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Economic Reforms and Its Impacts on Industrialization or Manufacturing

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Abstract

Although there has been much theorising on the impact of India's economic reforms of 1991 on Indian manufacturers, there is hardly any previous study that has taken up the task of actually asking the manufacturing firms as to what the true impact of economic reforms has been on them. In this paper, we report the findings of a small sample survey of manufacturing enterprises in the Delhi region regarding perceptions of the impact of economic reforms of 1990s. Most firms felt that the reforms were helpful by increasing access to foreign technology and making imports of capital and intermediate goods cheaper. They also felt that improvement in infrastructure and more flexible labour laws will facilitate further growth of India's manufacturing sector.

Keywords: Industrial sector and intermediate goods, Foreign technology.

The Impact of Economic Reforms on Indian Manufacturers:

Introduction

The Indian economic reforms of the early 1990s have stimulated much research and ahost of academic papers. It is common to attribute India's recently accelerated growth tothe reforms. An aspect that has remained relatively unclear is which policy changeswithin the reforms have led to which consequences for employment, incomes andpoverty. There is also debate about which further policy changes are required to sustainthe increased growth and to strengthen the diffusion of progress to the lower-incomesegments of the population. Most studies have analysed the reform impact on macroaggregates, which leaves it unclear how different policies have worked. In order toexamine this aspect it is useful to investigate at the firm level how different industrieswere affected by specific policy changes.

The objective of the present paper is to examine how the reforms were perceivedand coped with by manufacturing enterprises, especially smaller ones, and to comparetheir perceptions with what has been found on the basis of industry-level data. For thatpurpose a small-sample interview survey was conducted in the first three months of 2006.

Fifty manufacturing firms were contacted and their managers were interviewed using aquestionnaire, which was adjusted for some specific aspects of the sub-sectors. Thepresent paper reports the answers received and discusses them in the light of otherfindings, in particular our earlier findings from an analysis of industry competitivenessunder the reforms (Siggel, 2007).

The paper proceeds in the next section by highlighting first some perceptions ofthe reformimpact expressed in earlier studies. Some of them were clearly pessimistic since their authors saw their expectations of rapid positive change unfulfilled. In contrast,our earlier study (Siggel, 2007) of industry competitiveness had found that the outcomeof the reforms was more beneficial to the industries, their exports and employment. Thethird section reports the industry perceptions, first of the reform impact on theenterprises' business performance and then on issues of taxation and the businessenvironment. The fourth section reports some of the industry-specific issues andcompares them with our earlier findings based on aggregate data. The fifth sectionsummarizes the main conclusions of the paper.

Impact of Economic reforms of 1991

Several earlier studies have attempted to analyze the impact of the economic reforms of1991 on the economy and industrial sector of India. In one of the earlier studies Nambiaret al. (1999) started from the expectation that trade liberalization "encourages economicactivity and hence raises production and employment"; he then asked whether this wasalso true in the Indian case. Although this expectation may be justified in the longer run,it seems somewhat unrealistic to expect immediate benefits since trade liberalizationalways implies increased foreign competition, which in turn may lead to the closure ofless competitive firms and therefore job losses and income reduction in the initial phasefollowing trade liberalization. One may argue, however, that by 1999 it was possible toexpect the longer-run impact of increased productivity, competitiveness and acceleratedgrowth. This raises questions about the timing of the reforms and about the time lagsnecessary to achieve the longer-run changes. In spite of the accelerated growth figures ofthe mid-1990s being already available, Nambiar et al. (1999) concluded that "trade hasover the years shrunk India's manufacturing base, both in terms of value addition andemployment". Although the authors admit that "this 'high protection-high cost-poorquality' syndrome needed to be corrected by import liberalisation", their assessment ofthe reform impact is rather pessimistic.

A much more positive picture was drawn by Panagariya (2004), who argued thatgrowth in the 1990s was more robust than that of the 1980s and that it was achievedthrough important policy changes. The main policy changes held responsible foraccelerated growth are the liberalization of foreign trade, the reduction in industriallicensing and opening to foreign direct investment.

Balasubramanyam and Mahambre (2001) attempted to relate different aspects ofthe reforms with changes in industry performance, in particular with productivity change.

