Employment problem and phenomenon of missing middle

Part 1 – Comparative trends in sectoral shares of employment and labour productivity

Characteristics of economic growth in India

- First, the growth process seems to have been led by the tertiary sector—both in terms of value added and employment, rather than manufacturing;
- Second, while the expectation in labor-abundant economy might be that the tertiary sector had disproportionately absorbed labor displaced from agriculture at low levels of earnings, the data seems to suggest that this has not been so. Earnings level in the tertiary sector has been significantly above those in manufacturing, suggesting that growth in the tertiary sector has been productivity-led rather than employment led.
- Third, the manufacturing sector in India has been characterized by the persistence in "dualism". That is, employment is concentrated at two extremes. At one end, bulk of the employment is with household operated businesses and other end, it is with firm operating above 500 or more workers.

- There has been a strong bi-modal distribution in employment even when we confine our attention to the

non-household sub-sector (business firms) in manufacturing with strong concentration of employment at the small and large size-groups of establishments, with a conspicuous 'missing middle'.

- A related point is that the productivity (and wage) gap between the two extreme size groups is much larger in India than in even other Asian economies.

Arguments developed in the reading

- It is the ‘dualism’ in the manufacturing sector which has slowed down the expected dynamic role of this sector in the growth of the economy.
- The bias towards the tertiary sector in the growth a pattern and the productivity gap in its favor can also be traced to the persistence of dualism in manufacturing.

Trends in Overall Employment- reflecting a tertiary bias

- The share of employment of agriculture in the post-reform decade of 1993/4 to 2004/5 had declined by 6.5 percentage points — nearly doubles the decline in the pervious decade. Barely 1.1 percent of this decline was absorbed by manufacturing
- The tertiary sector, along with construction accounted of the bulk of the relative change in the industrial structure

Trends in tertiary employment

- First, in many developing countries the public sector has taken the lead in creating employment in government and related services. This is, however, not so in the post-reform India.
- Second, much attention has been paid top the development of the IT sector and outsourcing in recent years. The direct contribution to employment in these sub-sectors, however, has been quite small. Instead its sub-sector ‘transport, storage and communication’ accounted for no more than a sixth of total employment in the tertiary sector, although its incremental share was quite high.
- ‘Trade, hotel and restaurants’ continued to play the dominant role in employment in this sector, and its relative growth in the post-reform decade seems to have been higher than the average for the sector as a whole.

Asians neighbours and their experience

- The newly industrializing countries of Asia—Korea and Taiwan—had their share of employment in manufacturing increasing much faster than that of the tertiary sector during their initial period of growth in the seventies.
- Only in the nineties, after Taiwan and Korea had developed into mature industrialized economies, did their tertiary sector become the dominant provider of employment outside agriculture
- By contrast India's share of employment growth in the tertiary sector in the seventies was already 60 per cent higher than in manufacturing. Since then, the decades of eighties and the nineties have seen a virtual stagnation in the share of employment in manufacturing, with the tertiary sector absorbing virtually the entire loss of employment share by the agriculture.

- Other developing countries of Asia—Thailand, Malaysia and Indonesia – do have their larger shares of employment created in the tertiary sector, but the contrast with India is that none of them have a stagnant share in manufacturing in any decade

Productivity trends in tertiary sector

- It is seen that the mean productivity of labor has been higher throughout in the tertiary sector relative to manufacturing, and might have increased somewhat over the post-reform decade.
- Even manufacturing does not perform better than the least productive sub-sector of tertiary activities (trade etc.) which are supposed to be relatively free entry sector, allowing labor displaced from agriculture to push down earnings.
- The tertiary sector contrasts dramatically the experience of the construction sector.

Tertiary sector productivity comparisons (1960 -2002)

Comparing relative productivity of service sector (relative to our industrial sector) with other countries—China, Indonesia, Thailand, Malaysia gives us following:

- It turns out that the share of workforce in industry increased along with its share of GDP in all countries including India, but it contributed greater share of GDP in all Asian developing countries other than India. It implied that the relative sectoral productivity of labor in Indian manufacturing has been strikingly low by international comparison. In 2002 the tertiary sector in India contributed more than half the GDP in India but its contribution to employment was only 22 per cent.
- A second important point to note is that the productivity in services exceeds that in industry only in India and that by a substantial percentage. It shows that service sector growth in India has been productivity led and not employment led contradicting views of some economists that employment grew in services because this sector has been a repository of low income labor “pushed out” of agriculture.

- The heart of the employment problem in India would thus seem to be not an excess absorption of labor in the tertiary sector, but the low productivity of the manufacturing sector, and its persistence over time

Employment problem and phenomenon of missing middle

Part 2 – dualism in the organized manufacturing and its proximate causes

Statistical profile of the manufacturing sector

The Indian statistical authorities distinguish four types of establishments.

There are three sub-categories within the unorganized sector;

(i) Own-account manufacturing enterprises (OAME) which are household enterprises making use only of family labor;

(ii) Non-directory manufacturing establishments (NDME) who employ at least one wage (hired) worker) and have between 2-5 workers in total: and

(iii) Directory manufacturing establishments (DME) employing between 6-9 workers in total of which at least one would be a hired worker.

- These three sub-categories co-exist with the formal or organized sector which are statistically defined (by the Factory Act) to be employing ten or more workers.

Employment structure & missing middle

- Employment showed that household sector employs 55% of workers and contributes only 10% in GDP, which is perhaps a dominant factor in overall low productivity of manufacturing.
- Second problem of major importance is the peculiarity of the Indian structure in the sector of manufacturing which largely makes use of hired labor as the dominant type of employment in the enterprise.
- This includes both the DME and the organized sector as defined under the Factory Act. India has 'dualistic' structure with a bi-polar distribution. There are two strong modes in the distribution of employment in modern manufacturing: in the 500 and more category and the 5-9 category with the proportion of employment in the intermediate middle size groups being conspicuously small.
- This phenomenon-sometimes characterized as that of the "missing middle" is contrasted with other Asian countries—e.g., Korea, Hong Kong, Taiwan, Malaysia and Thailand.

Employment shares in comparative terms

- A few of these other Asian countries like Taiwan, Hong Kong, Japan and post-1990 Korea have strong presence of small enterprises in the 5-9 class but the proportion of employment in this group is never as much as in the large enterprises, and of course the intermediate size groups are well represented.
- A further striking difference between India and the other Asian countries with a strong small-scale sector in manufacturing is that the productivity gap between the small and the large units in modern manufacturing is much larger in India.
- The gap in labor productivity between the large and the small size groups in India is of the order of 8:1, as against 3:1 in Japan, Korea and Taiwan (and even smaller in Hong Kong

Reforms and its effect on structure of employment within manufacturing

- Over-all the employment elasticity in the pre-reform period 1973-90 and 1990-2005 has been 0.27 and 0.16 respectively, even as the output (value added) growth has increased from 6.6 per cent to 7.0 per cent over these two broad periods.
- It seems that the organized manufacturing sector has been reluctant to increase labor use per unit of output even as state policy has moved in the direction of a lessening of controls. The increase in employment in all manufacturing which we do observe has been almost entirely due to the increase in employment in the unorganized sub-sector.
- As far as the distribution of employment in hired labour segement (DME & Organized sector together) the only change over the period covered seems to have been a significant reaction in the number employed in very large firms (1000 & above). The distribution is, however still bipolar with strong modes at the employment size groups at the two extremes (6-9 and 500+).

