India's Economic Reforms an Appraisal

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India's economic reforms began in 1991 when a newly elected Congress government, facing an exceptionally severe balance-of-payments crisis, embarked on a programme of short-term stabilization combined with a longer-term programme of comprehensive structural reforms. Rethinking on economic policy had begun earlier in the mid-1980s by which time the limitations of a development strategy based on import substitution, public sector dominance, and pervasive government control over the private sector had become evident. But the policy response at the time was limited to liberalizing particular aspects of the control system without changing the system itself in any fundamental way. The reforms initiated in 1991 were different precisely because they recognized the need for a system change, involving liberalization of government controls, a larger role for the private sector, and greater integration with the world economy.

The broad outline of the reforms was not very different from the reforms undertaken by many developing countries in the 1980s. Where India's reforms differed was in the much more gradualist pace at which they were implemented. The compulsions of democratic politics in a pluralist society made it necessary to evolve a sufficient consensus across disparate (and often very vocal) interests before policy changes could be implemented and this meant that the pace of reforms was often frustratingly slow. Daniel Yergin (1997) captures the mood of frustration when he wonders whether the Hindu rate of growth has been replaced by the Hindu rate of change! Yet even a gradualist process can achieve significant results over time and India's reforms have now been under way for seven years.

This chapter attempts to evaluate what has been achieved by gradualism in this seven year period which has seen three different governments in office—the Congress government which initiated reforms in 1991, the United Front coalition which continued the process in 1996 and 1997, and finally the BJP-led coalition which took office in March 1998 and has also declared its intention of strengthening reforms. The chapter distinguishes between end results in terms of actual performance of the economy in this period and achievements in terms of policy reforms actually implemented. The distinction is important because dramatic policy changes may not always lead to comparable improvements in actual performance, as has happened in many countries. The first section of the chapter documents achievements in terms of the performance of the economy in the post-reform period. The second and third sections attempt to evaluate the extent to which the reforms were successful in bringing about policy changes. The second section focuses on the achievement in reducing the fiscal deficit, which was a key macroeconomic policy objective and the third section reviews achievements in bringing about various types of structural reforms. The fourth section presents a summary assessment of achievements thus far and of the challenges that he ahead.

ECONOMIC PERFORMANCE UNDER THE REFORMS

To evaluate the impact of reforms on the performance of the economy it is useful to distinguish between two periods. The first period is the three years 1991-2 to 1993-4 which were years of crisis management, when the primary objective of policy was to stabilize the economy. The next four years 1994-5 to 1997-8 constitute the post-stabilization period, when the focus of policy was on the longer-term objective of putting the economy on a higher growth path. Since objectives in the two periods were different, performance in each period must be evaluated in terms of objectives of the period. The major parameters of macroeconomic performance the two periods are summarized in Table 2.1.

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CRISIS MANAGEMENT 1991-2 TO 1993-4

India's performance in stabilizing the economy was commendable by any standards. The extent of achievement can be appreciated only if we recall the severity of the crisis. The surge in oil prices triggered by the Gulf War in 1990 imposed a severe strain on a balance of payments already made fragile by several years of large fiscal deficits and increasing external debt. Coming at a time of internal political instability, the balance-of-payments problem quickly ballooned into a crisis of confidence which intensified in 1991 even though oil prices quickly normalized. There was a flight of capital in the form of withdrawal of non-resident deposits from the banking system and an unwillingness of international banks to extend new loans. Foreign exchange reserves dropped to $ 1.2 billion in June 1991, barely sufficient for two weeks of imports and a default on external payments appeared imminent. The shortage of foreign exchange forced tightening of import restrictions, which in turn led to a fall in industrial output. In November 1991, the government entered into a stand-by arrangement under which the IMF would provide $ 2.3 billion over a two-year period and there was definite expectation on both sides that the stand-by arrangement may need to be followed by recourse to the ESAF facility because adjustment was expected to take longer than two years.

Performance in the next two years, measured in terms of the usual parameters of growth and stability clearly exceeded expectations (Table 2.1). The current account deficit, which had expanded to 3.2 per cent of GDP in 1990-1, was brought down to a comfortable 0.4 per cent level in 1993-4. Foreign exchange reserves were built to a respectable level of 8.6 months of imports by the end of 1993-4. Inflation, which had reached 13.7 per cent in 1991-2, declined to 8.4 per cent in 1993-4. Contrary to original expectations, there was no need to negotiate further access to IMF resources at the end of the stand-by arrangement in November 1993. Most important of all, and in sharp contrast to stabilization programmes in many other countries, there was minimal disruption of growth. The rate of growth of GDP had collapsed to 0.8 per cent in 1991-2 but it rebounded to a near normal 5.3 per cent in 1992-3, and then accelerated to 6.2 per cent in 1993-4.

A common concern about macroeconomic stabilization programmes is that they may hurt the poorer sections of population because of temporary reductions in employment resulting from demand restraining policies, or even permanent loss of employment in certain areas because of structural change. This aspect of performance in the stabilization period has been examined in detail by Tendulkar (1997). Tendulkar's estimates (see Table2.2) indicate that the incidence of both rural and urban poverty declined more or less steadily through the 1980s but this trend was briefly reversed in the early years of the reforms. Restricting the analysis to estimates of poverty based on consumption data for a full twelve-month period, we can compare 1990-1 (July-June) with 1992 (January-December) and this comparison shows an increase in poverty in both urban and rural areas in the first two years of the reforms.[1] However, this deterioration in poverty indicators was reversed in 1993-4 (July-June). In case of urban poverty the reversal was complete and the incidence of poverty in 1993-4 was actually lower than in 1990-1 but in the case of rural poverty it was marginally higher.[2]

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1 As pointed out by Tendulkar (1997), the poverty estimates for 1991 (July- December) and 1993 (January-June) are based on consumption observed over six-month periods and may not be comparable with estimates based on twelve- month periods because of known seasonal variations especially in rural areas.

2 The conclusions that poverty increased in the initial years is subject to an important qualification because it is based on NSS surveys using the so- called 'thin sample' of around 20, (XX) households and the full sample of around 120,000 households conducted every five years. Of the estimates reported in Table 2.2 for the period after the mid-1980s the full sample was used only for the years 1986-7 and 1993-4. Since thin sample estimates are subject to larger errors it can be argued that robust conclusions about changes in poverty can only be drawn for changes between 1986-7 and 1993-4 which show clear decline in poverty.

Table 2.1 Macroeconomic Performance Indicators
(Growth rates are percentages over previous year)

		1990-1	1991-2	1992-3	1993-4	1994-5	1995-6	1996-7	1997-8
I.	Growth Indicators								
	Growth of GDP (%)	5.4	0.8	5.3	6.2	7.8	7.2	7.5	5.1
	Industrial GDP Growth	7.0	-1.7	4.4	6.9	10.8	12.7	6.8	5.8
	Agricultural GDP Growth	4.2	-2.0	5.8	3.6	5.2	-2.3	7.3	-1.8
II	Internal Balance Indicators								
	Gross Domestic Saving (% of GDP)	24.3	22.9	22.0	22.7	25.6	25.3	26.1	
	Gross Domestic Investment (% of GDP)	27.7	23.4	23.9	23.3	26.9	27.1	27.3	
	Fiscal Deficit (% of GDP)	8.3	5.9	5.7	7.4	6.1	5.4	5.2	6.1
	Rate of Inflation	10.3	13.7	10.1	8.4	10.9	7.7	6.4	4.8
	M3 Growth	15.1	19.3	15.7	18.4	22.3	13.7	16.0	17.0
III	External Balance Indicators								
	Reserves (at year end) as number								
	of months of imports of the year	2.5	5.3	4.9	8.6	8.4	6.0	6.6	7.0
	Export Growth (US $)	9.2	-1.5	3.8	20.0	18.4	20.7	5.3	2.6
	Import Growth (US $)	13.5	-19.4	12.7	6.5	22.9	28.0	6.7	5.8
	Current Account Deficit (% of GDP)	-3.2	-0.4	-1.8	-0.4	-1.1	-1.8	-1.0	-1.5
	Debt Service Ratio	35.3	30.2	27.5	25.6	26.2	24.3	21.4	18.3
IV.	Social Indicators								
	Life Expectancy (m years)	58.7	59.4	60.8	N.A.	N.A.	N.A.	62.4	
	Birth Rate (per thousand)	30.2	29.5	29.2	28.7	28.7	28.3	27.4	
	Death Rate (per thousand)	9.7	9.8	10.1	9.3	9.3	9.0	8.9	
	Infant Mortality Rate (per thousand)	80.0	80.0	79.0	74.0	74.0	74.0	72.0	

Tendulkar addresses the issue of whether the increase in poverty was in any sense caused by the reforms and also the related issue of whether it could have been avoided by following a different set of policies. He explains the increase in poverty in 1992, especially in rural areas, in terms of decline in foodgrain production in 1991-2 which lowered rural incomes generally and the associated increase in food prices which lowered real consumption levels of the poor in both urban and rural areas. According to Tendulkar, increase in food prices was primarily the result of fall in foodgrain production which had nothing to do with the reforms though it was perhaps exacerbated by the effect of the devaluation of the rupee in 1991, which increased import parity price, and therefore also domestic market price, of foodgrains.

Table 2.2 Trends in Poverty in India: Alternative Measure

	Per cent of Population in Poverty		Poverty Gap*	
	Urban	Rural	Urban	Rural
1983 (January-December) **	38.33	49.02	9.95	13 86
1986-7 (July-June)	35.39	45.21	9.49	12.21
1987-8 (July-June)**	36.52	44.88	9.34	11.26
1988-9 (July-June)	35.07	42.23	8.91	10.20
1989-90 (July-June)	34.76	36.69	8.88	10.20
1990-1 (July-June)	35.04	37.48	8.96	9.11
1991 (July-December)	34.79	40.07	8.83	9.33
1992 (January-December)	36.37	46.12	9.37	11.81
1993 (January-June)	38.86	44 19	9.97	10.46
1993-4 (July-June)**	30.94	39.65	7.53	9.29

Source: Tendulkar (1997).

Notes: * The poverty gap is defined as the ratio (expressed as a percentage) of the aggregate poverty gap for all poor households to the minimum normative expenditure needed if all the poor households are to be pulled up to the poverty line The poverty gap is therefore a measure of both the extent and depth of poverty.

** Surveys for these years were based on the full sample. All other years are based on the thin sample.

It is difficult to determine whether the increase in poverty could have been avoided by a different mix of policy. One can postulate a counterfactual situation where this is attempted by expanding the scale of income-generating poverty alleviation programmes, which would have raised incomes of the poor, or by expanding the supply of subsidized foodgrains through the public distribution system to moderate rise in foodgrain prices for those years. However, both options would have required additional budgetary expenditures which would have been difficult to finance given the severe fiscal constraints affecting the economy at the time. Expanding supplies through the PDS would also have required additional imports of foodgrains to supplement domestic availability and this would have required additional foreign exchange, which was in short supply. All these considerations suggest that the measured increase in poverty in the first two years of reforms was largely due to exogenous factors and was probably unavoidable given the severe constraints on policy at the time. In any case it is important to note that the deterioration was short-lived and was almost completely reversed by 1993-4.

POST-STABILIZATION PERIOD 1994-5 TO 1997-8

The aim of policy in the post-stabilization period was to achieve sustainable acceleration in growth and here too the results were impressive. GDP grew at an average rate of 7.5 per cent in the three years 1994-5 to 1996-7, before slowing down to 5.1 percent in 1997-8. The slowdown in 1997-8 is a matter for concern—and I will return to this issue later in this chapter—but it is important to note that despite the slowdown average growth rate in the four years 1994-5 to 1997-8 was 6.9 per cent, significantly higher than the growth rate of 5.6 percent achieved in the 1980s. Four years is not a long enough period to claim that the economy has been firmly put on a sustainable 7 per cent growth path, but there is little doubt that growth in the post-reform period was faster than in the pre-reform years. It was also faster than targeted. The growth rate achieved in the Eighth Plan period 1992-3 to 1996-7 was 6.8 per cent, exceeding the Plan target of 6.5 per cent. India's growth in the post-reform period also compares favourably with the performance of other developing countries. As shown in Table 2.3, India's post-reform growth rate was higher than the growth of all

developing countries taken together. Comparing India with the twelve largest developing countries, we find that China, Indonesia, Malaysia, Thailand, and Chile grew faster than India in the post-reform period while India grew faster than the other seven.

