India: Privatization and Liberalization in a Trillion Dollar Economy

Tapen Sinha
Associate Professor of Finance
Bond University
Gold Coast, Q 4229, Australia

Dipendra Sinha
Visiting Professor of Economics
University of Nebraska, NE 68588, USA
and Lecturer
Macquarie University
Sydney, NSW 2109, Australia

Acknowledgment: We are indebted to the participants at the seminars at various universities in the United States, Australia, Singapore and India. Any remaining errors are our own. The opinions expressed here do not reflect the opinions of the universities we are affiliated with.

Abstract

Reforms in India has taken a dramatic turn beginning in July 1991. The experience differs markedly from that of the Eastern European countries: India was a fully functioning democracy that simply opened up internationally as well as freeing up resources domestically. We examine India's reform process in attracting foreign investment and foreign exchange regulations. Indian capital markets provide opportunities for foreign investors. Direct business opportunities in India have also opened up. India has a middle class of at least 200 million people. The potential buying power for this group is quite substantial. Niche marketing by smaller businesses from the US is also feasible. Future developments in further reduction in tariffs, infrastructure development, convertibility of Indian rupees will accelerate the process of integration to the World Economy.

Introduction

In 1955, Milton Friedman wrote:

> "The great untapped resource of technical and scientific knowledge available to India for the taking is the economic equivalent of the untapped conditions available to the United States 150 years ago. The basic question is one of method, of the social and economic arrangements that will best promote the conversion of these potentialities into realities while at the same time maintaining freedom and democracy and giving ever-widening opportunities to the mass of the Indian people" (Friedman, 1992, pp. 163-64).

Friedman clearly recognized the vast growth potential of India but most other Western economists failed to see such promise. Instead, in the 1970s, Kissinger's "ping-pong diplomacy" with China resulted in a shift of interest to China. Economically, India was dismissed as a failure. Politically, India's closeness to the former Soviet Union was not viewed favorably by the Western nations—especially the United States.

Prelude to Liberalization

After gaining independence from the British in 1947, India faced a choice of how to run the economy. Jawaharlal Nehru, the first Prime Minister of India, was deeply influenced by the apparent success of Soviet planning. He believed that the capital intensive industries ought to be run by the state. Economic infrastructure was too important to be left in the hands of the private sector. With this socialist bent, India embarked on an ambitious course of five-year plans. The first five year plan (1951-56) emphasized agriculture and irrigation while the second and the third five year plans gave priority to heavy industries and transport. The eighth five year plan was launched in 1992. The emphasis of this plan shifted to market reforms rather than on quantitative targets (Economic Intelligence Unit, 1993, p. 13).

In practice, India pursued more of a policy of indicative planning. An enormous private sector existed side by side with the public sector. The public sector was controlled through a complex system of licensing and other controls. In matters of policy, the private sector could be issued guidelines to follow, but the controls could never exceed a certain limit. Planning in India could thus never be like the planning in the former Soviet Union. India never has been a command economy. Although the public sector aimed at controlling, as Nehru used to say "the commanding heights of the economy", gradually the role of the public sector increased. Major banks were nationalized. Coal, insurance and other industries that were not doing too well in private hands were taken over. Over time, licensing and other controls became more cumbersome. India did not lack entrepreneurs. But the bureaucracy and its controls put severe brakes on the development of the entrepreneurial class. The well established existing business people enjoyed economic rents as a result.

When Rajiv Gandhi became the Prime Minister of India in 1984, he initiated a process of simplifying the licensing procedure. However, the regulations remained more or less intact. The World Bank and the International Monetary Fund were putting pressures on the Government of India to open up the economy and to liberalize the procedures for opening up of new units. Increasingly, the new loans of the World Bank were tied to India taking reform measures. Rajiv Gandhi's assassination in 1991 threw the country in a crisis. The ruling Congress Party went through a difficult time of choosing a new leader of the Party. P.V. Narasimha Rao was, at that time, chosen as the consensus candidate.

The New Beginning

Rao was, at first, thought to be an indecisive and weak leader. He had to depend upon the Left wing parties for survival because the Congress Party did not have a clear majority in the Parliament. History has proved that Rao is neither weak nor indecisive. He has taken bold steps to reform and revitalize the Indian economy. He has been helped tremendously the Finance Minister—Dr. Manmohan Singh. Singh got his Ph.D. in Economics from Cambridge University. He has served as a University professor and as a Secretary in the Ministry of Commerce before joining the Cabinet. He has a vast experience in the working of the Indian bureaucracy. Thus, many commentators including Bhagwati (Tyagi, 1994) think that he is the perfect person for the job.

