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Towards a Restructuring of Industrial, Trade, and Fiscal Policies

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1. The past several years have seen a number of changes in our industrial, trade, and financial policies which are commonly described as a process of "gradual liberalization." This process is generally felt to have contributed to an acceleration in industrial growth and an improvement in the competitive position of Indian industry. The favourable experience thus far has also created a substantial consensus for continuing the process of modernization and liberalisation, with specific correctives to deal with particular distortions.

2. The case for further liberalisation is reinforced by the fact that virtually all the better-performing developing countries have been engaged in a similar process, and almost all have carried it substantially further than we have. Dramatic changes are also taking place in East Europe, where long-established socialist economies are engaged in radical restructuring, replacing state and bureaucratic controls with market economy concepts and opening up to the world economy. These international examples are relevant not just for their "demonstration effect" but more importantly because of their implications for our competitive position. World markets are becoming closely integrated, and world trade is increasingly dominated by the operations of large transnational corporations whose production and marketing strategies are "globalised" through direct investment, linkages across countries. Our ability to compete is likely to be significantly impaired if our industry continues to operate in an environment which is much more restricted, and less amenable to various types of international linkages than our competitors.

3. All these factors point to the need for continuing the liberalisation process, and this broad direction has been endorsed in several recent official pronouncements. However, agreement on broad directions is not the same thing as a strategy. In fact, a valid criticism of the liberalization initiatives undertaken in the past is that they were essentially a series of ad hoc steps in a general direction. They were not conceived as part of an explicitly stated medium-term reform strategy in which (a) the end position to be reached is clearly identified, and (b) policy initiatives on several fronts are coordinated and appropriately sequenced to ensure steady movement towards this position. This lack of coordination was partly the result of the structure of our

decision-making process, in which individual Ministries deal with their own compartmentalized areas, making it difficult to evolve a consistent overall strategy. There was also hesitation at spelling out the full extent of change needed, so as to avoid controversy.

4. The object of this note is to spell out a medium-term policy agenda in which the extent of change needed over a five-year period in different areas is clearly defined. Individual steps can then be devised to achieve the end objective in a coordinated and phased manner. Clear definition of end objectives is bound to generate more controversy. But it is perhaps necessary if we want to build a consensus on basic objectives and to introduce clarity about medium-term directions both within Government and outside. This clarity is now essential if we are to move forward at a more rapid pace.

5. This note does not deal with important areas such as agriculture and infrastructure management, both of which have an important impact on industrial and trade performance. There are obviously several policy issues in these areas which also need to be addressed.

I. Key Areas of Policy Reform

6. It is important to recognize that "liberalisation" and "decontrol" by themselves do not constitute a sufficient recipe for rapid growth in industry. They will, at best, improve efficiency of resource use and resource allocation, but they have to be set in a macroenvironment which is conducive to rapid growth. One of the important limitations of the approach followed in the past several years is that the macroeconomic situation deteriorated gradually. As a result, we have today a serious macroeconomic imbalance which, if not corrected, would destabilise any serious reform effort. The agenda for policy reform must therefore give priority to restoring macroeconomic equilibrium. This must be accompanied by other measures designed to improve industrial performance efficiency and export competitiveness.

7. The following are the major areas in which policy action is needed:

- Achievement of macroeconomic balance with high investment levels
- Reform and redefining the role of the public sector
- Reducing and restructuring domestic controls over production and investment licensing
- Reducing the degree of protection to Indian industry
- Opening up to foreign investment

These areas are closely interrelated. Progress in some areas enables greater flexibility in others. Equally, progress in some areas is crucially dependent upon parallel progress in others. The action plan in all these areas should therefore be viewed as a package, in which all elements are essential and there is a clear medium-term perspective of evolution of policy in each area.

II. Macroeconomic Balance

8. There is general agreement that the Government's fiscal deficit has got out of control, and this is reflected in the increase in inflationary pressure and the widening BOP deficit. Restoration of short-term microbalance requires urgent steps to control the fiscal deficit this year. Over the medium term, it requires reduction of the revenue deficit from around 4% of GDP in 1988–89 to no more than 2% of GDP by 1994–95.

9. Government has signaled its intention to restore fiscal balance by the commitment to hold the budget deficit for 1990–91 to a much lower figure than last year. However, we should not assume that the deficit can be easily contained at the BE level. There are already several identifiable additional demands on the budget arising from defence (Rs 500 crores), other internal security requirements (Rs 100 crores), underfunding of certain central plan projects (Rs 500 crores), additional requirements for the loan write-off scheme (about Rs 1200 crores), funds needed for the crop insurance scheme (Rs 250 crores), and additional requirements for the food subsidy (Rs 200 crores). There will also be heavy demands from the states either for natural calamities (for which only a limited amount has been provided) or to meet their approved plan expenditures, which have been based on highly optimistic assumptions about their own resources. Assuming additional requirements of Rs 1,000 crores for the states, the presently foreseeable additional demands upon the budget already add up to about Rs 3,500 crores.