An encouraging aspect of India's experience is the behaviour of investment in the post-reform period. Latin American countries undertaking economic reforms in the 1980s experienced sharp decline in public investment without compensating acceleration in private investment with the result that the rate of investment in many of these countries declined significantly and stayed depressed for a long period. In India too, fiscal discipline did lead to decline in public sector investment as a percentage of GDP in the post- reform period, but this was offset by an increase in private investment in both the corporate and household sectors (see Table 2.4). Total investment as a per cent of GDP therefore did not decline compared to the pre-reform period and by 1995-6 it had actually increased to levels higher than before the reforms. However, it is important to note that the rate of investment in the later years increased only modestly and the average rate of investment in the post-reform period is only marginally higher than in the pre- reform years. The fact that GDP growth accelerated significantly after the reforms even though investment rate was only marginally higher suggests that productivity growth was higher—precisely the outcome one would expect from efficiency-oriented structural reforms.

Table 2.3 : India's Growth Performance Relative to Other Developing Countries
(Average annual growth of GDP)

	Pre-reforms 1980-90	Post-reforms 1992-7
India	5.8	6.6
*All Developing Countries**	3.0	2.7
- East Asia	7.7	10.2**
- Sub-Saharan Africa	1.9	1.9**
- Latin America & the Carribbean	1.6	3 .2**
- Middle East & North America	0.8	2.9**
Twelve Largest Developing Countries		
China	10.2	11.2
Indonesia	6.1	7.2
Thailand	7.6	7.3
Malaysia	5.2	8.4
Philippines	1.0	3.7
Mexico	1.0	2.3
Brazil	2.7	3.3
Argentina	-0.3	5.4
Chile	4.1	7.2
Venezuela	1.1	1.6
Turkey	5.3	4.8
South Africa	1 3	1.7

Source: Global Economic Prospects for Developing Countries, World Development Indicators and Sovereign Credit Ratios, J. P. Morgan Securities Inc. 1998.

Notes: * Estimates are for 1981-90 from Global Economic Prospects for Developing Countries.

** Estimates are for 1991-6

Table 2.4: Gross Fixed Capital Formation by Type of Institution
(% of GDP current prices)

	ANNUAL AVERAGE							
	1980-1 TO 1984-5	1985-6 TO 1990-1	1991-2	1992-3	1993-4	1994-5	1995-6	1996-7
PUBLIC SECTOR	9.6	10.2	9.5	8.5	8.3	8.8	8.0	7.2
PRIVATE CORPORATE SECTOR	3.4	3.6	5.7	5.9	6.2	66	8.0	8.1
HOUSEHOLD SECTOR	6.6	8.0	6.9	8.0	7.1	6.9	8.3	8.7
TOTAL	19.6	21.8	22.1	22.4	21.6	22.3	24.3	24.0

Source: Central Statistical Organization, *National Accounts Statistic* 1997.

Inadequate public investment in the post-reform period had an adverse impact on the economy in one respect. It led to serious under-investment in critical sectors of infrastructure such as electric power generation, roads, railways, and ports. The addition to power generation capacity in the public sector during the Eighth Plan was only a little over half the target and there were similar shortfalls in capacity creation in roads and ports. These shortfalls would not have mattered if capacity in the private sector had expanded, but this did not happen either. The end result was that total investment in infrastructure development was less than it should have been, leading to large infrastructure gaps[3]. These inadequacies did not come in the way of achieving higher economic growth in the post-reform years because there was some slack in the system, but there can be no doubt that rapid growth will be difficult to sustain in future unless investment in infrastructure can be greatly expanded.

The high growth of the post-reform period was also accompanied by an improvement in the external payments position. The current account deficit has varied between 1 percent and 1.8 percent of GDP and foreign exchange reserves have been comfortable throughout. Exports grew significantly for the three years after 1992-3, averaging 20 per cent dollar growth per year between 1993-4 and 1995-6, but then slowed down sharply in 1996-7 and yet again in 1997-8 (see Table 2.1). This decelaration in exports is in pan a reflection of slower growth in world trade in 1996 and 1997 measured in US dollars but even so, it is a matter of deep concern for the future. India's external debt indicators improved continuously in the post-reforms period. The debt service ratio had reached a worrying 35.3 per cent level in 1990-1 but it declined to 18.3 per cent in 1997-8 (see Table 2.1). Other indicators such as debt to GDP ratio, and debt to exports ratio, also show substantial improvement.

No definitive answer can be given to the all important question of what happened to poverty in the post-stabilization period since no poverty estimate is available after 1993-4. We know from past experience that there was no significant trend in poverty from the mid-1950s to the late 1970s, when per capita income grew at very low rates, but this changed after the late 1970s as growth rates accelerated, leading to steady though not dramatic decline in poverty. Projecting on this basis, acceleration in growth after 1993-4 must have led to a resumption in the declining trend of poverty in the post-stabilization period but in the absence of survey data this is at best a plausible projection. Data on social indicators such as life expectancy and infant mortality also provide some indication of the living standards of the poor and the information available is summarized in Table 2.1 These indicators show continuing improvement in the post-reform years which is consistent with the hypothesis of a continuing decline in poverty after 1993-4. However, these positive indicators notwithstanding, it remains true that progress in reducing poverty in India is much less impressive than

[3] For a detailed discussion of problems affecting infrastructure issues in developments in India's reforms see Ahluwalia (1997).

witnessed in East and South East Asia in the 1970s and 1980s. Replication of such success would provide a much more powerful constituency in favour of reforms than has been the case thus far. However, this calls for more rapid rates of growth than we have seen thus far, sustained over a longer period and also a stronger effort at improving social development through greater government activism in this area.

The slowdown in GDP growth witnessed in 1997-8 is a worrying feature of the post-stabilization period. As noted above, the average rate of growth in the post-reforms period remains respectable even after including the slower growth in 1997-8, but it is certainly relevant to ask whether 1997-8 was a purely temporary downturn or whether it reflects the restraining impact of specific constraints which, if not tackled urgently, could force a return to a lower growth path. This issue is examined in the fourth section of this chapter.

MACROECONOMIC BALANCE AND THE FISCAL DEFICIT

High fiscal deficits in the 1980s was one of the root causes of the crisis of 1991 and reducing the fiscal deficit was therefore a critical macroeconomic objective of India's reforms. This was particularly important in the initial years, when the country was subject to the discipline of an IMF programme in which fiscal deficit reduction was a key component. It was also important in the medium term as a means of reducing real rates of interest in the economy and creating conditions in which private investment would expand rapidly.

There was encouraging progress at the start of the reforms, when fiscal deficit was reduced from 8.3 per cent of GDP in 1990-1 to 5.9 per cent in 1991-2, but performance thereafter was disappointing. As shown in Table 2.1, the deficit declined only marginally in 1992-3 and then increased to 7.4 per cent in 1993-4. It declined again thereafter, but remained well above the Finance Ministry's medium-term target. In 1993 the Ministry had projected a fiscal deficit target of 3 per cent by 1996-7.[4] The actual fiscal deficit in 1996-7 was 5.2 per cent of GDP, more than 2 percentage points higher than the target, and it deteriorated further to 6.1 per cent in 1997-8. These figures refer only to central government fiscal deficit. If the deficit of state governments were to be added, the combined fiscal deficit would have been around 7.5 per cent in 1997-8, which is much higher than in most other developing countries.

The inability to reduce fiscal deficit in line with expectations is one of the most disappointing aspects of India's reforms. Some indication of what went wrong can be gleaned from the trends in revenues and expenditures summarized in Table 2.5. The sharp reduction in fiscal deficit in 1991-2 was achieved through a combination of significant decline in expenditure as a percentage of GDP and marginal increase in revenues. Total expenditure continued to decline as a percentage of GDP in subsequent years but total revenues also declined. The lack of buoyancy in revenues was the principal reason why the fiscal deficit could not be reduced. The scope for reducing the deficit in future depends upon the scope for reducing expenditures or increasing revenues as a percentage of GDP.

THE SCOPE FOR REDUCING EXPENDITURE

It is tempting to conclude that further reduction in expenditure as a percentage of GDP should be attempted to reduce fiscal deficits in future. However, the scope for reducing expenditure is probably limited. As shown in Table 2.5, all items of expenditure except interest payments already show a steady decline as a percentage of GDP in the post-reforms period. On the face of it therefore, the fiscal problems of the economy are not due to unbridled growth of public expenditure. In fact many would argue that India needs much larger volumes of public expenditure in health, education, and other social sectors to close the gaps which exist at present between India and other Asian countries. It is now widely recognized that closing these gaps is essential not only as part of the strategy for poverty reduction, but also as an essential precondition for transiting to an employment-generating, high growth path. Apart from expenditure in the social sectors, there is also need for larger expenditure in certain types of economic infrastructure, especially in rural areas, which can only be financed through the budget.

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[4] See, *Economic Reforms: Two Years after and the Tasks Ahead,* Finance Ministry, 1993. The fiscal deficit target of 3 percent was broadly consistent with the Eighth Plan projections which envisaged an average fiscal deficit of 4 per cent in the five years 1992-3 to 1996-7.

Table 2.5 Structure of Central Government Revenues and Expenditures
(Percentage of GDP)

	1990-1	1991-2	1992-3	1993-4	1994-5	1995-6	1996-7	1997-8
I. Total Revenues	11.33	12.18	11.69	10.19	10.89	10.74	11.11	10.52
Tax Revenues*	8.03	8.12	7.66	6.67	7.13	7.46	7.76	7.01
Non-tax Revenues	2.24	2.59	2.85	2.75	2.50	2.57	2.68	2.78
Recovery of Loans	1.07	0.98	0.90	0.77	0.67	0.59	0.62	0.67
PSU Disinvestment	0.00	0.49	0.28	—	0.59	0.13	0.05	0.06
2. Total Expenditure	19.66	18.06	17.38	17.71	17.00	16.23	16.15	16.63
Interest	4.01	4.31	4.41	4.59	4.66	4.55	4.67	4.65
Defence	2.88	2.65	2.49	2.73	2.46	2.44	2.36	2.55
Subsidies	1.79	1.59	1.33	1.34	1.22	1.10	1.14	1.30
Plan Expenditure	5.30	5.02	5.20	5.45	5.01	4.22	4.38	4.29
Other Expenditure	5.68	4.49	3.95	3.60	3.65	3.92	3.60	3.84
3. Fiscal Deficit (2-1)	8.33	5.89	5.70	7.52	6.10	5.48	5.04	6.11

Note: * Tax revenues shown in this Table are net of the states' share in shareable taxes. Figures in this table are therefore different from those in Table 2.6 which are on a gross basis.

In order to expand expenditure in these areas it is necessary to reduce expenditure in other areas so that total expenditure, as a percentage of GDP is kept under control. This calls for thorough review of government expenditures and staffing patterns to bring about operational economies, discontinue less important programmes, and reduce inefficiently targeted subsidies. There is also a very strong case for reducing the size of what is clearly a bloated bureaucracy.[5] Expenditure reduction is therefore critical for fiscal management, but more to provide room for other expenditures to expand than to bring about a reduction in total expenditure as a percentage of GDP. These limitations on our ability to reduce total expenditure as a percentage of GDP suggest that we must look to revenue buoyancy as the principal means of reducing fiscal deficits in future.

