



*EPW Special Article*

*October 11, 2003*

## **India's Growth Chase High Aspiration, Low Inspiration**

*This article critically evaluates India's growth 'stoppers' and growth 'boosters' and finds that both are exaggerated. The analysis is intended to provoke debate on what India needs to do to make 'growth happen'. India is a unique example of political democracy without economic democracy. However, more than the form of democracy the real constraint on growth is its bad practice. Thus, improved governance is the key to achieving sustainable growth and better living standards.*

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According to World Bank statistics, in 2001 India's purchasing power parity (PPP) adjusted per capita income was \$ 2,820. India stood 147th in a ranking of 208 countries. China did slightly better, at 127th position. The world's attention is focused on these two, now awake, Rip Van Winkles. China launched its economic reforms in 1978. Since then the Chinese economy has grown at an annual rate of over 10 per cent. Although India formally launched economic reforms in 1991, the Indian economy broke free from the Hindu rate of growth in 1980 and has since achieved growth rate of a little over 5.5 per cent, way below that of China. Many in India are unhappy about the comparison with China. One view is that it is impossible for 'economic elephants' to bounce like 'tigers'. According to this view, the Chinese performance is a statistical hoax. Some explain India's performance as the 'price' to be paid for democracy. Some even predict that China's nemesis is going to be its governance structure, making India the victor in the 'endgame'.

The argument that the next decade or two would be the period of India's shining glory goes somewhat like this. Economic and business growth in the 21st century would be driven by knowledge-based industries, more particularly information technology (IT) and research – technical, scientific, medical. India, with its formidable 'brain power' and managerial capabilities, would be globally the most preferred location for outsourcing. Already, from low-skill back office operations, business offloaded to India is rapidly changing to intelligent and skill-intensive business process outsourcing. The growing number of Indian non-IT multinationals and rising exports, some argue, prove that Indian businesses in general have become globally competitive. Indian exports are outperforming growth in global trade. NRI gurus (university teachers, researchers, consultants), whose interest in India has increased post-reform, spearhead 'out of the box' thinking about India's market driven growth strategy. The mood is so upbeat, prospects so titillating and euphoria so pervasive that any doubt or different point of view runs the real risk of being snubbed as the typical Indian habit of self-degradation or cynicism. Since India has missed bus so often in the past, it would be prudent to thoroughly examine the whole gamut of issues involved. There are two clear viewpoints emerging from the ongoing debate. One is the 'legacy mindset', reflected in conventional growth schools, and another is the 'modern mindset' represented by NRI gurus and young (including old, but willing to change) entrepreneurs.

Clearly, the latter is gaining ground, and rightly so. Several Indian companies have demonstrated their mettle, become globally competitive in cost structure, and are even exporting to China, the Mecca of low cost. Some young politicians and administrators have shown exemplary courage and acumen in taking reforms forward. This article deals briefly with a modified version of the 'legacy mindset' that accepts reforms in principle but is supremely content with a modest pace of growth instead of opting for acceleration of reform, if it is painful. However, most of the article deals with 'positive' elements.

Although visionary dreamers are any day preferable to 'extrapolationist pessimists', where this article differs from the 'optimist' school is in evaluating, instead of wishing away, several soft spots. A critical evaluation of 'growth boosters' justifies doubts on whether India has the wherewithal of delivering stretch goals. Confidence and optimism, though invaluable in the transformation from the 5 per cent to 10-15 per cent growth path, cannot achieve it without 'hunger for growth'. It would be foolish to expect politicians to 'show the hunger' by expediting reforms. Despite the laudable performance of some Indian companies, a large section of business still draws comfort from limited competition, high protection and domestic market operations. This lobby has sufficient political clout to apply brakes to reforms. The optimism is not justified by ground reality, where the vision of growth is 'painless gains'. The 'keynote' speakers at innumerable

seminars proudly refer to endorsement of the 10 per cent growth possibility (McKinsey India study) but seldom mention that the 'price' is drastic. Likewise, while proudly presenting the vision of 10-15 per cent growth (attributed to C K Prahalad by the media) only a fraction of the time is spent in spelling out how it is to be achieved.

In my view, these can best be viewed as 'frontiers of opportunity' rather than specific growth goals. Extensive empirical research on growth transformation in transition economies provides several important lessons. Good economic policies are necessary but not sufficient. Good governance is critically important for achieving high growth. The global environment is steadily becoming more hostile towards the aggressive pursuit of growth by Rip Van Winkles. Finally, in a fiercely competitive world, in addition to shortening of product life cycles, life cycles of 'strategies' have also shrunk. The net result is enormous increase in risks and uncertainty, which few economies have succeeded in managing all the time. Failures have invariably resulted in frequent economic crises, at times of global proportion. Research on excellent companies corroborates the thrust of these at a micro level. Excellence can be a 'class' and not a 'mass' phenomenon. A minuscule number of companies have achieved excellence and, with few exceptions, these are short-lived success stories. As recent corporate frauds reveal, many 'fly-by-night' leaders have either duped consultants, auditors and boards or have tempted them to collude to produce 'excellence'. Only business leaders with a high stock of ethical capital (honesty and integrity) and exceptional skills to tackle the challenges of an uncertain world can achieve genuine excellence. Besides, either very large companies (which Indian companies are not) or a significant cluster of small and medium companies can create the momentum for growth transformation of the order envisaged by India.

Against this backdrop, this article critically evaluates India's growth 'stoppers' and growth 'boosters' and finds that both are exaggerated. Hopefully, the following analysis would provoke further debate on what India needs to do for 'making growth happen'. The bottom line is that it is possible to generate growth without help from government but no country can generate high growth, despite all its resources, with bad governance. With all this evidence, I leave it to the readers to decide whether the 'doubting Thomas' style of this article is cynicism or a wise reality check.

### **Perspiration without Inspiration**

Much of the Indian growth debate centres on the financial resource matrix prepared by the Planning Commission. In economic character, it is based on the Harrod-Domar model, which stressed the role of savings. To quote the 10th Plan document, all previous plans assumed that "demand for investible resources always exceeds the supply, which implies that the level of total investment in the economy is determined uniquely by the availability of savings". More interesting than calibration of the economic model is the statement of the real problem. The commission states, "While the functions of the state in India have steadily widened, capacity to deliver has declined over the years due to administrative cynicism, rising indiscipline, and a growing perception that the political and bureaucratic elite views the state as an arena where public office is to be used for private ends." Having made this profound observation, the commission goes on to prepare the 10th Plan to translate the prime minister's desire to double per capita income in 10 years (instead of 20 years in the past). The 10th Plan aims at 8 per cent growth during 2002-07. For the next five years – 2007-12 – the growth rate may have to be 10 per cent. The growth arithmetic and estimates of savings and budgetary surpluses have already gone awry! It is this casual approach and total failure in bringing to bear the 'intellectual authority' of the commission that has made a mockery of the whole process.

India has been grappling for a growth breakthrough. Developing countries in south-east Asia achieved very high growth rates, a development popularly known as the Asian miracle and erstwhile communist countries of eastern Europe have also experienced rapid growth through economic reforms. These patterns of growth have enriched the understanding of growth.

The most famous is the 'perspiration theory', a term coined by Paul Krugman to explain the 'Asian miracle'. Based on this theory, he prophetically predicted, the Asian crisis. Somewhat similar to this is the 'accumulation' theory. The thrust of this line of argument is that long-term sustainable growth is not possible merely through application of financial, physical, human and even knowledge resources, as the law of diminishing returns would apply after a point. For sustained growth a country would need 'inspiration' or 'assimilation', that is, institutional arrangement for adopting and operating advanced technology and management practices. "In the assimilation paradigm, developing economies tend to start off below the best-practice frontier of world technology, and thus have the possibility of appropriating the technology developed elsewhere at prices below the cost of production. Once an economy begins to innovate, the process of assimilation should lead to a surge in total factor productivity (TFP) growth followed by convergence to the best-practice rate of growth" (Indian Manufacturing – Elephant or Tiger? Hutten and

Srinivasan). Almost all south-east Asian countries have moved up the technology chain and achieved productivity gains. In India, the overwhelming part of the debate is carried on as if growth is totally an economic phenomenon.

