South Asia’s Turn
Policies to Boost Competitiveness and Create the Next Export Powerhouse
Foreword

South Asia is at a turning point. The region is benefiting from a confluence of positive internal and external forces. South Asian countries are starting to receive the competitiveness dividends from the economic reforms and public investments in infrastructure and education carried over the last 25 years. Rising labor costs in East Asia are steering global investors towards South Asia as a possible cheaper alternative. At a time of declining global growth and trade, South Asia - home to a quarter of humanity - has the potential to boost global growth as both a major exporter and consumer market. This is good news, not only for South Asia but for the world as a whole.

But, challenges to the region’s competitiveness remain. More than one million young people are reaching working age every month and will need jobs; firm competitiveness is low; and countries in the region have not been particularly successful in integrating with each other.

This report, *South Asia’s Turn: Policies to Boost Competitiveness and Create the Next Export Powerhouse*, looks in detail at the drivers and constraints impacting South Asia’s competitiveness. It outlines the four policy levers which will help the region become more globally competitive across a broader spectrum of industries, accelerating growth and reducing poverty, especially for women. One of these policy levers (improving the business environment) is well known, but much remains to be done. The other three (policies to better connect to Global Value Chains, maximize agglomeration benefits and strengthen firm capabilities) are much less discussed and we hope this report will help policy makers focus more on them.

The report combines a critical mass of quantitative analysis, using the latest data and tools available, with a rich set of industry and company case studies to draw new insights on what South Asia needs to do to boost competitiveness. And it proposes a number of specific policy solutions drawn from relevant international good practices (including from within the region).

We very much hope that this report will help the countries of South Asia, individually as well as collectively, take a turn toward realizing their great competitiveness potential.

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How to realize South Asia’s Competitiveness Potential?

Which region will become the next global factory? As the workforce ages and labor costs rise in China and other East Asian countries, many eyes turn to South Asia. South Asia’s potential is unquestionable: education levels are on the rise, more than one million young workers enter the labor market each month, and the population of the region’s mega agglomerations and sprawling cities is expanding at roughly the same pace. By 2030 more than a quarter of the world’s working adults will live in South Asia. But despite flashes of brilliance across a handful of sectors, locations, and leading firms, this potential remains largely underutilized.

South Asia is less competitive than its neighbors and global benchmarks when it comes to attracting investment, penetrating tough markets, diversifying and upgrading its products, and integrating within the region. These foregone opportunities also manifest themselves in low scores across a range of international competitiveness metrics. At a time when the growth rate of global trade has dramatically slowed down, how can South Asia improve its competitiveness, become an exports powerhouse, create jobs, reduce poverty, and boost shared prosperity? This report proposes that the solution lies in improving productivity, and looks for clues on how to do it in the dynamics of firms, industry value chains, clusters, and cities across the region.

With few exceptions, South Asia has reaped limited benefits from global integration

South Asia’s intra-regional and global ties remain relatively weak. From 1990-2014, the region received, on average, between 2.2 and 2.8 percentage points of Gross Domestic Product (GDP) less Foreign Direct Investment (FDI) inflows than countries in East Asia. Moreover, countries in South Asia receive little FDI from within the region. Trade integration is also low. Over 1990-2014, South Asia’s average ratio of exports to GDP varied between 17 and 21 percentage points below East Asia, and the average ratio of imports to GDP was 21-22 percentage points lower.

The region has also made little progress in diversifying its exports and moving up the value chain. Although South Asia has had some success in penetrating new markets, almost 80 percent of the region’s export growth from 2001 to 2013 came from the sale of the same goods to the same destinations, and the remaining 20 percent came from selling the same products to new markets. Exports remain highly concentrated in textiles and apparel in Bangladesh, Afghanistan, Nepal, Pakistan and Sri Lanka, in minerals in Bhutan, and in animal and vegetable products in Afghanistan and Maldives. Overall, the region’s export basket does not reflect substantial transformation of production structures or innovative activities (Figure 1).

