Asie Visions 5

How Far Has Indian Industry Travelled down the Deregulatory Road?

Dilip Subramanian

June 2008

Centre asie ifri

The Institut Français des Relations Internationales (Ifri) is a research center and a forum for debate on major international political and economic issues. Headed by Thierry de Montbrial since its founding in 1979, Ifri is a non-governmental and a non-profit organization.
As an independent think tank, Ifri sets its own research agenda, publishing its findings regularly for a global audience. Using an interdisciplinary approach, Ifri brings together political and economic decision-makers, researchers and internationally renowned experts to animate its debate and research activities.
With offices in Paris and Brussels, Ifri stands out as one of the rare French think tanks to have positioned itself at the very heart of European debate.

The opinions expressed in this text are the responsibility of the authors alone.

This program is supported by:

ISBN : 978-2-86592-325-0
© Tous droits réservés, Ifri, 2008

IFRI
27 RUE DE LA PROCESSION
75740 PARIS CEDEX 15 - FRANCE
TÉL. : 33 (0)1 40 61 60 00 - FAX: 33 (0)1 40 61 60 60
Email: ifri@ifri.org

IFRI-BRUXELLES
RUE MARIE-THÉRÈSE, 21
1000 - BRUXELLES, BELGIQUE
TÉL. : 00 + (32) 2 238 51 10
Email: info.bruxelles@ifri.org

SITE INTERNET : www.ifri.org

Contents

INTRODUCTION 2

POLICY EVOLUTION 3

Delicensing 3

Foreign investments 4

SECTORAL ANALYSES 6

Automotive 6

Retail 9

Financial services/Banking 11

Financial Services/Insurance 13

Life Insurance 15

Non-Life Insurance 15

Infrastructure 16

SPECIAL ECONOMIC ZONES (SEZS) 23

CONCLUSION 25

© Ifri

Introduction

Since 1991 India's economic reform programme has set out to alter the production structure by increasing the role of markets in the economy, directly through privatisation, or by way of reduction in state investments and interventions, and indirectly through domestic deregulation and trade liberalisation. The overall effect of these measures have been to bring an end to India's relative economic isolation from the rest of the world economy. There is no doubt that there has been an increased degree of integration of the Indian economy with the global economy in the 1990s. This has led to a fundamental shift in Indian developmental strategy, away from Nehruvian socialism based on import-substitution industrialisation to an export-oriented industrialisation strategy.

The object of this paper is to evaluate the impact of the deregulationary policy initiatives pursued by successive governments from 1991 onward on various industrial sectors. It is structured in three parts. We shall begin with a brief review of the evolution of overall state policy in the twin areas of industrial controls and direct foreign investments. This will enable us to answer at once the question of the extent to which the heavy hand of dirigisme has retracted and the domestic economy become accessible to multinational corporations. Part two of the paper will be devoted to more micro-level sectoral analyses where we shall consider the implications of the above cited measures in encouraging growth in four specific areas: the automotive industry, retail trade, financial services (banking and insurance), and finally infrastructural activity (power-energy, telecommunications, and air travel). The third and final section will examine another aspect of liberalization policy bearing upon industrial development, the emergence of Special Economic Zones.

Dilip Subramanian is a post-doctoral Fellow attached to the Culture & Sociétés Urbaines (CSU-CNRS) research centre in Paris. The focus of his current research activity is the pharmaceutical industry in France with specific reference to the impact of regulatory controls on production and labour processes. He had earlier studied the relations between state, management and workers in the telecommunications equipment industry in India. This is going to be the subject of a fortchoming book to be brought out in early 2009 by Tulika Books (New Delhi). He has also published several articles on deregulation and industrial relations in India.

© Ifri

Policy evolution

Delicensing

The Industrial Policy announced in July 1991 aimed to free the industrial sector from barriers to entry, and from restrictions to expansion, diversification and modernisation. Much of the industrial licensing system was dismantled and areas once closed to the private sector opened up: electricity generation, some of the oil industry, heavy industry, air transport, road, telecommunications. The number of industries subject to compulsory industrial licensing has also been progressively reduced from 18 in 1991 to just 5 today. Some of these are environmentally sensitive industries (explosives, chemicals, etc.), others fall under the strategic category (defence equipment), still others have been classified as health risks (tobacco manufacturing and alcohol).

Products reserved for the small scale industries and which large firms propose to take up also need licenses. During the 1990s, little progress was made in reducing the number of industries reserved small enterprises: large firms were barred from entering as many as 821 sectors. But this anomaly started to be addressed from 2002 onwards. The number of items reserved exclusively for the small scale sector today has drastically contracted to 35. Similarly, at the launch of the reform programme, eight industries were earmarked exclusively for the public sector. Currently, only atomic energy and railways continue to be the province of state-owned companies.

Central government clearance for the location of industrial units has been dispensed with except for 23 cities having a population of more than one million. Now the states have opportunities to contact domestic and foreign firms directly to promote investment within them. Finally, the capital market was freed from government control; no restraints now exist on the volume and pricing of capital issues and companies are now free to tap the capital market after clearance from the regulatory authority.

© Ifri

Foreign investments

From being stigmatised as the "most autarkic non-Communist country in the world" India has gone on to become the poster child of international institutions for its openness to foreign corporations.[1] According to UNCTAD's *World Investment Prospects Survey*, in 2006 India ranked second after China as the world's most attractive destination for multinational corporations. The country received more FDI than ever before, $17 billion, an amount equivalent to the total inflows to the country during the period 2003-2005.[2]

India did not exactly throw open its doors to foreign investment in 1991 which continued to be subject to restrictions in terms of equity caps and sectors allowed to it. Maximum shareholding levels were pegged at 51% to start with and the number of sectors thrown open to foreign investment limited to 35. But successive governments have progressively adopted more friendly policies. From 1995 onwards, both the number of sectors open for automatic approval has expanded and equity participation up to 100% is common. In 2006, for example, agriculture and plantations was removed from the prohibited list for FDI.[3] The effects of this significant liberalization is reflected both in the increasing acquisition of majority stakes by foreign companies in their Indian ventures and in the rise in the share of wholly owned subsidiaries.[4]

Under the current policy framework, FDI can come into India in two ways. Firstly, FDI up to 100% is allowed under the automatic route in all activities/sectors barring a small negative list; in the other areas no prior approval either by the government or the Reserve Bank of India is required. Secondly, in areas such as alcohol and tobacco manufacturing, defence equipment and products reserved for small industries where proposals for foreign investment require government sanction, these are considered by the Foreign Investment Promotion Board (FIPB) which is chaired by the secretary of the Industries Ministry.

