Research Programme Consortium for Improving Institutions for Pro-Poor Growth

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Industrial Growth in Post-Reform India: Geography or Institutions?

In 1991, the Indian government dismantled the License Raj – a system of central controls that regulated market entry and production activity in the registered manufacturing sector. In the same year, the Indian government enacted far-reaching trade reforms which removed quantitative restrictions on capital goods imports and brought down import tariffs. Since the 1991 economic reforms, there has been strong industrial growth in India at an annual rate of 9 per cent.

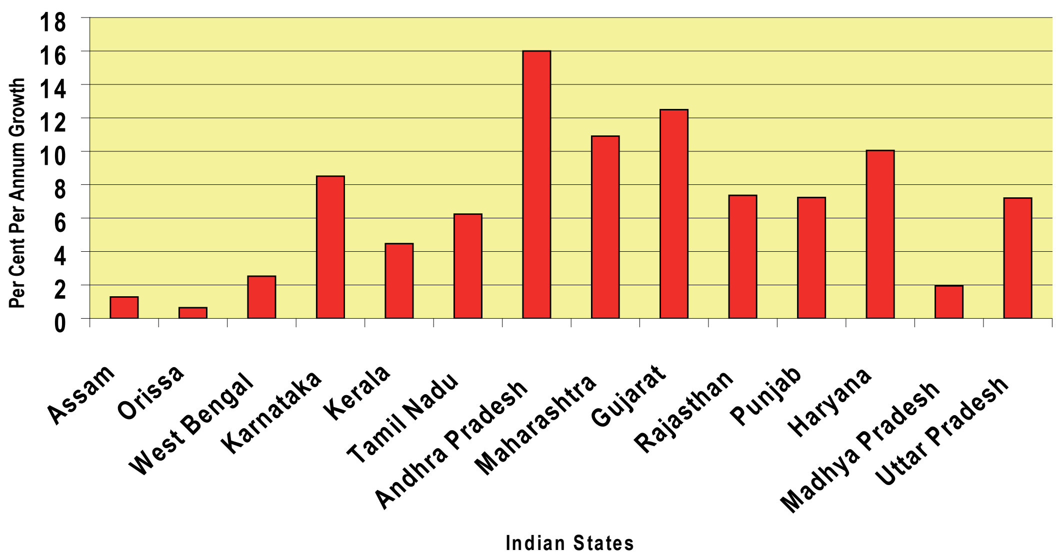
However, not all Indian states have performed well since the dismantling of the License Raj. The highest rates of industrial growth were observed in the Indian states of Andhra Pradesh and Gujarat which grew at more than 10 per cent per annum (Figure 1).[1] In contrast, Indian states of Assam, Orissa, Madhya Pradesh and West Bengal grew at 3 per cent or less per annum. The dismantling of the License Raj was expected to lead to more of a level playing field for political and business elites in Indian states as decisions on industrial entry, location and expansion were no longer taken in the capital, New Delhi. These decisions were often subject to lobbying pressures from well-organised elites in the more industrially advanced states in the days of the License Raj. Instead, regional elites had a relatively free hand in devising state-level industrialisation strategies since 1991, with little or no intervention from the central government.

Why then did we see such a large difference in industrial growth across Indian states in the post-reform period?

Two factors are often singled out as the deep determinants of economic performance. The first of these is geography. In the context of industrial growth, an important geographical factor is the access to the sea. Almost all countries with macroeconomic success in labour-intensive manufacturing exports have populations almost totally within 100 kilometres of the coast.[2] This would also be true at the sub-national level, and coastal states in India would have expected to benefit from the increased trade flows associated with the opening up of the economy rather than land-locked states. Another geographical factor emphasised by economic geographers as being important for manufacturing success is the presence of a large domestic market close to the point of production. Industrial firms would tend to locate near large urban populations as they could economise both on transport costs and production costs, and benefit from spillovers by locating near other firms. Therefore, initial conditions as reflected in past industrialisation and prior urbanisation can have a positive effect on present and future industrial growth.

