
Domestic Constraints on International Participation

India was one of the fastest growing economies in the developing world in the 1990s; its annual GDP growth averaged 6.1 percent from 1992 to 2000 (table 4.1). This simple average, however, obscures the fact that GDP growth slowed during the period 1997–2000 as the gross domestic saving rate fell from its peak of 25.5 percent of GDP in 1995 to 22.0 percent in 1997–99 before partially recovering to 23.4 percent in 2000–01. The public sector has dissaved to the tune of 1, 0.9, and 1.7 percent of GDP in 1998–99, 1999–00, 2000–01 respectively. The dissaving also coincided with the dilution of fiscal discipline (table 4.1).

India will have to accelerate and deepen integration with the global economy to reverse the slowdown in growth during 1997–2000 and sustain its rapid growth and further improve living standards. First, the simultaneous fall in public- and private-sector saving and investment rates (especially in the corporate sector) will need to be reversed and foreign capital inflows augmented.¹ Second, the surge in private fixed investment after the removal of entry restrictions on both domestic and foreign private investment in 1991 resulted in high growth rates of more than 7 percent annually in the first half of the decade, but for the investment to be justified *ex post*, the increased output has to be absorbed without depressing profits.

Clearly, this situation implies that unless increasing output is accompanied by reductions in cost, it is unlikely to be absorbed by domestic and

1. See Ministry of Finance, Government of India, *Economic Survey*, 2001–02, tables 1.5 and 1.6.

Table 4.1 Indicators of macroeconomic management of the Indian economy, 1980–81 to 2002–03 (percent)

Indicator	1980–81 to										1999–		
	1989–90	1990–91	1991–92	1992–93	1993–94	1994–95	1995–96	1996–97	1997–98	1998–99	2000 ^a	2001–02 ^b	2002–03 ^d
Economy: Growth performance and macroeconomic balances													
Growth rate of GDP ^e _{FC}	5.7	5.6	1.3	5.1	5.9	7.3	7.3	7.9	4.8	6.6	6.0	4.0	5.4
GDCF _{curr}	21.2	26.3	22.5	23.6	23.1	26.0	26.8	24.5	25.0	23.0	24.3	24.0	n.a.
GDS _{curr} ^g	19.3	23.1	22.5	21.8	22.5	24.8	25.1	23.2	23.5	22.0	23.2	23.4	n.a.
Net inflow _{curr} ^h	0.6	3.2	0.5	1.8	0.6	1.2	1.7	1.3	1.5	1.0	1.1	0.6	n.a.
GDCF _{const}	21.3	25.4	22.0	22.9	23.1	26.4	27.2	25.1	26.4	25.4	26.7	26.3	n.a.
Government: Fiscal management													
GFD/GDP, center ^j	7.2	7.9	6.0	5.6	7.0	6.3	5.0	4.8	5.8	6.8	5.5	5.8	5.7
GFD/GDP, states ⁱ	2.8	3.2	2.8	2.8	2.4	2.7	2.6	2.7	2.8	4.3	4.7	4.6	3.8
GFD/GDP, combined ^j	8.4	9.2	7.3	7.3	8.2	7.5	6.4	6.2	7.1	9.3	9.3	10.0	9.3
RD/GFD, center ^k	24.3	41.5	41.3	44.1	54.3	48.9	48.2	48.5	51.7	56.2	63.5	64.0	67.1
RD/GFD, states ^k	-4.5	29.6	33.5	24.5	18.5	22.9	26.1	43.0	37.0	58.4	58.9	53.9	55.7
Key variables reflecting macroeconomic management													
Rate of inflation													
WPI ^l	8.0	10.3	13.7	10.1	8.4	12.5	8.1	4.6	4.4	5.9	3.3	7.2	n.a.
CPIIW ^m	9.0	11.6	13.5	9.6	7.5	10.1	10.2	9.4	7.0	13.1	3.4	3.8	n.a.
Exchange rate													
NEER													
(percentage change) ⁿ	-7.6	-22.8	-17.3	2.8	-2.9	-2.9	-8.2	-1.7	2.2	-9.3	-2.9	-0.2	n.a.
REER													
(percentage change) ^o	-5.2	-16.3	-11.3	8.6	7.1	7.1	-3.2	0.3	4.2	-5.7	-0.7	4.6	n.a.
Prime lending rate													
IDBI	14.0–	15.0	18.0–	17.0–	14.5–	15.0	16.0–	16.2	13.3	13.50	13.6–	14.0	n.a.
	15.0	20.0	20.0	19.0	17.5	15.0	19.0	16.2	13.3	13.50	17.1	14.0	n.a.
ICI/CI	14.0–	15.0	18.0–	17.0–	14.5–	14.5–	14.0	16.5	14.0–	13.0	12.5	13.0	n.a.
	15.0	20.0	20.0	19.0	17.5	17.5	14.0	16.5	14.5	13.0	12.5	13.0	n.a.

ICICI = Industrial Credit and Investment Corporation of India
IDBI = Industrial Development Bank of India
n.a. = not available

- a. Provisional estimate.
- b. Quick final estimate.
- c. Revised advance estimate.
- d. Budget estimate.
- e. GDP_{Ec} : Gross domestic product at factor cost at 1983–94 prices.
- f. $GDCF_{curr}$: Gross domestic capital formation (percentage of GDP at market prices) at current prices (CSO 2000b).
- g. GDS_{curr} : Gross domestic savings (percentage of GDP at market prices) at current prices (CSO 2000b).
- h. $NetInflow_{curr}$: Net capital inflow (percentage of GDP at market prices) at current prices equals the difference between $GDCF_{curr}$ and GDS_{curr} (CSO 2000b).
- i. $GDCF_{const}$: GDCF (percentage of GDP at market prices) at 1993–94 prices (CSO 2000b).
- j. GFD/GDP : Gross fiscal deficit as a percentage of GDP at market prices (Reserve Bank of India, *Handbook of Statistics on the Indian Economy*, 2000). Gross fiscal deficit figures for the center, consolidated states, and combined (center and states)—rows 1, 2, and 3 in panel B—were obtained from the World Bank. For the central government they relate to the new definition with adjustment for the states' share in small savings.
- k. RD/GFD : Revenue deficit as a percentage of gross fiscal deficit.
- l. WPI : Wholesale Price Index (average of the weeks) (Reserve Bank of India, *Handbook of Statistics on the Indian Economy*, 2001, table 205).
- m. $CPIIW$: Consumer Price Index for Industrial Workers (average of the months) (Reserve Bank of India, *Handbook of Statistics on the Indian Economy*, 2000, table 206).
- n. $NEER$: Nominal effective exchange rate (36-country bilateral export weights) change in annual average index (1985 = 100) (negative for depreciation) (Reserve Bank of India, *Handbook of Statistics on the Indian Economy*, 2001, table 132).
- o. $REER$: Real effective exchange rate (36-country bilateral export weights) change in annual average index (1985 = 100) (negative for depreciation) (Reserve Bank of India, *Handbook of Statistics on the Indian Economy*, 2001, table 132).

international markets without a lowering of prices and profits. Because global markets are far larger than the domestic one, this underscores the need for international competitiveness to be able to sell growing output on global markets and sustain high rates of investment and savings.