10. If the deficit in the current year is allowed to deteriorate to the extent indicated above, it would mean that no fundamental change would have taken place in the fiscal situation, compared with the disturbing trends of the past few years. These trends indicate a "dynamic instability" arising from the fact that the Government has been relying to an ever-increasing extent upon borrowing not only to meet capital expenditure, but also to meet a continuously growing revenue deficit. (The revenue deficit increased from Rs 392 crores in 1981–82 to Rs 14,736 crores in 1989–90.) Revenue expenditure by definition yields no direct return to finance future interest payments, and borrowing to finance a growing revenue deficit is therefore bound to introduce "dynamic instability," with an expanding burden of interest payments, adding to the revenue deficit over time and necessitating larger and larger borrowing.

11. It is therefore essential to take steps in the current year and in the next year to ensure that a substantial fiscal turnaround is achieved over a two- to three-year period.

Fiscal Priorities for 1990–91

12. The following are some of the specific decisions which need to be taken in the current year to contain the deficit within reasonable levels. All these decisions are difficult, and if we slip on one or two, we can perhaps still manage, but most of these decisions must be taken if macroeconomic stability is to be assured.

(a) A serious effort must be made to hold defence expenditure within the BE level as far as possible. There are at present major uncertainties in our security environment. However, unless it becomes truly unavoidable, we should not undertake defence expenditure commitments, which would be destabilising in the short run and unsustainable in the medium run.

(b) The budget assumes that all DA will be absorbed within budget accounts. All Ministries have been informed of this provision, but there are bound to be protests in the course of the year claiming that this requirement will lead to a squeeze on plan funds. Ministries should be firmly instructed that they must comply with this provision and requests for additional resources even to project plan projects [sic?] will not be entertained.

(c) A number of administered price increases are pending. It may seem contradictory to recommend price increases when we are simultaneously trying to bring inflation under control. But the alternative is a larger deficit, which will impart a general push to prices. The administered price increases which are pending and which should be implemented in the next two months are rice issue prices (+14.5%), levy sugar price (to be raised from Rs 5.25 per kg to Rs 6), steel prices (+4% to cover cost increases in coal, electricity, railway freight), and coal prices (+6%).

(d) Certain central sector PSUs are saddled with heavy unpaid dues from SEBs. NTPC'S undisputed dues of more than 2 months are about Rs 762 crores. Coal India also has huge overdues. Continuance of this situation is completely unviable. It may be necessary to take the unpopular step of adjusting these dues against central Assistance due to the states.

(e) Fertiliser Prices facing the farmer today are at the same level as in 1980, although wheat and rice prices this year are almost double the 1980 level. Maintaining fertiliser prices constant for consumers when costs are steadily rising is obviously unviable. The fertilizer subsidy is now Rs 4,000 crores. It is projected to reach Rs 7,000 crores in 1994–95 if consumer prices are not changed. We should consider whether an adjustment of 10% in the fertiliser price can be implemented simultaneously with the announcement of the procurement price for kharif. The higher fertiliser price can be built into the procurement price. This is a good year to make the change since we have had two good crop years. We have given a big boost to procurement prices and are incurring a substantial cost on the loan write-offs.

(f) The demand for "one-rank-one-pension" is being examined. It is important to ensure that in implementing this promise we do so in a manner which avoids automatic extension of the principle, via the Courts, to the civilian sector also. The total cost of extending it to the civilian sector could be around Rs 400 crores per year.

(g) In order to avoid a build-up of new demands in the course of the year, Finance Ministry should indicate at an early date to all Ministries that no new supplementary demands will be entertained.

(h) It will be necessary to take a firm line on demands from the states for additional central assistance. Some demands may be politically inescapable, but these have to be kept to an absolute minimum. Besides, it will be necessary to convey to the States that they must put in the maximum effort to ensure their own resource mobilisation or else their plan expenditures will suffer. The most important single area for resource mobilisation in the states is adjustment in power tariffs, including the tariff to agriculture, which is heavily underpriced.

(i) An important step in establishing credibility vis-à-vis the states is to practice resource mobilisation in Delhi to reduce the large subsidy otherwise necessitated from the central Budget. The Budget assumes that steps will be taken in the current year to increase DESU charges and to raise DTC fares. Both steps should be taken in the next few months. DTC fares should ideally be raised during the University vacations.

Fiscal Priorities for 1991–92

13. The priorities for 1991–92 obviously depend upon whether adequate steps can be taken in the current year to contain the fiscal situation. If we fail to do this, and the budget deficit reaches Rs 10,000 crores or so, we will end the year with a much more visible crisis with double-digit inflation, no improvement in the BOP deficit, and foreign reserves even lower. Our options in this case would be severely limited. On the other hand, if the current year's deficit can be contained to reasonable levels, say, no more than Rs 8,000 crores, and we have a normal harvest, there is a good chance of ending the year with moderate inflation of, say, 6–7% and the beginning of a turnaround in the BOP.

