CH -7 CLOTHES AND SHOES: CAN INDIA RECLAIM LOW SKILL MANUFACTURING?

I. Introduction

- India needs to generate jobs that are formal and productive, provide bang-for-buck in terms of jobs created relative to investment, have the potential for broader social transformation, and can generate exports and growth.
- The apparel and leather and footwear sectors meet many or all of these criteria.

II. Why Clothes and Shoes?

Growth and exports

- Nearly every successful economic growth take-off in post-war history in East Asia has been associated with rapid expansion in clothing and footwear exports in the early stages.
- In the successful East Asian economies, countries where GDP growth booms averaged between 7-10 per cent, growth in the exports of these two sectors was exceptional.
- In its take-off phase of growth, India has underperformed relative to the East Asian competitors.
- The Indian underperformance has been particularly marked in the leather sector.

Jobs, especially for women

- Apparels and Leather sectors offer tremendous opportunities for creation of jobs, especially for women.
- The apparel sector is the most labor-intensive, followed by footwear.
  - Apparels are 80-fold more labor-intensive than autos and 240-fold more jobs than steel. The comparable numbers for leather goods are 33 and 100, respectively.
  - These attributes apply to the apparel not the textile sector and to leather goods and footwear not necessarily to tanning.
  - Drawing upon the World Bank employment elasticities, we estimate that rapid export growth could generate about half a million additional direct jobs every year.
- VEHICLES FOR SOCIAL TRANSFORMATION: The opportunity created for women implies that these sectors could be vehicles for social transformation. Women in apparel factories emphasize the agency they had gained on financial decisions. The agency also extended to husbands starting to helping with household chores.
- **In Bangladesh,** female education, total fertility rates, and women's labour force participation moved positively due to the expansion of the apparel sector.

A historic opportunity – China vacating; space filled by others and not India!

- India has an opportunity to promote apparel, leather and footwear sectors because of rising wage levels in China that has resulted in China stabilizing or losing market share in these products.
- India is well positioned to take advantage of China's deteriorating competitiveness because wage costs in most Indian states are significantly lower than in China.

- The space vacated by China is fast being taken over by Bangladesh and Vietnam in case of apparels; Vietnam and Indonesia in case of leather and footwear.
- Indian apparel and leather firms are relocating to Bangladesh, Vietnam, Myanmar, and even Ethiopia.
- The window of opportunity is narrowing and India needs to act fast if it is to regain competitiveness and market share in these sectors.

III. Challenges

- The Apparel and Leather sectors face a set of common challenges:
  - Logistics, labor regulations, and tax & tariff policy, and disadvantages emanating from the international trading environment compared to competitor countries.
  - Challenges relating to policies that prevent converting its comparative advantage—abundance of cattle—into export opportunities.

A. Common challenges Logistics

- The costs and time involved in getting goods from factory to destination are greater than those for other countries.
- Few very large capacity containers (VLCC) come to Indian ports to take cargo so that exports have to be transhipped through Colombo which adds to travel costs and hence reduces the flexibility for manufacturers.

B. Labor regulations

- Regulations on minimum overtime pay, onerous mandatory contributions that become *de facto* taxes for low-paid workers in small firms that results in a 45 per cent lower disposable salary .
- Lack of flexibility in part-time work and high minimum wages in some cases. There are strict regulations for overtime wage payment as the Minimum Wages Act 1948 mandates payment of overtime wages at twice the rate of ordinary rates of wages of the worker.
- One symptom of labour market problems is that Indian apparel and leather firms are smaller compared to firms in say China, Bangladesh and Vietnam.
  - An estimated 78 per cent of firms in India employ less than 50 workers with 10 per cent employing more than 500. In China, the comparable numbers are about 15 per cent and 28 per cent respectively.

C. Tax and Tariff Policies

- In the case of apparels, there are two sets of policies both of which impede competitiveness in man-made fibers and favor instead cotton-based exports and internationally demand is shifting strongly towards manmade fibers and against cotton-based exports.
  - On the one hand, high tariffs on yarn and fiber increase the cost of producing clothing. India imposes a 10 percent tariff on man-made fibers vis a vis 6 percent on cotton fibers.
  - To some extent this need not affect export competitiveness because drawback for tariffs paid on inputs is available. But drawbacks are not provided for purchases of domestically produced yarn that will reflect the high tariffs, adding to clothing costs.
  - And in any case, domestic sales of clothing will not benefit from duty drawback which could also affect overall export competitiveness.

    - On the other hand, **domestic taxes also favor cotton-based production** rather than production based on man-made fibers with 7.5 per cent tax on the former and 8.4 per cent on the latter.
- A similar problem also afflicts footwear production with taxes of 20.5 per cent on leather and 27 per cent on non-leather footwear. To this end, there is a need to undertake rationalization of domestic policies which are inconsistent with global demand patterns.
- The global demand for footwear is shifting away from leather footwear and towards non leather footwear. This shift can be attributed to a host of factors like physical comfort, aesthetics and price affordability which work in favor of non leather shoes as opposed to leather shoes.
- India's share of leather footwear exports in the world market is more than double the share of non-leather footwear.
- Efforts are required to promote non-leather footwear to be able to effectively capture world market share particularly in view of China's slowdown of exports.