- The productivity differentials by size-groups seem to have changed even less. If anything the extreme ‘dualism’ noticed in India compared to other Asian countries seems to have worsened since 1984-5, though much of the deterioration occurred in the first half of the eighties.

Dualism a problem?

- This could be understood by looking at following :

1. The impact on allocative efficiency and wage inequality;
2. The dynamic impact on the growth of skilled labor and entrepreneurship;
3. The stagnation in the growth of markets for manufactured goods.

The impact on allocative efficiency and wage inequality;

- We know from independent evidence that large firms have access to capital supplied by the formal financial institutions, while small firms mostly have to depend on local informal sources of finance and the interest rate differential between these sources can be huge.
- It is also well known that wage levels follow differences in labor productivity and large firms have a higher wage per worker which, even after we have controlled for measurable human capital attributes （education, training, occupation and knowledge of English） , are much higher in the large firms.
- To conclude, larger these differences , larger the loss in welfare . In other words, resources are not utilized efficiently . Also this dualistic pattern perpetuates income inequality

Impact on the growth of skilled labor and entrepreneurship

- Missing middle implies a weak process of graduation of small firms and the development of entrepreneurship. It is arguable that the dispersion of entrepreneurship as well as industrial technology over a wide spectrum of spatially and economically distributed regions is dependent on the mushrooming of medium scale enterprises, into which the small units are able to graduate.
- Similarly dualism slows down the growth of the labor force with industrial skills. This is particularly true in developing economies in which many of the skill requirements of modern industry (including discipline in the workplace) are acquired by on-the-job-training rather than education in schools.
- The slow growth of the skilled work force in its turn has an impact on the choice of technology. It has been established that capital intensive techniques have been adopted in economies or sectors more in response to a shortage of skilled rather than unskilled labor.

Dampening the growth of markets

- Dualism strengthens and perpetuates product market segmentation. The market for industrial products is split into low quality products catering to the need of low income consumers, and supplied by small-scale local producers on the one hand, and the higher quality segments which the large establishments supply to a limited number of high-income consumers.
- The lack of integration of markets could be a bottleneck in the development of mass markets for manufactured consumer goods.

Reasons for dualism

- Labour Legislation

The “factory Act” applies to all workers in the ‘registered’ sector which covers units employing 10 or more workers using power. Additionally, Job Security legislation kicks in for units with employment size of 100 or more workers. Both types of legislation would impose costs on units increasing beyond the threshold sizes

- Education Polices

Education polices have been biased towards the promotion of tertiary education and has neglected basic primary and low secondary education.

The relatively plentiful supply of skilled labor with higher education biases production to less labor- intensive industry and modes of production. Large units have a comparative advantage in using such labor which smaller units cannot afford.

- <u>The protection of small-scale units</u>

This has been an important aspect of Indian industrial policy since independence. It has taken the form of reservation of large number of items for production in exclusively small units and the provision of incentives—fiscal, financial and legislative—as long as the units stayed below a certain size. The threshold size was first defined in terms of the traditional employment size of 5 workers. It was in later years changed to a definition based on capital size. But this has provided incentive to expand horizontally with more small units, rather vertically with larger middle-sized units.

- <u>Hysteresis</u>

Economic agents and institutions acquire characteristics which sustain the system. For example, entrepreneurs develop with ambitions to think in terms of horizontal rather than vertical growth. Marketing channels, financial institutions and infrastructure are geared more to supporting small units with limited market rather than dynamic units growing into larger sizes and different markets. This is evident in the little progress visible in size structure of establishment even after the abolishment of small scale reservation policy in 1991.

- The Employment Problem in India and the Phenomenon of the Missing Middle , Dipak Mazumdar and Sandip Sarkar, 2008

Export performance vis a vis China

General argument for increasing exports

- A major misconception among policy makers in India is that the country should necessarily diversify to new markets in the developing world if it has to increase its exports.
- Based on this perception, in the recent past, Indian government had announced an export incentive scheme providing certain explicit financial supports for market diversification .
- Outcome of these polices so far don’t seem to be very benign.

Important questions to ask

India’s export performance since the 1990s leaves much to be desired especially when compared to that of China.

- What type of policy interventions would help India achieve faster export growth?
- Should export promotion policies be targeted at accelerating export growth along the intensive margin or extensive margin?

Export performance under Trade liberalization

- Prior to economic reforms, both India and China followed relatively autarkic (closed economy) trade policies accompanied by a battery of trade and exchange rate controls which severed the link between domestic and world relative prices (Lal, 1995).
- Exchange rates were overvalued in both the countries, which created a bias against exports. As a result, during the period 1950-1970, exports from these countries grew slower than world exports, with the gap being particularly pronounced for India.
- During the decade of the 1970s, however, taking advantage of buoyant world demand, exports from India and China grew faster at the rate of 17.7% and 19% per annum, respectively. Despite the acceleration in growth, world export market shares of both the countries remained paltry during the 1970s .

- China started the process of trade liberalization in earnest in 1978, while India started the process a decade later – during the early 1990s . Along with progressive dismantling of trade barriers, both the countries carried out exchange rate reforms to eliminate the anti-export bias of overvalued currencies.
- India has followed a 'managed floating' exchange rate system from 1994 onward, while Chinese Yuan was pegged to the US dollar from 1994 to 2005. Since July 2005, however, China allowed its currency to float within a range determined in relation to a basket of currencies.
- India removed most of the quantitative restrictions (QRs) on importing capital goods and intermediates in 1992, although the ban on importing several consumer goods continued until the late 1990s. Alongside the removal of QRs, customs duties in manufacturing industries were gradually reduced in both countries.

- Although policy changes have gone a long way toward easing the entry barriers, multiple barriers to exit for non-viable production units continue to remain due to the rigid labor and bankruptcy laws in India
- Exit barriers and other labor market rigidities act as major impediments to the process of comparative advantage based resource allocation in India (Panagariya, 2008).
- By contrast, labor market reforms in China since the early 1980s, particularly in the non-state sector, has provided it with greater flexibility in the allocation of resources (Meng, 2000; Brooks and Tao, 2003).

- Throughout the post-reform period, exports from India and China grew faster than world exports
- While China’s share in world merchandise exports increased dramatically from 0.9% in 1980 to 13.8% in 2015, India’s share increased rather slowly from 0.4% to 1.6% .
- The gap between the two countries is starker when we compare their shares in world exports of manufactured products: between 1980 and 2014, while China’s share steadily increased from about 0.8% to a whopping 17.9%, India’s share increased from 0.5% to just 1.6% .