They first observed a decline in debt/equity ratios in the majority of industries, especiallyin new firms, which was seen as a consequence of financial reform. The observedchanges in productivity (TFP decline) were mainly attributed to trade and licensingreforms. The authors concluded that in spite of declining productivity the industrial sectorhas benefited from the reforms by expanding its capacity.

Any assessment of the policy reform impact on industries has to start with adetailed evaluation and measurement of the incidence of specific policy changes. Das(2003) attempted such an assessment and computed effective rates of protection andimport coverage as well as import penetration ratios for 72 three-digit industries for foursub-periods of the period 1980 to 2000. Although these ratios are useful they do not showthe combined effect of tariffs and QRs on output prices. For that it would be necessary toestimate rates of protection based on price comparison, as had been done in the 1980s by5Pursell (1988). The author concluded that the Indian level of protection remained high incomparison with several South-East Asian countries.

Pandey (2004) focused on the measurement of several trade reform variables,including the measurement of protection based on price comparisons. As to the impact oftrade liberalisation on industry performance he concluded that this link appears to beweak, given the presence of other factors. Among these factors, government controls inform of industrial licensing and public sector investments are singled out, but the authoralso points to the well-known ambiguity between protection and growth: High protectiontends to generate growth in the initial stages, but declining protection may also lead togrowth through competition-induced gains in productivity and exports.

Closely related to the competitive effect of profit decline is the reform impact onproductivity. The longer-run expectation is of course increased productivity andcompetitiveness, but less dynamic enterprises may also disappear under increased importcompetition. While two recent studies (Unel, 2003; TSL, 2003) had found an accelerationof productivity growth in Indian industries, Goldar (Goldar&Kumari, 2003 and Goldar,

2004) re-examined the question by including further determinants, in particular capacityutilization. He concluded that trade liberalization had a positive influence on productivity, but this was counter-acted by a decline in capacity utilization and adeclining growth in agricultural production.

A somewhat different conclusion was reached by Das (2003a), who found thattotal factor productivity growth in manufacturing was close to zero over the 1980- 2000period, that it was positive in capital goods, but mostly negative in consumer andintermediate goods, and that it slowed down from the 1980s to the 1990s. The recessionof the mid-1990s as well as the continued labour market rigidity are held responsible forthis outcome. Topalova's study (2004), on the other hand, is more supportive of Goldar'sfindings and also adds a distinction between private and publicly owned enterprises, withthe former showing clearly more productivity growth thanthe latter.

General perceptions of industry representatives regarding the impacts of Reforms of 1990s

In analysing how the reforms of the 1990s have affected Indian manufacturers it is usefulto start with the distinction of various policy changes rather than treating the reforms as asingle act of reform. The sample enterprises were therefore asked which policy changesaffected them most strongly. Also, the firms were asked to describe specific problems oftheir industry that were related to the reforms.

Twenty out of 51 responding firms described the reform impact on their industryas positive, eighteen as mixed, eight as negative and five as absent. The policy changesmost often cited as affecting their industry were trade liberalization (35/50), whiledomestic policy changes were named in 15 responses. The problems that had mostaffected the industries before the reforms were trade-related issues, in particular thelicensing of imports (21/33 responses), while the remaining 12 responses were splitbetween domestic licensing (5), taxation (5) and other issues (2).

Trade liberalization

Trade liberalization has the immediate impact of increasing imports of products thatcompete with domestically produced products. These imports may be either cheaper atsimilar quality or similarly priced with superior quality attributes. In either case thedomestic producers are likely to face increased competitive pressure, to which they canrespond in various ways, mainly by reducing their own prices and profit margins.

The firms were asked to remember what had happened to their output pricesfollowing trade liberalization. Only half of the responding firms (23/46) reported pricereductions, while 15 representatives remembered their prices to have risen. This outcomeis not totally surprising, although unexpected, because it is difficult to separate relativeprice movements from the general upward trend of prices. Respondents tend to remembermore the upward trend in prices than the downward pressure of relative prices followingincreased competition from imports.