### **Economic Parameters Necessary But Not Sufficient**

While all economists clamour for a high savings rate, few emphasise that the relatively high household savings rate has encouraged Indian governments to pour resources into the public sector despite low (below cost) returns. Domestic savings, if efficiently used, would have supported much higher growth than that actually achieved by India. More than a paucity of resources, inefficient and corrupt utilisation has limited growth. With such monumental mistakes, perpetuated for decades, the inevitable economic crisis erupted in the late 1980s. It is a happy accident of history that Manmohan Singh launched the reform process. He started with a bang but soon began 'calibrating' reforms to the political fallout (for the party) rather than to growth acceleration [Jhaveri 1994].

Some economists have also made a case for releasing India's latent growth potential [Morris 1997]. By correcting the overvaluation of the exchange rate of rupee. It would be useful to note that right economic parameters constitute a 'necessary' condition but not a sufficient one. Further, the efficacy and effectiveness of economic parameters are directly correlated with the efficiency of the markets. Indian markets are inefficient. Due to fiscal laxity, monetary and trade policies carry a disproportionate load of economic stability. Inflation caused by deficit financing and 'competitive devaluation' have quickly neutralised the competitive advantage of devaluation in the past. More sustainable competitive advantage can be gained by outperforming competitors in factor productivity. China provides an interesting example of a country that has achieved superlative export performance without devaluation, though several of its Asian competitors had undergone massive devaluation during the economic crisis. Productivity growth is a key factor in China's success. While a top-down authoritative political structure might have driven Chinese productivity, significant empowerment of provincial governments and large cities strengthened the motivation for productivity improvement. One outstanding example is steel. "Among the main drivers of these impressive cost savings (one-third capitalisation cost per tone compared with the US) have been engineering companies spun off by the ministry of metallurgical industry about a decade ago. Although state-owned, they are fiercely competitive and have made great progress in designing blast furnaces, refining the smelting process and testing foreign technologies" (Financial Times, May 5, 2003). India has to create an appropriate institutional structure for productivity growth. According to D C North, "Economic growth throughout history could only be realised by creating an institutional and organisational structure that would induce productivity-enhancing activity – a supply-side argument; and equally that the consequent tensions induced by the resulting societal transformation have resulted (and are continuing to result) in politically-induced fundamental changes in the institutional structure to mitigate these tensions – a demand-side argument. Both the supply-side and demand-side institutional changes have been and continue to be fundamental influences on productivity change [North 1994]. Although 'modernists' have brought several nuances to the growth debate, several businessmen, economists and a large majority of politicians refuse to come out of the pre-reform mindset.

A classic example is the public vs private sector debate. Businessmen and free marketers, like their developed country counterparts, often argue that 'government has no business to be in business'. India's concern, with limited managerial resources and sunk capital, ought to have been determining the 'appropriate' role of public and private sectors in achieving objectives of growth policy and how entities in both sectors can be made more capable, efficient and accountable for results.

While private sector is a natural source of enterprise, contextually, the choice of the public sector to kick-start growth in India in the 1950s made sense, as private sector and capital markets were quite undeveloped. Instead of arrogating a 'commanding heights' role to itself, the public sector should either have followed the management model of the private sector or withdrawn in its favour. Even assuming that early stage politicians were well meaning (and had value base), visualising the public sector as an extension of 'bureaucratic empire', with same degree of controls and interference as government departments, was a costly mistake. How the 'showcases of a democratic socialistic republic' have been converted into hugely corrupt and grossly inefficient machines by 'humble servants of the public' (politicians and civil servants) is a well known story.

Political interference, pseudo-ideology, distorted accountability and opaque style of governance have deprived Indian economy of a potential growth engine, among other things, by scuttling initiatives by public sector managers, some of who are of high calibre. Privatisation is the only sensible solution for India largely because of the low quality of governance. Singapore offers several examples of well managed government-owned companies. In the absence of an honest, visionary and confident political leadership, Indian public

sector companies are used as legitimised conduits for exploitation and private fiefdoms in an inherently feudal style of governance. Ministers oppose privatisation for fear of losing personal empires, without giving even a moment's thought for what is good for the economy or the future of businesses under their (temporary) charge. In the 'musical chairs' democracy, though the power to govern has changed hands, all parties have recklessly exploited household savings. There are no politicians who can be entrusted to unlock value from the public sector through efficient operations. Privatisation is only a part of the overall question of tackling massive corruption and gross inefficiency. Out of huge amounts of public expenditure, only a small portion of benefits trickles to target groups. India's major problem is the chase of growth without governance. Most alternative explanations, as the following discussion shows, are quite hollow.

### **'Old' Growth Schools**

One politically influential view is that India needs neither outside capital nor access to world (markets) for sustaining high growth. It argues that India's growth rate is depressed because of thoughtless globalisation, which should be remedied by rollback of external reforms. While governments have not completely toed this line, they have pacified the anti-globalisation lobby by resorting to populism and delaying reforms as long as possible. The 'hit and run' process, evident in off-and-on privatisation and rollback of progressive budget proposals, has indeed helped to salvage some of the reforms. But one should not underestimate the harmful consequences on business planning and foreign investment of swings in policies and resultant uncertainty. Another view is the 'India is unique' school of thought. It attributes the high growth of the Asian tigers to lack of democracy and small size of domestic market. It would be foolish for India, according to this view, to indulge in 'export-led' growth. What has given credence to this view is the fact that except for Mexico and Brazil, no large country has qualified for the high-growth club. Even Mexico and Brazil, with their torrid history, are far from being role models. With an 'I told you' glee proponents argue that the east Asian crisis was a predictable outcome of tiger-style growth leaps. All these have bolstered strong faith in a slow and steady inward looking Indian growth model. What has dealt a decisive blow to the 'slow and steady is safe' school is China's consistent growth, maintaining a judicious balance between exports and domestic market (we shall revisit the India-China comparison).

By far the most popular view is that democracy holds back India's growth ambition. One senior cabinet minister describes this as 'democracy tax'. Therefore, the issue needs closer scrutiny. Political rights and civil liberty, as measured by Freedom House, a non-profit non-partisan agency, is much lower in China (7 and 6 on a scale of 1 to 10, 1 being highest freedom) than India (2 and 3). It is quite plausible that the need for carrying the majority may have restrained pace of reform in India. But Hungary and Poland, erstwhile Communist block countries, score better than India (1 and 2) with regard to degree of freedom and are acknowledged to have performed quite well on the reform front. It would be interesting to note that a World Bank research paper [Zoli et al 1999] finds that democracy has facilitated economic liberalisation in these countries. While one ought to make allowances for the large size and complexity of Indian democracy, whether democracy is as compulsive an explanation as is made out to be, requires serious debate.

There is no doubt that the process of democracy has been institutionalised and thanks to vigilant election commissions. In fact, Indian democracy has been lauded for its performance [Kohli 2001]. But is successful conduct of several (in fact, too frequent) elections the only test of good democracy? While it may not be easy to precisely define what constitutes a good democracy, it is not so difficult to identify what a good democracy should not be like. Any objective assessment of Indian democracy cannot miss a massive disconnect between the process and ground reality of it being practised as a feudal and self-serving process. One would have expected elections to be based on issues such as poverty, unemployment and lack of basic necessities, which have remained largely undented. Instead, elections are won or lost on the basis of playing one caste, community or religion against another.

There are four important attributes by which the quality of democracy can be judged, namely, level of corruption, ethical value base of elected representatives, their competence and efficient delivery of public service. The fracas regarding declaration of assets and pending criminal cases by candidates, speaks volumes for the 'killed spirit' of democracy. The Corruption Index of Transparency International ranks India as one of the most corrupt countries. Several political leaders at the state and central level are perceived as corrupt. While it is true that corruption, to use the famous phrase of an Indian prime minister, is a global phenomenon, Indian corruption, measured by economic results, is grossly 'inefficient' and 'incompetent' than corruption elsewhere.