14. Even on this favourable assumption, however, next year's budget would have to continue the policy of fiscal containment. The main focus will have to be on curbing Government expenditure, especially consumption expenditure. The fiscal problem we face has arisen not because revenue has fallen short of targets but primarily because non-Plan expenditure has greatly overshot targets. Curbing such expenditure is essential if we are to provide room for some expansion in the priority area of building social and economic infrastructure in rural areas.

15. The problem cannot be solved through drastic reduction in any single item. Rather, a start has to be made on several fronts, and work should begin now to explore feasible options for next year. The following steps are easily identifiable:

(a) Defence expenditure growth over the rest of the Plan should be fixed at no more than 7.5% in nominal terms. This is tight, but with appropriate prioritisation and slimming of noncombatant

activities, it may be possible to live within this amount without jeopardising combat effectiveness. The Defence Ministry should begin work now to identify the hard decisions which are necessary to live within this projection. It may involve abandonment of some ongoing projects, decisions to reduce recruitment levels gradually, and shedding of certain activities presently being performed departmentally which could be done more cheaply outside. To be effective, a plan for restructuring defence expenditure on these lines must come from within the services, and this can only happen if the services are given a clear idea of the resources likely to be available for defence.

(b) The growth of subsidies has been most out of line with targets. A number of minor subsidies were earlier identified by the Finance Ministry which could be abolished without much adverse impact. In fact, the main pressure groups behind these subsidies are the agencies which administer them and not the final beneficiaries. Action should be initiated now to abolish at least some of these subsidies next year.

(c) Even if a decision is taken to raise fertilizer prices by, say, 10% in the current year, a further increase of 10% is economically justifiable next year. We should establish a clear target for the feasible level of fertiliser subsidy we can finance in 1994–95 and tailor fertiliser pricing policy accordingly.

(d) A beginning has to be made in establishing the principle that the PDS should be aimed primarily at the needy segments of the community. It will take time to evolve an effective targeting mechanism, but Government could at least announce that the PDS will not be available for families where the head of the family draws Rs 2,000 p.m. or more. This will not be easy to implement but in the first instance, it can be effectively implemented for all Government servants and public sector employees, and in due course, it can be extended generally. It will at least establish the principle that subsidies must be targeted.

(e) Reductions in Government staff and elimination of certain offices have been considered on several occasions, but little has been done in this area. Nor will we succeed if decisions on staff cuts are left to a process of consultation. Most Ministries could be trimmed in staff terms by 10% without any adverse impact on substantive performance provided the nature of work is also restructured. In any case, progressive reduction in controls justifies a smaller staff. A small group under Cabinet Secretary could make specific recommendations to PM (Prime Minister) by October/November of this year which could be implemented beginning next year. These should include abolition of certain offices and mergers of certain departments. Departmental mergers are particularly important because we have had an unnecessary proliferation. Even a start in this direction would be symbolically important.

(f) Until the resource position improves considerably, we should not take on new obligations, which involve a heavy draft on resources. The proposals regarding the "Right to Work" therefore need to be processed with extreme caution. On present estimates, the Right to Work, consequent on a constitutional amendment, would require additional sums of about Rs 9,000 crores each year (for both Centre and states). Such a demand cannot be fitted into the fiscal situation without serious fiscal disruption.

(g) The process of price adjustments for administered prices is being unnecessarily delayed, leading to unplanned pressures on the deficit. For next year, issue price adjustments for rice, wheat, and sugar should be announced simultaneously with the increase in procurement prices even though the issue prices would become effective only at a later date. There is no harm in making an announcement in advance of a higher price to become effective six months later—it will actually reduce the shock when it actually happens.

III. Public Sector Reforms

16. The issue of public sector reform is directly related to restoration of the macrobalance because of shortfalls in resources generated by the public sector, and continuing losses in some parts of the public sector are important contributors to the macroeconomic imbalance. Public sector reform is also directly related to industrial efficiency and dynamism. A White Paper on the public Sector is to be submitted to Parliament. It should be the occasion to do some plain speaking.

17. The White Paper should reaffirm that the basic rationale for having a strong public sector remains valid in our system despite the enthusiasm for massive "privatization" all over the world. At the same time, it is necessary to adopt a much more flexible and innovative approach on many other aspects of the public sector:

(a) It is essential to give the public sector much greater autonomy in decision making, but we have not yet found effective ways of achieving autonomy with accountability. The mechanism of MOUs, which now covers 31 PSUs, was meant to do this, but it does so only to a limited extent. At best, the MOUs have provided a clearer statement of what Government expects from an enterprise in the short run, with a more objective basis for evaluating management performance. To some extent, objective measures of performance will help to create a certain measure of autonomy. However, effective autonomy can only come from change in our institutional culture, and a build-up of traditions, which will take time.