Closely related to the question of price changes is that of the timing of the reformimpact. When asked to remember the time in which competing imports started topenetrate the Indian market, the largest number of answering firms (13/28) claimed toencounter no competition from imports. This was particularly the case in metal industries(4/6) and pharmaceutical products (6/11). It may be explained either by the domesticfirms thriving in niche markets implying greater competitiveness of the Indian firms inthese sectors, or by the continued existence of some barriers to imports. Only six firmsreported increased import competition in the early 1990s, while nine firms observedincreased competitive pressure only in the late 1990s and after 2000. These responsessurely reflect the timing of the reforms, i.e. its gradual reduction of import restrictions,and indicate that the adjustment to trade liberalization by the firms seems to haveoccurred with a long time lag following the beginning of the reforms in the early 1990s.

One of the less expected answers was obtained to the question of how the pricesof competing imports compared with the producers' own prices. The majority (29/32) ofthe responses said that their prices were lower or equal to those of their foreigncompetitors, and this applied to potential imports before import duty. Only three firmsindicated that their prices were less competitive. In numerous interviews the impressionwas conveyed that the Indian producers were positively cost-competitive and, in somecases, ready to export. This opinion was most often heard in the Auto parts industry (6/7),but also in Metal products (5/6), Pharmaceuticals (8/11) and Wood products (5/7),whereas in Textiles and clothing it was heard in only three of 17 firms.

Cost reduction usually requires firing of redundant workers, but this is difficult inthe Indian context due to the existing labour laws. Not surprisingly, only five of theresponding firms admitted to having practiced retrenchment, while 35 respondents statedthat they managed without retrenchment. Subcontracting, on the other hand, was morepracticed, precisely in 24 of the 45 answering firms. Although subcontracting cantake various forms, the most common form amounts to the replacement of regularworkers by casuals, who are often hired by labour service providers. Such a change leadsto cost savings as it reduces social overhead charges.

Taxation

The Indian taxation system is known to be complex and to differ regionally. Whileincome and corporation taxes, as well as the value-added tax (replacing the excise tax),are administered by the Central Government, the states and municipalities levy their owntaxes and provide discretionary exemptions to attract investment (KPMG, 2005). Theanswers obtained in our survey reflected not so much the regional differences, but therecent changes, as well as exemptions. The answers conveyed the impression that firmsare not competing on a level playing field. The reported differences in tax rates seem tobe as important within industries as they are between industries. The corporate incometax rate, for instance, was reported as 30% (for small firms) 33% for domesticallyincorporated firms (even if foreign owned) with profits exceeding Rs 1 million, and 42%for foreign firms (not incorporated in India). Although the tax rate on foreign firms hasbeen lowered from 48% to 40%, new surcharges (corporate and education) have beenintroduced. The value-added tax (VAT) seems to vary between 4% and 12%, dependingon the stage of transformation in manufacturing. Excise and sales taxes vary even more,especially according to enterprise location as they are determined by the states. Althoughthe reforms have led to attempts of simplifying and reducing the tax burden, the surveyconveyed the impression that more transparency and equity are desirable for internationalcompetitiveness.

Domestic reforms and the business environment

Three aspects of the business environment are considered here, first the bureaucratic sideof doing business, then the supply of infrastructure and utilities, and finally policiesfurthering technological progress. One of the typical aspects of India’s traditionalbusiness environment has been far-reaching regulation. Various authors have referred toit as the “licence raj” and identified it as an obstacle to faster growth and development.

The reforms of the early 1990s gave rise to policy changes in this respect and led to analleviation of the bureaucratic burdens imposed on the business community.

In spite of these changes, the regulatory arm of the government is still strong andvery present. The sample firms were asked whether they needed government clearancefor their business and the majority of responding firms (20/36) reported positively. Asexpected, the pharmaceutical industry is leading in this respect, with 9 out of 11 firmsciting licensing requirements. For wood products (4/7), metal products (2/6) and autoparts (2/7) industries follow with minority views.