The Reforms and their Effects

Foreign investment: India followed a policy of "self-sufficiency" since Independence. Foreign investment was thus not encouraged. In the name of "national interest", many industries like coal, steel and banking were nationalised. The culmination of the pursuit of the isolationist policy came to a climax in 1977 when Coca Cola and IBM were booted out of the country. During the 1980s, India had made haphazard attempts to woo the American firms to invest in India. These attempts met with little success primarily because the restrictions placed on foreign investments remained more or less intact during that time. USA was reluctant to increase trade relations with India because India was seen to be too close to the Soviet Union.

Break up of the Soviet Union meant that India lost a large chunk of its export market. Export and import policies had to be changed out of necessity. To boost capital investment, India had to open up its economy by lowering barriers to foreign ownerships of business and by allowing repatriation of profits. Before the reforms, foreign investment was allowed only in a few selected areas—mainly in high technology industries. While the foreign investors were very interested in investing in consumer goods industries, these were off limit for them. This meant that India lost a good part of its potential foreign investment to other competing developing countries. Also, foreign investors were allowed to hold no more than 40 per cent of the equity in most cases. Starting in June 1991, foreign investment is allowed virtually in every sector of the economy. With the recent changes, foreign investors are freely permitted to hold up to 51 per cent (and even higher in some cases) of the equity. Foreign investment increased from $165 million in 1990-91 to $3.0 billion in 1993-94. Half of the investment is from the American companies. American multinationals such as General Electric, IBM, Coca Cola, Digital Corps and Kelloggs have entered the Indian market investing in a wide variety of projects.

There are several dimensions to attracting foreign investment: (1) access to domestic market; (2) export of profits; (3) favorable tax rates; (4) political stability. Among the developing countries, India has a stable political environment. It has a well-developed legal system. A substantial number of people can communicate in English, the *lingua franca* of the business world. Foreign businesses are attracted to the institutional depth India has.

The stability of India is reflected in the resilience of the stock markets in India to "big" political events such as the demolition of a Mosque in Ayodhya in Northern India and the ensuing riots around India or the bombing of the stock exchange building in Bombay. The biggest drop in the stock market came with the stock market scandal that has rocked the existing system of transactions to the core in April 1992.

When the process of deregulation was started in 1991, the ruling Congress Party government was in power with the support of a number of minority parties. Since then, it has consolidated its position by winning a number of by-elections. The process of deregulation seems irreversible at this stage. Even if the largest opposition party, the Bharatiya Janata Party comes to power, it is likely to continue the pace of reforms. Some observers believe that the pace of reforms might even quicken. Many Indians are quite skeptical about very rapid changes in the system. Very rapid changes are unlikely to go down well with the masses. In fact, a gradualist approach seems to be the safest route to take for India at this stage. The former Soviet Union's fast-paced reforms backed by economists like Jeffrey Sachs did not produce good results. The GDP in Russia fell by 15 per cent. Inflation skyrocketed. Healthcare and other infrastructure deteriorated.

Reforms in Specific Sectors

Trade and exchange rate reforms

Back in 1955, Milton Friedman wrote about India:

> "The existing structure of exchange-controls and their associated system of import and export licenses and of discrimination between sources of purchase, seems to this writer a major obstacle to the growth and progress of the Indian economy. They involve waste and inefficiency in the use of foreign exchange. They introduce delay, uncertainty and arbitrariness into domestic business activities....................Exchange controls necessarily involve the indiscriminate distribution of implicit subsidies to those granted import licences, and they lend themselves to abuse as a means of granting administrative protection from foreign competition to inefficient or monopolistic domestic producers. The elimination of the exchange-controls and import and export restrictions is thus a most desirable objective of the policy." (p. 173)

It is rather unfortunate that it took so long for the Government of India to realize the wisdom of Friedman's advice. The rupee remained a non-convertible currency until 1992. This created enormous obstacles to foreign investment in India. An official exchange rate was fixed and adjusted from time to time. Anybody wishing to buy foreign exchange at the official rate had to go through a bureaucratic process. The amounts were strictly rationed and the government developed a system of priorities. Favoritism was rampant.

As in many other developing countries, foreign exchange came to be sold in "black markets" at rates that were much less favorable to the rupee. Foreign exchange regulations were, however, relaxed to a certain extent during the late 1980s. In February 1993, rupee was made fully convertible on trade account. During the next few months, the rupee strengthened against the US dollar. Since then, the exchange rate has remained almost steady against the dollar. The government has announced its intention to move towards convertibility of the rupee on current account transactions. These changes would have been unthinkable a few years ago.