Equity caps on FDI now exist only in the following sectors:

- FM radio broadcasting (up to 20% allowed)
- Insurance, defence production, petroleum refining in the public sector, print and electronic media covering news and current affairs (up to 26% allowed)

---

[1] V. Joshi, I. Little, *India's Economic Reforms 1990-2001*, Oxford, 1996.
[2] UNCTAD, *World Investment Report*, 2007.
[3] Economic Survey, Ministry of Finance, 2007.
[4] R. Mohan, "Corporate Response to Economic Reforms," *Economic & Political Weekly,* 4 March 2000.

© Ifri

- Air transport services, asset reconstruction companies, cable network, direct to home hardware for uplinking (up to 49% allowed)

- Single brand retailing (up to 51% allowed)

- Atomic minerals, private sector banking, telecom services, establishment and operation of satellites (up to 74% allowed).

FDI is prohibited in retail trading, gambling, and atomic energy.

Initially only FDI was encouraged. But in October 1992, foreign institutional investors were allowed into the Indian market for the first time and policy changes announced in the 1997-98 budget have made such investments more active. The three areas that have attracted the bulk of proposed foreign investments from April 2000 onwards are services (22.4%), computer software and hardware (14%) and telecommunications (7.2%). In the manufacturing sector, the automotive industry (4.1%) tops the list.[5]

The FDI India has been able to attract has largely been for the purpose of accessing the Indian market, or for the acquisition of local firms, rather than using India as a platform for exports or for offshore resourcing to make India an integral part of the worldwide production system. But in sectors like automotive the trend is progressively changing, as companies leverage their Indian activities for export purposes. India ranks well below China on exports and inflows of FDI. Whereas FDI as a percentage of GDP in China rose from 5.8% in 1990-91 to 27% in 2005, in India they grew from 0,5% to 5.8% during the same period.[6]

Various explanations have been put forward for the low volumes of FDI India attracts relative to China, but none are fully satisfactory. India's requirements of FDI may be substantially lower than that of China because of the structure and composition of her manufacturing and services sectors and her endowments of human capital in science and engineering skills. India's manufacturing sector consists of a substantial proportion of science based and capital-intensive industries. The requirements of managerial and organisational skills of these industries are much lower than that of labour intensive industries such as those in China.[7] Today, the proactive FDI policy pursued by the government has generated some resentment among the local entrepreneur community. They feel that the government has levelled the playing field too much in favour of the foreign companies.

---

[5] FDI Fact Sheet, Ministry of Commerce, 2008.

[6] *World Investment Report*, op. cit.

[7] V.N. Balasubramanyam, D. Sapsford, "Does India need a lot more FDI?" *EPW,* 28 April 2007, pp. 1549-1555.

© Ifri

Sectoral Analyses

Automotive

The expansion of the Indian automobile industry over the last decade and a half stands out as a good advertisement for the success of the pro-market reform policies pursued by the government. Prior to the delicensing of this sector in 1993, customers could purchase just three models: one made either by Hindustan Motors, Maruti-Suzuki or Premier Automobiles. Today, they are free to choose from nearly 15 locally manufactured brands, the entry of new producers having led to the installation of large new capacities. Annual sales have seen an increase by over a multiple of 5, from around 320,000 units in 1996 to 1.7 million in 2008, thanks to a combination of rising per capita incomes, relatively easier availability of finance and young demographics.[8] With growth rates averaging between 3 and 5 percentage points above that of GDP, the sector as a whole has emerged as a significant engine of growth for the Indian economy. The Automotive Mission Plan 2006-2016 has set an ambitious turnover target of $145 billion for the industry from a modest $38 billion today.[9]

While demand for cars could have been met through imports, official policy was skewed towards domestic production by means of significant tariff differentials between vehicles and components. Emphasis on domestic manufacture has contributed to rapid increases in demand for components which have encouraged local vendors to invest at efficient scales of production. Many of them have gone on to become part of the industry's global supply chain. The size of the components market has risen from $2.4 billion in 1999-2000 to $10 billion today and is estimated to reach $40 billion by 2010. The domestic automobile industry has thus gone through a virtuous cycle of increasing volumes, declining costs through the realization of scale economies and the ability to price competitively. If attractive pricing strategies have played a major role in stimulating domestic demand, it has been reinforced by the growth of retail

[8] Society of Indian Automobile Manufacturers, Industry Statistics.
[9] B. Narayanan, P. Vashisht, "Determinants of Competitiveness of the Indian Auto Industry," ICRIER Working Paper No. 201, January 2008.

© Ifri

finance. This development itself was partly a consequence of financial sector reforms. The big increase in the access of individuals to automobile loans hugely expanded the potential pool of people who could afford vehicles.

The domestic automobile industry has therefore been a direct beneficiary of a number of reform initiatives that successive governments took during the 1990s.[10] The business environment has allowed the industry to not only grow volumes, but also be far more confident in launching new models in virtually all price segments of the market. Compared with around a dozen new model launches in 2007, this year 75 new models and variants across different segments of size and type will hit the roads.

With the Indian car market slated to touch 4 million units by 2016, the worlds' automakers are making a beeline here forging multiple alliances to help them cut both costs and time. Automatic approval for foreign equity investment up to 100% is permitted both for the manufacture of automobiles and component. Current annual sales of 1.7 million cars are nowhere levels of the Chinese market (4.1 million units yearly). But in the context of stagnating auto sales in North America and Western Europe, entering a small but promising country like India whose share of the world automobile market stands at under 3% makes sense.

In less than 10 months at least six major deals with a promised investment of $4.6 billion have been signed.[11] The Indian market does not deliver enough volumes to justify heavy overhead investments in new plant and distribution network. So to spread their risks and to avoid repeating past mistakes, auto majors are tying up with Indian companies which know the pulse of the market.

*Renault and Mahindra & Mahindra have been linked in a $100 million investment. This partnership became a test case for the auto market as the joint venture launched Logan in a mere 24 months and helped cut Renault's operational costs by 200%. The successful introduction of Logan has whetted the French company's appetite for other segments, notably small cars which account for over two-thirds of the Indian market and is the fastest growing category.

