CDE INSIGHT

Why growth matters: How India's growth acceleration has reduced poverty

A presentation by Professor Arvind Panagariya

Prof Arvind Panagariya, the Jagdish Bhagwati Professor of Indian Political Economy at Columbia University, and the co-author (with Prof Bhagwati) of Why Growth Matters: How economic growth in India reduced poverty and the lessons for other developing countries (2012), *spoke at a recent dinner in his honour hosted by the Centre for Development and Enterprise.*

Growth and poverty since 1950

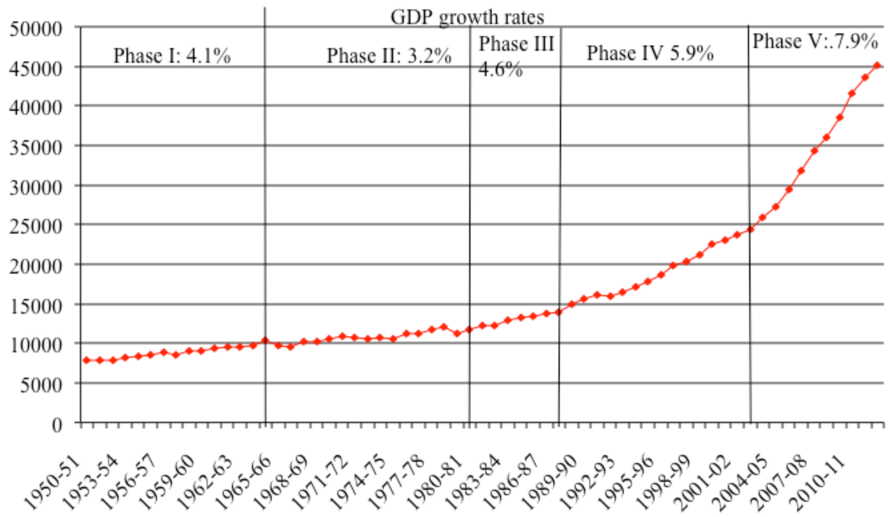
There is a lot of debate in India about growth and poverty reduction, and the effect of the first on the latter. As happens in these kinds of debates, many of the commentators produce their own facts on which they base their arguments. But the facts are actually pretty clear, and they show that growth has been enormously beneficial for the poor.

Between 1950 and 1980, economic growth in India, at about 3,8 per cent a year, was quite slow, especially in per capita terms since annual population growth was 2 per cent. So, although India was very poor, over those three decades, per capita income only grew about 1,5 per cent a year.

From 1980s, things began to move a bit and growth increased to around 4,5 per cent, which was better than before but still wasn't making a very significant difference to incomes, especially of the poor. However, with annual growth of around 6 per cent in the 1990s and around 8 per cent since 2000, the last twenty years have been significantly better than the decades that preceded them.

August 2013

FIGURE 1: GDP at Factor Cost at Constant 2004-05 Prices (Rs. Billion)



This improved growth performance made an enormous difference to levels of poverty, as shown by surveys of household expenditure dating back to the 1950s.

Between 1950 and 1980, when per capita income growth was less than 1,5 per cent a year, there was absolutely no reduction in poverty. If anything, there was a slight upward trend through the 1950s, '60s, '70s. Essentially what happened is that in years when rains were good, the income of the poor went up; when the weather wasn't as good, the poor ate less.

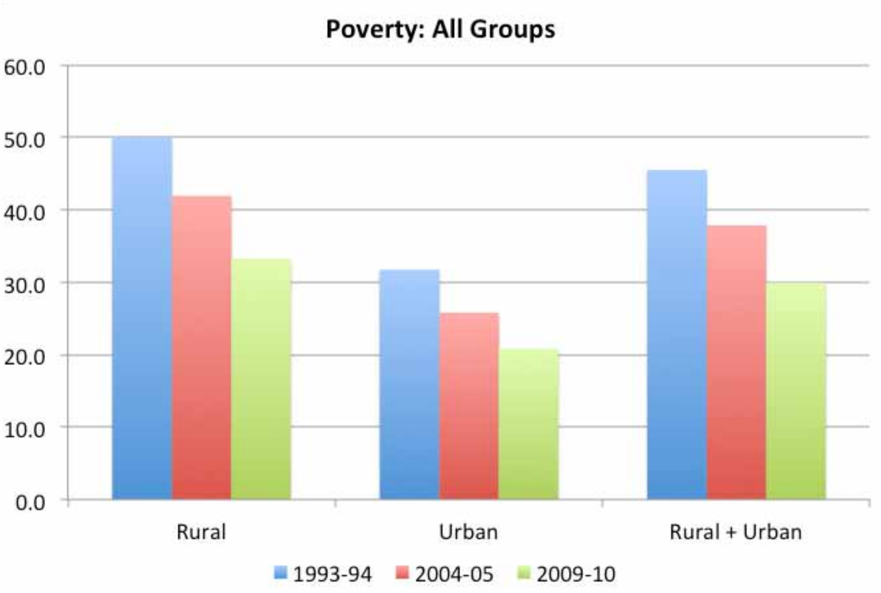
FIGURE 2: Poverty ratio: 1951-52 to 1973-74

By the start of the 1980s, economists started to write that there was no hope for India with its huge, very poor population. Ironically, this is just when things began to turn around. So, in the 1980s you see poverty beginning to decline. And the rate of improvement increases during the 1990s and again in the 2000s.

