CONVERSATIONS
A Global Forum

Arvind Panagariya

in conversation with
Ann Bernstein

Democracy | Markets | Development
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To mark 25 years since its establishment, in November 2020 CDE initiated a series of discussions with global experts and prominent individuals in South Africa on important questions on democracy, business, markets and development. The series was relaunched in 2022 as CDE Conversations. This was the 19th event in the series.

Ann Bernstein: My guest today is Arvind Panagariya, Professor of Political Economy at Columbia University, former chief economist of the Asian Development Bank, author of over 15 books and for nearly three years the first vice-chairman of the Indian Prime Minister's think tank NITI Aayog, which made him a cabinet minister in the Modi Government, between 2015 and 2018.

Arvind Panagariya: I feel really privileged to be invited to speak at this prestigious platform and glad to be at CDE.

Ann Bernstein: This year India celebrates 75 years of independence, which is a good time to talk about some of the central debates in the country. In 2013, you said that the key lesson to learn from India is the importance of growth. Many people argue that faster growth in unequal countries like India and South Africa only benefits the rich. They dismiss what they call 'trickledown economics', because it supposedly does not work or works far too slowly to reduce poverty. What is your view based on the facts from India, which has experienced tremendous growth rates in the last 30 years?

Arvind Panagariya: In India, the anti-growth perspective was partly influenced by experience during the early decades of independence when growth was low and not sufficient to reduce poverty. During that long phase it really felt like growth could never have any impact on poverty. However, once rapid growth emerged in the 1990s, poverty came down significantly. From the early 1990s to 2011, using a consistent poverty line, poverty was cut roughly in half, from an average of 45 percent to around 22 percent.

Another reason why growth is vital for India, and for South Africa too, is that in rich countries like the US and the EU countries, there are sufficient levels of income to permit meaningful redistribution. The rich countries can easily afford the levels of state redistribution that we have seen there during the Covid pandemic. Poorer countries, by contrast, do not have sufficient income. If poor countries want to do redistribution, all they can redistribute is poverty.

In a growing economy, redistribution is also politically much more feasible. High growth makes new resources available, which can be redistributed in a way that feels less like taking from one group of people to give to another than it would if there was no growth. Anti-poverty programmes in India, like the national rural employment guarantee scheme and the food security programmes, were made much more feasible by high growth.

As I mentioned in my book, Why Growth Matters, countries like South Korea, Taiwan and Singapore generated rapid growth in the 1960s to the 1980s, which drew in most of the population. They experienced growth with inclusion. India, by contrast, directed investment into heavy industries (e.g., steel mills) during that time. These industries used up most of India's limited savings and generated very little employment. This was 'dualistic development', where pockets of development were being created, but nobody else was included in the process.

That is one way to look at the link between growth and inclusion. But it is also clear to me now that, in a country where labour is the abundant factor of production, it is very difficult, if not impossible, to achieve high growth unless you include the poor.

We used to talk about growth for inclusion, but we need to focus more on inclusion for growth. Without inclusion you cannot get high rates of growth.

Ann Bernstein: You have said that poverty reduction should take precedence over reducing inequality, and that countries like India should focus much more on providing equality of opportunities for poorer people. To quote: "When we think of our historic economic policies, we in India worry too much about inequality, which leads to policy mistakes. For rich countries inequality is a bigger issue; for India the removal of poverty has much more importance than the reduction of inequality." Why are you arguing this?

Arvind Panagariya: As an example, I can point to two Indian states that are extremely different from one another: the state of Bihar, which has deep poverty levels and the lowest per capita income of all Indian states, and Kerala, a state with one of the highest per capita incomes. In Bihar everybody is poor, which means that inequality is very low. Kerala, by contrast is one of the most unequal states. But where do people prefer to live? Very few people migrate from Kerala to Bihar, while very many people migrate from Bihar to Kerala, because they have a better chance of getting out of poverty.