This chapter focuses on the domestic constraints on international competitiveness in the ongoing integration of the Indian economy with global markets. India has a comparative advantage in labor-intensive commodities as well as in human-capital-intensive activities associated with the information technology revolution. Efforts to translate this advantage into concrete export performance and integration into world factor flows are, however, constrained by the existing physical, legal, and social infrastructure. The domestic constraints not only choke the growth-promoting impulses in the economy but also undercut the efficiency gains from resource reallocation resulting from trade liberalization and limit the capacity of the economy to absorb private international capital flows. There is increasing evidence from rapidly growing economies that long-term foreign capital inflows help expand exports and stimulate growth through technological spillovers as well as supplement domestic savings efforts. Sustained rapid growth and rapid poverty eradication are unlikely without dramatic improvements in the efficiency, quality, and reliability of infrastructure.

The following sections discuss several domestic constraints on international integration. A stable macroeconomic environment is the first main prerequisite for increased integration, followed by an attractive investment climate and access to adequate transport, communications, energy, and financial infrastructures. Without these changes, the high transaction costs associated with transporting and exchanging goods and services in India relative to its competitors will outweigh any advantage the country has in production costs.

At the firm level, improvements in product quality and increases in productivity across the spectrum of export-oriented and export-related activities are required for sustained cost-competitiveness. Increasing firms' flexibility in resource allocation is clearly important in this context. A legacy of protection for workers and highly regulated labor markets handicap the kinds of rapid adjustments that are needed to improve efficiency. Bankruptcy laws also constrain restructuring toward more efficient activities. The continued reservation of certain industries for small-scale production, a legacy of Gandhian economics, impedes movement toward a more efficient scale of operation for several exportable activities. Reducing overextended state participation by disinvesting from commercial public-sector undertakings would not only yield efficiency gains and fiscal benefits but also enable the government to focus on core areas of long-neglected social sectors.

Macroeconomic Management of the Economy

A stable macroeconomic environment is particularly important for countries like India that are seeking to attract private capital flows. India's main challenges in macroeconomic management are to improve fiscal management at all levels of government, maintain a low inflation rate, and implement an active exchange rate policy that supports sustainable current account deficits as well as a desirable mix of foreign capital inflows.

Fiscal Management

The central government's gross fiscal deficit relative to GDP decreased after the fiscal adjustment undertaken in the early 1990s, but state government finances deteriorated during the same period. The central government's average gross fiscal deficit during the period 1992–2000 of 5.8 percent of GDP was about 2 percent lower than the deficit in the crisis year 1990, and about 1.4 percent less than the average for the 1980s (table 4.1). For the states, however, the corresponding average of 3.3 percent was higher than the prereform decade. The combined fiscal deficit of the central and the state governments in 2000 was 10 percent, higher than its level in the crisis year 1990 and 1.6 percentage points higher than the average for the 1980s.

The proportion of revenue deficit (defined as the excess of current expenditures over current receipts of the government) in the total deficit has also increased during the 1990s, suggesting that as much as two-thirds of central-government borrowing and three-fifths of the state governments' borrowing was to finance current consumption expenditures (table 4.1).² The latest data from the budget for 2002–03 and other sources suggest that the fiscal deficit of the center will remain in excess of 5.5 percent of GDP and that of the states is unlikely to fall below 4.5 percent of GDP in 2000–01 and 2001–02. Revenue deficit as a proportion of gross fiscal deficit for the central government is likely to be about 65 percent; and for the states, 56 percent (table 4.1). Thus no end is in sight yet for fiscal profligacy.

2. The Eleventh Finance Commission had recommended setting up an Incentive Fund of Rs106.07 billion for the next 5 years to encourage states to monitor fiscal reforms. Rs42.43 billion were provided for this purpose during the period 2001–02. Medium-term fiscal reform programs (with upfront reforms in the power sector) of eight states (Karnataka, Andhra Pradesh, Arunachal Pradesh, Himachal Pradesh, Kerala, Nagaland, Orissa, and West Bengal) have been discussed in the Monitoring Committee meeting. The governments of Orissa, Karnataka, and Nagaland have entered into memorandums of understanding with the Ministry of Finance, and through February 2002, Rs12.37 billion had been released (GOI-MoF 2002a, item 94, 16).

The increasing borrowing requirements of the government have contributed to higher interest rates for other investors. The inflation rate came down in the second half of the 1990s, but the decline in the nominal prime-lending rate was much slower, indicating that real interest rates increased. The previously discussed slowdown in private investment (see table 4.1, panel A) is thus at least partly attributable to the high real interest rates that resulted from an inability to manage government finances.

Persistent Inflation

Although the rate of inflation came down to single-digit levels in the second half of the 1990s, it is still higher than in India's trade partners. This is a second cause for concern in the macroeconomic environment. Panel C of table 4.1 provides two indicators of annual changes in nominal and real effective exchange rates (with negative magnitudes representing depreciation). An examination of this panel suggests that the rate of currency depreciation in nominal terms has been, with few exceptions, higher in absolute magnitude than that in real terms, indicating that India's rate of inflation has been higher than that of its trading partners.

Physical Infrastructure Constraints

The industrial and trade policy reforms discussed in chapter 2 reduced the relative profitability of selling to the domestic market, thus encouraging more attention to export markets. The surge in industrial growth as well as in aggregate growth from 1993 to 1996 suggests that domestic producers responded to these changes. Poor infrastructure, however, constrains continued growth and expansion into international markets.

There are several key challenges in updating and augmenting India's basic energy, telecommunications, and transport infrastructures. In the short term, the key is to get the most out of existing capacity by improving maintenance, focusing on the efficiency and quality of operations, and managing demand carefully. Infrastructure services, being nontradable, cannot be imported to relieve domestic shortages. In the long run, therefore, there is no alternative to undertaking large-scale expansions of capacities in infrastructure. Given past neglect, capacity shortfalls and the investments needed to close them are large and recognized to be well beyond the domestic savings and financing capacity. However, new technological and organizational innovations have enlarged the choices with respect to ownership (both public and private, and domestic and foreign); modes of organization and financing; scale of operation; and range, quality, and cost of services.

Difficult policy decisions remain. To what extent and by what modalities can the entry of the private sector into state-owned public utilities be facilitated? What should be the role of market competition and government regulation in reshaping these industries, and what kind of regulatory institutions are likely to perform most effectively? What is the best method to generate revenues for the government from the sale and future operation of these industries? India is yet to arrive at satisfactory answers to any of these questions for any of the infrastructure sectors. The following discussion concentrates on some of the more critical emerging issues in critical sectors and is not meant to be comprehensive and exhaustive.

Energy Shortages

Persistent power shortages and unpredictable supply quality are the most serious infrastructure constraints on production. Years of inadequate addition to capacity, inefficient generation, and unsatisfactory or poor maintenance of transmission networks have led to high transmission and distribution losses, frequent interruptions in supply, and common voltage and frequency fluctuations.³ The pricing, staffing, and operational decisions of state electricity boards (SEBs) were made more on political than economic considerations. An inattention to economics led to persistent losses and a poor allocation of resources. And the parlous fiscal position of state governments precluded their ability to finance additional investment to expand the power sector.

The pricing policy of SEBs continues to distort usage because the prices charged to industry for low-quality power supply are kept high to subsidize power used by farmers and nonfarm households. The high cost of power erodes any cost advantages Indian firms may have relative to their foreign competitors. Power subsidies also encourage wasteful use by farmers and households.

