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Prospects for Growth and Employment Generation in India

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Over the past decade, the Indian economy has demonstrated both remarkable acceleration in growth and employment and equally sharp deceleration. The high growth recorded during the period 2003-09 was based mainly on a sharp increase in the investment rate. At its peak, the gross fixed capital formation to GDP ratio stood at over 38%, which would yield a 9% plus growth rate without any increase in efficiency.[3] This sharp increase in the investment rate was permitted by significant improvements in the savings of the public sector, particularly government, and by the private corporate sector. The recovery of the economy from the industrial slow down which stretched from 1997-2002 was led by large improvements in the efficiency of the Indian corporate sector. The virtuous cycle unleashed by this increase in efficiency led to increased saving and investments by the corporates, which amounted to nearly 8 percentage points of GDP. At about the same time, the Government sector, prompted by the enactment of the Fiscal Responsibility and Budget Management Act (FRBM) and supported by rising revenues from increased corporate profits, reduced with the dis-savings of the Government very sharply and turned it into a small surplus during the latter part of the period. The improvement in Government savings allowed public investments, particularly in infrastructure, to be scaled up substantially, which gave further impetus to the positive growth dynamics. It also reduced the Governments draft on the savings of the households and thereby released investible resources for investment by the small and medium scale enterprises (SMEs).

The situation today is very different. As things stand, there can be little doubt that India cannot hope to achieve even 8% growth relying entirely, or even largely, on increase in investment. The global crisis of 2008 led to a situation where the government had to prop up the economy through fiscal expansion, which led to a sharp reduction in public savings. Despite the recovery of growth, neither the revenues of government nor the savings of the corporate sector managed to recover from the shock.[4] Since 2012, the sharp deceleration of the economy has made matters considerably worse.

During the corporate led growth process of 2003-09, the increased revenues of the government permitted expansion of both public infrastructure investments as well as SME investments. However, when the global crisis occurred, the corporate

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[3]Rough estimates of total factor productivity suggest that TFP growth slowed from above 2.5 in the beginning of the period to around 1 later.

[4] Corporate savings appear to be closely linked to corporate perceptions of investment opportunities. Post-2009, although corporate profits recovered, there was a sharp increase in dividend pay-outs rather than a recovery in retained earnings of firms.

sector in India cut back sharply on its investment activities. Conversely, however, the SME sector actually expanded its investments as a share of years GDP quite significantly.[5] Thus the resilience of the Indian economy in the first two years after the crisis owed almost as much to the small and medium entrepreneurs in the country as it did to the Government's fiscal expansion.[6] It appears that the corporate sector is much more sensitive to global developments than the SME sector which seems to be more attuned to the dynamics of the domestic economy.

In the immediate future there are two possible scenarios which could play out. The first is a steady recovery of the global economy and the return of confidence in the international financial markets. In such a scenario, there is a strong likelihood of return of the growth dynamics of the 2004-09 period, with a strong recovery of corporate investments leading to a high growth trajectory. The alternative, and the more likely, scenario is that the recovery process of the developed world will be at best slow and weak. The financial markets too will be jittery and display significant volatility in behaviour. In such a situation corporate sentiments in India may not be positive enough to be able to lead the growth process.[7]

However, an alternative process which can raise the growth rate significantly and hopefully trigger a revival in corporate confidence exists based on the dynamism of the SME sector. There is of course need to start the process by increasing the over-all savings in the economy as rapidly as possible. The current account deficit, running at over 4% at present indicates that even with the relatively subdued investment activity in the country, there is yet a substantial gap between investments and savings. Inflation too is high and sustained for an extended period. Demand is therefore not an immediate concern.

The increase in savings initially can only come from the government through steady correction of its fiscal balances. If the past is any indication, a reduction in the fiscal deficit, which is a measure of the public draft on household savings, leads to an immediate increase in the investments of the SME sector. Although the SME sector tends to have lower marginal savings rates than the corporate, nevertheless a positive cycle can be generated. If the Government were also able to lower its revenue deficit, the pace of infrastructure development, which has lately slowed down, can be revived without crowding out the private sector. This would contribute to increasing the overall efficiency of the economy, and therefore support the growth process.

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[5]In 2009-10, corporate investments fell by nearly 6.5 percentage points of GDP as compared to 2008-09. The non-corporate investment rate, on the other hand, rose by 3 percentage points.