Inequality can matter when it is within your immediate social context. This is especially true amongst poorer and wealthier farmers living in and around the same villages. In India, many of the programmes designed to address one kind of inequality simply make another kind of inequality much worse. For example, there are redistribution programmes designed to reduce inequality between rural and urban residents. What they succeed in doing, however, is increasing inequality within the rural areas. The government programmes buy surplus grain from farmers at a price that is much higher than the market price. Small farmers who have no more than an acre of land (sometimes only half an acre of land) cannot benefit from this programme. They have no surplus to sell. Larger farmers, by contrast, benefit substantially. Thus, the inequality between poor and rich farmers rises and because they share an immediate social context, poorer farmers feel growing resentment towards richer farmers and the government. The rich are already better off, but it is they who benefit from government redistribution. The whole thing then becomes horribly counterproductive.

Ann Bernstein: Why do you think poverty has not declined as rapidly in India as it did in South Korea and Taiwan in the 1960s and 1970s, or in China during the last three decades. Why has India not been able to sustain the high growth rates of other Asian countries?

Arvind Panagariya: Interestingly, countries like South Korea, Taiwan, Singapore and China eliminated abject poverty almost without any redistribution. It was only much later, when the population had already moved out of poverty, that they set up redistributive programmes such as public health care.

In the 1960s, 1970s and 1980s the growth process fundamentally transformed the lives of South Koreans and Taiwanese people. In 1960, 65 percent of South Koreans worked in agriculture. By 1990 it was a mere 20 percent, which means that 45 percent of the workforce had moved from agriculture into industry and services. By moving so many workers from an economic sector of low average value to ones of high average value, South Korea was able to generate incredibly high levels of inclusive growth.

These changes have not happened in India. Economic reform in the early 1990s led to a decline in the share of the workforce in agriculture from 59 percent to about 42 percent in 2018. Thus, 16 percent of the agricultural workforce moved into industry and services. Much more needs to happen to include poor Indians in the growth process, and by doing so, growth will also become faster and more sustainable.

Ann Bernstein: When I think of India today, a very big challenge for the Modi government is to create jobs. As you have said, several million young people join the labour market every year. In your view, this can only be done if large companies are encouraged to invest in labour-intensive sectors, like clothing, footwear and electrical goods manufacturing. Why is this the only, or the most important, route to more jobs? And what prevents India from taking this route?

Arvind Panagariya: It does not have to be manufacturing only. It could be services as well. Overall, services have become much more important than manufacturing in India. Despite concerted attempts to promote some kinds of manufacturing in the past, the sector has hardly grown. The employment share in manufacturing has been between 11 and 13 percent for the last 30 years. The services sector, by contrast, massively increased its employment share. Most of the people who moved out of agriculture went into services, into jobs that are not very well paid, but they provide a better income than what most people can get in agriculture.

To an outsider, the IT industries and some of the machinery manufacturers may look very successful. There are also big successful corporations like Ambani, along with the capital-intensive petroleum refineries. But that is not where the workforce is. The IT industry employs maybe four million of India's total workforce, which is close to 500 million people and growing at around six million a year.

In countries like China, success has been driven by large companies in labour-intensive sectors like apparel, footwear, kitchenware and electronics. These are goods that can be exported to a vast global market and create huge economies of scale, allowing them to absorb massive amounts of labour.

India has been unable to emulate these practices. Some reasons why are known, some are unknown. The known reasons are that India had this unique policy of 'small-scale industry reservation'. That meant that most labour-intensive industries were restricted to very small enterprises, those that invest no more than a million dollars' worth of capital, with the result that they could not achieve the economies of scale necessary to absorb many workers. These reservations have been dismantled since 2005, but their legacy remains.

Labour laws are still inflexible and continue to keep enterprises small. For example, if you have 100 or more workers in one enterprise, then under no circumstances can you lay off anyone. Apart from the challenges this creates for employers during slumps in the business cycle, it also massively reduces the incentive of workers to put in much effort, making these factories hugely inefficient. Parliament has legislated some changes in these laws, but none of them has been implemented so far.

India has also had many restrictions on trade, leading many industries to locate inland rather than near the coast. Couple that with poor infrastructure and you have another reason why India cannot set up globally competitive firms. What takes Singapore five hours to get out of ports would take five days in India. These are the challenges that must be sorted out if we really want to grow the economy and shift labour into higher value activities.