There have been several attempts to reform the energy sector in the past. The first was the steady expansion of the generating capacity owned and operated by the corporatized, central-government-owned National Thermal Power Corporation (NTPC) and National Hydroelectric Power Corporation (NHPC). These two public-sector undertakings, which controlled 25 percent of the country's generating capacity in the late 1990s, have been relatively better managed and freer from political pressures than the SEBs that control 70 percent of the capacity or the private industrial enterprises that control the captive plants producing the remaining

3. Power supply interruptions became so frequent and of such long duration over time that households, offices, and shops began investing in small power generators.

5 percent. The 73.6 percent plant load factor in the relatively newer thermal plants operated by the central public-sector undertakings in 1999 was higher than that of privately operated plants, and as much as 10 percent higher than that of plants operated by SEBs.⁴ However, because SEBs were the sole distributors of electricity, NTPC and NHPC as generators had to sell what they generated to SEBs, which predictably ran to arrears in their payments to generators! Besides increasing supply from non-SEB generators, this also reduced the pressure on SEBs to reform.

The second solution attempted was to permit captive power generation, especially in highly power-intensive, continuous-process metalliferous industries. Captive power plants, however, were inefficiently small in scale and used more expensive fuels (e.g., fuel oil) than the cheaper coal used by SEB plants. The use of higher-cost power reduced the competitiveness (at the going exchange rate) of Indian producers relative to those of their competitors abroad, including China, which did not face this problem. The third reform effort was to encourage the use of such unconventional energy sources as solar and wind power.

During the past 5 years, the central government and multilateral and bilateral lending agencies have entered into several memorandums of agreement with state governments to restructure the SEBs. The Central Electricity Regulatory Commission has been developing guidelines for tariff fixation and a grid code. Eighteen states have established state electricity regulatory commissions, of which 10 (Andhra Pradesh, Delhi, Gujarat, Haryana, Karnataka, Madhya Pradesh, Maharashtra, Orissa, Rajasthan, and Uttar Pradesh) have issued tariff orders. Eight states (Andhra Pradesh, Delhi, Haryana, Karnataka, Madhya Pradesh, Orissa, Uttar Pradesh, and West Bengal) have amended the Electricity Act of 1948, effectively transferring tariff fixation powers to state electricity regulatory commissions. Six states have unbundled power generation, transmission, and distribution and moved toward corporatization.

The central government progressively increased the allocation to the Accelerated Power Development Program from Rs10 billion in 2000 to Rs15 billion in 2001 and to Rs35 billion in 2002. The funds are to be allocated among states as an incentive to accelerate reforms of the SEBs. An Expert Group was appointed by the prime minister, state chief ministers, and state electricity ministers to address two basic problems: the settlement of debts owed by SEBs to the central public-sector utilities and the future financial viability of SEBs.

For the first problem, the Expert Group suggested a waiver of 50 percent of the surcharge and interest on delayed payments and securitization of the principal plus the remaining 50 percent of the surcharge and inter-

4. Ministry of Finance, Government of India, *Economic Survey*, 2001–02, table 9.3.

est through tax-free bonds issued by state governments. These bonds would be repayable during a period of 15 years with a moratorium on principal payments for the first 5 years.⁵ It remains to be seen if the state governments and the SEBs are willing to adhere to the strict discipline required by the package in return for the one-time settlement of debts.⁶ The Expert Group also suggested SEB reforms aimed at maintaining their continuing viability.

Efforts have also been made, not very successfully so far, to attract private foreign investment (Ahluwalia 1998). Enron, the only foreign company to set up and operate a large plant in Dabhol, Maharashtra, ran into several disputes with the state's electricity board and government even before the parent company filed for bankruptcy in the United States in 2001. The plant is currently idle. According to Mukherjee (2002), "Most of the foreign companies who had planned massive investments in Indian power projects have pulled out." The latest pullouts by Minant Asia Pacific, Daewoo, Bayerwerk, and Ogden Energy follow earlier ones by Cogentrix, Electricité de France, and others. Although each company had idiosyncratic reasons for its pullout, a common reason was insecurity about the recovery of dues from sales of electricity to SEBs. It is no surprise that private investors would shy away from investing in power generation as long as they are forced to sell electricity to bankrupt SEBs. (Other reasons for pullout included failure to secure fuel supply to the plants and to agree on implementation schedules and transmission services.)

The basic sources of the bankruptcy of SEBs have been the politically determined (and economically unviable) pricing of electricity, cross-subsidization of one class of users by others, and transmission and distribution losses (including the outright theft of electricity). These sources are being addressed belatedly by the evolving regulatory framework and through the privatization of distribution. As the World Bank (2000a, chap. 5) correctly noted, regulation is an imperfect alternative to competition wherever competition can be introduced. The first step of privatization of distribution of electricity was effective on July 1, 2002, in Delhi, where theft accounts for the bulk of the incredible 50 percent transmission and distribution losses. The central government is also bringing out a power tariff policy document to lay down guidelines for setting tariffs by power-sector regulators.⁷

5. See GOI-MoP (2001).

6. For the details, see Ministry of Finance, Government of India, *Economic Survey*, 2001–02, box 9.3.

7. MSN Business Web site, <http://www.msn.co.in/business/economy> (June 2002).

Telecommunications

The telecommunications sector, unlike the power sector, has exceeded most of the planned targets for investment as well as network expansion. Technological advances worldwide have not only drastically reduced the costs, improved the quality, and extended the range of telecom services but also have allowed competition in a sector hitherto regarded as a natural monopoly. India's low telecom density could be turned into an excellent opportunity for technological leapfrogging because the sunk costs in existing equipment using obsolete technologies are small.

The telecom sector has been better run than power generation. The pricing of telecom services, entirely under the purview of the central government, was less subject to political pulls and pressures. Low-volume local users were charged tariffs below cost, but the Department of Telecommunications exploited its monopoly position by overcharging for long-distance traffic to ensure internal resource generation. Thus there has been a substantial surplus for reinvestment and expansion.

Hesitant steps toward privatization were taken in the 1980s. The first manufacture of subscriber terminal equipment by private producers was allowed in 1984. Metropolitan and international telecom services were corporatized in 1986. A Telecom Commission was created in 1989. Further liberalization on a somewhat larger scale has been attempted since July 1991. Telecom equipment manufacturing has been opened to the private sector, including multinational corporations in 1991. Value-added services, such as fax and cellular mobile telephones, were opened for private competition in 1992, and permission was given for private networks in industrial areas a year later. The first National Telecommunication Policy, announced in May 1994, ended the public-sector monopoly and permitted private-sector entry into basic services (with foreign equity allowed up to 49 percent). Finally, the Telecom Regulatory Authority of India (TRAI) was formed in January 1997 and reorganized in 1999 after the announcement of the second Telecommunication Policy.

The pace of liberalization in the telecom sector accelerated in 1999, but state intervention continues to constrain modernization of the telecom infrastructure. The question of where the jurisdiction of TRAI as a regulator begins and that of the Ministry of Telecommunications as a policymaker ends has not been fully resolved. The government continues to control the number and location of new companies. Its regulation of entry and the use of an auction to grant the license to operate appears to be a means of generating and transferring windfall monopoly rents to the Ministry of Telecommunications. The creation of TRAI has been perhaps the most successful part of the reforms, but the agency's reputation as an independent regulator is still being established and the boundaries of its regulatory powers are being defined.

