

South Asia

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Productivity - the key to India's growth

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Sustainable economic growth is about raising productivity. Labor is one resource that India has in great abundance. In fact, virtually an entire Australian population is added each year to that of India's. Unfortunately, however, that population lives for the most part in absolute poverty. A recent International Labor Organization (ILO) study estimated that half of the world's working population lives on less than US\$2 per day and a large number of them are in India.

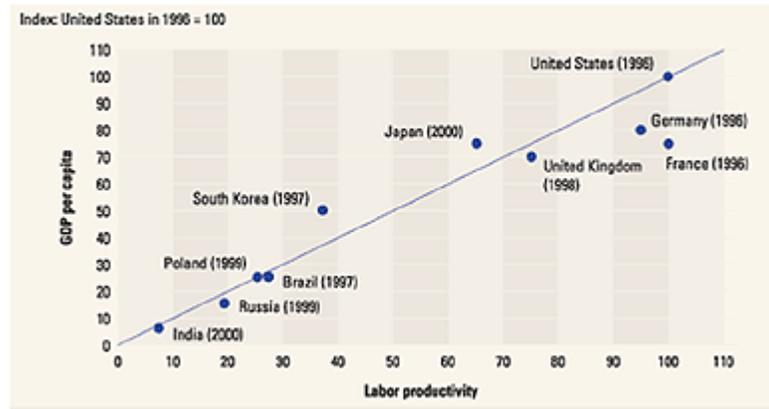
What explains the massive difference in income among various countries? Nobel laureate Edward Prescott and Stephen Parente in *Barriers to Riches* argue that massive income differences between developed and developing nations are explained by the differences in total factor productivity (TFP). Differences in TFP occur because of barriers to efficient use of technology which protect certain interests. These differences in TFP are consequences of the differences in knowledge individual societies apply to production of goods and services. Once these barriers are removed, the whole world would be equally rich, argued Prescott and Parente.

Admittedly, knowledge of technology is important, but poor countries do not need to create new ideas for the production of goods and services. They only need to apply the existing ones. However, it is the policy barriers that prevent adoption and efficient use of technology, leading to differences in TFP. Even relatively small differences in TFP of just one-third can lead to changes in the gross domestic product (GDP) of the order of more than one-twentieth.

Importance of productivity				
Savings rate & its relation to productivity as opposed to TFP and its relation to GDP				
Savings rate as				
fraction of GDP	Relative income level	Relative TFP	Relative GDP	
0.1	0.79	1	1	
0.2	1	0.5	0.13	
0.3	1.15	0.33	0.03	
0.4	1.26	-	-	

Source: *Barriers to Riches*, Prescott & Parente, MIT Press

According to a McKinsey report, per capita GDP is widely regarded as the best single measure of economic well-being. That measure is simply labor productivity (how many goods and services a given number of workers can produce) multiplied by the proportion of the population that works. This proportion varies around the world though, interestingly, not by much. Productivity, however, varies enormously and explains virtually all of the differences in per capita GDP.



Source: McKinsey

The Indian economy experienced jobless growth in the 1980s and the 1990s. Employment - in the organized sector only - numbered around 28 million people in the beginning of the 1990s and possibly stands at about 27 million now. Of this, as many as 20 million are in government and public sectors. So what explains the stagnation of employment in the organized sector?

It is the path of development that India followed after independence. Socialist employment laws and enforcement structures ensured that employment was not created in the over-regulated organized sector, but in the unorganized or informal sector. Though comprehensive data on the unorganized sector is not available, the report on the informal sector by the National Sample Survey Organization for 1999-2000 reveals that employment in the unorganized sector totaled about 80 million. Of these, 30 million were in manufacturing and 28 million in trading and repair. Next year's report pegged the number of employees in the unorganized manufacturing sector at 37 million - 7 million more than in 1999-2000. In all probability, at least 100 million Indians are employed in the informal sector by now.

The estimated value-addition by the unorganized sector as per the survey of 1999-2000 works out to little over 11% of the country's GDP in that year. Even if we consider this figure to be about 20% (assuming the estimate to be understated), this still means that 80 million people in the unorganized sector produced 20% of GDP, while the organized sector (with 27 million employees) produced 60% of GDP in that year, with agriculture accounting for the balance at 20%. Clearly, the per capita value-addition by the unorganized sector is a fraction of the value added by the organized sector, indicating a substantial difference in productivity in the two sectors.

Economic progress depends on increasing productivity, which in turn depends on undistorted competition. When government policies limit competition, even unintentionally, more efficient companies can't replace less efficient ones. Economic growth slows and the country remains poor. A study of the trend in the TFP growth in India is quite a revelation. Protection from international competition had a depressing effect on TFP growth in India during 1960-70. The TFP environment, however, has seen changes in the past 20 years. Since the early 1980s, India has carried out some degree of reforms and liberalization. This process was accelerated during the 1990s. Consequently, certain restrictive regulations that had earlier suppressed efficiency disappeared or were diluted significantly. Foreign technologies and efficient practices began to trickle in and the removal of import barriers and entry restrictions after 1991 unleashed competitive forces. The disappearance of government protection and the reality of foreign competition forced Indian entrepreneurs to seek urgent measures for cost-effectiveness. The years since the early 1980s have also produced faster average growth, a clear indication of invigorated TFP forces.

