

Should India choose manufacturing over services?

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Comment

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A jewellery manufacturing park in Coimbatore. | Photo Credit: Siva Saravanan S.

Manufacturing can create higher productivity jobs; but India's limited state capacity is a risk

Earlier this week, the former Governor of the Reserve Bank of India, Raghuram Rajan, questioned the Central government's production-linked incentive (PLI) scheme, arguing that it works against the interests of Indian consumers. In doing so, he revived the larger debate on the government's efforts to promote the country's manufacturing sector through subsidies, and on its relative importance vis-a-vis the services sector. **Ajay Shah** and **Nagesh Kumar** discuss this issue and talk about creating enabling conditions, in a discussion moderated by **Prashanth Perumal J.** Edited excerpts:

Should government policy focus on promoting any particular sector of the economy?

Ajay Shah: I'm sceptical of the state bureaucracy being able to understand and anticipate which sectors will do well and which sectors will do badly. It is very difficult to forecast the future. Only risk-taking entrepreneurs can take speculative bets, such as saying the computer hardware industry or automobile component manufacturing will do well in India. Who could have predicted that two-wheelers in India would fight off foreign competition pretty well while dozens of other manufacturing businesses would get butchered by foreign competition? It is not feasible for officials in bureaucracies to look at the industrial landscape and make speculative calls. That's because they do not have the necessary information or the forecasting ability. Nor do they have the incentive, like private businesses do. Also, there is nobody to protect them if their speculation goes wrong; when their speculation goes wrong, they will be investigated by the Central Bureau of Investigation and the Enforcement Directorate. So, which official is ever going to take a risk? For all these reasons, the task of figuring out which sector to focus on is best left to the private sector. The job of the government is to create a broad enabling environment.

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Nagesh Kumar: I have a slightly different view. I think the history of development not just in developing countries, but also in industrialised countries today tells a different story. They all made strategic interventions, or had an industrial policy. While I agree that the government can't do everything, prioritising certain sectors that have desirable features such as higher job creation or greater industrialisation is welcome. There was a time when industrial policy had become a bad word, but it has resurfaced in an aggressive manner with different countries favouring certain industries. The latest example is the 2022 CHIPS [and Science] Act in the U.S., under which some \$50 billion in incentives will be given to American companies to develop or to strengthen their semiconductor industry. Each of the East Asian countries such as Japan, South Korea, Taiwan, Malaysia, Thailand, China and Vietnam has a story of strategic interventions by the state and has become a manufacturing powerhouse running consistent trade and current account surpluses. There is something to be learned from them. In such a context, the Centre's decision to promote the manufacturing sector is timely because India has favoured an agriculture and services-dominated economy over the years.

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Nagesh Kumar: So far, in services, we have certainly developed some advantage and we are doing rather well. Services' share of the economy has gone up to over 50% of the GDP. However, this sector has not been able to create enough jobs in a commensurate manner. The result is that agriculture still continues to sustain nearly half of India's workforce, which means that 15% of GDP is supporting some 45% of the workforce. We need more productive job opportunities for the workforce to shift away from agriculture. We need to focus attention on the manufacturing sector because of the direct and indirect jobs that it can create. It is an empirical fact that manufacturing of all productive sectors has the

highest backward and forward linkages. So, all together, there is significant potential for the manufacturing sector to create higher productivity jobs for people stuck in agricultural activities. That is the future for India.

Ajay Shah: On industrial policy, when we look at world history, we see many attempts by governments to pick winners. It is always possible to find interventions which look good with the benefit of hindsight. But at the same time, there are many more stories of failure. Everyone who thinks that you should have a strong leader and points to [former Prime Minister of Singapore] Lee Kuan Yew as an example of how well a strong leader works also needs to counterbalance this with the fact that there are hundreds of strong leaders all over the world who have done badly. So, while it is always possible to find individual episodes, such as the role of the Taiwanese government in fostering the semiconductor ecosystem in Taiwan, it is also possible to identify a very large number of failure stories. And the overall assessment of industrial policy is not good.

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Second, we should think about the country that we operate in. We should think about state capacity, bureaucratic capacity, the incentives of policymakers, the capabilities of policymakers, etc. We've got to come up with policy ideas that are sensitive to our realities. There was remarkable civil service quality in the early years after independence in India. Later, interventionist policies led to a corrosion of civil service quality and of state capacity. So, we should be careful in giving high discretion in the hands of the state. Since we already have low state capacity, the greater the discretion in the hands of the state, the greater the danger of further corroding state capacity.