*Renault, Nissan and Bajaj Auto have announced a joint venture in which the Indian partner will hold a 50% stake and Renault and Nissan 25% each. They plan to develop an ultra-low cost car, costing $2500 which will give stiff competition to Tata's people car and market leader Suzuki. The three partners will be investing $175 million in a plant in the western state of Maharashtra capable of rolling out annually 400,000 cars.[12]

---

[10] Subir Gokarn, "Reforms and the Auto Sector," *Auto Monitor*, 1 April 2008.
[11] *India Today*, 21 January 2008.
[12] *Le Monde*, 14 May 2008

© Ifri

Thanks to the immense pool of talent available in India, Renault and Nissan have also committed $80-100 million towards setting up a R&D facility in Chennai which will provide design inputs for all future projects.

*Volvo and Eicher propose to invest $506 million. Their partnership will create a new holding company through which the Swedish company will bring in all of its product offerings.

*Fiat and Tata Motors: proposed investment $1 billion. This joint venture will manufacture cars, engines and transmission for domestic and export market giving both companies massive economies of scale. Fiat will also have access to a ready distribution network in India.

In parallel, General Motors and Ford after years of putting China ahead of India are now eyeing the latter market, while Toyota which enjoys a tie-up with Kirloskar has announced its objective of gaining a 10% market share by 2010. Two other big names attracted by the potential of the Indian market are Audi and Volkswagen, both of whom will soon be producing their models here.

At the same time, foreign car makers are making their Indian operations a platform for selling to other markets. In 2007-08, export volumes increased by 22% over the previous year. After complaints from the US and the EU at the WTO's Dispute Settlement Body, in 2002 the Indian government scrapped the annual export obligations that it had imposed earlier as a means of balancing any imports of components or completely knocked down/semi-knocked down kits multinationals may have brought in. In the current context, exporting cars produced in India is fast becoming imperative for auto companies for two reasons. One, most of them have set up huge capacities which are being utilised sub-optimally. Exploiting the idle capacity will thus make their operations economical. Two, global automobile giants, such as Toyota, Ford, GM and Hyundai are increasingly seeking ways of cutting development and production costs by globally sourcing specific parts and models. By 2010, both Suzuki and Hyundai, are planning to export 750,000 cars manufactured at its factories here.[13]

Besides penetrating the domestic market, India can also help foreign players cut material costs. Because engineering and R&D capabilities are of high quality and production costs are 25-30% less than in the west, India has the potential of becoming a global manufacturing hub. Investments in auto components have made this sector highly competitive in the export market. Exports are poised to jump from $1.8 billion in 2004-05 to $5.9 billion in 2008-09. The first foreign overseas components suppliers to set up activities in India were Delphi and Visteon, respectively global vendors to General Motors and Ford after the big two American firms had begun

[13] *India Today*, 23 October 2006.

© Ifri

assembling cars here. Today, several other leading players are establishing a base in India. They include:

*German auto parts maker Bosch whose investments over the last couple of years has exceeded $200 million has relocated the manufacture of certain products to its Indian subsidiary.

*Hitachi is planning to start auto component manufacturing once its principal customers Isuzu and Nissan roll out their cars on the Indian market.

Further, over 20 original equipment manufacturers have set up their international purchase offices in India. This number is expected to double by the year 2010. General Motors, for example, has decided to increase sourcing of components from Indian suppliers and intends to ship parts worth $1 billion to its global production units by 2010. Similarly, Fiat India is taking steps towards becoming a global sourcing hub for components. Fiat exported components worth $8.3 million in 2006 to its operations in South Africa.[14]

Retail

According to various estimates, the retail industry in India is now worth in excess of $330 billion and is set to grow by a further $100 billion by 2010. But it is heavily underdeveloped: well over 95% of the market is made up of small, uncomputerised family-run stores. No wonder then that big private players are determined to corner a bigger slice of this lucrative business. Eight new companies have entered the fray and more are expected to arrive as they try and drive up the share of the organised sector to at least 22% by 2010.[15] Among the key movers are:

Reliance Industries which intends to invest $5 billion in creating a chain of hypermarkets and back-end retail services. It has already rolled out 80 stores in different parts of the country and plans to open 1500 stores by 2009.[16]

Bharti Enterprises has signed a joint venture with US leader Wal Mart and announced an investment of up to $2.5 billion by 2015 to build neighbourhood stores, supermarkets and hypermarkets across India.[17]

Spencers Retail (RPG Group) is targeting a nation-wide network of 2000 stores by 2009, up from its present figure of 125. Size of its investment: $2 billion.

---

[14] Intec.net, "The Indian Automotive Industry."
[15] India Brand Equity Foundation, Sector Report 2008.
[16] *India Today*, 16 September 2007
[17] *Financial Times*, 11 April 2008.

© Ifri

Tata is building its own chain of shops and through a collaboration with the Australian retailer Woolworth wants to source consumer electronics products for its new business, known as Infiniti Retail.

In 2006, the government also eased restrictions on foreign investment, allowing overseas retailers to own 51% of outlets as long as they sell only single-brand goods. Now, for the first time, chains like McDonalds, Marks & Spencer, Body Shop and Ikea can, if they wish, open and control their own operations in India. Previously, many of them had gone down the path of working with franchise partners, a policy followed by Marks & Spencer which supplies clothes to eight Planet Sports stores. Britain's largest retailer, Debenhams, has also announced plans to expand its presence in the Indian market. The company which opened its first Indian store in October 2007 in Gurgaon with partner Planet Retail, will set up another two outlets in the city before the end of the year, its overall objective being to run a network of 30 department stores within the next decade.[18]

However, fears of the potentially disruptive impact that the entry of international retailers like Wal-Mart, Tesco and Carrefour could have on small traders explains the continued ban on investments by these multi-brand groups. Protests have already erupted in various states against the large domestic retail chains, accused of throttling small shopkeepers; several outlets of Reliance have been vandalised in Madhya Pradesh, UP and Delhi.[19] A visit to India in February 2007 by Wal-Mart executives also witnessed demonstrations.