THE NEED FOR BUOYANT TAX REVENUES

As shown in Table 2.5, tax revenues flowing into the central budget actually declined as a percentage of GDP in the first three years of reforms. The declining trend was reversed after 1993-4 but even so, tax revenues in 1997-8 as a percentage of GDP were about 0.5 percentage points below the pre-reforms level, whereas they should have been 1.5 percentage points higher. This decline in the tax ratio points to serious weaknesses in the tax system despite extensive reform of both direct and indirect taxes undertaken as part of the reform programme. India's tax reforms were based on the Reports of the Tax Reforms Committee (Chelliah Committee) appointed in 1991 which aimed at simplifying the tax structure, by moving to moderate rates of tax in line with trends in other countries, and relying upon base broadening and improved tax administration to yield strong revenue growth. It is important to consider why revenue buoyancy has been inadequate despite these reforms.

[5] The recent Pay Commission report had in fact recommended a 30 per cent reduction in size of the bureaucracy to be implemented over a period of tune is part of A package involving significant pay increases, but no decision has been taken on this part of its recommendations.

In the area of direct taxes, reforms have succeeded in establishing a regime of moderate tax rates which compare reasonably well with other countries. The maximum rate of personal income tax has come down from 56 per cent at the start of reforms to 30 per cent in 1997-8. The rate of corporation tax on Indian companies, which varied from 51.75 percent to 57.5 percent in 1991-2, depending upon the nature of the company, has been unified and reduced to 35 per cent. Despite these reductions in rates, revenues from personal and corporate taxes have remained buoyant as indicated by the continuing increase in these revenues as a per cent of GDP (see Table 2.6). The share of direct taxes in GDP is still too low, but it has increased steadily over time from 2 per cent in 1990-1 to 3.5 per cent in 1997-8. On the whole, this appears to be an area where the strategy of reform seems to be working fairly well and needs to be continued, with special emphasis on broadening the tax base and improving compliance by reducing under-reporting of taxable income.

Table 2.6 Trends in Tax Revenues

(Percentage of GDP) (Rs crore)

	Income Tax	Corporation Tax	Union Excise	Customs	Other Taxes	Total Central Taxes (excl. UT Taxes)
1990-1	1.00	1.00	4.58	3.85	0.11	10.54
1991-2	1.09	1.27	4.56	3.61	0.19	10.72
1992-3	1.12	.26	4.37	3.37	0.24	10.36
1993-4	1.13	.24	3.91	2.74	0.18	9.19
1994-5	1.2S	.43	3.88	2.78	0.22	9.56
1995-6	1 39	.47	3.59	3.20	0.26	9.92
1996-7	1.43	.45	3.52	3.36	0.30	10.06
1997-8	2.03*	.51	3.37	2.90	0.26	10.07

Note: * Includes Rs 10,050 crore as tax paid under the Voluntary Disclosure of Income Scheme, an amnesty scheme introduced in 1997-8.

Customs revenues declined steadily as a percentage of GDP in the initial years and then stabilized at a lower level. In view of the explicit intention of reducing levels of protection in the economy, the loss of revenue from customs duties is not unexpected and should be viewed as an acceptable cost of tariff reforms.[6] As argued later in this chapter, customs duty rates have to fall further in future, which implies that this cannot be a source of increasing the tax ratio in the years ahead. At best we can hope to avoid a further decline in the ratio of customs duties to GDP despite a continuing decline in duty rates because the removal of quantitative restrictions on consumer goods, which is part of the reform agenda, will add to the buoyancy of customs revenues as these imports are likely to be at the upper end of the duty rate structure.

Excise duties are a major source of indirect tax revenue in India and performance in this area has been unexpectedly weak. Excise duties as a percentage of GDP declined from 4.3 per cent of GDP in 1990-1 to 3.4 per cent in 1997-8. Had the tax ratio increased over this period, as it should have in view of the fact that the industrial sector, which is the base for excise duties, has grown faster than GDP, fiscal deficit would have been significantly lower. The reasons for poor performance of excise duties need to be carefully studied so that corrective action can be taken.

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[6] The impact of falling average tariff rates on customs revenues could in principle be offset if the import share in GDP increased proportionately more than proportional reduction in average tariffs, but this is unlikely with any reasonable assumptions about import price elasticities and likely changes in import intensity of production.

Ideally, the domestic indirect tax system should have been convened into a full-fledged VAT which integrates the tax system from manufacturing down to retail sales, creating a self-reinforcing chain of tax compliance. Experience in other countries shows that a shift to VAT would help improve revenue generation but this is not possible in India under the present constitutional division of powers, whereby excise duties at the production stage are levied by the central government while sales taxes at the wholesale or retail level are levied by states. In the absence of VAT, India had introduced a modified VAT (called Modvat) under which credit was given for excise taxes paid on inputs against excise taxes due on outputs, thus avoiding cascading of excise duties. This system was extended and rationalized during the reforms in various ways. The tax credit facility (Modvat facility) was earlier not available for all products and has now been made almost universal in coverage. Earlier, credit was given only for duties paid on inputs but since 1995 it has been extended to duties paid on capital goods. The number of duty rates has been reduced and some exemptions removed. These efforts at rationalizing the excise duty structure were expected to lead to a rising share in the ratio of excise revenue to GDP, but in fact excise revenues have declined steadily.

It is possible that expansion of the Modvat facility to all goods, including capital goods, as part of the tax reforms was not accompanied by a sufficient increase in excise duty rates on final products to maintain revenue buoyancy. In a system where full tax credit is being given for all inputs and for capital goods, excise revenue mobilization (net of Modvat credit) depends upon revenue realization from excise duties on final consumption. Unfortunately, India's excise duty structure contains too many consumer products which are either exempted from excise altogether or attract relatively low rates of duty.[7] Tax reformers usually recommend a tax structure characterized by a single duty rate, with additional duties to be levied on luxury items, as most likely to improve tax compliance and to increase revenues.[8] Even if a single rate proves difficult to implement immediately, it is desirable to move to a rate structure with at most three rates as soon as possible. However, this implies an increase in excise duty rates for a large number of currently low taxed consumer items. It is necessary to create public awareness that across the board increases of this sort, implemented as part of a strategy of rationalization in which other tax rates are reduced, does not increase the burden of taxation on the average commoner.

STRUCTURAL REFORMS

India's efforts at structural reforms covered the familiar gamut of decontrol of private investment, opening up the economy to foreign trade and foreign investment, financial sector reforms, etc. This familiar package of market-oriented reforms was supplemented by efforts to strengthen various anti-poverty programmes reflecting a widely shared perception that liberalization by itself would not provide adequate flow of benefits to the poorest sectors of population at least in the short run. In this section the extent of change actually implemented in the critical areas of structural reform, indicating the degree of consensus on each of these issues across the political spectrum is evaluated. Multifaceted reforms also raise issues of sequencing because the effectiveness of reforms in one area depends upon the implementation of reforms in other areas. These issues where they are especially important, or have been the focus of public debate are touched upon.

REMOVING CONTROLS ON PRIVATE INVESTMENT

India's industrial environment before the reforms was characterized by pervasive government controls on private investment, which prevented entrepreneurs from responding quickly and flexibly to market signals. Reducing these controls was essential to create a

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[7] This structure has arisen because of the tendency in the past of giving relief to consumers by lowering rates on or exempting consumer products while maintaining high duties on intermediate inputs. With tax credits being given on inputs and capital goods net revenue realization depends largely upon taxes imposed on final consumption. This means that the tax system must be extended to cover consumer goods.

[8] It has been estimated that if the present excise duty system with multiple rates were to be replaced by a uniform rate of duties of 17 per cent on all items it would generate the same amount of revenue with enormous efficiency gains in administration.

more competitive industrial environment and this part of the reform agenda—broadly described as domestic liberalization enjoys wide political support across parties. Major progress has been made in this area as far as central government controls are concerned.

Industrial licensing was a major instrument of control under which central government permission was needed for both investment in new units (beyond a relatively low threshold) and also for substantial expansion of capacity in existing units. Licensing was undoubtedly responsible for many of the inefficiencies plaguing Indian industry.[9] In a series of steps, licensing was abolished for all except six industries, viz. alcoholic beverages, cigars and cigarettes, electronics, aerospace and defence products, hazardous chemicals, and pharmaceuticals. Another major achievement was the abolition of the special permission needed under the MRTP Act for any investment by the so-called 'large houses'.[10] This was an additional instrument of control over large private companies or companies belonging to large groups, in addition to industrial licensing. Its stated objective was to prevent 'concentration of economic power' but in practice it only served as another barrier to entry, reducing potential competition in the system. Abolition of these controls has given Indian industry much greater freedom and flexibility to expand existing capacity, or to set up new units in a location of their choice, thus increasing the pressure of competition, as well as the ability to face competition.

Major progress has also been made in opening up areas earlier reserved for the public sector. At the start of the reforms, eighteen important industries, including iron and steel, heavy plant and machinery, telecommunications and telecom equipment, mineral oils, mining of various ores, air transport services, and electricity generation and distribution, were reserved for the public sector. This list has been reduced to six, covering industries such as arms and ammunition, atomic energy, mineral oils, atomic minerals, and railway transport. Because of this liberalization, private investment including foreign investment has flowed into areas such as steel, telephone services, telecommunications equipment, electricity generation, petroleum exploration development and refining, coal mining, and air transport, none of which would have been possible earlier because of public sector reservation.

An area where domestic liberalization has made very little progress is in the policy of reserving certain items for production in the small-scale sector defined in terms of a maximum permissible value of investment in plant and equipment.[11] The policy 'protects' small-scale units by barring the entry of larger units into reserved areas and also prevents existing small-scale units from expanding beyond the maximum permissible value of investment. India is unique in adopting reservation as an instrument for promoting small-scale producers and the policy obviously entails efficiency losses and imposes costs on consumers. Several committees have recommended various degrees of dilution of the reservation policy. Most recently, an Expert Committee on Small Enterprises set up in 1995, has recommended that reservation should be completely abolished and efforts to support

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[9] Industry licensing reduced competition by acting as a barrier for new entry ostensibly to avoid emergence of 'wasteful' surplus capacity. It encouraged the establishment of smaller sub-optimal scale plants, partly in order to encourage a broader spread of entrepreneurship. The system was often used to push new units into backward areas in the hope of promoting regional equity. The system also discouraged systemic project evaluation by banks and financial institutions by creating a presumption in favour of supporting projects which had received licensing approval from the government. The inefficiencies generated by the system in turn became the excuse to seek tailor- made protection through protective trade policies.

[10] In 1991 an Indian company was considered a large house for purposes of the MRTP Act if the total assets of the company either by itself, or together with the assets of related group companies equalled or exceeded Rs.100 crores.

[11] The policy of reservation was first introduced in 1967 and the list of reserved items originally consisted of 47 items. This was later expanded to 800 in 1997 though the actual expansion in coverage was less than it appears because many of the items in the expanded list consisted of elaborations of sub-items within a broader definition in the original list.

small-scale producers should focus instead on positive incentives and support measures. None of the governments in the post-reforms period have been inclined to accept a drastic reorientation of policy along these lines. The United Front government in 1997 mitigated the rigours of reservation by raising the investment limit for small-scale industries from Rs.60 lakh to Rs.3 crore. It also removed 15 items from the reserved list. Its successor, the BJP-led government, has announced the de-reservation of farm implements.

Many of the items on the reserved list are such as would in any case be produced in the small-scale sector, but a reconsideration of the reservation policy is urgently needed in areas such as garments, toys, shoes, and leather products. These are areas with large export potential but reservation prevents the development of domestic units of the size and technology level that can deliver the volume and quality needed for world markets. Some flexibility was introduced in 1997 by allowing larger units to be set up in these sectors provided they accepted an obligation to export 50 per cent of production. It remains to be seen whether this modification will provide sufficient incentive to encourage producers to set up larger capacities to tap export markets.