The initial government decision to control the number and location of private companies prevented the industry from serving the interests of the users of the telephone system. The government arbitrarily prevented some entrants from offering long-distance service and decided on the boundaries of each metropolitan and circle system rather than leaving these decisions to be made according to the cost of service and the intensity of demand for it. State intervention eliminated opportunities to create a seamless national wireless network that might have facilitated private provision of service to less populous areas. The government direction of investment also precluded the possibility of true competition among multiple carriers emerging in at least some parts of the nation.

The second decision, to auction the licenses, seemed solely driven by a desire to generate a short-term financial windfall to the treasury. Licenses were auctioned so as to create monopolies, even though there were no obvious economic reasons such as economies of scale in wireless telephony technology to justify this market structure. Limiting the number of private entrants to one in each telecom circle seemed designed to extract monopoly profits from consumers that could then be transferred back to the government through an auction. Whatever the motivation for the auction, the high price of licenses set an implicit tax on telecom that may have impeded the growth of the industry. However, after the auctions, the successful bidders found that they had overbid and wanted to renegotiate the fees. Eventually, the myopic revenue-maximizing, fixed-license-fee regime had to be replaced with revenue-sharing arrangements for private-sector basic and cellular service operators.

The best decision in the reform process was to create TRAI, an independent regulatory authority. TRAI's early days were marked by conflict with the Department of Telecommunications when its jurisdiction included the department's service-providing units. But the two agencies have been reorganized to avoid further infighting. TRAI's tariff regulatory function has been separated from its adjudicative powers. The latter have now been vested in a separate quasi-judicial authority. The department was also initially reorganized, with policy formulation assigned to a Telecom Commission and responsibility for service provision given to the Department of Telecom Services and Department of Telecom Operations, which were later corporatized in October 2000 into Bharat Sanchar Nigam Limited. The Department of Telecom has now taken over some functions of policy formulation, licensing, wireless, spectrum management, and research and development.

Entry restrictions into cellular and basic service operations have also been slightly relaxed to permit additional basic service operators along with the existing duopoly structure and a fourth cellular operator. Fixed-service providers can also provide wireless services within their local loop. Unrestricted entry has been allowed in domestic long-distance ser-

vice, and the termination date for the monopoly for international long-distance services has been moved to March 2002 from March 2004.⁸

TRAI rebalanced the tariff in two phases. Domestic and international tariffs were reduced by about 23 percent on the average in the first phase, which took effect in May 1999. At the same time, the Department of Telecommunications decided not to raise rental and call charges for rural subscribers and low-calling urban subscribers (those making up to 200 calls). In the second phase, domestic long-distance rates have been cut further by an average of 13 percent and international station (long-distance) dialing rates by about 17 percent as of October 2000. More recent (April 2002) cuts in domestic and international long-distance rates, resulting from increased competition, have been much more dramatic.

The government has issued guidelines for two categories of licenses for infrastructure providers. Type I licenses are for providers of assets such as dark fiber, right of way, and duct space and towers. Type II licenses are for firms leasing, renting, and selling such products and services as end-to-end bandwidth. By November 2000, 430 licenses had been issued to Internet service providers. Fifty of these providers have also been given approval to use satellites as a medium, and the government has solicited applications for licenses to set up submarine cable landing stations as international gateways for Internet access.⁹

Although the steps outlined here are indeed rapid in comparison to the past, they are not adequate for India to catch up with its neighbors. Ten years ago, China and India had equivalent information technology infrastructures. China's information technology penetration since then has far outpaced that of India. China's "teledensity" in 2000 was 112 telephone main lines per 1,000 people, compared with India's 32. There were 15.9 personal computers per 1,000 Chinese, compared with 4.5 per 1,000 Indians. Mobile phone density also showed similar disparities: 6.6 per 1,000 in China compared with 4 per 1,000 in India.¹⁰

Transport Network: Railways, Roads, and Ports

Railways and roads have been the two major means of transporting exportable goods to seaports or airports across India's continental expanse.

8. The state-owned monopoly Videsh Sanchar Nigam Limited has since been privatized, and several private- and public-sector firms have entered the area of international station dialing services. Competition is also getting more intense in domestic long-distance and cellular phone services. In addition, 25 new basic service license agreements have been signed by private operations (Ministry of Finance, Government of India, *Economic Survey*, 2001–02).

9. Ministry of Finance, Government of India, *Economic Survey*, 2001–02, 179.

10. World Bank, *World Development Indicators 2002*, tables 5.9 and 5.10. Indian "teledensity" as of December 31, 2001, was reported to be 39.5 per 1,000 people (GOI-MoF 2002a, 5).

Neither is currently able to ensure the timely delivery of exportables, creating a critical competitive disadvantage in international markets. The lack of transportation infrastructure is particularly worrisome for countries of continental size such as India, which could export perishable agricultural and horticultural products.

Railways

In track length, India compares favorably with rapidly growing Asian countries, with 12.4 kilometers of track per 1,000 square kilometers of land area and 42 kilometers of track per million people (McKinsey & Company 2001, vol. 1, appendix 5E).

Railways accounted for 89 percent of the freight traffic and 68 percent of the passenger traffic after Independence. Over the years, however, the railways' share has decreased—to 40 percent (freight) and 20 percent (passengers) by 1995—and road use has increased accordingly. The reasons have been obvious. Railways are state monopolies that depend on budgetary allocations for financing investment. Populism, rather than an economic rationale, continues to drive their staffing and pricing decisions. They employ more labor than needed, are unable to recover operational costs through user charges, and cross-subsidize passenger traffic by freight traffic—the former accounted for 59 percent of total rail traffic but contributed only 30 percent of the revenue in 1999. Consequently, they are unable to invest in track renewal and rolling stock and deliver poor-quality, irregular service.

Poor service quality has been particularly harmful for goods traffic, because passenger traffic has been accorded priority over goods movement by successive populist ministers of railways. The growth in wagon utilization (a measure of freight being transported) slowed down in the 1990s, from 4.8 percent annually during 1990 and 1995 to 3.1 percent annually during the subsequent 4 years until 1999. The ratio of average earnings per ton-kilometer from freight to average earnings per passenger-kilometer, a measure of the extent of cross-subsidization, hovered around 2 during the 20 years from 1950 to 1970. It deteriorated to 2.6 in 1980 and reached 3.3 in 1999. Given the rising costs of moving goods by rail combined with uncertain and irregular scheduling, it is no wonder that even long-haul goods traffic, which would be most efficiently handled by railways, is moved more and more by road.

Roads

As with rail track, length of Indian roads compares very well with the rapidly growing countries of Asia, with 280 kilometers of paved roads per 1,000 square kilometers of land area and 950 kilometers per million population (McKinsey & Company 2001). Poor maintenance and overuse resulting from increasing demand and inadequate traffic-carrying capacity

in terms of road width and lanes have been the key problems. The World Bank (2000a) cites a study for India that estimates the cost to the country from inadequate road expenditure and maintenance as on the order of Rs30 billion per year in 1988 (about \$2.2 billion at the 1988 exchange rate) in excess wear and tear of vehicles, accidents, fuel costs, and so on. The situation is likely to have worsened with the increasing volume of traffic stemming from faster GDP growth in the 1990s.

