour-intensive sectors.

In each sector, the key was to link foreign investor capital and expertise with a large and low cost Chinese labour force.

The foreign investors brought in the product design, specialised machine tools and capital goods, key intermediate products, and knowledge of world marketing channels.

The Chinese assured these foreign investors with regard to certain key conditions for profitability, such as low taxes, reliable infrastructure, physical security, adequate power, decent logistics for the import and export of goods, and so forth. At the centre of China's export strategy were the special economic zones (SEZs) in which favourable export conditions were assured:

These SEZs, along China's coastline, were designed to give foreign investors and domestic enterprises favourable conditions for rapid export promotion. All key aspects of the export environment were secured. Exporters, for example, were allowed to import intermediate products and capital goods duty free. They were also given generous tax holidays.

The exporters were assured decent physical infrastructure, often through the provision of land, power, physical security, and transport to the ports, within specially created industrial parks.

India too has experimented with special zones, mainly export processing zones (EPZs), but one has to say that India's approach to export zones has been one of relative neglect rather than support. While China's five main special economic zones (Shenzhen, Zhuhai, Santou, Xiamen, Hainan) exported $26 billion in 1994, roughly 22 per cent of the national total, India's main export processing zones, or EPZs (Kandla, Santacruz, Noida, Madras, Cochin, and Falta), managed a tiny fraction of that, both in absolute levels and as a proportion of total Indian exports.
India's export processing zones have not performed as well as those in China's for a variety of reasons. These include:

- limited scale and overcrowding of the EPZs;
- insufficient logistical links with airports and seaports;
- poor infrastructure in areas surrounding the zones (e.g. unpaved roads and poor physical security);
- government ambivalence and red-tape regarding inward foreign direct investment;
- unclear incentive packages governing inward investment;
- lack of interest and authority of state and local governments, and the private sector, compared with the central government, in the design, set-up, and functioning of the zones.

In China, the major responsibility for the export zones rests with local and provincial governments, whereas in India, the responsibilities remain heavily with Delhi:

Under the present circumstances, many state governments have actually been averse to the idea of EPZs in their state.

India's export environment suffers from several other institutional weaknesses. India's labour laws, noted unfavourably in the 1998 Global Competitiveness Report (GCR), make it very costly to fire workers in enterprises of more than 100 workers.

The result is that formal-sector, firms (those that are registered and pay their taxes) are loath to take on any new employment, and the vast majority of India's employment is informal, in small, tax-evading, inefficient enterprises. Equally remarkably, India's legislation continues to restrict the entry of large firms, or the growth of small firms into large firms, in several areas of potential comparative advantage.

Thus, such items as garments, toys, shoes and leather products continue to be reserved, to a varying extent, for small-scale producers.

Such restrictions virtually assure China's dominance in these sectors compared with India.

India's tax and tariff structures similarly remain anti-export biased. India's high overall tariff rates, especially tariffs on intermediate products that are used by exporters, impose a heavy indirect tax on export competitiveness. Furthermore, the Union budget for 1998-99 has imposed an additional non-modvatable levy of 8 per cent on imports. There are duty drawback systems to reduce this anti-export bias, but such programs are administratively burdensome and often too costly to use effectively.

Finally, the regulatory attitude to foreign direct investors, who could be the fuel for India's export drive, continues to be ambivalent.

The government promotes foreign direct investment on the one hand, but then maintains regulations against full foreign ownership, or insists on long drawn out approval processes for such
ventures, on the other. The proper elements of the first-prong of a revised growth strategy - rapid export-growth - should now be clear.

Both the hardware and software of export-led growth need revamping. On the hardware side, the development of industrial parks for exports should be greatly intensified and enhanced. Private developers need the freedom to acquire urban and peri-urban land and to develop privately financed infrastructure in support of exports.