Composition of Indian exports

- Studies have noted the idiosyncratic nature of India’s specialization patterns in that, despite being a labor-abundant country, the fast growing exports are either capital intensive or skill-intensive (Krueger, 2010). While the share of capital intensive products in India’s merchandise exports increased consistently from about 32% in 2000 to nearly 53% in 2015, the share of unskilled labor-intensive products declined from about 30% to 17% (Veeramani, 2016).
- Arguably, as a result of specialization in capital and skill-intensive industries, India has gained a competitive advantage in relatively poorer markets (such as Africa) but at the cost of losing market shares in richer countries. While capital intensive products from India are unlikely to make inroads into the quality conscious richer country markets, India’s labor intensive products have a significant potential to penetrate into these markets.
- Thus, specialization out of traditional labor-intensive products implies a general loss of India’s export potential in advanced country markets. Indeed, the share of high-income OECD countries in India’s export basket declined considerably over the last two decades, from 58.2% in 1992 to 38.6% in 2015 .

Composition of China’s exports

- In contrast to India, China’s export composition shows a strong bias in favor of labor-intensive product groups. As a consequence, the direction of its exports exhibits a palpable bias in favour of markets in developed countries . China’s export promotion policies since the 1990s have relied heavily on a strategy of integrating its domestic industries with the global production networks （Athukorala, 2012）.
- In particular, based on imported parts and components, China has emerged as a global hub for electrical and electronic goods assembly. Typically, China imports parts and components from other parts of East Asia and exports finished goods to the United States and Europe. A manifestation of China’s participation in global production networks is the growing importance of machinery items in its export basket . Though conventionally considered as capital-intensive, certain stages of production or tasks within the broad group of machinery, such as low-end assembly activities, are highly labour-intensive.

- Low wage countries like China mainly specialize in labour-intensive stages of production within machinery.
- As noted by Amiti and Freund (2010, p 36) "…on the surface, it appears that China is dramatically changing its comparative advantage, yet a closer examination reveals that it is continuing to specialize in labour-intensive goods".
- They observe that, once processing trade is accounted for, the labor intensity of China's exports remained unchanged during 1992-2005.

Veermani (2017) study

- Their study reveals that India lags behind China mainly along the intensive margin. China's export success has been essentially driven by volume growth, rather than price increases, in a wide range of product groups within the manufacturing sector. While exploitation of growth along quantity margin is the crucial driving force behind China's export success, India's poor export market penetration can be attributed mainly to an abysmally low quantity margin.
- While India-China export performance gap along the intensive margin can be seen across all product groups, the difference is particularly large for the group of unskilled labor-intensive products. India's export growth is biased in favor of human capital and technology intensive products and against unskilled labor-intensive products. This pattern of growth is idiosyncratic and is an anomaly for a labor-abundant and low wage country like India.

- The lackluster performance in unskilled labor-intensive products is entirely due to lack of depth (intensive margin) in India’s export relationships even as the country could expand the range of its products and markets (extensive margin). As far as extensive margin is concerned, the gap between the two countries is getting narrower over the years as India is catching up with China. Along the intensive margin, however, we find that the gap is getting wider over the years.

Explanation for China’s superior performance

- Their results suggest that China’s exchange rate policy was not the prime reason for its export success. Neither do they find that FDI inflows were significant in explaining the export performance gap between them.
- The results show that China’s export relationship bias towards high-income partner countries holds the key in understanding its superior performance. This bias is a natural consequence of China’s high degree of specialization in labor-intensive activities.
- India, by contrast, due to an idiosyncratic pattern of specialization, has failed to exploit its export potential in high income countries.

- Intensive and Extensive Margins of Exports: What Can India Learn from China? C. Veeramani, Lakshmi A, Prachi Gupta

MAKE IN INDIA

Part 1 - Context & Conundrum

World economic outlook (context for make in India)

- After the financial crises of 2008 , economies throughout the world findings it hard to maintain growth rate witnessed before the crises.
- Institutions like IMF has repeatedly lowered its forecast for world economic growth
- In fact, after 6 years of a tepid post-Crisis recovery, the IMF titles its latest World Economic Outlook "Legacies, Clouds and Uncertainties". The legacies, clouds and uncertainties continue even after 6 years after Financial Crisis.

Policy tools used so far

- The first phenomenon of this slow growth was in the 1970s when there were high levels of inflation when governments tried to finance the spending by printing money. It however didn’t work.
- But if the economy can't inflate its way and there is still the need to spend what does one do? The governments issue debt and debt levels started picking up in industrial countries. At some point, even that became difficult. Which led to the question, what next?
- It was thought that encourage private debt can do the trick, One would encourage people to borrow and spend, encourage housing loans and so on. There was the third phase which was an explosion of private lending just before the Financial Crisis and that also proved too much.
- In the US, it was private debt which was the problem. In Europe, it was public debt especially in the periphery which proved to be the problem. So, this phenomenon of trying to increase growth higher than the potential of the economy eventually came a cropper in the West with Great Financial Crisis.

Different explanations for lower growth

1) Overhang of debt
2) Secular stagnation
3) Decline in total factor productivity

Overhang of debt

- When countries have lots of debt it prevents them from growing fast. Banks can't lend, households find it difficult to borrow and governments can't do Keynesian spending simply because they don't have the fiscal space.
- The implication here is that growth is unacceptably low relative to potential and more can be done to lift it through a variety of stimulus policies. Then just monetary stimulus will not do, there should be a fiscal stimulus too. So, more and more governments are urged to do obvious things like building infrastructure.
- If there is one country which has tried this for a long time it is Japan. Japan has been in a quasi-recession for 20 years now, really hasn't got out of the Great Crash of early 1990s and it has done everything that has been suggested.
- Interest rates have been low for long, quantitative easing and massive debt-financed spending on infrastructure. Japan had very low levels of government debt to GDP. Today, it has the highest net government debt to GDP in the industrial world.

Secular stagnation

- There is now a different narrative of the pre-crisis period from this traditional view i.e. debt overhang to explain why the efforts at stimulating the economy back to the pre-Crisis growth paths have not been successful even six years after the Crisis.
- A common term, "secular stagnation" used by Larry Summers to describe this persistent slow growth phenomenon.
- Different economists focus on different versions of secular stagnation. Larry Summers emphasizes the inadequacy of aggregate demand, the Keynesian view, and the fact that interest rate can't be pushed below zero. Therefore we can't give more monetary stimulus than certain level in a period of low inflation.
- The possibility for financial instability prevents monetary policy from being more active. Coupled with that we don't have tools to stimulate but we also have headwinds to growth, specially ageing populations who want to consume less and the increasing income share of the very rich whose marginal propensity to consume is very small. Those are the arguments for slow growth from demand side.

