Paper Name – Indian Economy - II

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Course – GE (B. Com (H), BA (H) History, BA (H) English, BA (H) Political Science)

Semester – IV

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The Employment Problem in India and the Phenomenon of the "Missing Middle"

Authors in this paper, discuss the idea – manufacturing sector has 'dualism' with bimodal employment distribution i.e. either employment is there in < 10 worker units or in the > 500+ or > 400+ units implying conspicuous 'missing middle'. The paper begins by the enlisting the trends in Industrial Structure Employment (India) –

- Structural change in employment has been very slow. Share of employment in agriculture decreased by 6.5% points from 1993 – 94 to 2004 – 05. But out of this 6.5% points only 1.1% was absorbed in manufacturing (rest unemployment). Part of these unemployed got into tertiary.

- Increase in tertiary employment in India is observed. With respect to this increase it is crucial to note that –
  a) Public sector has not created much employment in India in government and related services. In pre reform period 1/3rd of increase in employment was due to increase in employment in tertiary but post reform generation of employment decreased.
  b) IT Sector has been given important but it has not created a corresponding level of employment. Tertiary sub sectors – transport or storage or communication (IT included); 1/6th of total tertiary employment. The sub sectors – trade, hotel or restaurants – played dominant role in employment creation.

Authors present a comparative of the Employment in Tertiary Sector
- In 1970s, in Korea and Taiwan, the share of employment in manufacturing increased during growth period i.e. it was three times that of tertiary. In 1990s, matured industrial structure was developed and after that tertiary became 2nd largest employment after agriculture. In Thailand, Indonesia and Malaysia, large share of employment was created by tertiary but manufacturing also was creating employment.

- Authors cite the study by Papola (2005) which presents an international comparison with respect to share of GDP and share of employment 5 economies – China, Thailand, Indonesia, India and Malaysia from 1960 to 2002. The following observations were made with respect to the relative productivity of sectors in international perspective. One, productivity in services exceeds that in industry in case of India in 1960 and 2002

when compared to the rest of the economies. 1960 – China (59); Indonesia (47); Thailand (72); Malaysia (60) and India (133). And two, productivity of services sector has increased implying growth has been productivity led. This means that more output is not because more people are working but because people (each one) has become more productive.

- Growth is productivity led and not employment led implying that economists' belief is incorrect that labour pushed out of agriculture got absorbed in services. Labour pushed out of agriculture got absorbed in tertiary and tertiary sector growth i.e. excess absorption of labour in agriculture is not there.

The paper further analyzes the Dualism in Indian Manufacturing –

- Household sector is very large, employs a lot of people (family labour or not hired) but very low in productivity. This as a result means low productivity of the manufacturing on the whole. Indian manufacturing makes use of hired labour primarily – DME and organized sector. In international comparison (1980 – 1990) – among other Asian economies India has a 'dualistic' structure with bipolar distribution i.e. there are 2 strong modes in distribution of employment in the modern manufacturing (DME primarily) – one, in '5 – 9' category and the other, in the '500 or more' category; with the proportion of employment in the intermediate middle sized groups being conspicuously small. This phenomenon is sometimes referred to as 'missing middle' and is in contrast with other Asian economies like Korea, Hong Kong, Taiwan, Malaysia, Thailand.

- Countries like Hong Kong, Taiwan and Japan (post 1990s), Korea – have strong presence of small enterprises (5 – 9 workers category). But one, the percentage of employment in these aren't large and two, intermediate enterprises too have good representation.

- Second difference between India and other economies is the productivity gap between the small and large units in modern manufacturing. The gap in the labour productivity between large and small sized enterprises in India 8:1 (large is 8 times more productive than small); in Japan, Korea, Taiwan 3:1 and in Hong Kong < 3:1 (say, 2.5:1 or 2:1).

Here, also refer to the case study of Japan in this context as presented in the paper.

Further, in this paper the authors elaborate the reasons regarding why dualism would be an issue for manufacturing growth –

1. **Dampening the growth of markets**
- Wages increase according to the size of the firm (most of the times). This change in wages according to the differential in the labour skills, education and experience. A second kind of heterogeneity between small-scale and large-scale workers is due to the technologies used in capitalist sector i.e. all workers aren't skilled enough to work with modern equipment (this is the difference between labour productivity). These 2 heterogeneities are further increased by the institutional pressures like trade unions, management perceptions, etc.

- Due to differences in labour productivity and wages – it is important to understand how labour demand is growing (i.e. how more employment is being created or it is not being created) and in which segment (small or large) more jobs are available. To do this – we focus on supply side factors – a). cost of labour; b). the demand of goods that labour / industries produce.