(b) We should unhesitatingly state that all public sector units should be ready to operate in a competitive environment. The existing system of price and purchase preference should therefore be withdrawn with effect from next year. Public sector units bidding for public sector contracts should bid competitively. If they run losses to remain competitive, it is better that the losses are

met from the budget than from other healthy PSUs through uncompetitive pricing. Full contractual provisions should be made for penalties, defaults, etc. against PSUs as in the case of private sector units, and these should be enforced. The relationship between public sector units should be made as commercial as possible.

(c) The principle that public sector units which are demonstrably unviable, and which cannot be revived, will have to be closed down should be clearly established. A number of such units have already been identified. NTC alone has indicated that about 29 mills need to be closed as they are completely unviable and involve large losses which are borne by the budget. It is obviously not practical to close down a large number of public sector units in the near future. However, we should certainly consider closing down some small units, if only to establish the principle. If this is done, it will help to ensure a work environment more conscious of productivity and mindful of the requirements of viability.

(d) Although privatisation of PSUs as a general strategy is ruled out, we should consider the case for partial privatisation (sale of part equity) of certain units where this can help to bring in new capital or to inject a new management culture. Partial privatisation, combined with sale of stock to employees in sectors which are highly customer oriented, may be a good way of introducing a much-needed customer orientation which will help efficiency. ITDC for example, could easily be partially privatized along these lines. Indian Airlines and Air India are other examples. We should immediately commission SBI capital markets or ICICI to undertake a study of how to proceed with this action on ITDC, Air India, and Indian Airlines. The study can be completed in six months and specific proposals for partial privatisation subjected to a public debate before Government decision is taken. If we can introduce some form of privatisation in these three cases within 2 years, we can consider subsequent steps in the light of experience gained.

(e) It is also essential to start moving towards greater productivity linkage in wage negotiation and acceptance of the liability to pay of the enterprise as a criterion for determining the extent of wage increases. This implies abandonment of the idea of introducing some degree of uniformity in wage structure of public enterprises. Implementing this approach is a matter for detailed negotiation with labour and will take time. However, the principle should be established in the White Paper.

(f) In order to strengthen the commercial viability of public sector enterprises, it is necessary to give public sector organisations a legal status which is distinct from Government. At present, certain court judgements have held that PSUs are covered in the broader definition of state under Article 12 of the constitution. This makes PSUs subject to the writ jurisdiction of the Courts, which reduces management flexibility very considerably. The Industrial Policy Resolution of 1956 clearly envisaged that public sector organisations needed to have an institutional

framework which was different from Government. There is a case for amending the constitution to solve this problem.

(g) The policy of reserving certain areas exclusively for the public sector needs to be changed. There is a case for such reservation where national security interests are involved, or where it involves exploitation of exhaustible resources, but in most other cases, there is no reason why private investment should be barred.

IV. Reduction of Industrial Licensing and Control

18. A number of steps have been taken in the past several years investment and licensing has to liberalise licensing controls over new expansion, and it is true that industrial become less restrictive. Nevertheless, our system remains much more regulated than in most other countries. In fact, the major change in the past five years has come less because of actual decontrol and more because we have administered the controls in a much more liberal manner, with a greater concern for better technology and economies of scale. Our efforts at actual decontrol or delicensing have only a limited effect, either because the fine print has negated the intention or because one control has been removed but others requiring the same scrutiny have remained.

Delicensing of Industry

19. The economy has become too complex to continue with the system of licensing control as it has operated in the past. As a first step, we should aim at achieving effective delicensing for smaller and medium-scale investment projects. The Ministry of Industry has announced a new scheme which aims at removing all projects costing Rs 25 crores (Rs 75 crores in backward areas) from industrial licensing control, provided they are (a) in defined positive list of industries and (b) do not require imported capital goods exceeding 30% of the total investment in plant and equipment or raw material and components exceeding 30% of the value of production. Unlike the previous scheme, location restrictions will not be imposed by the central Government scheme but will be left to the states. Although projects qualifying under the scheme will be freed from industrial licensing, they will be subject to the normal import policy for raw materials and components. However, capital goods [imports of] up to 30% of plant and equipment will be automatically granted.

20. The provision that these projects would get automatic access to capital goods up to 30% of the value of plant and investment is a very important feature. It means issue of CG licenses up to this level would not require detailed scrutiny by DGTD. The implicit freer access to imports means that the domestic capital goods industry competing for these orders would have to rely mainly upon tariff protection. There is evidence that the capital goods industry will be able to compete with the present level of tariff protection. If there are some specific subsectors of the capital goods industry which face difficulties because of high tariffs on raw materials or components, it may be better to adjust these duties downwards to help the local industry.

21. It is estimated that almost 90% of projects currently being licensed, accounting for about 30% of the investment, would fall below Rs 25 crores (Rs 75 crores in backward areas) limit. However, many of these may be caught by the stipulated criteria relating to import of capital goods and raw materials/components. Nevertheless, it is reasonable to expect that about 60% of the projects presently needing licensing would be freed from industrial licensing and also CG scrutiny. Although 60% in number, these projects are likely to account for only about 15% of the value of investment!