While central government controls on investment have been greatly liberalized except in the matter of small-scale reservation, little has been done about controls at the state level. Investors typically complain of having to obtain a very large number of separate state government approvals relating to acquisition of land, electricity and water connections, conformity with regulations regarding facilities to be provided for labour, various safety and pollution-related clearances, etc. These controls generate harassment, delays, and petty corruption and are viewed as major impediments by both domestic and foreign investors. Reforms to eliminate unnecessary controls at state level are urgently needed to complement decontrol at the central level. Some state governments are trying to streamline the system, and these efforts are being spurred by growing competition among states to attract both domestic and foreign investment. However, the situation varies from state to state and much more needs to be done in this area.

OPENING THE ECONOMY TO FOREIGN TRADE

Opening the economy to trade and foreign investment with a view to reaping the potential benefits from greater integration with the world economy was an important objective of the reforms. Unlike the effort to reduce controls on domestic industry, which enjoyed wide support, there was less consensus on external liberalization. Spokespersons for Indian industry initially voiced strong support for both domestic liberalization and external liberalization, especially liberalization of access to imports of components and capital goods. As tariff levels came down and the pressure of competition from imports increased, concern began to be expressed about the need to provide an adequate transition period for domestic industry to adjust to external liberalization, in particular the need to create a 'level playing field' by first removing domestic policy constraints afflicting domestic firms which made it difficult for these firms to become competitive. This was sometimes expressed as an issue of sequencing, in which it was argued that domestic liberalization must precede external liberalization. While the debate on these issues continues, a consensus of sorts has evolved in favour of a gradualist process of external liberalization. Significant progress has been made towards this objective over the past seven years by removing quantitative restrictions and lowering tariff barriers, though the process is not yet complete.

Dismantling quantitative restrictions

India's trade policy regime before the reforms was heavily dependent upon the use of quantitative restrictions (QRs) in the form of import licences, more than almost any other developing country. Imports of finished consumer goods were simply not allowed and even inputs into production such as raw materials, components, and capital goods were subject to restrictions through import licensing. The system began to be administered more liberally in the 1980s, with import licences being much more freely given, but it remained restrictive and also highly discretionary. The first phase of dismantling QRs occurred in the first two years of the reforms when import licensing was virtually abolished for imports of industrial raw materials, intermediates, components, and capital goods. By 1993, these categories could be imported freely, subject only to the prevailing tariff levels. However, agricultural products

and industrial consumer goods remained subject to import controls. Import restrictions on agriculture were probably redundant as India's agricultural product prices were typically lower than import prices and agriculture actually suffered from negative protection via export controls. Restrictions on imports of consumer goods on the other hand provided substantial and open-ended protection for all industrial consumer goods, which account for about 25 per cent of the manufacturing sector in terms of value added.

Continuing with a near infinite protection for consumer goods while liberalizing other imports has been widely criticized as illogical because it only distorts resource allocation in favour of highly protected consumer goods industries and away from basic and capital goods industries which are otherwise thought to be 'strategically' important. This was recognized at policy level and the need to extend import liberalization to consumer goods as part of the reforms was explicitly stated in the Eighth Plan as early as 1992, but implementation of this element of trade policy has been very slow because of perceived political sensitivity.[12] Predictably, once the balance of payments improved, the QR regime was challenged by India's major trading partners as inconsistent with the WTO. This led to protracted negotiations, which culminated in the United Front announcing, in 1998, a plan to phase out QRs on all imports within a period of six years. This was accepted by all the major trading partners except the US. The phase out will occur in three stages with most QRs being phased out in the first three years while QRs on agricultural products will be phased out only at the end of the period. The commitment to phase out QRs has been endorsed by the BJP government which took the first step in the process by removing QRs on 350 items in April 1998. This still leaves about 2200 items subject to QRs to be removed over the next six years. In August 1998, the government unilaterally removed QRs on 2000 of these items for imports from the SAARC countries in order to give a boost to trade liberalization in the region.

Reducing tariffs

India's import duties before the reforms were among the highest in the world, with duty rates above 200 per cent being fairly common. Significant progress has been made in reducing tariff rates since then. The maximum tariff rate was brought down in a series of steps to 45 per cent in 1997-8 (see Table 2.7). Tariff rates below the maximum have also been lowered over the years, bringing the import-weighted average tariff rate for all products down from 87 per cent in 1990-1 to 30 per cent in 1998-9.

Customs duties were steadily reduced in the first five years. Duties continued to be lowered on a number of items in 1996 and 1997 but this was offset to some extent by the imposition of a 2 per cent surcharge on most imports in 1996 as a revenue raising measure, followed by another 3 per cent surcharge in 1997 to finance the burden of the large civil service pay rise announced in that year. The Budget for 1998-9, presented by the new BJP government, introduced an entirely new special customs duty. Several industry associations had complained that domestic producers were subject to certain local taxes, which were not balanced by equivalent taxes on imports in the same way as excise duties on domestic production are balanced by an equivalent 'countervailing duty' on imports. It was argued that these local taxes had the effect of reducing the protective element in the existing duty structure, and in certain cases where customs duties were low, the erosion was said to result in complete elimination of protection. Responding to these demands, a special additional duty on imports to balance the incidence of local taxes was levied initially at 8 per cent but quickly reduced to 4 per cent. This duty was widely criticized as signalling a retreat into protectionism, a charge vociferously denied by the government which pointed to the fact that

[12] A small window for import of some consumer goods did exist through the mechanism of Special Import Licences which were given to exporters as export incentive. These licences were freely tradeable and allowed imports of a defined list of otherwise banned consumer goods. The list of permissible imports was progressively widened but total flow of consumer goods through this window was very small. The premium on these licences varied from 8 to 10 per cent indicating the implicit additional nominal protection enjoyed by the items importable through these licences. Special import licences continue today as a window for imports of items otherwise not allowed to be imported.

the 1998-9 budget also reduced customs duties on a number of products, and in this respect continued the trend of tariff reduction of earlier years. The deadline for zero duty treatment of a number of electronic products, agreed to under the Information Technology Agreement-1, was also advanced by two years, signalling an acceleration of the process of opening up in this area.

Table 2.7 Import-weighted Customs Duty Rates

(Per cent)

	1990-1	1992-3	1993-4	1994-5	1995-6	1996-7	1997-8	1998-9
Whole Economy	87	64.0	47	33	27	25	25	30
Agricultural Products	70	30.0	26	17	15	15	14	16
Mining	60	34.0	33	31	28	22	22	20
Consumer Goods	164	144.0	33	48	43	39	34	39
Intermediate Goods	117	55.0	40	31	25	22	26	32
Capital Goods	97	76.0	50	38	29	29	25	30
Peak Rates of Duty	>200	110.0	85	65	50	52	45	45

Source: World Bank, *India 1998 Macro-Economic Update,* Annex Table 10.

Despite the new duties introduced in the past two years, the average rate of duty is much lower than in 1990-1 (see Table 2.7). However, average tariff levels in India are much higher than in other developing countries, where tariff rates typically range between 5 and 15 per cent. Since consumer goods continue to be protected by QRs, the tariff levels understate the degree of protection for these items. The process of reducing tariff levels clearly needs to continue to complete the reform process in this area.

Tariff reform in future must pay particular attention to the problem of tariff inversions, whereby duties on final products are lower than duties on inputs thus giving rise to very low or even negative protection in some cases. The duty on various types of steel for example is 30 to 35 per cent whereas the duty on capital goods ranges from 20 to 25 per cent and is even zero in some cases. Such tariff inversions did not matter earlier because of quantitative restrictions on imports of the final product but they obviously become very important once QRs are phased out. The problem has arisen in part because tariffs on many intermediate inputs were relatively high to begin with and the gradualist pace of reduction has left many of these tariffs at too high a level, while other tariffs have been reduced more rapidly.

There is a strong case for a pre-announced timetable for future tariff reductions. The Congress government had indicated that tariffs would be brought down to levels 'comparable with other developing countries' but had not specified either the final structure of tariffs or the time-frame for reaching it. The United Front government stated that it would move to Asian levels of tariffs by the year 2000 but the exact tariff structure was left undefined except in the case of hydrocarbons where a terminal year structure for 2002 has been indicated and for information-technology-related products where India has accepted the ITA-1 commitments. The BJP-led government has stated that it favours 'calibrated globalization', which implies that the process of reducing tariffs will continue, but again no specific time-frame has been spelt out. Gradualism in tariff reduction is justifiable but there is no reason why it should lead to uncertainty about the future. A clearer indication of target levels of tariffs over the next three to five years would help investors making decisions on new investments.

To summarize, India's tariff reduction programme, though still incomplete, has certainly created a more open economy, with significant beneficial effects as Indian firms are being

pushed to restructure their operations to become more competitive. The fact that protectionist noises from some segments of industry have increased in recent years indicates that this process is beginning to bite. Banks and financial institutions are also increasingly assessing the viability of new projects on the basis that the economy will continue to open up and tariffs will be reduced further. The pace of transition has been slow, consistent with the gradualist strategy, and it is necessary to continue lowering tariffs, focusing especially on tariff inversion problems. Fortunately the present levels of duly are now in the range where the remaining adjustment can be completed in two or three years.

Exchange rate flexibility

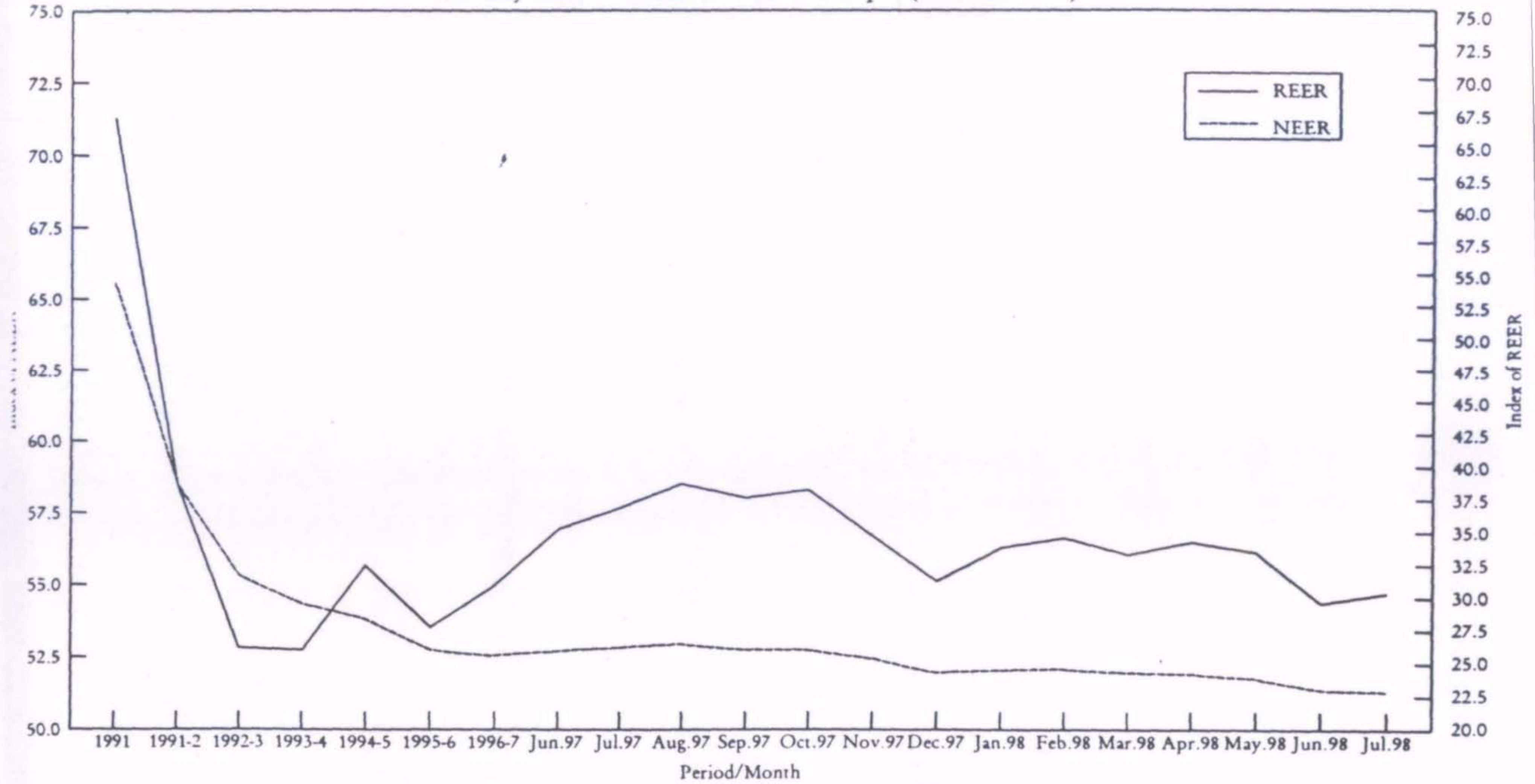
The removal of QRs and reduction in tariff levels described above would not have been possible but for parallel changes in exchange rate policy. The rupee was devalued in July 1991 by 24 per cent as part of the initial stabilization programme, and a dual exchange rate was introduced in March 1992. The dual exchange rate was unified shortly thereafter in March 1993 and the unified rate was allowed to float. The cumulative effect of these changes was that between June 1991 and March 1993 exchange rate depreciated from $ 1 = Rs.20 to $ 1 = Rs.31, a depreciation of 35 per cent in the dollar value of the rupee and a real depreciation (adjusting for price changes) of around 27 per cent *vis-a-vis* India's major trading partners. This adjustment in exchange rate clearly helped Indian industry meet the import competition resulting from trade liberalization.

