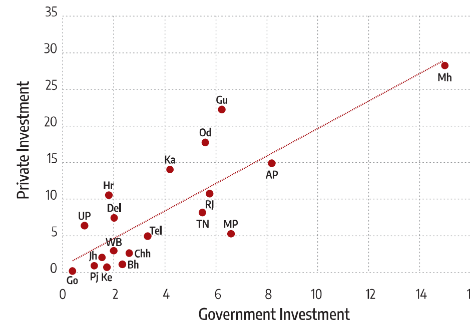
The investment divide across states

Low income or lack of industries alone doesn't explain why some states struggle to attract investment

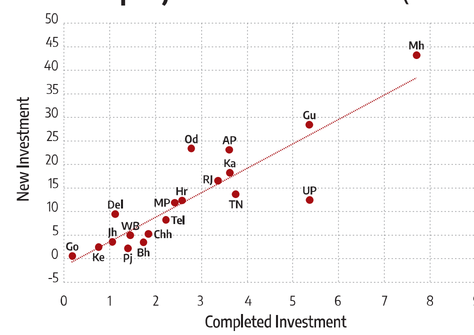
ILLUSTRATION: BINAY SINHA

The crowding-in effect

Public-private link (₹ trillion)



Finished project vs investment (₹ trillion)



Source: CMIE

While the Indian economy has been resilient in its growth even through uncertain times, a persistent concern both globally and locally is the significant variation in economic performance across states. Per capita income varies widely alongside the nature and composition of economic activity. Many studies have pointed out the lack of convergence in growth observed among Indian states. For India to achieve its aspiration of becoming a developed nation by 2047, it is critical for growth to be broad-based, with the gains from economic growth accruing to a larger range of economic actors.

A crucial driver of growth in a developing economy is investment. By creating capacity and supporting employment, it can support both demand as well as supply. While, there are no officially published series of investment at the state level, the capital expenditure database of the Centre for Monitoring Indian Economy provides some insights. It tracks projects across states, excluding the north-eastern and hilly states.

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A project in capex represents an intention to set up an additional productive capacity in India. This database covers both government and private sector projects, with economic activities spanning manufacturing, services and infrastructure. However, since the database relies on formal announcements regarding the intention, initiation, and completion of projects, it focuses on larger projects undertaken in the economy. Yet, factors that support large-scale investment could create forward and backward linkages, encouraging the micro, small and medium enterprises (MSME) sector. This piece, therefore, focuses on available information on investments in larger projects.

To understand investment across states, the new projects category is a useful point of reference. These represent intentions. Since announcements can fluctuate considerably across years, let us look at total announcements over a 10-year period from 2015 to 2024. As one would expect, Maharashtra tops the list with a share of over 15 per cent of total investment. The following three states — Gujarat, Andhra Pradesh, and Odisha — present a more diverse picture. Together these states account for 42 per cent of total new investment. In terms of per capita income, however, they are quite different — Gujarat is among the high-income states, Andhra Pradesh among the middle-income states, and Odisha is a low-income state. In other words, new investments are not concentrated only in high per capita income states. Agglomeration benefits do not seem to be the primary driver of new investment decisions. To explore what else matters, we look at two other aspects here.

Among important drivers of investment decisions, government investment can play a key role. The literature discusses two alternative perspectives that connect government investment and private investment — "crowding in" and "crowding out". Public investment in public goods and merit goods creates significant positive externalities. These, in turn, can translate into lower costs for private investment or, alternatively, increase the return on private investment, thus supporting higher levels of private investment. This loop of interaction is referred to as crowding in. Crowding out, on the other hand, refers to a discouragement of private investment if public investment pre-empts available resources.

The graph (*Public-private link*) shows government investment and private investment (announcements) aggregated over the period 2015-2024. A clear positive relation is evident. The correlation between these two variables is a high 0.82. In other words, there is significant evidence of crowding in — higher government investment supports higher private sector investment. States that have devoted more resources for public investment, through the budget and through their institutions such as public-sector enterprises, also tend to see higher levels of private investment.

Another aspect to consider is the impact of governance and business environment on decisions to invest in a state. States with more conducive environment attract more investments. Governance could be captured through a variety of indicators. One indicator could be the size of completed investments. This indicator reflects on the outcomes of good governance and the ease of doing business, since the success of governance models is not limited to attracting new investments alone but to support the execution and commissioning of said investment.

Better levels of completed investments, therefore, should be associated with higher levels of new investments as well. The second graph (*Finished project vs investment*) reflects a positive relation. Higher levels of completed investment do seem to be significantly associated with higher levels of new investment — public and private put together. The correlation between completed investment and new investment is once again very high at 0.89.

These correlations highlight the possibility of two lines of action by states wanting to improve investments levels — augmenting public investment and institutionalising mechanisms that support the completion of announced projects across both private and government segments. The former would support better infrastructure and create positive externalities for private investment, while the latter would reduce impediments to translating intentions into augmented capacities. By improving the overall economic environment — and through backward and forward linkages with the corporate sector — these initiatives could also support growth in the MSME segment.

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