Nevertheless, the government realises that foreign investment and expertise is badly needed to provide the infrastructure - the warehousing, distribution and processing operations - needed to upgrade the country's backward retail industry. Because of the absence of a good cold chain, around 5-6% of produce is lost in transit daily. This is partly the reason why foreign multi-brand retailers have been allowed to function in the wholesale market where they can own up to 100% equity through the automatic route. German group Metro has made tentative steps, via its chain of wholesale cash & carry centres in cities like Bangalore. About 90% of the goods it offers come from local producers and suppliers, which could give it a head-start if the rules on selling to individual shoppers are relaxed in the future. Similarly, Carrefour which is still scouting for a local retail partner will launch its first cash and carry in 2009. Wal Mart has also been lobbying the Indian government to allow it to open an office in Bangalore where it could research the Indian retail market and the possibilities for developing its operations there in the future.

[18] *The Hindu Business Line*, 28 May 2008

[19] *India Today*, 16 September 2007.

© Ifri

Financial services/Banking

Reform of the banking system took a gradual sequenced path focussing on improved prudential control, recapitalisation of public sector banks and the introduction of greater competition. Competition enhancing measures proceeded along the following paths:

- Granting of operational autonomy to public sector banks; reduction of public ownership in public sector banks by allowing them to raise capital from equity market up to 49% (later hiked to 67%) of paid-up capital.

- Transparent norms for entry of Indian private sector, foreign and joint-venture banks and insurance companies; permission for foreign investment in the financial sector in the form of FDI as well as portfolio investment; permission to banks to diversify product portfolio and business activities.

- Roadmap for presence of foreign banks and guidelines for mergers and amalgamation of private sector banks and banks and non-banking financial corporations

- Guidelines on ownership and governance in private sector banks.[20]

By 1994, as many 28 private Indian banks had been created, some by the transformation of existing institutions, others started from scratch. State-owned banks which controlled 90% of bank deposits prior to the reforms continue to remain the dominant force. They control the largest banking network embracing 90% of all branches nationwide in 2005, and their market share stands at close to 84%.[21] But though the geographical expansion of private banks has not occurred at the rapid pace initially envisaged, their performance has been quite impressive. Against the industry average growth of about 20% in the past five years, the new private bankers registered a growth of about 35% per annum, growing from around $42 billion to $187 billion by March 2007. Consequently, their market share has increased from about 9% in 2001-02 to 16% in 2006-07.[22] While private sector banks are progressively opening rural branches, they are concentrating more on semi urban, urban and metropolitan areas.

---

[20] R. Mohan, "Financial Sector Reforms and Monetary Policy: The Indian Experience," 2006.
[21] B. Kalita, "Post-1991 Banking Sector Reforms in India: Policies and Impact," 2007.
[22] India Brand Equity Foundation, Sector Report 2008.

© Ifri

Competition was also encouraged through the deregulation of bank interest rates. As opposed to the earlier government-driven interest rate structure, Indian banks are now adopting a completely market-driven structure where they charge rates according to their cost of funds and the creditworthiness of different borrowers. The ability of the banking system to lend freely was also enhanced by the progressive reduction of the extent to which it had to make loans to the government. At the beginning of the reform period, banks were required to lend 63.5% of their assets to the government in the form of a statutory liquidity ratio and a cash reserve ratio. In 2003 ceilings on both the statutory liquidity and the cash reserve ratio were ended.[23] Another major impact of banking sector reforms in India is reflected in the changing business strategy of the commercial banks. Prior to liberalization, more than 90% of their income came from interest income. This has dropped to 80% in recent years. It shows the diversification into non-fund business and also into the treasury and foreign exchange business as a source of profit for Indian banks.

Foreign banks have been allowed into India since the early 1990s and their number stood at 29 in June 2007. Despite operating exclusively in urban and metropolitan areas they have fared well. For example, India was the fastest growing market for global banking major HSBC in 2006-07, with a growth rate of 64%. Foreign partici-pation, both direct and portfolio investment, in public sector banks is restricted to an aggregate cap of 20%, but one official report has re-commended raising the limit to 40% albeit restricting voting rights and prohibiting voting rights. In the case of private domestic banks, the BJP government in March 2004 raised aggregate foreign inves-tment limits from 49% to 74%.

A year later, the Reserve Bank of India (RBI) presented a roadmap clarifying both the question of foreign banking presence in India and defining guidelines for the ownership and governance of private domestic banks. The roadmap is divided into two phases: 2005-2009, and beyond 2009. During the first phase, the government has proposed to adopt a more liberalised policy with respect to the opening of new branches by foreign banks notably in unbanked areas. Currently, in line with World Trade Organisation commitments, foreign banks are authorised to launch 12 branches or wholly-owned branch subsidiaries every year. The actual figure has, however, been much higher in many instances.

On the sensitive issue of foreign control of Indian private banks, the RBI announced that permission for acquisition of share holding will be limited to banks identified by RBI for restructuring. After April 2009, foreign investors are free to acquire any private bank up to 74%, subject to an assessment made by the RBI of the extent of foreign penetration in Indian banking. In its road map for private banks, the RBI has made clear what "private" means. It means that in

---

[23] OECD Economic Survey, India, October 2007.

© Ifri

general no single entity can own more than 10% shares in a bank, although a higher shareholding will be possible with prior RBI approval. In keeping with international practices, the RBI wants diversified private ownership. Privatisation of public sector banks cannot happen via acquisition by domestic industrial houses, but only through sale to banks, domestic or foreign that satisfy the criterion of diversified ownership. In practical terms, this means that only two private Indian banks, HDFC and ICICI, have a chance of acquiring public sector banks. So far the privatization of public sector banks is not yielding the expected results. In 2001, it was decided to dilute government ownership in banks to 33% with the condition that no individual shareholder can hold more than 1% of the shares. By March 2001 of the 20 state-owned banks, only 11 were listed on the National Stock Exchange.

If at all privatisation takes place down the road, the main contenders, both in terms of satisfying criteria and in terms of financial muscle, will be foreign banks. In the Doha Round of WTO, India has offered to allow foreign banks a total share of 15% of total banking assets (this figure is in line with the presence of foreign banks in developed countries)—the current share of foreign banks is around 12%, comprising both balance sheet and off balance sheet items. Indian banks, public and private, argue against exceeding the 15% threshold and point to the difficulties involved in acquiring a branch licence, not just in east Asia but also in the western economies. The RBI has also underlined the problems of regulating a foreign bank where economic decisions are often taken abroad, while the risks are borne locally. Getting foreign banks to have local subsidiaries does not make much of a difference unless there is a substantial local shareholding as well.[24]

Financial Services/Insurance

Alongside the reforms initiated in the financial sector, in 1993 the government appointed a high-powered committee to evaluate the Indian insurance industry and recommend its future direction. It was clearly recognised that insurance was an important part of the overall financial system, hence the need to undertake similar sweeping structural changes in a sector where private companies were totally excluded. In 1994, the committee submitted the report and some of its key recommendations included:

Reducing the government stake in insurance companies to 50% and giving them greater operational freedom.