The flexible exchange rate regime has worked reasonably well with the exchange rate responding to market conditions while the Reserve Bank of India (RBI) intervenes periodically through foreign exchange sales and purchases or through monetary fine tuning to 'maintain orderly market conditions'. Exchange rate management has avoided the danger of excessive rigidity and also the opposite dangers of overshooting with associated loss of confidence. Although there is no declared real effective exchange rate target the system has worked in a manner to preserve the advantageous real exchange rate achieved in the early years of the reforms. As shown in Fig. 2.1, the real exchange rate depreciated sharply at the start of reforms, and appreciated thereafter in 1994-5 and 1995-6, but this appreciation in real exchange rate was corrected in subsequent years, bringing real effective rate close to the level reached in 1993-4.

As part of the process of transiting to an open economy India declared full current account convertibility in 1994 and accepted the corresponding obligations of Article VIII of the IMF. Following this decision a number of steps have been taken to liberalize exchange restrictions on current account transactions. The United Front government in 1997 announced that the Foreign Exchange Regulation Act of 1973 would be repealed and replaced by a more modern Foreign Exchange Management Act (FEMA) but the government fell before this could be done. It is a measure of the continuity in policy that FEMA was subsequently introduced in 1998 by the successor BJP-led coalition.

POLICY TOWARDS FOREIGN INVESTMENT

The reforms involved a radical reorientation of foreign investment policy with foreign investment being actively sought not only as a preferred means of financing balance-of-payments deficits compared with external borrowing, but also because it provides access to closely held technology and to global marketing linkages. Both foreign direct investment (FDI) and portfolio flows have been encouraged in the post-reforms period with positive results in both cases.



Note : An increase (decrease) in the index means appreciation (depreciation) of rupee.

The process of approving FDI was expedited by providing a window of automatic approval of FDI up to 51 percent foreign equity in a defined list of 48 industries and up to 74 per cent for 9 high priority industries.[13] Foreign investment proposals which are not eligible for the automatic route can obtain approval from an inter-ministerial body called the Foreign Investment Promotion Board (FIPB). Approvals from FIPB are generally seen to have been speedily and liberally given. Despite widespread concerns about the BJP's attitude to foreign investment, the BJP-led coalition government continued this system and has announced its intention to expedite clearances and also set up mechanisms to help translate approvals into actual investment decisions.

The results achieved by the new policy are summarized in Table 2.8. Total approvals for FDI have increased from $ 325 million in 1991-2 to $ 16 billion in 1997-8. Actual inflows are of course much lower, reflecting the lag between approvals and inflows, but even these have increased from a negligible level of $ 133 million in 1991-2 to over $ 3 billion in 1997-8. This may not appear impressive compared to the volumes attracted by many other countries, but it represents a dramatic increase from earlier levels and it is growing. The change in the foreign investment environment in India is reflected in the fact that a large number of Indian companies have sought foreign joint venture partners while major foreign investors have focused on India for the first time. The latter category includes several of the Fortune 500 companies such as General Motors, Ford, Merck, Sony, Honda Motor, Coca Cola, Hewlett Packard, Texas Instruments, LG International, Fanuc, Samsung, Du Pont, AT&T, BT, Enron, Shell and a host of others. The amounts invested in most cases are as yet small, but the entry of such investors holds out the potential for substantially larger inflows in the years ahead.

Table 2.8 Foreign Investment Flows
(US $ million)

	1991-2	1992-3	1993-4	1994-5	1995-6	1996-7	1997-8
Total Approvals of FDI	325	1781	3559	4332	11,245	11,142	15,752
Total Flows of which:	133	559	4153	5138	4881	6008	4798
- Foreign Direct Investment	129	315	586	1314	2133	2696	3197
- Foreign Institutional Investors*	4	4	2047	1742	2065	1946	956
- GDRs issued abroad by Indian companies		240	1520	2082	683	1366	645

Note: * Represent fresh inflow of funds for portfolio investments by FIIs. Figures also include Offshore Funds

The economy was also opened to portfolio investment in two ways. In 1993, Foreign Institutional Investors (FIIs) meeting certain minimum standards were allowed to invest in Indian equity and later also in debt instruments through secondary market purchases in the stock market. Over 500 FIIs are now registered with the Securities and Exchange Board of India (SEBI) and around 150 are active investors. A second window for portfolio investment was provided by allowing Indian companies to issue fresh equity abroad through the mechanism of Global Depository Receipts (GDRs). This enabled Indian companies to raise resources from passive investors in world markets instead of seeking active investors as is the case with joint venture partners. Portfolio investment has expanded rapidly in the post-reforms period. From a level of $ 4 million in 1991 the inflow on account of FII flows and GDRs taken together quickly increased to $ 3.6 billion in 1993-4 and fluctuated thereafter. It declined to $ 1.5 billion in 1997-8 reflecting the effect of the Asian crisis on capital flows to

[13] Initially, the automatic approval was available subject to two conditions, viz. import of capital equipment should be covered by the inflow of foreign equity and dividends outflows in the case of consumer goods industries should be covered by export earnings. The condition relating to capital goods imports has since been removed.

emerging markets. Despite the often expressed concern about the volatility and unreliability of portfolio capital flows, India's experience in this area has been fairly encouraging. Inflows of portfolio capital have fluctuated but they did not turn negative even in 1997-8 during the East Asian crisis. The cumulative inflow of portfolio capital since the reforms began exceeds $ 15 billion, a significant amount in absolute terms even if it is associated with some potential for volatility.

While liberalizing inflows of FDI and portfolio capital, other elements of the capital account remained subject to controls though the controls were more flexibly administered. Corporations and individuals need government permission to borrow abroad and such permission is granted within a framework which places a cap on total external borrowing and also ensures a minimum maturity period for each borrowing. This policy has helped control India's exposure to external debt and in particular to avoid a build up of short-term debt which is viewed with particular disfavour in the aftermath of the Asian crisis. Foreign investors are allowed to repatriate dividends and capital freely but Indian residents are not free to take capital out of the country, a restriction which makes it easier to avoid panic overreaction in foreign exchange markets.

In 1996, the government appointed a Committee on Capital Account Convertibility to advise on the transition to full capital account convertibility. The Committee recommended moving to capital account convertibility over time in a phased manner, but emphasized that certain preconditions must be established first. These include a moderation in the rate of inflation, a reduction in fiscal deficit to 3 per cent, and also considerable strengthening of the domestic banking system to deal with stresses created by an open capital account. These conditions implicitly rule out any quick move to capital account convertibility. The recent experience of East Asian countries certainly suggests that there is merit in a cautious approach in this area.

REDUCING PRICE CONTROLS

Reduction, if not elimination, of price controls is a familiar component of market-oriented reforms everywhere and this was the case in India also. Price control was abolished at an early stage of the reforms in some key industries, viz. iron and steel, coal, phosphatic and potassic fertilizers, newsprint, naphtha, lubricating oils and molasses.[14] Price control on pharmaceuticals was not abolished but its coverage was reduced in 1995 from 143 basic drugs to 76. However, price control remains in place in three major areas, i.e. hydrocarbons, electricity, and nitrogenous fertilizers, introducing significant distortions in the system. Interestingly, though price decontrol is clearly a part of domestic liberalization which enjoys wide support in principle, there is great reluctance across all parties to implement it in practice.

Decontrol of hydrocarbon prices

The petroleum sector in India was fully state owned at the start of the reforms with the state also controlling imports of crude oil and production. Prices were determined by a complex administered price mechanism (APM) under which domestic producers of crude and natural gas were paid controlled prices, which were much lower than world market prices. Refineries also received controlled prices for their products based on the cost of crude oil supplied to them (either underpriced domestic crude or market-priced imported crude) plus a refining margin for each refinery based on plant- specific refining costs. Prices charged to consumers were also controlled and were expected to cover the cost of domestically produced and imported supplies. However, there was substantial cross- subsidization across products, with kerosene and diesel being underpriced, while gasoline and aviation fuel were overpriced. The inefficiencies in this system were extensive. Underpricing of crude oil discouraged exploration. Cost-based product prices paid to refineries gave them little incentive to reduce costs. Severe underpricing of kerosene led to pervasive black marketeering and adulteration

[14] Molasses is a byproduct of sugar and was earlier subject to price control along with partial price control in sugar under which 35 per cent of the output of sugar nulls is procured at a controlled price for sale through the public distribution system. Partial control on sugar prices continues.

of diesel with kerosene. Since consumer prices were not adjusted sufficiently frequently to reflect changes in the cost of imports, the system often generated deficits in oil sector accounts. The controlled price regime was particularly unsuitable for attracting private investment in either production or refining since private investors expected an assured structure of market-related prices.

In a major decontrol initiative, the United Front government in 1997 announced a phased deregulation of petroleum prices to be completed by 2002. The first step in 1997 was to fix domestic consumer prices of diesel, fuel oil, and LSHS on the basis of import parity, with monthly adjustments to reflect changes in import prices. Domestic crude oil and natural gas prices, as well as petroleum product prices paid to refineries, will be progressively adjusted within an APM framework to reach import parity prices by the year 2002 at which point they will be deregulated. Import parity pricing for crude and products is feasible only if the customs duty structure is rationalized to avoid anomalies in the present structure, where customs duty on crude oil is higher than on many products. The government has announced a duty rationalization, and the structure of customs duties in this sector to be achieved by 2002 has been published, though the annual phasing to reach that level has not been announced. Kerosene, which meets fuel and lighting needs of the poor, will continue to be subsidized, but this subsidy will be made explicit and met from the budget. Similarly naphtha, which at present is supplied at a subsidized price to the fertilizer industry, will be provided only at normal decontrolled price, requiring either an increase in fertilizer prices or an increase in fertilizer subsidy from the budget. The transfer of these subsidies of the budget will impose a severe fiscal burden but a successful transition to market prices in this important sector will be a major achievement with significant efficiency gains.

Control over electricity prices

Pricing of electricity is subject to regulatory control in most countries but the way it has operated in India is seriously flawed. Electricity prices charged to consumers are fixed by state governments and have been set very low for certain categories of consumers such as households and agricultural users, and this is one of the major reasons for the poor financial condition of SEBs.[15] The SEBs are expected to earn a rate of return of 3 per cent on capital employed but they actually earn a negative rate of -13.7 per cent with total losses amounting to Rs.10,000 crore or about 0.8 per cent of GDP. This is one of the main reasons why public investment in this sector has fallen below target. It is also the reason why it is difficult to encourage private investment in electricity generation since private investors are deterred by high risks of non-payment by financially weak SEBs which are the sole buyers.

