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Supporting India's Twenty-Eight Development Paths

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[1] The views presented here are those of the authors and do not necessarily represent the position of either Institute for Competitiveness or Stanford University. Working papers are in draft form. This working paper is distributed for purposes of comment and discussion only.

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Supporting India's Twenty-Eight Development Paths

India is positioned to have the leading role in human development in the coming decades. The pace and pathway for this development will naturally be impacted by government policies. While the world pays a great deal of attention to economic policymaking by the Union Government sitting in New Delhi, less attention is paid to the economic and development priorities of India's twenty-eight states. Yet, in India, states collectively play a far larger role in defining India's development path than the national government. In turn, states face unique challenges in implementing necessary reforms due to demographic and electoral considerations. The capital outflow from China as well as increasing urbanization provides India the perfect context to grow. The central government should provide the states with the necessary policy structure to grow. India and all her states must act.

The world is waking up to India's emergence as a global economic power. According to the United Nations, India is expected to surpass China as the world's most populous nation this year. Even with a sharp economic decline during the recent Covid onslaught, India has averaged well over six percent growth over the last two decades. The success of India's dynamic technology services sector is well-documented. Firms like Tata Consultancy Services, HCL, Wipro, and Infosys are critical partners to leading multinational firms. And global technology firms like IBM, Microsoft, and Google have massive employment bases in India supporting these firms' global operations. India has also achieved notable success in a few other sectors such as the production of vaccines, generic pharmaceuticals, and automotive parts. Still, manufacturing remains a relatively small portion of India's gross domestic product (GDP)- around 14 percent, per the latest World Bank data, despite a stated target of 25 percent of GDP by 2025, per the Ministry of Commerce and Industry's National Manufacturing Policy.

Success in manufacturing will be important for India's development and will also support social harmony. Today, well over forty percent of India's labor force remains mired in basic agriculture, yet produces only around 18 percent of GDP. The Indian government has taken steps to stimulate agriculture modernization, and one likely outcome is the increasing mechanization—rendering millions of workers redundant in the coming decades. With relatively low skills, finding employment for these workers is a monumental task. Lower-skilled manufacturing and assembly jobs could potentially absorb this labor pool. But creating these jobs requires the right mixture of policies and infrastructure.

India enjoys one current advantage- the growing desire of multinational corporations to reduce their reliance on China as a dominant place for global supply chains. Covid taught a powerful lesson about the dangers of over-reliance on a single market. And, on top of these logistical risks, there are increasing concerns over the security aspects of relying on China for producing a range of critical technologies for the world.

The central government is cognizant of these challenges. Since assuming office as the nation's prime minister in 2014, Mr. Narendra Modi has initiated a range of significant policy reforms that should support India's manufacturing ecosystem. The 2017 approval of a national "Goods and Services Tax (GST)," which removed barriers to inter-state trade and created a more transparent and uniform taxation system is perhaps the most notable of these measures. Other reforms like the Insolvency and

Bankruptcy Code (IBC), reducing corporate taxation rates, revoking the "small scale sector reservation," and relaxing government controls over major ports will have a stimulative effect on India's desire to expand manufacturing and integrate with global supply chains.

However, not all of the Modi government's manufacturing policy interventions have been positive. Over the last nine years India has redoubled policies focused on trade protectionism. Successive Union Budgets have steadily increased tariff rates on goods for which India relies on imports. India has expended local manufacturing mandates in a range of sectors. And price caps have expanded in areas like pharmaceuticals and medical devices.

More recently, India has shifted its approach to trade once more. Over the last two years, the government has launched a dual-track approach supporting local manufacturing while aggressively pursuing foreign trade. On one hand, the government is incentivizing local manufacturing through the "Production Linked Incentive (PLI)" program. And on the other hand, India is revitalizing dormant negotiations with multiple key trade partners to sign trade agreements. As of January 2023, two new agreements have already been concluded- with the United Arab Emirates and with Australia. Other negotiations are underway, including with the United Kingdom, Israel, Canada, and the European Union.