A massive highway-building program is clearly warranted in the face of increasing demand and long neglect in the past. The demands on road transport have been rising progressively due to a relative cost advantage as well as the convenience of control over the timing and delivery schedule. Nevertheless, investment in and the maintenance and improvement of India's road network, the third largest in the world, has long been neglected.

The central government appears to have recognized the urgency of this task. The National Highway Authority of India, with initial capital contributed by the central government, has been in charge of improving interstate infrastructure since February 1995. Its mandate has been expanded to include implementing the National Highways Development project that will augment the carrying capacity of national highways. The high-traffic-density Golden Quadrilateral connecting the four major cities of Chennai (Madras), Delhi, Kolkata (Calcutta), and Mumbai (Bombay), for example, has been widened from four to six lanes under this program. The government has also established a dedicated Central Road Fund for the development of all roads (from national highways to state highways to rural roads) that has been financed with a duty of Rs1 per liter on petrol since June 1998 and on high-speed diesel since March 1999.

Some steps have also been taken to attract the private sector to build and operate toll roads. Foreign equity participation of up to 100 percent for projects of under \$400 million is automatically approved. By the end of December 2000, 20 "build, operate, and transfer" contracts were awarded, costing about a modest \$250 million rather than the estimated investment requirement of \$20 billion.¹¹ It is clear that to go beyond these modest beginnings swiftly and to make a significant impact, it is necessary to devise innovative schemes with built-in incentives for the private sector to develop commercial facilities along the highways, quickly remove the legal and institutional obstacles to private-sector participation, and establish a credible regulatory framework for setting tolls.

It is also important that investment in constructing feeder roads, particularly rural roads, not be neglected. Apart from their intrinsic value in linking rural residents and producers to urban facilities—including educational and health care institutions and markets—the return from the in-

11. Ministry of Finance, Government of India, *Economic Survey*, 2001–02, 182.

vestment national highways would be enhanced by investment in feeder roads connecting them to the rural hinterland.

Ports

India's 11 major ports are effectively controlled by the central government and handle 90 percent of the country's port throughput. The cargo shipping facilities at these and the 139 minor ports operating under the control of the state governments were neglected under the restrictive import and export policy of the past.

Even with improvements in the indicators of port productivity since the mid-1980s, Indian ports are hopelessly inefficient in comparison with other Asian ports like Colombo and Singapore. The average output per (ship-berth) day slowly crept up by 2.7 percent annually, from 3,942 tons in 1991 to 4,497 tons in 1996, and rose by 5.9 percent annually to 5,338 tons in 1999. Average preberthing waiting time, after hovering around 1.7 days in the first half of the 1990s, came down to 0.9 days in 1998, where it remained a year later. Average turnaround time for ships was as high as 11.9 days in 1984. This came down to 7.5 days in 1996 and further to 4.7 days in 1999.¹²

However, this improvement compared very poorly with average turnaround time in other countries' ports (as short as 6 to 8 hours for container ships in Singapore). Indian cargo has come to be predominantly transhipped through the hub ports of the region, such as Colombo and Singapore. The cost of transshipment adversely affects the competitiveness of Indian merchandise exports and provides an additional layer of protection (over and above tariff and nontariff barriers) for import substitutes.

The unionization of labor, combined with age-old labor-intensive methods and antiquated equipment, has resulted in high labor costs for most major ports.¹³ Labor requirements are likely to go down with the introduction of containerization and automatic cargo handling, but government policy does not allow retrenchments and the termination of services before retirement—unless a person retires voluntarily and accepts a generous compensation.

A policy for private investment in ports was announced in 1997, but the overprotective labor laws and unionized labor practices that would apply

12. See GOI-PC 2000.

13. *The Mid-term Appraisal of the Ninth Five-Year Plan* (vol. 2, para. 7.1.183, 813) mentioned that 88 percent of wharf cranes, 66 percent of mobile cranes, and 31 percent of forklift trucks were still being used beyond their economic life. McKinsey & Company (2001) estimates that the currently massively overstretched capacity of Indian ports can be increased almost fivefold by focusing on the right equipment to remove bottlenecks to existing capacity and through better organization of functions and tasks.

to even these privatized entities make the investment less attractive. The finance minister's 2001 budget proposed several amendments in labor legislation to address the problem of low labor productivity and inflexible labor practices. Obviously, this is a small but desirable step in the right direction, but it has yet to be acted upon.

Financial Intermediation

Government interference in the financial system has been extensive, but current reforms meant to reduce the transaction costs of financial intermediation are not proceeding at a rapid pace. Financial institutions in India came under government ownership with the nationalization of banks in 1969. Life insurance companies were nationalized earlier, and the general insurance business was nationalized in the 1970s. Stock exchanges (of which Bombay's is the oldest) have existed for more than a century, but these have also been very tightly regulated and their importance in financing corporate investments has been greatly reduced by the expanding operations of public-sector term-lending institutions.

The government used financial repression to mobilize savings for priority investments and played a large role in the allocation of funds throughout the 1970s. Government-owned term-lending institutions, the main providers of long-term finance, had no choice but to invest in approved public- and private-sector investment projects. Commercial banks, the providers of short-term working capital, were directed to lend to priority sectors. Public-sector commercial banks and other financial institutions were forced to hold low-interest, long-term government debt in reserves of up to 38 percent of deposits. Interest rates on both long- and short-term loans were often set low enough so that the real interest rate was negative and the cost of capital was lower than its social opportunity cost in an economy where labor was abundant, capital was scarce, incomes were low. There was little incentive to use capital efficiently.

Government control was relaxed slightly in the 1980s and at a faster pace in the 1990s. Starting in the 1980s, over time the issuance of government bonds for long maturities (5 to 30 years), at fixed interest rates, and in predetermined "notified" amounts was replaced by the issuance of bonds with shorter maturities, floating interest rates, and an auction system. The capital market also emerged as an important source of funds for corporate units in the private sector. The 1990s also saw the gradual deregulation of interest rates, recapitalization of public-sector commercial banks, steady improvement in risk-weighted asset ratios, and enforcement of prudential accounting norms.

Two government committees appointed in the 1990s made several recommendations for strengthening the banking system, improving the asset quality, and tightening the prudential norms and disclosure require-

ments. Their major proposal for structural reform was to end the segmentation of financial institutions according to function (short- and long-term lending) and to bring about the convergence of activities between banks and development financing institutions. This will require major changes in the regulatory and legal framework, supervisory practices, and statutory obligations applicable to financial institutions.

The Ministry of Finance reports a significant decline in the ratio of incremental nonperforming assets to total gross advances, from 15.9 percent in 1998 to 12.4 percent in 2000, as well as an increase in the number and strength of debt-recovery tribunals (*Economic Survey, 2001–02, 60–69*). Bank supervision and regulatory practices regarding an increasing array of financial intermediation have moved closer to international best practice standards. Increased competition from the entry of the private sector and the partial privatization of public-sector financial institutions are forcing improvements in efficiency that are expected to further reduce the transaction costs of financial intermediation. The progress, however, is painfully slow and needs to be accelerated in view of the critical role of financial intermediation in an export-oriented economy.

