Building a Climate for Investment, Growth, and Poverty Reduction in India

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It is a great pleasure to be here at the Export-Import Bank of India to deliver the annual Commencement Day lecture. EXIM has long played a key role in India's ever-expanding presence on the world stage, and it surely has a major and growing agenda. I have followed India's progress for a long time, and I am deeply committed to this country. As a researcher, I lived and worked in the small Uttar Pradesh village of Palanpur during much of the agricultural year of 1974/75, and I have been able to return there on many occasions during the past 25 years. Seeing Palanpur grow and change has taught me much of what I know of development (Lanjouw & Stern 1998). The key drivers of its growth—which has been significant, if slow and haphazard—have been off-farm employment in small and medium-size firms and agricultural productivity. In the 1980s and 1990s I also studied economic policymaking at the central and state levels, and I observed how perceptions of the role of the private sector were changing. In this process, and in my work on rural India, I have formed a great admiration for Indian entrepreneurship across the board.

India's experience has, in many ways, embodied and driven change in development thinking. Its agenda has shifted from relatively statist and planned to more liberal and open. As has happened in other developing countries, India has generated positive results from its reforms. Indeed the main theme of my talk will be that by building on this progress and deepening these reforms, India now has a great opportunity to accelerate growth and poverty reduction.

The reform agenda that I am going to discuss can be brought together under the rubric of "improving the investment climate." Now that macroeconomic and trade reforms have been carried out (or are under way)

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and have borne fruit, the main question is, what other changes at a more institutional and micro level are needed to create a fertile climate for investment, productivity growth, and job creation?

I am optimistic that India is answering this question in a clear and constructive way. Today, I will discuss some concrete areas in which further progress would have a big payoff. To preface that discussion, I want to be very clear on two points. First, when I use the term "investment climate," I am speaking of the climate for rural as well as urban productivity and investment. Indeed, rural entrepreneurship is key to overcoming poverty in India. Second, the fight against poverty cannot be waged through the investment climate alone. We must also work to empower poor people and invest in them to ensure that they are able to be fully involved in both the process of growth and the rewards from growth. Although I shall have something to say on both topics today, the empowerment story must be the subject of another lecture.

In trying to answer the question that I posed a moment ago, I shall make four broad points:

- Globalization has created great opportunities for India, which it is embracing only in part.

- The central challenge in reaping greater benefits from globalization lies in improving the investment climate—that is, in providing sound regulation of industry, including the promotion of competition; in overcoming bureaucratic delay and inefficiency; in fighting corruption; and in improving the quality of infrastructure.

- While the investment climate is clearly important for large, formal sector firms, it is just as important—if not more so—for small and medium-size enterprises (SMEs), the informal sector, agricultural productivity, and the generation of off-farm employment. For these reasons, the investment climate is itself a key issue for poverty reduction.

- There are large variations across Indian states in the quality of the investment climate and the strength of reforms, and the states with a positive climate are experiencing more rapid growth and faster reduction of poverty. The challenge for lagging states is to learn from the experience of the first group.

These points involve mostly structural and micro issues. In examining the micro issues, I will be drawing on collaborative research involving

World Bank and Indian researchers and on comparisons of these results across the states of India. The analysis points to the kind of policy reforms that can provide India with a much more positive investment climate and foster growth in output.

Globalization and the Developing Countries

I am going to say only a few words about my first point, concerning the opportunities from globalization, because it is, I believe, the least controversial. What I mean by globalization is the growing economic integration among nations, reflected in larger flows of trade, services, foreign investment, people, and information. We should note that these same processes can also bring crime, conflict, disease, and instability. But it is pointless to think that the integrative forces can be reversed; the challenge is to make the most of them while mitigating the risks.

The sources of this integration lie in part in technological innovations. But integration has also been driven by a clear policy choice by many developing countries, based on their own analysis of their experience and that of others, to participate more in the global economy by lowering trade and investment barriers. It has been, for the most part, a sound choice based on sound analysis.