Aren't schemes like the PLI prone to the risk of cronyism?

Nagesh Kumar: It is possible that the PLI would lead to some kind of cronyism. But when subsidies are linked to performance, there is little room for discretion. There are objective criteria which have been defined, such as you getting a certain percentage in incentive if you perform better than last year. And of course, one can have third-party verification of performance to minimise misuse. Also, as we go along, we can tighten the criteria further to things such as export performance, competitiveness and innovation. So, it is possible to have an incentive system and achieve most of the objectives without major problems.

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Ajay Shah: If you read the details of the PLI policy framework and the industries that it applies to, of course it is subject to many discretionary decisions. There are always pushes and pulls. When these frameworks are established, only large firms are able to do the hard work of pounding the corridors of power, and engaging with the government, filling in all the forms and getting these benefits. If there are structural problems, it's better to go to the root cause and solve it because then everybody benefits, every company — large or small, domestic or outward oriented — benefits from a more rational policy environment.

If there is a mistake in the GST (Goods and Services Tax), solve it; if there is a mistake in the Companies Act, solve it; if there is a mistake in income tax treatment, solve it. I don't buy it when people say electricity is expensive in India or labour is cheap. The competitive advantage of operating in India is that labour is cheap. But it doesn't mean everything has to be cheap. There will be a variety of inputs that goes into an industry and each firm has to figure out whether it is competitive to operate in India. What policymakers should focus on is just mistakes of public policy. We should focus on things like the way the Companies Act works, the way Indian capital controls work, the way income tax works, the way GST works, etc.

Shouldn't the government liberalise all sectors and let market forces decide outcomes?

Nagesh Kumar: The sectors that have been selected by the government include some of the new sunrise sectors, such as the semiconductor industry, which are highly import-dependent. The feeling is that we can make some of these things in India a part of a domestic industrialisation drive. Industries have been chosen based on where there is an opportunity to create new industries or reduce the dependence on imports, or where there are high spillovers or linkages to other sectors. So, industries benefiting from these subsidies have not been randomly chosen. Of course, one could argue that there are also other sectors that merit subsidies, but one has to start somewhere. The start would obviously be from the most promising sectors and sunrise sectors which are coming up. I don't think these sectors have been selected to benefit a particular individual. You could find one or two of them, but most represent opportunities that India should be exploiting at this moment.

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Ajay Shah: I remain sceptical, as economic policymakers do not have a crystal ball to know the future. In India's history, the decisions of some of the most respected thinkers and policymakers, when it comes to favouring this or that sector, have proved to be wrong. So I just don't find it persuasive that we have the forecasting capacity. It is risky, it is speculative, and the word speculative appropriately belongs in the private sector. You want to trade on the stock market? I'm all for sophisticated discussion on that. Should we be buying the stocks of a labour-intensive garment company? Or should we be buying the shares of an electronics manufacturing company? That's a discussion for private speculators to have; it's not a discussion for people in public policy. And I just want to come back to the argument that since in the U.S. there is the CHIPS Act, that justifies a similar policy in India. I have two problems with that. First, as Ashok Desai stated, 'Every bad idea has been adopted in at least one good country.' For example, because they have agricultural subsidies in Europe, you will argue that we should have agricultural subsidies in India. That's a slippery slope. We should always be able to argue things from first principles. And then remember the magnitude of the numbers we are comparing. When you look at the European agriculture subsidy divided by European GDP, it's nothing. When you take the American subsidies for chips and divide it by the American GDP, it's

nothing. Whereas here, in India, if you think of a trillion dollars of exports, and then 6% of that, it's taking a significant chunk out of the tiny amount of tax revenues of the Indian state.

Nagesh Kumar: I don't buy this argument. Until a policy has been implemented, how will you know if it is right or wrong? When we are trying to revive our economy, and we want the investment cycle to pick up, we need to persuade investors to invest. And for that, some incentivisation is important, especially in the context of other countries offering incentives. If we don't offer incentives, we do so at our own peril. So, we need to be vigilant. It is an open economy context that we are working in; it is not a closed economy context any more. So, we have to see what others are doing. And if you don't, all the investments of chip manufacturers will simply go to the U.S. or Taiwan. Wherever they get more incentives, they will go, and we won't get any of them. So, I feel that what has been done through the PLI, and the current focus of the government to promote the manufacturing sector, is the right thing to do at this moment.

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