The Indian Economy

In the last couple of decades India has undergone a number of economic reforms. Previously seen as a very interventionist economy, India's market reforms have brought big rewards. Growth has averaged 9 per cent per annum for the last two years. However, in order to meet its medium term aims of surpassing 10% growth rates, the OECD believes that India needs to undertake yet more reforms.

India has by far the most restrictive employment-protection laws for collective dismissals, scoring much worse than China and Brazil as well as rich countries. In the UK, companies can layoff workers with relative ease – save the payment of redundancy payments. In India, manufacturing firms need to obtain government permission to lay off workers from factories with more than 100 staff. This partly explains why most firms are so small: 87% of employment in Indian manufacturing is in firms with fewer than ten employees, compared with only 5% in China. Small firms cannot reap economies of scale or exploit the latest technology, and so suffer from lower productivity than big firms.

However, take Indian service-based companies and the story is completely different. No such hiring and firing laws apply. This sector is booming. While in the manufacturing sector unprofitable companies that should exit the market have to keep going because of restrictive employment law. As a result the average rate of productivity in the manufacturing sector falls.

The OECD's indicator of product-market regulation (i.e., the extent of state ownership, the red tape involved in setting up a business, and barriers to international trade and investment) also places India at the bottom of the class. India has the second-highest government subsidies relative to GDP of all countries surveyed and the highest import tariffs.

There is compelling evidence that further reforms would boost India's growth. Industries in which the government has eased regulation and encouraged competition, such as telecommunications and IT services have grown fast. State-owned firms still account for 38% of output in the formal non-farm business sector, yet the OECD estimates that

private firms are on average one-third more productive than public-sector ones. States with looser labour- and product-market regulations enjoy higher labour productivity.

Questions

1. Explain the shape of the long and short run aggregate supply schedule.

2. Why is it important for countries to explore productivity gains as a means of achieving higher growth rates?