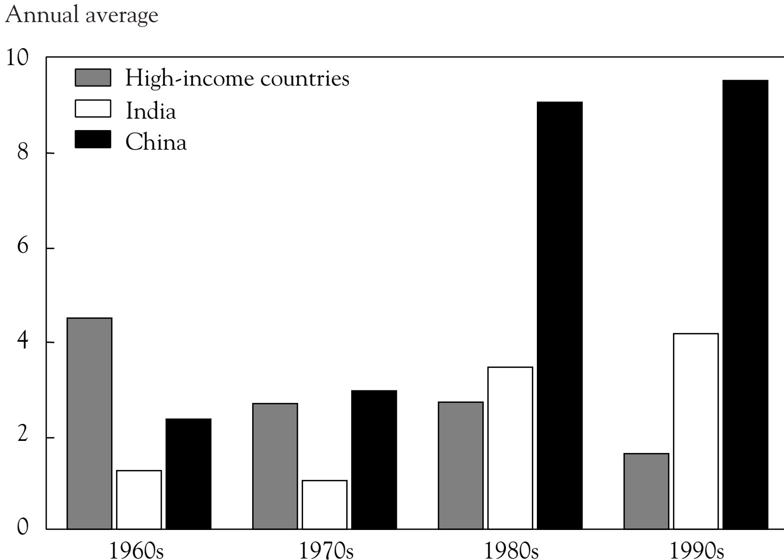
The two most populous countries in the world, India and China, are the most striking and important examples of this shift in policy toward openness. In India's case the early five-year plans were very much focused on state-led, inward-oriented development. But what India and other developing countries have found is that while the state-led model can generate fairly high investment rates and capital accumulation, it has not succeeded in stimulating the sustained productivity growth that is the hallmark of long-run economic development in the most advanced economies. Something that constantly reminded me of this on my many visits to India was the fact that the ever-present Ambassador was the same model of car, the Morris Oxford, that I had known as a child in the United Kingdom in the 1950s.

In the three decades beginning in 1950, China closed its face to the outside world even more emphatically than did India. Through high investment in education and physical capital, it managed to grow more rapidly than India, despite suffering the traumas of the Great Leap Forward and famine in the years around 1960, as well as the Cultural Revolution of the late 1960s and early 1970s. The experience of India and

China does show that the state-led model can, for a while, generate accumulation-driven growth. But the model is inefficient and undynamic.

China and India, each in its own way, drew their conclusions from the experience of the three decades from 1950 on. The single most important development in the world economy in the past 20 years has been the shift of these two countries toward more outward-oriented development strategies and the freeing of entrepreneurial spirits. Both economies have found that significant and positive results have flowed from reform. India's average annual growth rate of real per capita income rose from about 1 percent in the 1970s to almost 4 percent in the 1980s and 1990s, and China's per capita income growth rate accelerated from about 2 percent in the 1960s to almost 3 percent in the 1970s and then 9 percent in the 1980s and the 1990s. This trend is all the more remarkable because what happened to the growth rate of the high-income countries as a group has been exactly the opposite; according to World Bank data, their per capita growth slowed steadily from 4.5 percent in the 1960s to 1.6 percent in the 1990s (see Figure 1). Thus, between

Figure 1. Growth Rates of Real Per Capita Gross Domestic Product (GDP): China, India, and High-Income Countries, 1960s–1990s



Source: World Bank data.

1960 and 1980 India and China were falling further and further behind the advanced economies, but since 1980 they have begun to catch up.

Now, while India has done reasonably well with its reform program, one point that is striking is that it has attracted so little foreign investment. Benefits can come from many types of integration—from expanded trade and greater Internet use, for example—but one important vehicle for these benefits is foreign direct investment (FDI). Both the macro and the micro evidence suggest that this is an important conduit for new technology, as well as for management experience and access to markets. Indeed it was foreign investment from Suzuki that finally introduced to India a genuinely new car, which quickly became the largest-selling model.

Foreign investment has been going primarily to the large reforming economies. In 1998, World Bank data show, China received FDI amounting to 5 percent of gross domestic product (GDP). The corresponding figures were 4 percent for Brazil, 2.5 percent for Mexico—and, for India, less than half of 1 percent. In other words, China, with a GDP twice that of India, received 20 times as much FDI (CII 2000). This and other evidence suggests that India is not benefiting as much from globalization as it could—which leads me to my second point.

What Makes for a Good Investment Climate?

The quantity and quality of investment in India or in any other developing country depend on the returns that investors expect and the uncertainties around those returns. It is useful to think of three broad and interrelated components that shape these expectations: the macroeconomic situation, governance, and infrastructure.