A shift to a rational system of setting electricity tariffs is essential if investment in power, whether public or private, is to take place. The primary responsibility for such reforms rests with the state governments but the central government has an important catalytic role to play. In 1995, the Congress government announced a National Minimum Action Plan for power which sought to depolitcize electricity tariffs by entrusting tariff fixation to an independent State Regulatory Commission with terms of reference which would ensure that tariffs must cover costs and earn a 3 per cent return. The Plan sought to limit the extent of price distortion through cross-subsidy by stipulating that the maximum underpricing allowed to any category of consumer should not exceed 50 per cent of the cost of production nor should any consumer be charged more than 50 per cent above the cost of production. The successor United Front government introduced legislation to set up a Central Electricity Regulatory Commission but was not able to get it passed by parliament. The BJP government in 1998 was able to get parliamentary approval for a modified Central Electricity Regulatory Commission Act which sets up a central statutory commission to regulate all interstate sales and transmission of electricity, and set tariffs in such cases. The Act also provides for separate State Regulatory Commissions to be set up by individual states which

[15] Whereas the average cost of generation in 1996-7 was around Rs.1.86 per kwh, the tariff charged for domestic consumers was Rs.0.90 and for farmers it was as low as Rs 0.20. Some states have actually made power free for farmers. Low rates for these consumers are offset by higher tariffs for commercial and industrial users but even so average realization from sale of electricity is only 80 per cent of average cost.

will regulate the electricity sector within a state and fix all tariffs. Though the establishment of State level Commissions is not mandatory it is expected that a large number of states will enact the necessary legislation setting up state-level commissions. Another important step forward in electricity sector reforms was the passage of the Electricity Transmission Act in 1998, which opened transmission for private investment.

The process of reform in the power sector has made good progress in some states. Orissa was the first to restructure its power sector by setting up a state-level regulatory commission for fixing tariffs and unbundling the monolithic SEB into separate generation, transmission, and distribution corporations. It is currently engaged in privatizing distribution. Andhra Pradesh, Haryana and Rajasthan are considering similar reforms. It is difficult to say how fast these changes will be implemented in other states, but there is no doubt that the process has begun.

Price controls on nitrogenous fertilizer

Nitrogenous fertilizer is another important industry where prices continue to be fully controlled. Fertilizer factories are paid a cost-based plant specific producer price, and the government fixes a low consumer price for farmers. The difference between producer and consumer prices is met by a budgetary subsidy which amounts to about 0.7 per cent of GDP. The inefficiencies of the system have been noted by many critics. The cost-based, producer-price system provides insufficient incentive for cost reduction. Underpricing of nitrogenous fertilizers for farmers is also leading to wasteful use of fertilizers and distortion in the N:P:K ratio compared to the agronomically recommended norm. The resources absorbed by the subsidy have also increased consistently over time and it has been argued that the same resources would be far more beneficial 10 agriculture with superior distributional effect if directed to increase public investment in irrigation and other agriculture-related infrastructure.[16] While these concerns are well recognized, it has not been possible to change the system of pricing nitrogenous fertilizers.

LABOUR MARKET CONTROLS

An important area untouched by reforms thus far is the labour market. India's labour laws, which apply to all industrial units employing more than 100 persons, make it difficult for firms to either shed excess labour or close down unviable units. Indian firms complain that labour market rigidities make it difficult to achieve the levels of efficiency and competitiveness needed to survive in the more competitive and more open economic environment created by the reforms. They also discourage entrepreneurs from investing in relatively labour-intensive areas, which not only reduces employment below its full potential but also introduces an additional bias against exports since India's exports are typically at the labour-intensive end of the spectrum.

Labour rigidities also make it difficult for Indian companies to undertake much needed restructuring. Indian companies in the past were encouraged to enter into diverse lines of production outside their areas of 'core competence', often setting up plants of sub-optimal scale because the industrial environment provided assured protection from international competition with very limited domestic competition. In the present more competitive environment, these companies need to consolidate their position in core areas, where they must modernize and expand, while selling off other units to other entrepreneurs in a better position to manage and modernize them. Such restructuring should normally take place through mergers and acquisitions but it is more difficult in India because potential new owners are unwilling to take over existing units if they are burdened with surplus labour. They would rather set up a new unit, even though restructuring may be much cheaper if labour laws were less rigid.

It is sometimes argued that labour problems in India are exaggerated by inefficient managements as an excuse for management failures. Certainly, many well-run firms have been able to shed excess labour through generous voluntary retirement schemes. The costs incurred are significantly higher than the statutory minimum compensation payable under the

[16] See Ahluwalia (1996).

law, but this only reflects the fact that the statutory compensation requirements are very low. Restructuring through mergers and acquisitions has also become more common, especially after 1996. The attitude of labour unions has also changed considerably because of competition in product markets. Labour intransigence beyond a point in a competitive market situation only weakens the unit relative to its competitors and therefore militates against the interest of the labour employed in the unit. However, these factors do not negate the case for more rational labour laws. On the contrary, as protection levels are lowered further in future, Indian industry will need all the possible efficiency gains it can achieve to be internationally competitive and greater flexibility in the labour market will be an important prerequisite to achieve this goal. This is an area in which there is very little consensus anywhere in the political spectrum at present, but such a consensus will have to be developed.

PUBLIC SECTOR REFORMS

India's approach to public sector reforms has been much more cautious than that of other developing countries. Radical solutions such as outright privatization of commercially viable units and closure of unviable units, which have been attempted elsewhere, were eschewed to begin with, in favour of a much more cautious approach. In the 1980s public sector reforms focused on increasing the functional autonomy of public sector organizations to improve their efficiency. In the 1990s, this was combined with 'disinvestment' involving sale of a portion of the government equity in public sector enterprises while retaining majority control with the government. Unlike privatization *a la* Margaret Thatcher, which was driven by the conviction that government control makes public sector units inherently less efficient and privatization therefore improves economic efficiency and is good for the consumers, the policy of disinvestment in India was initially motivated largely by the need to raise resources for the budget. Equity sales took place intermittently through the post-reforms years, and by 1997-8 the government had sold varying proportions of equity, ranging from 5 per cent to 49 per cent, in fifty public enterprises, generating a total of over Rs.8400crore for the budget.[17] Partial privatization of this type can be legitimately criticized on the grounds that it is unlikely to yield the efficiency gains associated with full privatization including transfer of management. However, it needs to be recognized that even the induction of minority private shareholders makes some difference. It rules out budgetary subsidies to the enterprise, which is an important improvement in the incentive system. Public sector managers in partially privatized public sector enterprises become much more conscious of market indicators of performance such as earnings per share, dividends and share price, and this creates greater commercial orientation. Many public sector units also acquired international portfolio investors by making fresh issues of equity in international markets for the purpose of raising funds for their expansion programmes. The presence of private investors and especially international investors has helped create a climate in which public sector enterprise managers are able to extract greater *de facto* autonomy from the government.

Over time, insistence on maintaining government control in public sector enterprises was steadily diluted, and a broader consensus evolved towards eliminating government control in some areas. The United Front government in 1996, established a Disinvestment Commission and specifically requested the Commission to identify units in 'non-strategic and non-core' areas where government stake can be reduced to a minority or even to zero. The Commission has examined fifty public sector enterprises and recommended disinvestment of a majority stake, with transfer of management control, in several cases. Implementation of these recommendations has been slow, but effective privatization in a few PSEs, with private investors being offered a majority stake and effective management control now appears very likely in the near future. This clearly heralds a very different approach to public sector reform and this approach has been further reinforced by the BJP government's announcement that government stake in public sector enterprises will be reduced to 26 per cent 'in the generality of cases'.

The area of public sector reforms where very little has been done relates to the treatment of chronically loss-making public sector enterprises. While some of these units can be turned

[17] The total revenue realization has been less than targeted because market conditions in the last three years made it difficult to complete intended sales of equity.

around, many have been making losses for a very long period of time and are unlikely candidates for revival.[18] Summary closure of these units was ruled out in the early years of the reforms and the government decided instead chat the scope for reviving each unit would be carefully examined. Only those units where revival was found to be economically feasible would be revived while others would be closed down. The feasibility of revival was to be determined by the Board for Industrial and Financial Reconstruction (BIFR) and government would take a decision based on the Board's recommendations. Several public sector units have been identified as fit for closure through this process, and the government has even decided on closure in many cases, but no unit has actually been closed because the decision has been challenged in courts by labour unions. The BJP government in its first budget announced a generous retrenchment package to be offered in cases of closure in order to overcome labour opposition.

Have these efforts at partial privatization, combined with some effort to increase public sector autonomy, led to improved performance of public sector? Available data on the financial performance of public sector enterprises in the post-reforms period (see Table 2.9) show that the profitability of public sector enterprises as a whole has improved significantly in the post- reforms period. Gross profit (before deduction of interest) was 10.9 per cent of capital employed in 1990-1 and increased to 16.1 per cent in 1995-6. Since the economic environment became much more competitive over this period, it is reasonable to assume that increased profitability reflects improvements in operational

Table 2.9 Profitability of Public Enterprises

	1990–1	1991–2	1992–3	1993–4	1994–5	1995–6
No. of enterprises	236	237	237	240	241	239
Capital Employed (Rs crore)	1,02,084	1,17,991	1,39,930	1,59,836	1,62,451	1,73,874
Gross Profit before interest payments	11,102	13,675	15,957	18,556	22,630	27,989
Gross Profit as per cent of Capital Employed	10.9	11.6	11.4	11.6	13.9	16.1
Profit after interest payments before tax deduction	3501	4002	5200	6655	9768	14,065
Pre-tax profit as per cent of Capital Employed	3.4	3.4	3.7	4.1	6.0	8.1

As in so many other areas of structural reform, it seems reasonable to conclude that a process of public sector reform has clearly begun and the scope of what is feasible is now seen to be much wider than was the case initially. Bolder efforts at privatization of the public sector are called for, not only to mobilize larger volumes of resources, which would help reduce fiscal deficit, but also to generate greater efficiency in the public sector.

PRIVATE INVESTMENT IN INFRASTRUCTURE

It was recognized early in the reforms process that a faster growing economy would need major investments in infrastructure and these investments could not be financed solely by the public sector. Private investment to supplement public sector effort was seen as the solution and new policies were announced to encourage private (including foreign)

[18] Many of these perennially loss-making units are erstwhile private sector units which were headed for closure but were nationalized in the 1970s to prevent job losses.

investment in power generation, telecommunications services, ports, and roads. There has been some success in this area but the results thus far have fallen considerably short of expectations. In retrospect it is clear that the difficulties in attracting private investment into regulated sectors such as infrastructure were underestimated. Infrastructure sectors have many special characteristics. Tariffs are controlled and public interest issues are invariably involved. Private investors have to deal with a number of government agencies and are also subject to their regulatory control to a much greater extent than elsewhere. In these circumstances, special efforts are needed to create a policy environment in which good quality private investors will be encouraged to invest.

The experience of private investors in power and telecommunications provides many examples of problems which could have been avoided if the policy framework had been designed to deal with these difficulties.

• The early power projects were criticized on the grounds that the cost of private power was too high. This criticism gained credibility because tariffs were fixed on the basis of a cost plus formula which inevitably attracts the charge of cost padding. It could have been avoided if tariffs had been determined on the basis of competitive bidding, as was done later.

• Private sector power producers wanted fuel supply contracts which protected them from risks of fuel supply interruption by providing for sufficient compensation in the event of non-performance by either the public sector coal supplier or by the railways which have to transport coal to the power plant. Such contracts had never been signed for coal supplies to public sector projects and there was reluctance on the part of public sector suppliers to accept new obligations for private sector projects. The power policy had not anticipated the need to mitigate fuel supply risk.

