India’s manufacturing sector: New policy, no progress

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LSE’s Rajeev Sibal argues that India’s new manufacturing policy will fail to spur sectoral growth owing to characteristics of India’s labour force, complex regulation and a lack of political will to address the complex realities of doing business in India.

Indian economic planners dream that one day India will become a manufacturing hub for the world and that manufacturing will drive broad-based development, as it did in East Asia. So it is no surprise that the government has again concocted a new Manufacturing Policy. The 2011-12 version aims to raise the sector’s GDP contribution from 15 per cent, where it has lingered for decades, to 25 per cent. Unfortunately, the characteristics of India’s labour force, complex regulation and the lack of political will are likely to prevent this goal from being realised.

Manufacturing growth would be ideal given India’s population size. In fact, from a Ricardian perspective, it is confounding that India has yet to develop a globally competitive manufacturing sector. To understand why, one must look beyond Ricardian paradigms. The fact is, the Indian market structure and developmental model is not comparable to that of East Asia and the lofty expectations for the sector as laid out in the new manufacturing policy are unrealistic.

The new manufacturing strategy of the Ministry of Commerce’s Department of Industrial Policy and Promotion hopes Indian manufacturing will comprise 25 per cent of GDP and create 100 million new jobs within 10 years. National Investment and Manufacturing Zones (NIMZ), which are intended to mimic the successful model of Software Technology Parks of India, are at the centre of the plan. NIMZs are complemented by efforts to improve access to technology, training, infrastructure and regulation. All these elements are attempts to facilitate entrepreneurship in the sector.

From an economic standpoint, the policy is intended to unleash pent up productivity and enable the country to catch up with its “comparable” Asian neighbours. As the report puts it, “the increasing gap in the sectoral share and the productivity of the manufacturing sector, between India and [Asian] economies, indicates that we have not been able to fully leverage the opportunities provided by the dynamics of globalisation.” Such a perspective fails to recognise the inherent differences between India and its neighbours.

Certain characteristics are common to the East Asian growth stories. First, a cohesive political body drove state policy with state-business alignment. Second, the labour force was largely homogenised and firm-labour relations were not contentious, nor did they pose a constant threat to productivity. Third, firms were not protected by tariff barriers and had to compete in the global market on price (non-tariff barriers such as subsidies and currency devaluation are common strategies used in lieu of direct tariffs, but still force firms to compete on price, which drives efficiency). Fourth, East Asian development models left firms to make their own decisions by limiting formal regulatory requirements.

Unfortunately for India, few, if any, of the abovementioned characteristics apply. First, the Indian system of governance is highly divisive and fragmented; complex layers of government, especially across states, means that state-business relations are inconsistent and discordant. Second, the Indian labour force is comprised of multiple ethnicities, languages and union structures that antagonise firm-labour relations. Third, India is a heavy user of tariff barriers, which dis-incentivise price competition. To make matters worse, a culture of corruption and politicisation hinders tariff removal, even in the face of WTO accession. Fourth, and perhaps most importantly, India is home of the “license raj”—firms face onerous regulatory requirements in doing business, a legacy of historical models of development in India.

In addition to failing to take account of these ground realities, the new manufacturing policy is insufficiently different from previous policies. The new policy does little to unwind the domineering influence of state oversight. For example, the policy suggests that the digitisation of the 100-plus reports that must be filed annually by manufacturers will be a key enabler of growth. But digitisation does little to mitigate the burden of having to file such reports in the first place. Nor does it overcome the difficulty of complying with more than 70 legal requirements. Admittedly, electronic filing will help drive some profitability since it circumvents the need for bribes to be paid for paperwork processing, but the larger, structural problems in the sector will remain. Ultimately, the political will to create a functional market space in manufacturing is lacking.

Growth in any sector is dependent on both big and small firms finding new growth opportunities in the market. Firms need not only an amenable environment (for instance, of the sort envisioned in NIMZ) but also freedom. Current manufacturing policies constrain firm ability to be nimble and react promptly to market trends and opportunities. Moreover, the ease and ability to conform to government requirements is a function of firm size; put simply, big firms can comply while small firms cannot, making burdensome regulation a major barrier to growth in this sector.

Finally, the development state in India is a far cry from that which drove growth in East Asia. The East Asian model depended on economic stakeholders working in parallel, a condition that India's heterogeneity makes almost impossible. Despite the many points of divergence between India and East Asian countries, it seems the state will continue to pursue a model that is ill-suited to the Indian economy. It is a shame that brilliant concepts, such as NIMZ, will ultimately fail to deliver owing to a web of government regulation and the lack of political will to truly liberate the sector.

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