Enhancing Flexibility for Industrial Restructuring

The availability of efficient and inexpensive financial and infrastructural services facilitates improvements in international competitiveness of domestic industry. However, if enterprises do not have the flexibility to reallocate capital and labor swiftly in response to changing domestic and international market conditions, better financial and physical infrastructure in and of itself can only have a limited effect on competitiveness. Unfortunately, labor and bankruptcy laws continue to constrain the flexibility of enterprises.

Labor Market Reforms

Rapid growth requires continuous adjustment to changes in domestic demand, technology, and opportunities for international expansion. A regulatory framework that allows for the mobility of labor and capital away from inefficient uses and into efficient uses is absolutely critical. The legacy of the activist government's intervention in labor and capital markets has yet to be undone.

Two pieces of legislation provide the defining characteristics of the pre-1991 policy regime that was designed to protect the laborer's rights. First, the precolonial Trade Union Act of 1925 fragmented the trade union movement by permitting any seven workers to come together and form a

trade union eligible for recognition in collective bargaining.¹⁴ There were no restrictions that these “unions” had to represent the majority of workers in a given industry.

The second major law, the Industrial Disputes Act of 1948, closely follows the Defense of India rules formulated by the colonial government during the emergency situation created by World War II. This legislation, which is still on the books, aimed to provide employment security by including a “no retrenchment” guarantee and restricting employers’ flexibility regarding production techniques as well as placements, transferability, and the allocation of labor. Production units of more than 100 workers must secure government permission for closure. Elaborate compulsory arbitration and adjudication procedures laid down in the act discourage voluntary settlements through bilateral collective bargaining.

Along with this law, comprehensive labor legislation has been enacted to ensure minimum labor standards with regard to wages, other benefits, safety standards, and conditions of employment. Judicial interpretations have further expanded the scope of labor legislation and labor security regulations.

This regulatory framework, far from promoting social justice, has constrained job growth and exacerbated inequalities among formal- and informal-sector workers. The relatively high cost of overprotected labor led the organized sector to choose capital-intensive technology and limit labor absorption. Industrial and trade policies exacerbated this misallocation of resources and contributed to artificially high capital-output ratios in the factory sector.

The protective labor laws, which effectively apply to fewer than 10 percent of the total workforce of 374 million, have also increased inequalities between formal- and informal-sector workers. P.C. Mahalanobis, the architect of India’s development strategy, pointed out long ago that India’s labor laws imitated those in advanced industrialized countries and were out of tune with Indian labor market realities. Not only do they protect only a small proportion of workers and their families but they also get in the way of more rapid and efficient growth.¹⁵

There has been little connection between wages and market forces. The industry-level wage boards that are occasionally appointed to help labor secure reasonable wage levels do not consider the commercial viability of individual enterprises. The mandatory minimum bonus payment prevents the bonus from rewarding workers’ productivity and reinforcing the viability of productive units.

14. The Trade Union (Amendment) Act of 2001 came into existence in September 2001. This act proposes to bring about reforms in the trade union movement, apart from curbing the multiplicity of trade unions (*Times of India*, New Delhi, September 19, 2001).

15. E.g., see P.C. Mahalanobis, “Asian Drama: An Indian Perspective,” *Economic and Political Weekly* 4, nos. 28, 29, 30 (July 1969): 1119–32.

The net result of these legislative provisions and judicial interpretations has been to increase hiring costs, require companies to carry surplus labor power, and prevent them from adjusting the workforce in response to demand fluctuations. Labor in the organized segment of the economy has thus been legislatively transformed into a fixed factor of production at par with fixed capital.

These state interventions in the labor market have also affected producers' behavior. The labor code has discouraged new investors from entering into the highly productive organized segment of the manufacturing sector. Resources are wasted as private-sector employers look for legal loopholes that enable them to evade the legal provisions by subcontracting to producers in the unregulated informal sector, by giving workers limited contracts, or by artificially fragmenting their productive capacity. Employers have also bypassed the employment security provisions by using prolonged lockouts, inducing closure by not paying electricity bills, and forcing separations by linking pay to production and then stopping output.

We have dwelt at some length on the evolution of overprotective labor market legislation because of the strong reaction that it evokes among the Indian intelligentsia and the fact that discussing it has been politically taboo until recently. Recently, the Prime Minister's Economic Advisory Council's report (GOI-PM-EAC 2001, 19–20), the Planning Commission's *Mid-Term Appraisal of the Ninth Five-Year Plan* (GOI-PC 2000, vol. 2, 508), and the Ministry of Finance's *Economic Survey* for 2000–01 (p. 29) all have emphasized the need to amend labor legislation to introduce flexibility in the labor market.

The most concrete proposal has appeared in the finance minister's budget speech on February 28, 2001. He proposed that Section V.B of the Industrial Disputes Act of 1948 relating to prior government permission for layoff, retrenchment, and closure should apply to industrial establishments employing not fewer than 1,000 workers¹⁶ instead of the existing limit of 100 workers. As a compromise, separation compensation will be increased from 15 to 45 days for every completed year of service. Although

16. The industrially advanced state government of Maharashtra raised the mandatory limit for prior government clearance from the existing 100 to 300 workers in December 2001 (*The Times of India*, December 21, 2001). This change has been reportedly endorsed by the Second National Labor Commission (SNLC), which submitted its report to the Indian prime minister on June 30, 2002 (*Economic Times*, July 4, 2002). The SNLC recommended (a) doing away with the mandatory prior government permission with respect to layoffs and retrenchment and (b) full protection of workers' dues in case of closure, with no employment size limit for both (a) and (b). (Government of India, Ministry of Labor, Agenda for the 38th Session of the Indian Labor Conference (ILC), New Delhi, September 28–29, 2002, page 69). The annual tripartite ILC that took place on September 28–29 sought a consensus on labor-market reforms among employers, workers, and the government. The labor minister at the post-ILC press conference admitted failure to reach a consensus as all the central trade unions opposed amendments to labor laws recommended by SNLC (*Business Standard*, September 30, 2002).

this compromise sounds reasonable, most firms (including those in the public sector) have been strapped for cash, so there is clearly a need for a contributory fund for voluntary retirement, retrenchment, and layoffs—with the initial funding coming from the center, but over time contributions also coming from workers and employers.

Under economic pressures for maintaining bottom lines in an increasingly competitive environment, the process of downsizing has picked up in recent years in the public-sector banks and central public-sector undertakings. More recently, a very modest beginning has also been made in reducing the bureaucracy in the central government by the abolition of long-vacant posts. As was noted in chapter 2, layoffs and retrenchments were reflected in aggregate industrial employment in 1999 and 2000, in addition to the impact of a significant slowdown in industrial growth after 1997. Barring cash-rich private corporations that offer attractive separation packages, most of the layoffs and retrenchments might be taking place on terms less attractive than those offered by the finance minister, because the bill incorporating the proposed changes into the Industrial Dispute Act is still “under consideration” by the Group of (central-government) Ministers, which is chaired by the deputy chair of the Planning Commission (GOI-MoF 2002a, item 59, 9).

Trade unions face painful short-run decisions between increasingly shaky protection of a limited number of existing jobs versus permitting orderly layoffs and flexibility in expectation of future growth in job opportunities. The industrial boom during the period 1993–96 immediately following the economic reforms provided sufficient evidence that even limited international integration and industrial restructuring accelerate growth in real output and generate new employment opportunities far exceeding the job losses.