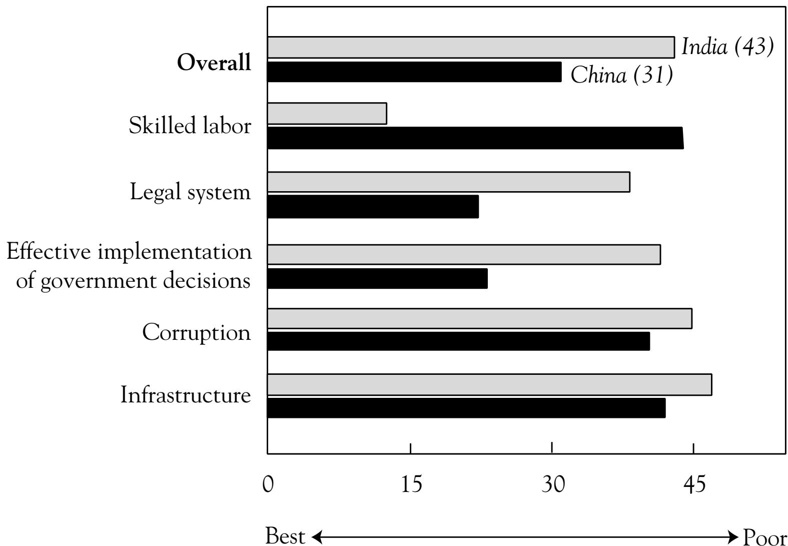
Macroeconomic issues. First are macroeconomic or country-level issues concerning economic and political stability and nationwide policy toward foreign trade and investment. Here, India looks good; in fact, it is these macro-level reforms that in large measure drove the high growth of the 1990s. Relative macroeconomic and political stability, and trade liberalization with further commitments within the World Trade Organization (WTO)—these make up one crucial set of ingredients for spurring investment and productivity growth.

But creating a good climate for investment involves two other factors as well: the institutions of economic governance, and the foundation of basic infrastructure (power, transport, telecommunications, and so on).

It is common for developing countries to start with the macro reforms, which often produce good results compared with past performance. If, however, the country does not move ahead on the institutional and infrastructure agenda, the growth generated by macro reform is likely to peter out. I think it is now broadly recognized within India that the country has reached a crucial point and that the challenge now is to move forward on this institutional and infrastructure agenda.

It is instructive to look at *The Competitiveness Yearbook* to put India in an international context on these matters. The yearbook (International Institute for Management Development 2000) ranks 47 countries—basically, the members of the Organisation for Economic Co-operation and Development (OECD), plus emerging market economies—on a range of factors, with the top performer ranked 1. The rankings are based on the opinions of 3,000 executives. Of the 47 countries, India ranks 43rd overall, while China is 31st (Figure 2). India scores very well on such measures as its supply of skilled workers, in which it ranks 12th. It does less well in those areas identified in the survey as particularly important for reform, which are key elements of a good investment

Figure 2. Competitiveness Rankings, China and India, 2000
(country rankings, 1–47, with 47 best)



Source: Based on International Institute for Management Development 2000.

climate: curbing corruption (ranked 45th), improving the effective implementation of government policies (42nd), and infrastructure (47th). The foreign investment numbers cited earlier indicate that businesses are acting on these perceptions.

Governance. Turning to the governance component of the investment climate, let me take the institutional questions first. Obviously, all countries need to regulate firms in some ways—for example, on fire, safety, pollution, and monopolistic practices. This is true for every market economy. The issues are the extent and nature of regulation, its effectiveness and transparency, and the corruption associated with it. The evidence shows great variation across developing countries. To take one example, according to the World Business Environment Survey, which covers a large range of countries, managers report spending about 5 percent of their time dealing with government officials in Latin American countries and about twice that in the transition economies of Eastern Europe, many of which are well known for bureaucracy and corruption (World Bank 2000f). For India the average reported in the survey was 16 percent of management time. Those who have worked in India know that it can indeed be very difficult to get things done. Bureaucratic harassment can be an art form, a special consumption good that too many bureaucrats enjoy—money does not have to change hands to realize the psychic fulfillment of ritual humiliation. (Having said that, let me also say that some of the individuals and friends I admire most in the world serve in India's administration.)

Two other related areas of regulation that I want to single out concern the exit or bankruptcy of firms and the redundancy of labor. India's bankruptcy and liquidation procedures are notoriously cumbersome, with recent estimates showing that over 60 percent of liquidation cases before the High Courts have been in process for more than 10 years (Mathur 1993). The burden on SMEs regarding labor redundancies has been recognized and is addressed in the new budget, with proposals that the size ceiling beneath which firms are not required to seek government permission to retrench workers be raised from 100 to 1,000 employees. These areas of regulation are of great importance, because much of the productivity growth that comes from a more open and competitive economy arises from the movement of capital and labor from less-productive to more-productive activities. If regulations make it difficult for labor and capital to adjust, much of the potential benefit of openness is lost. I should, however, make it clear that the argument is not antilabor; workers' rights are of great importance. Rather, it is in favor of productive employment and growth.