The region’s great competitiveness potential is shown by a number of islands of excellence ranging from highly successful apparel industries in Bangladesh and Sri Lanka to India’s software and Business Processing Offshoring (BPO) sectors, and from productive agglomeration of light manufacturing firms in

FIGURE 1. Outside of garments, South Asia’s market share growth has been low
Sialkot, Pakistan, to Bangalore, India, becoming a global research and development (R&D) hub for major auto-parts and electronics producers. South Asia’s leading firms have managed to rise to standards of global excellence, demonstrating that world class levels of operational performance, efficiency, and innovation can be achieved with the right management, scale/technology and worker training.

**Productivity is the key to improved competitiveness**

What lies behind South Asia’s subdued competitiveness and what strategies can help the region become more competitive? Although competitiveness can be buttressed in the short term by keeping costs low, the only sustainable path to improved competitiveness in the long term lies in increased productivity. And yet, South Asia’s growth over the past two decades seems to have been driven mostly by accumulation of factor quantities rather than improvements in their productivity. This means that accelerating productivity growth should be front and center on the policymakers’ agenda in the region, to ensure continued and sustained progress on job creation, growth, poverty reduction, and shared prosperity.

Similar to patterns observed in OECD economies, labor productivity differentials between agriculture and more modern activities play an important role in explaining the movement of labor across sectors – with the sensitivity of labor movement to productivity much higher in South Asia than in high income countries. However, the movement of labor from agriculture to industry and services in South Asia has not been rapid enough to substantially reduce the large differences in productivity across sectors. In other words, the region has a significant untapped potential (e.g., compared to OECD economies) to reap productivity gains by further reallocation of labor from agriculture to manufacturing and services.

Another important mechanism for productivity growth operates within sectors through movement of resources from less productive to more productive firms. In South Asia, high dispersion of productivity levels across firms and a strong bias of the firm distribution towards small, inefficient, and slow-growing firms indicate that the potential of this channel to raise efficiency is large (Figure 2). Firms aged 25 years or more in Bangladesh, Bhutan, India, and Sri Lanka are only 50 – 90 percent larger than start-ups, while in China, Indonesia, and Vietnam similar firms are two to five times larger. According to some estimates, if distortions which prevent the reallocation of resources to more productive firms in India were brought down to the levels observed in the US, this could lead to productivity gains of as much as 60 percent.

![Figure 2. Labor productivity is lower in small firms in India and China](source: Francis (2015))

**Business environment challenges remain a constraint on firm performance**

On average, countries in South Asia score poorly on major indices used globally to capture key aspects of competitiveness, such as the Global Competitiveness Index (GCI) published by the World Economic Forum and the World Bank’s Doing Business report. In the most recent (2015-2016) GCI rankings, India is the only South Asian country in the top half of nearly 140 countries. In the World Bank’s 2016 Doing Business report, all the South Asian economies, with the exception of Bhutan, are ranked in the bottom half. Ten years ago, a World Bank Investment Climate Assessment argued that South Asian countries under-perform comparators on many investment climate dimensions,
including infrastructure and electricity supply, access to finance, employee skills, and corruption. Similar results emerge from the most recent round of Enterprise Surveys, where an average firm in South Asia consistently ranks each investment climate constraint as more binding than does an average firm in China or Vietnam (Table 1). While performance varies substantially across countries and indicators – pointing to significant potential for improvement by leveraging best practices from within the region – the overall gap puts South Asia’s firms at a clear disadvantage vis-à-vis select comparators in other parts of the world. These challenges may be particularly binding on the region’s high potential firms – which would otherwise grow more rapidly and create more jobs in the absence of distortions. This is particularly the case along the crucial agribusiness value chains (Box A).

**Box A: Industry specific business environment issues limit the inclusive and sustainable growth of agribusiness**

Agribusiness (including agriculture) accounts for one third of South Asia’s GDP and has the potential to double over the next fifteen years (reaching US$1.5 trillion by 2030). This increase will be driven by rapid growth in income and urbanization leading to the consumption of higher value products (including for export markets) and downstream food related services. This will create millions of productive jobs outside agriculture and positive backward linkages to farmers, most of them small and vulnerable.