Decline in total factor productivity

- There are others who argue that low growth from the supply side has been building for a long time.
- Prominent among those are Tyler Cowen and Robert Gordon who argue that the post-World War II years (30 years) of growth was extremely strong. This was because growth was helped by reconstruction in Europe, the spread of technologies such as electricity, telephones, and automobiles, rising educational attainments, and higher labor participation rates. Remember that women joined the workforce in a big way post World War II as well as restoration of global trade and increasing investment of capital.
- Everything was going in the right direction. Interestingly the one thing that was not going in the right direction was total factor productivity which was the highest during 1920-50 when world growth was relatively slow but since then productivity has been falling off.

- For those who think face book and social media are wonderful new inventions and the world has been more inventive and innovative in this period than ever before, think about the innovations that happened in early part of the 20th century.
- There was a transition from horse drawn car- to motor cars, from gas lit lamps to electricity, from coal filled irons to electric irons, and from washing clothes at the stream to washing machine. Compare those kinds of changes with twitter, Facebook etc. and it can be seen that productivity growth was really quite larges at that time.

Job implications for industrialised regions

- Further complicating this environment of slow growth is a growing angst amongst the middle class in a number of countries.
- It is coming because of technology, because of globalization. The routine jobs that used to exist have all gone away. Adding up both sides of the balance sheet is now taken by computers or by somebody sitting in India.
- What are left are the non-routine menial jobs such as flipping hamburgers that is still not automated. Nor is gardening automated. Haircut is still not automated. These are still non-routine and relatively low skilled jobs as well as non-routine high-skilled jobs such as the consultants and lawyers etc. So we have got bifurcation of jobs available, low paying and very high paying and nothing in the middle.

Current situation

- The middle class in a number of industrial countries is desperately anxious They realize they haven't had the quality education they need to apply to Ivy League. Moreover if they enter to the Ivy League, they don't have the money to afford it. So, there is a very great angst in the middle class in Europe about what will happen to them.
- This has given rise to populist movements all over the world. For example- Tea Party in United States or UKIP in the United Kingdom have come up. These are all parties that are playing to the middle class angst. The kind of message they often give is that there is a possibility of a backlash against technology, global finance, and foreign immigration and trade, saying these are the kind of things that hurt and these are the things that have be kept in check.

Make in India

Part 2- Exports prospects

Export led growth (prospects)

- Over the last 3 decades, every Asian country has developed on the back of its export- led growth. In fact, most recently, Latin America has developed on the back of exporting to China which has exported to industrial countries.
- Export led growth has been a facet of emerging markets because relying on domestic demand is very difficult due to the temptation to over stimulate.
- Developing countries when they have to rely on their own demand tends to run excessively large fiscal deficits and have credit booms which turn into credit bust and excessively high inflation.
- Those are the problems which always existed in relying only on domestic demand which is why when one exports efficiently that growth becomes very sustainable. That is more difficult today.

- It also becomes more difficult because of the abundance of liquidity around the world as a result of the ultra-accommodative monetary policies around the globe , countries competing with each other in attracting these funds.(which means keeping high interest rate to attract foreign investors).
- Even if developing country like India becomes successful in attracting these funds, when monetary policy in industrialize countries tightens reducing excess money or liquidity available for lending abroad , it results in foreign investor withdrawing their funds from developing nation markets thereby creating significant disruption in the form of cycle of boom and bust , asset price bubbles and crash , exchange rate overvaluation and devaluation.

Make in India

- First is 'Make in India'. The Government has announced this and it meant improving the efficiency of producing in India, whether of agricultural commodities, mining, manufacturing, or services. To achieve this goal, the Government has to implement its ambitious plans on building out infrastructure. This includes physically linking every corner of the country to domestic and international markets through roads, railways, ports and airports.
- Second element is ensuring the availability of inputs such as power, minerals and water at competitive prices. Everyone has to be linked electronically and financially through mobiles, broadband, and intermediaries such as business correspondents. Institutions such as markets, warehouses, regulators, information aggregators and disseminators, etc. are required.
- Finally, there is a need for affordable and safe homes and work places across the country.

- A second necessity for increasing productivity in India is to improve human capital requiring healthcare, nutrition and sanitation. Unless the people are healthy and able they can't participate in the modern economy. That has to begin but then more appropriate education and skills that are valued in the labor market and firms have the incentives to invest in workers are required. One of the biggest consequences of labor reforms will be to give firms more incentives to invest in their workers because they intent to retain them longer
- The Government is examining the third aspect which is reducing the cost of doing business in India. The woes of the big business are well known but woes of small entrepreneur are even greater as they confront the myriad, mysterious regulations that govern them and the numerous inspectors who have the power to close them do.
- Finally, access to finance has to be made easier. If we want domestic demand people have to have the ability to borrow and spend not easily but to a reasonable extent.

Some Caveats

- First, there is a danger when we discuss "Make in India" of assuming that it means a focus on manufacturing, an attempt to follow the export-led growth path that China followed. There is a need to be careful because slow growing industrial countries are much less likely to absorb a significant amount of imports in the foreseeable future. Other emerging markets certainly could absorb more.
- We have to more and more regional focus. We have to look at Africa. We have to look at East Asia. But, the world as a whole is unlikely to be able to accommodate another export-led China for which we are currently aiming under Make in India.

- Second, industrial countries them selves are now adopting capital intensive flexible manufacturing, dispensing with labor but doing what they outsourced, at cheaper cost made possible by the fact that, for example, United States has very cheap energy today. Any emerging market wanting to export manufacturing goods will have to contend with this new phenomenon of the industrial countries moving into that area.
- Third, when India pushes into manufacturing exports, it will have China, which still has some surplus agricultural labor to draw on, to contend with. Ex port-led growth will not be as easy as it was for the Asian economies that preceded us and, therefore, we have to be careful about focusing on that.

- The aforesaid should not lead to export pessimism here. The country must export. India has been extremely successful at carving out its own areas of comparative advantage, and will continue to do so. Instead, the counsel is against an export-led strategy that involves subsidizing exporters with cheap inputs as well as an undervalued exchange rate, simply because it is unlikely to be effective at this juncture.
- There is also a need to caution against picking a particular sector such as manufacturing for encouragement, simply because it has worked well for China. India is different, and developing at a different time, and should be agnostic about what will work.
- Instead of subsidizing inputs to specific industries because they are deemed important or labor intensive, a strategy that has not really paid off for us over the years, let us figure out the public goods that each industry needs and strive to provide them.
- For instance, there is need to produce for the inter SMEs might benefit much more from an agency that can certify product quality, or a platform to help them sell receivables, or state portal that will create marketing web sites for them, than from subsidized credit. The tourist industry will probably benefit from the announcement of visa on arrival and a strong transportation network than from the tax benefits they usually demand. The caution should be on subsidies and tax benefits and focus on public goods that can be provided for by the Government.

