

CAN INDIA  
OVERTAKE  
CHINA?

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## Foreword

A host of factors prompted me to do this study. One, my Ministry selected me for a one-year fellowship at a prestigious academic address – Harvard University. Then, after arriving here and surveying the scholarly scene, I decided to do the unfashionable thing and study India, since *nearly everyone else* was studying China!

No, more seriously, it was a passion, shared with many of my compatriots, to understand what was happening in the Indian economy and what could be done to make us a world-class economic power. At the same time, the astounding growth in a vast neighbouring country, a potential superpower, economic partner as well as competitor, forced one to ponder over the reasons China was ahead of us. Was it because of their head start - a case of the early bird getting the worm, or the superiority of their reforms strategy? What lessons could we derive from China's example for India? How could we catch up and overtake China? Why was everyone studying China and not India?

I had earlier attempted a study of Chinese reforms in *Chinese Economic Reforms and their Relevance to India*<sup>1</sup>. But I realised I could not find concrete answers until I also understood *India's* economic reforms. India's performance could then be benchmarked against China's, a model worthy of comparison. This I set out to do in the following essay.

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<sup>1</sup>“China's Economic Reforms and Their Relevance to India”, by Smita Purushottam. Published in *South Asia and Its Neighbours* edited by Prof. Muchkund Dubey and Prof. Nancy Jaitley, 1999.

# *Can India Overtake China?*

## Contents

Foreword

Executive Summary

1. Pre-reforms scenario -India and China
2. Chinese and Indian Reforms in the First Phase
  - China
  - India
  - Worrying Trends: the Whittling Down of the Manufacturing Sector Advantage - services
3. The Indian Information Technology Sector
  - Domestic E-spending and Increasing Digitisation
  - Is the Indian IT Sector Stuck at the Low End of the Technology Spectrum?
  - MNCs are locating R&D Centres in India
  - The Challenge from China
  - Recommendations
4. Reforms in the Telecom sector
  - China's Strategy – Domination by the State Sector
    - Protection of Telecom Services Sector
    - Protection for Domestic Equipment Manufacturers
  - Latin American Strategies
  - India – Initial Reforms
    - Role of IT in India's Telecom Revolution
    - Big-Bang Reforms
    - Corporatisation and Privatisation
    - Telecom Infrastructure
    - Convergence Bill
  - Lessons from the Reform Strategies of Other Countries
  - Recommendations
5. Privatisation
  - Balco
  - Airlines Privatisation
  - Privatisation in other Sectors
  - Political Opposition
  - Comparisons with China
    - Role of the State sector and “Privatisation” in China
    - Attempts at SOE reform
    - China's Stock markets
    - Effects on the Banking System
    - Indian Banking and Insurance Sector Reforms
6. Infrastructure

- Power
- Roads
- Ports
- Airports

**7. Other reforms in India**

- SSI Dereservation, Labour Reforms, Pension Reforms, Fiscal Responsibility Bill

**8. The External Sector**

- FDI –India and China
- Trends in the FDI Scenario in India
- The Importance of Foreign Invested Enterprises in the Chinese Economy
  - FDI - a Chinese success story?
  - Round-tripping
  - Why does China need so much FDI?
  - Lessons for India
- China’s Success in Foreign Trade
  - Lessons for India

**9. Agriculture**

- Is there a Need for Reforms?
- Reforms
- China Liberalises
- Directions

**10. Other Issues**

- Poverty
- Comparisons with South Korea

**11. Dangers ahead**

**Conclusion: Well then, Can We?**

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# Can India Overtake China?

## Executive Summary

An overview of India's reforms actually implemented after 1999<sup>2</sup> - since there was a long hiatus between the 1991-93 reforms and the second spurt of reforms starting in 1999 - has been attempted in this paper.

- The overview starts with a description of the remarkably similar (given the different political contexts) but sub-optimal “socialist” policies pursued in both India and China in their respective pre-reform eras. This is to remind us what must never be repeated, unless we want to revert to the earlier suicidal policies of low growth and mass deprivation.
- In Chapter 2, an assessment of the 2 countries' reform strategies in their first phases and their results has been attempted. China (1978-1997) created an economic juggernaut based on a solid manufacturing base through policies involving State control over the economic reforms process, huge infrastructure investments, and open FDI and export oriented policies. India's first phase not only started 13 years later, but also witnessed the launching of only the “easy” reforms between 1991-93. Neglecting infrastructure, India also did not derive full advantage from the limited liberalisation effected in this first phase. The current economic slowdown and whittling down of the manufacturing sector in India can be attributed to the neglect of core sector reforms, something China tackled early on, with a host of repercussions for sustained growth in many sectors.
- It is however felt that despite impressive achievements, imperfections in the Chinese economic system remain. These are discussed in the Chinese media and admitted by the Chinese leadership. Some of these downsides are analysed in the chapter on State sector reform in China (*Ch. 5*) and on FDI inflows (*Ch. 8*). Caution should however be exercised in reading too much into these aspects. Critiques of the phenomenon have not been made to detract from China's achievements, but rather to arrive at a sober assessment of the overall reforms strategy. Moreover, with all its flaws, the FDI phenomenon has contributed massively to China's prosperity and global competitiveness. China is also making attempts to redress some of the inefficiencies of the State sector.

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<sup>2</sup> It is assumed that readers are familiar with the pre-99 reforms – an excellent summary is contained in an essay by former Finance Secretary, Member Planning Commission and now Executive Director IMF Mr. Montek. S. Ahluwalia in “*India in the Era of Economic Reforms*”.

Table 1<sup>3</sup>: Gross Economic Indicators (Note: ROG - Rate of Growth; b- billion)

	India 2000-01		China 2000	
<b>GDP</b>	US\$ 442 b		US\$ 1,102 b	
<b>Annual growth</b>	6%		8%	
<b>Sectoral Composition: Share</b>				
<b>Agriculture</b>	24.0%		17.6%	
<b>Industry</b>	21.9%		49.3%	
<b>Services</b>	54.2%		33%	
<b>Foreign Trade<sup>4</sup></b>				
<b>Exports 2000-2001</b>	US \$ 44.1 b	ROG: 19.83%	US \$ 249.2 b	ROG: 27.8%
<b>Imports</b>	US \$ 49.8 b	ROG: 0.27%	US\$ 225.1 b	ROG: 35.8%
<b>FDI</b>	US\$ 2.155 b (99-00)		US \$ 40.8 (2000)	
<b>Foreign exchange reserves</b>	US \$38.36 b (End-Jan '01)		US\$ 165.6	
<b>External debt</b>	US \$ 97.86 b		US\$ 146 b	
<b>Debt service ratio</b>	1999-00: 16%		8%	
<b>Exchange rate to \$</b>	Rs. 46		RMB 8.28	
<b>Savings rate 99-00</b>	22.3%		41%	

- In the second phase of India's reforms, reforms in the telecommunications sector, the privatisation process and other sectoral reforms are surveyed. These reforms demonstrate that when well structured, India's reforms have the potential to catapult the economy forward. Comparisons have been drawn at times with developments in China and in other countries, and overall lessons drawn at the end of each chapter.
- In Chapter 3, the achievements in the Information Technology sector in India, including our success in attracting investment in the area of software research and development from reputed MNCs, are analysed, even though IT is not part of the reforms process. It is rather a fortuitous development powered by India's human capital, stress on higher education and easier regulatory environment for the services sector; incidentally, IT had a chance at the phenomenal success it had *because* it is a services industry. The reasons for including an analysis of the IT sector are 4-fold:
  - i. Firstly, India's success in the IT sector acted as the main spur for the Government's wholesale commitment to restructuring the telecommunications sector, characterised then by poor bandwidth, mammoth PSUs, inefficient delivery and outdated technology.
  - ii. Secondly, the IT sector has the potential to reinforce the reforms process and revolutionize the Indian economy.
  - iii. Because of IT, India is probably the only developing country where several major MNCs are locating their R&D Centres.
  - iv. The necessity of sustaining out IT advantage is evident, which brings us to the 4<sup>th</sup> reason – the possible threats to India's current eminence, as we

<sup>3</sup> For India source: *Central Statistical Organisation* Advanced estimates February 5, 2001 for 2000-2001. India's GDP calculated by dividing Rs. 198 94 80 crores, GDP at current prices, by 45, the mean exchange rate in 2000-01. For China sources are *EIU Country Reports 2000 and May 2001* and official statistics on trade.

<sup>4</sup> For India source for foreign trade statistics is the *Directorate General of Commercial Intelligence & Statistics (DGCI&S)*. For China it is the *World Bank*.

**could be overtaken in the only area in which we have achieved international excellence, unless we are aware of developments across the border, in China. China has a declared objective to replicate India's export success in software and related services, in which China has 6 distinct advantages over India, enabling it to pose a serious challenge in the near future. These are:**

- ✓ A solid IT and telecommunications equipment manufacturing base, which will enable China to translate it to an advantage in software;
  - ✓ Huge investments by Taiwan in building up its IT hardware base;
  - ✓ A domestic software market which is already larger than India's;
  - ✓ An above 90% literacy rate compared to India's 60%;
  - ✓ A firm Government commitment to achieve excellence in the software sector, and
  - ✓ The State structures which are able to translate these goals into reality. This includes high-tech alliances between the State, State-owned enterprises and engineering institutes.
- **India has to consolidate its IT advantage by building up a hardware industry and implementing power sector reforms. The Manufacturers Association of Information Technology (MAIT) has recognised the importance of hardware, as embedded technologies, which marry software to devices and make them “intelligent” and “interactive”, become the next major growth opportunity. The influential economic daily *The Economic Times* reported that John Chambers, CEO of Cisco, said this on embedded technology as the next frontier of growth as he exhorted India to take the leadership of the next IT – driven Industrial Revolution, during his January 2001 visit to New Delhi: "You don't realise how many different areas the Internet technology would spawn. Every electronic device would be connected to the Internet. And each of these devices will have different software to run applications on them...".**
- **The urgency of power sector reforms to sustain our IT advantage was underlined by Jack Welch, CEO of GE, a long-time well-wisher and friend of India. A few recommendations, which India needs to follow urgently to preserve its lead in the software sector – power sector reforms, encouragement of the IT manufacturing sector, a public-private sector partnership to improve both mass elementary and higher technical education, are therefore provided at the end of that chapter.**
- **In Chapter 4 the telecommunications reforms since 2000 are described, compared and contrasted to reforms in China and in Latin America, with the conclusion that the Indian reforms, though very late, are clearly the best of the cases studied in conception and implementation.** China achieved impressive results, but it had to place an overt *ban* on foreign participation in the telecommunications *services* sector, though it encouraged foreign investment in telecom equipment manufacture. However once Chinese companies moved up the technology ladder, China clamped down on foreign investment in the telecom *manufacturing* sector also, even while promising to liberalise it once it joined the WTO!

