What Ails Manufacturing?

Poor Investment Climate and Bad Governance

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A high growth rate for the Indian economy cannot be sustained without a vibrant and growing manufacturing sector. A policy aimed at GDP growth based mainly on attracting investment in the services sector will not succeed. Moreover, a thriving manufacturing sector is vital for employment generation. Under these circumstances, reforms should be aimed at good governance and transparent and time bound decision-making.

The development experience of most countries, including Europe and Japan, shows manufacturing to be the main engine of growth. During periods of sustained rapid economic growth, the share of agriculture in national income and the share of agricultural employment in total employment decreases. The space vacated by agriculture is mainly occupied by manufacturing. The share of manufacturing in national income increases rapidly and then stabilises after reaching about 30 per cent. After this the service sector grows filling the gap left by manufacturing..

In the recent past the newly emerging high growth economies like China and East Asian countries have also been following the international trend. For China, South Korea and some East Asian countries the share of the manufacturing sector in the national income increased rapidly and stabilised only after it crossed 35 per cent. In these countries exports have also been led by manufacturing exports.

For India, the share of the manufacturing sector stopped growing even before it touched 20 per cent of the national income. India's growth has been mainly led by the growth in the service sector. This has prompted some to conclude that India is different from the rest of the world and the Indian growth can be sustained by the growth of the service sector. Several econometric studies show that manufacturing continues to be the engine of growth in India; growth led by services is not sustainable.

But does the growth of the service sector in India reflect actual growth? There are some peculiarities in the way service sector growth is reckoned. It is important to note that most advocates of services have high end services like banking, insurance and information technology in mind. These services are mostly in the organised sector and they do not constitute the bulk of the growing services. Furthermore, salaries paid by the governments (both centre and states) to their employees are also included under the service sector. This reflects in a higher growth of the service sector whenever the pay commission awards a higher pay for government employees. Thanks to this strange method of accounting, the growth of the service sector, in this case, does not reflect the actual growth. The unorganised sector occupies a prominent position in the service sector. This sector mainly constitute self employed poor persons who cannot afford to be unemployed, and who will, to avoid starvation, to self employment with low incomes. Clearly, the growth of this sector does not constitute development or prosperity. In fact, it reflects the opposite.

As some of the econometric studies show (Chakravarty and Mitra, 2009, Kathuria and Rajesh Raj 2013), even during the period of rapid growth of the service sector in India, it was the manufacturing sector that emerged as the main engine of growth. In particular, Kathuria and Rajesh Raj (2013) based on a study of several Indian States show that an incremental increase in the growth of the manufacturing sector leads to a substantial increase in the growth of income. The statistical results clearly showed that high growth of income through the growth of the service sector is not sustainable.

Liberalisation and Corporate Sector

India introduced internal deregulation in 1985 and a series of external liberalisation measures in early 1990s. During 1985, the Government of India introduced important policy changes aimed at improving the competitiveness and performance of the Indian firms. These reforms substantially deregulated the Indian industrial licensing system, allowed expansion of capacities without prior permission, liberalised the procedures for the import of capital goods and arm's length purchase of technology. This resulted in a substantial increase in investments, imports, and import of technology across all industries. The early 1990s saw the introduction of several external liberalisation measures like current account convertibility of the rupee, drastic reduction in import tariffs, liberalisation of FDI inflows and outflows. Several research studies show that these resulted in notable changes in the structure, conduct and performance of the Indian corporate sector (See Pandit and Siddharthan 1998 and 2009, Siddharthan and Pandit 1998). During the license and permit Raj of pre-1985 period, a prominent part of the corporate sector was owned and managed by large business houses belonging to traditional business families. After liberalisation new enterprises started by young professional entrepreneurs with technology background entered the corporate sector and achieved eminence. Few of these successful entrepreneurs came from business families. In the earlier regime the main entry barrier was the requirement of industrial licensing. During the 1990s the main prerequisite for success became technology and other intangible assets.

In recent years the investment climate has deteriorated and the share of manufacturing has stagnated. Before discussing the causes of stagnation of the manufacturing sector, it would be useful to examine the current global investment and trade regime and its implications for the manufacturing sector.

WTO Regime and Manufacturing Sector

The emergence of the World Trade Organisation (WTO) regime in 1995 has fundamentally changed the nature of manufacturing and the characteristics of the foreign direct investments (FDI) both inflows and outflows. The WTO regime drastically reduced import duties, abolished quotas and quantitative restrictions, discouraged local procurements and the favouring of local firms by the government agencies, and liberalised FDI inflows and outflows. Improved intellectual property protection has encouraged the licensing of technology.