- A second possible misunderstanding is to see “Make in India” as a strategy of import substitution through tariff barriers. This has been tried before and it has not worked because it ended up reducing domestic competition, making producers inefficient, and increasing costs to consumers.
- "Make in India" is seen as more openness and creating an environment that makes our firms able to compete with rest of the world, and encourages foreign producers to come take advantage of our environment to create jobs in India. It is about creating the environment rather picking specific set of terms.

- Make in India: Largely for India , Raghuram Rajan, 2015

Reforming labour laws

Part 1 - Theoretical perspectives

Arguments against labour laws (in their present form)

- India’s labour laws are decades old and are said to suffer from rigidities which are holding back economic development. Worker-protective labour laws, it is argued, are deterring investment and stalling the growth of formal employment.
- India’s labour laws are set at an inappropriately high level for a developing economy, which would otherwise be in a position to use low-cost labour as a source of comparative advantage.
- The strict regulation of employment terminations (“retrenchments”) in Part V B of the Industrial Disputes Act (IDA) 1947 (as amended in 1976) has been a particular focus of criticism. Critics of this law argue that as it targets larger plants and enterprises for regulation, it discourages the growth of fi rms, and contributes to labour informality.

Theoretical discourse on labour laws

- Beginning in the 1980s and gathering strength during the years of the "Washington Consensus", the economic critique of labour law was part of a wider case against regulation, which saw state interference as the source of distortions and inefficiencies in the operation of markets.
- This argument depended critically on the validity of its main premise, which is that markets, if unregulated, will move naturally or spontaneously to an equilibrium state.
- This follows axiomatically from the assumptions of individual rationality (consistent preferences coupled with maximisation) and market equilibrium which underlie neoclassical models (Becker 1976)

Shifts in theoretical discourse

- Since the mathematical formalisation of the competitive market economy reached its climax in the middle decades of the 20th century (Arrow and Hahn 1971), economic theory has directed its attention towards understanding how market exchange comes to be established in the first place, a very different question.
- The reorientation of the social sciences away from the study of markets in equilibrium towards analysis of the dynamics of institutions and institutional change has significant implications for labour markets in general and for the experience of developing countries in particular.
- Modern institutional economics recognises that labour markets are far from perfect. Labour market outcomes are skewed by transaction costs arising from uncertainty and incompleteness of contracting (Williamson, Wachter and Harris 1975) and by externalities arising from asymmetric information

Understanding labour laws development in industrialized countries

- Characteristic features of labour market regulations in industrial market economies can be understood as evolved responses to the coordination problems associated with the distinctive form of the employment contract (Deakin and Sarkar 2008). These include social insurance, employment protection and worker representation.
- Transition to a wage-based economy with formal labour market relations does not occur in an institutional vacuum. Loss of access to traditional means of subsistence is compensated for by new forms of mutualisation and protection for the working population

- In the global North, the transition to an industrial economy occurred conterminously with the evolution of institutions for managing and diffusing labour market risks, including laws on wage regulation, poor relief and apprenticeship, which anticipated later features of modern welfare states in Europe and North America (Deakin and Wilkinson 2005).
- This point of view does not imply that labour market regulation is always and everywhere efficient. In the context of industrial economies with established institutions, there is a debate to be had over the appropriate form of regulation and over the degree of worker protection which is compatible with the use of the market as a mechanism of resource allocation

Labour law debates in developing countries

- In developing economies, the debate takes a distinct form. Where the institutions which might underpin a formal labour market are still in the process of emerging, the issue for policymakers is, or should be, whether labour laws are likely to advance that process, or to hinder it.
- In particular, laws which presuppose the existence of a formal economy in which wage dependence is the norm may have little relevance for economies in which the majority of the population relies on access to the land or the family for subsistence.
- Thus the claim that developing countries have no need of laws to underpin emerging labour market institutions, whatever other arguments might be made in its favour, is not supported by the historical record of the countries which were first to industrialize. On the contrary, it was largely through the legal framework that labour capacity, which is not a "natural commodity" acquired the form needed to sustain the complex economic relations and deep division of labour of a market economy

- Middle-income countries today are very far from being pure subsistence economies. The characteristic pattern is for a formal economy consisting of a minority (of varying size) of the working population to coexist with a larger informal sector. In the informal sector, workers and households tend to rely for subsistence on a combination of waged work and access to the land and family incomes.
- In economies with this type of mix, it is far from clear that labour laws are irrelevant to the operation of the economy. Even when reliance on wage labour is partial or incomplete, laws which regularise the hiring process, protect the right to wages and permit workers to self-organise for the purpose of collective bargaining can address needs of workers in the informal sector for greater income security

- Much has been made of the argument that poverty in developing countries is the result of the failure of the legal system to recognise the interests of the poor in land and other tangible assets which could, with appropriate legal title, be used as collateral (De Soto 2000).
- The limited success of land titling programmes to date suggests that the simple equation of legal rights with developmental capacity is misplaced (Haldar and Stiglitz 2013).

Inconsistency in the "rigid labour laws" argument

- It is striking that the proponents of legal formality in credit and capital markets should have had little to say about the role the legal system could play in promoting access to labour markets in middle-income countries.
- There is an inconsistency in regarding credit as an institutional commodity when labour power is seen as a natural one, requiring nothing more than the free play of market forces.
- This omission is the more surprising since extending wage protection and social insurance systems has the potential to benefit a far higher proportion of the working-age population in these countries than can be reached through land titling schemes.

Summary

- Viewed in a comparative perspective, India's recent focus on labour law reform is not unique: other middle-income countries have been having similar debates about the form and content of labour regulation.
- While these debates sometimes lead to deregulation, there is no worldwide trend towards the weakening of worker-protective labour laws (Adams and Deakin 2015).
- Although the discourse of the World Bank and other international financial institutions remains focused on the need for flexibility in labour markets, there is an emerging view at the country level that labour flexibility is not a sufficient condition for economic development, and perhaps not even a necessary one. Instead the focus is increasingly on how to build institutions for managing labour market risks in the transition to a formal economy (Marshall and Fenwick 2015)

Reforming labour laws

Part 2- Economics effects of labour laws

Empirical evidence

- In the late 1990s and early 2000s a small but influential literature appeared to have settled the debate in favour of the supporters of deregulation and labour market flexibility. Fallon and Lucas (1999), using a cross-national panel data analysis, found evidence of a negative relationship between worker-protective labour law and labour demand in a number of countries, including India.
- This finding was repeated in the larger panel data set of labour laws across the world constructed by Botero et al (2004).
- Of most significance for India was the study carried out by Besley and Burgess (2004), which found evidence of a negative impact on employment and investment of the adoption of worker-protective laws at the sub-national (state) level.