- Latin America's telecom sector reforms were carried out under the pressure of internal fiscal crises and balance payments problems. Latin American countries attracted substantial amounts of foreign investment in the telecommunications services sector through the privatisation route, but only by making the terms of entry highly favourable for foreign firms. They were accorded monopoly rights and many other sweeteners, sometimes at the cost of efficiency enhancing policies. Indigenous companies took a back seat.
- India in contrast, structured its own reforms in the most transparent and competitive manner possible. The reforms package consisted of deregulation, entry of the private sector, re-regulation and privatisation of Public Sector Units (PSUs), albeit impeded by massive concessions to labour in the PSUs and departmental obstruction. Services were unbundled and licences were mandated for each separate category on a non-exclusive basis. Strong regulatory institutions, albeit with confusing mandates, were put in place. All sectors were opened to competition and foreign investment norms were liberalised.
- This strategy carried risks, as the excessive segmentation of services gave rise once again to opportunities for arbitrage, while obstruction by vested interests led to tussles between government agencies, regulatory bodies and private firms.
- Despite the above caveats, a lot has been achieved. The consumer has been the primary beneficiary, with declining corruption and reduced tariffs, greater competition and improved services. Strong Indian firms ready to develop telecom infrastructure and services have emerged, because the fierce competition, minority foreign equity ceilings and low profit margins, have meant that foreign companies have not find the Indian telecom services sector as attractive as the Latin American. India's reforms have achieved the optimum result in liberalising and opening up, attracting private domestic investment into a strategic sector, retaining control in Indian hands and creating a competitive and consumer friendly structure, something neither China nor the Latin American countries could do. The speed and quality of reforms have been exemplary. India has shown that given the political will, it can implement a sound, win-win policy of reforms.
- Some very important lessons of the telecom reforms are that (i) the bureaucracy can be brought in line once sufficient political will is mustered; (ii) Indian firms can be unbeatable once the market is freed and conducive conditions created, and (c) the reforms expose the folly of those opposing Privatisation and second-generation reforms, which together have the tremendous potential to lift the Indian economy out of its current doldrums. The importance of privatisation as a way to ensure that thriving Indian companies emerge to give a good fight to the MNCs is detailed later.



- A few recommendations to consolidate the gains have been provided at the end of the chapter. These include encouraging the telecom manufacturing sector including FDI, announcing a public-private partnership ensuring that private funds and entrepreneurial energy are released for infrastructure development rather than fighting court battles with Government departments/ PSUs and passing the Convergence Bill – which can solve all the problems at one stroke, including ensuring mass access to IT. Vested interests should not be allowed to dissipate the good start.
- In Chapter 5, India’s attempts at privatisation and China’s attempts at reform of its state-owned firms have been described. The Balco case, airlines privatisation and privatisation in some other sectors have been examined. The conclusion here is that although the Indian scenario presents special difficulties - privatisation is being undertaken fairly and openly in India. Thus, the Government has to structure the privatisation in an open and transparent manner, ensure competition, elaborate a fail-safe regulatory framework, protect the rights of workers, and get a fair price for its equity to bring down the fiscal deficit. In most other countries these goals are considered mutually incompatible, and it has usually been impossible to fulfill all objectives simultaneously. The Balco privatisation showed that these issues were fairly handled – another cause to rejoice in the efficacy of India’s reforms. It also gave the opportunity to the Government to demonstrate real political will in withstanding the political storm against privatisation. One solution to speed up privatisation would be to mobilise mass support by providing some direct benefits to the masses from the privatisation. Another would be to shift the PSUs on sale to a separate Ministry – Disinvestment or Finance, as some media reports have suggested, so that internal departmental opposition is overcome.
- Regarding China, reforms of its State sector have not achieved critical mass, and the sector continues to be an over-all “drag” on the economy. Thus, though the Chinese model characterised by strong State intervention seems to deliver high rates of growth, it is achieved at a high cost and hidden risks may accumulate within this model, as the experiences of other countries experimenting with strong State direction of the economy have shown.
- One Harvard University Professor (Prof. Yasheng Huang of Harvard Business School) has posed the relevant question that with FDI inflows 20 times that of India, a savings rate double that of India’s, why is China’s rate of growth only 2-3 percentage points ahead? This is a valid question and is explained by the State sector’s “drag” effect on the Chinese economy. It reinforces the urgency of privatisation in the Indian context, as more efficient, privatised domestic firms can pose a stronger challenge to multinationals and improve overall productivity. In fact a real nationalist would support privatisation of firms which have failed to generate optimum value and whose retention in the public sector has no benefits to society at large. The immediate benefits of privatisation in the Indian context are – creation of strong and competitive Indian companies which can resist foreign

takeovers, immediate impact on the fiscal deficit and consequent relief to honest taxpayers as the pressure on the Finance Minister eases, boost to private consumption, and multiple relief for industry which is suffering under an uncompetitive cost structure imposed by high interest rates and taxation structures which are necessitated by the huge governments deficit.

- Chapters on reforms or proposed reforms in the infrastructure, power, insurance, labour, banking and small-scale sectors follow.
- A comparative analysis of FDI inflows into India and China followed by a small section on China's foreign trade - has also been undertaken in Chapter 8. In India it is observed that, post 1991 reforms, a large portion of FDI has started to move to the services sector. This is because the climate for *all* investment in the manufacturing sector is relatively unattractive, and FDI follows the same market signals as domestic investment. India also missed out on the era of relocation of manufacturing facilities from the East Asian Tiger economies. The current emphasis on providing incentives for foreign investment without tackling the issue of the general economic slow-down is misplaced and is predictably not yielding the desired results. We stand a better chance of attracting decent and high quality FDI inflows if we revive our manufacturing and agriculture sectors and domestic market. China's comprehensive approach, which emphasizes an economy-wide span of measures including creation of world-class infrastructure and supply of cheap power, special economic zones, flexible labour laws, preferential treatment and single window clearances, holds some lessons for India which has focused too long on a compartmentalized approach to promoting FDI.
- There are other views however, qualifying the Chinese FDI phenomenon. A Harvard University critique (such critiques incidentally include prominent mainland Chinese economists) contending that China has been unable to attract good quality and high-tech FDI, has been examined in detail because of its important implications. Prof. Yasheng Huang of Harvard University points out that the proportion of FDI in total capital formation in China approximates levels in the far more open western economies, and FDI's ratio to domestic investment is also increasing. He attributes this to certain peculiarities in the Chinese system which leads (a) to FDI acting as the domestic financial intermediary and (b) low-tech FDI being attracted. Heavy FDI inflows also place domestic firms at a disadvantage.
- The Chinese phenomenon incidentally provides an interesting contrast to investment in core R&D activities by many MNCs in the Indian Information Technology sector. MNCs rarely locate core R&D activities in a developing country. It speaks well of the trust reposed in India and India's reputation in this field.
- The anomalies in the Chinese approach to FDI, the benefits they have received and the lessons India can draw are laid out. It is concluded that while there are some drawbacks in encouraging indiscriminate inflows of

FDI, FDI has played a huge role in building up China's manufacturing sector and exports. India should draw the right lessons – improve the overall domestic economic environment through second-generation reforms, invest in infrastructure, speed up Privatisation, reduce corruption and improve policy implementation to attract FDI.

- China's success in foreign trade is again due to a strategic focus on promoting the export sector by tailoring other economic policies to serve this goal. These include infrastructure investment, the special economic zones, FDI policy, and a duty structure that minimizes or eliminates duties on inputs and raw materials and raises duties on value added manufactured imports. China has also followed policies restricting the foreigners' access to sell in the domestic market. India can emulate many of these features in its foreign trade and foreign investment policies, but most of all it needs to rise above a compartmentalized approach to FDI or foreign trade promotion.
- Chapter 9 touches on the problems of Indian agriculture and attempts at reform. The Green Revolution has proved a mixed blessing, engendering adequate increases in food grains production but unsustainable increases in subsidies and penalising balanced growth in non-food grains products. The vast power of agricultural lobbies compels constant increases in food grains support prices and power and fertiliser subsidies. Attempts are being made to curtail the burgeoning deficit on account of producers' subsidies, remove the restrictions on the free movement and marketing of agricultural produce and support rural infrastructure. China has already started the process of withdrawing ruinous producer subsidies for cotton and food grains.
- Chapter 10 briefly dwells on the poverty issue. China's absolute levels of poverty are not as distressing as India's, and the proportion below the poverty line is also said to be well below even the revised Indian percentage of 27%. However China's gini coefficient at 0.39 is above India's at 0.29, and on Premier Zhu Rongji's own admission, approaching international danger levels.
- Some musings on South Korea follow before conclusions are arrived at, as chapter-wise conclusions are not reiterated at the end of the main essay.

## CONCLUSIONS

The conclusions contained in this Executive Summary have been distilled from the main text, and will thus not be found in any one chapter; rather, they will be found strewn in various chapters. The main conclusions revolve around the following points:

1. China, following the pattern of late developing economies, has retained a very strong role for the State in the economy, while grafting and internalising the elements of a market system. India on the other hand, is elaborating a liberal model, though this is not immediately apparent because of the dead-weight of

the enormous State apparatus and the snail's pace of reforms. Thus, India is experimenting with an arms-length approach to State involvement in the economy and its withdrawal from some economic fields, while the private sector assumes its rightful place as the most efficient driver of economic growth, its likely excesses mitigated by strong and autonomous regulatory bodies, a judicial system, and the court of public opinion. This process needs to be greatly speeded up.