Ann Bernstein: Many of these issues are equally challenging and important in South Africa. What you are saying is that there are big opportunities for India to get into much more labour-intensive manufacturing. However, there are a lot of people who say it is too late for India or South Africa, or any other developing country, to adopt

strategies that could create factories, local or foreign-owned, producing low-skilled goods for the global market. They say that automation and a retreat from globalisation has made it too hard for this kind of approach to industrialisation and job creation to succeed. But you seem to be arguing differently. What would be your answer to these people?

Arvind Panagariya: The differences between South Africa and India can easily be exaggerated. True, South Africa is a higher-income country with a smaller population. But this makes the challenge less difficult, because only a few enterprises must succeed in the global marketplace before you would see a substantial improvement in unemployment and inclusion. A more difficult issue is that if low-skilled wages are set at average income levels, then South Africans will struggle to achieve competitiveness.

Can developing countries still succeed in low-skill manufacturing in today's global marketplace? I certainly think so. First, China has been exiting some of these labour-intensive sectors and other, poorer countries have stepped in. Vietnam, for example, has expanded their textile exports from about $10 billion in 2010 to $31 billion in 2019 (its total merchandise exports have risen from $72 billion to $264 billion over the same time period). It is not impossible to imagine that in another 10 or 15 years China will have moved totally out of apparel production allowing other countries to fill the space.

Second, the market for these goods remains massive and is growing. If there are eight billion people on the planet, and each person needs at least two shirts, then about 16 billion shirts have to be produced each year.

Third, the threat of automation is exaggerated. It has been difficult to create competitively automated manufacturing processes in many of the more labour-intensive sectors, such as textiles.

One very good example is the Adidas factory, where they tried to automate shoe manufacturing in factories in Germany and in the US (Atlanta). They could not build a robot that could fasten the shoelaces, but robots were able to do all the rest. Despite that they were unable to compete globally with labour-intensive factories in China.

Mechanisation is an ongoing phenomenon, so all these industries have become and are becoming less labour-intensive. But at the same time the scale of demand keeps rising, so even if the labour per unit of capital ratio has been falling, the total amount of employment has been rising. Mechanisation is also accompanied by increasing productivity, and that raises incomes. As incomes rise, so does demand for manufactured goods, which is why the clothing market has expanded dramatically.

Finally, production has become increasingly specialised and it is no longer necessary to produce a whole product in one factory or even one country. Many parts of the iPhone value chain may in fact be very capital-intensive, but there will be other parts that can be produced with a lot of labour. Making these components, or even combining several existing components, will not generate the highest additional value per unit, but if you can capture a big chunk of the global market in one or more components, the total value addition will still be large. For example, China assembles iPhones and iPads. The assembly part of the production process generates perhaps 10 percent of value added, but it is 10 percent multiplied by possibly 200 million devices assembled annually. That makes the total value extremely large, and the total employment it generates is large as well.

These are the set of arguments that continue to make labour-intensive manufacturing extremely attractive for most developing countries.

Arvind Panagariya in conversation with Ann Bernstein on 24 August 2022

Ann Bernstein: Contrary to many people, you argue that 'small is not beautiful' if the goal is to achieve prosperity and inclusion in India. You say that India has far too many small economic units. Briefly give us a feel of why you are arguing this for urban and rural India?

Arvind Panagariya: The proliferation of small economic units is the biggest challenge that India must overcome. Take for instance agriculture. Almost 85 percent of farms in India are defined as small. Just under half of Indian farms are less than half a hectare. When you average the size of these farms, it turns out to be 0.23 hectares. Nobody with a family of five can make a living on such a small farm. In most countries, you would not even define that piece of land as a farm. It would probably be called a kitchen garden.

About 43 percent of India's workforce is in agriculture. As you would imagine, the productivity of agricultural workers is very low. Even the productivity per acre of land is much lower than it should be. Consequently, if rural people could move into services and manufacturing, labour productivity would rise substantially and, in addition, the labour to land ratio would decrease, which would allow farmers to farm more efficiently.