India pursued an inward looking policies since independence. Import substitution policies were pursued with much vigor rather than export promotion policies. Many studies that compared the two strategies found that the outward looking countries performed better economically than the inward looking countries. The policies of the government of India since the advent of planning emphasized self sufficiency which is but another name for import substitution. Indian thinking was much influenced by Mahatma Gandhi. Gandhi believed that villages should be self sufficient in most respects. Later on, the idea was extended to the whole nation. However, he had little understanding of modern capitalist economics. He was a master of populist ideas. These inward looking policies pervaded the thinking of the government until 1991. Pervasive quantitative restrictions on imports, high import tariffs and a complex system of export subsidies were features of the Indian economy until then. The complex import licensing system discouraged entrepreneurs to set up industries with imported machinery. The last three years have seen changes in this respect which are no less than dramatic. Import restrictions have almost been eliminated except for final consumer goods. Raw materials and machinery can be now be freely imported (Ahluwalia, 1994). The list of goods for which an import license is still required is becoming shorter progressively. In this regard, India has moved much faster than China.

Tariff levels have been dramatically reduced. In 1991, the peak rates were close to 200% for some items. For capital goods, the average rate was 95%. The latest budget (1994-95) has reduced the peak rates to 65%. The average rates for capital goods now stand at 35%. Even these rates are rather high if we compare these with other developing countries. But, the government of India has adopted a policy of reducing these rates over time.

Tax reforms

The type of federal system of government that India has gives vast financial powers to the central government. States in India have limited sources of raising revenue. The center-state financial relations have been a matter of constant debate. A Finance Commission is appointed at least every five year to look at the financial relationship between the center and the states. Two fundamental issues are involved in the center-state financial relationships. One is about the division of powers between the union and the states in respect of raising and distributing public funds. The second relates to the transfer of funds from the center to the states. Successive Finance Commissions have not greatly increased the revenue sources and states are still dependent on the center to a large extent.

One important feature of the tax system of India since the independence has been the heavy reliance on indirect rather than on direct taxes. The share of indirect tax rose from 63 per cent in 1950-51 to about 81 per cent in 1981. Direct taxes had a limited scope in India because a very insignificant part of the total national income comes under its purview. India did experiment with an expenditure tax after Nicholas Kaldor recommended it in his Report on Indian Tax Reform. The principal benefit of an expenditure tax in the Indian context is that such a tax will encourage savings and reduce tax evasion. The expenditure tax was in force from 1957 to 1962 and from 1964 to 1966. There were no subsequent attempts to reintroduce expenditure tax.

Over time, customs duty as a part of tax revenue increased. Customs as a measure of revenue generation has two important negative effects: (1) It breeds corruption and consequent loss of revenue. (2) It breeds smuggling activities, which inturn leads to a loss in potential revenue.

India's income tax base has eroded tremendously. Only 7 million people are paying direct income tax. For a country with a middle class of at least 200 million, this is a problem for the government.

In 1991, the Tax Reforms Committee was appointed to look into the tax structure and suggest changes. The basic recommendations of the Committee were (1) to simplify the tax system with moderate rates of tax in both direct and indirect taxes and fewer exemptions (2) a broadening of the tax base (Ahluwalia, 1994). With regard to income tax, the government is trying to amend the situation by (1) giving amnesty to the past non-payers (2) reducing the tax rates to reduce non-compliance of future tax payers. Current pool of non-payers is huge. The part of the economy unaccounted for due to non-reporting is estimated to be 25 per cent to 50 per cent of the overall economy (Gupta, 1992). Therefore, giving amnesty has generated political tension between the government and the leftist parties. The maximum marginal rate of taxation has been brought down from 56 per cent in June 1991 to 40 per cent in 1994. The reduction of tax rates, however, is controversial. The government believes that since the rates had been historically so high that a reduction in rates will actually bring in more revenue (the so called "Laffer Effect"). The size of such an effect has generated a lot of controversy among the economists.

Other changes have been made following the Committee's report. Custom duties have been gradually reduced since 1991 and further reductions are to take place over time. To remove the barriers to financial savings, all financial assets have been made exempt from the wealth tax.

High corporate income taxes have been a feature of the tax system for a long time. Publicly listed companies and closely held companies now attract a tax rate of 46 per cent inclusive of a surcharge. It is planned that the surcharge will gradually be removed so that corporate income tax rate is brought down to 40 per cent which is now the highest marginal income tax rate. These measures are expected to promote domestic and foreign investment.

