Labor, Governance, and the Information Age

By Swaminathan S. Aiyar

East Asia has produced miracle economies galore in the twentieth century. South Asia, alas, has been the under-achiever of the century.

In the nineteenth century and first half of the twentieth, leading economic powers like Britain and the USA averaged less than 3 percent annual GDP growth. But in recent decades, several countries in East Asia have averaged GDP growth rates of 8 to 10 percent, the fastest in history. They have rightly been called miracle economies. Per capita incomes in Singapore and Hong Kong now exceed that of their former colonial master Britain.

South Asian countries have chugged along at barely half the speed of East Asia, and remained poor. India’s per capita income is just $370. Many other developing countries have fared far worse. But India used to be an economic superpower before the industrial revolution, with a large mercantile and financial class. Under British rule it was the most advanced of all colonies, boasting the biggest railway and canal networks. So it seemed destined to be at the vanguard of developing countries. That potential has never been translated into reality.

One reason is India’s colonial legacy. Before the British came, India was one of the richest countries in the world. When the British left in 1947, India was poor and industrially backward. Indian politicians blamed this on colonial exploitation. They claimed Britain had extracted large surpluses from India, and forced it into a free-trade pattern which obliged India to export commodities and become a dumping ground for British manufactures. Historians estimate that the net transfer of capital from India to Britain averaged 1.5 percent of GNP in the late nineteenth century. The wealth transfer was financed by a persistent trade surplus. India’s export-import ratio was 172.5 percent in 1840-69, 148 percent in 1870-1912, and 133.4 percent in 1913-38. Indian politicians interpreted this to mean that export orientation was a tool of colonial exploitation, and free trade a British ploy to force its manufactures on India and crush domestic industry.

On achieving independence, Indian leaders aimed for socialism and self-sufficiency, reducing the role of foreign trade and investment. They forgot that pre-colonial India had prospered greatly as a trading power, and that export-orientation could be a boon if profits were ploughed back into the local economy instead of being sent to a colonial master. Autarkic policies reduced India’s share of world exports from 2.2 percent in 1950 to 0.4 per cent by the mid-1980s, amidst cheers from misguided politicians.
The East Asia-South Asia gap

The space vacated by India was filled quickly by East Asian countries. They did not have identical policies. Hong Kong ran an almost laissez-faire economy, while Korea had extensive controls which kept out foreign investment and channeled massive sums to a handful of conglomerates.

Yet three major differences stand out between the two regions. First, India (and most of South Asia) was inward-looking while East Asia was outward-looking. Second, India wanted the state to dominate production and take over private sector industries, while East Asia used the state to facilitate private sector development. Third, East Asia paid far more attention to primary education: adult literacy is 98 percent in Korea, 94 percent in Thailand and 84 percent in Indonesia against just 52 percent in India and 38 percent in Pakistan.

India’s first Prime Minister, Jawaharlal Nehru, followed socialist policies which generated GDP growth averaging 3.5 percent per year. This was thrice as fast growth as it was in the first half of the century under British rule, and convinced most South Asians that this was the right path. But soon East Asia demonstrated that, in the new global conditions after World War II, 3.5 percent growth was not rapid but slow. Indians were reluctant to acknowledge this. At first they predicted that outward-orientation would soon convert the East Asians into neo-colonial puppets. When the supposed puppets became miracle economies, Indians claimed such strategies could work only in small countries, not a big one like India. Only bankruptcy finally forced India to reform in 1991, as it had earlier forced the rest of South Asia. This has led to some improvement, but no South Asian country is on its way to becoming a tiger economy.

New challenges

So much for the past. What challenges do the two regions face at the start of the new millennium? At least three stand out.

First, low wages will cease to be a significant source of comparative advantage, and countries will have to focus on improving labor productivity. Second, good governance and strong institutions will become vital. Outward-looking economic policies alone will not suffice. Third, the world economy is shifting from manufacturing to services. Countries must seize the new opportunities while minimizing the costs of the shift. In recent decades, globalization has induced the relocation of factories from high-wage to low-wage countries, especially for labor-intensive manufactures. However, technological change is reducing the labor content of manufacturing: in most industries it is now below 10 percent. Steel and automobiles were once big job-creators. But steel from India’s newest plants in the private sector has a labor content of just 1.3 percent. Cars from Maruti Udyog, India’s
biggest automobile company, have a labor content of 2.5 percent. A few industries, like garments, remain highly labor-intensive since machines cannot yet handle soft fabric efficiently, but that will surely happen one day.

The challenge of the new millennium will be for countries to switch from low wages to rising labor productivity as a source of comparative advantage. This means developing an educated and flexible workforce; high-quality technical and managerial skills; and low-cost, efficient infrastructure to lower transactions costs.