As regards the value base of elected representatives, there is enough evidence to suggest that politics has become a commercial profession, devoid of all ideology, honesty and integrity. Rare politicians view their job as 'public service' in the genuine sense. While formal education is not sufficient proof of competence, the quality and manner of parliamentary debates (e.g., on privatisation or fiscal policy) clearly suggest a

limited grasp of issues and their seriousness, as well as scanty interest in India's burning problems. Few would consider Indian democracy a roaring success on the test of timely delivery. Whether it is fiscal discipline or reform legislation, its record is unimpressive. The appearance of India as a robust democracy is deceptive. Except in the case of emotional issues (as in the case of the recent Gujarat assembly elections) many citizens have reached such a point of frustration that they do not care. Some are conniving after negotiating their 'cut' (by 'selling votes' for a small consideration). Many are too scared to oppose because of the fear of abuse of power. A view is gaining ground that democratic politics works in a similar fashion everywhere in the world. In fact, recent happenings in the US democracy (the Florida votes in the presidential election, alleged links between some highly placed politicians and fraudulent corporations, 'crony capitalism', according to Jeffrey Sachs, in the award of Iraq reconstruction contracts) have strengthened this argument. This is an issue that would call for a separate debate. Limiting the discussion to Indian democracy, there are reasons to suspect 'state capture' in India. The term state capture connotes "efforts of firms to shape and influence underlying rules of the game (legislation, laws, rules and decrees) through private payments to public officials. There has been analysis of how firms in the transition economies use their political influence to distort both the legal framework and the policy-making process in an effort to gain concentrated rents with detrimental consequences for the economy and society at large" [Jones et al 2000]. State capture is also defined as "undue and illicit influence of elite in shaping the laws, the policies and regulation of the state". While I have not come across an empirical study measuring state capture in India, the symptoms are visible even after economic reforms, recent happenings in the telecommunications industry being one of the examples. The earlier quote from the 10th Plan provides 'official corroborative evidence'! Normally one would expect income growth to positively impact governance but when there is 'state capture', additional incomes largely accrue to the elite who benefit from ill governance and develop a vested interest in it [Kauffman and Kraay 2002]. Therefore, before making democracy a scapegoat for low growth, the least that is needed is a systematic research on whether and to what extent improvement in the functioning of democracy can help growth acceleration. For instance, do Indian legislatures spend 'optimal' time on reform legislation than on other trivial issues? Are government policies formulated without any influence of private sector company(ies)? Are disclosures and checks and balances functioning in accordance with the spirit of democracy? Clearly, answer to these questions is no. Are governments abusing power for political ends [Jhaveri 2003b] (Also see, 'Ethical Capital and Corporate Values', Business Standard, March 27, 2003). In this case the answer is yes. The relatively better performance of south India compared with the north could be an interesting case study. Is such a disparity a threat to the unity of the country? Is it a source of instability? These are all issues that cannot be totally ignored. India has got a bad bargain of low growth and poorly functioning democracy.

### **Economic Democracy and Growth**

Economic democracy without political freedom is conceivable and can achieve economic prosperity (a good example being Singapore, which is considered 'partly free' and rated five each on criteria of political freedom and civil liberty). India is a unique example of political democracy without economic democracy. Genuine expansion of economic freedom, even without a perceptible change in corruption and efficiency of governance has significantly improved the environment for growth acceleration. Abolition of licensing, for instance, has perceptibly improved the response capability of efficient players. The automobile industry, which received a disproportionately large dose of reforms, is an outstanding example. Competition has improved operating efficiencies in Indian manufacturing across the board and consumers have benefited from wider choices of better quality products at declining prices. The entry of new private sector banks has transformed the functioning of otherwise placid public sector banks. The IT industry is a shining example of reforms. Clearly, therefore, accelerated reform (economic democracy) is key to accelerated growth. What is holding it back is the abuse of power for retaining control over the economy for suspect purposes.

Staunch believers of self-sufficiency endorse economic freedom, but only for domestic players. This is not the place to debate this point but closed doors for imports and foreign capital and open door for exports was a model successfully pursued by Japan and several other Asian countries in the past. Rapidly growing world trade and the voracious appetite of the developed world facilitated this but also concealed intrinsic inefficiencies and fragility of this type of economy. Due to slow growth of trade and intense competition in global markets, all these countries have switched over to a 'both doors open' economy and have benefited from it.

Although some Indian companies have realised the value of exports in raising the efficiency bar, a 'myopic' view of treating exports largely as a source of additional foreign exchange and gap-filler for domestic recession is pervasive. Businesses that have pursued exports as a route to global competitiveness have improved domestic competitiveness through cross learning – intricacy of logistics, timely delivery, better management of working capital, importance of quality, lowering of business risk through market diversification. Exports have become the most powerful and speedy efficiency transmission mechanism

in an otherwise closed market. However, weak infrastructure and a lethargic work culture frustrate application in the domestic market of (superior) export market practices. Many believe that these shortcomings, even if they take time to correct, would not hamper high growth aspiration because of other strong growth propellers.

India has achieved high growth, without any significant pump priming (because of fiscal stresses) in a difficult global economic environment. The country's foreign exchange reserves are healthy. The ratio of short-term external debt to GDP is small. Inflation, though causing some anxiety, is under control. Interest rates are at historical lows. Consumer confidence is high. Several Indian companies are ready to take on the challenge of competition. Politically, the coalition government has remained stable and has carried out some difficult reforms in key areas.

But there is a flip side. There are no signs of sustainable investment buoyancy except in infrastructure projects. The long-term future of manufacturing remains uncertain. Power sector reform is excruciatingly slow. Fiscal deficit is out of control and internal debt to GDP ratio is precariously high and rising. The government has shied away from meaningful fiscal consolidation. Whether low (nominal) interest rates can be sustained is a question. Would inflation remain benign should growth pick up is another question. If interest rates and inflation rise, buoyancy of consumption demand would suffer. Most countries have experienced consumer credit default if growth in consumer debt is very rapid. India cannot ignore this danger. Several key reforms are still pending. Corruption is growing unabated. Barring some exceptions, quality of governance is poor and decision-making slow. With frequent elections, political focus on key economic issues is inadequate and costly populism rampant. It is too early to pronounce judgment that India has crossed the hump of macroeconomic vulnerability. One of the classic examples of how swiftly macroeconomic fundamentals can deteriorate is the wide swing in the US, from estimated large fiscal surpluses to large fiscal deficits in a short span of time. It would be unwise to ignore the impact on India of huge volatility, and possible return of recession, in the global economy.

### **Globalisation and Indian Multinationals**

While the global competitiveness of the IT industry is well known, many believe that the growth of non-IT Indian multinationals and of exports are signs of India's success in competitive global markets. There are three elements of globalisation, namely, Indian multinationals, participation in global outsourcing, and exports, that need to be looked at separately. Overseas location could be driven either by market opportunity or cost advantage. As argued below, in the category of market-opportunity driven multinationals, one ought to distinguish between, those which principally aim at the 'host' country and contiguous markets and others that are 'truly global'. Cost advantage driven multinationals may be formed for servicing domestic or global markets.

Aditya Birla was the pioneer of the 'market-opportunity driven' multinationals. This tradition continues in the Birla group, which has a presence in 17 countries and earns 30 per cent of its revenues from overseas operations. The Tata group, even before its acquisition of Tetley, had overseas operations mainly to service 'exported products'. Asian Paints, with a presence in 22 countries, earns 25 per cent of its revenues from overseas operations. With a few exceptions, most Indian multinationals are 'market opportunity driven'. Typical preferred locations for Indian multinationals are perhaps more competitive than India but less competitive compared with developed country markets. Also, markets were generally small in size. Most Indian multinationals chose industrial products rather than consumer goods, which are difficult to penetrate due to strong brand preferences. Whether overseas turnover of a relatively modest size can be treated on par with multinational activity of businesses from developed countries is debatable. Restrictive licensing and unimaginative control of monopoly, which left little room for domestic expansion, might have driven some Indian companies to expand overseas. Many could have gone abroad to escape bureaucratic hurdles. For products that attracted opposition from powerful developed-country competitors on the grounds of the 'sweat factories' in India and were subject to quotas and anti-dumping litigation, routing through overseas locations was the best way of servicing export markets.

There may well be 'truly global' Indian companies in the making. But before projecting Indian multinationals as a powerful growth engine, should not one count whether there are enough sparrows to herald a summer? Not every expert is bullish. Some doubt the capability of Indian managers to cope with the challenge of multidimensional organisations. In running their own businesses locally, many Indian managers are yet to reach the high levels of transparency and empowerment that are required for the success of a business in truly competitive markets. Would a typical Indian company with relatively small scale of operations (compared with global competitors) have the capability to incur the cost of global brand building or to handle a much larger risk than in the domestic market? Are Indian multinationals comparable to the Japanese automobile and electronics companies, which built the 'Japanese brand' in the US on which

others could piggyback? Or to South Korean companies (Samsung, for instance, has captured a significant portion of the US cellular phone market)? China's first major multinational, Haier, was set up only after a long incubation period of recognition of China as a reliable producer of quality goods. The final question is whether a country could leapfrog to multinationals status with insignificant exports.

