

# Issues for Parliamentarians

To facilitate informed discussions among Indian Parliamentarians on key economic policy issues

## Good Economics is Good Politics



Parliamentarians' Forum on Economic Policy Issues (PAR-FORE)

*The principal goal for India's manufacturing growth is to create 100 million additional jobs by 2022.*

## Industry's Missing Middle

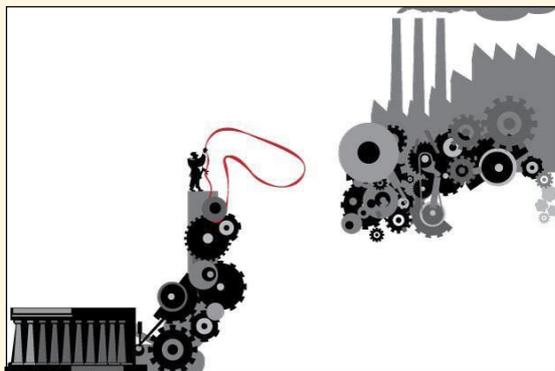
*A radical transformation of government processes for making policies and implementing them is necessary to change the limping trajectory of Indian manufacturing. Economists and analysts clutch at them to gauge the condition of India's ailing manufacturing sector. They would have more solid evidence of where India's manufacturing stands if they could feel the ground underfoot. There are three models that policymakers must apply to strengthen the limping trajectory of Indian manufacturing, says Arun Maira\* in his articles which appeared in the Mint (January 06-07, 2014).*

Policymakers must get beneath the surface to the fundamentals on the ground. Deng Xiaoping's famous dictum, "You must cross the river by feeling the stones underfoot", explains very well what the nature of policy processes must be. Signals to the policymaker's head must come from the experience of feet on the ground, not from numbers in the air. I will return to Deng's metaphor of the river later.

### MODELS TO STRENGTHEN MANUFACTURING

There are three models that policymakers must apply to strengthen Indian manufacturing. Policymakers, doctors and gardeners, whose objective is to improve the condition of the organism in their care, require three models to guide them. The first is a good model of the organism itself — what are its constituents and what functions do they perform. We would not trust the care of our body to a doctor who did not know the locations of the complex organs inside it. Nor would we leave a plant in the care of a gardener who had no knowledge of what functions its roots, stems, and leaves perform. Human bodies and plants are not merely a lot of stuff put together. It's the unique way in which the stuff works that gives them their lives.

In the same way, a manufacturing enterprise is not merely a sum of factors of production such as capital and labour. These factors interact with each other in complex ways inside a manufacturing enterprise, and insights into those interactions are necessary to understand the essence of manufacturing.



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Industrialisation is a process of societies and economies learning to do more complex things they could not do before. Industrial nations evolve from agricultural societies and producers of primary materials when they are able to convert materials into more complex products. Advanced industrial nations are those that have learned to design and produce even more complex products than developing nations. The learning that stimulates industrial development takes place in these countries' manufacturing enterprises.

A manufacturing enterprise is not merely a list of resources to be summed up in an accountant's balance sheet – capital, machinery, land, labour and knowledge (patents or other units of knowledge). Rather, it is a living, learning system. This is the first model that any policymaker, at the corporate level or national policymaking level, wanting to improve the performance of manufacturing must adopt.

The second model explains how the system improves itself. All doctors must know how bodies function. The best doctors also understand how bodies heal themselves. Their interventions are very effective because they know what to prescribe to assist the body's own healing process. Similarly, a gardener with "green fingers" has a touch with

which to help the plant to revive and grow. In the same way, the masters of manufacturing improvement, such as the developers of the Total Quality and Kaizen movements in Japan, and their counterparts in the industrial engineering disciplines in Germany, understood where the keys to enable manufacturing enterprises to speed up their pace of improvement lie.

The keys are in the processes by which these enterprises perform, and they are in the minds and motivations of human beings in these enterprises. These leaders know that a manufacturing enterprise is a "system" and that the Total Factor Productivity (TFP) of a system can be increased by improving the interactions among its parts. Therefore, the keys to performance improvement are in the design of production processes and the quality of relationships among the people in the enterprises.

