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Pattern of Industrial Investment in the Indian States during Liberalization

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Abstract

Industrial investment has been a key issue in economic development literature in any country. After the liberalization of the Indian economy, there has been a completion among Indian states to attract more and more industrial investment because it concerns to development and economic reforms have been used as a tool to enhance investment in most of the states in India. Economic reforms have also been applied in India after the globalization of the Indian economy. This paper tries to find out the trend of industrial investment in India before and after liberalization but focused on investment after the liberalization of the Indian economy. Manufacturing made up 27.5 percent of India's gross domestic product (GDP) in 2019, the lowest in two decades, showing the share of the sector continues to shrink in the economy despite the government's Make-in-India push. This makes India one of the least industrialized countries in Asia with the exception of Pakistan, and, Nepal. This study is based on secondary data as well primary data through observation and experience and discussion with persons having knowledge of investment. This study finds the unsatisfactory investment trend in India during liberalization. Moreover, it also finds the heterogeneous industrial investment in different sectors and regions in India.

Keywords

Liberalization, IndustrialInvestments, Poor infrastructure, Competition, Indian economy, etc.

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Introduction
Industrial investment has been a key issue in economic development literature in any country. After the liberalization of the Indian economy, there has been a completion among Indian states to attract more and more industrial investment because it concerns to development and economic reforms have been used as a tool to enhance investment in most of the states in India. Economic reforms have also been applied in India after the globalization of the Indian economy. India is a complex federal democracy where state-level politics are dominated by state-specific issues rather than national issues, making the economic development of the respective states the focal point of a potential electorate. As economic reforms are now driven by the states, due to the withdrawal of controls exercised by the central government in key areas, states are forced to compete against each other in terms of attracting investment which would generate jobs and boost their respective economies. Some states have been comparatively succeeded while some failed to attract investment particularly the foreign direct investment during liberalization. The capital formation rate and investment rate have been low in India particularly the industrial investment. This paper tries to find out the trend of industrial investment in Indian states before and after liberalization but focuses on industrial investment after the liberalization of the Indian economy.
Literature Review
Industrial investment during the liberalization period in Indian states has been heterogeneously distributed. Therefore it is said that states have faced the inter-state completion to attract the investment. Do states in India compete for investment? As the opening quotes illustrate, in India today the state governments are desperate to attract private and foreign investment by removing policy bottlenecks that are often viewed as unattractive to firms. Many in the industry feel that this sort of competition is good for the respective states as it not only helps solve problems associated with excessive bureaucratic controls, corruption, and creating an investment-friendly atmosphere, but also creates enormous job opportunities which form huge political capital for incumbent politicians. Therefore, there is every reason to believe that states in post-reform India tend to compete for Schneider (2004) and Venkatesan (2000) cite examples of large tax and other fiscal incentives the states within India offer to attract investment. In this paper, it has been examined whether states in India compete for big-ticket investment proposals. While there is a growing literature estimating the extent of the competition in international taxation and environmental policies, policy reforms, and labor standards, to the best of my knowledge there is no empirical evidence examining the potential competition among states within India, a gap the current paper fills?

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Spatial econometrics has been used in the literature to examine the race to the bottom arguments regarding taxes, environmental regulations, economic policy reforms, and labor standards. These studies tend to find evidence consistent with the race to the bottom argument. Focusing specifically on spatially weighted third-country determinants of inbound and outbound FDI, Blongien et al. (2007) and Baltagi et al. (2007) provided empirical support for the existence of various modes of complex FDI. Extending the analysis to labor standards, Davies and Vadlamannati (2009) find strong evidence of the potential race to the bottom in labor standards, i.e., labor rights in one country depend on those elsewhere. On the contrary, Neumayer and de Soysa (2009) find support for a race to the top with respect to women's labor rights in foreign countries with which a country is connected via trade and FDI. Interestingly, Cho, Dreher, and Neumayer (2009) also find evidence of a race to the top with respect to human trafficking policies across countries. Using the Economic Freedom Index as a measure of policy liberalization, Pitlik (2007) and Gassebner, Gaston, and Lamla (2009) find strong evidence of a race to the bottom among European and developing countries to liberalize regulatory, monetary, and trade policies. Similar such findings were echoed by Simmons and Elkins (2004). Finally, Elkins, Guzman, and Simmons (2006) also find evidence of a race to the bottom with respect to bilateral investment treaties. While there is a growing literature estimating the extent of the competition in areas related to taxation, environment, labor standards, investment treaties, and economic policy reforms internationally, evidence on the potential impact of competition to attract investments (domestic and foreign) within a country is scarce. Coughlin and Segev (2000) are an exception, testing for the existence of spatial heterogeneity and spatial dependence in FDI inflows within China. This is the gap the current paper fills by specifically focusing on competition among Indian states in new investment policy during the post-economic reforms period. Using the information on large investment proposal approvals in 32 Indian states during the 1991–2019 periods, the paper finds that the inflow of investment proposals in one state is positively correlated with the investment proposal inflows in other states. Furthermore, This study interprets these results as direct evidence of interstate strategic interactions in investment policy; we find that investment policies are strategic complements, a key requirement for finding a 'race to the bottom/top' in attracting investments. Since there is a noticeable upward trend in investment proposals being put up for approval over the sample period, one might consider this evidence as a race to the top.