Among the pathbreaking changes in manufacturing and international trade in recent times, outsourcing would perhaps rank the highest. It started with the need felt by global companies to find cost-effective ways of sourcing, without compromising quality, for gaining (retaining) competitive edge. On account of a variety of factors, outsourcing has gained enormous importance as an element of competitive strategy, well beyond its limited objective of low-cost sourcing. With supply outstripping demand for a large number of commodities, 'market power' has shifted away from manufacturers to distributors. The integrated manufacturing model, which left entire market risk with the manufacturer, is being replaced by 'shared risk' practice, which distributes risk at several points in the manufacturing chain. Shortening product life and delivery cycles have aggravated market risks, largely at non-retail points in the value chain. Coping with these risks necessitates deep pockets, ability to manage risks and manufacturing flexibility. While I have no details of product outsourcing from India, judging from the level of export of manufactured goods (discussed later), it is unlikely to be of a significant magnitude.

Global markets for consumer goods – both durable and non-durable – are ferociously competitive. Few Indian companies have either the scale of operations or deep enough pockets to build global brands. Further, reliable delivery and consistent quality are the crux of the success of this model. Till an outsourcer gains confidence, volumes would be small. Typically, for large volumes direct ownership by a developed country outsourcer becomes a key factor. In fact, with easing of norms on foreign investment, even holding on to their market share in the domestic market has become a major challenge for several Indian companies. Indian manufacturers have lost market share to global brands in televisions, refrigerators, air conditioners, passenger cars and other categories. Internal reform is decisively loaded against domestic manufacturers, who cannot rationalise labour as easily as their competitors. Even the relatively small-size domestic market is fragmented among a number of players.

In contrast to the resistance from family-owned businesses in India against foreign ownership, China opened its doors wide to foreign capital. China is a more attractive proposition than India with regard to physical infrastructure for manufacturing and trade. Further, according to a recent McKinsey study, labour productivity growth in China was almost four times that of India. All in all, in relation to India's GDP as well as the need to more than double annual growth rates, neither Indian multinationals nor outsourcing can be counted upon as a great contributor in the near future. Besides, one does not know how many Indian companies have strong enough commitment to continue with globalisation. In the past, whenever domestic markets became buoyant, Indian manufacturers have shied away from exports. In contrast the mindset of Asian companies was tuned to global markets from the beginning. China, with its large domestic market, is a major exception and is also comparable with India in this regard. The key difference is that China has struck a judicious balance between the domestic and export markets.

### **Export as a Growth Engine**

The fastest growing element of exports from developing countries is procurement by large global retailers and distribution chains. By now, consumers have come to accept the 'Made in developing country' product sold under global brand names and at global outlets, provided they meet with their price-quality expectations. High visibility on the shelves of global outlets of large retailers helps build the country's image (such as Made in Korea, Made in China) through recognition and consumer satisfaction. This helps export diversification and movement forward in the value chain. Several Asian countries have followed this route. The only segment in which India is visible, is cotton garments and to an extent handicrafts. In contrast, according to a Business Week report, WalMart, the largest US retail store chain, is gearing up to procure \$12 billion worth goods from China in 2003 (a plan that may have been jeopardised somewhat by the SARS outbreak earlier this year).

Like outsourced manufacturing, linking fortunes with global retailers is a double-edged sword. Despite large retailers de-risking their business by outsourcing to multiple suppliers, volumes expected are quite large and delivery conditions rigorous. Suppliers have to set up large capacities, which raises the risk of business downturn and of change in consumer tastes, partly offset by reduced market risk. By not participating in burgeoning trade volumes, India has lost the opportunity to build country brands and scale up manufacturing, thereby availing economies of scale advantages. In the process the domestic market is also deprived of the benefit of the rub-off effect of quality. India has also missed the collateral benefits of enhanced global competitiveness, efficiency improvement, cross learning and productivity improvement along the chain. The principal beneficiaries of the 'hollowing' of developed market economies (increase in

GDP share of services at the cost of manufacturing) are Asian countries and, to an extent, Latin American countries that have entered into bilateral trade arrangements with the US. China, with no worthwhile 'domestic' private sector companies, adopted the FDI-driven 'round tripping' model for export dominance. It has already overtaken all other Asian countries, including Japan.

Another important element of globalisation is moving up the value chain, from a 'low quality producer' image (Japan in the 1950s and China till recently), to high value added and high technology products. In the case of India, except for the reported tie-up of Tata Motors with Rover and ambitious forays planned by some Indian two-wheeler companies, most deals are relatively small. Two most promising sectors are automobile components and pharmaceuticals, including biotechnology. Will India suffer due to scale disadvantage compared with its competitors? Can India mount a massive export effort with relatively low penetration of products in domestic markets? Will gestation period for benefits be too long to gain a 'decent' market share from the position of being a 'marginal' exporter? One must also recognise that, as a late entrant, India would face hostility in slowly growing world markets. Can Indian manufacturing bridge the widening productivity gap with its competitors? How important is integration of large and small industries (which are largely in the confrontation mode because of reservation policy) for achieving cost competitiveness in an environment of declining costs and seamless delivery chain? Clarity on all these issues, and several others, is necessary for evaluating whether India's manufactured goods exports have reached critical mass and whether the momentum would be sustained. Answers to these questions will help to prepare a road map as India's present and potential competitors are not static.

India outperformed world export growth in 2000-01 and again in 2002-03 (CMIE estimate of 19 per cent growth), increased product and market diversification and reduced dependence on traditional exports. But exports of metals are largely driven by China's voracious appetite to execute massive infrastructure projects. Once this cyclical blip is over, export buoyancy could very well end. According to an ET-CMIE survey (The Economic Times, February 21, 2003) India has improved exports of low technology products, whereas its world market share in medium technology products was 0.3 per cent and in high technology products it was 0.15 per cent in 2000-01. High technology products account for 5 per cent of India's exports compared with 24 per cent among developing countries as a group. Another comparative dimension is India's share of 0.8 per cent in world exports compared with China's 5 per cent. Clearly, India needs to develop a sustainable export strategy for manufacturing. According to NRI gurus, despite the impressive performance of India's IT and forays made in global markets by manufacturers, there has been little effect on foreign investors, who still flock to China. One wonders whether it is because of poor marketing or lack of confidence in credible performance and consistent policies (one might want to see Web site of the finance ministry, reproduced in Jhaveri (2003a)). There is, however, a view that if one eliminates definitional differences, India's FDI flows, as measured by ratio of FDI to GDP, is not very different [Srivastava 2003], which we shall return to later.

### **Knowledge-Based Economy**

The emergence of IT as world-class Indian industry in a short time is impressive. Industries such as telecom and entertainment have also registered impressive growth. Even resident Indians, be it fashion designers, musicians or filmmakers, have achieved global recognition. IT and other knowledge-based services have helped India earn its rightful place in western markets.

However, the IT story is not unfolding the way it was expected to. After all, despite (misplaced) assurances by several Indian companies about their 'immunity' from the global IT recession, the inevitable has happened. The recent carnage of IT stocks on Indian bourses suggests that IT is now being subjected to a reality check, and that it is not passing the test. On the face of it IT is passing through a typical business cycle, but there could well be some structural issues involved. The moral is that even if IT's impressive growth is endorsed by competent agencies, all futuristic exercises are based on explicit and implicit assumptions, which can never be underwritten.

A balanced evaluation of IT as India's sheet anchor for growth is called for. Can Indian IT companies handle very large orders? Can they move up the value chain? Is there a need for consolidation? Are their cost advantages sustainable? Are they equipped to handle turnkey jobs that involve different skills than those they readily possess? Can IT thrive as virtually an 'export industry'?