Numerous examples show how leading private firms and market forces are needed to develop and diffuse the new higher value products and services as well as to facilitate access to knowledge, finance and markets to smallholders. Government-led arrangements, put in place to support farmers and achieve food security, are no more relevant and in fact counterproductive now. On one hand they discourage private investments and limit competition in the new high value markets (trade barriers, price caps on higher value goods, restrictions on private agricultural markets, storage and FDI in retail), on the other hand they encourage excessive production of low value commodities (minimum support prices and government procurements) and unsustainable agricultural practices (large blanket subsidies leading to overuse of water).

**Table 1. Investment climate constraints in South Asia manifest across a range of dimension**

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Source: Staff calculations using Enterprise Surveys.
Note: Cells indicate the percentage of firms who view any given obstacle as a major or severe constraint.
Growth of the region’s cities and clusters offers multiple opportunities to raise firm productivity

Economic activity in South Asia is highly concentrated. In most countries a small number of districts account for a large share of economic activity: for example, in India, the five largest districts account for 18 percent of total employment. However, the degree of geographic concentration of manufacturing activities in South Asia has not changed substantially in the last two decades: the share of the top five districts in total employment has remained relatively constant, although which districts are in the top five has changed. This indicates that more productive locations have generally not been successful in attracting additional resources at the expense of less productive locations, although congestion in the major economic centers has not reached sufficiently high levels to push a substantial share of economic activity out to the periphery. In the three South Asian countries with adequate data, district or state borders tend to be “thick” in the sense that impediments to efficient allocation of resources between districts are stronger than distortions within districts.

Agglomeration economies – the benefits that accrue to firms and workers from locating close together in cities or clusters – matter for firm productivity: a 10 percent increase in district employment leads to a 0.2-0.9 percent increase in total factor productivity of the district’s firms. The effect operates primarily through two channels: localization (i.e., firms in the same industry locating close together to benefit from, for example, a specialized labor pool) and urbanization (i.e., firms from different industries locating close together to benefit from a diverse supplier network, common infrastructure, or a large number of workers). Unlike in high income countries, firms in South Asia appear to benefit relatively more from wide diversity of workers available in a single location (urbanization economies) rather than a concentration of highly specialized workers (localization economies). These results suggest that cities, with diverse labor pools catering to a range of industries, may currently be more effective vehicles of supporting firm productivity in South Asia than clusters, which cater to a specific sector – although the two are not mutually exclusive. For example, a number of top firms in South Asia’s automotive and electronics sector fostered innovation by locating close to customers to enable their engineers to work together with those of the client, and gradually built up their capacities from simpler to more complex components (Box B).
Increasing prominence of global value chains provides a pathway to greater efficiency

Participation in global value chains (GVCs), and exposure to international markets more generally, is associated with higher levels of firm productivity in South Asia. Access to foreign markets—either through trade or licensing foreign technology—brings stronger outcomes in terms of ICT adoption and innovation, and these in turn have a robust positive relationship with firm-level productivity. Greater exposure to international trade makes firms more viable participants in GVCs, which in turn can further enhance productivity in a virtuous cycle. For example, a number of South Asia’s leading firms in the automotive sector learned by becoming domestic suppliers to multinationals entering the region, and then leveraged that experience to access international markets on their own. While it is also true that more productive firms may self-select to join GVCs, evidence suggests that GVC participation and deeper global integration more generally have positive productivity impacts on firms.

At more than 20 percent of its exports coming from GVC products, South Asia has the second-highest rate of GVC participation among developing regions. However, this largely reflects the region’s strong performance in apparel (Table 2). Bangladesh has one of the highest GVC participation rates in the world precisely because Bangladesh exports are heavily concentrated in garments. India’s participation in GVCs is low, because it has a more diversified export basket. There is also substantial variation in terms of apparel, electronics, and footwear participation further highlighting the role of strategic policy support.