The government must take urgent measures to reduce, export costs, including private-sector provision of port services; zero tariff ratings on capital and intermediate goods imports used for export (based on an effective duty exemption scheme); enhanced export-oriented infrastructure, especially roads to the airports, reliable power supply, and telecommunications facilities to support export zones.

Labour legislation should be also revised to allow managerial flexibility in the hire and dismissal of workers in export-oriented sectors.

The reservation of labour-intensive sectors to small-scale enterprises should simply be scrapped. This is the ‘kiss of death’ to effective international competitiveness in labour-intensive exports.

The government should actively encourage inward investment in export-oriented sectors, allowing 100 per cent foreign ownership without administrative interference, and with the provision of generous tax holidays. All this is as necessary to attract internationally mobile capital from other locations.

We must mention, in addition to labour intensive manufacturing exports, India's clear and growing capacity in service sector exports based on information technology (IT).

The Global Competitiveness Report confirmed the high international opinion of India's engineering and scientific capacities, the products in part of India's long term investments in the Indian Institute of Technology (IIT).

India's prowess has been most evident in the software sector, where world-class programmers operate in technology centres such as Bangalore, Delhi, Mumbai, and Chennai.

Operating through satellite links, Indian programmers are providing IT support to US and European firms in areas ranging from software development and maintenance, back-office operations, data transcription and transmission, telemarketing, and other relaxed areas.

Software exports have been growing around 50 per cent per year in recent years, reaching an estimated $1.75 billion in fiscal 1997-98, or roughly 5 per cent of merchandise exports, a proportion that is likely to rise significantly in the years ahead (by some estimates to around 10 per cent in the year 2000).

Around 10 per cent of Microsoft's programmer workforce round the world is composed of Indians.
Here, as in labour-intensive exports, Indian government policy could do much more to spur export growth.

On the plus side has been the government's long-term commitment to the IIT. More recent has been its support for Software Technology Parks (STPs), in Bangalore, Pune and other cities, which are the IT industry equivalent of the EPZs in manufacturing industries.

There are serious negatives; however. The continuing state monopoly of Videsh Sanchar Nigam Ltd (VSNL) in international telephony as well as in Internet provision within the Indian market seriously raise the costs of telephone and IT services in the country, and will do considerable damage in India's international competitiveness in the IT sector unless rectified. India's telephone density (a point we re-visit later on) is abysmally low, at around 1.3 per hundred in 1995, compared with around 62.6 per hundred in the United States.

International telephone calls originating in India are among the highest in the world, largely due to lack of competition. Physical infrastructure for data transmission within India (e.g. fiber optic cables) remain underdeveloped despite some recent progress.

Restrictive government policies on foreign investment of the sort already discussed have kept international chip makers out of India, and have indirectly raised the prices of PCs in the Indian market.

The lack of enforcement of intellectual property laws most likely inhibits inward investments in IT sectors.

All of these problems are remediable through further deregulation of telecommunications and FDI, as well as effective law enforcement in a more liberalised and competitive environment. India's strengths in IT will be an important bulwark of export growth for many years to come assuming that the administrative barriers are overcome.

The second prong: rural improvement There is no doubt that geography heavily influences economic performance.

In China, for example, the real economic success has come in the coastal provinces, which can take advantage of the export-led growth.

The interior has done fared less well. GDP growth in the hinterland has lagged behind the coastal states by several percentage points per year.

The discrepancy in performance is leading inevitably to massive internal migration, with perhaps 100 million or more Chinese engaged in rural to urban migration, much of which is from the interior of China to the coastal states.

In India as well, it is likely that a successful growth strategy will also result in differing performance among India's very disparate regions.
Not all regions, for example, will be able to take advantage of export-led growth to the same extent. As a general matter, coastal states in India will have an advantage over interior states, just as in China.

We might expect, therefore, that the hugely populous, mainly rural, and inward-oriented Gangetic states, especially Uttar Pradesh and Bihar, would lag behind the more outward-oriented coastal states such as Gujarat, Maharashtra, and Tamil Nadu, in export-led growth. It is too early to draw strong conclusions about relative economic performance since the start of India's market reforms at the beginning of the 1990s.