Discrimination in export markets

- India's competitor exporting nations for apparels and leather and footwear enjoy better market access by way of zero or at least lower tariffs in the two major importing markets, namely, the United States of America (USA) and European Union (EU).
    - Example: In the EU, Bangladesh exports enter mostly duty free (being a Less Developed Country (LDC), while Indian exports of apparels face average tariffs of 9.1 per cent.
    - Vietnam could also attract zero tariffs once the EU – Vietnam Free Trade Agreement (FTA) comes into effect. In the US, India faces tariff of 11.4 percent. Ethiopia, which is an emerging new competitor in apparels and leather, enjoys duty free access in US, EU and Canada.
- Indian leather exports also face high tariffs in partner country markets in exports of leather goods and non-leather footwear, with considerable added disadvantage in Japan.
- An FTA with EU and UK will help. In the case of apparels, it will offset an existing disadvantage for India relative to competitors- Bangladesh, Vietnam and Ethiopia which already enjoy better market access. In the case of leather, the FTA might give India an advantage relative to competitors. In both cases, the incremental impact would be positive.

B. Sector Specific Challenge – Leather and Footwear Sector Comparative advantage in cattle

- The leather and footwear industry uses raw hides and skins of a number of animals like cattle, buffalo, goat, sheep and other smaller animals as its chief raw material.
- Amongst these, leather made from cattle hides has greater global demand owing to its strength, durability and superior quality.
- It is estimated that cattle-based global exports dominate buffalo-based exports by a factor of 8-9. However, despite having a large cattle population, India's share of global cattle population and exports of cattle hides is low and declining.
- This trend can be attributed to the limited availability of cattle for slaughter in India, thereby leading to loss of a potential comparative advantage due to underutilization of the abundantly available natural resource.

IV. Policy response and Conclusions

- Several measures form part of the package approved by the Government for textiles and apparels in June 2016.

- Apparel exporters will be provided relief to offset the impact of state taxes embedded in exports, which could be as high as about 5 per cent of exports.
- Similar provisions for leather exporters would be useful. This is not a subsidy but really a drawback scheme that should be WTO-consistent because it offsets taxes on exports.
- Textile and apparel firms will be provided a subsidy for increasing employment. This will take the form of government contributing the employers' 12 per cent contribution to the Employee Provident Fund (EPF) (the Government is already committed to contributing 8.3 per cent; so the new measure will be additional to that).
- India will still need to carefully weigh the benefits and costs of negotiating new Free Trade Agreements, such as, with the European Union (EU) and the United Kingdom (UK).
- It is estimated that an FTA with the EU and UK can lead to 108029, 23156, and 14347 additional direct jobs per annum in the apparel, leather and footwear sectors respectively. Many more indirect jobs could be added, although these are more difficult to estimate.
- Second, the introduction of the Goods and Service Tax (GST) offers an excellent opportunity to rationalize domestic indirect taxes so that they do not discriminate in the case of apparels against the production of clothing that uses man-made fibers; and in the case of footwear against the production of non-leather based footwear.
- Third, a number of labor law reforms would overcome obstacles to employment creation in these sectors, some of which include the following:
    - Low Wage Employees (people with less than Rs 20,000 salary per month) only receive 55 percent of their salary because 45 per cent goes to statutory deductions like Employee Provident Fund Organization (EPFO), Employee Pension Scheme (EPS), Labour Welfare Fund (LWF), Employees' Deposit Linked Insurance Scheme (EDLI), and Employee State Insurance (ESI) etc.
    - Low wage employees do not have a 45 per cent savings rate and therefore they may prefer to receive these contributions today than benefit from them tomorrow.
    - The two largest deductions of Provident Fund and ESI may not result in the best value for money for employees. The EPFO has 40 million account with unclaimed balances and charges 3.3 per cent of contributions as fees (amongst the highest in the world).
    - ESI only pays out about 45 per cent of contributions received as benefits (few other private or public health insurance policy in India has a claims ratio of less than 90 per cent).
- Formal employment could increase by offering employees three choices when they start employment:
    - Decide whether they want 12 per cent employee contribution to be deducted.
    - Decide whether their 12 per cent employer contribution goes to EPFO or National Pension Scheme (NPS).
    - Decide whether their health insurance premiums go to ESI or a private health insurance of the employee's choice.
- Offer choice to employees, which will also result in competition for service providers such as the EPFO and ESI.
- Thus, more FTAs, GST-induced tax rationalization, and labour law reform would add considerably to the job creation potential of the clothing and footwear sectors.