A recent cover story in Business World (May 5, 2003) magazine raises some important questions and comes to the conclusion that the way ahead is far more difficult than the journey made so far. Another cover story, in Business Week (Asia Tech, April 14, 2003), notes the momentous efforts made by China to acquire some reckoning in the global IT industry. To an extent, the Chinese gamble draws strength from large

domestic base of IT-intensive industries as well as a reasonably large hardware industry. What characterises the Chinese effort is a strong determination and 'hunger to catch up', by developing "homegrown alternatives to Microsoft software, Intel microprocessors, Cisco routers" or developing "TD-CDMA standard for third generation cell phones". What is also impressive is the provision of financial support by government and building competitive pressures on state-owned companies to achieve highly ambitious goals. While, as of now, no one expects China to succeed smoothly in this technological gamble, unlike Japan and Korea, the Chinese have opened the doors wide for foreign investors. Japan, Korea and Taiwan have taken serious note of the Chinese gamble and are trying 'to keep going up' and some senior managers from multinational competitors do not rule out the possibility of China going "from being on the receiving end of technology to the generating side" (all quotes from *Business Week*).

India's acknowledged superiority in terms of intellectual capital (brain power, managerial skills, entrepreneurial qualities and so on) can give the lead. Should one take these qualities for granted as a perpetual advantage? The main driver of Indian IT growth is its cost advantage. How sustainable is this in the face of the possible entry of countries such as the Philippines and Vietnam, not to mention China? Besides, China is aggressively pursuing 'teaching' of English in local schools and has earmarked large amounts for software education. Indeed, standalone software capabilities would throw out several opportunities, and quite lucrative ones at that if they are at the upper end of the value chain, for which India would have limited competition, but this could be short-lived. As survey of Asian entrepreneurs has shown, though India has a large pool of entrepreneurs, 'herd mentality' is quite strong.

Against this backdrop, it is legitimate to ask whether IT, along with other services, can make up for the low export of manufactures. Potential candidates, besides IT, are tourism, education and health and other knowledge-based services. Tourism needs strong infrastructure support, which is not there. Differences in the 'tourism culture' between India and most other countries are rather stark. Several states are toying with the idea of projecting themselves as medical and education centres but as of now these are still on the drawing boards. All in all, it would be unwise to depend upon the services sector to the extent of virtually neglecting scope of recouping the manufacturing sector to gear up for global competition.

In this context, it would be useful to note that the role of IT in improving the competitiveness of India's output-producing sectors, particularly manufacturing, finds virtually no place in the IT debate. McKinsey studies on productivity for various countries identify IT as a key factor in high productivity. Scanty data available on Nasscom's Web site about domestic market for IT products (one wishes that Nasscom provides more information to researchers) suggest weak linkages with the other real sectors, except for select service industries. Applications in manufacturing are confined to fairly rudimentary data processing, now extended to enterprise resource planning (ERP) and customer relationship management (CRM) by some companies, but there is still a long way to go. How India can gain through more aggressive and imaginative integration of IT capabilities with manufacturing in terms of global competitiveness is an issue worth examining. One reason possibly is economics arising from significantly higher realisations on 'exports' than in the domestic market. Export advantage is further accentuated by exemption of export earnings of IT from income tax. China has achieved impressive productivity gains (8.8 per cent per annum, according to a CII-McKinsey study) without as much intensive application of IT as in developed countries. Rigidities in India's market mechanism and timidity of government cannot replicate the Chinese model of productivity growth. So far, India has been marketed to foreign investors on the basis of 'hidden treasures' (of a large and growing middle class, skilled and English-speaking workforce). Investors have not bought the story, as there is little conviction about 'delivery'. But even if this happens, the gestation period will be long and a concerted effort would be required. Innovative thinking in condensing rollover time is called for.

### **Challenges in Acceleration of Growth**

These are not the only challenges facing growth acceleration. The entire process of Indian democracy is bedevilled by a history of conflict, nurtured by petty politicians for their survival. Indian political parties vie with one another in being champions of agriculture versus industry and small industries versus large but have shown little concern for 'modern' agriculture and an efficient small-scale sector. Left to the present class of politicians, conflicts will perpetuate. These tactics have been used to divert attention from failures in delivering results in key areas. The least that growth acceleration would need is seamless integration of the domestic economy. This is a key to permeation of economic and operating efficiency through all the producing sectors.

Theoretically, an efficient market mechanism could ensure such economic harmonisation, which is indeed an important goal of reforms. India is faraway from that. Being carried away by a grand vision, it is easy to overlook the need to create institutional mechanisms to things moving. Making the Indian elephant dance may be far more difficult than the Chinese elephant, as 'change of mindset' has proved to be quite a

formidable challenge. This is a difficult proposition but not an insurmountable problem, provided India is able to design a right motivation-cum-penalty structure.

Few could have visualised the dramatic transformation of Indian managers. The factor that precipitated change was market competition. Changing a rigid bureaucratic and political mindset, is a totally different challenge. What are the mindset change drivers? Interested readers may find a more detailed discussion on the issue of transforming bureaucratic mindset and role of IT in my comments on the Kelkar task force [Jhaveri 2002]. Mindset change is only the first step. Wherever business managers have comprehended nuances of a changed operating environment, they have prepared organisations for growth in an open economy. Public governance also needs to go through a similar process but the number of such 'managers' is too small to make a significant impact. Even if one assumes (heroically) that the mindset of politicians and bureaucrats does change, improvement in decision-making processes, institutionalisation of this change and organisational structure for effective and efficient delivery would not happen automatically. Unless the 'young', who have a greater stake in India's future, and have an 'open' mind (and sufficient disgust for the way things are happening) get involved, mindset change will be a frustratingly slow process. Unfortunately, the way Indian democracy functions on the ground, there are no serious penalties for incompetent and errant politicians. More often than not, they manage to get back to power as soon as opportunity arises. The key is to find politicians committed to reforms so that they can be trusted to find solutions, even if they are not the best ones. For instance, when Manmohan Singh was faced with strong resistance from vested interests in pursuing conventional privatisation, he introduced competition by relaxing the entry of the private sector into public sector arenas which has had a salutary effect. This process can be extended, by adapting a public-private participation model, which is extensively used by the British government for number of areas of public expenditure. Already, the Infrastructure Development Finance Corporation (IDFC) has used multiple approaches and innovative structures with regard to central and state infrastructure expenditure. Public-private participation and involvement of non-government organisations in various other areas of government expenditure will have to increase rapidly along with active participation of beneficiaries. Honest and competent governance would have created the necessary willingness to improve political and administrative processes.

To make the transition efficient, the capability of the private sector in assuming high growth leadership has to be enhanced. Few businessmen, and this applies to lenders and institutional investors, realise the dangers of growth through expansion or extrapolation of existing economic activities. Mere shuffling of incremental resources – human, financial, physical and managerial – from one business to another cannot produce high growth. New investments and initiatives, without massive constructive destruction – restructuring or redundancy – will create an avoidable 'efficiency drag'.

Transformation to efficiency necessitates significant labour market reform, which is not in sight. Ongoing voluntary retirement schemes are an expensive and cumbersome way of tackling the problem of surplus workers. All the more so when companies need to invest large amounts in technology, quality improvement, cost efficiency and brand building. On the other hand, little attention is paid to the issue of managerial redundancy and owner incompetence. Several high-profile managers have been removed from US and European companies; one would be hard pressed to find similar examples in India. It would be flattering to conclude that Indian managers are great value deliverers! The reality is that institutional investors are either neglecting their duties or are prevented from performing them by a political-corrupt/incompetent manager nexus.

Any meaningful debate on growth acceleration must guard against the danger of 'growth intoxication' or 'growth exuberance'. As late as in the mid-1990s, Indian companies chased asset growth to achieve formidable size even if it meant unrelated diversification. Such opportunistic expansion has loaded balance sheets with high cost debt. Chasing topline growth to gain market share and disregarding the impact on bottom lines is common among managers, not only in India but also in developed markets. Likewise, in a majority of businesses supply-demand imbalance has affected margins. Transformation of marketing model from high-margin low-volume – to which several companies were accustomed in a protected market – to high-volume low-margin is proving to be a difficult adjustment for several companies. It would be worthwhile ponder the innumerable examples of failure of strategies designed with implicit assumption of 'static equilibrium', that is, assuming passive competition.

Globalisation exposes businesses to huge uncertainty emanating from a 'dynamic response' from potential competitors. There are several game theory issues involved in doing business in an open economy. My experience with a number of companies suggests a limited awareness of strategy alignment to a dynamic and uncertain global business environment. While capital market reform in India is one of the best reform stories, for supporting resource needs for faster growth the issue of balancing savings with investment without destabilising interest rates and efficient allocation of private savings will have to be resolved.