Industrial Restructuring and Bankruptcy Laws

Post-1991 liberalization has resulted in the removal of barriers to entry into some economic activities. However, in the absence of a speedy legal framework for restructuring or exits, the resource reallocation will be slow, resulting in lower industrial growth and less new employment. The transfer of resources is complicated in India because, unlike in most countries, the procedures for reorganization, bankruptcy, and liquidation are governed by separate laws. The Companies Act of 1956 governs bankruptcy and liquidation, and the judicial proceedings take place in the relevant High Court. Industrial revival and reorganization, however, are covered by the Sick Industrial Companies Act of 1985 (SICA), and the authority in this respect is vested with the quasi-judicial Board for Industrial and Financial Restructuring (BIFR). SICA was originally applicable only to private-sector units, but since 1991 public-sector units have also been referred to BIFR under SICA.

The existing two-step procedure is explained in the report of the Prime Minister's Economic Advisory Council (GOI-PM-EAC 2001). A sick company (according to criteria defined in SICA) has to report to BIFR under SICA. BIFR then explores reorganization and restructuring for revival. If revival is deemed infeasible, closing down the company is recommended, and the issue is referred to the relevant High Court under the Companies Act. The High Court appoints the official liquidator to look into the affairs of the company and to enable the subsequent bankruptcy and liquidation proceedings. This process can often take 20 years or more.

The Economic Advisory Council describes the system as "dilatatory and fundamentally flawed" (GOI-PM-EAC 2001, 18). The *Mid-Term Appraisal of the Ninth Five-Year Plan* (GOI-PC 2000) also notes several drawbacks, including the fact that BIFR takes a "rather long time to come up with an appropriate revival plan." The report goes on to observe that "it has not been possible to close down a single unit in the private or public sector, based on BIFR's recommendations" (para 23, 116). Both the Planning Commission and the Advisory Council recommend the repeal of SICA and the winding up of BIFR because it creates an incentive to induce sickness in order to keep creditors at bay and attract low-interest funds allegedly for revival. The council has also recommended amending the Companies Act to allow for reorganization and revival where feasible and rapid bankruptcy and liquidation where necessary.

The finance minister proposed repealing SICA in his 2001 budget speech. A bill repealing SICA was introduced in Parliament on September 30, 2001, and has been referred to the Standing Committee on Home Affairs for its examination and report (GOI-MoF 2002a, item 58, 9).

Reservation of Production for Small-Scale Industries

The reservation of the production of certain commodities for small-scale industrial units is another constraint on reallocating resources to efficiently produce exports. Modern small-scale industrial (SSI) units, defined by an investment ceiling (varying over time) on the value of plant and machinery, have been given a variety of promotional concessions to help them overcome genuine handicaps arising from the small scale of operation.¹⁷ The additional preferential measures (to protect them from larger competing units) include excise tax concessions, preferred access to government procurement contracts, and subsidized priority credit from the nationalized commercial banks. Several industrial products (more than 800 in number) have also been reserved for exclusive production in SSI units.

These protective concessions penalize efficiency and success by giving firms strong incentives to stay small. The benefits of the concessions out-

17. See Tendulkar and Bhavani (1997) for the details.

weigh the increase in profitability from a higher scale of operation that would take the unit beyond the SSI investment ceiling and make it ineligible for the concessions. The World Bank (1998) also points out that some Indian joint ventures abroad (e.g., in Nepal) were established in response to the domestic reservation policy. Large Indian firms in effect circumvented the reservation policy by moving abroad where there are no reservations and by producing there for exports to India. They also have an incentive to fragment production in several small firms rather than produce in one large firm. These are avoidable costs imposed on large firms, and the benefits, if any, in employment generated in the small-scale sector do not seem to outweigh the costs.

A government committee concluded in a 1997 report that “the case for reservation is fundamentally flawed and self-contradictory . . . the policy crippled the growth of several industrial sectors, restricted exports and has done little for the promotion of small-scale industries.”¹⁸ As the World Bank (1998) points out, only large *domestic* firms are prevented from entering sectors reserved for small-scale production. Large *foreign* firms can now export to India and compete with domestic small-scale firms. In fact, according to the Hussain Committee report, as many as 563, or 54 percent, of the 1,045 tariff lines that corresponded to products reserved for small-scale production are now under a free import regime. There is also redundancy in reservation: there is *no* small-scale production for roughly a fifth of the reserved items.

Many of the reserved products, including ready-made garments (which remained reserved until January 1, 2001, when, except for knitted garments, the reservation was abolished for the rest), are significant current or potential export items. One victim of this policy, the cotton textile industry, was a major exporter competing with Japan in the 1950s. The reservation of domestic production for the handloom sector and restrictive technology import policies contributed to its demise. Ironically, the intended benefits of the government intervention did not accrue to the handloom sector but were cornered instead by the power loom sector.

The prospective phaseout of the Multi-Fiber Arrangement in 2005 increases the importance of removing the reservation policy. India will lose its share in world markets unless its garment sector can compete effectively with other efficient producers in the world. The requisite evolution—in which successful small enterprises consolidate and expand while large domestic and foreign firms enter the sector—will not take place unless the reservation policy changes.

A recent study by Bhavani and Tendulkar (2000) on the reserved small-scale garment and apparel units in Delhi (India) finds two types of SSI units: a few catering to competitive export markets and a large number of

18. Hussain (1997, 130), as quoted in World Bank (1998, 27).

very small units catering to the domestic market to take advantage of protective measures. The study indicates that exporting units tend to be larger than nonexporting units, have better access to capital and technology, and be more able to afford the marketing costs essential for operating in international competitive markets.

The exporting industries were also more efficient users of labor in terms of having a lower share of wages and salaries in gross output but higher productivity per worker. The higher productivity per worker in exporting units allowed them to pay higher wages and employ more workers on the average per establishment. The analysis indicates that the employment objective of absorbing more workers at a higher wage per worker can be more effectively served by inducing greater efficiency through competition rather than restricting competition through the policy of reservation of products for exclusive production in the small-scale units.

The Prime Minister's Economic Advisory Council as well as the Planning Commission's *Mid-Term Appraisal of the Ninth Five-Year Plan* recommended phased abolition of the reservation policy for small-scale industries. More recently, the Task Force on Employment Opportunities appointed by the Planning Commission has suggested a two-stage abolition by first raising the investment ceiling and then phasing out the ceiling.¹⁹

Progress, however, has been painfully slow. Salvation is coming in small trickles; 15 items were dereserved in April 1997, 9 in December 1999, 14 in May 2001, and 50 more in May 2002. These include leather goods, toys, shoes, agricultural components, and some drugs and chemicals.²⁰ The investment limit defining small-scale production was raised on October 9, 2001, from Rs10 million to Rs50 million for knitted garments.