- Much has been written on the Besley–Burgess study.
- On one view, the methodology used to measure differences in state-level labour laws is insufficiently robust to justify clear conclusions being drawn from their analysis (Bhattarcharjea 2006, 2009; Jha and Golder 2008).
- On another, once the Besley–Burgess index is corrected for coding errors, the same negative impact of labour laws is found (Ahsan and Pagés 2009).
- Even so, the results of the original study do not survive once account is taken of limited effectiveness, including court delays and difficulties of accessing the judicial system, in the enforcement of labour laws in India (Fagernäs 2010)

Data limitations in assessing legal framework

- An obstacle to achieving a better understanding of the role of labour law in economic development has been the lack of data that can track changes in the legal framework over time in both developed and developing countries. The most widely used index for employment protection law is the Organization for Economic Cooperation and Development's (OECD), Employment Protection Index (EPI) (OECD, various years).
- However, it does not cover many developing countries, and while its ambit has recently been extended to include some systems outside the OECD, it does not provide a continuous time series for these countries. India and China, for example, are coded from 2008 only, and Brazil from 2010.
- So it is better to look at cross country legal developments to assess our labor laws

Cross country comparisons

- India’s dismissal laws are at the more protective end of the scale when compared to developed countries such as Germany and the UK, although they are not stricter than those of France.
- In relation to middle-income countries, India has again scored more highly for worker protection, but the reforms made in China by the Labour Contract Act 2007 have removed the gap between these two countries, at least as far as the formal law is concerned. Changes made in the Labour Contract Act include a significant strengthening of procedural and substantive standards affecting dismissals and the introduction of rules on redundancy selection and priority in re-employment

- The aspect of Indian labour laws which has given rise to most discussion and criticism is the requirement of government permission for large-scale retrenchments, contained in Section 25N of the IDA
- This change, made in 1976, makes Indian labour law among the most worker protective in the world, but it by no means is the only country with a high level of legal protection for workers in matters of dismissal.
- Nearly all have a notification law of some kind. France required administrative permission for dismissals between 1975 and 1986. This requirement was repealed in 1986 and replaced by an obligation to notify a state body, while also leaving intact the right of a dismissed worker to seek compensation or (less usually) reinstatement before a labour court.
- In Germany, notification of dismissal to the works council is required, and failure to comply with the process laid down for notification can lead to the nullification of the dismissal under certain circumstances.

- When administrative permission was needed in France, prior to 1986, it was normal for it to be granted if the employer could demonstrate a prima facie case for the dismissal and if procedural requirements were followed. The move away from administrative oversight was accompanied by a strengthening of protection for the worker in the context of individual claims and by a growing role for collective worker voice on issues of dismissal
- In Germany, although the works council can, in principle, exercise a veto power over a dismissal, this very rarely happens in practice. Works council approval is sometimes used by employers to provide legitimacy for dismissals which might otherwise have been questioned.
- Thus in the European approach, laws on notification of dismissal generally do not constitute an absolute bar on employment terminations. Rather, they serve to proceduralise the dismissal decision, in the sense of subjecting it to standards of fairness whose application is worked out on a case by case basis

- In the Indian context, the requirement of state permission contained in Section 25N of the IDA may have been operated somewhat more strictly than its equivalents in western Europe.
- Empirical research (Ahsan and Pagés 2009) suggests that the law has in the past provided a disincentive to employers to increase numbers in employment over the threshold at which the requirement is triggered (300 workers from 1976; 100 from 1984). A case may therefore be made for modifying the IDA's notification requirements.

- However, as we have seen, it is unusual for labour law systems to make no provision of any kind for notification. When formal administrative permission for terminations was removed in France in the mid-1980s, this was against the backdrop of a dismissal law which in other respects continued to provide significant procedural and substantive safeguards against dismissal, enforceable through recourse to the labour court (the conseil de prud'hommes).
- In Germany, the involvement of collective employee representatives in the dismissal process provides a check on the employer's termination power.
- In the Indian context, given the delays affecting court claims and the absence of a codetermination law or its equivalent, there can be no guarantee that the repeal of Section 25N would allow a similar shift from one mode of regulation to another.

Gujrat Model

- The “Gujarat model” of development has become a byword in development and economic policy circles since Narendra Modi’s election as prime minister on 16 May 2014. The focal point of Modi’s electoral campaign was the promise that he would do for India as a whole what he did for his home state, Gujarat.
- Over his decade-long period at the helm since 2001, the state acquired the reputation of being unparalleled in its “pro-business” approach, by offering a package of improved infrastructure (especially roads, but also ports) and good governance (reduced corruption and a streamlined bureaucracy, often achieved by means of innovative use of technology as in the case of the Jan Vikas Kendra simplifying certification processes, or the E-Jamin scheme for digitising land records).
- Land and labour were offered on favourable terms to businesses, including through the creation of special economic zones (SEZs) which were set up via forced land acquisition on a large scale. Under the Gujarat Industrial Disputes (Amendment) Act 2004 and the Gujarat Special Economic Zone Act of the same year, the bulk of national labour law was disapplied in the SEZs.

- In particular, Part V B of the IDA was replaced by a more liberal regime for employment terminations, under which the requirement of administrative authorisation for dismissals was replaced by a limited right to compensation for workers with a year or more of continuous employment. Further incentivisation was provided through “assistance packages” for investments over a certain amount

Different models

- Managing to outcompete several other Indian states in bids for international and domestic investment, Gujarat has established itself as a major industrial hub and manufacturing centre, becoming home to major industrial houses like Reliance and Essar, and developing a special competence in automobiles with investments from Maruti Suzuki and the Tatas.
- The obvious contrast to the Gujarat model in policy terms is West Bengal, ruled for the majority of the history of post-independence India by the Communist Party that was elected to power on the back of a widespread land redistribution policy, and associated with extremely stringent labour laws and support for trade unions. The weak economic performance of West Bengal, despite its illustrious history, rich endowment of natural resources and advantages of geographical location, has become a cautionary tale of the ills associated with an overprotective government apparatus
- The contrasting approaches of the two states were underscored dramatically by the defection of the Tata Nano car factory from West Bengal to Gujarat in 2008, in the wake of violent protests about forced land acquisition in the Singur region

- The Gujarat model can also be contrasted with the Kerala model that has long been prominent in development discourses. Unlike the Kerala model, that became famous for its high attainment in human development-type welfare indicators (notably 100% literacy), the Gujarat model is more focused on traditional models of economic success, particularly high growth rates.

Limitations of Gujrat model

Before Gujarat is accepted as an undisputed “gold standard” for Indian economic policy, however, there are a few points that should be considered:

- To begin with, an extensive literature indicates that the dynamics of institutional replication are more complex than they may initially appear (Berkowitz et al 2003a, 2003b). The apparent success of a certain set of economic policies in the context of Gujarat may be due to local factors such as a long established entrepreneurial tradition in that state and advantages of geographical location that do not apply in other contexts
- Nor is it clear that Gujarat’s deregulatory approach should be credited with the growth it has achieved. Other Indian states, including Maharashtra, have grown as quickly as Gujarat or even surpassed it. Thus the idea of the Gujarat model is a unique path to unparalleled growth may be questioned.