TFP, the economists' holy grail, lies in the "residual" that cannot be explained by accounting for the quantities of resources used in the system. TFP rises by improving the interactions between the resources in the system. Economic models are built on production functions, such as  $y = f(a,b)$ . Where  $y$ ,  $a$  and  $b$  are quantities, and  $f$  is the transformative function that must be changed to improve the productivity and the competitiveness of the economy and its enterprises. For an economist, the transformative function may be a "given".

For a manager, it is not. In fact, the innovative manager's job is to improve the transformative function by learning and experimentation. Indeed, to sustain their competitiveness, economies

and enterprises must keep improving their TFP —their transformative functions — faster than others.

I return to Deng's metaphor of the river crossing to explain the third model for the policymaker. Enterprises and economies when they are changing and improving are learning to do what they have not done before. Without a precise map to connect them from where they are to where they want to go, they must find their way across the river by feeling the stones underfoot.

Manufacturing enterprises are the feet of a nation's manufacturing industry. They are trying to improve their competitiveness by learning and innovating. The national policymaker is in the head of the body. The policymaker has to be very sensitive to the signals from the feet, to shift the weight of the whole body and enable safer and faster movement forward.

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## ESSENCE OF THREE MODELS

Let me summarise the essence of the three models required to accelerate growth of India's manufacturing sector. First, what is "manufacturing"? It is a system of learning at an enterprise level to carry out more complex activities competitively. Second, how does a manufacturing enterprise (and a manufacturing nation) advance? By improving the quality of processes and relationships between people within the enterprises and across them. And third, how does a policymaker help the manufacturing sector to accelerate improvement of its productivity and competitiveness? By listening very well to signals from the ground and changing national policies accordingly.

Since the industrial reforms of the 1990s, India's manufacturing sector has failed to deliver what was expected. It has not been a driver of economic growth, which the service sector was. More worryingly, it has so far failed to create jobs in the large numbers it now must to absorb the burgeoning population of Indian youth.

Following Albert Einstein's dictum that you cannot solve the problem you have with the same mindset that created the problem, the Planning Commission undertook a soul-searching examination, in the run-up to the 12<sup>th</sup> Plan, of its processes of formulating and implementing industrial policy. For this, it also took the help of some of the world's leading industrial economists to understand the policymaking processes of successful industrial countries.

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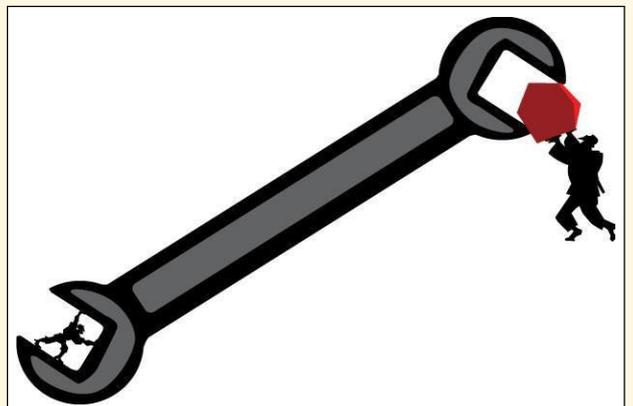
## MANUFACTURING WEAKENED BY 'MISSING MIDDLE'

India's policymaking process for manufacturing has been weakened by a "missing middle". From numbers and opinions (quite often those of economists, rather than persons with hands-on manufacturing knowledge) the policymaking apparatus jumps down to devise schemes and rules. This is analogous to an inexperienced doctor prescribing surgery after merely reading numbers on a scanner.

What has been missing mostly in India's manufacturing policymaking is the middle: a systematic process of connecting the heads and numbers in the air with the producers with their feet feeling the stones on the ground. What has passed for "consultation" is generally pro forma, a ticking of boxes, and a barely disguised lobbying for sectoral interests.

Growth of Indian manufacturing will require many reforms, in addition to improvement of the country's transport and power infrastructure; reforms of the business regulatory environment which is among the most cumbersome in the world; reforms of antiquated labour laws; improvement of manufacturing management practices; reorientation of policies for the MSME sector, etc. These "what's" that must be done are now well-known. Rather than repeating them again and again in seminars and papers, the government and producers must move on together to the "how" and get them done.