FDI inflows in the current WTO regime are not of the tariff jumping type. While in the earlier regime foreign investments were mainly market seeking investments, in the current regime they were principally efficiency seeking investments. Foreign firms would invest in India if they considered India efficient for manufacturing purposes. Likewise Indian firms would not invest in India, but instead, would invest in other countries and import the manufactured goods into India

The share of manufacturing in FDI inflows was more that 60% in early 2000; it came down to about 40% in 2005 and further down to 20% in 2008 (Rao and Dhar 2011). So the decline of manufacturing sector is reflected in the FDI inflows. Currently 'construction and real estate' attracts as much FDI as manufacturing and they come mostly from tax heavens.

Poor investment climate is also reflected in FDI outflows from India. A substantial part of FDI outflow from India is in manufacturing. Medium sized enterprises dominate investments abroad and this is due to a combination of push and pulls factors. They have been setting-up manufacturing units in Asian countries where the investment climate is better, and importing the goods back to India.

Growth of Manufacturing: Two Sets of Constraints

Two sets of factors stand in the way of the growth of manufacturing in India. They also inhibit FDI inflows and encourage FDI outflows from India. They are (1) poor physical infrastructure and (2) bad governance. These two reinforce one another. It is common knowledge that Indian physical infrastructure like roads, railways, ports and electricity are bad compared to our Asian competitors like China and East Asian countries.

The deficiencies in Indian infrastructure are not merely because of insufficient investment in these sectors. It is also due to corruption in high places. It is widely believed and reported in the media that only a fraction of the allotted money is spent on the laying of roads or other targeted projects. In the case of electricity coal blocks were given to firms at concessional rates on the condition that they would supply coal to electricity generating units. Several of these coal blocks have yet to fulfil their promises and supply coal. The result is a huge electricity shortage resulting in power cuts and power holidays for industrial units. Most large units have gone in for captive electricity plants that have pushed up the costs and made our manufactures uncompetitive.

The situation is worse for smaller enterprises that cannot even afford the captive electricity generation units. Likewise the turnaround time for ships in Indian ports compares very unfavourably with other Asian countries. Further, most Indian ports do not have X-ray machines for containers resulting in time consuming physical examination of the contents of the containers.

These and other factors make manufacturing expensive and uncompetitive. It is hardly surprising that India's rank is 59 out of 144 countries (2012-13) in the global competition index and compares very poorly with most high growth Asian economies.

The World Bank (Batra, Kaufmann and Stone 2003)'s survey of investment climate around the world captures companies perceptions of key constraints in the business environment – perceptions that shape operational and investment decisions – as well as several quantitative indices of companies experiences. The survey collected information on companies' perceptions on several variables representing corruption, judiciary, financing, infrastructure, policy instability, inflation, exchange rates, street crime, organised crime, anticompetitive policies and fiscal and taxation policies. Perceptions on India were not very different from those of other Asian countries except in the case of corruption, infrastructure, policy instability, customs delays, roads, electricity and water. In other words, what separated India from its Asian competitors (including China) were governance indicators. It was not fiscal and monetary policies that have placed India at a disadvantage but bad governance.

Role of Governance Factors

To better understand the determinants of investment climate in manufacturing let's analyse the relative importance of fiscal incentives and governance factors. In a study analysing FDI based on inflows from 12 source and 45 host countries, Wei (2000) found that corruption is as much if not more important in inhibiting FDI inflows than the increase in tax rates. Corruption index turned out to be important even after controlling for other determinants like GDP, population, political stability, wages and other control variables. The paper concludes, "...a one-step increase in corruption level is equivalent to a rise in tax rate by 7.5 percentage points, other things equal. An increase in corruption level from that of Singapore to that of Mexico has the same negative effect on inward foreign investment as raising the tax rate over 50 percentage points".

Governance infrastructure does not deal only with corruption. It consists of several other indicators like rule of law, political instability, violence, regulatory burden, government effectiveness, corruption and accountability. Globerman, and Shapiro (2002) considered all these governance indicators and analysed inter country FDI inflows and found governance indicators highly significant. In addition they also found education index important. In my view, education index also reflects good governance.

Studies show that corrupt countries not only receive less FDI but the investments they receive are mostly from other corrupt countries. Cuervo-Cazurra (2006), clearly show that corrupt countries (corruption indicators taken from World Bank publications) mainly receive funds from other corrupt countries that have neither technology nor other intangible assets to transfer. The result holds good even after taking into account all the standard determinants of FDI.