---

[24] T.T. Ram Mohan, "Banking Reforms in India: Charting a Unique Course," *Economic & Political Weekly*,
31 March 2007.

© Ifri

Allowing private companies with a minimum paid up capital of Rs 1 billion to enter the sector.

Authorising foreign companies to access the market in collaboration with domestic partners.

Prohibiting the same entity from dealing in both life and general insurance.

Creating an independent regulatory body, the Insurance Regulatory and Development Authority (IRDA) in order to provide insurance companies with greater autonomy and ensure their functioning obeyed economic motives.

None of these recommendations were implemented for almost six years. Finally in March 2000, the BJP-led government pushed through of the Insurance Regulatory and Development Authority (IRDA) Bill, lifting all entry restrictions for private players and allowing foreign players to enter the market albeit with some conditions. Direct foreign ownership was limited to 26% under the automatic route, though there is talk now of raising this equity cap to 49%. Ironically, when in opposition, the Hindu nationalist party had successfully thwarted moves by the United Front coalition government in 1997 to liberalize the insurance sector. That the question of foreign participation remained sensitive was evident even subsequently. Faced with stiff internal party opposition, the BJP government was forced to scale back its goal of authorising overseas firms to own up to 40% of a joint insurance venture with Indian companies.[25]

The opening up of the industry has led to a greater spread and deepening of insurance in India. The potential for growth in India is immense as nearly 80% of Indian population is without life insurance cover while health insurance and non-life insurance continues to be well below international standards. The combined penetration of both life and non-life is less than 2% of GDP compared to a world average of 7.5 %. Presently, there are 16 life insurance companies and 15 non-life insurance companies in the market. In 2006-07, they recorded a 20% growth in premium in dollar terms (adjusted for inflation), compared to the world market growth rate of just 2.9%. The booming domestic market along with the saturation of markets in many developed economies has made the India a very attractive proposition for global insurance majors. Among those who have established a presence are:

- Societe Generale which has entered into a joint venture with IndiaBulls Financial Services through its French affiliate Sogecap.

[25] Baldev Raj Nayar, "The Limits of Economic Nationalism in India. Economic Reforms under the BJP-led Government, 1989-1999," *Asian Survey*, Vol. 40, No. 5, 2000.

© Ifri

- American International Group has signed up with Tata as has New York Life with Max India.

- Tokio Marine and Fire of Japan has partnered Indian Farmers' Fertiliser Cooperative to form IFFCO Tokio General Insurance Company.

- Cardiff, the insurance arm of BNP Paribas Bank, has tied up with State Bank of India.

- UK-based Prudential has joined hands with ICICI.

Some of the other major joint ventures feature Bajaj and Allianz, ING and Vysya, HDFC and Standard, etc.

Life Insurance

The life insurance market in India was extremely underdeveloped and only tapped by the state-owned Life Insurance Corporation of India (LIC) until the entry of private insurers. LIC sold insurance as a tax instrument, not as a product giving protection. Most customers were under-insured with no flexibility or transparency in the products. With the entry of private insurers the rules of the game have changed. Though LIC remains the dominant player with a market share of about 74%, its new premium business has fallen as private companies have already grabbed 26% of the market. Their numbers have also progressively grown and of the 17 life insurers operating at the end of 2007, 16 were private.

Innovative products, smart marketing and aggressive distribution have enabled private players to sign up Indian customers faster than anyone ever expected. The growing popularity of the private companies shows in other ways. They are coining money in new niches that they have introduced. Public sector LIC still dominates segments like endowments and money back policies. But in the annuity or pension products business, the private sector has already wrested over 33% of the market. And in the popular unit-linked insurance schemes it has a virtual monopoly, with over 90% of the customers. Private insurers have also been successful in persuading people to take out bigger policies. The average size of a life insurance policy before privatisation was around Rs 50,000; now it stands at about Rs 80,000, while that of private companies is around Rs 110,000-120,000.

Non-Life Insurance

Of the 14 general or non-life insurers operating in the country, ten are private companies. The four public companies are all former subsidiaries of the General Insurance Corporation of India which were delinked from the parent concern and restructured as independent

© Ifri

insurers in July 2002. Although the state-owned companies still dominate this business, private players are slowly gaining a foothold. They are estimated to hold a 40% share of the market in 2007, up from 4% in 2001. Last year, while the public sector could increase its premiums by under 4%, the private sector recorded growth of nearly 29%.

Infrastructure

In 1999, the World Economic Forum asked businessmen to rank countries according to the adequacy of their overall infrastructure and of its various segments. Altogether fifty nine countries were ranked, and India ranked fifty-fifth in terms of quality and quantity and fiftieth in terms of the importance accorded to infrastructure by the government. For individual components of infrastructure, only railroads fared significantly better where India came twenty-eighth. For adequacy and efficiency of road infrastructure (fifty-fifth), port facilities (fifty third), telecommunications (fifty-first), and air transport (forty fifth) India was ranked well down the scale.[26] Today, with the exception of telecoms, it is doubtful whether perceptions of India's infrastructure are less negative and they probably constitute a significant barrier to foreign willingness to undertake direct investment in India.

How then has India succeeded in recording 9-plus% GDP growth for the last two years despite an acute deficit of infrastructure, particularly power ? The answer to this economic enigma is that over 50% of GDP growth is fuelled by services which consumes less power than manufacturing whose share has remained steady at 24%. Policy makers and business circles however realise that it will be impossible to sustain existing levels of economic development unless means are found to improve infrastructure quality and quantity. Better infrastructure, says the National Manufacturing Competitiveness Council, can result in a 1.5% incremental GDP growth out of which 1% is only on account of the power sector.[27]

Investment requirements for infrastructure during the Eleventh Five Year Plan are estimated to be around $320 billion. While nearly 60% of these resources are expected to be generated by the public sector, the remainder must come either from the private sector and /or through public-private partnerships (PPPs). By end 2006, the total value of PPPs was equivalent to just under 3.5% of GDP with most contracts having been awarded in the previous two years. The potential benefits of such partnerships are cost effectiveness, higher

---

[26] A. Krueger, S. Chinoy, "The Indian Economy in Global Context," in A. Krueger (ed.), *Economic Policy Reforms and the Indian Economy*, Chicago, 2002.
[27] *India Today*, 15 October 2007.