[6]Indeed, during the 4 years that have elapsed since the crisis broke, growth in India has been largely SME driven, with corporate investment remaining extremely subdued. Something very similar had occurred during the cyclical slowdown in India during 1997 to 2002. Thus the counter-cyclical behavior of SMEs, at least in India, seems to be worthy of inclusion among the "stylized facts" of the economy. The reasons for this behavior need to be explored further, but *a priori* it appears that it could be due to two factors: (a) the formal financial sector increasing SME lending when corporate investment demand goes down; and (b) the nature of the markets primarily addressed by the SMEs.

[7]During the boom period of 2003-08, Indian corporates borrowed heavily from global financial markets for investment in both productive and speculative assets. Post-crisis, many of them are facing illiquidity of their assets, and are perceived to be over-leveraged by the Indian financial sector.

India is fortunate that it is richly endowed in entrepreneurial talent. The Economic Censuses demonstrate the huge size and growth of entrepreneurial activity in India.[8] At a rough estimate, the net increase in the number of non-agricultural establishments in the country is about 8 million every ten years. While admittedly many of these enterprises reflect basic survival strategies, many do not.[9] The past decade has shown the dynamism that is possible in this sector under the right circumstances and with the proper policies. Many of the leading corporate today belonged to the SME category at the turn of the century.

It may therefore be possible to achieve and maintain growth rates of above 7% per annum without any significant improvement in the global economy, relying mostly on the dynamism of the Indian entrepreneur and the creation of financial space through government fiscal correction. Taking this up to the 8% plus level, however, would require either favourable developments in the global economy or additional policy action to improve both the efficiency as well as the sentiments within the domestic economy.

In so far as efficiency of capital use is concerned, there is mixed evidence on whether the SME sector is inherently more efficient than the corporate. Although it is certainly true that the SMEs tend to have lower capital to labour ratios, it is also true that the value added per unit of capital may actually be lower. In the aggregate, the probability is that an SME-led growth process would require a higher investment rate to achieve a particular growth rate than a corporate-led strategy. This, taken with the lower marginal savings rate of the SMEs, implies that the burden for generating the requisite savings would fall more heavily on the government. On the other hand, there is no doubt at all that SME-led growth would generate far higher employment growth than the corporate-led. This would in itself reduce the need to support aggregate demand through fiscal action since the private consumption arising from such incomes will be higher.[10]

There is, however, cause to believe that the capital efficiency of the SME sector can be increased significantly with proper policy since much of the measured inefficiency arises from a variety of constraints within which the SME sector has to operate. The most important of these are; (a) the quality of labour that is available to the SME sector; (b) the lack of support to entrepreneurship in general, and to innovation and risk-taking in particular; and (c) the operation of the financial sector.[11]

In the absence of an adequate skill development system in the country, the SME sector invariably recruits untrained workers who are then trained on the job. Quite often once the workers have reached a certain level of skill they are absorbed

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[8]The 2004 Economic Census revealed that there were 42 million non-agricultural enterprises.

[9]There is a view that India actually has fewer entrepreneurs than it should for its level of development. See: Ghani, E., W.R. Kerr, and S.D. O'Connell, "Promoting Entrepreneurship, Growth and Job Creation", in E. Ghani (ed), **Reshaping Tomorrow**, Oxford University Press, 2011. The difference between the two views arises from the Ghani, et al. definition that functional entrepreneurship is revealed only when it is formalized. We disagree.

[10]In a weak global economy, it is almost certain that the government will have to provide fiscal support for any reasonable growth target.

[11]Technology is deliberately not mentioned since technology access has improved in recent years, and the issue is partly covered by innovation.

by the corporate sector. As a consequence, the SME sector is in a constant process of training raw hands and being unable to retain skilled workers. The efforts that are being made at present to improve the skill development infrastructure in the country need to focus on the skills which are needed by the SME sector. If this can be carried out effectively, we should expect to see a significant improvement in the efficiency of SME production and thereby an increase in their value added per unit of capital.

There is, however, a more fundamental point that needs to be noted. The SMEs are the primary source of employment opportunities for new entrants to the labour force.[12] This is certainly true of India, but is probably true in most countries of the world, including the developed countries. One of the reasons possibly why India has one of the lowest incidences of youth unemployment is because of the fact that it has one of the highest shares of SMEs in its GDP.[13]Thus, if youth unemployment is a concern for policy, focussing on entrepreneurship is a better strategy than supporting existing corporate enterprises.