Specific (rather than *ad valorem*) excise duties have existed since the 1950s. The 1994 budget has simplified the Modified Value Added Tax (MODVAT) which was introduced a few years ago. Under MODVAT, a tax credit is given for taxes paid on inputs. The new MODVAT is *ad valorem* tax. The government has plans to move ultimately to a Value Added Tax (VAT). This will require an amendment to the Constitution because the Constitution authorizes the central government to impose tax on production while sales taxes are the domain of the state governments.

Industrial policies' reforms

As pointed out earlier, the system of industrial controls that was instituted in the early 1950s was not very cumbersome. Over time, it became more complex and all pervasive. Through a system of industrial licensing, the public sector exercised tremendous control over the setting up of new units and over expansion of existing units. The entrepreneurs used to get a bureaucratic run-around to get such licenses. Two objectives of the central government in imposing such restrictions have been to influence the choice of technology and location of such units. The effects were to cause long delays and to reduce competition. During the last three years, the industrial policy of the government has been completely overhauled. Except for a few strategic industries and for certain small scale industries, no licenses are needed to start a new unit or to expand an existing unit.

The changes in the foreign investment policies described earlier, are aimed at complementing the changes in the industrial policies. The advocates of industrial policies in the US, perhaps, have a lesson to learn from the Indian experience during 1950-90.

Reform of the financial sector

The financial sector in India has been dogged by excessive government regulations for many years. Most of the major banks are still in the public sector. In 1955, the Imperial Bank was nationalized and renamed the State Bank of India. The 14 private sector banks were nationalized in 1969. A few others were nationalized in 1980. Branches of some foreign banks which had been operating for a long time in India were allowed to remain. Service in the public sector banks has remained very poor compared with the branches of foreign banks that provide much better service. The government regulated the interest rates. Some of these rates were fixed at uneconomic levels. Reserve requirements were set at very high levels so that the government could borrow from the public sector banks at below market rates of interest.

Changes in the banking sector have been slow. The government announced a number of changes in policies in 1992. Private sector banks will now be allowed to be established. The major public sector banks will be allowed to raise capital in the private market although government will retain at least 50 per cent share of these banks. Regulation of interest rates will be gradually phased out. The burdensome reserve requirements will be reduced during the next few years.

The Stock Market

The stock market in India has bounced back from the setback in 1992 when a securities scam involved illegal diversion of bank funds into the stock market. Reforms of the stock market has increased interest in the stock market. One of the most important changes has been the establishment of Securities and Exchange Board of India (SEBI) in February 1992. SEBI is a statutory body charged with overseeing the operations of the capital markets. The central government is now preparing legislation that will introduce electronic trading.

The size of the stock market is quite substantial. India has 24 stock exchanges (22 currently operating). However, Bombay is the biggest one with 70-80% of the total market value. Capitalization in the Bombay Stock Exchange was about 100 billion US dollars at the end of 1993.

Reform of energy, transportation and telecommunications

The involvement of the government has been very extensive in these areas. In most cases, power generation has been in the hands of the state governments. The supply of power generation has not kept up with demand. Many state electricity boards are now bankrupt. Mismanagement, corruption and inefficiencies coupled with low tariffs have played havoc with power generation. If the present reforms were to continue at a rapid pace, power generation is an area where urgent reforms are called for. Some state governments are moving towards injecting private investment into the power sector. Wholesale privatization of power generation and distribution is not on the cards (Khalilzadeh-Shirazi and Zagha, 1994).

Telecommunications have been the target of major reforms of the government. The phone system of the country is still managed by Indian Telephones — a department of the government of India. The telephone system remained very poor until a few years ago. The government has announced to overhaul and modernize the phone system. During the last few years, the phone system has improved. AT & T and Motorola have entered the cellular phone market in India. India has only 0.8 phone per 100 persons whereas neighboring Pakistan has 2 phones per 100 persons. There is long waiting list for households wanting to get phone connections. The government has announced plans whereby the waiting list will be eliminated by the year 2000.

The roads especially those connecting major cities in India have remained in overall poor quality. Air travel is growing by leaps and bounds in recent years. Improvements and expansion of air travel services are crucial for success of the economic reforms. A few years ago, the government broke the monopoly of the government owned Indian Airlines for domestic air passenger travel. Since then, private operators have mushroomed. Some of the private airlines operate regionally. Others operate nationally. These airlines have given Indian Airlines run for its money. The private airlines have competed with the Indian Airlines in terms of price and service. Indian Airlines lacked the marketing orientation because it operated as a monopoly for so long. Indian Airlines has lost a lot of passengers and is now operating at a loss. However, Indian Airlines has now announced plans to streamline its operations in order to meet the challenges of increasing competition that it faces. The number of airlines providing international service has increased in recent years. Delta has started to operate its services from New Delhi. British Airways after a long absence has resumed service to Calcutta. The international (as well as domestic) airport terminals have not coped with the increased traffic well. By international standards, facilities and services at airports in India have been poor. Buoyed by the success of its reforms in other areas, the central government has now announced its ambitious plans to privatize the airports.