2. As a result of its development strategy, China has raced ahead of India. Today India's economy is half of China's, and its average growth rate in the 1980s-90s was several percentage points behind. There is a stark contrast between the share of the manufacturing sector in China's GDP, at 50%, and India's at 22%. This has many consequences. FDI in China flows mainly to the booming manufacturing sector, strengthening even further China's global competitiveness in goods, whereas the relatively pitiful amount received by India is increasingly finding its way into the growing services sector (*Ch. 8, Trends in the FDI Scenario in India*). Not only will the weakness in our manufacturing base affect our overall global economic competitiveness, it will affect our capacity to sustain our IT advantage, as next generation software applications focus on embedded technology.
3. Clearly, China has 2 main advantages over India – (i) the State's commitment to growth and (ii) a robust manufacturing sector. Its earlier policies, which encouraged the manufacturing sector, have laid a solid basis for sustainable growth, rising exports and FDI inflows. China can be said to have carried out the equivalent of our so-called second-generation reforms at least a generation earlier.
4. We MUST learn lessons from this and implement our reforms in the power, labour, land and other sectors speedily as well as make the State an enabler of, rather than an obstruction in, the path of reforms. It is necessary to have a competitive manufacturing sector. In nearly all the chapters - the implications of not addressing revival of the manufacturing sector for creating an expanding economy, attracting more FDI, generating larger exports and employment and even for the IT and Telecommunications sectors - have been analysed. We should not succumb to a defeatist mentality that Indians do not have good manufacturing skills. Indians on the contrary are a nation of fixers. India is in fact half-heartedly beginning to implement policies to encourage the manufacturing sector similar to China, but more than 20 years later.
5. At the same time, the tendency for wholesale copying has to be avoided. While we can learn from China in terms of goals, the specifics have to be elaborated by us to suit our own requirements, especially since the contexts are so different.
6. There are a few creditworthy achievements. We have developed a competitive advantage at the top end of the technology spectrum in IT. Our

Telecom reforms have started to yield results. We should however be aware that one of the reasons for success in the Telecommunications sector was that the only vested interests were the Departments and the PSUs, whereas in the next phase of reforms in the core labour and power sectors -- a whole array of vested interests will have to be tackled. Strong resolve will be required to meet these challenges. At the same time, the telecom reforms demonstrated that opposition by the bureaucracy is not an insurmountable obstacle in the path of reforms, hence the bogey of departmental obstruction should at least be laid to rest by this experience.

7. The above is not to belittle the potential of the services sector and India's enormous human capital. India can build a competitive advantage in some areas in the services sector besides IT. In education for example - there is tremendous potential for setting up higher educational institutes to attract foreign students and accommodate the swelling masses of Indian students seeking quality education. In health care, there is a potential global market for India's highly qualified and expert health care practitioners and hospitals. Here are many other areas in the services sector in which India is building a brand advantage, such as the entertainment industry.
8. The other essential step for success in our reforms, is to simultaneously strengthen and downsize the State apparatus. Otherwise India's semi-feudalistic legacy will continue to thwart progress unless there is a strong, disinterested and powerful arbiter for the painful reforms necessary for economic transition.
9. Ironically, State systems cannot be strengthened in India without their drastic pruning. The Indian State absorbs the major part of Government expenditure, depriving other sectors of much needed funds. The high cost structure of the Indian economy and Indian industry is both directly and indirectly due to the cost of maintaining the huge State apparatus. The Indian bureaucracy should be reduced in phases to 25% of its current size to eliminate its sheer nuisance value and its predatory nature. To avoid political mobilisation (although it is doubtful how much real political clout bureaucrats have in the face of a determined political leadership, given how smoothly the telecom reforms were implemented once the political leadership had made up its mind), this should be done in a phased manner, starting immediately.
10. We can achieve our goals if we apply the right reforms to other sectors of the economy, where there are many portents of hope. Pharmaceuticals and biotechnology, not covered in this study, beckon as additional sectors with great potential, to realise which a focused national policy should be implemented. The freeing of agriculture including establishment of direct links between the producer and the market, should help to rejuvenate this sector. The dismantling of the APM will bring in fresh revenues for the Government, while Information Technology exports have been compared to oil as generators of revenue. Services exports/ outsourcing is another

potentially lucrative area. Privatisation will unlock the massive value in PSUs and generate new engines of growth.

11. The reforms in the last year, nothing short of breath-taking, are however again losing steam. They come after a long period of inaction and barely make up for lost time. But the imperatives are such that if these issues and the issue of corruption are not tackled head on, we will be unable to undertake the race with China, *which we must remember is not confined to the economic sphere.*
12. A strategy based on the following reforms will create a very dynamic, low-cost economy capable of very rapid growth:
  - a) Privatisation
  - b) Labour reforms
  - c) Power sector reforms
  - d) Infrastructure investment in public transportation systems, roads, airports, ports, railways, education and health
  - e) Property market reforms
  - f) Government deficit reduction and
  - g) An export oriented economy attracting higher FDI inflows
13. Implementing the right policies will not create a flourishing manufacturing sector overnight. But even if it is not as large as China's, it will be established on a sounder footing, with private Indian firms eventually eclipsing the performance of China's State-owned firms. Coupled with our advantage in the services sector, we will swiftly narrow the gap with China.
14. India will have to make a huge effort to achieve a steadier, higher rate of growth both in quantitative and qualitative terms. Once achieved however, it will be feasible to swiftly bridge the gap between the two economies, and overtake China within 10-15 years. If not, India's potential will remain just that, potential.

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## 1. PRE-REFORMS SCENARIO: INDIA AND CHINA

Both China and India are ancient countries, with similar experiences of being colonised, though with very different outcomes. Chinese Economist and Director of the China Centre for Economic Research at Beijing University, Prof. Justin Yifu Lin, to whom I owe these insights, pointed out that both countries settled on an import substituting, capital intensive, heavy industry development strategy, influenced by the Soviet model – to achieve self-reliance. While China aimed at socialism, in India too equity goals were at the forefront. Unfortunately the means adopted to reach these worthy goals had unforeseen consequences (except by a few brilliant economists such as Professors Jagdish Bhagwati and Padma Desai) on both the quality and the rate of growth.

Both countries inherited similar economic legacies - capital scarcity, a scattered agricultural surplus, low technological levels and a weak industrial base. Development of a heavy industrial complex required the suppression of market forces; otherwise they would spontaneously flow into sectors where they could reap the natural comparative advantages of the economy. Both India and China's leadership chose central planning, through which resources could be mobilised/ commandeered administratively to develop heavy industry. Prof. Lin's estimates are that between 1953-85 in China upto 80% of investment was channeled into heavy industry. Governments in both countries drew up national plans and empowered the huge bureaucracy to micro-manage economic decisions. In India this was called the "*licence or inspector raj*" where the co-existence of a repressed market economy and enormous discretion in the hands of the bureaucracy, created endless opportunities for rent seeking. In time the lower level bureaucracy was to become a vast constituency impeding economic growth and later, reform.

Such a system may have succeeded with better oversight and a committed national leadership as in South Korea in the 1960s. However bureaucratic coordination did not reach the intrusive and pervasive depths in South Korea as it did in India, nor was it misdirected as it was in India towards suppressing the natural advantages of the economy, and in any case South Korea could never match the scales we are talking about. However even in South Korea, State intervention was not without cost, either in terms of rent seeking<sup>5</sup>, or in contributing to the moral hazard in Korea's banking system that led to the 1997 financial crisis.

China went further and extended administrative mobilisation to the countryside with full collectivization of farms by 1958. While India continued to tolerate the existence of a private sector, China nationalised all private firms by 1958. Banks were nationalised in both countries, slightly later in India, and became an extension of the State budget, permitting administrative lowering of interest rates to favour the heavy industry sector and discouraging sound asset management.

In China centralised job and benefit allocation systems, replaced labour markets, enabled control of rural-urban migration and locked out the rural population from urban employment and social security benefits. In India unionisation of organised labour achieved pretty much the same objective, as the labour aristocracy strove to keep competition out, restricting employment growth in the well-remunerated organised sector. Wage levels for unionised workers raced ahead in India even as autarky ensured that their relative

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<sup>5</sup> Paper by Yoon Je Choo in "*The Economies of Asia - 1950-1998: Critical Perspectives on the World Economy*", edited by Robert Ash and Anne Booth.

international productivity declined. In both countries central planning resulted in overstaffing, overstocking, low worker productivity and low technological innovation.

A closed capital and current account with an overvalued exchange rate depressed the cost of imported capital equipment for the heavy industrial sector. Foreign investment was prohibited in China and severely curtailed in India. Foreign trade was either monopolised by the State as in China or heavily controlled as in India, again affording plenty of opportunities for rent seeking. Imports of consumer goods were banned. But as Prof. Deepak Lal observed<sup>6</sup>, profits in the consumer goods sectors were thus raised inordinately in India, thus perversely creating incentives for investment in consumer goods production rather than in the desired heavy industry sector!

Living standards for the general populations in China and India improved very slowly as their economies became inward looking. The isolation from the world economy meant that growth impulses did not filter in, thus further accentuating technological obsolescence and low productivity. The opportunities for slow but steady industrial restructuring and upgradation and hence maintenance of international competitiveness was foregone.

Admittedly, the rate of economic growth increased from pre-colonial levels, which is not saying much when compared with the growth rates of the Tiger economies, and an extensive though uncompetitive industrial sector was established. These achievements however masked serious and obvious failures, which showed up in all macroeconomic indices and in the quality of life for the vast majority of their populations. The two economies were reduced to lower Production Possibility Frontiers with ever diminishing returns from the misapplication of resources in sectors in which the economy did not enjoy a comparative advantage. Some measure of their opportunity cost can be gauged from the rapid growth rates unleashed with the onset of reforms in both countries. In fact, the reasons for the success of the East Asian and South East Asian countries was that they exploited their natural advantages in the light industry and agricultural sectors in an export oriented, open to Foreign Direct Investment (FDI) framework, as Prof. Jagdish Bhagwati has successfully demonstrated in his many works<sup>7</sup> (the one cited here includes an answer to Prof. Dani Rodrik's postulate that export orientation did not fully explain South Korea's economic miracle).

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<sup>6</sup> "India in the World Economy", by Prof. Deepak Lal.

<sup>7</sup> Cornell paper on "The Miracle that did Happen: Understanding East Asia in Comparative Perspective", which is on: <http://www.columbia.edu/~jb38>.