© Ifri

productivity, accelerated delivery, clear customer focus, enhanced social service and recovery of user charges. Following the road shows abroad for attracting global financial capital, the setting up of a $5 billion fund to finance Indian infrastructure by four major financial institutions (Citigroup, Blackstone, Infrastructure Development and Finance Corp, and India Infrastructure Finance Company) is an encouraging development.[28]

Power: Many see the shortage of power as the most critical constraint. In contrast to China which adds 70000MW to its power grid every year, India in the last five years has created 21180MW. Since the Indian domestic power producers, the state electricity boards (SEBs) are generally loss-making entities, profits from existing players cannot provide a sizable share of financing for new plants. A comprehensive modern Electricity Act was introduced in 2003 which has enabling features for encouraging private sector entry, enhanced competition, and rational regulation. However, despite the formation of a central regulatory authority and others at the state level, implementation of the tariff reform has proved intractable. In fact, one reason why power reforms have failed miserably while telecom reforms have proved remarkably successful has to do with differences in the nature of the regulatory regime. In telecommunications where the regulatory policy environment is essentially central, authority is vested at one level of government. In power, controls are spread between the states and the centre.[29]

The Electricity Act promised that private producers including those with captive power plants could wheel their power on the national grid and sell it directly to big consumers. This would have earned state electricity boards some revenue through wheeling charges, enabled supply of power to starved factories and created a mechanism for private producers to set up capacity and sell directly to bulk consumers. The SEBs justifiably worry that if this happened the cream of their clientele would migrate to better suppliers triggering a collapse of the boards. Successive political regimes have failed to successfully negotiate the price of wheeling charges which has in turn hampered better utilisation of capacity and creation of new capacities. Private investors have been deterred by the ability of the SEBs to price electricity at uneconomically low rates until the problem of pricing is realistically addressed. Although the Act also allows for private participation in distribution, practically it has not been found easy to privatize distribution systems. Industrial users paying high prices are either locating inefficient but low cost captive power suppliers other than the SEBs or they are at a competitive disadvantage.

[28] Economic Survey 2006-07, op. cit.
[29] Rahul Mukherjee, "Managing Institutions: Politics and the Building of Independent Regulatory Institutions," *India Review*, October 2004.

© Ifri

Plans to set up ultra mega power plants (4000MW) have also not substantially progressed. Though private investors queued up for profitability and scale, only two of the nine proposed plants have been awarded (Lanco in MP, Tata Power in Gujarat) and even they have been stuck since December 2006 in controversies and clearances. Earlier, American energy giant Mirant had pulled out of a $5 billion power project which was originally planned to be the largest coal-fired complex in the world and the largest power plant in India. Pricing and distribution uncertainties are thought to have led Mirant to cancel the project. But the process of revival of one of the country's largest investment project, the $2.9 billion Dabhol Power Project, launched by Enron and closed since June 2001, was initiated in 2005.

Energy: India is blessed with proven reserves of 95 billion tonnes of coal. This offers the cheapest option for generation of electricity, yet annual output is a paltry 361 million tonnes. All coal is mined by two public sector enterprises. The Coal Mines (Nationalisation) Amendment Bill which would enable entry of private players in competition against public units is pending since 2000. This measure would inject investments and technology but it has encountered strong opposition from trade unions. Though private sector firms are entitled to operate captive mines since the early, very few such mines have started production partly because of bureaucratic hurdles.[30]

No major oil discovery has been made in the last three decades since the Bombay High, and oil production is stagnant. But gas has been located on the east coast in the Krishna Godavari basin triggering hopes of further finds. The new finds by privately-owned Reliance Industries (RIL), public sector ONGC-GSPC and others are expected to treble gas availability by 2012. But though the first big find by RIL was in 2002, till date there is no clarity on who this gas can be sold to and at what price. Conflicts over gas pricing have arisen between the Ambani brothers with RIL charging a higher price now for gas to Reliance Energy compared with the earlier agreement between the two companies.[31]

Telecommunications: India's telecom sector has been one of the biggest success stories of market oriented reforms. The country is now among the fastest developing major market worldwide. Five million subscribers are being added every month and the number of telephones crossed 250 million at the end of 2007. The objective is to reach 650 million telephone connections by 2012, the overwhelming majority being wireless subscribers.[32] Though teledensity figures lag far behind those of China (63%) or Brazil (68%), they have nonetheless registered a spectacular improvement, rising from a lowly 5% in 2003 to almost 27% today. Growth has been particularly

---

[30] OECD Economic Survey, op. cit.
[31] *India Today*, 18 February 2006.
[32] Economic Survey 2006-07, op. cit.

© Ifri

explosive in mobile telephony because of a combination of technological availability, sourcing of affordable handsets, and decreasing tariffs. Between 1998 and 2006, the price of calls fell by over 90% as operators strove to woo potential customers while handsets cost under $20. As a result, more Indians are acquiring cell phones than Chinese every month. China's mobile subscriber base is registering a compound annual growth rate of 11% compared with 31% for India where more than four out of five phones available today is wireless. Yet although telecom service in India is the cheapest in the world, service providers are still earning healthy profits. Revenues in 2005-06 rose 30% over the previous year's levels.[33]

Currently, the Indian telecommunication market is valued at roughly $150-200 billion. Dominating the scene are two Indian private operators Bharti Airtel whose market share is estimated at 27% and Reliance Communications with a 20% share. The major foreign player is Vodafone which recently acquired a controlling stake in the mobile firm Hutchinson Essar (ranked fourth with a 16% market share) after buying out the Hong Kong-based conglomerate Hutchinson for $11.1 billion.[34] Following the reforms, the private sector has become the dominant player in the industry. While publicly owned operators took on 54 million subscribers between 1998-2007, private companies have added a massive 134 million subscribers during the same period. The dominance has been much more pronounced in the mobile market, where private firms have signed on 125 million subscribers compared with only 32 million subscribers for the public sector.