22. The implementation of this scheme should be closely monitored. To begin with, it is important that the positive list of industries should be extensive to ensure that the liberalisation is effective on the ground.

23. Although the initial impact may be limited, the coverage of this scheme should be gradually increased as experience is gained with the operation of the scheme by (a) increasing the positive list of industries, (b) relaxing the maximum import percentage depending upon developments in the BOP, and (c) increasing the size limit of investment. By the end of the 8th Plan, we should aim to reduce industrial licensing to, say, 20% of the present number, covering around 50% of the total value of investment. Industrial licensing should remain mainly for the larger projects or for projects with a high import content.

24. The above liberalisation does not affect areas reserved for the small-scale sector. This is a highly sensitive area, and for the present, no change should be contemplated in the reservation policy. However, we should not rely upon expanding the area of reservations either. We should look for positive ways of building linkages between small-scale enterprises and large-scale enterprises through ancillarisation and through marketing tie ups.

MRTP Act

25. Under the MRTP Act, investment proposals from large houses (assets of Rs 100 crores or more) and also from dominant firms (market share of 25%) are subject to special scrutiny. The intention behind these provisions is the prevention of concentration of economic power and the control of monopoly. Neither objective is well served, and there is a case for reconsideration.

26. As far as the control of monopoly is concerned, there is no doubt that some control of monopolistic practices (in the sense of noncompetitive pricing) is necessary. But it is not at all clear that this should take the form of preventing or discouraging expansion by a firm in a product line in which it is dominant, i.e., its market share exceeds 25%. It may often be better to allow such firms to expand freely but to control any monopolistic tendencies by delicensing domestic production in the area and, more immediately, by introducing greater pressure from imports.

27. The scrutiny of investment proposals from large houses with a view to preventing concentration of economic power is also of questionable value. If the intention is to direct large houses into priority areas, this is in any case achieved by the requirement that MRTP firms must invest only in Appendix I industries. Subsequent MRTP scrutiny of investment proposals within the Appendix I area only introduces a dilatory legal procedure. Hearings have to be held inviting objections from concerned parties, who may often be MRTP houses themselves holding licenses and wanting to protect their own position. The system is also somewhat inflexible since MRTP permissions are given subject to detailed specification of financing parameters, and even minor modifications of the financing scheme require fresh approval. The net effect of all these provisions is to reduce competitive pressure and introduce considerable delay.

28. Spokesmen of large industry have also argued that the MRTP Act, with its built-in prejudice against large-sized companies, is out of line with the requirements of the emerging world trade scenario. International trade is increasingly being driven by the global operations of transnational companies building intercorporate networks of production and marketing linkages. To operate effectively in this situation, we need to build companies which can be credible players in global markets. We should therefore recognise the need to encourage our large companies to grow in scale, and simultaneously push them to establish niches in world markets.

29. There is considerable force in these arguments, and some restructuring (not abolition) of the MRTP Act is therefore overdue:

(a) The asset limit of Rs 100 crores was fixed in 1985 when it was raised fivefold. There is a good case for raising it again to, say, Rs 300 to Rs 500 crores. The limit should be set to ensure that Act covers a much smaller number of the really large houses.

(b) At present, a company with market share of 25 does not attract coverage under “dominance” if its assets are below Rs 1 crore. This minimum limit should be raised to at least Rs 15 crores. Threats of monopoly in particular products by companies below the asset limit should be met by easing entry of others and, where possible, by imports.

(c) In order to give MRTP companies special incentives to invest in export-related activity, any company in an MRTP group which reaches an export ratio of 25 of total turnover should not attract the provisions of the MRTP Act in terms of investment approvals.

(d) Normally, any company in which an MRTP company has a 25 shareholding or more is treated as an MRTP company by virtue of interconnection. We could provide that companies with assets below Rs 15 crores would not be covered by MRTP under the provisions of interconnection even if MRTP companies have equity holdings in the company as long as the

holding is less than 40%. There is some merit in allowing MRTP companies to invest in smaller companies which could operate outside Appendix I as this will encourage greater dispersion of industrial activity and possibly also greater labour intensity.

(e) There are a number of other minor simplifications which have been identified in the Department of Company Affairs such as, for example, rationalisation of the common directorships criterion for determining interconnection and also permitting greater flexibility in the approved schemes of finance to avoid the need for fresh approvals for even minor modifications.

V. Reducing the Degree of Protection

30. As shown below, the level of protection given to Indian industry is very high, much higher than in most other developing countries:

Mean ad valorem Tariffs 1985

	Intermediate Goods	Capital Goods	Consumer Goods	All Mnf.
India	146	107	141	137
Argentina	21	25	22	23
Bangladesh	98	81	116	101
China (PRe)	79	63	131	91
Mexico	26	24	32	25
Pakistan	75	74	127	90
Philippines	22	25	39	28
Thailand	28	25	9	34
Turkey	29	55	55	37
Yugoslavia	18	21	20	19

Source: Data reported in a recent Cabinet note of the Commerce Ministry.