## 2. CHINESE AND INDIAN REFORMS IN THE FIRST PHASE

### CHINA

To China's credit, it woke up to its relative backwardness in 1978. In 1978, Deng Xiao Ping launched the reforms by phasing in market forces and popularised the slogan "to get rich is glorious". He denounced the "*leftism*" which had wreaked havoc on the economy, indicating that it was simplistic to equate market mechanisms with capitalist economics only and arguing that both socialist and market economies had room for planning and the market. He also rejected the orthodoxy that the open-door policy was in contradiction to the principle of self-reliance. The revolution in mental attitudes he spawned cannot be underestimated in the Indian context, where these simple truths are still being contradicted.

China introduced market forces and gradually loosened the elements of control, while ensuring that the Communist Party remained in charge. Certain pillars of the economy were not only preserved but also strengthened – the State-owned Enterprises (SOEs) and State Banks that funded them. The system of direct handouts from the Budget to the SOEs was phased out. SOEs were however given greater freedom in production and management decisions and market pricing was gradually phased in. China reversed its pre-reform policies on the exchange rate, foreign trade and investment and agriculture, enabling the peasant to lease his land, sell produce on the market and substantially increase his income. This led to a boom in production and the explosive growth of township and village enterprises (TVEs). Foreign Invested Enterprises (FIE)'s were granted the right to hire and fire labour and full freedom to invest in any sector, thus doing away with the earlier bias in favour of heavy industry (the State however continued to support it).

The Government simultaneously embarked on a policy of massive investment in infrastructure and preferential treatment to attract foreign investors, especially in the 5 Special Economic Zones (SEZs). By 1993, investment in infrastructure was 6.5% of GDP. Though concentrated in urban and coastal areas, most visiting Indian businessmen including top Confederation of Indian Industry (CII) members used to muse that it was better to have world-class infrastructure in some areas, than to have none at all in the entire country. FDI inflows, attracted by preferential policies and excellent infrastructure in the coastal areas, began to pour into export-oriented activities.

An export oriented, FDI intensive policy which banked on China's comparative advantages, and an increasingly market oriented economy unleashed tremendous dynamism, at first in rural and then in urban areas<sup>8</sup>. All this led to an enormous generation of wealth in an unregulated, freewheeling atmosphere reminiscent of the Wild West, an analogy captured in a People's Bank of China (PBC) document published in 1994.

China thus broke out of its fettered past more than a decade before India. That is why images of invincible juggernauts and superlatives like dynamic inevitably spring to mind when thinking of the Chinese economy, while the Indian economy has till recently evoked a far more inert image, in fact, that of a supine Gulliver, shackled by tiny but thousands of rope wielding, tunnel-visioned bureaucrat-Lilliputians.

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<sup>8</sup> Later, China allowed greater autonomy for and corporatisation of state-owned enterprises (SOEs) and tolerated privatisation of smaller enterprises.

## INDIAN REFORMS

This changed following the onset of reforms in July 1991: India's annual rate of growth picked up to an average 6%, following the macroeconomic stabilisation package, industrial delicensing and opening up of the foreign trade and investment sectors. The little space to breathe unleashed, as in China, one of the fastest and steadiest rates of growth in Asia.

However, the momentum acquired was soon lost due to political instability and complacency, which sets in whenever things seem to be going right, which Prof. Manmohan Singh, Leader of the Opposition in the Rajya Sabha (upper house) *and* architect of India's reforms has reportedly acknowledged<sup>1</sup>. The so-called second-generation reforms were continually postponed. Meanwhile a ruinous pay rise for the bureaucracy without any moves to downsize or reform it, further squeezed government finances and prevented investment in physical and social infrastructure, drove up interest rates, and crowded out private investment, *while China at the same time was pouring funds into infrastructure*. No moves to expand the tax base or cut misdirected subsidies were made as the country lurched from one election to another. In the process yet again India's promise seemed to be dissipating in the wind.

On the other hand, with the return of political stability in 1999, a series of business-friendly reforms were implemented. These reforms were in the banking and insurance sectors, with the Government recapitalising nationalised banks, introducing international prudential banking norms, and gradually easing restrictions on the capital account which hindered foreign currency transactions for business purposes. Major reforms were launched in telecommunications and measures to elaborate a legislative framework corresponding to the requirements of the 21st century, were initiated. Efforts were made to reduce the fiscal deficit. *Real* Privatisation was launched with the ultimately successful though unnecessarily controversial Balco case. Other public sector firms Air India, Indian Airlines, VSNL, IBP, ITDC, CMC etc. were put up for privatisation in order to meet the revenue mobilisation target of Rs. 12,000 crores or approximately US \$ 2.5 billion announced in the Union Budget of 2001. Foreign investment picked up in the banking, insurance and services sectors, while domestic investment picked up strongly in the telecommunications sector.

Important announcements were made in the President's Address to the Budget Session of Parliament in February 2001 and in the Finance Minister's Budget Speech, in which the intention to move forward with pension, labour, and power sector reforms was proclaimed. The Government also faced down strikes by trade and government unions –the postal strike, the telecom employees' strike, the banking strike, the Balco strike etc. All this was despite Kargil and other problems that cropped up in between. This showed that when political will was summoned, essential second-generation reforms could be implemented.

### *Worrying Trends: The Whittling Down of the Manufacturing Sector in Contrast to China*

After a heady decade of an average of over 6% growth, real GDP growth in 2000-01 decelerated to a worrying 5.2%, compared with a growth rate of 6.4% in 1999-2000 and 6.6% in 1998-99. Growth in the manufacturing and agriculture sectors fell precipitously. Growth in India's exports to US \$ 44.1 billion<sup>9</sup> was accompanied by a 3-year uninterrupted decline in capital goods imports, not a good sign for the economy. The gathering recession

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<sup>9</sup> Source: Directorate General of Commercial Intelligence & Statistics, DGCI&S.

was partly explained by the fact that industry went on a capacity-creating spree in the wake of the reforms. An Economic Times study of 476 manufacturing companies in 20 industries showed aggregate installed capacity in each sector barring two — cigarettes and cotton textiles, had increased between 1993 to 2000<sup>10</sup>. To sustain it, the requisite increase in aggregate consumption had not taken place. In fact, with the increasing squeeze on government finances, the Government followed a tight fiscal policy and public spending slowed to a trickle. This accentuated further worrying trends in the Indian economy —i.e. — the shrinking share of the manufacturing sector.

In the Indian Financial Year (FY) April 2000-March 2001, the share of the services sector in real GDP had increased to a whopping 54.2%<sup>11</sup>. In China the share of the manufacturing sector in GDP was nearly 50%<sup>12</sup>, while in India it shrank to 21.9%<sup>13</sup>. China's manufacturing sector was nurtured by the following policies:

1. Enormous investments in infrastructure and power generation.
2. The Chinese State's complete control over its labour force. Ironically unions and strikes were banned, it being a *workers' State*.
3. FDI policies encouraging the growth of the manufacturing sector. Labour policies for foreign investors were especially flexible.
4. China did not have a maze of regulations governing production. Of the most serious impediments, the consequences we are beginning to realise now, was small-scale sector reservation in India, which has still not been fully done away with. China on the other hand never had a policy for reserving and restricting production of goods in the small-scale sector — the concept did not exist and probably never crossed their mind. In fact a major part of China's export success can be credited to FIEs investing in the areas that we reserved for the small-scale sector, churning out cheap and good quality mass consumption goods with which it flooded export markets.
5. China sheltered its manufacturing sector behind high but very rational tariff and non-tariff barriers (internally, it introduced the VAT). Thus China ensured duty free imports of inputs for exports from the beginning of its reforms, and had a graduated import duty structure taxing manufacture imports at very high rates while lowering them on low value, unprocessed materials (which is why the major part of Indian exports were confined to the low value end of China's import spectrum). Because of this policy and strict restrictions on accessing China's internal market (foreign companies *cannot* distribute their product within China), substantial tariff-jumping FDI was attracted into China's manufacturing sector.

These simple policies ensured China's manufacturing sector grew and prospered. India in contrast seemed to have skipped the manufacturing stage in the economy's evolution due to the heavy penalties imposed on industry through 40 years of *licence raj*, autarky, small-scale sector reservation and other self-defeating policies, which confined Indian industry to a small domestic market. While China was crafting a massive State sponsored, global export strategy based on economies of scale, we were busy ensuring that a major part of the industries we had a natural competitive advantage in, remained in the small-scale sector and were actually not permitted to grow.

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<sup>10</sup> "Manufacturing's on a roll" by Tushar K Mahanti & Ajoy K Das, *ET* Friday Jul 13 2001.

<sup>11</sup> From 53.0% in 1999-2000 and 51.5% during 1998-99.

<sup>12</sup> According to the *Economist Intelligence Unit* or *EIU*.

<sup>13</sup> *RBI Bulletin*: Advance Estimates 2000-01 and Quick Estimates 1999-2000 of National Income: A Review.

This was a real pity as we are a nation of fixers. Every neighbourhood has its quota of repair shops and handymen. No other country is as good as fixing broken down equipment, which leads me to conclude that Indians, with their quick learning abilities and nimble fingers, have untapped engineering abilities.

We also eschewed export orientation, which could have enlarged the market for manufactures, reserved several industries exclusively for the public sector, and erected high tariff walls behind which *all* industry became flaccid. The 1991 reforms left most of these and other problems of infrastructure unaddressed, so the impact of delicensing alone was not enough to take the economy very far. Services on the other hand were relatively free from the constraints on the manufacturing sector, being beyond the purview of the *licence raj*.

### Advantage –services

Associate Professor Ashutosh Varshney, University of Michigan points out in the joint introduction to “*India in the Era of Economic Reforms*” that in the first phase of reforms the liberalisation of investment rules, capital markets and the trade and exchange rate regime had gone farther than the reform of agricultural trades, public finance or labour markets and the privatisation of public sector firms. Indian leaders had gone for the less risky and relatively safer reforms, reforms that primarily affected elite welfare while leaving reforms more relevant to the masses relatively untouched, which explains the reason for the current boom in the services sector and the fact that post-reforms, even foreign investment has started to flow into this sector. FDI will also ultimately obey the same market signals as domestic investment. The key lesson we should learn, is that the better the business environment for a particular sector, the more investment - domestic and foreign - will be crowded in. We have not created a conducive environment for investment in manufacture, hence its decline and the relative boom in services.