### Table 2. Outside of apparel, US$ per capita GVC exports from South Asia lag well behind East Asia

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<td>3.7</td>
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<td>0.6</td>
<td>6.9</td>
<td>252.8</td>
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<td>6.2</td>
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<tr>
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<td>56.1</td>
<td>230.5</td>
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Note: Data for Bangladesh 2013 are mirror data.
of where most firms in each country locate along the value chains: firms in Pakistan tend to be more upstream, while Sri Lankan and Bangladeshi firms are much further downstream. Final apparel producers in Sri Lanka and Pakistan have been more successful at penetrating higher-income markets than firms in Bangladesh and India, while firms in Pakistan and Bangladesh have shown greater ability to penetrate high-income markets in intermediate apparel. Overall market sophistication, however, declined between 2000 and 2010 in all four countries, indicating either increased sales to middle-income markets or more intense competition in high-income markets, or both.

The importance of taking a regional perspective to the competitiveness agenda is emphasized by the fact that value chains tend to cluster on a regional basis in light of transport and other transactions costs, as well as the need for timely delivery. Bangladesh and Sri Lanka have the highest share of final apparel goods (86 and 44 percent of apparel exports) in the region, and source many apparel inputs from Pakistan and India who focus relatively less on final products (18 and 6 percent of apparel exports). In 2013, two-thirds of India’s exports of knit and crochet fabric were destined for Sri Lanka and Bangladesh, while nearly half of Pakistan’s exports of woven cotton denim were destined for Bangladesh and Sri Lanka. There is also an emerging “East Asia/South Asia” regional value chain, especially in intermediate apparel: 70 percent of South Asia’s imported apparel inputs come from East Asia and, together with intra-South Asian trade, account for 94 percent of the regions apparel inputs. South Asian GVC activity is more integrated with East Asia than any other region in the world, except East Asia itself.

Despite the importance of GVCs for firm productivity and overall exports growth, South Asia lags on many capabilities that matter for GVC participation. Countries in South Asia are, on average, more wage competitive and closer to markets than members of Association of Southeast Asian Nations (ASEAN) or Southern Africa Customs Union (SACU), but compare unfavorably with regard to policy variables such as human capital, institutions, logistics and trade barriers on imports of intermediate inputs (Box C). Bangladesh, Pakistan, and Maldives charge high tariffs on intermediate apparel goods, and all countries
impose high tariffs on final autos. Non-tariff barriers are also pervasive, particularly in the auto sector in Pakistan. There is also substantial room for improvement with regard to trade facilitation, with the ability to access imported inputs in a timely manner particularly important for sectors where South Asia has already developed an advantage (apparel) as well as sectors of emerging opportunity (electronics). Restrictive product market regulations—such as limits on storage, processing, and marketing of agricultural produce, price caps and minimum support prices on key agricultural commodities, fragmented approaches to food safety standards and their poor enforcement, and gaps in harmonization of local norms with international auto standards—inhibit South Asia’s ability to further link to GVCs in agribusiness and automotive.

Improving firm capabilities and leveraging technology can substantially raise firm productivity

Outside of a few global leaders, firm capabilities in the region tend to be limited. The region’s firms over-employ relatively scarce capital and under-employ South Asia’s abundant labor. Given the prevailing wage rates and marginal products of workers, the optimum level of labor in Indian and Sri Lankan firms is 3.3 times current employment levels, while estimates for Nepal and Pakistan are even higher. Thus, most firms in South Asia do not operate close to what would be considered optimum efficiency levels given the prevailing factor prices, bringing down aggregate productivity. Potential reasons for this less-than-rational behavior include limited managerial capacity, labor market rigidities (particularly with regard to firing workers), and spatial distortions which prevent firms locating close to a ready supply of workers (or vice versa).

Box C: Trade barriers hold back the apparel sector

*(Based on the Stitches to Riches report)*

With rising labor cost in East Asia, South Asia has an historic opportunity to capture its fair share of the global apparel market (it has only 12 percent compared to 41 percent for China alone), pulling in the process millions out of poverty, especially women.

However, taking advantage of lower labor cost will not be sufficient as global buyers have ever more stringent conditions in terms of quality, lead time, reliability and social/environmental compliance. Lead firms from across South Asia show that it can be done. A key reason for their success was their ability to connect to global value chains—both in terms of being able to source world class fabrics and serve demanding customers which pushed them to ever greater heights.