This still leaves the obnoxious issue of sharing costs of inefficiency correction and redundancy, which are inevitable in the transformation of Indian economy from low to high growth. Restructuring of grossly inefficient state-owned undertakings in China has resulted in the separation of a large number of employees. Restructuring of the financial sector in South Korea has led to a substantial reduction in the number of banks. In the case of India, neither in the financial sector nor in manufacturing is, restructuring anywhere near what is needed to improve efficiency. Organic growth would take too long a time. The faster the rate of growth and bolder the reform in attacking 'rent incomes', speedier and smoother would be the resolution. Rapid growth, along with focused training for redeployment, would also reduce the quantum of 'net surplus' of workers. Against this backdrop, it would be useful to examine the issue of composition of growth and compatibility of resources (not only financial) with those required for high growth.

### Sources of High Growth

From a critical evaluation of 'growth engines', a few things clearly emerge. Income generated by the services sector, the current growth engine, is of 'inferior' quality. The popular debate refuses to learn the lesson from manufacturing, that 'resource advantage' and large market are not sufficient conditions for building commercially successful businesses. While some private sector airlines and commercial banks have built a 'service culture', converting resource advantage in tourism, education, a medicine, to mention a few, into a vibrant business requires a much deeper understanding of the process and the entry of private sector players into these businesses on a substantial scale. Public ownership, a bureaucratic mindset and excessive taxation could kill this business before it can take off. One should not underestimate the risk of business cycle on an 'export-dependent' business. A huge erosion in enterprise value of IT companies is a rude reminder of this real probability. The 10 per cent growth challenge would become clear from even a perfunctory analysis of its implications.

Let us start with the simple scenario in which shares of various sectors remain unchanged in a 10 per cent growth target. Actual agricultural growth rate (simple average during 1991-2001) was 2.85 per cent, manufacturing growth was 4.01 per cent and services sector grew at 7.41 per cent when GDP growth was 5.58 per cent. For a 10 per cent GDP growth rate (with no change in shares), derived agricultural growth works out to 5.1 per cent, manufacturing 7.18 per cent and services sector 13.28 per cent, assuming zero inflation. The purpose of this crude exercise is not to digress into arithmetic but to focus on implications.

Theoretically, there is no reason why agriculture cannot grow at an annual rate of more than 5 per cent but the best that India has been able to achieve is long-term agricultural growth of around 3-3.5 per cent. I leave it to experts on agriculture to work out a road map for 5 per cent plus growth. It is a fair assumption that such acceleration would need consolidation of holdings, land reform, investment of technology, at the least. I am not clear whether this would mean substitution of workforce by capital assets. There is no doubt that commercialisation of agriculture would need large investments in irrigation, rural roads and electrification, as well as in process industries. It would also need high quality organisation. What would happen to the cost structure and subsidies is something I am not able to figure out. In the 'best case' scenario of fulfilment of sufficient conditions, it would take much longer than 3-5 years. In that case, manufacturing and services would have to grow faster than the rates implied above.

Let us examine the 13 per cent implied growth rate for the services sector. A significant portion of services comprises administration, defence and public sector commercial banks, which typically carry sizeable surplus workforce. Most of these are characterised by low productivity. Trends in public sector services during 1993-94 to 1999-00 gives some idea. As percentage of GDP from public sector (at current prices), the share of services rose from 61.85 per cent in 1993-94 to 67.53 per cent in 1999-00 whereas share in value added (by public sector) declined from 37.48 per cent to 36.29 per cent. Gross capital formation, on the other hand, increased from 50.85 per cent (of gross capital formation in public sector) to 52.33 per cent, the highest growth being in the administrative department and defence, which also experienced the fastest rate of GDP growth. The ratio of compensation to service sector employees to service sector GDP has marginally declined from 34 per cent in 1993-94 to 32 per cent in 1999-00 (source: National Income Statistics, CMIE, January 2003). This is by no means an exhaustive analysis of the service sector but it clearly suggests very limited increase in service sector productivity during the decade of reforms, a modest shrinkage of public sector and predominance of non-productive services, which also saw the highest rates of growth. Services that have linkages either with consumption (tourism, public health, education) or manufacturing activity (distribution, transport, and advertising) account for a relatively modest proportion. This also includes food storage and the unorganised sector. No separate information is available for 'purchased' IT and R and D services. Clearly, acceleration of growth rate of services with existing composition would be disastrous. It would be sensible to opt for lower growth than rejoice at growth in non-productive services. Desirable growth of the services sector would need downsizing in government owned services and significant investments in the rest. The chances of this happening in the near future are slim.

Even assuming, for the sake of argument, that there is rapid growth in non-public sector services, one ought to check matching of new job opportunities with the current 'supply' of job seekers, with their skills and expectations. Skills required, say, at a call centre or fast food counter are quite different from those needed on the shop floor. They are also different from those being imparted at industrial training institutions. While adapting training programmes or learning new skills may not be difficult, much of the outsourcing work is largely confined to developed urban areas due to infrastructure issues. An important point is that by its very nature, the bulk of service sector jobs are low skill jobs. Typical compensation would be lower than in shop-floor jobs. Indeed, at the other extreme there would be very lucrative knowledge-based jobs. Not that these are insurmountable issues but they ought to form part of the high growth transformation matrix.

In all probability, job opportunities in the 'desirable' services sector, and hence income growth, may not be anywhere near 13 per cent. The inevitable conclusion is that the manufacturing sector would have to grow much faster than the 7 per cent assumed in our exercise (the Planning Commission assumes 10 per cent industrial growth). Requirement of high manufacturing growth also fits in, as argued by me elsewhere [Jhaveri 2003a], with the fact that at current low levels of penetration of goods, a significant proportion of incremental disposable incomes will be spent on manufactured goods.

Therefore, it will be useful to develop a scenario of increased share of manufacturing in GDP. Since, as argued earlier, India's exports of manufactures of consumer goods cannot be taken for granted, growth may have to be largely driven by the domestic market. In either case, Indian manufacturing would have to be competitive enough to ward off threat from imports on account of reduction in tariffs and non-tariff barriers. There is no doubt that high growth would require additional investment. The question is, to what extent? Aggressive mergers, privatisation and supply chain management, and overall improvement in asset sweating can reduce investment requirements significantly (that is, lower capital output ratio). The effects of substantial increase in worker and managerial capability will also be similar. While there are, theoretically, no limits to 'manufacturing excellence', the parameters of achieving excellence become progressively more challenging. Several Indian companies have achieved cost reduction through managerial action of cutting flab. Many more are going through the process of cost restructuring and quality improvement through more rigorous and quality managerial inputs, aided by established techniques such as TQM and Six Sigma. Some have achieved globally competitive cost structures with the help of Korean manufacturers, who are aggressively trying to capture market share in white goods and electronics. What is not realised is that these methods of achieving 'manufacturing excellence' are increasingly 'commoditised'. Indian manufacturers would be generally competing with others, who also deploy similar techniques. Besides, as has recently happened in the case of steel, changes in input costs due to factors beyond the control of users can nullify all cost savings in one sweep.

For any company to win global market share in this scenario, differentiating 'intellectual assets' required would be entrepreneurship/intrapreneurship that could breed innovation and strong and growing R and D. In my judgment, this is a much bigger challenge for Indian management style than is generally visualised. Genuine empowerment and knowledge creating organisations, with some exceptions, are quite alien to Indian management culture and style. As regards R and D, budgets are limited and its importance in creating a competitive advantage is appreciated by only a few companies. Indian companies ought to judge the pace of achieving 'excellence' by benchmarking with their Asian and developed-country competitors. As in many other things, mindset would have to be tuned to a dynamically moving target. Developed country manufacturers are moving towards 'flexible' and 'automated' manufacturing to gain cost competitiveness. More important is 'co-optation' and collaborative efforts in R and D, for instance, and standardisation that helps manufacturers to cope with high cost of ever-shortening product life-cycles. Cost cutting through managerial tightness, which several Indian companies have achieved, is reaching its limits. Migrating from this 'survival stage' to 'robust growth stage' is a quantum jump. Indian manufacturers are relatively small in size and are quite averse to making a collaborative effort, even when it comes to overseas markets. I have elaborated these concerns elsewhere [Jhaveri 2003a].