Initial efforts to deregulate the Indian telecom market in 1994 by ending the monopoly of the public sector in the provision of basic telephone services and introducing cellular telephony proved a relative failure. The independent statutory regulator, the Telecom Regulatory Authority of India, came into being only in March 1997. It required the approval of the New Telecom Policy (NTP) in March 1999 to bring about a definitive and successful transformation. NTP-99 laid down a clear roadmap for future reforms, contemplating the opening up of all the segments of the telecom sector for private sector participation. It clearly recognized the need for strengthening the regulatory regime as well as restructuring the state-controlled telecom services by creating a corporation so as to separate the licensing and policy functions of the government from those of an operator. It also understood the importance of resolving the multiple licensing problems faced by private players so as to restore their confidence and improve the investment climate. All the commitments made under NTP-99 were fulfilled, some even ahead of schedule, and the reform

---

[33] A. Rastogi, "The Infrastructure Sector in India 2006," in *India Infrastructure Report*, ICRIER, 2006.
[34] *Financial Times*, 27 April 2007.

© Ifri

process is now complete with all the sectors opened for private competition.

Deregulation also allowed foreign companies to tap the tremendous potential offered by the Indian market. Initially restricted to 49% under the automatic route in most sectors (basic, cellular, national/international long distance, etc.), the ceiling on FDI was hiked to 74% in April 2007, subject to the grant of a license by the Department of Telecommunications. Cumulative FDI inflows from April 2000 to December 2007 in this sector have been $3.6 billion, and the surge in the mobile services market is likely to see investment worth about $ 24 billion by 2010. Vodafone, for instance, has announced investments of $6 billion over the next three years in a bid to increase its mobile subscriber base from 40 million at present to over 100 million.

National long distance telephony opened for private participation in August 2000. No restrictions were placed on the number of operators whose number has jumped to 21 today. Only two are public sector companies. In the field of international telephony, India had agreed under GATT to review its opening up in 2004. However, open competition in this sector was allowed with effect from April 2002 itself. There is now no limit on the number of service providers in this sector. The licence for international long distance service as for national long distance telephony is issued initially for a period of 20 years, with automatic extension of the licence by a period of 5 years. At present this segment counts 14 service providers (12 private and 2 public sector units). Foreign presence in both national and international telephony is represented by BT, AT&T, Vodafone, and Verizon.

Rising demand for a wide range of telecom equipment, particularly in the area of mobile telecommunication (handsets and towers), has provided excellent opportunities to domestic and foreign investors in the manufacturing sector as well. But so far most of the FDI has gone into telecom services and not manufacturing. During the last two years signs of change are afoot and with the government authorising 100% FDI under the automatic route in the manufacturing sector, several companies have started entering India. In addition to launching its R&D centre in Chennai, Sony-Ericsson has set up a GSM radio base station manufacturing facility in Jaipur as have Motorola and Nokia-Siemens in Chennai. The latter whose investments in India are expected to soon exceed $300 million and also runs R&D facilities in Bangalore, Hyderabad and Mumbai will shortly be shifting its global services business unit headquarters from Munich to India. The government's aim is to attract FDI of the order of $2 billion in manufacturing, so as to raise production volumes four-fold by 2010.

Air Travel: The government's biggest success in public sector reform has been in shaking up domestic air travel by permitting the entry of private operators since 1995. Since then the industry has

© Ifri

experienced explosive growth: domestic passenger numbers have been increasing at the rate of 20-25% per year and are estimated to cross the 100 million mark by 2012. The number of domestic airlines has doubled to 12 since 2004 and competition among them for market share has sparked fierce price wars. Low cost carriers' market share has climbed to 29% from 5% in 2005.[35] Overall, private sector airlines now account for roughly two-thirds of the domestic aviation market. In comparison, growth in the number of domestic passengers carried by the state-owned airlines has stayed virtually flat since the mid-90s. The government recently merged the two public sector airlines, Air India which predominantly flies international routes and Indian Airlines which services the domestic market.

Yet, despite the boom, airline companies are losing money because of rickety infrastructure and the scramble for market share through predatory pricing and fleet expansion. Foreign investment caps in domestic airlines have been hiked to 49% from 40%. However, foreign carriers are still barred from owning equity in Indian companies, though the adoption of such a policy has been consistently backed by different ministries in the present government as well as past ones. In September 2001, Singapore Airlines and the Tata group which had joined hands to acquire a 40% stake in Air India withdrew their bid in the face of strong political and media opposition.[36]

But the Indian aviation industry is hampered by overcrowded airports, stretched air traffic controls, antiquated ground handling equipment and a shortage of pilots and engineers. The government may have perceived a deficit in infrastructure but chose to open up the skies instead, with demand preceding a policy push in the hope that the demand push will increase pressure on the creation of infrastructure. This is resulting in the private sector becoming increasingly involved in the provision of airport infrastructure. A major reform initiative was the privatization of Delhi and Mumbai airports so as to upgrade them to international standards. The contracts have been awarded to joint venture companies that are 74% owned by private players. While Indian companies head the consortiums foreign partners are also involved. The government has opened up 28 airports for foreign direct investment in areas of operation and maintenance. For greenfield airports, FDI up to 100% is permitted through automatic approvals, while for existing airports, the maximum stake is 74% through the automatic route and up to 100% following special permission. The selection of the private companies for both the Delhi and Mumbai airports, however, took 25 months of debates among various official committees reflecting the slow pace of policy formulation. State governments are also being encouraged to set up greenfield airports with private sector participation and three such

---

[35] *India Today*, 29 November 2007.
[36] *The Hindu Business Line*, 3 September 2001

© Ifri

projects are nearing completion in Hyderabad, Bangalore and Delhi.[37] In all of these cases the private sector partners were chosen after a transparent and competitive bidding process.

In 2003, an official committee on civil aviation recommended the corporatisation of airport management, currently vested in the hands of the Airports Authority of India. Corporatisation would considerably enhance the transparency of airport management and help ensure equitable treatment for public and private carriers. Despite their diminished market share, state-run airlines, for instance, are allocated much more terminal space at Delhi and Mumbai airports. The committee also proposed setting up an Airport Economic Regulatory Authority. Its powers would include among other things setting service tariffs and determining capital expenditure and investments to improve airport facilities. So far neither of the committee's recommendations has been implemented.[38]

[37] Economic Survey 2006-07; OECD India Survey, op. cit.
[38] Rastogi, "Infrastructure Structure in India," op. cit.