1976-77 to 2000-01	2.07	5.07
1976-77 to 1979-80	-0.73	2.12
1980-81 to 1988-89	2.68	5.52
1989-90 to 1991-92	1.59	4.40
1992-93 to 1996-97	3.00	6.47
1992-93 to 2000-01	2.85	6.15

Source: Survey report on Total Factor Productivity Growth, 2001-02, Asian Productivity Organization Note: Without adjustment in capital stock for capacity utilization.

[1] The choice of periods for computing the averages takes into consideration the unique economic and political conditions prevailing in the Indian economy in the respective periods. For example, the periods 1976-77 to 1979-80 and 1989-90 to 1991-92 had political and economic disturbances and uncertainties, whereas 1980-81 to 1988-89 and 1992-93 to 1996-97 were periods of reform and more rapid industrial and economic growth. The table shows that the annual average of TFP growth rates exceeded 2% in both the 1980-81 to 1988-89 and 1992-93 to 2000-01 periods, which were reform periods.

The development of the Indian automotive sector over the years is a case in point. Twenty years ago, two monopolistic carmakers - Hindustan Motors and Premier Automobiles Limited (PAL) - dominated the market and offered a handful of outdated models. In 1983, the government allowed Suzuki Motor to take a minority stake in a joint venture with small state-owned automaker, Maruti Udyog. In 1992, nine more foreign automakers were allowed to invest in India. This infusion of new capital and technology created serious competition for the two erstwhile leaders, eventually forcing PAL out. The industry, one of the fastest growing in the world, now produces 13 times more cars than it did 20 years ago. Tata Motors hit a milestone in 2004 by exporting 20,000 cars to the United Kingdom, to be sold under the MG Rover brand. Total Indian automotive exports during the first eight months of the current financial year have already crossed 100,000 (the total number achieved last fiscal). Meanwhile, prices for Indian consumers have fallen by 8-10% annually, unleashing a burst of demand and allowing steady employment despite rapidly rising productivity. Along with the assemblers, successful component manufacturers and suppliers have come into being, enriching the industry even further.

Clearly, productivity is the key. At times, though, it might seem counter-intuitive as it can be argued that productivity would reduce employment. The fact is that the US is the most productive nation, but it does not have substantial unemployment. While unemployment rates in most nations are almost similar and ranges from 4-12%, it is the productivity difference that really makes the difference between national incomes.

Productivity is impacted by policies that distort competition. Why then are such policies so pervasive? For one, most governments favor the social objectives that inspire high minimum wages and lay-off hurdles. They may not be aware of the unintended adverse consequences that create major barriers to growth. Instead of attempting to achieve social objectives by limiting competition, countries should allow fair competition and thereby generate more national income, which can then be redistributed through taxes and government subsidies for the poor. Countries that follow bad competition policies also help the business elite. In developing countries today, every domestic firm is a potential special interest that stands to lose from more competition. These unproductive firms' workers often think, mistakenly, that they too stand to lose in the face

of competition. To have healthy economies, countries must allow unsuccessful owners and managers to fail so that more productive ones can take their place. In healthier economies, workers will find a better job market.

Take India's textile mills for example, which were done in by protectionist public policies. The Indian government has directly limited competition by insisting that several hundred consumer goods can be manufactured only in small-scale plants. As a result, Indian consumers pay higher prices than they should, and India, unlike China, hasn't been able to emerge as a global center of low-cost manufacturing. China, in fact, exports to India. Moreover, in housing construction, competition among developers and construction firms is based not on cost and productivity advantages but on gaining control of scarce parcels of land with clear ownership titles.

A decade ago, both India and China were poised on the brink of new prosperity. But while Chinese per capita GDP soared at the end of the 20th century, India stagnated, posting only 40% of China's growth - a clear indication of India's antiquated business policies and inadequate business environment that continue to stifle competition even now. According to a World Bank report on the Business Environment in 2004, it takes an average of 11 procedures and 89 days to start a business in India, compared with the regional average of 9 and 26 and the OECD (Organization for Economic Co-operation and Development) average of 6 and 25. For registering properties in India, it takes 6 procedures and 67 days as against the regional average of 5 and 55 and OECD average of 4 and 34. Enforceability of contracts is another major area of concern. The number of procedures counted from the moment the plaintiff files a lawsuit until actual payment is 40 in India and it takes 425 days for the same. The regional average is only 29 and 349 while the OECD average is even less at 19 and 229.

The 2001 McKinsey report proclaimed that India could grow at 10% if it focused on removing policy barriers to allow adoption of best technologies and processes to allow the increase of TFP and the growth rate. The report recommended removing licensing and quasi-licensing restrictions like reservations for small sectors, eliminating ambiguities in real estate, privatizing government companies and reforming labor laws. Dismantling barriers to economic growth may be difficult, as the short-term effect of transition can be painful, but keeping in mind the long-term benefits, that's a small price to pay.

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