Let me give you a concrete example. A recent study of the Indian machine tool industry by John Sutton of the London School of Economics found that some Indian firms were very competitive in the production of computer numerically controlled (CNC) lathes (Sutton 2000). When Sutton compared the Indian firms with best practice in Taiwan (China) and in Japan, he found that the real productivity of the best Indian firms had improved in the face of new international competition. Their productivity was now close to the level in Taiwan, whose firms are leaders in the world market for this product. Since the wages for the skilled labor used in this field are six times higher in Taiwan, the best Indian firms are very competitive, domestically and internationally. Sutton also found, however, huge variations in productivity among Indian producers—much more so than among Taiwanese firms.

This is a common feature of heavily regulated, closed economies: large productivity differences among firms producing the same thing. With a more open strategy, what we would expect to happen in this industry is some shake-out, with more successful firms expanding and perhaps taking over some competitors and with, probably, some firms going out of business. I recognize that there are real social costs involved in these adjustments and that it is important to have good social protection policies to help workers, in particular, adjust. But the key word here is adjustment. If regulations make it difficult for firms to reshape their labor forces or to enter or exit when necessary, the benefits from globalization will be severely constrained. Sutton also notes that in the altered situation created by the opening of the machine tool industry to greater foreign competition, it is a new firm that is the top Indian performer and that is growing most rapidly.

Not only does heavy regulation of labor relations and of firm entry and exit make it difficult for existing Indian firms to compete; these regulations must be one of the prime reasons why India has seen so much less foreign investment than other large reforming economies. The procedural hurdles faced by prospective foreign investors provide a striking example. The Confederation of Indian Industry (CII) reports that a typical power project needs to obtain 43 clearances at the central government level and 57 at the state level. For mining projects the numbers are 37 and 47. One result is that, cumulatively, only a quarter of approved foreign investments was actually realized between 1991 and 1999 (Ministry of Industry 1999). But I am not arguing for special privileges for foreign investment. The priority is to generate the productivity and investment that will be required for sustained growth, and these will be driven first and foremost by Indian firms. What is good for Indian enter-

prises is good for foreign investment, as well. Foreign investors need no special privileges, and there is no need to offer such inducements. It is the investment climate that counts.

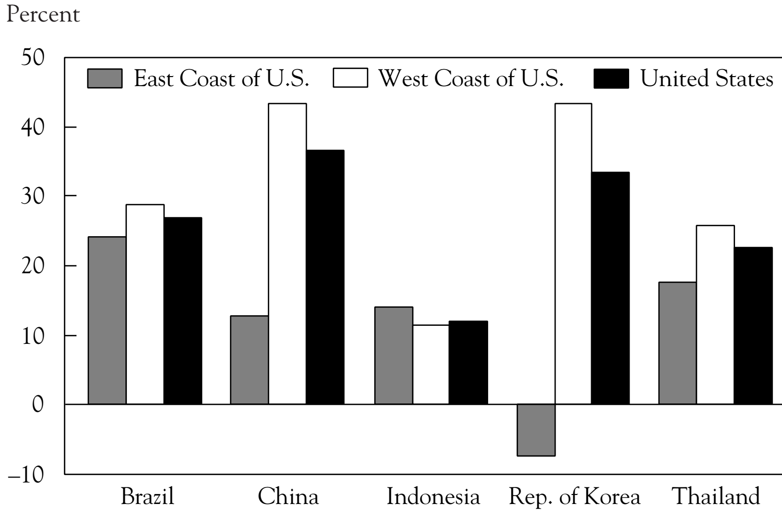
Infrastructure. Infrastructure is the third broad investment climate issue. The shortcomings of the power supply in India are well known. Although this problem is a deterrent for big investors, many of them would expect to have their own generators anyway. It is SMEs that are especially burdened by the unreliable power supply.