The 2023-24 Union Budget, released on February 1, 2023, maintains this new approach to trade policy. While about a dozen sectors saw customs duty increases, a higher number of products saw customs duty decreases. This is a reversal of the trend from earlier budgets by this government which typically saw hefty customs duty increases in dozens of sectors simultaneously.

CSIS WADHWANI CHAIR IN U.S.-INDIA POLICY STUDIES

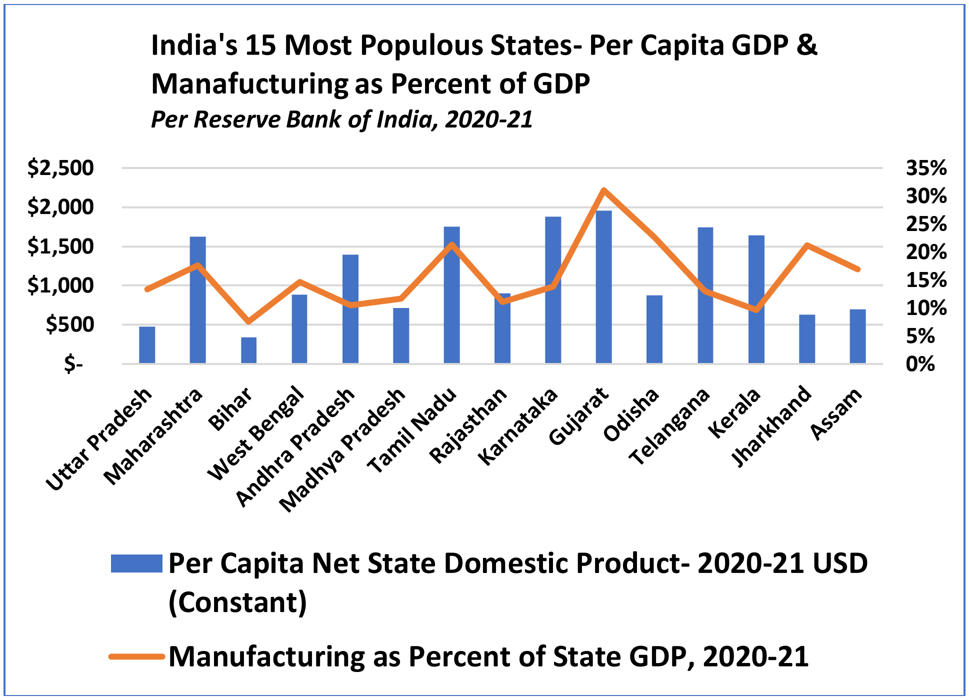
India's Union Budget 2023-24
Trade/ Customs Duty Changes

Customs Duty *Increases*	Old	New	Customs Duty *Decreases*	Old	New
Styrene	2%	2.5%	Pecan Nuts	100%	30%
Vinyl Chloride Monomer	2%	2.5%	Fish / Krill Meal	15%	5%
Naptha	1%	2.5%	Fish Lipid Oil	30%	15%
Silver	7.5%	10%	Algal Prime Flour	30%	15%
Silver Dore	6.1%	10%	Mineral/Vitamins for Fish Feed	15%	5%
Precious Metal Items	20%	25%	Crude Glycerin	7.5%	2.5%
Imitation Jewelry	20%	25%	Ethyl Alcohol	5%	0%
Vehicles, Semi Knocked Down	30%	35%	Fluorspar	5%	2.5%
Vehicles, Completely Built	60%	70%	Lab Diamond Seeds	5%	0%
EVs, Completely Built	60%	70%	Capital Goods- LiON Batteries	Var	0%
Bicycles	30%	35%	Goods for Mfg Ferrite Powder	7.5%	0%
Toys, Parts	60%	70%	Palladium Tetra Amine Sulphate	7.5%	0%
Compounded Rubber	10%	25%	Camera Lens- Mobile Phone	2.5%	0%
Electric Kitchen Chimney	7.5%	15%	Parts for TV Panel	5%	2.5%
			Heat Coil- Kitchen Chimney	20%	15%
			Horses- Sport	30%	0%
			Vehicles & Parts for Testing	Var	0%