© Ifri

Special Economic Zones (SEZs)

India is keen to emulate the considerable success of China and other Asian countries which have created SEZs where export-oriented production can be undertaken. Such regional enclaves provide scope for cultivating manufacturing competitiveness when licensing, labour rigidities and high import duties and taxes act as a disincentive in other areas. The failure of the earlier SEZ policy (April 2000) led the government to push through a more comprehensive law in May 2005, backed a year later by the SEZ Rules. These regulations allow for simplified procedures for development, operation and maintenance of the SEZ together with a system of single window clearance at both the central and state level for setting up such structures. Companies engaged both in the development of SEZs and in establishing operations here have also been promised a larger package of tax breaks. Around 100 SEZs are operational at present in various states.

The government's initiative has attracted huge interest among private developers, entrusted with providing all the infrastructure. Reliance Industries Limited has signed an agreement to build the country's largest such project. The $8 billion special economic zone will cover over 10,000 hectares near Delhi, in the northern state of Haryana. Another Reliance project is a hub in Rewas in the western state of Maharashtra. Tata has been authorised to set up an SEZ in the eastern state of Orissa as has information technology firm Wipro in the southern state of Andhra Pradesh. Investments will also be flowing from Bajaj, Mahindra & Mahindra and Ranbaxy. The biggest multinational to operate in an SEZ is Nokia whose handset manufacturing plant is sited in the southern state of Tamil Nadu.[39]

The government has so far sanctioned close to 450 new SEZs, some of which are product-specific (information technology, auto components, telecoms, etc.). It is estimated that total investments will amount to Rs 58,459 crores by December 2009.[40] What the developers are essentially banking on is a huge pent-up demand for high-quality facilities, the absence of which is deterring a range of investment activity. Although the policy objective is oriented towards exports, it does not prohibit producers from selling in the domestic market, provided they pay all the duties that exports are exempt from, including customs duties on imports into the country.

[39] Rastogi, "Infrastructure Structure in India," op. cit.
[40] Economic Survey 2006-07.

© Ifri

But besides exposing divisions within the ranks of the government itself, the SEZs have provoked significant controversy, especially after violent demonstrations last year in West Bengal against a proposed petrochemical centre. Critics say that the policy will be misused for real estate development rather than for generating exports. They argue that companies will simply relocate to SEZs to take advantage of the tax incentives being offered. This would not create new jobs but merely displace people, and exacerbate India's already wide regional imbalances. Worried that the government's plans could further alienate poor voters ahead of the upcoming parliamentary elections, Sonia Gandhi, head of the ruling Congress (I) party after warning that farmers' interests must be protected added that prime farming land should be not be used for industry as it risked jeopardizing agricultural prospects.[41]

Critics include the Finance Minister, P. Chidambaram, who has publicly stated his fears that the central government risks losing as much as $20 billion in tax revenues because of the special concessions given to firms operating in the SEZs. There is also apprehension that the tax subsidies being offered by the government may face challenge in the World Trade Organisation, and could attract trade retaliatory measures from importing countries. Much to the chagrin of the Commerce and Industry Ministries, the principal champions of SEZs, the Reserve Bank of India has directed all banks lending money for projects set up in these zones to charge higher interest rates - similar to those paid on loans advanced for commercial real estate development.

Commerce Ministry officials justify their decision to approve a very large number of SEZs unlike China which has developed only six large export-oriented industrial areas on the grounds that India's democracy makes it difficult to allow one corporate group to set up a SEZ and not another. Nevertheless, the criticism has forced the Commerce Ministry to change a number of guidelines relating to the acquisition of fertile land and on the space allowed within SEZs for the construction of housing, shopping malls and recreational outlets. The government is also working on a law to ensure adequate financial compensation and jobs to people who would be displaced by these zones.

---

[41] *India Today*, 17 August 2007.

© Ifri

Conclusion

Despite the lowering of barriers to FDI in the manufacturing sector which has led to a marked increase in investment flows, restrictions still exist in certain critical areas. These concern potentially fast growing service industries such as banking, insurance and retail distribution. According to a recent OECD survey, the overall level of product market regulation as measured by the criterion of state control, barriers to entrepreneurship, and barriers to international trade and investment are still quite high in India and restricts competition.[42] Public ownership of firms is high and they operate across a range of competitive sectors, often even dominating them. State-owned companies have a strong presence not just in the financial services but also within the industrial sector in areas such coal and lignite production, electricity, petroleum, metal industries and fertiliser. The Competition Act passed by the government in 2002 followed a year later by the establishment of the Competition Commission of India which is the principal enforcement institution of the Act means that a robust policy framework now exists in India. But the policy is yet to become fully operational and the commission remains badly understaffed.

Similarly, while rules and procedures have been simplified and 'one-stop shops' introduced in several states for providing information and processing licenses, the administrative burden that the government imposes on entrepreneurs is still very high and an obstacle to new entry. Much has changed at the level of the central government, but the need for reform at the local level remains strong.[43] Firms interacting with government find themselves in a complex maze of regulations and administrative requirements that are repetitive with different departments collecting essentially the same information. A World Bank study while rating India among the top ten reformers in the world places it in the bottom quartile with respect to the ease of doing business. The average time taken in China to secure the necessary clearances for a start-up, or to complete bankruptcy procedures is much shorter than in India. Indian labour laws also allow firms less latitude vis à vis employees compared with

[42] OECD Economic Survey, op. cit.
[43] Naushad Forbes, "Doing Business in India. What has Liberalization Changed?" in Krueger, op. cit.

© Ifri

similar legislation in China, Brazil or Mexico.[44] Barriers to firm exit are also still formidable across all sectors. Existing legislation requires companies with more than 100 employees to obtain prior permission from the appropriate state government before effecting retrenchments. Moreover, permission is rarely granted.

Doing Business Indicators			
Procedure	Brazil	China	India
Time required for starting a business (days)	152	41	89
Time required for registering a property (days)	42	32	67
Time required for enforcing contracts (days)	566	241	425
Time required to complete insolvency proceedings (yrs)	10	2.4	10

[44] World Bank, *Doing Business in 2005: Removing Obstacles to Growth*, World Bank-Oxford University Press, 2006.

© Ifri