Nonetheless, the early evidence is tantalising. If we look at the rise of domestic output per capita between fiscal year 1990-91 and 1994-95 (the most recent state level data at our disposal from CMIE), the all-India figure in rupees went up from Rs 5,073 to Rs 8,399, a rise of 65.5 per cent.

In Uttar Pradesh, the increase was 52.3 per cent; in Bihar, 25.9 per cent; in Gujurat, 78.8 per cent; in Maharashtra, 78.0 per cent; and in Tamil Nadu, 76.3 per cent.

Fortunately, there is scope for greater economic reform to improve the conditions in rural India, especially in the Gangetic valley.

There is no reason for expensive and counter-productive charity for these great northern states, and still less any case for holding back the fast growing coastal regions. Perhaps the key step in the Gangetic plain is to improve the most basic infrastructure so that the vast rural populations can take part in more rapid national economic growth.

They will do so through increased exports to coastal states, and greatly improved productivity for local production. We should stress that while China's hinterland has lagged behind the coastal regions, the Chinese hinterland, too, has enjoyed rapid economic growth.

The 1998 GCR highlighted one of the great liabilities of India as a whole, and of rural India in particular: the disastrous state of physical infrastructure.

Once again, the comparison of the Gangetic states and the others, is telling. In every infrastructure dimension, the northern interior states are in dreadful condition. Per capita power consumption (in Kilowatt hours) in 1994 was 82 in Bihar and 181 in Uttar Pradesh; compared with 549 in Gujurat, 483 in Maharashtra, and 393 in Tamil Nadu.

Unsurfaced roads were an astounding 62 per cent of total road length in Bihar in 1994 and 45 per cent in Uttar Pradesh; compared with 12 percent in Gujurat, 27 percent in Maharashtra, and 32 per cent in Tamil Nadu.

In telecommunications, there were 3 telephone lines per 1,000 people in Bihar in 1995 and 5 in Uttar Pradesh compared with 18 in Gujurat, 29 in Maharashtra, and 17 in Tamil Nadu. Of course, these differences did not emerge in 1991, but rather have a long legacy.
For example, in 1991, literacy rates in the Gangetic states lagged far behind the others: 38.4 per cent in Bihar and 41.6 per cent in Uttar Pradesh compared with 61.3 per cent in Gujarat, 64.9 per cent in Maharashtra, and 62.7 per cent in Tamil Nadu. The differences are likely to grow, however, unless adequate policy reforms are undertaken.
## Economic Performance of China and India

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<thead>
<tr>
<th></th>
<th>GNP per capita</th>
<th>Exports (Bn $) (excluding services)</th>
<th>Trade (% of GDP)</th>
<th>Exports of goods &amp; services (% of GDP)</th>
<th>Exports per capita $ per person</th>
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<tbody>
<tr>
<td>China</td>
<td>620</td>
<td>8.3</td>
<td>18.1 148.8</td>
<td>13 40</td>
<td>6 21</td>
</tr>
<tr>
<td>India</td>
<td>340</td>
<td>3.2</td>
<td>8.6 30.8</td>
<td>17 27</td>
<td>7 12</td>
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Notes:
- Column I: This measures the total domestic and foreign value added claimed by residents. It comprises GDP plus net factor income from abroad. GNP per capita is calculated using the resident population in the corresponding year.
- Column II: This represents the value of all goods provided to the rest of the world.
- Column III: This represents the total of all imports and exports of goods as a proportion of the gross domestic product.
- Column IV: This represents the value of all goods and nonfactor services provided to the rest of the world. This includes the value of merchandise, freight, insurance, travel, and other nonfactor services. The value of factor services, such as investment income, interest and labor income, is excluded. Current transfers are also excluded.
- Column V: This represents the value of all goods exported per person.

**Source:** World Development Report, 1997, The World Bank