In the area of infrastructure and utilities manufacturing industries rely verystrongly on the availability at low cost of energy (petroleum and electricity), transportand communication. It is one of the governments’ important tasks to generate an enablingenvironment, in which these goods and services are available at competitive costs. Thesample firms were therefore asked to state their satisfaction or dissatisfaction with regardto these policy concerns. While for communication the satisfaction level was relativelyhigh, with 26 out of 29 responses being positive, energy cost and availability drew largelynegative responses, 11/18 for petroleum and 16 out of 31 for electricity. These responsesunderline the need for further reform in the area of energy supply. For transport services,the responses were similarly negative, with 15 out of 30 responses advocating furtherimprovements of roads and rail transport as well as ports.

Finally, one of the instruments of industrial policy in liberal economies istechnology policy. It can take the form of subsidies for research and development or ofinvestment incentives. The latter are more questionable as they tend to distort theincentive structure across the different sectors of the economy. The majority ofresponding firms (24/37) reported that they did not receive any kind of particularbenefits, whereas five firms reported investment-related support, four firms admitted toreceiving technology-related support (in pharmaceutical and metal products) and fourmore firms claimed to receive other forms of support, such as cheaper credit from public sector banks, worker training and tax rebates.

VIEWPOINTS OF PARTICULAR INDUSTRIES REGARDING THE IMPACT OF REFORMS OF 1990S

The selection of industries for the present survey was based on two considerations. First,our earlier study of industry competitiveness using ASI data had identified rising anddeclining industries. It was decided to further investigate the reasons for both, growth anddecline. Second, some sectors are presently very much in the public eye, such aspharmaceuticals and automobiles and automotive parts. They attracted our interest inspite of possibly average industry performance in terms of growth and exports.

Therefore,in this section we try to contrast the survey answers with our previous findings from thestudy of competitiveness (Siggel, 2007) and observations of a few other authors. Thiscomparison, however, is necessarily somewhat impressionistic, because the subset offirms interviewed does not necessarily reflect the same structure as the correspondingindustry at ASA 2-digit level.

Textiles and clothing

Although the textile and clothing industries are often treated as separate entities they are not easily separated, since many firms produce some kind of fabric together with garments. In fact, the ASI distinguishes at the 2-digit level three kinds of textile products, cotton textiles, wool and silk-based textiles and jute & hemp textiles, but only one clothing industry. The present survey covers 17 enterprises, 9 of which produce predominantly textile products (yarns, fabrics and other non-garment products) and 8 of them produce mainly garments. The majority of them are small and medium-sized firms and only three employ more than thousand workers. All except one are privately owned and only two firms are partially foreign-owned.

The competitiveness study revealed that the textile sector, especially cottontextiles, was one of the least profitable industries, in spite of being strongly tariff protectedand in spite of its success in export markets. This apparent contradiction can beexplained by two further observations: First, de-facto protection based on pricecomparison was significantly lower than the nominal tariff. Second, in spite of relativelylow production cost, the industry has been submitted to intense competition with importsunder the reforms, especially due to imports from China. Garments, on the other hand,are in the middle range of profitability. While cotton textiles have seen their share inGDP decline, the share of wool & silk products, as well as that of garments, hasincreased. While textile products occupy the second rank in Indian exports (followingother products including jewellery), garment exports have held fourth rank (followingfood products) in the late 1990s. The ratio of exports to output has gone up in thecombined three textile branches, from 15% in 1987/88 to 25% in 1997/98, while it hasgone down in clothing. Finally, employment in textiles has grown less rapidly than inother manufacturing (at about 1%), but in clothing it has grown at 10%, significantlyabove the manufacturing average of 2.2%. Labour productivity rose by 7.5% in textiles,but only 5.5% in clothing.

The majority viewpoint expressed by the sample firms of the present surveyis that the reforms had a positive impact, through reduced red tape and increasedavailability of new technology. The increase of exports was also related to the abolitionof quotas of the Multi-fibre agreement (MFA). A smaller number of firms reported eitherno or a negative impact of the reforms, due to increased competition of imports. This wasparticularly emphasized by producers of silk products, who blamed cheap silk importsfrom China for the reduction in silk production. Subcontracting is particularly prevalentin the clothing industry, where many firms have much of their output produced by a largenumber of families in the villages.