India's Powerful State Governments

But enough about Delhi and the Union Government. While the reforms outlined above will improve aspects of India's business environment, these changes will be along the margins. The most significant elements of India's business environment are defined by India's twenty-eight state governments. At the state level, India has a mixed record in creating a credible, world-leading business environment.

Dramatic differences in development data between different states underscores the impact state-level policymaking can have on a state's advancement. The following chart looks at the 15 most populous states in India, highlighting the significant differences in per capita income levels and the relative size of the manufacturing sectors within each state economy.



To further appreciate states' role in boosting India's manufacturing sector, we must first look at the distinct areas where the center, and the state governments operate. The seventh schedule of India's Constitution defines the respective separation of powers between the Union Government and states. There are three separate categories:

- **The Union List:** Areas of policymaking and authority that rest with the Union Government. This includes national security, nuclear power, foreign affairs, citizenship, railways, communications, airlines, banking, insurance, and other sectors.
- **The States List:** Areas of policymaking under the purview of state governments. This includes administering police, health, agriculture, water, land, gambling, and more.
- **The Concurrent List:** Areas of policymaking shared between the Union government and states. This includes regulation of factories, labor, electric power, forest, and wildlife management, and more.

As evident from these lists, most of the key factors of production for manufacturing lie either in the states list or the concurrent list. At the startup phase, most approvals required by an entrepreneur are state-level approvals. The number of approvals and transparency of the process varies dramatically from state-to-state. Companies also require access to reliable electric power, water, sanitation, transparent land acquisition and clear title, and balanced labor policies that simultaneously offer worker protections while encouraging companies to expand their workforce. In practice, all these factors are almost entirely defined by state governments, even if some—like electric power—are on the concurrent list. And investors also need fair and transparent processes for ongoing approvals such as environmental and safety inspections, as well as effective recourse if these tools are misused for corrupt activities. Even as the center's hands are tied in most areas, it can promote effective federalism, and provide states the necessary growth impetus they require.

An Evolving Balance of Power

As a former state leader, Prime Minister Modi outlined the twin concepts of Cooperative Federalism / Competitive Federalism to support the role states can play individually, and collectively, to promote development.

Some of the key steps the Modi government has taken to underpin these concepts include:

- **Abolishing the Planning Commission.** Until 2015, India retained a powerful Soviet-style planning body that set 5-year national development plans and pressed state governments into complying to receive fiscal transfers. The Planning Commission has been recast as an advisory body called NITI Aayog which is more of a think tank. NITI Aayog assists states by agenda setting, and offers relevant policy advice.
- **Ranking States Business Environments.** The Ministry of Commerce & Industry has started a program to rank the business environments of Indian states, called the "Business Reforms Action Plan (BRAP)" covering 301 areas of regulation.
- **Framing Model Laws & Regulations.** The Union government has prepared a range of model laws and regulations for states to consider adoption, covering topics such as agriculture land leasing, and regulation of "shops and establishments."
- **Reforming/ Bailing Out Electricity Distribution Companies.** The Union government has made two recent attempts to improve the operations of India's woeful electricity distribution utilities. In 2015 the Ministry of Power launched the Ujwal Discom Assurance Yojana (UDAY) program, offering a range of incentives to state governments that agreed to undertake key reforms. After seeing mixed results, in 2021 the Ministry launched the Revamped Distribution Sector Scheme (RDSS), further detailing a range of incentives states can receive for making specific reforms over a four-year period.