- **Small** – if more jobs are created in small sector then the cost of labour is less. But the kind of goods that will be produced; their demand would also be low and hence increase in income per capita would be low. So, the limited demand (for goods) expansion and limited employment generation.
   Medium – if more jobs are created here then the labour cost would be more (than small) but this increase in cost would partly reflect the increase in efficiency. Also, the per capita income and the demand for the industrial goods would increase faster leading to growth opportunities for economy.
   Large – not many jobs are created because firms are geared towards high wage – low employment approach. Labour cost is also lower because of this and firms prefer because of more trade union pressures can be there with larger labour force. Although large establishments increase per capita income faster and increase the demand for industrial goods (partially met by imported goods) but increase in employment does not happen correspondingly.

- Hence, the <u>dualism or the missing middle</u> splits the market – low quality, low price goods for low income consumers and high quality, high priced goods for high income consumers and this prevents the growth of domestic markets in terms of mass manufactured consumer goods market.

2. **Impact of Dynamic Efficiency –**
- If there is a missing middle then the small enterprises aren't able to graduate into anything i.e., they cannot turn into large scale (from 5 – 9 workers to 500+ workers is not easy).

- Dualism slows the growth of labour force with industrial skills. This is so because in most of the developing countries the skill acquiring is done as 'on the job training' rather than education. So, when middle level firms are non – existent then labour would not be able to gain skills, expertise and training. This in turn would impact the choice of technology i.e. firms would use capital intensive technology due to shortage of skilled labour. This would decrease the employment elasticity and slow down the rate of growth of employment in industrial sector.

3. **Allocative Efficiency and Inequality –**

- Between the 2 sized firms – small and large – the labour productivity and the wage gap is also very large. Marginal Product of labour and Marginal Product of capital is also very different for these two as a result.

- $(MP_L)^{Small} < (MP_K)^{Large}$ – Small firms usually take capital or loan or finance from informal sources and large firms usually borrow capital from formal sources and as a result which basically means – $(MP_K)^{Small} \neq (MP_K)^{Large}$.

- The wage gap between labour in small – large is too huge or substantial – much more than even if the difference in skills is considered or taken care of.

- Two conclusion –
  a) Larger the differential in productivity and wage, larger is the loss of welfare in terms of static allocative efficiency.
  b) Employment is concentrated in smallest and largest groups and wage inequality is also huge as a result.

Authors discuss the reasons or causes of why the phenomenon of missing middle and the massive productivity gaps in the Indian industry or manufacturing sector context have been observed? The reasons for this can be listed as follows –

a) <u>Labour Legislation</u> – In India, the labour legislation has been quite strict or rigid. For instance, 'The Factory Act' applies to workers in the registered sector to the firms which employ 10 or more workers. Also, the job security legislation applies to units with 100 or more workers. This implies that firms usually would keep the size of the employment (<10 or <100) in order to remain out of the official labour legislation laws.

b) <u>Infrastructure</u> – Lack of proper and adequate infrastructure also hindered the growth of small enterprises into larger ones. For instance, inadequate supply of power meant low productivity for small units, as well as additional expense (lump sum capital investment) for providing generators and electricity alternative mechanisms. This also prevented such units from expanding their scales. Small and medium enterprises developed in other countries because of adequate infrastructure. Secondly, the wireless technology or the computer-based

technology and various others also couldn't benefit the small sized firms because of inadequate support structure like power supply, cable laying, etc.

c) <u>Education Policies</u> – In India, education policies have been geared towards tertiary education and not so much towards basic primary or low – secondary education. The medium scale enterprises or modern manufacturing requires minimum basic education in the labour force to perform minimum standard works (and not very high level of skills or education). Medium scale enterprises would greatly benefit from ample supply of basic minimum educated labour supply. The highly skilled labour benefits large scale enterprises which however, do not have very labour intensive techniques and do not generate much employment opportunities.

d) <u>The Protection of Small – Scale Units</u> – Indian industrial policies have always been of reservation in SS units i.e. a large number of products have been reserved to be produced only in the SS units exclusively. SS units have been traditionally categorized as a firm with 5 – 6 workers but later on the classification was also made on the basis of size of capital investment. The initial limit of capital investment size has been increased over time. Also, the policies of government have encouraged the SS units to expand horizontally rather than vertically. This is to say that a number of units producing same products, each with limited capital and limited number of workers (5 – 7) – all owned by single entrepreneur rather than vertical expansion of SS units into the medium sized enterprises.

e) <u>Hysteresis</u> – Post 1991, the reservation policy of SS units was abolished as a part of reforms. However, the changes in policy also didn't impact much mainly because the already or long-established production system (in SS units) is often hard to dismantle. This happens because the economic agents and institutions also sometimes are developed in a way to sustain existing systems. For instance, the marketing channels, financial systems, infrastructure availability, etc. all support SS units which already exist rather than the newly formed (or the new or yet to be formed) medium scale enterprises.