Trade barriers are the main constraints standing in the way of South Asia realizing its great potential in apparel. In particular, problematic duty drawback schemes in India and Pakistan make it difficult for exporters to import textiles, imposing delays that are unacceptable to global buyers and cutting them off from the increasingly important man-made fiber segment. These issues have been resolved in Sri Lanka (which has no import duties on textiles) and Bangladesh (which has a very effective system of bonded warehouses to facilitate duty free import of textiles). This is one of the main reasons for why Sri Lanka and Bangladesh export ten times more apparel than India and Pakistan (once adjusted for population size).
Although the region’s top firms make investments in creating knowledge and skilling/training their workforce a priority, on average firms in South Asia under-invest in knowledge. Overall (public and private) investment in R&D in the region is low and is increasingly falling behind Latin America and particularly East Asia (Figure 3). There is large heterogeneity within the region, with higher incidence of firms conducting R&D in Bangladesh and India (above the rates observed in Africa and Eastern Europe & Central Asia) and a much lower incidence in Nepal and Pakistan (below the average of Africa and ECA). In general, larger firms are more likely to engage in R&D activities. With the exception of Bangladesh, access to licenses to use foreign technology increases R&D, while financial constraints significantly inhibit R&D investments.

Adoption rates of ICT also vary across the region. Indian firms score very high on multiple dimensions of technology use: close to 100 percent of registered firms have computers and an internet connection, which is in line with the average for OECD countries. ICT use in Pakistan is in line with global peers, but very low in Bangladesh and Nepal. However, despite widespread internet use, the adoption of e-commerce and other online business tools is limited. At most three quarters of digitally connected firms use the Internet to buy, sell, market, or manage their inventory online, with the regional average closer to 50 percent. Firm size, export status, and to a lesser extent import status are important determinants of ICT adoption at the firm level. Complementary factors—technology and skills—are also important determinants of ICT adoption. Lastly, access to finance and to financial institutions is critical in facilitating the adoption of e-commerce. The region’s moderate achievements on many of these dimensions may explain the limited penetration of some technologies and hint at missed opportunities to improve productivity performance.
Patterns of investment in innovation inputs—including ICT, managerial practices, and R&D investments—are reflected in innovation outputs. Within the region, close to 80 percent of firms in Bangladesh and India engage in technological innovation, well above the average in Eastern Europe and Africa. On the other hand, only around 20 percent of firms in Nepal and Pakistan invest in new products or processes. Moreover, the acquisition of knowledge capital (e.g., R&D, investments in equipment, and training) is highly concentrated in a few firms, and mature, exporting, and foreign-owned firms tend to be the most innovative. Relative to other regions, a much larger share of innovation in South Asia takes place in-house, limiting productive collaboration across firms and possibly explaining high rates of imitation instead of radical innovation.

Box D: Protections from global good practices limit the spread of world class firm capabilities in the automotive industry

The automotive sector is one of the most important industries globally and in South Asia, contributing 19 million of direct and indirect jobs in India alone. The potential for South Asia to become globally competitive in this sector is shown by the experience of Indian auto-parts manufacturers who became world leaders by having first acquired technical and managerial skills from leading original equipment manufacturers (OEMs) established in India, followed by a process of serving increasingly discerning customers in competitive export markets. Although level of investment in R&D remain low, a few leading global manufacturers are moving their R&D centers to India pointing to the region’s potential to be at the heart of the technological revolution taking hold in this critical industry with important ramifications to many others—e.g., electronics, machining and tooling.

The challenge for the region is two-fold. First, to spread these world class firm capabilities throughout the industry, from OEMs and tier 1s to tier 2 and tier 3 suppliers. In effect, large productivity gaps persist in the sector, with most OEMs (together with their suppliers) having subscale/fragmented operations with low capacity utilization, quality levels and investments in skills below international benchmarks. A second—and connected—challenge is moving up the global value chain through greater innovation, investment in R&D and commercialization of new products which remain below global average, with local suppliers primarily relying on build to print models.