India's manufacturing sector cannot be allowed to muddle along much longer with weak policymaking and implementation processes. Too much is at stake. The next part of this article will explain the most essential "what's" to accelerate Indian manufacturing's growth and the "how's" of getting them done. These "what's" and "how's" have been developed by the most extensive and systematic process of consultation between the government and producers undertaken so far in the country. The good



news is that several of these initiatives are already underway. What is required now is much wider support for them and better alignment amongst stakeholders.

A look at three core strategies developed to address the root causes for the slow growth of Indian manufacturing

## MANUFACTURING'S CONTRIBUTION TO GDP

The baseball star Yogi Berra once said that “you must know where you are going or you will end up somewhere else”. India’s manufacturing contributes only 16 percent to India’s gross domestic product (GDP), much less than manufacturing does for China (30 percent). It is even less than that for Germany (21 percent) and Japan (20 percent), countries with much higher wages and strong currencies. The percentage is very low, but the principal goal for India’s manufacturing sector cannot be to increase to 25 percent of GDP or any other percentage of GDP.

Manufacturing’s contribution to GDP will increase should the service sector’s growth slacken. It will also increase with growth of more capital-intensive manufacturing which will increase the sectoral GDP but will not contribute sufficiently to the country’s principal strategic requirement in the next few years, which is to increase employment.

The principal goal for India’s manufacturing growth is to create 100 million additional jobs by 2022. Moreover, these jobs should be generated across the country, and rapidly, to fulfil the country’s imperative for faster, and more widespread inclusion in GDP growth. Another goal that must be achieved simultaneously is to increase value addition and technological depth in India’s manufacturing sector.

The Planning Commission, in the run-up to the 12th Plan, established a steering process and a flotilla of 26 working groups to develop a national manufacturing plan to achieve the country’s goals. Sixteen working groups concentrated on plans for their industrial sectors. In each, sectoral industrial associations along with relevant government functionaries determined what must be done by the producers and what support would be required from the government to achieve targets they set for themselves. These bottom-up targets set by industry leaders with their feet on the ground did add up to 100 million jobs.

The achievement of these targets requires industry to do what it has planned. It also depends on trends in the general economic environment. And it depends on what the government must do to ease the constraints in the country that are affecting all manufacturing sectors.

Ten working groups, also staffed with hands-on industry leaders and government officials, focused on finding practical solutions for these “cross-cutting” issues. This systematic analysis located the root causes for the slow growth of Indian manufacturing. Then strategies were developed to address them. I will explain three core strategies here. Two others, not explained here, are for enabling faster growth of MSMEs (micro, small and medium enterprises) and for policy alignment to induce more value addition and technological depth in domestic manufacturing.

*India needs a two-pronged strategy to improve its business regulatory environment. Firstly, concentrate on motivating the states and assist them to improve. Secondly, focus immediately on the larger opportunity for improvement which is better management of processes rather than changing laws.*

## STRATEGY TO IMPROVE THE BUSINESS REGULATORY ENVIRONMENT

The productivity of Indian manufacturing enterprises, especially MSMEs, is stifled by poor business regulations. The plethora of tangled and tardy procedures to obtain government approvals (and for inspections thereafter) places India towards the bottom of the World Bank's annual rankings of ease of doing business. An analysis reveals that over two-thirds of the regulations applying to manufacturing enterprises are generated and administered in the Indian states. Moreover, as World Bank studies show, and experience on the ground confirms, the impediments to business are often in the ways in which laws and rules are administered rather than the content of the laws.

Therefore, India needs a two-pronged strategy to improve its business regulatory environment. Firstly, concentrate on motivating the states and assist them to improve. Secondly, focus immediately on the larger opportunity for improvement which is better management of processes rather than changing laws.

The Planning Commission is implementing this two-pronged strategy. It has launched an annual assessment of the business regulatory environment in Indian states. The survey will rate all states on the critical regulations that have the most impact on industry, especially MSMEs. Comparisons will reveal to the states where their biggest opportunities are, and will also show them who is doing better, from where they can learn. The Planning Commission is "importing" internationally established processes for tuning up business regulatory environments, such as Business Regulatory Impact Analysis (BRIA), and these will be provided to the states to improve themselves.