It would thus be a dangerous fantasy to think that a country as large as India can develop a competitive advantage based on the services sector alone. The pre-Budget Economic Survey (2000-2001) issued by the Ministry of Finance recognised this and was unusually forthright for an official document. It termed the economic situation difficult and warned that unless urgent measures were taken, the current deceleration would continue. It implicated the "identifiable gaps in the reform process" as clouding "the long-term growth prospects of the economy". The Survey identified the key problem as the "persistence of high fiscal deficits at both the central and state levels". Inefficient monopolies, such as in power were implicated in undermining the competitiveness of Indian manufacturing and agriculture. Other gaps in the reform process - labour laws, bankruptcy, land ceilings, rent control and small-scale industry reservation, inhibited industrial restructuring, raised costs and reduced international competitiveness. "The high industrial and GDP growth rates seen during 1994-95 to 1996-97" could "be replicated only if these critical gaps in the reform process are attended to".

In strong and unambiguous terms it went on to recommend a wide-ranging second generation reforms agenda to help the economy and particularly the manufacturing and agriculture sectors recover from the current slowdown. The President's Address to the Budget session of Parliament was also frank on the need for second-generation reforms, calling for a *bipartisan* approach on core issues. The Finance Minister followed this up with the path-breaking Union Budget of 2001-02, which surprised everyone with its bold declarations of intent on second-generation reforms, especially since the Government was expected to take it easy before the upcoming assembly elections in 5 States. But as the brilliant Indian columnist Prem Shankar Jha pointed out, it only contained *a promise* of

change on the deepest structural reforms needed. The proof of the pudding would be in the eating.

How this neglect affects India's long-term prospects is sought to be highlighted as we examine specific sectors in the Indian economy. Though the Information Technology sector is one of our success stories and merits an in-depth examination as an integral part of the economic landscape, we could lose our advantage in this sector also if we do not implement the above core reforms especially since China's declared objective is to achieve supremacy in IT also. I have gone into some detail to showcase this. Another reason for bringing this sector up is to contrast the phenomenon of MNCs locating their high-tech R & D activities in India while China has largely been unable to attract such investment.

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### 3. THE INDIAN INFORMATION TECHNOLOGY SECTOR

The Information Technology (IT) sector recorded a compounded annual growth rate of 55% between 1992 and the present. As India's only world-class sector, it was largely a fortuitous development, owing little to governmental intervention as barring the successful computerisation of the railway passenger reservation system in the early 80s<sup>14</sup>, there was little mass application of IT in the real economy. There is therefore an impression that it operates as an isolated enclave, and a tendency to take the *virtual* terminology literally and perceive IT as a phenomenon *outside* the *real* economy as a purely export oriented sector with no backward or forward linkages, not surprising as the initial stimulus for India's software services originated abroad. In an article on Indian IT technocrats returning to the mother country, the Far Eastern Economic Review observed perceptively that this phenomenon said "*much about how India is changing--and more importantly about how the world is changing in a way that benefits India!*"<sup>15</sup>.

The IT software and services industry today accounts for nearly 2% of India's GDP, and the National Association of Software and Service Companies (NASSCOM) - McKinsey study of 1999 - projected that this share would rise to 7.7% by 2008. In 2000-01, IT software and services exports at US\$ 6.2 billion<sup>16</sup> - represented over 14% of India's total exports of US\$ 44 billion. By 2008, Nasscom expects Indian software and services exports at 35% of India's total exports<sup>17</sup>. Software exports have indeed been called India's oil<sup>18</sup>.

#### DOMESTIC E-SPENDING AND INCREASING DIGITISATION

At the same time, domestic e-spending in India is rapidly increasing. Software revenues from the domestic market accounted for Rs. 9410 crore or US \$ 2.06 billion in 2000-01, a growth of 31% over the previous year. The Nasscom survey found that an increasing number of Indian companies recognised E-strategy as a core necessity. Thus - "100% of the companies surveyed either already use or plan to use IT service providers for application development, 94% for website or application design, 86% for staffing help, 78% for network infrastructure assistance and 75% for security services"<sup>iii</sup>. Other major drivers of growth in the domestic software market were e-governance and banking.

The above is taking place in response to fierce competition in the Indian marketplace persuading companies to turn to IT. Indian commentators are increasingly talking of bricks and clicks as complementary to each other. As the FEER puts it, the changes aren't just confined to the New Economy - the traditional business families of India are "transforming their Old Economy behemoths at a speed that makes most of the tycoons of Southeast Asia seem somnambulant by comparison".

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<sup>14</sup>And arguably, the introduction of computers in senior government servants' offices in the 80s, which may have spurred a change in the outlook of at least some senior officials.

<sup>15</sup> *FEER* July 13, 2000 "Building the New India" by Henry Sender/BOMBAY Issue cover-dated July 20, 2000

<sup>16</sup> 62% went to North America; 24% or Rs 6,800 crore/ US\$ 1.5 billion - to Europe, a 68% increase over 1999-2000, with the UK once again the most favoured destination; 4% to Japan at Rs. 1,100 crore or US\$ 250 million, and 10% to Rest of the World.

<sup>17</sup> In 2001-02 the Indian software industry is expected to aggregate revenues of Rs 52,500 crore (US\$ 11.2 billion). This will include software exports of Rs 40,000 crore (US\$ 8.5 billion) and a domestic market of Rs 12,500 crore (US\$ 2.7 billion)- *NASSCOM which is the source of practically all the data here.*

<sup>18</sup> An *Economic Times* report<sup>18</sup> quoted a Goldman Sachs Global Equity Research report as predicting that about 5% or \$30 billion - of the global market for infotech-enabling services, estimated at \$585 billion by 2004, could go to Indian companies. Today Indian companies have 1.6% of the global IT market and 4.9% of the global outsourcing market. Source: Anurag Prasad & Neeraj Saxena Nov 25 2000 *The Economic Times*.

IT connects, admittedly a small, but influential section of Indian industry with the best and most innovative companies in the United States (Government policy is helping this by easing provisos for acquisition of software firms overseas). It is no accident that some of India's best-managed *Indian* companies are also the ones most globally integrated - the IT companies. They are setting benchmarks in good corporate governance for other Indian companies<sup>19</sup>. The increasing backward and forward linkages with the real economy, within and across national frontiers, are contributing to the country's *global* integration and *domestic* economic upgradation. IT has thus become a transmission channel for innovation, economic dynamism and better corporate governance - to India.

## **IS THE INDIAN IT SECTOR STUCK AT THE LOW END OF THE TECHNOLOGY SPECTRUM?**

There is also a perception that the Indian IT sector is stuck at the low end of the value spectrum, a view propagated amongst others by Prof. AnnaLee Saxenian at a lecture given at Harvard University last fall. There is nothing wrong in expanding low cost, high volume, mass white-collar employment opportunities through the booming call centre business and relocation of simple back office operations of major multinationals in India, though even *Bill Gates* has denied that this is the reason why American software giants base operations in India. In fact in a country like India it would be folly not to exploit the twin advantages of cheap labour rates and English language skills.

1. But this is not the whole story. **Indian software companies have been moving up the value chain while growing exponentially.** The world's best firms are outsourcing their work to India - 40% or more than 185 of the Fortune 500 companies outsourced their software requirements to Indian software firms in 1999-2000 (*Nasscom*)<sup>20</sup>. Offshore software development strengthened its share to 44% of software exports with on-site services contributing 56%, a big change from 1991-92, when the latter comprised 95% software exports.

2. **Indian software companies are striving to stay abreast of global technology trends.** According to the Nasscom survey, Research & Development (R&D) spending in the software industry in India increased from 2.5% of the total in 1997-98 to over 4% in 2000-01 and is expected to increase further.

3. **The size and complexity of projects contracted to Indian firms is also increasing.** NASSCOM's survey indicated that in 2000-01, almost 30 software companies in India exported more than US\$ 44 million each; 75 companies exported more than US\$ 11 million each. The top 25 exporters thus accounted for almost 60% share of the IT software and services export revenues. Prominent software exporters included TCS, Infosys, Wipro, Satyam and HCL Technologies. A Goldman Sachs report quoted in the *ET* said "Most of the large Indian companies have the diversity of broadline companies but the growth and technological agility of much smaller and more nimble e-business integrators".

4. Also according to a Nasscom survey, **Indian software have continued to get international recognition for quality;** out of the top 400 IT companies, more than 250 had acquired ISO 9000 certification. 28 companies had received Software Engineering Institute

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<sup>19</sup> The next best internally governed are multinationals operating in India, and these sectors snap up India's best and brightest, except for those who head abroad. The government is considering a corporate governance bill, on the argument that if western companies can adopt such standards, so can Indian companies.

<sup>20</sup> Merrill Lynch's 2001 Survey in January found that while only 14% of companies surveyed were outsourcing to India in 2000, 46% are considering it in 2001.

Capability Maturity Model (SEI CMM) Level 5 certification<sup>21</sup>, the highest in the industry. Thus while Philips has 60 centres all over the world, it is only its Bangalore centre and that of Hewlett-Packard that have obtained the SEI CMM Level 5 certification. Hughes Software Systems Limited (HSS) has obtained the SEI-CMM Level 4<sup>22</sup>. Ericsson has appointed Wipro Technologies as preferred supplier for R&D consultancy services. There is also a growing trend of top Indian IT companies launching branded products in banking and financial services software. Thus, Infosys launched Finacle and BankAway, Polaris - BankWare, Nucleus - Finness and Banconet, while iFlex launched FlexCube. TCS already has a wide range of branded software products, like Quartz, for the banking sector. Infosys Technologies is developing a global information technology network for Toshiba. Infosys is said to be joining forces with American Express, Tibco Software and WestBridge Capital Partners in a new firm Workadia offering intranet products and consultancy services.

**5. Indian companies have developed global ambitions/ global vision** - Premji plans to make Wipro one of the top ten IT companies in the world and recently issued 2.75 million American Depository Shares (ADRs) in the NYSE, the 6th Indian company to list in the US (after Infosys, Satyam, Rediff, ICICI etc.) – to raise the required funds. Tata Consultancy Services established its Asia Pacific regional headquarters in Singapore, which includes Australia and New Zealand. Others are acquiring subsidiaries in major markets.

### **MNCS ARE LOCATING R&D CENTRES IN INDIA**

Another remarkable trend is for global majors to locate R&D centres in India, in sharp contrast to China, which has just begun after 23 years of its open-door policy to attract similar kinds of investment (Taiwan has begun to shift higher-technology manufacturing to China). I am indebted for this insight to Associate Professor of Government, Devesh Kapur at Harvard University, perhaps the only faculty member I met there who was promoting interest in India. Major employment opportunities for India's postgraduates are opening up and this should provide an incentive for students to take up the study of science subjects as their majors again at the college going stage.