Oddly enough, there remains contentious debate about this in India, with some people insisting that the overall decline of poverty does not necessarily mean that this has happened across all social classes.

India has a long history of disadvantaged castes and tribes, stretching back millennia. The data, however, clearly show that poverty has declined among all the groups. In fact, since 2004-05, poverty is falling faster among disadvantaged groups than among other groups. This means that, although disadvantaged castes and tribes still show higher rates of poverty, the gap in the poverty rates between these groups and the rest of the population is declining. Evidence shows that the wage gaps between disadvantaged groups and other groups are also shrinking. The same is true for the education attainment gap.

FIGURE 3: Poverty: All Groups



What has driven the decline in poverty?

So what is the mechanism that accounts for the accelerating fall in poverty? There are two basic forces that we identify in our book.

Firstly, we argue that it is wrong to think of growth as "trickling down" (as sceptics sometimes say). In fact, it operates by pulling people up. Basically, when growth hits 8 or 9 per cent a year, it is not a matter of simply trickling down, but it becomes a forceful mechanism that creates lots of jobs for the poor and the unskilled, and which pulls these people in to gainful employment. On top of that, high growth means that real wages rise. So you get a double benefit that comes from moving people from jobs that pay poorly into jobs that pay better, along with rising wages. Thus, the Indian experience of this coincides with the movement of workers from agriculture to industry and services.

The second effect is that once you begin to have some growth, increasing public revenues, which are crucial for redistribution of any sort, become available.

Redistributive policies have been prominent in government thinking since 1950. But when incomes are so low, and when people from whom you want to redistribute are so few in relation to the people to whom you need to redistribute, you really can't get very far this way. Indeed, even if you were to redistribute everything equally, or give everybody at least something, population growth would make this unsustainable. So growth is crucial for redistribution purposes and social programmes and so on. In India we saw that from the moment per capita income growth went up substantially and revenues became available, public spending could increase, as it has done on education. Without growth India couldn't have launched its massive rural employment guarantee scheme either.

What about inequality?

One area of continuing debate relates to inequality, with sceptics saying that growth has been captured by the rich. While there were no dollar billionaires in India in 2000, for example, *Forbes Magazine* reckons there are now 60 of them. So, for the layman it looks like inequality has risen. But actually, what change there is to the Gini coefficient is quite small. Our data suggest, for example, that the level of inequality in rural areas did not change. Urban inequality initially did rise somewhat, then declined again, and then rose again. So overall, for the last twenty years, you see perhaps a slight increase, but nothing very substantial.

In any event, our view is that this is something of a side issue. Poverty rates are what matter, and, as long as those are declining and as long as you're bringing the poor up, even if inequality was rising marginally, that should be tolerable. And all the evidence suggests that this is so. Take, for example, the case of Kerala versus Bihar. India has a large number of states, with 15 large states being home to about 95 per cent of the population. Kerala and Bihar are both large states, but are very different. Kerala is the most unequal state in terms of income distribution, but it also has the lowest proportion of its population that is poor in the entire country. Bihar, at the other extreme, has the lowest level of inequality but the highest level of poverty. Per capita income is very high in Kerala; it is in the top four of all states. In addition, Kerala is connected to the global economy through migration resulting in high levels of remittances from people working in other countries. For all these reasons, Kerala has low poverty levels.

Now, if it were inequality that drove people, surely they would be migrating out of Kerala into Bihar? But that is not what's happening. Migration is all from Bihar, with the highest poverty level, to Kerala, which is more unequal.

But…

Despite the successes, India has not seen the kind of massive, rapid decline in poverty that occurred in countries like Korea and Taiwan in the '60s and '70s, or in China in the last three decades. The explanation for the difference lies in the fact that manufacturing in India has not grown as rapidly as it did in the other countries. In fact, most of India's growth is concentrated in the services sector. Within manufacturing, especially labour-intensive firms that typically employ a lot of workers and produce things like apparel, footwear and light consumer-good have not done all that well. And it is this that accounts not only for the smaller effect of growth on poverty that other countries experienced , but also for the general poor performance of manufacturing. Why has this been the case?