• Private sector telecommunications projects could not achieve financial closure because lenders insisted that in the event of debt service default by original licensee, the telecom licence should be assignable at the option of the lenders to a new operator. The terms of the licence under Indian law did not provide for easy assignability and new provisions had to be devised to meet these requirements. This was an important source of delay in implementation.

• Private sector telecom operators claimed that the interconnection charges levied by the public sector network were too high, making it impossible for new operators to compete with the existing public sector operator. They also complained that the regulatory framework was inadequate because the government was both regulator and owner of the public sector network. Private operators demanded the establishment of an independent regulatory authority to adjudicate disputes with the public sector network. This demand was conceded and the Telecommunication Regulatory Authority of India was established in 1997. This has helped increase confidence levels but the scope of its authority is narrower than private operators would like.

• Cellular licences were awarded through competitive bidding on the basis of the licence fee bid. Subsequently market demand proved to be less than anticipated, making these projects unviable at the agreed licence fees. The licensees have appealed to the government for an adjustment of licence fees and an extension of the period of licence. The government is considering whether such adjustments can be made at this stage consistent with public interest and how to ensure transparency if this is to be done. In retrospect, a revenue-sharing arrangement would have provided a better method of protecting against the downside of market risk.

These problems illustrate the fact that a great deal of preparatory work is necessary if private investment is to play a significant role in infrastructure development. In particular, it is necessary to have much greater clarity about the regulatory framework within which the private sector will operate. The aim should be to create as close to a competitive situation as possible, with an unbundling of risks so that private operators can take on only those risks which it is reasonable to expect them to take. Since the complexity of these problems was not fully realized when the policies were initially introduced, there was a great deal of 'learning by doing'.

Fortunately, some learning has taken place and many private sector infrastructure projects have taken off successfully. The first two private sector power projects are now in commercial production and several others are at various stages of construction. Private telecommunication services (both cellular and basic) have commenced in various parts of the country. A major expansion of the Jawaharlal Nehru Port at Mumbai involving doubling of container handling capacity is being implemented on a BOT basis by a private consortium. Several minor ports are being built entirely in the private sector. Roads are the most difficult area for private investment, but a few small private sector toll road projects are being implemented, while other larger projects are being planned for the future. The extent of progress in implementing private infrastructure projects can be seen from the fact that total loan approvals for private infrastructure projects by the All India Financial Institutions have increased from Rs.5880 crore in 1995-6 to Rs.22,255 crore in 1997-8. Actual disbursement has increased from Rs.2332 crore to Rs 6505 crore in the same period.

REFORMING THE FINANCIAL SYSTEM

Structural reforms aim at reallocating real resources in the economy and this process needs to be lubricated by an efficient financial system. India's reform programme therefore included a concerted effort to reform banking and capital market institutions. There has been steady forward movement in these areas.

Banking sector reforms

Banking sector reforms were first initiated in 1992, based on the recommendations of the Committee on the Financial System (Narasimham Commitee), and the first stage focused on interest rate liberalization, improvement in prudential norms and standards, strengthening supervision, and increasing competition in the banking sector. In 1997, the United Front government appointed a second Committee on Banking Sector Reforms also under the chairmanship of M. Narasimham to review what had been accomplished and to chart the agenda for a second stage of banking sector reforms. The second Narasimham Committee submitted its report in 1998 and its recommendations are expected to guide banking reforms in the years ahead.

The pace of banking sector reforms exemplifies gradualist change. The achievements thus far are substantial though a great deal remains to be done.

• Interest rates have been almost completely decontrolled since 1991, when both the interest rate on government debt as well as the deposit and lending rates of commercial banks were strictly controlled. Mandatory requirements for investment by banks in low interest government securities have been sharply lowered and interest rates on government securities are now determined by the market on the basis of periodic auctions conducted by the RBI.[19] Deposit rates have been completely deregulated and lending rates have also been largely deregulated.

• Prudential norms and standards relating to capital adequacy, income recognition, asset classification, and provisioning have been upgraded and brought into closer alignment with the Basle Committee recommendations. The second Narasimham Committee has recommended further tightening of these norms to ensure full alignment, and this will be done in phases.

• External supervision of the banks has been strengthened to monitor and evaluate bank performance on the basis of the new prudential standards. This has made the financial condition of banks more transparent, focusing attention on the size of the non-performing assets (NPAs) of the banking system. The net NPAs of public sector banks as a proportion of their commercial advances declined from 16.3 per cent at the end of 1992-3 to 8.2 per cent at the end of 1997-8.[20]

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[19] The move to market-determined interest rates for government securities is an important step in creating a broad-based market for government debt, which provides the underpinning for an efficient market for private debt.

[20] It is important to consider net NPAs (i.e. net of provisioning) rather than gross NPAs in India because Indian banks are typically hesitant to write off NPAs even when adequate

• Competition in the banking system has increased significantly as new private sector banks have been given licences and foreign banks have been allowed to expand much more liberally than in the past. The share of business of private sector banks and foreign banks has increased from around 10.6 per cent in 1991-2 to 17.6 per cent in 1996-7. Public sector banks still dominate the system, but greater competition among public sector banks is beginning to make an impact on their behaviour.

These reforms are already changing the way banks function. Higher prudential standards are forcing banks actively to seek quality borrowers in order to improve their asset quality. Interest rate liberalization gives banks flexibility to offer borrowers more attractive interest rates. Quality borrowers on their part are also able to demand better terms because of competition among banks and because the opening up of both domestic and foreign capital markets enables them to look for cheaper sources of funds outside the banking system. In short, better regulation and competition is working to the advantage of better quality borrowers which should improve the allocative efficiency of the system.

However, the reforms still have a long way to go. As pointed out above, the existing prudential norms need to be further tightened and fully aligned with international practice. More importantly, reforms in banking are about changing the way banking institutions function. A liberalized and more open economy, with freer flow of capital, will place particularly heavy demands on the system. Bank margins will be threatened as better quality clients gain access to other sources of funds especially in international markets. Banks will have to develop much stronger credit appraisal skills than were necessary in the past to reflect the more competitive environment facing borrowers and the consequent higher risk of failure. A liberalized economy also involves exposure to greater volatility in both exchange rates and interest rates and credit appraisal techniques must take account of the impact of uncertainties on these counts on the quality of the loan portfolio. Static measures of asset quality need to be supplemented by methods of assessing asset quality in the face of uncertainty. Handling these challenges calls for basic restructuring of management systems in banks and massive upgradation of staff skills.

The next stage of banking sector reforms also requires parallel improvement in the legal system relating to debt recovery. Efficient banking requires a credible threat of legal action to force recovery from defaulting borrowers. Without such a threat, the incentive system encourages borrowers to default. India's legal system in these areas needs massive improvement. The government has recognized the need for this change and a full-scale review of banking laws is being undertaken to identify the nature of legislation needed. Early action in this area should have high priority.

A key issue in banking reforms in the future relates to government control over public sector banks. Public sector ownership imposes several constraints including limitations in methods of recruitment and promotion and restrictions on the salaries they can pay. Public sector banks are also burdened by standards of public accountability which may be inconsistent with the degree of flexibility needed for commercial decision making. Many credit decisions taken in good faith can end up as non-performing assets for a number of reasons but public sector managers are peculiarly vulnerable to accusations that such decisions were malafide *ab initio* and these accusations can often trigger lengthy investigations by investigative agencies and also become issues of public concern. This can lead to an overly cautious approach on the part of bank managers impairing the speed and quality of decision making. The Committee on Banking Sector Reforms has recommended that the government's equity holding should be reduced to 33 per cent which would free the banks of constraints arising from government ownership. No decision on this issue has been announced thus far. The weight of international experience is certainly in favour of moving away from government ownership, though a consensus on this issue is yet to develop in India.

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provisions have been made. The figure of 9.2 per cent for net NPAs as a proportion of commercial advances may appear high but it has to be kept in mind that the balance sheets of Indian banks include large investments in government securities reflecting high mandatory investment requirements in the past.

Capital market reforms

Major changes have taken place in the capital market in the past seven years. In 1991 India's capital market did not have a statutory regulatory framework. The Securities and Exchange Board of India (SEBI), was given statutory powers in 1992 and has since laid down a structure of regulations governing various participants in the capital markets, including rules for insider trading, takeovers, and management of mutual funds. These rules are now in operation and will need to be refined on the basis of experience. The stock exchanges, which were earlier dominated by brokers and lacked effective supervision, are now much better governed. The focus of the new regulations is to ensure investor protection through transparency and full disclosure.

The technology of trading has been modernized. The National Stock Exchange introduced on-line electronic trading in 1994 and the system today allows brokers located in 140 cities and towns all over the country to trade in a single unified market through terminals linked by VSAT to NSE computers. It provides automatic matching of buy and sell orders with price time priority, ensures transparency for investors and assurance of the best price. Competitive pressure has led the Bombay Stock Exchange also to introduce an on-line trading system in 1995, with linkages to brokers all over the country.

The settlement system has also seen major improvement. Earlier, completion of a trade involved physical transfer of share certificates from seller to buyer followed by submission of the certificates to company registrars to effect changes in the register of stockholders. The process was vitiated by long delays, frequent loss of certificates, return of certificates because signatures of the seller on the certificates did not match with signatures on record with registrars, and also the danger of forged certificates. In 1996, a National Depository commenced operations offering investors the facility of holding securities in dematerialized form and settling trades through book entries in the depository, eliminating delays and uncertainties in transfer of ownership. The volume of business done by the Depository has expanded rapidly. In June 1997 only 48 companies with a market capitalization of Rs.94,000 crore had signed up enabling their securities to be dematerialized. By June 1998 this had increased to 198 companies with a market capitalization of Rs.2,88,000 crore. The value of securities actually dematerialized increased from Rs.2518 crore to Rs.35,000 crore in this twelve-month period.

These changes are slowly putting in place a set of capital market institutions which can generate confidence among investors and encourage financial intermediation in this area. As with all institutional development, much depends upon how the system actually functions under the new rules and regulations but a good start has been made. The presence of FIIs, which have invested a total of around US $ 9 billion in the stock markets, is an important force which will push the capital market to come closer to international standards.

Insurance sector reforms

The missing element in India's financial sector reform thus far relates to insurance which remains a public sector monopoly, a situation which exists in only three other countries, Cuba, North Korea, and Myanmar. The industry suffers from a very high mandatory requirement for investment in government securities which lowers implicit return on insurance products. The lack of effective competition also leads to a lack of variety in pension products available for savers. Opening the insurance sector to new private sector participants, with suitable regulation is clearly overdue. It will help create a more competitive insurance industry, offering attractive insurance and pension products, which become especially important as per capita incomes rise, life expectancy increases, and traditional family support systems, which are a substitute for insurance and pensions, are eroded. A vigorous insurance industry would also increase the volume of long-term contractual savings in the economy and channelize these savings towards infrastructure sectors which have the greatest need for long-term funds.

The pace of insurance reform in India reflects both the time taken to build a consensus on difficult issues and also the fact that a consensus does evolve. The Congress government had recognized the importance of reform in this area and appointed the Malhotra Committee

to look into these issues. The Committee submitted its report in January 1994 and recommended opening up the insurance sector to private competition permitting foreign investment with a minority stake. No decision could be taken on this recommendation within the remaining term of the government because of opposition from unions. The United Front government in 1997 moved a step forward and announced its intention of creating a statutory regulatory authority for insurance and also allowing a limited opening of the pension and health insurance segment to private sector participants to begin with. The legislation could not be passed because the BJP at that time opposed foreign investment in insurance. In 1998 the BJP government introduced legislation to allow insurance to be opened to new private entrants with foreign equity capped at 26 per cent with an additional provision of 14 per cent for Non-Resident Indian investors. The earliest that the legislation could be passed is 1999. This will be more then five years after the Malhotra Committee submitted its report!