However, geography does not do very well in explaining the differential manufacturing performance of Indian states in the post-reform

Figure 1: Industrial Growth across Indian states in 1991-1997



period.[3] While some coastal states such as Andhra Pradesh and Gujarat have prospered in this period, other coastal states such as Orissa and Kerala have languished. In contrast, a land-locked state such as Haryana has done exceedingly well. A state like West Bengal with a large metropolitan region, access to the sea and an extensive history of past industrialisation has performed significantly below par in the post-reform period.

An alternate set of factors seen to be causal to economic growth are institutions – 'the rules of game in the society, and their conduciveness to desirable economic behaviour'.[4] It is likely that institutions hold the key to explaining regional manufacturing performance in India. Recent research shows the importance of labour institutions in explaining the unequal effects of liberalisation in India. States with more rigid or pro-worker labour institutions have witnessed slower growth in the registered manufacturing sector than states with flexible or pro-employer labour institutions since the dismantling of the License Raj.[5] Other institutions such as those that govern state-business relations at the subnational level may have also exerted a decisive influence on regional industrial growth. Where effective state-business relations led to an active co-operation between governments and the business sector in Indian states with the joint objectives of increasing investment and productivity, industrial growth was more likely to result. In a recent survey of over 1600 industrial firms conducted by the Confederation of Indian Industries, firms were asked which India states in their view had the best and worst business environments in the entire country. The states which were seen to have the best business environments were Andhra Pradesh and Gujarat, and the states with the worst business environments were Kerala and West Bengal. It is not a coincidence that Andhra Pradesh and Gujarat have out-performed Kerala and West Bengal in manufacturing performance by a wide margin since 1991.

What explains the differences in effective state-business relations across Indian states? A set of projects conducted by the IPPG consortium is examining the political and historical factors that have determined the evolution of state-business relations in three states which has witnessed starkly different rates of industrial growth – Andhra Pradesh, Orissa and West Bengal – and whether the effectiveness of the institutional arrangements underpinning state-business relations in these three states has affected firm-level investment and productivity and consequently, industrial growth.[6]

If state-business relations are indeed the key to the evolution of regional disparities, this suggests that a collaborative relationship between the state government and the business sector is far more crucial in explaining manufacturing performance, rather than innate advantages borne out of geography or history. The clear implication here is that policy-makers in states such as Orissa (which does not have a history of industrialisation) and Madhya Pradesh (which does not have access to the sea) can expect to bring about a stronger performance in manufacturing if they were to provide a more conducive institutional environment for the business sector to expand with greater infrastructural development and a credible investment climate that will create incentives for industrial firms to locate in these states.

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For further information on the SBR research undertaken by the IPPG please see the IPPG website at www.ippg.org.uk

1 Registered manufacturing growth, estimates based on the Annual Survey of Industries.
2 Radelet, S. and J. Sachs (1998) 'Shipping Costs, Manufactured Exports, and Economic Growth'. Harvard Institute of International Development, (http://www.cid.harvard.edu/archive/hiid/papers.html).
3 Sen, K. (2008) *Trade Liberalisation, Inequality and Performance in Indian Manufacturing*. London: Routledge.
4 Rodrik, D., Arvind Subramanian and Francesco Trebbi (2004) 'Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development'. *Journal of Economic Growth*, Vol. 9, pp. 131–165.
5 Aghion, P.; R. Burgess; S.J. Redding; and Fabrizio Zilibotti (2008) 'The Unequal Effects of Liberalization: Evidence from Dismantling the License Raj in India'. *American Economic Review*, Vol. 98, No. 4, pp. 1397–1412.
6 See http://www.ippg.org.uk for a description of the projects.

IPPG: The IPPG Programme is the shorthand name for the inter-disciplinary Research Programme Consortium on Improving Institutions for Pro-Poor Growth. The DFID-funded IPPG supports innovative scholarly research, and seeks to influence development policy and practice that contributes to the UN Millennium Development Goals (MDGs). IPPG Programme partners are based in South Asia, Sub-Saharan Africa and Latin America. IPPG funds research projects across all these regions.

If you would like to know more about the Research Programme Consortium for Improving Institutions for Pro-Poor Growth (IPPG), please contact the programme office: email ippg@manchester.ac.uk; telephone +44 (0)161 306 6438. Alternatively, please see the IPPG website at **www.ippg.org.uk**