A powerful exposition of 'hollowing' of India's output base has been given by Lester Thurow ('Corporate Dossier', The Economic Times, May 2, 2003). By pointing to India's 800 million illiterate people (even if it is no use quibbling about the number) versus 200 million literate and gainfully employed people, India can only become an 'enclave' economy. Thurow sees no way the 200 million can march into the first world without breaking up from the rest of India. Commenting on the IT engine, he compares it with a Japanese plant in China, which is manufacturing, wiring harnesses and employs 50,000 people. As against this, US software multinationals employ far fewer people in India. In his view, India's only strategy for sustainable growth is manufacturing but he adds that it would not be easy as China is working hard to make itself a good location for outsourcing. To resurrect the manufacturing growth of the past, and in fact to better it, India would have to address at least two critical issues, namely, the level of investment required and role of foreign investment in it. Even after trimming investment requirements to 'efficient' levels, will the quantum be

such as not to rock interest rate levels? Will industry and government allow free flow of foreign direct investment? Apart from domestic and foreign savings, a key determinant of the benign interest rate environment is fiscal deficit. In addition to shrinkage of government, containment of fiscal deficit will depend upon how aggressively privatisation is carried out. One important reason for high cost of capital for private sector users, apart from market inefficiency, was 'crowding out' by the public sector demand for capital. What happens to the public sector is also important because cost-plus pricing by monopoly suppliers of utility has ruined cost-competitiveness of businesses, which typically cross-subsidise users from political vote banks. Only the very bold would expect dramatic improvement in the fiscal situations [Jhaveri 2003b]. This is perhaps the right stage to comment on three specific points made by participants in the growth debate, namely, India is reaching 'inflection' point at which consumption expenditure has triggered elsewhere, industry should reach out to the 'poor' instead of complaining about market size and understatement of Indian growth.

Empirical evidence (for instance, in China) suggests that when per capita income reaches the 'inflection point' of about \$600-700, consumer demand takes off, triggering consumption-led growth. There is evidence of consumption boom but one needs to take note of several qualifiers. Inflection point at which consumption-led growth is triggered would have a correlation with how skewed income and wealth distribution is. Interestingly, the Gini coefficient (a measure of 'skewness') at 37.8 for India, suggests a marginally better (more even) distribution than China, whose Gini coefficient is 40.3 (World Bank). Purchasing power parity (PPP) adjusted income for China (in 1999) was \$3,291 compared with that of India's \$2,149. However, annual growth rate of private consumption during 1980-98 in China was 7.2 per cent compared with 2.7 per cent for India. Respective growth rates adjusted for distribution were 4.3 per cent and 1.7 per cent. Since China's savings rate is much higher than India's, a plausible explanation for such large disparities in consumption growth rate could be difference in prices that have pushed out inflection point.

An important determinant of inflection point is price-income multiple, that is, how many weeks' or months' (or years') income equals the market price of product. Inflection point in India is bound to be higher than China because of relatively high prices of Indian consumer durables (as pointed out by the CII-McKinsey study) and resultant higher price multiples. The boom in consumer credit rides on price reduction plus low interest rates. At this stage, any increase in price and/or cost of consumer credit could raise inflection point and scuttle the boom in consumer demand. While the cost of credit has not risen as yet, prices of manufactured goods are moving up. Some surveys show that an important reason for low penetration of electronic goods in semi-urban and rural areas is poor quality and uncertain supply of electric power. If this finding can be generalised, penetration of consumer durables would take much longer in India, despite reaching inflection point, compared with China, which has paid attention to building infrastructure. The importance of after-sales service in determining penetration ratio is empirically established. The quality of after-sales service even in urban areas bears little resemblance to what is postulated in customer relationship management (CRM) models.

### **'Inclusive Capitalism'**

In this context the argument [Prahalad and Hart 2002] that the poor (over 4 billion in number) constitutes a major market opportunity assumes importance. Although the article is largely addressed to global MNCs, Prahalad has used it in the context of Indian growth (Business World, February 17, 2003) and hence it merits some discussion. There are three elements of the paradigm of 'inclusive capitalism'. The obvious one is the positive (income) effect of increase in the level of income. Higher income is largely a function of the rate of growth, 'percolation effect' and distributive intervention. The second relates to institutional arrangements for enhancing creditworthiness of the 'poor' by converting 'assets' owned by them into bankable collateral and thereby raising the economic participation rate of the poor. The final element is 'innovation' in marketing and products to increase reach and lower cost to (the very low income) users. The net result given the high propensity to consume at low levels of income, would be to increase 'discretionary' income (surplus left after meeting basic needs of food, clothing and shelter) of the poor.

There can be little disagreement of the 'income effect' on consumption growth. The key issue is how to make growth acceleration an 'inclusive income generation process'. This aspect has been extensively debated in economic literature. Higher growth and better distribution are dependent upon, among other things, the structure of output, better spread of education and public health, rural infrastructure and efficient public governance. Without belabouring the point, it would be useful to note that if India had public and corporate governance of better quality, the problem of poverty and unemployment would by now have been of a different nature altogether. Whether, as has been argued earlier, growth driven by knowledge-based activities, technology concentrated at locations with developed infrastructure would be powerful 'inclusive income generation process' requires a separate debate. Without employment generation the poor would not

be able to utilise their biggest asset, namely, 'muscle power'. The alternative is, and there is evidence from the census data, that the poor turn into entrepreneurs, even without using 'physical' assets owned by them as collateral for access to 'business capital'.

In this regard, it should be noted that 'priority sector lending' (up to 40 per cent of deposits) was principally designed to redress 'credit exclusion' of (potential) small borrowers in rural areas and in the urban 'informal sector' by providing business capital to the poor, irrespective of collateral assets. How this provision was abused by politicians, administrators, middlemen and unscrupulous lenders is well known. Foreign banks and private sector banks found ways of lending to those parts of organised trade and business (such as export trade, export manufacturing, inputs used for agriculture), again, defeating the underlying spirit. Unfortunately, local institutions such as cooperative banks have turned out to be even worse. An objective analysis of 'priority sector lending', of which 'micro lending' was a part, suggests that lack of 'creditworthiness' is not the only problem. Besides integrity and efficiency of intermediaries, there is also the issue of high 'transaction cost'. Rural (low cost) branches of nationalised banks are largely a failed experiment. Although the Gramin Bank is the most well known model for 'inclusive lending', some years ago Syndicate Bank successfully tried to mobilise 'pigmy deposits'. The point to ponder is why such examples have remained 'one-off' experiences instead of becoming widely used business models. Part of the answer lies in the fact that operating such institutions requires enormous amount of commitment and identification with the problems of 'fringe borrowers', as in the case of most non-government, non-profit organisations. Over time, Syndicate Bank gave up 'pigmy' deposits and its business model became similar to those of other commercial banks. Most nationalised banks gave up lending schemes to 'fringe borrowers'. Successful examples of 'inclusive capitalism' such as milk producers' cooperatives are pioneered by individuals with missionary zeal. Only when the economics of the business is established does it become a replicable business model. Otherwise, such efforts remain one-off examples driven by highly committed and motivated individuals. The economics of micro lending to fringe borrowers needs to be clearly established, if it is to become a business proposition.

As regards product innovation, 'low cost products' (made out of recycled plastic and rubber) and smaller packet sizes are already happening. But 'product innovation' for reaching out to millions of Indian poor is not there. One wonders whether the example of Nirma (a low priced detergent), used by Prahalad and Hart, is the right one. It is not known to what extent return on capital employed (ROCE) of the order of 121 per cent for Nirma was a result of a 'tax play' to avail of fiscal and other cost advantages available to small-scale industry. Besides, it could well have been a 'low cost' choice grabbed by the price-conscious Indian middle class rather than an 'innovative product' for fringe customers. As regards HLL, while separate ROCE for detergent business is not available, ROCE for the entire company was around 70 per cent (2001-02) compared with 93 per cent (for 1999) for Wheel. Low cost detergent, therefore, irrespective of whether it reached out to the 'poor' or not made better business sense. On the face of it, if servicing the 'poor' was as lucrative as the example suggests it would be difficult to understand the irrational behaviour of otherwise profit chasing entrepreneurs when there is so much of capacity underutilisation. More research is required to determine what makes better sense – intensive effort in improving cost-quality parameters of existing products, or incurring R and D expenses, building long distribution chains, and operating on low margins to cater to the poor. In my judgment, what could give a boost to consumption is across-the-board reduction in cost, especially 'transaction cost' of governance, including tax and 'transaction cost' of bad governance, building rural infrastructure, improved efficiency of delivery mechanism, protection of the poor from exploitation, better education and infrastructure. The surest way of 'inclusive capitalism' is if the government does what it ought to do, efficiently and honestly.