Among the complaints and recommendations for change most respondentsmentioned the labour laws, infrastructures, the need for export incentives, tax and interestrate policies, as well as bureaucracy and corruption. Although infrastructureimprovements in recent years were recognized, more needs to be done in the view ofmost of the responding firms. In that context, unreliable electricity supply is oftenresponsible for high cost. The call for export incentives, even when limited to duty drawbackschemes, was heard from five out of 17 firms.

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Wood products

This industry was chosen for the survey as one of the declining ones. Wood productsrepresented only 0.5% of manufacturing value added before the reforms and this sharehas gone down to 0.3% by the late 1990s. The analysis based on ASI data had shown thatthis industry has experienced declining profitability. Its export competitiveness hasincreased, however, which is in line with its growing export/output ratio (from 2.6% to7.0%). Both its employment and labour productivity record have been below themanufacturing average.

The seven sample firms of our survey are all in the small to medium size range:only three of them employ more than 100 workers, the largest one no more than 300.

Although five of the seven firms do export (two of them 100% of their output ofhandicraft and furniture), the majority expressed dissatisfaction with the reforms. Importpenetration of cheaper products, mainly from China, seems to have been the main reasonfor declining profits. Another factor, however, which is specific to this industry, seems tohave affected the industry's competitiveness. The 1997 ban of domestic logging forcedthe industry to use more expensive imported wood, which contributed to the profitsqueeze. The firms' recommendations to government include, besides the frequentlyheard complaint against the labour laws, stronger incentives for exports through dutydraw-back, but also further reduction of import duties on material inputs.

Rubber and plastics products

This industry, which in its 2-digit ASI definition also includes petroleum and coalproducts, stands out by its high labour productivity, due to its capital intensity. Within the

1987 to 1998 period its share of total manufacturing GDP declined from 9.1 to 6.4%. Itsprofitability has been positive, although declining during this period, and its exportcompetitiveness has risen to slightly below the sector average. Export performance andgrowth (tires and tubes) have been minimal, but employment has grown at an averageannual rate of 5.2%, the third-fastest among manufacturing industries. Not surprisingly,labour productivity growth has been slow and below industry average.

The present survey sample includes five manufacturers of plastics and rubberproducts. All of them are privately owned, without foreign participation, and all aremedium-sized with between 25 and 150 employees. Four of them export, but only smallproportions of their output (maximum of 15%). The general consensus on reform impactis positive and includes the following benefits: easier procurement of raw materials,access to new technology, enhanced opportunities for trading, increase in productionefficiency and improved quality of products. Two firms reported declining profits due toincreased competition, especially from Chinese imports, and increasing costs of power,transportation and labour. The main areas in need of further reform were identified aslabour laws, road and sea port infrastructure, power supply and the cost of credit.

Chemicals including pharmaceutical products

The chemical industry was included in the present survey because of its increasingimportance. Its share of value added increased from 16.3 to 18.5%, placing it at the firstrank, although in terms of employment it ranks only fourth. Its profitability was found tobe above the industry average and increasing, whereas its international competitivenesswas found to be about average but rising. Its ratio of exports to output has doubled fromabout 5 to 10%. The main export products of the industry are pharmaceutical products,which prompted the present survey to focus on this sub-sector.

The Indian pharmaceutical Industry derives its strength from the development,production and export of generic drugs, which was encouraged by India's Patent Act of

1970. The legislation removed medicines, food and agro-chemicals from product patentprotection to process patents, which had a shorter life (7 years as opposed to 14 years ofproduct patents). Since 1995, when trade-related intellectual property rights (TRIPS)legislation was adopted by the World Trade Organization (WTO), India had to amend itspatent laws to make them compatible with TRIPS. Since 2005 the law is now fullyTRIPS-compatible, with product and process patent protection of 20 years. This meansthat the Indian industry experiences a similar confrontation between the R&D-basedformulation drugs dominated by multinational corporations and its low-cost bulk drugmanufacturing arm, as in other WTO member countries. India has competitive advantagein the latter, due to the expansion of this industry since 1970, but it also searches nichemarkets in the formulation drug domain.