- Serious questions and concerns remain about the inclusivity of the model, and about social indicators (on health, education, infant mortality, and women's literacy) lagging behind the economic ones.
- Gujarat's scores on the Human Development Index place it below the national average, so that it is still classified as a "less developed state." The Union Ministry of Health and Family Welfare estimates that the shortage of doctors in Gujarat is 34%, compared with the national average of 10%, while one child in three in Gujarat is reported to be malnourished on 2013 estimates.

Concluding observations

- The Gujarat model emphasizes the streamlining of governance structures as the pathway to development, with the deregulation of labour laws a key element of this process. The state appears to have reaped significant benefits from this approach in terms of attracting investment and augmenting growth.
- It is consequently a noteworthy model, and its successes are worth studying. However, implicit in the model are a range of normative and policy choices that need to be examined carefully before adopting it as a template for the entire country.
- In particular, it is not clear that a policy of deregulation and subsidization of business through fiscal exemptions is sustainable over the longer term. This strategy may produce some quick wins for state governments keen to attract inward investment, but it will not lead to sustainable growth unless it is coupled with investment in institutional capacity

- In particular, it is not clear that a policy of deregulation and subsidization of business through fiscal exemptions is sustainable over the longer term. This strategy may produce some quick wins for state governments keen to attract inward investment, but it will not lead to sustainable growth unless it is coupled with investment in institutional capacity.
- For the labour market, this means supporting the institutions through which human capital is created and sustained, in particular, education and training systems, and social insurance. Without such changes, it is unlikely that access to the formal employment will become a reality for more than a small minority of Indian workers, as it is at present.
- There may be a case for modulating the strict controls over employment terminations set out in Part V B of the IDA. However, removing all regulation of the termination decision and leaving workers with a limited financial claim following dismissal is unlikely to encourage investment in firm-specific skills. Such an extensive deregulation of dismissal protection would do little to help fi rms remain competitive over the long run

- How should India reform its labour laws ?, 2015, Deakin & Halder.

Slow pace of urbanization in India

Issues & implications

- The Economic Survey of 2016-17 begins its chapter on '[The Other Indias]' with a quote from Arvind Adiga's novel: "India is two countries...Every place on the map of India near the ocean is well-off. But the river brings darkness to India." This quote echoes what social scientists have known for at least two decades – the economic and demographic divide between peninsular India extending southwards, and the northern hinterland states of Rajasthan, Uttar Pradesh, Bihar, Madhya Pradesh, Jharkhand, and Chhattisgarh.
- In the South, per capita incomes and fertility rates are higher and lower respectively, than in the North. There is, however, an additional aspect of this regional difference that manifests itself in the pace of urban growth and urbanisation. The population of towns and cities in northern India is growing faster than in the South.
- Yet the pace of urbanisation, or the rise in the share of population living in urban areas, has been extremely slow in the North relative to the South. Why?

Urbanization trends

- India's urbanization rate gradually rose from less than 9% in the 1870s to 17% in the 1950s and 31% in 2011. The urbanization rates for the southern states are now inching towards the 50% mark while many of the northern states are still stuck at rates below 25%.
- Study done by Tumbe(2015) shows a robust relationship between urbanization and per capita income levels, and more importantly, growth rates over the past four decades at the sub-national level.
- However, India's urbanization rate is observed to be more than 10 percentage points lower than the rate predicted for its level of per capita income at the cross-country level. Further, the pace of urbanization has been slower in India than in many other countries with similar or lower growth rates.
- India thus poses two challenges to urban trends:

1. Why is the level of urbanization low relative to its per capita income level, and
2. Why has the pace of urbanization been slow in the last four decades despite relatively high economic growth rates?

In this context , two explanations often discussed pertains to:

1. Urban definitions

India uses a conservative urban definition that assigns many settlements to be ‘rural’ when they would have been classified as ‘urban’ in other countries. A more liberal definition would raise the urbanization rate and explain part of the difference between the actual urbanization rate and the rate predicted at the corresponding per capita income level.

The urbanization rate in India in 2011 could vary between 31% based on the official definition and 47% if rural settlements with population exceeding 5,000 were classified as urban areas – a practice followed in many countries. However, Tumbe (2015) argues that irrespective of the definition used, the change in urbanization rate between 2001 and 2011 remains constant at 3 percentage points. That is, a definition-based explanation addresses the issue of low urbanization but not slow urbanization.

2. Migrations restrictions

Another explanation on the slow pace of Indian urbanization focusses on low levels of spatial mobility. Census statistics on in-migration show low rates of mobility especially for non-marriage related reasons. However, as documented in Chapter 12 of the Economic Survey 2016-17, alternative estimates of migration reveal magnitudes of a much higher order such that at least 20% of the workforce can be considered to be migrant in nature.

Definition and migration-based explanations have overlooked another potential reason for India’s relatively slow pace of urbanization.

This is related with the fact that urbanization also depends on **rural-urban differences in natural growth rates which correspond to their respective demographic transitions.**

The Demographic divergence

- In the 1970s, birth and death rates were lower in urban areas but natural growth rates were identical in both rural and urban areas.
- Since then, rural and urban natural growth rates have diverged such that rural natural growth rates are now substantially higher than urban natural growth rates. This is a significant phenomenon as it indicates that in the absence of migration and reclassification effects,
- India has been de-urbanising for four decades. In other words, the demographic divergence has dragged down the pace of India's urbanisation and needs careful scrutiny.

- A clearer picture emerges in the state-level analysis. The southern states did not undergo the demographic divergence observed at the all-India level. In these states, the decline of rural and urban natural growth rates occurred at the same pace. This trend is also observed in the relatively richer states of Maharashtra and Gujarat in the West and Punjab in the North.
- The states that did undergo the demographic divergence are Bihar, Madhya Pradesh, Rajasthan, and Uttar Pradesh. As these states have a large demographic weight in India’s population, the divergence within these states translates into the overall divergence noted at the all-India level. Assam, a relatively poor north-eastern state also exhibits the demographic divergence.

- A district-level analysis reveals that low rural literacy levels, and more importantly, low levels of agricultural productivity, are strongly associated with larger rural-urban fertility differentials and consequently larger rural-urban natural growth rate differentials.
- Simulation analysis reveals that closing the rural-urban divide between natural growth rates would lead to an increase in urbanization rates by over 4 percentage points, without any change in urban definition. This would explain nearly 50% of the observed gap between India's official rate of urbanisation and that predicted at its level of income.

- The rural-urban demographic divergence explains not only India's slow pace of urbanization but also why northern states have been urbanizing slowly compared to the South. Yet the levels of urban natural growth rates are substantially higher in the northern hinterland states than elsewhere.
- Since natural growth rates account for nearly 50% of overall urban growth rates, towns and cities in northern states are growing faster than those in the south, even as overall city-level population growth rates are falling on account of fertility reduction.
- The North-South urban paradox occurs because northern states have higher fertility rates in urban areas than in the South and also because they exhibit higher fertility rates in rural areas relative to urban areas. In simple words, northern towns and cities are growing faster but so are the villages!