One of our important projects in the Research Group of the World Bank has been to work with the Confederation of Indian Industry on a survey of 1,000 manufacturing and software firms in 10 Indian states (CII and World Bank 2001). We have conducted similar surveys on the investment climate in other countries as well. India is fairly remarkable in that most of the SMEs we surveyed had their own power generators, something that is much less common in, say, the Republic of Korea or Thailand (Hallward-Driemeier 2001). To have a vibrant SME sector, a functioning public power grid is needed. One of the positive things about large-scale foreign investment is that many multinational firms like to develop a set of local parts suppliers, and this is a great stimulus to the SME sector. But if the basic economic infrastructure is poor, the country receives less foreign investment, and there is less spillover benefit to SMEs from the investment it does attract.

One other infrastructure issue I want to mention is the operation of seaports. Here, governance and infrastructure intersect. Governance is important because international trade has to pass through customs. We have found in our surveys that Indian firms report an average time for clearing goods from customs that is about twice as high as in emerging markets such as Korea or Thailand and three to four times as high as in Singapore or the most efficient OECD countries. Furthermore, there is a lot of variation in how long it takes. For any firm, this delay and the variation in it impose a high, tax-like cost. A firm needs to keep larger inventories to protect against these delays, and holding inventories costs money. And in India, the cost of credit is particularly high.

Aside from customs clearance, there is the issue of how well ports operate. Inefficient ports combine with transport costs to make countries less competitive. As Figure 3 shows, sending an identical shipment of textiles to the United States from India costs, on average, 20 percent more than from Thailand and 35 percent more than from China.

Figure 3. Cost Savings in Maritime Transport of a Shipment of Textiles to the United States from Selected Countries Compared with India



Source: U.S. Department of Transportation, U.S. Import Waterborne Databank.

The Investment Climate and Poverty Reduction

My third point is that the investment climate plays a crucial role in poverty reduction. When developing countries improve their investment climates, the poor benefit. How do they gain?

First, some members of poor households obtain employment from formal sector firms that expand in a good investment climate. The poor are more likely to be employed in small and medium-size formal sector firms than in the very largest firms, which are able to select the most educated and most skilled workers. My own experience of studying economic diversification in Palanpur village, Uttar Pradesh, has indicated that employment in SMEs is occasionally within the reach of even the very poor in rural areas, although it must be recognized that the better educated and better connected often have an advantage in gaining such jobs. Given adequate transport infrastructure (in the case of Palanpur, a railway link to the nearby towns of Moradabad and Chandausi), employment in bakeries, metal-polishing shops, textile mills, and other factories is not only possible but is highly valued by farm households seeking

to balance their portfolio of activities (Lanjouw and Stern 1998). I have already noted that the problems of bureaucracy, corruption, and poor infrastructure take their greatest toll on this SME sector. Large firms are often able to find ways around bureaucratic and public infrastructure problems, but small firms have fewer options. We found in our survey with the CII that the impact of a poor investment climate on firm productivity was greater for SMEs than for large firms.

Second, a positive investment climate has benefits for the informal sectors, which is where the poor often have the best chance of finding employment. Formal sector employment creates new demand for informal sector expansion, as well as for more farm output at better prices. Increases in agricultural productivity and farm income, in turn, generate additional off-farm employment opportunities. Off-farm employment is crucial in combating rural poverty. Let us look at some of the evidence on these points from India.

Research carried out by the World Bank in collaboration with the National Council for Applied Economic Research (NCAER) in Delhi shows that in 1994 roughly a third of household income in rural areas in India accrued from nonfarm sources (Lanjouw and Shariff 2000). This countrywide average masks considerable variation across states, a point to which I will return. The nonfarm incomes come from a variety of sectors, including commerce, manufacturing, and services, and stem from regular and part-time wage employment, as well as from own-enterprise activities. Evidence from village studies documents that rural households value such nonfarm incomes highly, not only because they contribute significantly to overall income levels but also because they can reduce the exposure of households to potentially devastating income fluctuations stemming from harvest variability.

Rising nonfarm incomes are associated with increased demand and higher prices for cash crops such as fruits and vegetables. In addition, to the extent that the nonfarm sector can provide farm households with a stable source of income, farmers move closer to crop choices that maximize expected profit rather than minimize risk.