Policies such as high import tariffs on completely built units (CBUs) of passenger cars, which helped attract market-seeking OEMs in the 1990s and 2000s, are now slowing down the spread of world class managerial good practices. The situation is worse in Pakistan than India because only a few OEMs are “competing” behind even higher import tariffs on both CBUs and auto-parts. The experience of the Indian auto parts and commercial vehicle sectors shows that a gradual reduction of import tariffs, far from leading to the debilitation of an industry, could be a powerful catalyst to its global success. Converging towards international environmental and safety standards, as the Indian government is planning to do, would further encourage automotive firms in South Asia to adopt (and contribute to) international good practices.

Returns to innovation in Bangladesh, India, and Nepal are positive and statistically significant. One percent increase in innovation intensity raises firm productivity by 0.6—1.4 percent, an impact that is 2-5 times stronger than magnitudes commonly estimated for OECD countries. However, even among the leaders, most innovation reflects imitation of existing products and/or processes. Few firms engage in disruptive innovative activities such as introducing new products to the country or to the world. Most of the firms in the region tend to innovate for upgrading the quality of their products, although the introduction of new products is slightly more frequent in India. And most innovation is done in-house (more so than in Africa or ECA), which may contribute to limiting the potential for new products. The automotive sector shows the importance of exposure to global international good practices to foster the adoption and spread of world class capabilities (Box D).
Faster exports and jobs growth are within reach if productivity performance improves

South Asia has tremendous potential to increase incomes and gain market share in exports through policies that enhance productivity. In a forward-looking scenario where productivity growth contributes around 2 percentage points per year to increases in regional GDP—consistent with South Asia's best historical performance—South Asia becomes the world's fastest-growing region in terms of exports. By 2030, it could more than triple its share in global exports of electronics and motor vehicles, and come close to doubling its already significant market share in wearing apparel (Figure 4). Additional steps to boost productivity through (i) further investments in port infrastructure, improvements in customs processes and behind-the-border services (e.g., warehousing, transportation); (ii) more rapid implementation of ongoing improvements in the port-to-port trade and transportation costs; and (iii) a reduction in the domestic cost of trade could boost exports growth by more than one percentage point per year relative to the baseline and lead to additional unskilled wage gains of as much as 17 percent.

Turning to job creation, the report considers the intensely competitive apparel market. Productivity-enhancing measures which could result in a 10 percent cost advantage vis-à-vis Chinese apparel may lead to a 13–25 percent (depending on country) rise in South Asian countries' apparel exports to the United States. Given the high labor intensity of apparel manufacturing and the large sensitivity of South Asia's labor supply, particularly for women, to higher wages, a 10 percent price advantage over China in the US market could translate into employment gains of 8.9 percent in Pakistan, followed by Bangladesh (4.2 percent) and India (3.3 percent). These would be well-paying jobs; the wage premium of the apparel sector over agriculture ranges from 8 to 27 percent, depending on the country, and is even higher for women. Moreover, jobs created in textiles and apparel are likely to particularly attract low-skilled women. These results point to the critical importance of implementing productivity-enhancing measures in the apparel sector—but also caution that inaction may lead to a decline in market share as competitors that have pursued more aggressive apparel-friendly policies (such as Vietnam and Cambodia) can stand to gain much more than the South Asian countries in terms of market access. The prospect of new mega-regional trade agreements such as TPP and TTIP—where South Asian countries have thus far remained on the sidelines—giving an additional boost to the region's main competitors further underscores the urgency of reforms.
Policy levers to boost competitiveness and productivity

In order to realize these gains and more, the region’s policymakers should re-examine the contents and prioritization of the policy toolkit when it comes to competitiveness and productivity. In addition to policies aimed at further improvements in South Asia’s business environment, this report highlights three policy areas which have so far been less prominent in discussions around competitiveness and productivity but which—as shown by the empirical results and the industry case studies—have the potential to raise productivity across the region. These include policies to maximize benefits of agglomeration economies, better connect to global value chains, and boost firm capabilities. They also include, in the critical case of the agribusiness value chains (amounting to one third of South Asia’s GDP), the need to reform agricultural markets, price regulations, product standards and large poorly targeted subsidies.