Customs duties on many items have been reduced since 1985, and the average rate on intermediates is now probably around 120 with capital goods attracting an average duty of around 80%. However, other countries have also moved in the same direction in this period, and the relative position is probably much the same.

31. It is important to recognise that the continuance of such high rates of protection for the industrial sector whether through tariffs or through import licensing will greatly limit our ability to penetrate export markets in a big way. The heavily protected domestic market is bound to be more attractive than the highly competitive export market. Our exporters will be at a severe disadvantage because our domestic cost structure will remain much above the levels prevalent in our competitor economies. We can offset these high costs to some extent through export incentive schemes such as tax rebates, subsidies, and access to duty-free imports. However, such schemes can never completely offset the full direct and indirect impact of protection on domestic costs. Incentive schemes are invariably open to misuse, and this tendency is greatest when the incentive scheme is offsetting a large cost disadvantage. As a result, the scale of the incentive which can be offered is automatically limited by the extent of misuse. Besides, relying on such schemes has the disadvantage of encouraging exports which are heavily dependent on duty-free imports of raw materials and components.

32. A clear policy decision is needed to substantially reduce the average levels of protection over the next five years. We should set our sights boldly in this respect and aim to bring down the average duty level on raw materials, components, and capital goods to around 30–40 by 1994–95. This would involve halving the duty on capital goods and cutting intermediate goods duty even more. It is possible that for some items, duties at present are so high (e.g., petrochemicals at 150–190) that reduction to 30 or 40 is not feasible. For such items, higher duty levels may have to be tolerated, but even here tariff levels should be reduced to no more than 75 by 1994–95. These broad quantitative targets should be publicly announced.

33. Parallel with phased duty reduction, it is also necessary to shift away from import licensing to tariff-based protection as far as possible. This was a key recommendation of the Abid Hussain Committee, which was accepted, but progress has been sporadic at best. Consumer goods can continue to be restricted by import licensing, but all raw materials and capital goods should be shifted to a CGL regime. It may be noted that any shift to tariff-based protection by itself will require an increase in individual tariffs. In effect, we should increase tariffs where necessary to shift from licensing to tariffs, and, as a parallel process, bring about a general reduction in tariff levels combined with reduced dispersion in tariffs across commodities.

34. An important consideration in implementing tariff reform of the type proposed above is that duty reductions on a particular item have to be synchronised with duty reductions on inputs and components also. Otherwise, we can unwittingly precipitate a situation where effective protection (i.e., the degree of protection to intermediates) can become too low or even negative. It is not easy to achieve this synchronisation, and it is impossible to do it perfectly, but with careful advance planning a reasonable solution can be found.

35. Our ability to reduce duties to the extent indicated above will be constrained by two very important considerations. First, the reduction in duty should not lead to a totally disruptive shock

to Indian industry. Second, the duty reduction should not lead to an unacceptable drain on revenue.

36. As far as disruption to industry is concerned, it is not difficult to achieve a managed transition over a 5-year period. A reduction in protective duty from 100 to, say, 40 requires a reduction in domestic cost of production from 200 to 140 for the industry to remain competitive. This means a cost reduction of 30 over a 5-year period. Part of this cost reduction should come through efficiency gains, and the rest would have to be achieved by an offsetting depreciation in the exchange rate. For example, if the real exchange rate is depreciated by 20% over a 5-year period, the cost reduction needed to maintain competitiveness would be from 200 to 168 ($100 \times 1.2 \times 1.4 = 168$)—a reduction of 16. It should be possible for industry to achieve cost reductions of this order over 5 years.

37. The implied changes in the exchange rate are also not alarming. A 20 real depreciation over a 5-year period is not very large. If the annual differential between our rate of inflation and the inflation in our major markets is contained to around 5% or so, a steady depreciation of around 5% per year is needed simply to maintain the real effective exchange rate at present levels. To achieve a real exchange rate adjustment of around 20 in 5 years, the annual rate of depreciation would have to be around 10 per year. Of course, if our inflation rates are higher than assumed above, the rate of depreciation will have to be even higher. This underscores the importance of more economic management in bringing about effective trade reform.

38. The revenue consequences of the proposed reduction in import duties pose a more difficult problem. A reduction in duty from 100% to 40%, with a real exchange rate depreciation of 20%, implies a reduction in customs revenue of 52% if import volumes are unchanged! The revenue loss will be moderated by certain factors. To the extent that the total package improves export performance, it could support a higher level of imports in relation to GDP than would otherwise be feasible, and the larger base of imports on which customs duty would be levied (albeit at a lower rate) would reduce the revenue loss. Where tariffs are being increased in shifting from licensing to duty protection, there will also be a gain in revenue. Nevertheless, it has to be accepted that a significant reduction in customs revenue is bound to accompany any programme for significant reduction in customs duties. This has to be offset by expanding other sources of revenue since the macroeconomic objective requires not a reduction in the tax ratio but rather an increase.