All ten enterprises included in the present survey are in pharmaceuticals, so that,unfortunately, the apparent ambiguity about performance of the chemical industry couldnot be clarified further by the interviews. As Srinivasan (2006) reports, industrialchemicals (the other major sub-sector) also increased their share in global exports;therefore, the observed decline in value added and employment remains unexplained. Thesample firms are mainly (7/10) of small-to-medium size, but three of them employ morethan 100 workers. Only four of them sell in export markets. In addition to the tenpharmaceutical firms the survey also benefited from an interview with a representative ofthe Indian Drug Manufacturers' Association (IDMA).

Automobile and automotive parts

This industry is one of the most interesting ones because of its visibility and the attentionit has recently received by the government. One of the striking features of domesticconsumption is the appearance of new automobiles on Indian streets since the 1990s,which has accelerated in the new millennium. The industry has attracted significantamounts of foreign investment and has become an exporter of automotive parts and alimited number of cars. According to a recent statement of the Government, the industryis targeted as global manufacturing hub for small cars in the next 3 to 5 years (Srinivasan,2006).Based on aggregate (ASI) data, which at the 2-digit level includes all transportequipment, the industry is still relatively protected. Its nominal rate (collection) declinedonly marginally from 48% to 47% from 1987/88 to 1997/98, but our price-based estimateis much lower at 15%, although higher than the industry average of 10%. The industrywas shown to have improved its profitability and international competitiveness in thesame time period (Siggel, 2007). Its growth of exports has been in the same order as thatof metal products (13%), although its proportion of output exported was smaller than thatof metal products. Finally, employment growth was only half the industry average,suggesting that some retrenchment may have occurred. This is confirmed by larger thanaverage gains in labour productivity.

The present small-sample survey has covered only seven enterprises, whichincluded two very small firms (five to ten employees) but also three large firms with over1000 employees. Their output ranges from automotive parts and maintenance/repair toassembly of commercial vehicles, buses and trucks. Three of the firms do export, one at arate of 30% of its output. Four firms have existed since the 1960s or 1970s, but three ofthem have started operations only in the 1990s. Four of the firms were either foreignownedor had joint ventures with foreign partners.

The reform impact was viewed quite differently by the participating firms,depending on whether the respondents were connected with foreign firms or not. Theforeign-linked firms described the impact as favourable due to their access to newtechnology. The firms that are not connected to foreign firms saw the impact asunimportant or negative, due to diminished protection, increased competition and fallingprofits. The main obstacles to business were identified by the respondents as electricitysupply failures, infrastructure deficiencies, rigid labour laws and access to and cost of credit.

Conclusion

Interview-based sample surveys often reveal a wide variety of views, depending on thesize of the firm and the industry to which it belongs, and the present one is no exception.

Nevertheless, there are a number of perceptions that dominated the responses in thepresent survey and they form our conclusions. First, the inquiry confirmed our formerobservation that the manufacturing sector as a whole did not decline as a result of thecountry opening its borders to freer trade and foreign investments. The main benefitsoccurred to industries through the access to new products, technologies and skills, as wellas lower costs of intermediate inputs. In some industries the increased competitivepressure led to shrinking profit margins, but others managed to increase profits byadjusting to the new environment. Second, the relative success of the reforms can beattributed to its timing and sequencing, as well as to the fact that they also includedinternal reforms amounting to reduced regulation. The timing of the trade liberalizationwas gradual over the 1990s and it was preceded by macro stabilization includingcurrency realignment. Third, although the majority of firms in the sample were smallfirms and not affected directly by the existing labour laws, the need for further reforms inthis area was frequently stated. Finally, most firms said that the manufacturing sectorfaces serious constraints in the form of infrastructure deficiencies in electricity supply,domestic transportation, sea ports, etc. and the government needs to improve theinfrastructure to ensure continued future growth of the manufacturing sector.

Thus our study suggests that economic reforms of 1991 were helpful to mostindustries by increasing access to foreign technology and cheaper capital goods & rawmaterials. Most firms felt that improvement in infrastructure and more flexible labourlaws will further aid the growth of India’s manufacturing sector. The conclusions fromour study tend to confirm the assessments of several earlier observers, especiallyAhluwalia (2002), Goldar (2003, 2004 and 2005) and Panagarya (2004).

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