Deriving maximum productivity benefits from South Asia’s rapid urbanization requires policies which leverage agglomeration economies while minimizing the adverse impacts of congestion forces. The removal of policy-induced distortions that limit the flexibility of labor, capital, and land markets could enable more productive firms to grow. In particular, policies to increase the flexibility of labor markets, especially for women—who face particularly high discrimination in South Asia’s labor markets—are likely to substantially reduce misallocation of labor and improve productivity. Policies directed at improving urban governance and bridging the region’s infrastructure gap will ensure that firms and workers will be matched more easily. Achieving this will require tackling congestion issues head-on. In particular, investments in roads and public transit, provision of quality affordable housing and other basic infrastructure services, and reducing the negative social impact of agglomeration (e.g., crime) should be high on the policymakers’ agenda.

When large-scale solutions are difficult or costly, improved infrastructure could be delivered through industrial zones or clusters. While a number of traditional approaches to industrial zones in South Asia have not delivered the expected benefits, there are encouraging examples of new approaches from within and outside the region, such as India’s SITP model and China’s plug-and-play industrial zones. Location of clusters often makes all the difference, and countries in the region could make further efforts...
to identify and develop industrial areas close to ports, resolve pending issues in existing industrial zones, and ensure provisions for worker housing. Providing access to R&D and testing facilities, waste dumping, and recycling facilities would make these zones more attractive to SMEs.

Strengthening the participation of the region’s firms in global value chains calls for taking specific steps which matter most to global buyers as well as broad-based investments in GVC capabilities. The former include fundamentals such as cost, quality, and lead times, particularly relevant given the shift toward lean retailing and just-in-time delivery in many industries. However, other factors are also growing in importance. Buyers who attempt to reduce the complexity of their supply chains increasingly value offering accompanying services such as input sourcing, product development, and financing (known as full package services). Buyers also take into account social and environmental compliance, which has become more important to their bottom line in response to pressure from corporate social responsibility (CSR) campaigns by NGOs and compliance-conscious consumers.

Improving broader-based GVC capabilities requires policy actions such as facilitating imports for exporters (e.g., through better functioning duty drawback schemes), reducing average rates of protection and harmonizing tariff schedules across intermediate and final goods, improving standards and product market regulations, and strengthening trade logistics to reduce customs clearance and transit times—all areas where the region falls short of its Southeast Asian competitors and global benchmarks. At the firm level, improving firm capabilities to adopt new technology (including better managerial practices) and innovate will be critical to accelerate introduction of new products, improving product quality, and moving into higher value segments within existing or new GVCs.
When it comes to innovation, managerial capabilities, technology adoption, and worker skills, the report’s findings suggest different priorities across the region. In Nepal and Bangladesh, the focus should be on further efforts to foster the general adoption of internet and computers, which will require overcoming infrastructure challenges as well improving the provision of complementary skills—such as technology and human capital. In the case of India, where the use of ICT is already highly mainstreamed, the focus should be on further improvements of ICT practices, in particular e-commerce and other online business tools. Given the large extent of software development and the relative high availability of IT engineers, access to finance and establishment of broad base financial transactions platforms online could be critical in broadening the use of internet for commercialization.

A possible explanation for South Asia’s growing gap in R&D investments vis-à-vis other regions are low returns to R&D in the absence of complementary factors: managerial capabilities, worker skills and finance. Therefore, investing in these should be a policy priority throughout the region. Modernizing training institutions and expanding access to on-the-job training can lead to higher efficiency and lower costs, while programs that support improving firm capabilities through technology extension, managerial training, access to consulting services, networking, and information can have large and long-lasting productivity benefits. In addition to these initiatives, the region’s innovation leaders should focus on breaking the nature of inward innovation development by supporting cooperation with other firms and institutions in order to generate novel, and if possible, radical innovations. On the other hand, for laggards policy should focus on increasing the number of firms engaged in incremental innovation in order to boost productivity, profits, survival rates, and sales growth.