East Asia is already on this track. Literacy is high everywhere. Korea’s research and development is now a source of comparative advantage. Over half the exports of the Philippines, the slowest-growing ASEAN nation, are now classified as high-tech. Technical skills still need upgrading in Indonesia. But the whole region has moved up the manufacturing ladder from low-tech to high-tech items.

South Asia will find the transition much more difficult. Literacy is unsatisfactory in all countries of the region except Sri Lanka. Bangladesh and Nepal remain highly dependent on low-wage exports. India has developed some impressive high-tech industries and institutes of technology, but not nearly enough for a country of its size. Infrastructure is generally expensive and inefficient in South Asia. Bombay’s port takes eight times as long to handle a container as Singapore’s. Labor markets are often rigid because of obsolete labor laws and trade union traditions. Major changes in laws and attitudes are required to produce a flexible, adaptable workforce.

**Good governance**

Good policies and rules are necessary but not enough: they must also be enforced efficiently and honestly. Corruption, legal slackness and civil strife can cripple development. The World Development Report 1997 showed that countries with strong institutional capability and low policy distortions grow much faster than those with weak capabilities and high distortions. Transparency International reckons that South Asian countries are generally more corrupt than East Asian ones (Indonesia is the notable exception). This is at least part of the reason for the difference in their performance. Two years ago, a member of India’s Election Commission estimated that 40 members of Parliament and 700 members of state legislative assemblies had criminal records. Singapore and Hong Kong are far more rule-based.

Four major factors associated with corruption are policy distortions, the ratio of civil service wages to manufacturing wages, the extent of merit-based recruitment, and the predictability of judicial decisions. East and South Asia need to tackle these four factors to succeed in the new millennium.

Good governance implies an attitude of mind no less than a set of rules or strong institutions. A society which respects rules and norms will enjoy governance even
where there is no written constitution (as in the UK). The creation of strong, independent institutions can provide checks and balances that prevent a few powerful people from ignoring rules. Competition in the economic marketplace induces better corporate governance. Competition in the political marketplace, through democracy, improves the accountability of rulers to voters. Good governance also has a technocratic dimension. A rule-based society needs skilled, well-remunerated institutions. The East Asian crisis of 1997-99 showed that even miracle economies can suffer economic calamity if they lack well-supervised financial systems, transparent and reliable accounting systems, and good corporate governance.

**Shift to services**

Hong Kong and Singapore became richer than European nations only when they switched from manufacturing to services. The share of services in GDP in Hong Kong is 83 percent, the highest in the world. The share in the United States is 71 percent, and has made the country an economic powerhouse in the 1990s. Manufacturing will still matter in the future, but services will matter more.

The communications revolution has made possible a big shift of services from rich to poor countries. The best-known example is India’s computer software exports, which have grown at a compound rate of 40-50 percent annually. They are estimated at around $4 billion in 1999-2000, and a McKinsey study predicts they will touch $50 billion by 2008 (against current merchandise exports of only around $38 billion).

Even greater potential lies in teleworking. Cheap communications enable many clerical and professional jobs, from payroll and bill processing to inventory management and answering consumer complaints, to shift from rich to poor countries. Indeed, by taking advantage of different time-zones, U.S. companies can get their clerical jobs done in other countries while Americans sleep, raising U.S. productivity. GE Capital initially shifted 700 service jobs to India, and is now expanding the number to 5,000. Bechtel employs almost a thousand Indians to provide professional support to its global operations. Medical and legal transcription service companies are coming up in India: they convert tape-recorded interviews from the United States into written scripts.

The labor content of manufacturing may have dropped below 10 percent, but the labor content of services can approach 100 percent, so the shift of services can generate more economic miracles than the shift of factories. Computer software can employ only a limited number of highly skilled people, but teleworking can provide jobs to millions of middle-skilled people. Only big multinationals can invest the large sums needed to shift manufacturing jobs to developing countries. But individual doctors, lawyers and small U.S. businessmen can shift clerical jobs to India without investing a penny.
Developing countries must rapidly create world-class communications and spread the Internet culture. They must become proficient in English, the leading global language of the Internet. India today has perhaps 150 million English speakers: in another 50 years its entire population of 1,500 million should aim to speak English. China and Korea will find the language barrier harder to overcome. Having been a British colony could, ironically, become a source of comparative advantage for India. This could help the underachievers of the twentieth century to catch up with the miracle economies.

The potential shift of service jobs is so large that it will probably generate a protectionist backlash in rich countries. That challenge must be met early, if possible in the next WTO round. The silver lining is that rich countries will find it difficult to impose import duties on electronic data sent over the air-waves. For teleworking, technology itself may be the biggest protection against protectionism.

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