Although there is evidence that even the poor sometimes do find employment in the nonfarm economy, they more typically lack the assets, particularly the educational levels, necessary to gain access to such jobs. The World Bank–NCAER study indicates that the poor also often face other barriers associated with low social status and low wealth. These findings resonate with my observations for Palanpur, where access to

regular nonfarm employment depends critically on a network of contacts who can provide information about vacancies and who may be able to furnish references. It is generally the higher-status households that have access to such networks. In addition, villagers in Palanpur are often required to pay bribes to obtain the more attractive nonfarm jobs. As a result the poor are generally confined to casual employment in unskilled nonfarm activities or engage in residual, last-resort, self-employment activities. This emphasizes the point I made at the outset: improving the investment climate is crucial to poverty reduction, but it is far from the whole story. We also have to empower and invest in poor people if they are to play a full part in the growth process and overcome poverty (Lanjouw and Stern 1998).

Research undertaken in the World Bank by Martin Ravallion and Gaurav Datt illustrates how these mechanisms fit into an aggregate picture of economic performance across Indian states (Ravallion and Datt 1999).[1] The authors show that in the period from 1960 to 1994 the pace of poverty reduction varied widely across states. The contribution to poverty reduction of farm productivity and development spending did not typically vary much by state, but the impact of nonfarm growth did vary markedly. Those states with initially higher farm productivity, a smaller gap between rural and urban living standards, and better educational levels experienced growth that was clearly more pro-poor. Basic education was especially important in explaining why nonfarm growth had more of an effect on poverty in some states than in others. The sectoral composition of growth (notably, how much comes from agriculture) is key, especially in states with low human resource development. Let me reiterate: the investment climate—the three dimensions that I have emphasized being stability and openness, governance, and infrastructure—is as important to those investing in their farms and agricultural activities as it is to those investing elsewhere.

It is of some comfort to note that even when the poor do not yet enjoy easy access to nonfarm employment opportunities, expansion of the nonfarm sector can still contribute to poverty reduction. As is shown by the World Bank–NCAER study, growth in nonfarm employment is often associated with rising agricultural wage rates. The study indicates that this effect is particularly strong in the construction sector, where increases in construction employment lead to a tightening of the agri-

1. See "The India Poverty Project: Poverty and Growth in India, 1952–1994," http://www.worldbank.org/poverty/data/indiapaper.htm.

cultural labor market, resulting in higher agricultural wages. A well-known stylized fact about rural poverty in India is that agricultural laborers are highly represented among the rural poor in most parts of the country. With more than 250 million people, accounting for over two-thirds of India's entire labor force, still employed in agriculture, it is clear that an expanding nonfarm sector which exerts upward pressure on agricultural wages can play a crucial role in aggregate poverty reduction, even via this indirect route (Lanjouw and Shariff 2000).

In India expansion of the nonfarm sector has been steady, with the share of nonfarm employment rising from around 19 percent in the 1970s to around 24 percent in 1997 (Acharya and Mitra 2000). In Palanpur I witnessed this process firsthand. While the village economy remains primarily oriented toward agriculture, employment in regular and semiregular nonfarm jobs has increased dramatically, both in number and in range of activities, since the 1950s, resulting in a contribution to village income (depending on the quality of the harvest) of more than one-third (Lanjouw and Stern 1998).

This expansion of nonfarm employment in India is welcome, but it is slower and more uneven than might be hoped. In China nonfarm enterprises grew at a rapid rate after liberalization policies were introduced in the late 1970s and early 1980s, first in agriculture and then elsewhere. China's annual rate of growth of off-farm employment over the past 20 years or so has been 12 percent, versus the 2 percent observed in India.

To a considerable extent, India's slower progress in this regard can be attributed to the development strategy it has pursued. A large share of total nonfarm investment in India has been directed to public works projects, especially during the 1980s. These projects often combine the provision of infrastructure with a safety net for the poor in the form of jobs. Their importance in mitigating poverty has been widely noted.

Sustaining these expenditures during the 1990s has been difficult, in the face of fiscal constraints, and this has led to a slowdown of public investment–induced poverty reduction in recent years. Yet employment-generating projects are surely much more important than deeply wasteful subsidies, such as those in infrastructure—power, in particular—or for fertilizers.

Public works projects have also played a role in China, and what has been particularly noteworthy is the extent to which such infrastructure provision has been accompanied by a pro–rural industry investment

climate that has made possible a major expansion of rural nonfarm employment. Today, an estimated 31 percent of the rural labor force in China is employed in rural industry, compared with 18 percent in India (Lele, Gandhi, and Gautum 2001). Rural enterprises in China have been both a major engine of economic growth and a potent force for rural poverty reduction during the past two decades.