Analysis and Discussion

In an extremely diverse country like India, when a private or foreign firm intends to undertake large-scale investment, usually they narrow their options down, after extensive research, to a few specific potential destinations (states) for various reasons. Often, this results in intense competition among those potential states to attract big-ticket investment. One such example is Tata's new Nano car project in 2008, which after withdrawing from the West Bengal state, was offered several packages by other states including Karnataka (in the outskirts of Bangalore), Maharashtra (in Pune), Andhra Pradesh (near Vizag) and Gujarat. Over the years, such incentives offered by states in India to attract large-scale investment projects have not only increased drastically, but have become commonplace. In fact, Kanta (2010), Schneider (2004), and Venkatesan (2000) cite numerous examples of large tax and other fiscal incentives offered by states within India to attract investment. It began in 1991, when the government of India embarked upon a series of economic liberalization measures, thus ending the 'license and permit raj' which required firms to obtain licenses from the central government of India, not only for setting up businesses, but even for expansion and increasing their production capacity. The objective behind such a restrictive policy was to spread investment evenly across the states. Instead of creating a balanced regional development, however, the 'license raj did not allow firms to benefit from economies of scale. In addition, Biswas and Marjit (2002) find that industrial licenses were granted to the states based on the political considerations of the central government. Thus, this licensing system was also subject to political manipulation leading to market distortions created by political incentives. The system was abolished in 1991 and since then, industrial firms with investments of Rs. 10 crores (20 US$ million) in the manufacturing sector, and Rs. 5 crores (10 US$ million) in the services sector, are now only required to file information in the Industrial Entrepreneurs Memorandum (IEMs hereafter) with the Secretariat of Industrial Assistance in New Delhi.

Manufacturing made up 27.5 percent of India's gross domestic product (GDP) in 2019, the lowest in two decades, showing the share of the sector continues to shrink in the economy despite the government's Make-in-India push. This makes India one of the least industrialized countries in Asia with the exception of Pakistan, and, Nepal. The industrial and manufacturing sector's share is down 250 basis points (bps) over the past five years. It accounted for 29.3 percent of the country's GDP three years ago and 30 percent in 2014.

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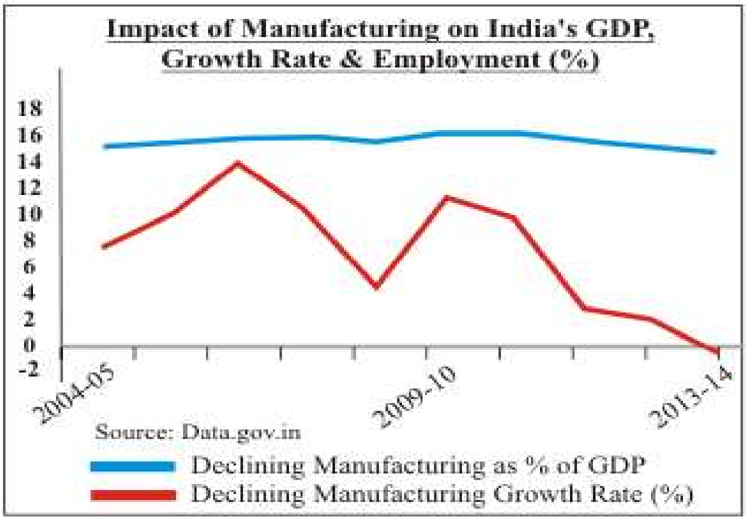

Source: Manufacturing Sector in India 2020, Google Images

This diagram depicts the declining manufacturing growth rate in India and also declining the role of the manufacturing sector in GDP in India. Post-1991, the dominance of the center in economic policy decision-making has significantly diminished, paving way for the state governments to design their own policies. It highlights the role of state governments in the Indian economy. According to them, in recent years, aggressive competition among states for private and foreign investment has attracted the attention of the media and policymakers locally and internationally. In addition, there was a marked decline in public investment, which coincided with a rapid increase in private investment. As a consequence, the center's financial leverage over the states declined steadily as states looked more and more towards attracting private and foreign investment to finance their investment requirements. In the process, states which possessed location advantages such as larger markets, better infrastructure, a more skilled labor force, and the presence of a large investor base in comparison to less well-endowed states, started to benefit. This in turn put more pressure on less developed states, and all states for that matter, to increase their competitiveness in order to gain investment. In addition, if the benefits associated with these investments do in fact spill over into other states in the country, then this agglomeration (in the case of private and foreign investments) might lead to more investment proposals coming from the other states.

Conclusion

India is a complex federal democracy where state-level politics are dominated by state-specific issues rather than national issues, making the economic development of the respective states the focal point of a potential electorate based on the industrial investment. As economic reforms are now driven by the states, due to the withdrawal of controls exercised by the central government in key areas, states are forced to compete against each other in terms of attracting investment which would generate jobs and boost their respective economies. Some states have been comparatively succeeded while some failed to attract industrial investment particularly the foreign direct investment during liberalization. The capital formation rate and investment rate have been low in Bihar, Orissa, Uttar Pradesh, Madhya Pradesh, Rajasthan particularly the industrial investment. The investment in India has not been satisfactory during liberalization for income, employment, and output. This in turn put more pressure on less developed states, and all states for that matter, to increase their competitiveness in order to gain investment. In addition, if the benefits associated with these investments do in fact spill over into other states in the country, then this agglomeration (in the case of private and foreign investments) might lead to more investment proposals coming from the other states.

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