One person who has been consistently positive about India is Chairman and CEO of General Electric Jack F. Welch (*Economic Times*, September 17, 2000), although even he admitted that while India had exceeded his expectations in terms of intellectual capital, it had disappointed him as a market. General Electric's central research laboratory at Bangalore, inaugurated personally by Mr. Welch, is to become GE's largest laboratory *in the world*. GE is engaged in a range of high-tech and R&D activities in India. GE's locomotives are being designed in India<sup>23</sup>. GE Capital International Services (GECIS) in Gurgaon is processing the treasury operations of *all of GE's European businesses*. GE Medical Systems in Pune will soon be its only unit producing medical equipment for scanners. GE's Global Development Centres in India's exported software worth \$250 million in 2000 etc.

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<sup>21</sup> SEI CMM Level 5 framework developed by the Software Engineering Institute of Carnegie Mellon University – the top level that can be reached out of the 5 defined stages - Initial, Repeatable, Defined, Managed and Optimizing, of which Level 5 is the highest. The SEI is a federally funded research and development center sponsored by the U.S. Department of Defence. The model was defined in response to industry demand for quality criteria on continuous improvement through increased productivity, quality and reduced cycle time. A July 16 report by *The Hindu* reports that NIIT is the latest Indian company to acquire it, taking the tally to 28.

<sup>22</sup> HSS is a dedicated software development center for parent Hughes Network Systems, itself a unit of US\$6.4 billion Hughes Electronics Corporation, and has 2 state-of-the-art development centers in India in Gurgaon and Bangalore, besides a global presence.

<sup>23</sup> *Business Today*.



Another American CEO who endeared himself to Indians with his praise for India's potential is John Chambers, President and CEO of **Cisco**, who announced during his visit to New Delhi in January 2001 that Cisco would increase its financial commitment towards R&D in India to \$200 million (its Indian centre in Bangalore is already its largest R&D facility outside the US). Cisco would jointly promote 5 development centres with major Indian IT firms HCL, Infosys and Wipro and fund 34 regional networking academies in the States to promote IT education. Cisco Systems would also set up a dedicated venture capital fund in India.

John Chambers' urgings to the Indian corporate sector to do everything to exploit India's emerging advantage in IT hopefully did not fall on deaf ears. He made a passionate plea for India to "leap-frog" and build a network of the future, which combined voice, video and data, instead of building an old telecom network. Some inspiring quotes and a vision for India's IT sector which *must* be factored into the policy making process cited from *The Economic Times* and *Business Standard* during his visit is given at the end of this paper<sup>iii</sup>.

American, European and Japanese companies have chosen to set up software development centres in India. Intel's R&D centres in Delhi, Bangalore and Mumbai service its global operations. Oracle has 2 development centres, in Bangalore and Hyderabad; Sun Microsystems is doubling its Indian investments and its Indian facility is developing high-end servers for global markets. Texas Instruments reportedly applied for several patents in the US based on the work on integrated circuits and software at its Bangalore centre<sup>24</sup>. Phoenix Global Solutions is to set up a Rs 100-crore R&D and technical support centre in Bangalore (ET Nov 11 2000).

India is being considered as a hub for ABB's software activities worldwide<sup>25</sup>. IBM plans to invest US \$100 million in a software development laboratory in India, the fourth such facility IBM established in India (CNET [News.com](#), Singapore). America Online (AOL) is investing \$100 million in India. The US insurance company Conseco will move about 14% of its jobs to India. It was reported that Chase had made Bombay, not Hong Kong or Singapore, its centre for Asian technology investments. Lucent Technologies and Microsoft are in India. Microsoft has a development centre at Hyderabad and has forged an alliance with Infosys. Gates has been reported by at least one Indian newspaper as having referred to India as an "IT superpower". Motorola India Electronics plans to set up a state-of-the-art technology development centre near Bangalore, the largest development centre of Motorola's global software group (Business Standard).

Amongst Asian companies, Japanese giant Casio is setting up a software development centre in India to produce and do research on embedded software for the company's digital products. During a recent trip to Japan we became aware how far ahead the Japanese are going with this technology and strategic alliances with Japanese firms are therefore very important for Indian software development. Samsung is already present in a big way in the electronics hardware sector. Via Technologies, from Taiwan, plans to set up a research and development centre. Hong Kong and Shanghai Banking Corporation plans to expand and diversify its operations and set up R&D centres in India after showing consistently strong

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<sup>24</sup> The TLV320AD15, a mixed signal chip which enables 8 channels of a digital subscriber line (DSL) loop modem on a single integrated circuit (IC), thereby significantly reducing cost and power at the central telephone exchange, was designed entirely by the mixed signal products group of Texas Instruments, India, at its R&D centre in Bangalore. The group was also entirely responsible for the architecture and development of Monet, TLFD600 and Damini -- all Analog IC solutions for broadband and LCD panels (Source: *TI press release as reported in Business Line*).

<sup>25</sup> ET Oct 19 2000, Shubham Mukherjee.

growth (various sources). Sony is planning to set up R & D centres in India (and China) to design advanced large-scale integrated circuits for digital household appliances (*PTI*). Jardine Matheson has established Jardine India Software Technologies Pvt. Ltd. etc.

**Better late...:** The Government recognises the contribution the IT industry has made to India's self-image *and* its potential as an instrument for the modernisation of India's economy (see also the following section on telecommunications). After initially being a passive spectator, which ironically helped the sector to flourish in an otherwise *dirigiste* era, it designated it a priority sector, actively promoted IT usage in government and outside and created a conducive legislative environment for its development. According to Nasscom, in 1999-2000, Government spending in India constituted more than 34% of total IT spending. An IT taskforce (on which more later) has been set up headed by the Prime Minister of India. A legal basis for regulation and enforcement of online contracts and conducting business including e-governance online was laid with the passing of the Information Technology Act, on June 16<sup>th</sup>, 2000<sup>26</sup>. Customs duties for the IT sector have been either eliminated or drastically reduced, several IT related activities made tax exempt or given generous concessions, FDI norms eased, modalities for acquisition of software companies overseas liberalised and special incentives and infrastructure offered in several Software Technology Parks (STP) located all over the country. Liberalisation of rules governing venture capital fund raising in the latest Budget will further boost this source of funding. According to an *ET* report Tuesday Dec 12 2000 venture capital funds in India in 2000 registered the highest growth in all of Asia, and are expected to match Taiwan, second only to Japan.

## THE CHALLENGE FROM CHINA

While the above represent laudable achievements, it is important to be aware of the challenges which inevitably lie ahead in a sector as fiercely competitive and as dependent on constant innovation as the Information Technology sector. India simply cannot afford to rest on its current laurels; there are many internal constraints and the challenge of external competition which have to be dealt with.

First of all, we must be aware that China has set its eyes on surpassing India's achievements in IT, the only sector in which it perceives India as being ahead. According to multiple sources including conversations with Chinese officials, China has launched an all out drive to study the causes behind our success, positioned its own companies in Bangalore to study the phenomenon, and encouraged Indian IT companies to set up in China. It has pumped funds into its universities and technical institutes to churn out "software programmers at an increasing rate"<sup>27</sup>. The government has promoted software exports, which were US\$130m in 1999, with major tax breaks, access to cheap capital, and relaxed rules on sending employees abroad, with the goal of achieving US\$ 1 billion in software exports by 2004.

China already has a domestic market larger than India's and its software workers are less well paid. Its success in imparting universal primary education to its masses also ensures that it has a potentially larger pool of engineering and IT talent to choose from (China's literacy rate is over 90%, compared to India's 60%). The *ChinaOnline/EIU* report quotes a

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<sup>26</sup> The Act gives legal recognition to digital signatures, online conclusion of contracts and outlines the penalties and procedures for dealing with cyber crimes for which a Cyber Regulations Appellate Tribunal is to be established. The Government is also understood to have instructed other Ministries to synergise all laws, rules and regulations with that of the IT Act.

<sup>27</sup> "Beijing hopes to emulate India's software success", [http://www.chinaonline.com/issues/econ\\_news/NewsArchive/secure/2001/March/C01030551.asp](http://www.chinaonline.com/issues/econ_news/NewsArchive/secure/2001/March/C01030551.asp). *Business India Intelligence*. From EIU: © 2001.

finding by consultancy IDC, that in 1999 China's packaged-software market was twice the size of India's, at US\$759 million, and it is expected to grow at around 50% a year to reach US\$5bn by 2004. Chinese firms also “dominate the domestic accounting software market and are making aggressive moves into high-value business applications such as enterprise resource planning (ERP). Chinese government agencies and state-owned enterprises are investing in IT much more aggressively than their Indian counterparts, and many Chinese firms stand to get rich doing system integration work for complex government and enterprise networks. Many of these companies have technical skills comparable to those of Indian firms. Major US firms are beginning to think about sourcing work in China.” China is already strong in the Japanese market.

In 10 years, it is estimated that China will become the world's largest producer of Information Technology hardware. Every major computer company in the world has outsourced production of computer components to China, whose advantages include a skilled labour force and lower costs. Most of the investment has come from Taiwan, itself the top global sub-contractor for PCs and computer peripherals. Cultural factors act as an added incentive. The Chinese Government encourages Taiwanese investment as it helps bind the two economies together and helps China acquire the high-tech skills it is unable to develop on its own. Last year saw a major breakthrough for China, with President Jiang Zemin's son Jiang Mianheng forging a joint venture with the son of the Chairman of Formosa Plastics, one of Taiwan's biggest firms, to launch a US\$ 1 billion mammoth chip foundry manufacturing facility -- Shanghai Grace Semiconductor Manufacturing in the world class Pudong development zone. Significantly the firm is registered in the Cayman Islands, in order to circumvent Taiwan's investment restrictions for the mainland. The plant will make 8-inch silicon wafers, a desire China has been harbouring for years, and will help China eventually catch up with the latest Taiwanese technology.

China does have some disadvantages at present –its high rate of piracy and its restrictions on Internet companies to monitor content and Web users. But with a strong hardware base and commitment like that, it is a matter of time before China catches up with India in the software sector.