Policies for poverty alleviation

The impact of the reforms on the poor has been a constant focus of the policy debate in India. Supporters claim that the reforms will help the poor by encouraging rapid and efficient growth, which in India's circumstances means labour using, employment generating, growth which is the only sustainable way of reducing poverty to any significant effect. Critics claim that this process will take time, especially if reforms are implemented at a gradualist pace, and large sections of the population may therefore not benefit in the early stages. Some sections may even be hurt as certain kinds of products and processes are displaced by structural changes brought about by the reforms. India's reform programme sought to deal with these problems by combining structural reforms with strong poverty alleviation programmes to ensure an adequate flow of benefits to the poor even in the short term.

From the outset, the reforms emphasized a continuing commitment to traditional programmes for poverty alleviation which existed even before the reforms. These included direct support of consumption of the poor by subsidized sale of foodgrains through the PDS, employment programmes providing wage employment in public works type projects especially in rural areas, and a variety of self-employment programmes involving provision of a combination of capital subsidy, credits, and technical assistance to set up micro-enterprises in both rural and urban areas. Fiscal constraints in the first two years of the reforms prevented any large increases in these programmes but there was substantial expansion from 1993-4 onwards.

The effectiveness of these programmes in achieving their stated objective varies considerably. Parikh (1997) has shown that the PDS is a very inefficient instrument for helping the poor since the entitlement of subsidized supply is available equally to all house-holds and in practice the poor have less access to the system. The spread of the PDS varies considerably across the country and most of the offtake is accounted for by a few states where the PDS is well organized and these are not the states where poverty is most concentrated. In 1997 the United Front government tried to introduce better targeting in the system by distinguishing house- holds below the poverty line which would obtain their entitlement at a lower price. It is too early to judge how effectively this is being implemented. The other poverty alleviation programmes are better targeted, especially those providing wage employment, and it is generally agreed that they have helped to provide income support to lower income groups. The experience with self-employment programmes is much more varied. While reasonably well targeted it is not clear that they provide a sufficiently stable additional flow of income to the beneficiaries.

As the reforms progressed the approach to poverty alleviation was broadened to include efforts to improve supply of social services, especially health, education, and family welfare. This focus was spurred by the recognition that India lags far behind most other developing countries in this respect, including most countries in sub-Saharan Africa which are otherwise regarded as least developed. Dreze and Sen (1995) have pointed out that India's social development indicators at the start of the reforms were lower then in the East Asian countries three decades ago which suggests that unless significant improvement takes place in these indicators, it may not be possible to achieve a growth rate of 7 to 8 per cent as

envisaged by the reforms. Larger investment in the social sectors is therefore necessary not only because social development is an end in itself, but also as a precondition for accelerating growth.

Trends in central government social services expenditures as a percentage of GDP in the post-reforms years are summarized in Table 2.10. These show a marginal decline in the first two years of the reforms, when the fiscal situation was under severe pressure, followed by a steady increase after 1993-4. However, the real problem in this area relates to expenditure in the states which account for the bulk of social services expenditure. As shown by Guhan (1995) social services expenditures at state level as a percentage of GDP declined steadily in the post-reforms years up to 1994-5. This decline swamps the increase in central government expenditure so that the trend in consolidated expenditures shows a steady decline.

The poor state of social indicators in India is obviously not a consequence of the reforms but a reflection of prolonged neglect of this crucial area in the pre-reforms years. However the trend of the past few years is clearly alarming and has to be reversed. Remedial action lies primarily in the domain of the states and this underscores the importance of fiscal reform and restructuring at state level. In practice this means that states-must take hard decisions to rationalize electricity tariffs to reduce the large losses of the SEBs, increase water charges to reduce the very large operating deficits of the irrigation system and also reduce losses of the State Road Transport Corporations. These corrections would ease demands on state government budgets from these sectors enabling the state to expand social sector expenditures. A major effort in this area, reinforced by continuing efforts to push the reforms agenda, is probably much more important for poverty reduction than marginal expansions in the traditional poverty alleviation schemes even though these are often seen to respond more directly to the demand for tackling poverty. In fact, the present levels of leakages from these poverty alleviation programmes are so high that major improvement is needed in administrative capacity, including involvement of NGOs, to improve the effectiveness of these programmes before attempting any significant expansion in their scale.

Table 2.10

Central Government Expenditure on Social Services

(Rs crore)

Item	1990-1	1991-2	1992-3	1993-4	1994-5	1995-6	1996-97	1997-98
1. **Social Services**	**5318**	**6112**	**6771**	**8374**	**10,210**	**12,819**	**13,885**	**16,250**
(a) Education, Art & Culture and Youth Affairs	1672	1795	1989	2457	2760	3959	4048	5134
(b) Health and Family Welfare	1279	1399	1796	2143	2426	2608	2867	3369
(c) Water supply, Sanitation, Housing and Urban Development	638	965	776	1176	1426	2316	2969	3449
(d) Information and Broadcasting	480	444	420	437	452	565	653	896
(e) Welfare of SC/ST and Other Backward Classes	324	432	469	595	741	825	823	728
(f) Labour, Employment and Labour Welfare	316	381	383	558	540	595	633	651
(g) Social Welfare & Nutrition	609	696	938	1008	1865	1950	1892	2293
2. **Rural Development**	**2535**	**2356**	**3113**	**4833**	**5637**	**6099**	**4924**	**5321**
3. **Basic Minimum Services, including Slum Development (BMS)***						**2494**	**2873**	
4. **Total Social Services, rural Development and Basic Minimum Services (1+2+3)**	**7853**	**8468**	**9884**	**12,207**	**15,847**	**18,918**	**21,303**	**24,714**
5. **Social Services Expenditure As per cent of GDP at Market Prices**	**0.99**	**0.99**	**0.96**	**1.03**	**1.06**	**1.15**	**1.09**	**1.17**
6. **Social Services, Rural Development and Basic Minimum Services as per cent of GDP at Market Prices**	**1.47**	**1.37**	**1.40**	**1.63**	**1.64**	**1.69**	**1.67**	**1.75**

Note: Figure for all the years are based on revised estimates.

* Came into operation from 1996-7.

Conclusions

India's achievements in the past seven years as far as economic performance is concerned are clearly impressive. The recovery from the 1991 crisis was exceptionally swift and the post-stabilization period saw a significant acceleration in growth compared with the growth rate before the reforms. The rate of growth in the four years 1994-5 to 1997-8 averages 6.9 per cent which amounts to growth in per capita GDP of over 5 per cent per year. Poverty may have increased in the first two years after the crisis, but this was not because of the reforms and in any case, the deterioration was reversed by 1993-4. It is likely that as economic growth accelerated in subsequent years, the incidence of poverty also resumed its earlier declining trend.

The good performance thus far does not mean however that high growth rates will be easy to maintain, let alone accelerate, in future. The slowdown in 1997-8 and the continuing crisis in East and South East Asia raise legitimate concerns about the pace at which India can grow in the near future. The Asian crisis has proved to be deeper and is likely to be more prolonged than was initially expected and its depressive effect on world growth and on India is likely to continue in 1998-9. The imposition of sanctions by some countries following nuclear tests by India and Pakistan in May 1998 has added new uncertainties. However, even if we assume that the sanctions are temporary or their effect is marginal, it is clear that the international environment facing India in the next two years will be less supportive than in the recent past. World trade is likely to grow more slowly, competition from South East Asia will intensify, and the environment for capital flows to emerging market is likely to be more restrained . All this suggests that India will have to make additional efforts to ensure that the post-reforms growth rate is maintained.

The reforms under way are clearly wide ranging and have yielded good results thus far, but they need to be further strengthened. A credible signal that reforms will continue and a clearer statement on the time path of reforms will increase confidence among investors both domestic and foreign. The fact that three different governments have endorsed the broad direction of re-forms indicates that while there may be differences in emphasis, and even more so in presentation, there is also substantial consensus on many of these issues. This should help insulate economic policy from perceptions of political uncertainty which are perhaps unavoidable in an era of coalition politics.

Where reforms have already begun they should be swiftly completed preferably with a clearly announced time-frame. Examples of such continuing reforms are the reduction in protection levels, continuing reforms in banking, decontrol of petroleum prices, and reform of the power sector. An important positive factor for the future is that the productivity gains from many of these ongoing reforms have yet to be realized. For example, the new investments that were made responding to the more open environment gained momentum only in 1995-6, when corporate investment and foreign investments picked up (see Tables 2.4 and 2.8) and the benefits from these investments will materialize only in the years ahead. Similarly, reforms in the public sector and in the financial system are as yet at an early stage, and the improved allocational efficiency from these reforms is only just beginning to be realized and should provide significant efficiency gains for the economy in the future.

There are also many areas where reforms have not yet gained momentum and these will now have to be addressed with urgency. An obvious area for priority attention is the continuing high level of fiscal deficit of the centre and states combined. Unless this deficit is reduced significantly, the economy will not be able to transit to a regime of low real interest rates which, with efficient financial intermediation, can give a boost to private investment. This calls for a two-pronged approach. It will be necessary to restructure government expenditure by restraining inessential expenditure while increasing government expenditure in important areas. It also calls for further tax reform, especially in excise duties, and a strengthening of the tax administration to increase buoyancy in tax revenues. These efforts can be supplemented by much bolder efforts at privatization of the public sector generating larger revenues from privatization. There is much greater acceptability of privatization today than was the case even two years ago and this new consensus should be used to strengthen policies in these areas.

Infrastructure bottlenecks are likely to be a binding constraint on achieving even 7 per cent growth over the next few years. India's infrastructure system is clearly overstrained and has suffered from under investment in the post-reforms period. Massive investments will be needed in both the public and private sectors to overcome this bottleneck. The two are not alternatives because the need is so great that even the most optimistic projection for private investment will leave a large proportion of the need to be met by the public sector. Public investment in infrastructure depends crucially upon the ability to raise resources in the public sector and this in turn depends upon the ability to levy user charges. Reform of power sector tariffs, introduction of road user charges (either direct in the form of tolls or indirect in the form of a cess on petrol and diesel earmarked for road development), and rationalization of railway fares are all extremely important in this context.

These efforts at expanding public investment in infrastructure must be supplemented by a vigorous effort to attract private investment by creating an environment which is attractive to private investors. This includes simplification and transparency of various clearance procedures, a policy framework which allows the various risks involved in infrastructure projects to be unbundled so that private investors are expected to take only those risks which are reasonable for them to bear, and a credible and independent regulatory framework which assures private investors of fair treatment. Fortunately, a number of private sector infrastructure projects in power, telecommunications, and ports have taken off and the process could gain momentum.

The pace of private investment in infrastructure will of course depend upon the availability of finance for such projects especially debt finance. There are limits to the amount of foreign currency exposure which infrastructure projects can take since the tariff in most cases is fixed in local currency and this limits the extent of foreign exchange risk which the project can take. Infrastructure development in the private sector will therefore depend crucially upon the availability of long-term debt finance for such projects at reasonable interest rates. Reform of the insurance sector is especially important for this reason.

Finally, India cannot afford to ignore the poor state of social developments relating to health and education which has resulted from prolonged neglect of the important area over the decades. Other countries starting from a similar situation have demonstrated an ability to improve social indicators over lime through determined public action. Some states in India have also done so; Kerala is the best known example, but more recently, Tamil Nadu has made excellent progress in literacy and fertility and Himachal Pradesh has also shown significant improvement in literacy and primary schooling. This is clearly an area where the public sector must play a dominant role. The role of the state needs to be redefined to withdraw from direct involvement in areas which can be easily privatized and to expand in areas such as the social sectors the state is the natural, indeed in most cases, the only agent.

To summarize, the process begun in 1991 has proceeded steadily if not as rapidly as it should have but the changes already made and currently under way are impressive. At the same time there are formidable challenges ahead many of which will involve a much more active role for state governments than has been the case hitherto. It will be necessary to make steady progress on these pending issues if India is to achieve the objective of 7 to 8 per cent growth.

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