The study takes into account the following control variables: Population, distance between the two countries, landlocked countries, island nations, common border, common language, common colony, ever colonial line, restrictions on trade, and restrictions on FDI. The investment flows are merely parking of money from tax heavens and other such countries placed in speculative ventures in other corrupt countries. They normally go to real estates and construction. In India only 10 percent of FDI into real estate came from technology rich developed countries. More than 90 percent came from tax heavens and other such countries.

Thus in recent times, industrial climate changed drastically in India due to bad governance and all pervading corruption. In the last few years, major scams have broken out in resources sectors that are mainly owned by the government — like real estate, mining and ores, and spectrum. A number of individuals who have obtained government permission to enter and exploit these resource sectors have amassed billions of rupees. In other words, under the existing business environment, the path to amass wealth, it would appear, is not through manufacturing but through exploitation of resources under government ownership.

Mergers and Acquisitions

After the WTO regime came into existence, there has been a huge spurt in cross border and domestic mergers and acquisitions. As already discussed, in the pre-WTO regime, most of the FDI was of the market-seeking type. The objective was to jump import tariffs and sell in the host country markets. The WTO regime drastically reduced tariff rates, and abolished import quotas and encouraged exports rather than market seeking investments. Most FDI now is of an efficiency seeking type. This necessitated a drastic change in the location of industries. It was no more necessary to produce all products in all countries. Production in a particular country depended on efficiency and location advantages.

This new regime resulted in a huge wave of mergers and acquisitions. In the post-2000 era most FDI went into mergers and acquisitions and not for green field investments.

India also witnessed rapid growth in mergers and acquisitions during this period. Consequent to parent companies merging in Europe and the US, the Indian subsidiaries also automatically merged. Furthermore, Indian companies also merged with other Indian companies to achieve size advantages to face global competition.

Not all mergers and acquisitions helped the companies to be globally competitive. Impact of mergers depended on two factors: (1) mergers promoted by political contacts and, (2) level of corruption in the host and home countries. Brockman, Rui and Zou (2013), based on a sample across 22 countries found political connections played a significant role in the post merger performance of the companies. In countries with a good legal system and low levels of corruption politically connected mergers did not perform well. However, in highly corrupt countries they outperformed others. Political connections in countries with weak institutional framework can give companies certain advantages. Governments could relax standards and allow them to merge. Government could also give them sensitive information about other firms. They could also obtain preferential access to bank finances. None of these factors contribute to efficiency and global competitiveness. Thus efficient companies from corrupt countries become victims of global competition even when it comes to mergers and acquisitions.

Policy Imperatives

There is enough evidence from several research studies to show that bad governance, and in particular corruption, has been the most important factor inhibiting the growth of the manufacturing sector. I discussed the policy imperatives in my op-ed page article in the Hindu (Siddharthan 2012). In what follows I propose to reproduce the points I made there. Corruption mainly takes place where important discretionary powers are vested with the decision maker and where rules are not clear-cut and decision making is not transparent. The way out is to reform the decision-making process by making it transparent and rule-based and by drastically reducing the discretionary powers of officials. So far, despite brave declarations of intent, no serious attempt has been made in this direction of administrative reforms.

In addition to administrative reforms, the government should also introduce rules and laws to drastically discourage cash transactions and cash holdings. Corruption cannot be reduced so long as cash transactions dominate. Newspapers frequently report police and income tax raids and the discovery of huge amounts of cash kept at home, offices and lockers. In this context, it is vital to introduce laws that discourage cash transactions. Drastic situations need drastic remedies. To discourage cash transactions, the government could place a limit on cash transactions. For example, the government could declare that any transaction, say, above Rs. 5000 should be a bank or credit card transaction and not a cash transaction. This would bring huge expenditures on items like consumer durables, hotels and resorts under bank transactions and increase accountability. Likewise, the government could place a limit to cash holdings at homes, offices and lockers. The limit could be as low as one or two lakh rupees

To conclude, a high growth rate for the Indian economy cannot be sustained without a vibrant and growing manufacturing sector. A policy aimed at GDP growth based mainly on attracting investment in the services sector will not succeed. Moreover, a thriving manufacturing sector is vital for employment generation. Under these circumstances, reforms should be aimed at good governance, transparent and time bound decision-making, reduction of currency transactions and holdings, and the rule of law.

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