States' Urbanization and Political Stability

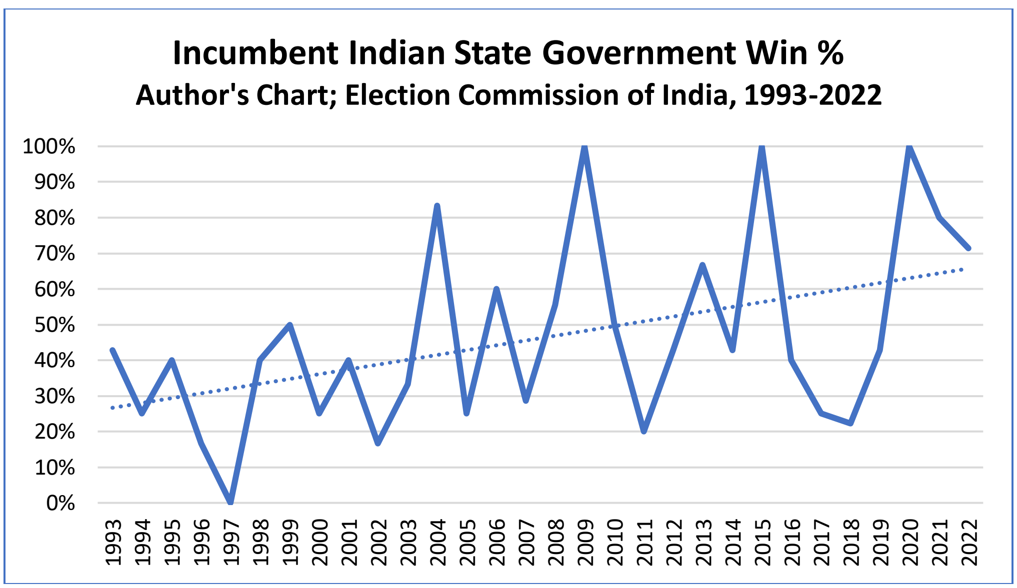
While the Union government is attempting to coopt state governments in national development, states are not always equally receptive. Deep reforms in areas like electric power, infrastructure development, and similar structural changes desired by manufacturing firms require time and patience by state governments. The key counter-pressure to a state government is a mixture of the vote base and re-election rates.

Despite steady urbanization, India's state elections are largely decided by voters living outside the nation's major metropolitan areas. For most of this major voting bank, their needs from the government are more focused on social programs and support, rather than the types of structural reforms important to manufacturers. For instance, leaders are wary of privatizing electricity distribution companies (DISCOMs) to ensure a reliable electric supply, lest they may offend farmers and rural voters who are used to cheap or free electricity. According to the World Bank, India's rural population makes up 65 percent of the nation's total population. This percentage has been declining by a percentage point every two or three years in recent decades. India's urbanization shift is happening—but slowly. It will still be decades until voters in large cities begin dominating state-level elections, and presumably push for the types of urban infrastructure investments required by industrial investors. Nonetheless, the demographic shift is a good omen.

This urban-rural shift should have a profound impact on India's pace of development. Today, India's municipal governments have very little authority. Without independent sources of revenue, major decisions on urban planning and infrastructure are made by the state governments—which rely more heavily on rural and semi-urban voters. In November 2022, the Reserve Bank of India (RBI) released a powerful "Report on Municipal Finances" that underscored this gap in funding and planning. One passage by the authors sums up the report's key findings:

> *"Indian cities are emaciated financially and are far from being able to generate the resources required for providing good quality infrastructure and services to their citizens. Accordingly, the availability of basic urban infrastructure in India lags behind the levels achieved in the OECD and other BRICS nations."*

Another critical impediment to state governments' long-term planning is the low re-election rates of sitting state government leaders. Over the past decade, a chief minister has only a fifty percent chance of winning re-election. While this rate is nearly double the rate from two decades ago, it forces state leaders to prioritize short-term policies and programs that will achieve quick, tangible benefits that are visible to voters.



