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Can India make it without manufacturing? by Peter Drysdale

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There's one school of thought in Indian academic and policy circles that India represents a new model of development on the way to prosperity. India, it's claimed, will be a services-led growth model, built on the spectacular international success of its IT hub in Bangalore, and its supply of English-literate back office services to the world.

This way of thinking eschews the experiences of Japan, South Korea, Taiwan, and China in East Asia that saw prosperity built on investment in competitive manufacturing and skills, and eventually a world-class manufacturing base. No need to try to emulate the Japanese or South Korean industrial powerhouses or Global Factory China in this model: skip all that and go straight to the top of the ladder.

This is no idiosyncratic Indian thought bubble. Its articulation in an extreme form may be confined to narrow circles. But the germ in the idea infects the way in which some of India's top policymakers think about how, for example, the country should position against what is frequently conceived as the challenge of Chinese competitiveness. There is little conception in many Indian policy circles of the transformation that is taking place in East Asian manufacturing, where China is moving into higher-value manufacturing and vacating its labor-absorbing end to others, including potentially India.

India, unlike China, has one of the world's youngest populations, with some 260 million people below the age of 25, and its economy is once again growing quickly. At 7 percent growth it is one of the world's fastest-growing economies as of August 2015. It also has one of the world's largest concentrations of poor people, with more than 723 million people in 2011 living on less than $2 a day and its per capita income, at $1596 in 2014, is much lower than that of the East Asian economies.

There is no doubt that India needs a strategy on how it will compete in a rapidly changing global market for manufacturing as well as services, a market that is shaped by global supply chains, distributed sourcing and processing, and technologies that are constantly changing. India also has a low female labor force participation rate – around 33 percent in 2012, compared to an East Asian average of 63 percent – and it needs to draw more women into the organized workforce. It need look no further than its neighbor Bangladesh to see what a dramatic impact opening up can have on moving toward these policy targets.

The reality is that it is manufacturing that has contributed most strongly to economic growth in developing countries like India. Internationally competitive IT services play an important role in the economy, but it is small and unlikely to be able to absorb the wave of new labor that will enter the Indian labor market over the coming decades.

On any objective measure, India has a comparative advantage in low-skilled labor-intensive manufacturing. But the opportunities for its deployment in the formal sector have been frustrated by restrictive labor laws and a less than welcoming environment for foreign investment, essential to effective participation in international production networks. The formal manufacturing sector in India currently uses *skilled* labor more intensively. This sector is crucial to absorbing the vast, informal labor force. Otherwise, manufacturing will struggle to provide the productive employment opportunities India sorely needs. And growth in the formal manufacturing sector as a share of national output seems to have stalled well before India as a whole has fully industrialized. The data suggests that only in Gujarat and in Himachal Pradesh is the formal manufacturing sector's share of value added increasing.

There are more than 140 overlapping labor laws in India: 44 at the federal and about 100 at the state level. States with overly restrictive laws have experienced weaker industrial growth and have benefited less from investment delicensing. This burdensome regulatory environment is part of the reason why the growth of India's manufacturing is stunted. Land acquisition laws are another.

As noted in this week's East Asia Forum Weekly Digest, Anthony D'Costa is skeptical about whether Prime Minister Narendra Modi's "Make in India" strategy provides the answer. While it's a catchy and visionary idea, he suggests, it looks rather too much like a reworking of the Nehruvian policy of import-substituting industrialization. Modi's strategy and Nehru's are both aimed at increasing local content (fewer imports), although they do differ in significant respects. More imports alongside more exports are essential to lifting incomes via efficient integration in the global economy today. India's and the world economy are no longer the same as they once were. The economic importance of agriculture has declined substantially, while that of services has increased dramatically. But Indian industry is still stagnating. Employment in agriculture remains high at nearly 50 percent of India's 475 million-strong workforce. Industries and services both have roughly 25 percent.

"Most of India's employment is in the informal sector, where employment is low paying, precarious and unregulated," D'Costa points out. "The services sector is a mixed bag, with both low-paying domestic work and high-salaried IT professionals. The interrelated tasks for Modi are: to make agriculture productive; raise rural incomes; and effectively reduce rural dependence, while expanding industrial and services jobs."

The best bet for "Make in India" lies in labor-absorbing manufacturing, like that of China, as D'Costa argues. On this, Modi has made some headway with foreign investors. But that alone won't do the job.

The political economy of Indian reform in most areas is difficult, particularly because of the regulatory overlap with different levels of government. The Modi government's plan of decentralizing policymaking, backed by a large increase in the states' share of tax revenue, is one way of providing incentive for the states to implement reforms themselves in order to compete for investment. Competitive federalism is potentially critical to momentum in Indian reform that looks outward, and gets rid of the regulatory burdens on internationally competitive manufacturing.

D'Costa is right that it will need more than ad hoc exhortations of foreign investors for Modi's "Make in India" campaign to succeed. Yet the Modi government has shown that it understands better than any government before it the scale and breadth of the task at hand – even if it is still yet to articulate fully the reform strategies that will deliver the growth of incomes and employment in manufacturing that it will need to satisfy the aspirations of India's youth over the coming decades.

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