In addition to these challenges, less than 10 percent of India's workforce is employed in enterprises that have 20 or more workers. The remaining 47 percent of the workers are employed in enterprises with less than 20 workers, the vast majority in own-account enterprises, meaning enterprises that do not employ even one hired worker on a regular basis.

The challenge is not that small enterprises, by definition, cannot succeed. It is just that if they are the dominant form of enterprises then average productivity will be extremely low. By contrast, about 75 percent of the Chinese manufacturing workforce was in medium and large enterprises, which ensures that their productivity levels are significantly higher. Even workers in small enterprises in China have higher productivity because they operate in ecosystems dominated by medium and large enterprises, which pulls up the productivity of the small firms.

Finally, and very significantly, small enterprises cannot successfully connect to the global marketplace in the ways that the Chinese economy is connected. This cuts India off from a major engine of prosperity and inclusion, which is the one China harnessed so successfully.

Ann Bernstein: The central government in India has 53 Cabinet Ministers for a population close to 1.4 billion, but in your view this large number of ministries is detrimental to governance and to development. Can you tell us why you think that?

Arvind Panagariya: That many cabinet ministers and ministries generate a lot of problems in India. One of the biggest sources of inefficiency is that every industrial sector has its own ministry. This makes it very convenient for each industry to lobby for its narrow interests and to find a sympathetic ear. Whatever you think of lobbying, it is definitely not the case that the interest of the industry is necessarily the same as the interest of the individual enterprises within the industry, nor of the economy as a whole.

These sectoral ministries also control a very large number of public sector enterprises, which are mostly grossly inefficient, or 'sick enterprises'. The latter often produce virtually nothing or very little and hoover up a lot of taxpayers' money.

So, we need to consolidate these ministries and privatise the industries that justify the ministries' existence. As the chief of NITI Aayog I started the process of privatisation in 2016. I was often told that the workers were opposed to privatisation and would go on strike. But I discovered that it was not so much the workers who

opposed privatisation, but the ministries and CEOs of public sector enterprises who did not want to part with those enterprises.

Ann Bernstein: You're a strong proponent of free trade, and you've said that "No nation has succeeded or has successfully transformed based on import substitution. If you restrict imports, you also restrict exports." There's a big debate in South Africa about increased localisation, which is not about making companies more competitive, but about giving local companies protection from competition with imports for the local market. Can you give us your thoughts on this? Why is import substitution not a good idea for a developing country?

Arvind Panagariya: Import substitution is very tempting for governments because it allows them to demonstrate that, through their intervention, they gave local companies a boost, and saved or created jobs. By stopping imports, you give somebody local the opportunity to produce for that local market, no matter how inefficient they may be. So, it is a very tempting strategy, and if you do it at a limited scale, in one or two sectors, it may not be very damaging, even though consumers will normally have to pay more.

However, if undertaken at a large scale it is damaging and will never succeed. Every country has scarce capital. So, if you encourage protection from imports, capital will flow into those protected industries, but it has to come from somewhere, and usually it comes from industries that would have been ready to compete in export markets. So, as you favour the locally focused industries through this protection, you are punishing existing or future export industries.

Export industries are the ones in which the cost of production, relative to your competitors abroad, is the lowest, which is why you can produce for that market. Whereas products that you are importing, are being imported because the cost of producing these goods is higher locally than the cost of production abroad. So, if you have an export focus you are producing more of what you are good at producing while importing those things that you are not good at producing. Once you implement protection you reverse the entire process, while disengaging from the very large global market where there are many more opportunities to learn, innovate and expand. Empirical evidence shows that every country that has succeeded has done so by choosing to be an active participant in the global marketplace.

Ann Bernstein: I think it is noteworthy, if you consider how big the domestic market is in India, that you make such a compelling argument for getting into global markets and avoiding the downsides of protectionism. That, to my mind, is very persuasive for a much smaller South Africa. Thank you very much. I have learnt a great deal from our conversation.

Arvind Panagariya: Thank you very much for having me.

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