39. What is needed therefore is to synchronise the reduction in customs revenue by an offsetting increase in direct tax revenues and also excise duties. The reduction in customs revenue should not be viewed as a net reduction in the tax burden, but only a shift from “trade-distorting taxes” to “non-trade-distorting taxes.” Higher excise duties, for example, may raise costs, but since excise duties are fully rebated on exports, they do not affect competitiveness.

40. It may be noted that while Indian industry (and the Industry Ministry) is usually enthusiastic about reducing customs duties, it is not supportive of either an increase in excise duties or an offsetting depreciation in the exchange rate! Both measures will help exporters, but nonexporting industry will feel the pinch.

41. It is evident from the above that the objective of reducing the degree of protection to Indian industry over a five-year period requires careful coordination of several initiatives undertaken in parallel. To summarise, we must:

(a) Introduce a programme for gradually shifting from licensing controls to tariff-based controls for all intermediate and capital goods. This would, in general, raise tariffs for these items.

(b) Lower the average tariff level in a phased manner, with special emphasis on lowering high-end tariffs and avoiding anomalies where tariffs on a product are lowered but tariffs on inputs remain high.

(c) Synchronise the lowering of average tariffs with some offsetting exchange rate changes to avoid a destabilising effect on industry.

(d) Offset the reduction in customs revenue by a shift to other sources of tax revenue, keeping total tax revenue roughly unchanged. Implementation of a tariff reform programme along these lines requires close coordination among various Ministries (Finance, Commerce, Industry, and RBI). A great deal of technical preparatory work must be done to ensure that reasonably steady progress can be made year by year.

42. An important reason for hesitation in implementing a policy reform of the type outlined above is the fear that any relaxation in our traditional instruments of control such as licensing and high tariffs could make us vulnerable to sudden pressures on the Balance of payments. The fear is understandable, but it should not hold up a process of structural reform which is overdue. A key issue here is whether steps can be taken to correct the fiscal deficit, which is the primary cause of the BOP problem. If we can take effective steps to bring the macroeconomic situation under control, we can be reasonably confident that the BOP position will be manageable, and we can take greater risks in shifting items from licensing to OGL. If, on the other hand, the macroeconomic situation is not brought under control, the risk of vulnerability on the BOP is very genuine. The pace at which the liberalization in foreign trade can proceed obviously depends critically upon the pace at which we can bring the fiscal deficit under control.

43. Since effective control of the fiscal situation is likely to take some time, the BOP may remain under pressure for another two years at least. We may, therefore, have to accept a more gradual process of transition than is perhaps ideally called for. In this situation, there is a strong case for pursuing "import liberalisation linked to foreign exchange earnings." This can be done by keeping the import licensing system in place, but expanding the operation of the replenishment licensing scheme. Under the present policy, REP licenses are issued to exporters

as a percentage of the f.o.b. value of exports, and they can be used to import any item in the limited permissible list. We could widen the scope of the REP licenses by (a) increasing the REP percentage in the f.o.b. value of exports, and (b) allowing a part of the REP license to be used for import of restricted items also. This would introduce greater flexibility of access to imported requirements while ensuring that total imports remain limited. If there is excess demand for imports, the total imports would remain constrained because licenses can be tightened up, but importers will also be able to import via REP licenses. The resulting premium on REP licenses would accrue to exporters and would provide an additional incentive to exports. We could aim at widening REPs to account for about 30 of total exports (other than gems and jewellery) in two years' time. The premium on REPs in the market would be a good guide to the extent to which the exchange rate needs to be adjusted from time to time.

VI. Opening up to Foreign Investment

44. Traditionally, we have adopted a cautious—at best, tolerating—stance towards foreign investment. The rapidly changing world economic situation has led to rethinking on foreign investment in most developing countries and also in socialist countries. Our policies are now more restrictive than those in most other countries.

45. Foreign investment can play an important role in industrial modernisation through the following:

(a) Providing additional financial resources on terms which have some advantage over commercial borrowing, especially when exposure to commercial borrowing has become very large.

(b) Providing access to technology on a continuing basis, with the technology holder having stake in ensuring absorption and subsequent updating.

(c) Providing a potential link to global marketing networks which can help our industry to carve out niches in world markets as part of the global network of large firms.

(d) Providing a source for "software inputs" such as management styles and methods. We have tended to assume that we have little to learn in this area, but this assumption is not justified. All these considerations are important for India in the years ahead. They are more relevant now than they were earlier, partly because the world has changed and partly because there is much greater self-confidence today about our ability to absorb foreign investment without being swamped by it.

