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Opinion - Economy

The growth mirage

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Abundant optimism is needed while betting on the economic growth engine to touch 7-8 per cent. But misplaced optimism can be dangerous and lead to wishful thinking. Politicians and businessmen must realise that growth will come only from good policies, backed by hard work.

ONLY economic growth can take India out of poverty. In recent times, there has been a lot of discussion on how to increase the GDP growth rate. Rightly so, as in the 1970s and the 1980s by growing at a snail's pace India lost a great opportunity and allowed many countries to get ahead of it.

Many economists are talking of a growth rate of 7-8 per cent, significantly more than the 4-5 per cent one used to hear till a few years ago. The Finance Minister is also betting on growth. Many of his deficit projections are crucially dependent on the fulfilment of these growth assumptions.

Optimism is needed in abundant measure while taking up a challenging task. But a misplaced sense of optimism can be dangerous and lead to wishful thinking. India's politicians and businessmen must realise that growth will not come just because we want to grow.

Growth needs vision backed by a lot of systematic, hard work. As *The Economist* (June 12, 2004) commented on the Common Minimum Programme: "But its (CMP's) admirable goals — annual growth of 7-8 per cent, alleviating poverty, helping farmers, empowering women, raising spending on health and education and so on are so vaguely presented that it is like a child's letter to Santa Claus. Everybody can pick a desired outcome from the list and believe that Christmas is coming."

Four factors drive economic growth — natural resources, human resource, capital formation and technology. The first factor provides a platform but it is the other three that drive productivity. The history of developed nations tells us that it is productivity improvement which frees resources that can be invested elsewhere. That creates a virtuous cycle of growth.

Indeed, the story of development is one of productivity growth. The only way per capita income can rise is through an increase in the marginal productivity of labour.

While natural resources can facilitate growth, they do not represent a sufficient condition. They have to be exploited effectively through efficient value addition. That needs technology, capital and human resource. The quality of human resource — the skills, knowledge and discipline of the labour force — plays a critical role in generating economic growth. Improvements in literacy, health, discipline, ability to use computers, all have a significant impact on the productivity of labour. This calls for significant social sector spending. Unfortunately in India, this area continues to get inadequate attention.

Economic growth needs the accumulation of capital. Current consumption must be cut to drive up the savings rate. The savings rate is still low compared to many Asian countries. Also, the government must facilitate the creation of social overhead capital such as roads, irrigation and water projects. The country's infrastructure remains pathetic. The kind of investments envisaged, have just not materialised.

Economic policies will also have to focus on the improvement of technological capabilities through product and process innovations. Product innovations refer to the development of new products or services. Process innovations involve the development of new processes that facilitate dramatic increases in productivity. Rapid innovation requires the fostering of an entrepreneurial spirit, which is usually found in start-ups. This is facilitated by well functioning markets for both products and capital.

Entrepreneurship has to be fostered by encouraging people to take risks, open new plants, embrace new technologies and find new ways of doing business. The failure of the Small and Medium Enterprises (SME) sector to take off reflects the lack of entrepreneurship.

This is a system failure not an individual one. When talented engineers migrate, the kind of support they receive, such as venture capital, greatly increases the chances of success in entrepreneurial ventures. With the government's deficit already very high, private investments, especially foreign direct investments, will have to be attracted in a big way. Unfortunately, nothing much has changed on the ground. Foreign investors look for flexible labour laws, faster roads, better ports and reliable power.

Countries such as Malaysia, China and Taiwan are far more attractive in this regard. Also, especially when compared to China, India's economic policies lack stability. The country's politicians are capable of sending wrong signals. Without understanding the implications, they make all kinds of noises that confuse investors and create uncertainty.

To understand how good policies can boost growth, recall the days of President Ronald Reagan, who succeeded Mr Jimmy Carter. Inflation had climbed to 13.5 per cent in Carter's last year while the economy remained stagnant. First, Reagan fought inflation by reappointing Paul Volcker as chairman of the Federal Reserve and giving him full support.

But Regan did not stop there. He was a great believer in supply side economics, a school of thought which believes in providing incentives that boost both output and productivity.

On August 13, 1981, Reagan introduced his Economic Recovery Tax Act (Kemp-Roth Bill), which slashed taxes heavily. His message of competitive markets, entrepreneurial vigour and minimal regulation gave a massive impetus to innovation.

Deregulation had started tentatively under Carter in the airline industry, but Reagan extended it to energy and broadcasting and supported it with a dismantling of antitrust laws.

Under pressure from foreign competition, and with the anti-trust authorities looking the other way, mergers, leveraged buyouts, massive restructurings and corporate raids took off in the US.

It was painful, chaotic and hurt a lot of workers, both blue and white collar. But in the end it produced a more competitive economy, with more innovative, nimble, and customer responsive companies. That is how the US left Europe far behind in the productivity race.

The proof of the pudding lies in the eating. Good policies must produce results. If one were to go by results, Reagan can rightly claim to have led the American renaissance. Reagan's first term saw the creation of such companies as Sun Microsystems, Compaq, Dell and Cisco Systems which went on to become giants in the Information Technology (IT) industry. (Microsoft and Oracle had been formed a few years earlier.)

For the US, this marked the greatest entrepreneurial burst of new companies, since the early 20th century. Following the 1986 Tax Reform Act, the marginal tax on top earners came down from about 70 per cent to 30 per cent. Oracle's average tax rate declined sharply from 44 per cent in 1986 to 32 per cent.

There was a similar gain for Microsoft. The loss in revenue due to lower tax rates was substantially made up by eliminating most of the exemptions and special tax breaks and shelters. Effectively, the government stopped trying to micromanage the economy and control investment behaviour.

The new policies supported knowledge based industries while cutting or eliminating tax benefits for traditional industries such as utilities. That is how Silicon Valley became a hot bed of innovation, creating hundreds of millionaires (many of them Indians) in the process. True, Reagan cannot be given all the credit for America's economic boom. Some of the seeds of growth were sown earlier and some later.

In India, there are only tentative half-hearted measures. What the country needs are leaders who can stick their neck out and boldly champion the reform process.

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