## RECOMMENDATIONS

The nature of the industry, with incredibly high obsolescence, is such that the horizons will keep expanding. But the Indian Government must address itself in a holistic manner to the issue of maintaining our lead in the IT sector. In the next chapter we shall see how the IT sector prompted a thorough overhaul of India's telecom policies. The same missionary zeal could be applied to reforms in other sectors, both for their relevance to IT and otherwise. Meanwhile the following have to be speeded up:

1. **Creating a World Class Hardware Base:** At the cost of sounding repetitive India should complete the unfinished agenda of reforms to boost growth and technological development in its *manufacturing sector*, as IT will depend on the ever-increasing sophistication achieved by domestic industry. *Embedded technologies being a major source of growth in the future, India must focus on building up a hardware base, with foreign investments from Taiwan, South Korea and others inclined to assist in this area.*
2. **Power sector reforms: crucial and immediate movement is required in power sector reforms to sustain the IT momentum.** As Jack Welch never tired of pointing out during last year's visit to India, digitisation comes at an enormous cost in power consumption. He is quoted to have said that “When you think about digitalising India,

the mass amount of power required will blow your mind. ...The little hand held devices or PCs would consume more electricity than refrigerators. ...To realise the dreams and the beautiful potential of the gorgeous people in this country and the opportunities presented by digitisation... you have got to have free people to go and do it. ...I love this country. I want it to win desperately. In order to win, it has to capitalise on tomorrow's technology and in order to do that, you have to have infrastructure to make it happen"<sup>28</sup>.

3. **Mass Use of IT:**

(a) **Convergence Bill: One of the surest means of spreading IT use in India would be to enable convergence technologies to become freely available.** Both private and public sector firms are creating national fibre-optic backbones over which they can carry multimedia services. Videocon is already making Internet TVs for the Indian market. However the Convergence Bill is still to be enacted.

(b) **E-governance:** The current drive on e-governance must be extended across all areas of economic activity, including agriculture, so that IT is brought to the masses.

4. **Education:** China has achieved another notable success, which India has not – in universal primary education. They have an ever-growing pool of talented and skilled workers to choose from for their manufacturing and future high-tech/ IT requirements. India should focus equally on expanding the base, i.e., invest in universal education. The information technology industry has also been lobbying to increase the number of graduate engineers. Plans have been announced to double India's annual output of IT graduates, and some incentives were given in this year's budget to the education sector. Some overseas Indians were talking about giving something back to their mother country in exchange for the excellent start in education it gave them, but one has not heard of further progress in this regard.

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<sup>28</sup> *Business Standard/ ET.*

## 5. REFORMS IN THE TELECOM SECTOR

In no other sector crucial to economic growth in India has there been as sweeping reforms as in the telecommunications sector. The speed with which reforms were implemented in 2000<sup>29</sup> is *not explained* by technological advances which the world over abolished the need for natural or State monopolies several years before the Indian reforms. *Rather, it was the determination to sustain India's emerging advantage in the Information Technology sector, with the Prime Minister of India himself giving the call to make India an Information Technology superpower within ten years*<sup>30</sup>.

This was clearly impossible given the condition of India's telecommunications (hereafter referred to as 'telecom') infrastructure, where we fell far short of not only international performance parameters but also regional ones. Less than 3 out of every 100 people in India were connected by phones. In our own neighbourhood, simple comparisons yielded the following tale:

Table 2:<sup>31</sup>

	<b>India</b>	<b>China (June 2001)</b>
Fixed-line subscribers	30 million*	160 million**
Mobile phone subscribers	4.1 million (June 2001 figures)***	110 million <sup>32</sup>
Internet subscribers	1.8 million	22 million
International bandwidth*	1.2 giga bits per second	860 mega bits per second

### CHINA'S STRATEGY – DOMINATION BY STATE SECTOR

China's overall policy is to develop its telecom infrastructure by itself with minimal foreign participation<sup>33</sup>. The government has a strong protectionist policy for local manufacturers. Operators are urged to buy domestic equipment. China allows foreign investment in the production of telecom equipment where it perceives benefits in terms of high technology transfers. But China formally prohibits foreign investment in the telecommunications services sector and has recently prohibited foreign investment of any kind in mobile phone production. Thus, the PRC Ministry of Information Industry (MII) and the State Development and Planning Commission (SDPC)'s joint notice dated 27 March 2001 "reiterated that, prior to our country's entry into the World Trade Organisation, no

<sup>29</sup> Albeit after a long hiatus of half-baked efforts starting from 1997.

<sup>30</sup> Source: Excerpts from the speeches of Prime Minister of India, 1998. Please also see my Chapter on the Information Technology Sector.

<sup>31</sup> Sources for China: Ministry of Information Industry (MI) of China (June 22, 2001); Xinhua News Agency, June 20, 2001. Sources for India: 1. Department of Telecommunications' homepage (<http://www.investindiatelecom.com/basic.htm>). 2. \*Article by Vinnie Mehta Director of Manufacturers' Association in Information Technology (MAIT), in Times of India May 2, 2001 "Enter the Dragon, exit India from Infotech?" DOT figures estimate these at 27 million at the end of 2000. 3. \*\*\* *Economic Times*, July 20, 2001. Gartner Group, a research and consultancy firm, predicted that while India would have less than 15 million Internet users by 2004, China would have 51 million. As a consolation, Gartner estimated that as the market opens up, India could replicate the kind of growth pattern that China has enjoyed (Gartner Group is quoted on several webpages including [http://www.security-informer.com/english/crd\\_gartner\\_505582.html](http://www.security-informer.com/english/crd_gartner_505582.html) under the title "Mobile phone use surges in Asia", David Legard, IDG News Service, Singapore Bureau, April 10, 2001).

<sup>32</sup> The data for fixed-line subscribers in China needs to be verified, as though usually whole apartment buildings operate on one exchange with presumably a few lines, all the connections/extensions may be included in the tally to come up with this figure. The mobile phone subscribers figures may be more accurate.

<sup>33</sup> See my Essay published in "China' Economic Reforms and Lessons for India, 1998".

foreign organisation or individual and no organisation or individual from Hong Kong or Macao Special Administrative Regions are allowed to have any direct investment of whatever form in the construction, operation and management of telecommunication networks in mainland China"<sup>34</sup>. China had given assurances to permit, in a phased manner, limited foreign equity in telecom services, including Internet services -- *after* it has joined the WTO. China's recently published Telecom regulations require that even after WTO accession, China (which denotes the State) must hold at least 51% of the shares in basic services<sup>35</sup>.

## PROTECTION OF TELECOM SERVICES SECTOR

In an excellent analysis of the pitfalls of investing in the telecom *services* sector in China, Danny Magida, business development manager, Jones Day, Shanghai<sup>36</sup>, described the heavy financial losses borne by companies like Sprint, France Telecom and First Pacific of Hong Kong following the 1998 closure by MII of joint ventures between China Unicom and foreign partners, forged 4 years earlier in spite of the prohibition on FIE's operating telecom services. To launch operations they had simply "borrowed the licence of China Unicom to provide telecom services and share in network profits".<sup>37</sup>

An apparent exception was a US\$25 million venture between AT&T (with a 25% stake) with Shanghai Telecom, a subsidiary of China Telecom and Shanghai Information Investments. This deal apparently came to fruition only after 8 years of negotiations and was described by various sources as the first permitting a foreign invested enterprise to provide telecommunications operation services in the People's Republic of China.

Foreign telecom firms have persisted in China despite a rapidly changing policy environment aimed at restricting their operations, in the prospects of getting a toehold in China's booming markets. It serves to remind us in India that no matter how many obstacles China places in the path of foreign investors, they still queue up to get a toehold in the market because it holds such strong potential.

As a result of all the measures taken by the Chinese Government, China's corporatised behemoths, China Telecom, China Mobile, China Unicom etc. monopolise telecom services despite some complaints of high tariffs and less than optimal customer orientation. According to the *China Daily*<sup>38</sup>, China Telecom owns the world's second largest fixed-line telecom network and had 145 million fixed-line telephone subscribers and three-quarters of the country's 22.5 million Internet users by 2001. It could soon become the world's largest fixed-line telecom operator. China Telecom has also announced it would finish the construction of a nationwide broadband access network in 3-5 years<sup>39</sup>, completely

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<sup>34</sup> Source: Hu Zaichi, Associate, Clifford Chance (Hong Kong) and member of Clifford Chance's PRC Telecoms Group, as quoted on webpage of the offices of German Industry and Commerce (GIC) in Beijing, Shanghai, Guangzhou and Hong Kong; <http://www.ahk-china.org/ban-reiterated-foreign-invest-telecom.htm>

<sup>35</sup> Article 10, Telecommunications Regulation of the People's Republic of China: Order of the State Council of the People's Republic of China, promulgated on September 25, 2000.

<sup>36</sup> "Only fools rush in", April 2001 "Telecommunications Online", <http://www.telecoms-mag.com/issues/200104/tci/onlyFools.html>.

<sup>37</sup> Webpage [http://www.pbs.org/newshour/bb/asia/july-dec97/chibiz\\_10-31.html](http://www.pbs.org/newshour/bb/asia/july-dec97/chibiz_10-31.html) contains a fascinating interview with the then President of Sprint International Andres Bande, which forged a joint venture to offer telephone service in Shanghai in 1997. Some of us witnessed the frustration of representatives of foreign phone companies at the prospects of a constantly changing regulatory environment, price controls in the telecom sector etc. while in Beijing.

<sup>38</sup> "Phone firm looks to be world's top", March 8, 2001".

<sup>39</sup> *China Daily* – "Broadband network planned", February 28, 2001.

replacing copper cable with optical fibre. China's largest mobile carrier China Mobile has a subscriber base of 56.6 million users. China United Telecommunications Corporation, or China Unicom, China's second largest mobile telecommunications operator's base is also expanding at double-digit rates.

## **PROTECTION FOR DOMESTIC EQUIPMENT MANUFACTURERS**

Danny Magida (see above) also points out that China banned any new foreign investment in mobile phone production to protect domestic manufacturers, on the same day that AT&T announced its landmark joint venture and just after Motorola concluded a US\$1.9 billion deal to produce chips for mobile phones. Motorola is China's largest manufacturer of cellular phones with 36% of the domestic mobile phone market share. According to official figures, domestic brands accounted for only 10% of domestic sales and competed with brands like Nokia, Ericsson and Motorola.