### **Understating Growth**

There is also a view that India's growth is understated, exponential growth in retail finance being the evidence for this. High growth (50 per cent plus) in retail finance and 20 per cent growth in production of consumer durables can be readily explained, consistent with the current (modest) GDP growth. Passenger cars, trucks and two-wheelers account for an overwhelming proportion of retail finance of consumer durables. As per CMIE data, the growth rate of passenger cars and multi-utility vehicles significantly picked up from August 2002, commercial vehicles from April 2002 and growth in two-wheelers (particularly motorcycles) has remained high for almost 18 months. While these were the shining stars of retail finance, according to CMIE, consumer durables as a group registered a decline during April-November 2002. Several items such as air conditioners, refrigerators, pressure cookers, washing machines and, electric fans experienced a far more subdued market environment. This disparity is clearly visible in the balance sheets of the manufacturers.

As regards 50 per cent plus growth in retail finance, one is not sure whether it includes housing. Even if housing is excluded, (retail) financing is an act of intermediation. To put it differently, it is a balance sheet

item. In the books of lenders, assets increase is matched by liabilities in the accounts of borrowers. The element of income out of retail financing comprises factor costs – salaries and wages, margins, administrative costs and so on, which would be far smaller. Currently the high spread enjoyed by retail finance intermediaries is partly because of market inefficiency and 'protection' from competition. The only item that may be rising at an explosive rate is compensation paid to retail finance managers! Besides, as mentioned earlier, superlative growths should be a matter for approbation as well as anxiety. Before concluding this article, it would be interesting to examine some popular India-China beliefs.

### **India-China Comparison**

The good news is that few Indian manufacturers perceive China as an invincible threat. Many Indian companies have identified opportunities for supplying to China. Although several studies, done mainly by consultant firms, have tried to unravel the mystery of the Chinese cost structure, there is a popular belief that China's opaque cost structure comprises several undisclosed subsidies, which will be exposed with its membership of WTO, and that Chinese costs will rise. The CII-McKinsey study has demolished some of these myths but doubts about the transparency of Chinese cost structure persist.

Among economists in particular, one view which heavily relies on studies done by international scholars, is that the quality of Chinese statistics is unreliable and they are doctored to overstate growth. Consistency tests such as energy consumption (in relation to manufacturing) have been put forth as strong evidence. One way of ending this debate at this stage would be to say, "So be it. How does it help India? If China is a paper tiger it would be the funeral of the Chinese!" However, since many are forecasting India's victory in the 'endgame' one might as well deal with this issue.

The growth stories in China and India are still unfolding. Many scholars have scrutinised the massive inflows of foreign direct investment, China's most powerful growth engine. An overwhelming proportion of 'overseas Chinese FDI', it is widely believed, involves a significant amount of 'round tripping'. Some scholars explain this phenomenon as the Chinese way of arranging backdoor entry for local entrepreneurs (Jhaveri 2003a). Whether FDI flow is genuine or 'round tripped', the point remains that additional savings are deployed for productive purposes. The argument is similar in character to that used with regard to 'black money' in India. It deprives the exchequer of revenues but not the country of growth. China's trade ratios, level of genuine FDI, penetration of all kinds of consumer durables, massive imports of steel and aluminum, visible presence of a variety of Chinese goods in supermarkets all over the world, provide strong evidence of tangible growth.

Apart from first hand accounts of several Indian visitors to China, studies carried out by global international consultants and economists also find corroborative evidence of China being on the roll. Most NRI gurus also advance China as a growth role model for India and caution that unless India catches up, the income gap between the two countries will expand. I have already referred earlier to technological transformation that China is attempting, one of the examples being steel industry.

It is true that there are grave doubts about the health of the Chinese banking system. The reported level of non-performing loans (NPL) is a potential volcano, which could cause its economic edifice to collapse. One should look at the 'contamination ratio' comprising non-performing loans, fiscal deficit and internal debt-to-GDP ratios together to gauge financial health and latitude to cure it. India's contamination ratio is higher than that of China.

### **Concluding Observations**

There is little disagreement that India's growth potential is underutilised. The Indian economy certainly has several inherent strengths. There is also a broad consensus that accelerated reform is the key to accelerated growth. India has achieved a respectably high growth rate over a period but its adequacy has to be judged with reference to the performance of other countries. Most Asian countries have achieved a much higher growth rate in the past to race ahead of India and established a sizeable lead in economic and social determinants of quality of life. India and China are bridging the 'growth gap' but China is doing it much faster, thereby demolishing the belief that 'elephants cannot dance'. Empirical evidence suggests that more than the form of democracy, real constraint on growth is its bad practice.

Whether the pace of Indian reforms and resultant macro economic stability constitute a strong enough platform for sustainable high growth is open to doubt. Whether the collective force of Indian 'star performers' is sufficient to outperform the equally (perhaps more) aggressive determination of businesses in other countries requires a dispassionate examination. Several doubts linger. Are Indian multinationals globally

competitive or in regions and markets with low intensity of competition? Can small companies provide the same locomotive power for penetration in global markets and building country brands as the large companies? Would not a stagnant manufacturing base limit the chances of India getting a sizeable share of global trade? Would not low penetration of a number of products in Indian households impair India's ability to outperform world trade? Can India achieve a large market share without significant increase in FDI? It would help growth acceleration if India can achieve the following targets:

(1) Economists, commentators and industry associations having influence on the policy-making process ought to realise that economic parameters constitute a necessary but not sufficient condition. To enhance the role of economic parameters, the market mechanism has to gain efficiency. Along with minimal discretionary interference, the government would have to practise fiscal discipline and establish strong and independent regulation.

(2) It is unlikely that India can achieve sustainable high growth and improvement in living standards without a significant increase in the share of manufacturing in GDP. The existing GDP mix, with services sector as the most powerful growth locomotive is unsustainable. Nor, with heavy bias towards non-productive services, is it desirable.

(3) The popular belief that India can have a high growth strategy on 'knowledge-based' industries and services, principally IT, needs serious re-examination. India's low cost IT model would have to change drastically. Shift to 'product' and 'product-based-service' model would require much larger investments in R and D and scaling up of size. Low penetration of IT in domestic market-linkages with output sectors limits the size of the IT market and also deprives productivity benefit to the Indian economy.

(4) The private sector and government need to address several soft issues. If government policies adversely affect desirable consolidation, management attitude is also a roadblock. If small and medium companies are better equipped to provide entrepreneurship and innovation large size is essential for availing scale economies. The multiplicity of industry associations without 'specialisation' deprives industry of knowledge-based and focused lobbying.

(5) Several companies have accepted the goal of corporate social responsibility, more rigorous and transparent accountability standards and measures of performance. In practice, because of weaknesses in pursuing these goals, resolution of conflict between interest of management and expectations of society remains a major source of grievance. This has to be addressed.

(6) Improved governance is the key. Even the best managers cannot generate high growth if governance is poor. Successful conduct of democratic elections is indeed an achievement but no assurance that society and citizens are protected against abuse of power for personal gains. There is considerable evidence to suggest that bad governance is the strongest growth-retardant. Good governance and productive collaboration between government and industry, based on mutual confidence and respect, is absolutely essential for safeguarding national interest. One perceptible outcome of globalisation is much greater uncertainty and volatility as well as frequent and pronounced conflicts of interest between dictators of globalisation and interests of countries. Improvement in standards, penalty for failure and wrongdoing, and accountability, to name a few, have become an integral part of the environment for any economic entity. Unfortunately, while it is easier to control corporate conduct and penalise wrongdoings, citizens' effective authority is too weak to rein in and punish erring politicians and bureaucrats.

(7) Ideally, if one can repair all the institutions and motivation structures, many things would fall in place. This can only happen if ethical and social capital, which is substantially eroded is restored. There are three principal options to leverage post-reform transformation into a sustainable growth momentum. One is a top-down approach driven by political leadership. The second is for business leaders who have demonstrated vision and the urge to grow to also assume growth leadership. Perhaps the best alternative is to forge meaningful relationships and alliances between star performers in diverse fields, such as manufacturing, finance, administration, trade, social services and politics.

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