Electoral instability presents three specific challenges to investors. First, in the months ahead of an election, it can be hard to get policymakers' attention on securing key approvals related to investing in significant projects. Second, if an incumbent government loses, it can take several weeks or months for an investor to build rapport with new officials that oversee approvals for a significant project. And third, newly elected state governments often feel the need to revoke decisions made by the previous governments, throwing the policy environment and specific projects into turmoil- and often into a legal morass. Some notable instances include:

- ***Maharashtra, 2019.*** After forming an unusual coalition, the Shiv Sena-led government began altering and revoking projects launched by the previous government, most notably the creation of a new Mumbai Metro car shed at Aarey, north of Mumbai's downtown. The Shiv Sena-led government also initiated reviews of pending rail and Hyperloop projects.
- ***Andhra Pradesh, 2019***. The YSR Congress party defeated the incumbent Telugu Desam Party (TDP). The new government immediately attempted to renegotiate previously-signed power purchase agreements with electric power companies, revoked plans for building a new state capital, cancelled state-issued bar licenses, and more.
- ***Delhi, 2014:*** After taking over the territory government, the Aam Admi Party cut electric power tariffs and asked for a Comptroller and Auditor General (CAG) audit of the two private electric power distribution companies.
- ***Tamil Nadu, 2011:*** After the All India Anna Dravida Munnetra Kazhagam (AIADMK) won the state election, it stopped honoring tax incentives promised to multinational automotive firms like Nissan.

While reversing projects started by a previous government may have merit, investors feel these decisions are often taken capriciously. Many resultant disputes have been favorably adjudicated by the courts when contracts are arbitrarily revoked. But investors do not want to constantly spend their time before judges and endure lengthy legal processes to make their investments work.

Road Ahead: Increased Center Support

State's electoral challenges are an impediment. However, sometimes inaction on development policies and projects by state governments can be indicative of a lack of capacity. For this reason, the Union government can still do much more to support states' development priorities.

- **Re-Prioritize and Improve the Business Reforms Action Plan (BRAP).** The attempt by the Ministry of Commerce & Industry to rank states' business environment has been done irregularly. And the Ministry must ensure that related data points are confirmed in practice. Companies felt that there was a major gap between what states self-reported and their practical experience.
- **Expand Model Laws and Regulations for States to Consider:** The Union government has done some work in crafting model business laws and regulations for state governments. For example, in 2016, the government released a model "Shops and Establishment Bill" to reduce onerous regulations on places of business. This is helpful and should be expanded.
- **Include State Governments in More Forums:** State leaders should be strongly encouraged to join key industrial forums like the U.S.-India CEO Forum. They need to engage business leaders directly to get a deeper understanding of how major investment decisions are made.
- **Expand the National Single Window System:** Many state governments are already onboarding their business permits onto the National Single Window System, created by the Department for Promotion of Industry and Internal Trade (DPIIT). Expanding states' coverage should be encouraged. States that want to win investments should want to be a robust partner in this process.
- **Transparency of India's State-Level Regulations:** Recognizing the lack of transparency around state-level policymaking in India, our team started a free, weekly states' regulatory

update in 2015. We find that, even after a state cabinet approves a new regulation, it can often take weeks—or months—for the policy to be made available. And states are notoriously poor at placing draft laws and regulations for public comment. The Union government can do more to ensure better regulation-setting and transparency.

State governments truly hold the key to India's development future. The world needs a large, strong Indian economy for multiple reasons. India's heft will provide a counterbalancing economic power to China. The Indian market holds incredible potential for trading partners. And India's young labor market could help India take on the mantle of "workshop for the world".

In recent decades, the Union government has plunged ahead with deregulating areas of the foreign investment and domestic business environment under their control. The process is, of course, never-ending. But most big challenges in deregulation are now in the past. The metaphorical ball is now in the states' court.

A higher degree of action must now fall to state governments. Urbanization and education will provide powerful stimuli for state governments to apply more time and energy towards modernization. The Union government can hasten this process through an appropriate mix of support tools.