A good transportation is essential if India is to attract more foreign tourists. Tourism is the sixth largest export earner for India. India's potential in this regard has remained virtually untapped. Unlike many other countries, the central and the state governments have not vigorously pursued the promotion of tourism. A small country like Singapore is way ahead of India in this respect. India's share of world tourists is only 0.3 per cent and in terms of tourist spending it is 1 per cent (Economic Intelligence Unit 1993/94, p. 41). This means that the per capital tourist spending is higher in India than in other countries. Since India is a terminal destination for many tourists, the tourists are likely to spend more days in India on an average than they do in countries. India has a rich and varied history. It is a vast country that has so much to offer to a tourist. One thing that the British rule did was to lay railway lines in almost all parts of the country. While railways have languished and declined in the western countries, it has thrived in India. The government owned Indian Railways is profitable. In line with reforms in other fields, Indian Railways has a plan to upgrade and improve its services. Computerized reservation system has recently been introduced in most cities. Indian Railways is seeking private investment to provide luxury service to tourists.

Future for Multinationals

India offers enormous potential for foreign producers. The market has remained untapped for the most part until the end of the 1980s. But, now visible changes taking are taking place. There are 30 million television sets in India. Government run TV channels now compete with the channels offered by local cable TV operators. The cable TV offers Indian language programs besides providing such channels as Cable News Network (CNN), Music Television (MTV) and a whole range of programs originating in the US. The burgeoning middle class has become aware of many Western brand names. This offers opportunities for multinationals. Coca Cola is going back to India. PepsiCo (which wholly owns Kentucky Fried Chicken and Pizza Hut) already sells its soft drinks with joint collaboration with an Indian company. PepsiCo is expanding its operations in other areas. General Foods has set up its South Asian production and distribution units in India.

The middle class in India includes some 200 to 250 million people. According to the Economic Intelligence Unit (1993/94), among this group, 50 per cent have telephones, two-wheelers (motorised and peddled), cameras and stereos, over 80 per cent have refrigerators and food mixers, over 30 per cent have cars and video recorders and 100 per cent have televisions (black and white and color). Although majority of the middle class is in the urban areas, rural areas have seen a surge in the purchase of consumer goods. The bottom 60 per cent of the income earners in India have consolidated their position and are enjoying consumer goods to a much greater extent. India has experienced a reduction in the income inequality. This partly explains the general lack of protest against such sweeping reforms in a democratic country like India. The opposition parties have criticized the Central government from time to time but have not organized mass rallies against the reforms.

However, marketers face challenges. For example, Western food items may have to be modified in order to suit the Indian taste. First, Indians tend to prefer spicy food. Western foods normally appear bland to the Indian taste bud. Second, there are tremendous inter-regional variations in food habits. North Indian food is quite different from South Indian food. However, certain South Indian food items are gaining popularity in North India and vice versa. Third, 85 per cent of population are Hindus and most of the Hindus in India abhor eating beef. Macdonald's is developing a new line of goat burgers and vege-burgers to be marketed exclusively in India. However, to some extent, Indians have adapted to dishes that were not part of the staple Indian diet. Consider instant noodles: they have become a part of the staple in Eastern India.

Conclusion

Development in India has been quite rapid in the past three years. It has created opportunities for investment. It has also created opportunities for smaller American businesses explore niches in joint ventures. For example, automotive parts, electronic equipment are in great demand. Smaller companies can gain easy access to the vast Indian market through these areas.

References

Ahluwalia, M. S. "India's Quiet Economic Revolution," *Columbia Journal of World Business*, Spring 1994, 6-13.

Economist Intelligence Unit, *Country Profile: India/Nepal* (London: Economist Intelligence Unit, 1993/94)

Friedman, M., "A Memorandum to the Government of India 1955," in Roy, S. and W. E. James, *Foundations of India's Political Economy: Towards an Agenda for the 1990s* (New Delhi: Sage Publications, 1992), 163-77.

Gupta, S. B., *Black Income in India* (New Delhi: Sage Publications, 1992)

Khalilzadeh-Shirazi, J. and R. Zagha, "Economic Reforms in India," *Columbia Journal of World Business*, Spring 1994, 24-31.

Tyagi, S, "The Giant Awakens: An Interview with Professor Jagdish Bhagwati on Economic Reforms in India," *Columbia Journal of World Business*, Spring 1994, 14-23.