Another source of possible efficiency increases comes from the higher levels of innovation, both product and organisational, that is possible in the SME sector. We do not as yet have systems which encourage and nurture such innovations. There are some efforts that are being made through incubation centres and early venture capital activities. These have however yet to reach scales where their impact is economy wide. Encouraging such activities should become a core activity in the coming years. This is not merely for attaining the desired growth rate over this plan period, but as an important component of the inclusive growth strategy for the longer term as well.

Indeed, the Twelfth Five Year Plan makes a strong distinction between supporting entrepreneurship and supporting enterprises: a common confusion in policy-making. Clearly there are commonalities: ease of doing business, improving infrastructure, better governance, and so on.[14] However, there are differences which arise from the size and age of the two categories. For instance, in cases of public procurement or public-private partnership (PPP) projects, the conditions almost always work against new companies.[15] How this bias can be corrected without compromising on quality and time depends upon circumstances. Two successful cases in India have been the rural roads programme and the early years of the National Highway Development Programme.[16]

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[12]Campus recruitment by corporates receives a lot of publicity and occupies considerable mind space, but this is probably far smaller than the lower end jobs which absorb most young people.

[13]The quality of jobs created and of the working environment is a different matter altogether. Also, unemployment among educated youth is higher than over-all youth unemployment in India mainly because of these and aspirational factors.

[14]SMEs are much less able to cope with the costs associated infrastructure deficiencies or rent-seeking behavior.

[15]In India, government procurement has reservations for small scale units, but the conditions imposed always tend to favour established enterprises, which are quite often fronts for corporates.

[16]In the rural roads case, high technical standards were laid down for low cost projects which allowed small companies to build up their capabilities. In the NHDP, initial contracts were for only 50 kms, which enabled technically proficient but financially weak firms to compete.

The other major constraint is finance. The financial sector in India, comprising primarily of banking and insurance, has been growing fairly rapidly in recent years, like most other components of the services sector. In the recent past, this sector has shown an elasticity of 1.22 against GDP growth. At first glance, this may appear to be a more than adequate performance, but the size of the financial sector in India, at 6.8 per cent of GDP, is small compared to that of most other countries. It is of course entirely possible that there is a serious underestimation of the financial sector in the country, since the National Accounts capture primarily the organized segments of the financial sector and virtually not at all the unorganized. Since anecdotal evidence suggests that informal credit arrangements play a significant role in a wide range of informal sectors, especially agriculture, SMEs, trade, transport and real estate, it is very likely that actual financial transactions are significantly larger than captured in the official statistics.[17] Although there is no rigorous measure of this, an indication can be obtained from the national accounts data which suggests that "financial intermediation services indirectly measured" (FISIM), which is a euphemism for such transactions, could be larger than 40% of formal financial intermediation services.

Although India has implemented a number of measures to improve the flow of formal finance to the SME sector, especially through directed bank lending to small enterprises though 'priority sector' lending targets, the experience is not entirely positive.[18] It is felt that entrepreneurship support cannot be achieved by such policies when banks (and other formal financial sector entities) continue to follow traditional methods of lending. A possible solution would be to change banking rules in a manner that for certain categories of lending, banks shift from a "project appraisal" approach to an "actuarial" approach. This is not a new idea at all, but banks simply do not have the capacity to adopt this model in most cases.[19] In the period while banks develop the technical capacity to adopt this approach for building their loan portfolios, two methods can be adopted. The first is to permit insurance companies to issue credit default swaps (CDS) against bank loans to SMEs, and the other is for banks to partner insurance companies in determining joint customers.[20] The important point, however, is that innovations in finance are essential, and should not eschewed simply because of the recent experience.

[17]The micro-finance sector has made significant strides in India and competes actively with informal credit providers. However, microfinance is relevant mainly, if not only, to the self-employed (own-account enterprises), and does not meet the needs of other small enterprises, who are forced to fall back on money-lenders.

[18]For a brief but comprehensive overview of the measures taken by the Government of India and the Reserve Bank of India see: Chakrabarty, K.C., "Strengthening SMEs Capacities for Global Competitiveness", RBI.

[19]A well-known "actuarial" product in banking is the Collaterised Loan Obligations (CLOs), which has been in vogue in the USA since the 1980s. However, this is an *ex-post* instrument, and what is required is an *ex-ante* procedure.

[20]Unfortunately, the global crisis has brought into disrepute some of these financial innovations such as the CLO (too often confused with CDOs) and CDS.