To summarize the conclusions from the examination of this third point, and to underline a key part of what I want to say today, great potential exists in India for improvements in investment climate that can translate into further progress in poverty reduction. An expansion of both formal and informal nonfarm employment, particularly in rural areas and in the small urban centers that service them, can provide highly sought after employment to the poor. Such an expansion can also tighten labor markets in general, allowing even those who remain employed in agriculture to benefit. The injection of nonfarm incomes into rural areas will also boost agriculture and kick off further rounds of linkages. To the extent that the improved investment climate is accompanied by policies to improve the capacity of the poor to participate in the nonfarm sector (education will be central here), there are grounds for expecting India's performance in poverty reduction to at least match that of China.

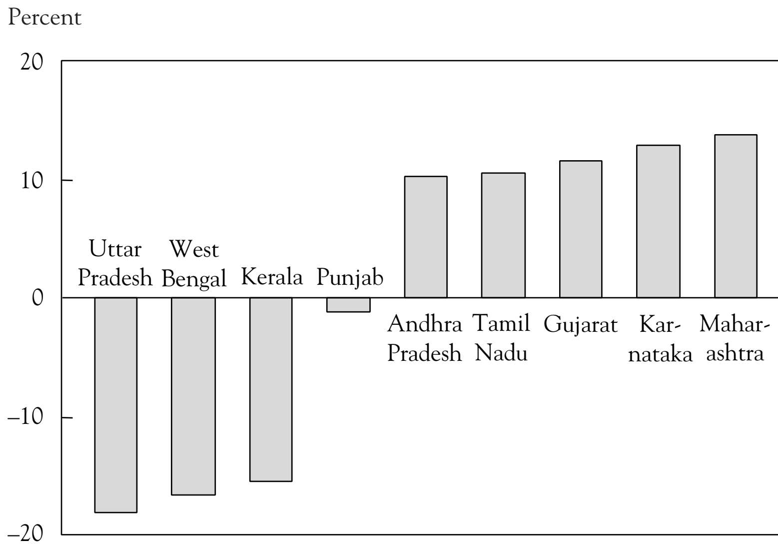
Variations in the Investment Climate among Indian States

The last point that I want to take up in this analysis is the large variation in the investment climate across Indian states. India's national-level reform is yielding its greatest benefits in states that are complementing that reform with improvements in the investment climate at the micro level.

Gaining insights into the impact of the differences in state-level investment climates was a key motivation for undertaking the 1,000 firm survey with the CII. The survey covered 10 Indian states. Among other questions, we asked entrepreneurs to identify the states with the best investment climates and to estimate the cost saving from operating in these locations relative to the states with the worst climates. I recognize that this is subjective, but it is a starting point for looking at differences in the investment climate.

In the first place, we found fairly consistent views. Delhi was roughly in the middle, making it a useful reference point. The entrepreneurs viewed Maharashtra, Karnataka, Gujarat, Tamil Nadu, and Andhra

Figure 4. Cost Advantage in Relation to Delhi, 10 Indian States



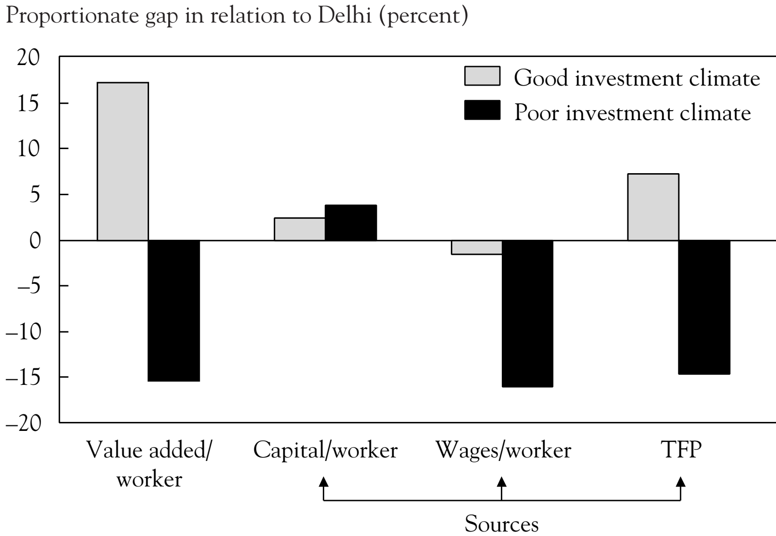
Source: CII and World Bank 2001.