A new Study Group was appointed by the Planning Commission in May 1999 to look into the SSI policy (GOI-PC 2001a). The recommendations of this group were at odds with those of the 1997 Hussain Committee mentioned above. The Hussain Committee recommended abolition of reservation on all of the 800-odd products reserved exclusively for SSI units, while the Study Group recommended continuation of the reservation policy. The Hussain Committee recommended raising the investment ceiling from Rs6.0 million for small and Rs7.5 million for ancillary SSI units to a uniform Rs30 million. This was implemented by the government of Inder Kumar Gujral, but the ceiling reverted back to Rs10 million in December 1999 with the new National Democratic Alliance government. The Study Group's recommendation to maintain the Rs10 million limit has been followed as of this writing.²¹

19. See GOI-PM-EAC (2001); GOI-PC (2000, 2001b).

20. GOI-MoF (2002a); *Economic Times*, June 14, 2002.

21. On 41 out of 849 reserved items (mainly textiles and hand tools), the investment ceiling for reservation was raised to Rs50 million as of October 9, 2001, according to a communication from the Department of Industrial Policy and Promotion of the Ministry of Industry.

Industrial Policies: Disinvestment versus Privatization

Disinvestment of public equity in the commercial public-sector undertakings (PSUs) incorporated under the Companies Act of 1956 is a second priority for reform. As was noted in chapter 2, government ownership was extended beyond the conventional public goods and services to basic and heavy industries in the Mahalanobis strategy (the Second Five-Year Plan, 1956–61) to accelerate the process of industrialization. Over the years, the scope of the public sector has expanded indiscriminately and moved well beyond the administrative, organizational, and managerial capabilities of the government. The public sector was also looked upon as an instrument of employment generation and has thus absorbed more than the limits dictated by commercial viability.

The incentives facing managers of PSUs bear little resemblance to those in a competitive commercial enterprise. The provisions of section 617 of the Companies Act of 1956 bring PSUs under Article 12 of the Indian Constitution so that, among other procedural requirements imposed on the government, they are accountable to Parliament and subject to public audit by the comptroller and auditor general. PSU managers can be accused of corruption and subjected to investigations applicable to civil servants, a chain of accountability that limits their willingness to take commercial risks. Even in exceptional cases of well-run PSUs, the rate of return on employed capital is low because managers have little freedom to set the prices of their output according to market forces. Matters have been made worse by political and bureaucratic interference and by pressure to create jobs rather than operate efficiently.

Experience in other countries shows that public ownership need not necessarily be inimical to commercial operation. Nevertheless, autonomous commercial operation of PSUs in the Indian political and bureaucratic culture does not appear possible. Reforms applying to the private sector have only increased the PSUs' drain on the public treasury. Private-sector units have been freed from license-permit restrictions since 1991, but PSUs remain shackled by a procedure-driven bureaucracy, a need to gain administrative clearances in commercial investment and operational decisions, and fast vanishing budgetary support owing to fiscal constraints. PSUs' ability to compete with less regulated, more modern private-sector units is fast decreasing, along with any commercial success that they may have had.

The rapid privatization of commercial PSUs is imperative not just for efficiency gains in production but also to refocus the government on its role of supporting a liberalized and globalized economy. The PSUs overload the public sector, distracting the state from core functions of basic governance, such as cost-effective supply of public goods and social services like basic health and primary education. Concrete (but still piece-

meal and hesitant) action has emerged only in the period 2001–02, with the trade sale of Modern Food Industries Limited and the strategic sale of Bharat Aluminum Company (BALCO).

The strategic sale of BALCO on March 2, 2001, though not significant in terms of the magnitude of proceeds (less than \$110 billion) may prove to be a landmark in institutionalizing and building consensus on the process of disinvestment and privatization. The Government of India sold 51 percent of its equity in BALCO to the private company Sterlite Industries (India) Limited. In protest, the workers went on a 67-day strike.

The Congress Party, which governed the state of Chattisgarh (newly carved out of Madhya Pradesh), backed the protest. This party initiated the economic reform process in 1991 and is currently the main opposition party in Parliament. It had opposed the privatization of profit-making, public-sector enterprises. Three writ petitions were filed against the government decision in the Delhi and Chattisgarh High Courts and were transferred to the Supreme Court. In its order dated December 10, 2001, the Supreme Court, while validating the BALCO disinvestment and dismissing the petitions, observed: “Thus, apart from the fact that the policy of disinvestment cannot be questioned as such, the facts herein show that fair, just and equitable procedure has been followed in carrying out disinvestment” (GOI-MoF 2002a, 168).

This case is important for at least three reasons. First, it established the principle that government policy on disinvestment cannot be questioned. Second, legitimization of this case by the highest court of the land would blunt the political opposition to disinvestment. Third, what happened subsequent to the Supreme Court decision is most important. The state government has since signed a memorandum of understanding with BALCO for a fresh investment of Rs5.515 billion in one of the smelter plants.²²

The government has also reduced its stake to a minority share in the state-owned international telecommunications monopoly Videsh Sanchar Nigam Limited by passing its control to Tata Industries. It has also issued letters of intent for international station dialing services to nine private companies. Two state-owned and incorporated basic telephone service providers—Bharat Sanchar Nigam Limited and Mahanagar Telephone Nigam Limited—have also entered the race for these services. This follows a drastic reduction last year in domestic long-distance tariffs by these same two state-owned firms, which are the major basic service providers. These developments are important not only for privatization of infrastructure service provision but also for the introduction of competition in all segments of telephone service.

22. *Economic Times*, May 29, 2002.

The most recent case of passenger car producer Maruti Udyog Limited marked the government's seriousness in moving out of noncore areas and privatizing profit-making concerns. It sold a part of its equity shares in Maruti to its joint-venture partner Suzuki Motor Company, which increased its share to 54.2 percent, thus giving it a controlling stake. Suzuki has also agreed to underwrite a further 20 percent in equity, to be off-loaded during the period 2002–03 with a mutually agreed-on floor price per share.²³

These cases of privatization—of BALCO, which was in what had been regarded as a basic industry exclusively reserved for the public sector under the earlier industrialization strategy; Videsh Sanchar Nigam, an infrastructure monopoly service provider; and Maruti, producing a profitable consumer product—may be expected to accelerate the process of disinvestment and privatization. However, the continuing problem with divestment in state-owned Air India and Indian Airlines suggests some caution.

Conclusion

India's further integration in world markets for factor and goods flows is necessary to improve efficiency, make up for shortfalls in domestic savings, provide an export outlet for increased production, and sustain further high growth. This chapter has outlined the most important impediments to this integration: macroeconomic instability, weaknesses in infrastructure, labor market rigidities, and restrictive laws and policies regarding resource use.

Efforts to reform these policies and rebuild infrastructure will have to be made at both central and state levels. We have noted several serious problems with the operation of state electricity boards as well as their obvious adverse implications for industrial production and exports, but there are also many other infrastructure facilities and services whose supply depends on efficient and corruption-free state administrations. These include, for example, the acquisition of land, the provision of water supply and construction of access roads, the availability of an educated and disciplined workforce, and the prevalence of law and order.

23. *Times of India*, India Business Online, <http://www.timesofindia.indiatimes.com/cms.dll/articleshow?articl=1197822785type=1> (May 2002).

Sources: For panel A: CSO (2001a, 2001b); Press Information Bureau, "Quick Estimates of National Income, Consumption Expenditure, Saving and Capital Formation, 2000–01," Press Note, January 31, 2002. For panel B: World Bank staff estimates. For panel C, prime lending rate: Reserve Bank of India, *Handbook of Statistics on the Indian Economy*, 2001, table 56.