46. The total inflow of foreign investment in India today is only about $200 million per year. This compares with about $2.3 billion for China, $1.1 billion for Thailand, $650 million for Malaysia, $700 million for Indonesia, and $500 million for the Philippines. The four South East Asian countries—Malaysia, Thailand, Indonesia, and the Philippines—have a combined GDP

which is only 80 of India's, yet their combined foreign investment inflow is almost $3 billion, or 15 times the inflow in India.

47. The inflow of foreign investment does not depend solely on foreign investment policy. The extent of infrastructure and the degree of freedom allowed to investors in economic decision-making are both crucial factors, and in this respect, our environment cannot compete with South East Asia for quite some time. Nevertheless, India has several attractive features, including especially availability of technical and managerial skills and a substantial domestic market, and we could attract much more foreign investment than we do. In this background, the following initiatives should be considered:

(a) A clear announcement should be made that foreign investment up to 40 is welcome in a specified positive list which is quite large (though sensitive areas may be excluded). Within this list, the only criterion to be checked should be a "reasonable foreign exchange balance." Reasonableness should not mean strict foreign exchange neutrality. Instead, a minimum import entitlement, reflecting some sort of import requirement for industry, should be allowed without having to be covered by specific export obligations. Above this level, however, foreign exchange requirements should be covered by foreign equity and credible export commitments. A scheme along these lines is being prepared by the Ministry of Industry.

(b) We should define a list of high-priority industries where 51 ownership will be automatically allowed. This has already been announced for hotels. There should also be a list of manufacturing industries chosen on considerations of technology acquisition.

(c) We should also announce that all cases of foreign investment will be allowed to increase their equity to 51 if they can increase their export performance to 50 of turnover. This could be done on an ex-post basis, i.e., the foreign investor begins with 40 equity but with the assurance that he can go to 51 if he shows a 50 export performance over, say, 3 years.

(d) In the short run, the best signal we can give that we are keen on foreign investment is to attract some high-visibility cases of "good foreign investment" speedily and ensure wide publicity for successful foreign investment operations. This can be done administratively without any specific policy changes. We should actively encourage some of our large public sector organisations and also private sector units to seek joint venture collaborations in attractive areas. We should separately approach reputed international firms in areas of our choosing to look to India as an investment possibility.

(e) It would be useful to set up a tracking mechanism for all foreign investment proposals involving foreign investment in excess of $10 million to see that these projects, once approved at the FIB, are not unjustifiably stuck for other clearances. There is an element of unfairness in providing such "escort service" to foreign investments and not to other projects, but there is a case for making an exception for foreign investment projects for the next two years or so if we are concerned to project a new policy to the outside world.

Conclusions

48. The package outlined above provides a balanced medium-term agenda for policy reform aimed at accelerating the pace of industrial growth and increasing the long-term competitiveness of the industrial sector. If the broad outline is accepted, an operational plan could be devised to implement most of the package over the next few years.

49. It is essential to view the proposals in this note as a package, including especially the measures needed to restore macroeconomic balance which are a precondition for the success of the rest of the package. Failure to restore the macroeconomic balance will mean continuing pressure on the balance of payments, which will make it impossible to undertake the trade liberalisation which is recommended in the package.

50. It is important to note that measures to restore the macroeconomic imbalance are essential whether or not industrial and trade policy reforms are carried out. Otherwise, the pressure on the BOP will continue, and in the absence of fiscal correctives, we will be forced to contain BOP pressures through tighter import licensing and/or higher tariffs. This will only be counterproductive, leading to build-up of inflationary pressure disruption of industrial production, worsening export performance.

51. It should also be recognised that the immediate consequence of a programme to restore macroeconomic balance may well be a slowdown in industrial growth, partly because of the deflationary effect of corrective fiscal policy on industrial demand and partly because some parts of industry will take time to respond to the proposed restructuring. This slowdown could be offset if agriculture performs better than expected or if exports do exceptionally well, but we cannot count on this. We should, therefore, be ready for somewhat slower growth in the first two years of the Eighth Plan, which can be made up in the next three years when the deflationary consequences of macroeconomic adjustment would have been overcome and the full effect of policy reforms would be evident.

52. There are two other elements which are crucial for industrial performance but which have not been explicitly addressed in this paper. These relate to reforms in the financial sector on the one hand and reforms relating to labour legislation on the other. There are a number of difficult issues to be faced in both areas, and they should also form part of any medium-term strategy. On balance, we can probably make reasonable progress in financial sector reforms aimed at supporting the process of industrial and trade liberalisation. This would involve strengthening the capital market as a means of mobilising and allocating resources and encouraging greater autonomy and competition among banks and financial institutions combined with a measure of interest rate reform. Some proposals along these lines are already under consideration in the Ministry of Finance and should be implemented over the next year or so.

53. Reforms relating to labour legislation are also necessary. However, this is a much more difficult and politically sensitive area. A great deal of preparatory work is needed before we can begin to make significant progress.