The Planning Commission will do the ratings every year. This will reveal the states that are making the fastest improvements. The "change management" and stakeholder alignment processes used by these states will be very useful for others who want to accelerate their own improvements. Business associations are collaborating with the Planning Commission by gathering examples of best practices in the states and providing platforms for their dissemination. They are also facilitating the convergence of stakeholders to set each state's specific regulatory improvement agenda.

*India has a massive ambition to skill 500 million persons in the next few years. Manufacturing enterprises must play two crucial roles for this venture to succeed. The first is to provide jobs for these millions. The second is to develop higher level (and tacit) skills which give the edge for improving productivity and competitiveness, and can be developed only within a manufacturing enterprise.*

## THE 'HUMAN ASSET' STRATEGY

Industrial development, as was explained in the first part of this series, is a process whereby a nation learns more complex capabilities. Manufacturing enterprises must be faster learning enterprises than enterprises in other nations to stay ahead of competition. The only asset in a manufacturing enterprise that can appreciate its value over time is the human asset. All other assets will inevitably depreciate in value. The human asset can learn and improve when it is motivated and enabled. Moreover, workers and managers can improve the organisation's processes to get more productivity out of the machines, buildings, and materials than competitors can.

The sustained competitiveness of German and Japanese manufacturing enterprises, even when wages rose and their countries' exchange rates appreciated, is attributed to their continuous learning and improvement. Managers and workers in these countries' enterprises collaborate to improve processes. It is worth noting that human resource

management in these countries is characterised by longer term commitments to employment in enterprises, and supported by stronger unions too.

If there is one resource which can provide Indian manufacturing enterprises a sustainable competitive advantage it has to be the human resource. India will be well endowed with young aspirants for good work for the next two decades. However, for workers to be a competitive advantage rather than a bother, entrepreneurs and managers must change their attitude to workers in their enterprises. They must see them as the only appreciating assets on the balance sheet, and not as avoidable costs on the P&L account to be turned off and on as quickly as possible.

Some economists insist that unless India changes its labour laws, investments will not come and manufacturing will not grow. Both employers and unions have been demanding changes in India's antiquated labour laws for many years. Employers want more "flexibility". Unions want more "fairness". However, merely repeating the need for labour law reforms will not change the laws. There must be a consensus about what the new laws should be.

India has a massive ambition to skill 500 million persons in the next few years. Manufacturing enterprises must play two crucial roles for this venture to succeed. The first is to provide jobs for these millions. Because skilled persons without jobs can be fodder for massive social unrest. The second is to develop higher level (and tacit) skills which give the edge for improving productivity and competitiveness, and can be developed only within a manufacturing enterprise.

Fresh thinking is required about the country's human asset strategy. New attitudes and better relations are necessary within enterprises. Along with these, a better process is required to arrive at a consensus between employers and unions without which demands for changes in labour laws will remain just that: demands without a resolution. Therefore, the Planning Commission is supporting new dialogues between employers and unions.

*The India Backbone Implementation Network is an innovation to assist India's policymaking and planning processes. Ibln processes are already being applied to improve the business regulatory environment and the human asset environment.*

## STRATEGY TO IMPROVE IMPLEMENTATION

In the course of developing the Manufacturing Plan, it has become clear that investments are not forthcoming and manufacturing is not growing because there are too many bottlenecks in the country. Infrastructure projects are stuck. Policies do not translate into outcomes (such as foreign direct investment in multi-brand retail). Intentions to improve laws remain intentions too long (such as labour laws). The root causes of these bottlenecks are the same: contention among stakeholders and confusion in getting things done.

The Planning Commission has looked around the world for processes being applied to convert contention among stakeholders into collaboration, and confusion into coordination, so that intentions can be implemented more swiftly. The Planning Commission developed the concept of the India Backbone Implementation Network (Ibln) to propagate the use of these systematic, participative processes so that the goals of India's Manufacturing Plan will be realised.

The India Backbone Implementation Network is an innovation to assist India's policymaking and planning processes. Ibln processes are already being applied to improve the business regulatory environment and the human asset environment as mentioned before. They are also being introduced to resolve other contentious issues such as the availability of low priced medicines. They should be applied more widely for the country to achieve its ambitious goals for the manufacturing sector.

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