Implications of the North-South urban paradox

The North-South urban paradox has three important implications.

- First, unless agricultural productivity is boosted substantially in the northern hinterland states, the rural-urban demographic divergence will continue to stall the pace of urbanization in India, especially in the northern hinterland states. Rural prosperity is thus demographically linked to the process of urbanization.
- Second, in the next two decades, the bulk of urban population growth will occur in the northern states on account of higher fertility rates. Urban planning and infrastructure development projects and allocation of central government funds will need to take this demographic reality into account.
- Finally, fertility reduction is occurring at a rapid pace along the distribution of cities whereas migration tends to be disproportionately channeled towards the larger cities. As a result, city population growth rates will fall substantially for most towns and cities with important implications for city-level labour and housing markets and public finances.

- Urbanisation, demographic transition, and the growth of cities in India, 1870-2020 , Chinmay Tumbe , September 2016 , IGC.

Privatization

- Privatization may be broadly defined as the transfer of various activities from the public to private sphere. Specifically , it could mean the sale by the govt. or state owned enterprise to private economic agents. It could refer to a sale that is effected in full or in part. It can also mean a partnership between public and private sectors through a transfer of responsibilities from the public to private sector. In terms of broad political economy it could also simply mean a shrinking of the welfare state.
- Past quarter century has witnessed a significant move towards privatization in economies across the globe. Several industrial countries have embraced it as have most of the transition economies of east Europe and large parts of developing world.
- In India , privatization or disinvestment of the public sector emerged as a major policy option after country embarked on process of economic reforms in 1991.

- It would be tempting to assume that since privatization has been accepted as a legitimate, and even a core, tool of statecraft by more than a hundred governments in the past two decades, its economic merits are firmly settled.
- There is in fact a widespread perception that privatization brings about outcomes that are superior from the point of efficiency in terms of resource allocation as compared to the situation under public ownership.
- This read attempts to test these claims about privatization looking at theoretical as well as empirical evidence in support of privatization.

Microeconomics Case for privatization

- From the Coase theorem in microeconomics, it is quite clear that it doesn’t really matters who owns the enterprise as long as the conditions for perfect competition perfectly holds up.
- But in scenarios where these conditions are not met for example- presence of single supplier , restricted availability of information on parts of economic agents , govt. intervention can help increase welfare of the collective.
- Yet it is widely contented that public ownership brings efficiency losses that are non negligible. In some cases it could be higher than the gains ensured by solving market failure (Sheshinski & Lopez-Calva 2003).

Regulatory Case for privatization

Broadly there are two perspective from regulatory side that tries to explain inefficiency associated with public ownership:

1. Managerial perspective – This holds that monitoring is poorer in publicly owned firms and, therefore, the incentives for efficiency are weak (Vickers and Yarrow 1988). This is often , though not always, due to the fact that these firms were are not traded in market, unlike private firms. This eliminates any threat of takeover whatsoever.
2. Political perspective- It contends that it is political interference that distorts the objectives and brings in the possibility of soft budgets constraints faced by public-sector managers. It is argued that privatization would effectively create a wedge between politicians and managers.

Sappington & Stiglitz (1987) paper

- In a seminal paper examining the choice between public and private provision of goods in a context where both modes involve significant delegation of authority.
- They showed that conditions under which privatization is optimal are rather stringent. The authors concluded by emphasizing that neither public nor private prevision can fully resolve the difficult incentive problems that arise when considerations of imperfect information result in the delegation of authority.
- This leads to the position that it is not ownership, but the degree of competition, that ultimately matters for improving monitoring possibilities , and hence for productive efficiency. Hence, major gains are expected via deregulation policies.

Empirical evidence

Studies on privatization can be broadly classified in three groups :

1. Case studies
2. Cross sectional comparison of public & private sector performance
3. Statistical analysis of pre and post divestiture performance of enterprises.

In a study conducted to examine the performance of several British firms that were privatized in 1980s, it was revealed that there is little evidence of any systematic improvement in performance.

But there exist other studies which contradicts this study like the Megginson & Netter (2001) which claims privately owned firms does earn more profit and are more efficient.

- Study on disinvestment by Galal et al.(1994) compares the actual post privatization performance of 12 large firms, mostly airlines and regulated utilities, in the UK, Chile, Malaysia & Mexico. Study concluded disinvestment indeed works.

Most statistical analysis of pre and post privatization performance are marred by the failure to control for the economic environment. These could contribute to improved performance in the post – divestiture period and, therefore, need to be factored out. In many cases where privatization appears to have resulted in efficiency enhancement, this was accompanied by deregulations in many sectors and other competition enhancing measures.

Indian experience with privatization

- In the interim budget of 1991-2 the government took a policy decision to disinvest up to 20% percent of the equity in the selected PSUs in favour of mutual funds and financial institutions in the public sector.
- Rangarajan committee report on the Disinvestment of Shares in PSEs in April 1993 emphasized the need for substantial disinvestment and recommended the percentage of disinvestment could go up to 49% for industries specially reserved for public sector.
- It was argue that enterprise which are of importance for strategic reasons , disinvestment could go upto 74%. In all other cases, it recommended 100% disinvestment of the government stake.

Holding of 51% was recommended only for six industries:

1. Coal and lignite
2. Mineral oils
3. Arms , ammunitions and defence equipment’s
4. Atomic energy
5. Radioactive minerals
6. Railway transport

- In 1996, govt. established a disinvestment commission. By august 1999, the disinvestment commission made recommendations indicated a shift from public offerings to strategic/trade sales, with transfer of management.
- The commission also observed that the essence of a long term disinvestment strategy should be not only to enhance budgetary receipts , but also to minimize budgetary support to unprofitable units while ensuring their long term viability.
- By 1998 govt. was of the view that ‘in the generality of the cases its shareholding in PSEs will be brought down to 26%’.

- By 2000-1 govt. policy comprised the following considerations : restructure and revive potentially viable PSEs, close down PSEs that cannot be revived , bring down govt. equity in all strategic PSEs to 20% or lower.
- From 2004 onwards, after Dr Manmohan Singh assumed office, all privatization projects were to be considered on a transparent and consultative case by case basis. It was made explicit that UPA would retain the existing 'navaratna companies' which included (BHEL) and these will be permitted to raise resources from the capital market.
- The total quantum of receipts on account of privatization during 1991-2005 is Rs. 49000 crore. This is just a little above the half mark of the target receipts of Rs. 96000 crore for this period.

Concluding thoughts

- There is no superiority of private vis a vis public ownership from the stand point of economic theory. More than ownership it would seem that degree of competition and the regulatory environment are more relevant to productive efficiency.
- Empirical evidence present a mix picture. As the world environment get more competitive , we will need to put resources in more productive use to compete.
- Ultimately this consideration that should be of relevance rather than any presumption about the superiority of private sector or inefficacy of public sector.

- Pulin Nayak 2012, Privatization in India , in NOC