

Role of Trade, Competition and Regulation in India's Economic Growth¹

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"Markets work for the poor because poor people rely on formal and informal markets to sell their labour and products, to finance investment, and to ensure against risks. Well-functioning markets are important in generating growth and expanding opportunities for poor people." – World Bank's World Development Report, 2000-01.

"Whenever you take a decision think of the poorest man you have ever met and think whether this decision will help him" – Mahatma Gandhi

1. Introduction

1.1 Reforms in India started in earnest in the early 1990s. Until then the Indian growth story was disappointing. The lack of growth has led to a failure of the growth strategy as the principal means to 'pull up' the poor out of the poverty trap. But once the growth picked up due to the reforms, poverty declined. Since the population is huge while there was a declaration in percentage, the absolute number still remains overwhelming.

1.2 There is no doubt that there should be greater attention to growth promotion policies in India. However, such an approach to emphasise on growth often results in contention and that mainly arises from different perceptions on the role of growth in poverty reduction.

1.3 There is a perception that growth almost invariably leads to high income inequality because accrual of benefits thereof is biased in favour of the upper strata. However and as evidence shows, rising inequality does not prevaricate poverty reduction.

1.4 Moreover, in many cases we find that the debate on the relationship between growth and poverty happens while ignoring the fact that the flow of causality between them is not unidirectional and static but circular and continuous. Therefore, growth policies should be given a head start accompanied by poverty reduction programmes.

¹ This note is based on the following publications of CUTS International. They are available at www.cuts-international.org.

Ahmed, Faisal and Anutosh Biswas (2011), *Grassroots Reachout of Foreign Trade Policy: Evidence from Indian States*

Gokarn, Subir (1997), *Regulatory Reforms: Why and How?*

Marjit, Sugata and Saibal Kar (2008), *Regional Trade Openness Index, Income Disparity and Poverty – A An Experiment with Indian Data*

Mehta, Pradeep S. and Bipul Chatterjee (ed.) (2011), *Growth and Poverty: The Great Debate*

Mehta, Pradeep S. and Nitya Nanda (2001), *Competition Policy, Growth and Poverty Reduction in Developing Countries*

Melchior, Arne (2011), *Globalisation, Domestic Market Integration and the Regional Disparities of India*

Dube, C (2008), *Competition Policy and Economic Growth – is there a causal factor?*

1.5 This leads to a question: whether it is feasible to target growth and poverty reduction through simultaneous policies. This is based on a view that government's capacity to do simultaneous policy reforms and execution is limited especially when the state is weak. However, it has been observed in India that over time governmental capacity to execute a mix of policies can improve significantly.

1.6 Given the current scenario of India's economic growth and perceptions about growth policies and their impact on poverty reduction, this brief note outlines some issues on the role of trade, competition and regulation in India's economic growth.

1.7 The question is whether the outcomes of growth are improving the standards of living of our population or not. If it is not then our growth cannot be inclusive. On the other hand, if standards of living are improving but a large part of our population is not participating in shaping the growth process it (growth) is not inclusive.

1.8 There is no ready answer to the question: whether India's growth is inclusive or not. Our growth rates have improved over time. So is the standard of living of a large section of our population. A recent study by the National Council of Applied Economic Research has found that 33% of our urban poor own a colour television and 25 percent own a two-wheeler. For the rural poor the corresponding figures are 6 percent and 9 percent. People's participation in the process of growth has also improved over time. But this does not mean that India's growth is fully inclusive – in fact, inclusive growth is a relative term and should be interpreted accordingly.

2. Trade and Economic Growth

2.1 Over the last two decades or so, India has become more open to international trade. Our tariff rates have been reduced drastically. We have found that with increased openness the depth of poverty has gone down in urban areas, whereas it has gone up in the rural areas. This is not surprising because the skills-based technological changes and the overwhelming contribution of service sector in India's growth has unambiguously led to an increased demand for skilled workforce, unlike in the industrial sector in general, where exposure to foreign competition has significantly reduced new employment opportunities, particularly unskilled and semi-skilled employment.

2.2 Taking this observation into account and particularly from the point of view on inclusive growth, it is important to underline the fact that for a large country like India, inter-state trade plays a crucial role in enhancing economic growth and addressing regional disparities. In the debate on India's growth, it has been argued that manufacturing expansion is essential to provide enough new jobs and promote structural change. One of CUTS study supported the fact that inter-state integration in India is essential for manufacturing development.

2.3 There is no contradiction between inter-state and international trade: they are complementary and both contribute to higher welfare. India's trade strategy should, therefore, not only focus on international markets but also on India's own 'single market'.

2.4 Our study found that international liberalisation promote decentralisation and convergence of economic development of different regions, not divergence, so trade is not to blame for India's growing regional disparities. We have found that in high growth countries like India (having a large and growing domestic market), intra-national trade grows faster than international trade.

2.5 In short, increased trade integration of India, inter-state as well as internationally, should lead to decentralisation and a reduction in regional disparities, and that would result in relatively more inclusive growth in India.

2.6 In our analysis on the inclusiveness of India's Foreign Trade Policy, we have found that while it has addressed the issue of export promotion and resultant employment generation, there is a vast scope for improvement in regard to formulation and implementation. The formulation and implementation of this Policy is biased towards large economic agents and the small producers/exporters often do not qualify as beneficiaries of its various schemes. In many cases, awareness levels among such players are also low. We have recommended that India's Foreign Trade policy should devise and implement a benefit sharing mechanism between small and large producers/exporters.