Pradesh as better places to produce than Delhi, whereas Punjab, Kerala, West Bengal, and Uttar Pradesh were perceived to be worse (see Figure 4). The estimated cost difference between the best and the worst states was about 30 percent, which is a very large hurdle for the poor-policy states to overcome in trying to attract investment.

A second important finding was that the objective data on productivity closely match these subjective views; entrepreneurs, even in small firms, are pretty well informed about variations in problems and bottlenecks. So, in the same sector and controlling for size, we find that firms in the good-climate states have about 30 percent more value added per worker than do firms in poor-climate states. One point that I find very interesting is that capital per worker is actually somewhat higher in the poor-climate states. This makes sense to me because a firm operating in the poor-climate environments, is, for example, more likely to need its own generator—a large capital outlay.

The good-climate states have higher wages, a finding that we will examine more closely in our research. Perhaps this reflects the use of higher-quality (that is, more educated or more experienced) labor as better workers migrate to the good production locations. Or it may reflect

Figure 5. Productivity Gaps between States with Good and Poor Investment Climates, by Source of Productivity, India



Note: TFP, Total factor productivity.
Source: CII and World Bank 2001.

higher payments for the same skills in good-climate states, which would indicate that some of the productivity gain from the better climate is being passed through to the workers. Probably both explanations are relevant. The CII and the World Bank have recently produced a comprehensive report, "Improving the Investment Climate in India," on the basis of this survey and other information.

Firms in the good-climate states have higher total factor productivity, which is basically a measure of how well capital and labor are being combined to produce value. We can trace these productivity differences back to specific problems in the investment climate. Some of the poor-climate states have particularly acute problems with the public power grid. In Uttar Pradesh 98 percent of the firms we surveyed had their own generators, and collectively the firms in the survey got only 50 percent of their power from the public grid. In Maharashtra, by contrast, only 44 percent of the firms had their own generators, and taken together, the firms drew 90 percent of their power from the public grid. I want to

emphasize again what a burden an uncertain power supply imposes on a small firm, for which own–power generation is extremely costly and capital-intensive.

The regulatory burden of government also varies by state. The number of times per year that firms are visited by government officials is more than twice as high in the poor-climate states as in the good-climate states.

Naturally, these differences translate into differences in the rates of investment and growth across states. For our sample of firms, the average real growth rate of sales for the past five years was 9 percent per year in the good-climate states but only 2 percent in the poor-climate ones. The aggregate growth figures for these states are quite consistent with this pattern.

Let me close by linking my last two points: the investment climate varies across Indian states, and better investment climates lead to more rapid poverty reduction. The combination of open policies at the national level and good governance and infrastructure at the micro level have delivered on the poverty reduction agenda in the 1990s; the available data suggest that the good-climate states as a group reduced poverty at considerably faster rates than the poor-climate states.

Conclusions

When I give a talk that focuses on the investment climate, there is a danger that I will be misperceived as a champion of big business and misunderstood as arguing that the investment climate agenda is all that is needed for poverty reduction. That is not what I am saying. There is an equally important agenda having to do with the issues of educating and empowering poor people, especially in rural areas, and assisting them to participate in the market economy. I have written and spoken extensively on that agenda and will have much to say about it going forward. Indeed, it was a central argument in *World Development Report 2000/2001: Attacking Poverty*.

That agenda of empowerment and education will have much greater impact if it is pursued simultaneously with the kinds of reforms of the investment climate that I have discussed here today. By the same token, reforms in the investment climate will be much more effective if the population is rapidly becoming more educated, more empowered, and better able to participate in the market economy.

I think that there is a tendency in some quarters to think of the investment climate agenda as being concerned with growth and the empowerment/education/rural development agenda as being concerned with distribution and poverty reduction. The former is taken as structural and the latter as social. That is the wrong way to think about how these two agendas interact. Improving the investment climate has as much of an effect on poverty reduction as any action directly aimed at poverty. In many real-world cases, improving the investment climate will be the single most important thing that can be done to alleviate mass poverty.

At the same time, enabling poor people to gain education and assisting them to obtain the assets and tools to participate in the market economy are not just measures for poverty reduction; they are also crucial for the growth of the whole economy. Rapid success in poverty reduction requires real progress on both the investment climate and the empowerment of poor people. I believe that India is making such progress and that it must continue to move forward. If it does, the next two decades will see great strides in poverty reduction. A halving of income poverty rates in India over the next 15 years is perfectly attainable. That would be a wonderful prize, for India and for the world.