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India's economy

# A Himalayan challenge

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**India needs to tackle rigid labour laws to reach its full growth potential**

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THE Organisation for Economic Co-operation and Development has long lectured its rich member countries about pursuing free trade, privatisation and flexible labour and product markets. It has now produced its first economic survey of India, which once had some of the world's most interventionist economic policies. India wins much praise for its reforms over the past two decades, but the OECD reckons that the country still has a long way to go: on many measures India scores badly relative to both member countries and the other emerging giants.

India's market reforms have brought big rewards. The OECD estimates that on today's polices, India can sustain annual growth of more than 8%, up from 3.5% during the three decades to 1980. The economy has been growing even faster, by more than 9%, over the past two years, but this has pushed up inflation, forcing the central bank to raise interest rates.

The OECD reckons that India cannot reach the government's medium-term growth target of 10% without further bold steps. These include reducing government meddling in the economy, labour-market reform and improving the infrastructure.

Take the labour market. 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 (see chart). 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.

India's reforms have certainly boosted the productivity of many firms. The snag is that unprofitable companies, which should have been squeezed out by competition, have remained alive because it is so hard to fire workers. This reduces productivity across the economy. India's hiring and firing laws also explain why the growth in manufacturing has been weak compared with the boom in services, which are not covered by the same rules.

The OECD's indicator of product-market regulation (ie, the extent of state ownership, the red tape involved in setting up a business, and barriers to international trade and investment) again puts 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.

Sadly, further bold reform is currently blocked by the communist parties on which the coalition government depends for its majority. In an economy where income per person used to rise by barely 1% a year, today's growth rates feel like a miracle. But to eliminate India's vast poverty the country must try harder.

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