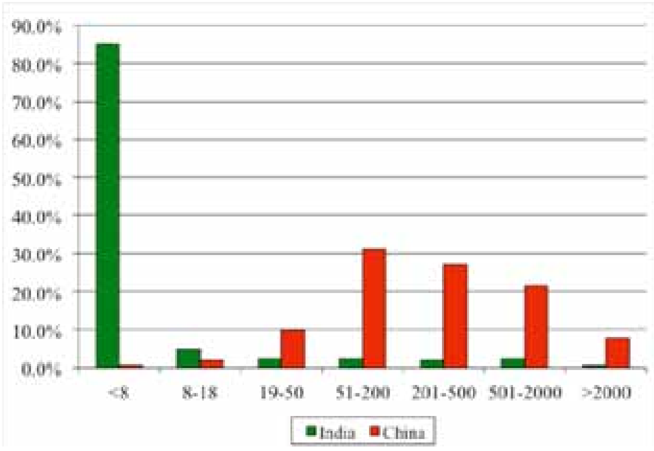
India has seen a lot of reform since 1991. Prior to that, it was among the most highly regulated and protected economies in the world. The earlier approach was to use industrial policy to grow and diversify the economy, but it created a huge mess. Indiscriminately, the government protected every single industry under the banner of diversification. If you said you wanted to produce something but were facing competition from abroad, they stopped the import of these products. So basically, protection was provided on demand in the name of diversification.

Since 1991, however, industries like telecommunications, airlines and banking were granted liberal entry of private entrepreneurs and the economy was opened to foreign investment. This is what lifted economic growth. In some areas—the labour market in particular—the economy is still very much regulated.

The labour situation is incredibly complicated: when you go from six workers to seven in a firm, the Trade Unions Act kicks in. When you go from nine to ten, the Factories Act kicks in. And when you go from 19 to 20, something else kicks in, as happens again when you go from 49 to 50 and 99 to 100. The biggest killer is the Industrial Disputes Act, which says that if you are a manufacturing firm with 100 workers or more, you cannot dismiss any of them under any circumstances unless you get prior approval from government. This is rarely given and it applies even if you go bankrupt, in which case you still have to pay your workers. This has important consequences, because investors are not going to enter into an industry if they can't exit. So India has a very pernicious set of labour laws and that really, to me, is the reason why Indian firms have remained so small on average.

The most serious impact of this stifling regime is on labour intensive industries, and you see it when you compare the distribution of firms by size in India with that of China. In India, 85 per cent of the apparel workforce is sitting in small firms employing seven workers or fewer. In China, by contrast, this is only 0,6 per cent. Look at the large firms with 200 workers or more, and you see more than 50 per cent of China's workforce being employed in those firms, while in India it is only 5 per cent.

FIGURE 4: Size distribution of Firms: Apparel



So, large firms are missing in India, especially in the labour-intensive sectors, and their presence, as you see in all sectors that do well, is critical. Sectors that have large firms, will see the medium and small firms flourish. But sectors where the large firms or even the medium sized firms are missing, and where small sized firms are predominant, generally have very low productivity. The reason for this is that the innovation process, for both end products and production processes, is generally driven by the larger firms. Also, large firms demand quality from the medium and small firms that are their suppliers. Basically, large firms define the industry's dynamism.

The opposite example of what we see in manufacturing is visible in the auto-industry in India. This has really flourished, and went from producing half a million cars only eight or nine years ago to 3 million today, which is a growth rate of 15 to 20 per cent a year. This suggests that it is possible to have large firms, despite the nature of the labour market regime. But it's important to recognise a key difference between apparel and motor vehicle manufacturing: in the former, labour costs are a very substantial component of total costs, whereas in motor vehicles, labour costs are a much smaller proportion of costs. This means that motor vehicle manufacturers are able to absorb the risks and costs of employing people, something that isn't true of large labour-intensive firms.

Concluding remarks

To summarise, then, I would say that the key lesson to learn from India is the importance of growth. Let me illustrate that by noting that it is true that the period of most rapid poverty reduction—2005 to 2010—was the period of most rapid growth but was also the period during which India's largest public programme for poverty reduction—the rural employment guarantee scheme—started. Seeing this, some people say, 'Was it redistribution or was it acceleration in growth that caused the reduction in poverty'? My response to that question is, 'Where would the employment guarantee scheme be without growth?' It is the availability of the revenues through higher growth and much larger revenues that enable you to undertake that programme. Frankly, it doesn't matter whether it was done using the instrument of redistribution, which I think most democracies have got to do to some degree at least. But it's vital that you don't do it in a way that kills growth. That is something to watch out for.

So that is where I come out on this. Not ideological about whether you help the poorest through redistribution—if you can deliver through redistribution politically, certainly do so, but without really compromising growth too much. A small compromise that has a big poverty reducing effect may be okay. But if you go too far and really compromise growth, you're in trouble.

Next year, 2014 is an election year in India. We hope that more reform is going to come in and pick up where the prior government left off. Unfortunately, the current government, even though it is headed by a Prime Minister who pioneered India's economic reforms in 1991, hasn't carried forward the reform process. So we are all waiting eagerly for next year, and hopefully we'll get a change of leadership for the better.

Published in September 2013 by The Centre for Development and Enterprise
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