3. Competition/Regulation and Economic Growth

3.1 Given that trade and other kinds of openness results in increased competition, the most important question is how could a (more) competitive environment serve to enhance rather than impair economic growth? The main objective of competition policy and law is to preserve and promote competition as a means to ensure efficient allocation of resources in an economy. This should result in more growth, better distribution, and lower prices and adequate supplies to consumers.

3.2 Empirical evidence, though focusing mainly on the experience of developed countries, has confirmed that barriers to competition within an economy (including barriers to inter-state trade as in the case of India), whether due to governmental and/or private restraints, lead to welfare losses. A study carried out for the Australian economy estimates the expected benefits from a package of competition promoting and regulatory reforms to an annual gain in real GDP of 5.5% or \$23billion where consumers would gain by almost \$9billion besides having an increase in real wages, employment and government revenue. A study of the Peruvian competition agency found that in the first seven years of its operation, the economic benefits amounted to \$120million as against operating costs of \$20million.

3.3 It is important to note that competition policy should not be looked in isolation but within the overall context of a country's public policy objectives such as macroeconomic stability, creation of employment opportunities, promotion of innovations and ensuring high standards of living. Regulation is an important tool to achieve these public policy objectives in a competitive environment to ensure a smooth functioning of democracy whose central function is to promote the social and economic well-being of its people.

3.4 The fundamental objective of regulatory reform is to infuse 'dynamic efficiency' in different systems influencing the functioning of markets. Other objectives include:

- revision of existing incentives to make the market players more innovative and competitive;
- introduction of greater transparency thereby encouraging entrepreneurship; and
- (sometimes) ensuring swift reduction in prices and improvement in the quality of products/services supplied.

3.5 In other words, the objective of attaining dynamic efficiency depends on the following three conditions:

- Existence of near-perfect competition – given a large number of consumers there exist a large number of producers supplying the same product or close substitutes, and no single producer dominates the market.
- Full information or minimal information asymmetry – all consumers are fully informed about all the options the market offers them.
- Low switching costs – costs a consumer faces in switching from one option to another should not be high enough to deter the switch in and of themselves.

3.6 The structure of the market plays a leading role in determining the different market indicators. It determines the opportunities that are available for both a green-field investment and further expansion by the existing firms, as this would determine the size of the expenditure that is required to gain a significant share of the market from the established firms. Market structure also plays a part in determining the level of profitability of the industry, with monopoly and monopolistic structures normally associated with more profits. It is on this basis that it is expected that competition policy will have a significant impact on economic development. It is generally conceivable to accept the notion that the nature of competition prevailing in the market will have an impact on innovation, implying that adopting competition policy, to induce competition, will affect the incidence of innovations. The fact that innovation has an influence on economic development is not a subject of debate. Hence, linking competition to innovation implies that competition policy will affect economic development.

3.7 In an emerging market economy like India, there is a need for regulators in markets that have been opened up due to the liberalisation process, to ensure that firms interact with each other and with consumers according to the rules. A regulator is an institution which uses its powers to simulate an environment where the interests of both consumers and producers are protected. In other words, a well-structured regulatory institution with adequate powers, independence and accountability forms an indispensable component of a modern regulatory reforms process, and helps promote inclusive growth as it helps in participating in the growth process through an institutional mechanism.

3.8 However, a regulatory institution can only act within the scope of a legislation, and not beyond its precincts. It is unfair to expect that competitive markets can be achieved single-handedly by the Competition Commission of India. There are various policies that have a direct (or indirect) impact on competition in specific markets. A National Competition Policy (NCP) aims to address such distortions in those policies enabling emergence of a level playing field across the economy. The Indian government has realised the need for adopting (and enforcing) a NCP in order to sustain the growth trajectory in the economy, and this is a welcome step. Once the National Competition Policy is adopted (hopefully in the first half of 2012) in India, a number of policies would have to undergo subsequent refinements. There are elements of political-economy, which would come into play at that juncture, and one can only hope that decisions are taken keeping in view the larger interests of the country.

3.9 It is crucial that the competition enforcement agency in the country (or the overall process) acts in sync with the existing regulatory institutions (and in line with the legislations that determine their functions). Many jurisdictions have grappled with this challenge, and India should derive lessons from the exiting knowledge on how best to coordinate the actions of these entities. While the competition agency is better placed to undertake regulate competition (and curb anti-competitive practices), the sector regulators have an upper hand in technical/economic regulation.

4. In Search of a Future Agenda

4.1 Given the fact that inclusive growth is an important public policy agenda for India's democratic development and for that to happen markets are to function efficiently, one has to have a close look at how trade, competition and regulatory policies can work in coherence with each other so as to ensure better entrepreneurship development leading to more participatory economic growth.

4.2 In order to fulfil this agenda, among others, the following interventions are necessary:

- Devising an inclusive process of economic and regulatory policy-making so as to ensure better economic governance in the country by engaging multiple stakeholders (including sub-national governments) in discussion and delivery
- Mainstreaming trade policy into the national development process by designing a benefit sharing mechanism between small and large producers/exporters
- Assigning due importance to competition policy to remove barriers to market entry and stimulate economic progress

4.3 In short, there should be sustainability impact assessment (in terms of economic, social and environmental sustainability) of major macroeconomic policies such as trade, competition and regulation so as to understand and address factors benefiting/hindering the process and outcomes of inclusive growth in India. In doing so, there should be institutional analyses of state-business, state-civil society and business-civil society relations in India so that there is a better political buy-in for inclusive growth.