The *South China Morning Post* also reported the ban and the government's intention to support 10 top domestic mobile phone manufacturers<sup>40</sup>. Thus existing foreign joint ventures would have to export at least 60% of output and by the end of 2001 have a local content of 50%, on which access to the domestic market would depend. As Danny Magida commented, "The discretionary nature of foreign investment approvals in China allows the government to effectively enforce such announcements for new investments even in cases where a project is legally permitted".

China thus protects its own hardware equipment manufacturers and also actively promotes R & D (funding is through Treasury bond issues, network connection fees, and 5% of the connection fee from fixed-line phone users, an idea we should explore in India). Big names in sophisticated, high technology products are Huawei, with revenues exceeding US\$1 billion, whose R & D facilities are located in a hi-tech industrial park in the Shenzhen Special Economic Zone, and which has recently set up a software centre in Bangalore to study India's high-tech success in Information Technology; Zhongxing, which might soon overtake Huawei as the most profitable company in China; Great Dragon Information Technology; Jinpeng, Guangzhou; Xi'an Datang Telecom, manufacturer of S-CDMA (synchronous CDMA) wireless local loop systems, GSM 900 and 1800 cellular systems and the Shenzhen company Sun & Sea, constructing optical fibre networks. The Chinese government wants 82% of optical fibres installed between now and 2000 to be locally produced.

## **LATIN AMERICAN STRATEGIES<sup>iv</sup>**

In Latin America reform of the Telecom sector was achieved principally through privatisation, a strategy radically different from the Chinese, and also from the Indian. Against the background of the so-called Lost Decade of the 1980s (multiple macroeconomic and balance of payments crises, debt defaults etc.), the motives for reforms in the Latin American countries most affected, such as Argentina, were to rapidly earn foreign exchange and obtain budget relief. As Prof. Ravi Ramamurti explains in his *Multilevel Model of Privatization in Emerging Economies*<sup>41</sup>, the primary need of countries that are experiencing macroeconomic crises is to maximise revenues from privatisation. Such countries are likely

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<sup>40</sup> "China bans mobile makers" by Mark O'Neill, *SCMP*, November 4, 2000.

<sup>41</sup> The entire analysis on comparison with Latin American telecom sector privatisation has been made possible by relying on Prof. Ramamurti's work in the above cited and in his *Privatising Monopolies*". Prof. Ramamurti teaches at North-Eastern University, Boston, and was kind enough to share his views with me.

to privatise without pursuing competition-enhancing policies, such as breaking up monolithic State owned companies. This is not a static process and may be followed by further changes; thus in the Telecom sector, Prof. Ramamurti showed how Chile and Mexico transited from a State monopoly to a private monopoly and eventually to a competitive structure. Conversely countries not in a macroeconomic crisis are likely to pursue competition-enhancing policies without privatising State-owned firms. This differentiation is broadly true both within Latin America, and when reforms in Latin America and the Indian privatisation/ reforms programmes in the telecom sector are compared<sup>42</sup>; the latter will become clear later.

Argentina was in the direst straits after a decade of hyperinflation and related crises, hence it needed to go the extra mile to make the privatisations attractive (I call it “Shotgun privatisation”). What Prof. Ramamurti called “the signaling objective” - as opposed to competition enhancement policies and consumer interest protection - was thus most important in Argentina, an analysis confirmed by the essays contained in *Privatization in Latin America*. Venezuela benefited from the growing credibility of other countries and did not have to sacrifice the other two goals to the same extent they did. But even Venezuela “was more intent on satisfying potential investors and placating employees than maximising the interests of consumers” (Prof. Ramamurti).

However to ensure speedy privatisation the firms had to be made attractive for private investors, particularly foreign investors. As Prof. Ramamurti puts it “The asset had to be a plum rather than a lemon”. Thus telephone companies in the four countries he examined were amongst the first big firms to be sold as their growth potential was excellent, an important difference with airlines’ privatisation, which as in India attracted very few or no buyers at all. The following is derived from a very useful table in his book “*Privatising Monopolies*”<sup>43</sup>, which summarises the different strategies of Jamaica, Mexico, Argentina and Venezuela.

Prior to privatisation local and national/international services and even cellular services in some cases were merged in many of the State monopolies. Then the privatised company was frequently granted exclusive rights for several years (from 6 in Mexico to 25 in Venezuela) to operate these multiple services with unrestricted entry rights into others. Finally, prices on certain services, generally the long distance ones, were raised and in some cases taxes were scrapped or reduced. The government also assumed part of the company’s debt through various strategies. The workforce was reduced through attrition in Argentina, and in Mexico labour contracts were restructured. Employees were offered shares in the company, sometimes at a discount or with concessional loans. In Argentina and Venezuela they were also granted seats on the Board. Regulatory reforms were implemented half-heartedly. Problems were anticipated on this account and there were fears of regulatory capture.

Thereafter, to protect investors from future inflation risks and price regulation, all countries except Jamaica “adopted the price cap method of rate regulation pioneered in the UK, where the privatised firm was permitted to raise prices automatically for regulated services to offset inflation, less an adjustment for productivity improvement. However in Latin America pricing rules did not assume productivity improvements after privatisation.

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<sup>42</sup> *Privatization in Latin America*, Edited by Manuel Sanchez and Rossana Corona, Instituto Tecnológico Autónomo De México (ITAM), Mexico, published by the Inter-American Development Bank.

<sup>43</sup> The Johns Hopkins University Press, 1996.



Since the room for productivity improvements was greater than in the UK, these provisions therefore ensured generous returns”.

Another imperative faced by Latin American countries was to maximise foreign exchange proceeds. Foreign participation was required to get foreign exchange, technology and capital. So in several Latin American countries (barring Brazil and Mexico), foreigners were able to take management control as equity stakes were structured to enable strategic control by minority equity foreign investors. Though the strategic investors’ group had to include both local and foreign firms “to avoid charges of sellout to foreigners” (a handy accusation which is frequently unleashed at the drop of a hat in India to sabotage any reform), in 3 out of 4 privatisations, foreign firms were allowed to control the firm. Fortunately such a necessity is not present in the current Indian scenario, hence the reforms have taken a different path.

Telecom sector privatisations raised the maximum amount of money. Airline privatisations in contrast raised much smaller amounts<sup>44</sup>. In Venezuela proceeds were US\$ 1.89 billion; Argentina: \$3.3 billion; Mexico: \$6 billion – with Telmex raising 4 times as much money as 732 firms privatised before it. The privatisations also succeeded in boosting the governments’ credibility with foreign and domestic investors. In the countries Prof. Ramamurti studied foreign investment surged and flight capital began to return after the privatisations. *Despite the monopoly conditions, there was a rapid expansion in networks including rural connections, resulting mainly from massive increases in investment and an unprecedented growth in labour productivity.*

## **INDIA: INITIAL REFORMS**

With technological change (Internet, e-business, wireless, cellular developments) the justification for State monopolies in the telecom sector had vanished in India as in other countries. Some half-hearted attempts at reform were made in 1994, with basic services opened up to limited competition and the establishment in 1997 of a statutory body to ensure fair competition and protection of consumer interests - the Telecom Regulatory Authority of India (TRAI). However the bid amounts were so high that it bankrupted potential operators before these services were launched. As a result only 2 of the 6 circles awarded saw any roll out of services.

In the 1999 New Telecom Policy, as a precursor to corporatisation, the government separated the policy and licensing functions of the Department of Telecommunications from its service provision functions and created a new Department of Telecom Services. Later, the Department of Telecom Services (DTS) was bifurcated into two Departments - the Department of Telecom Services and the Department of Telecom Operations<sup>45</sup>. The regulatory structure was further restructured in 2000 with the creation of a separate appellate tribunal - the Telecom Dispute Settlement and Appellate Tribunal (TDSAT) and the whittling down of TRAI’s regulatory powers (there had been a constant tussle between TRAI and government departments over its decisions), with the Supreme Court being the final court of appeal.

The new telecom policy<sup>46</sup> defined national objectives and the parameters for operations of new private operators for each category of service – national long distance,

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<sup>44</sup> All this information is quoted from Prof. R. Ramamurti’s work.

<sup>45</sup> DOT press release June 25, 2000.

<sup>46</sup> DOT Webpage.

international long distance, cellular, basic, Internet services etc. It allowed multiple fixed service operators and opened national long distance (NLD) services to private operators from January 1, 2000. The corporatised version of DTS/MTNL would be allowed to enter as third cellular operator in each service area, while existing license holders of basic and cellular services were allowed to switch over to revenue sharing arrangements. Mobile service providers were permitted to carry their own long distance traffic within their service area within the terms of their license. Fixed Service Providers (FSP) were permitted to establish 'last mile' linkages to provide all types of fixed services and carry long distance traffic within their circles, with the number of players and precise terms of entry (a one time entry fee and a revenue share) to be recommended by TRAI. All access providers were required to provide interconnection to NLD operators with the terms and conditions specifying number of operators and licence conditions to be worked out in consultation with TRAI by August 15, 1999. Resources for meeting the Universal Service obligation USO would be raised through a 'universal access levy' as a percentage of the revenue earned by all the operators under various licences.

## **ROLE OF IT IN INDIA'S TELECOM REVOLUTION**

Despite these moves, there was still no rush by private operators to snap up licences. Meanwhile the Information Technology star had risen over the Indian horizon (previous section on IT). For the first time Indians got a taste of what it was like to be among the world's best in a high-tech field. The obvious connection with America's rising prosperity and the improved profile of Indian knowledge workers, sent an adrenaline rush into governed and government alike. *Actually the only area China in which feels threatened by India and is determined to beat it is Information Technology!*

As earlier mentioned, the Nasscom-McKinsey Report 2000 had painted an achievable future of US\$ 50 billion of software and services exports by <sup>v</sup>2008. Important issues which needed to be addressed before this became a reality were a huge push to quality universal school education, development of more engineering institutes, liberalisation of global acquisitions by Indian software companies, new and sophisticated Cyber laws, *but most important – the creation of a world class communications infrastructure*. It soon became obvious however that India's primitive communications infrastructure could not support the IT industry's exponential growth even in the short -term.

Once this realisation dawned, obstruction to reform in the telecom sector was swept away as excellence in IT became a national goal. NASSCOM's vision and lobbying in its pursuit spurred the fastest pace of reforms ever seen in the country. Somehow the political will was mustered to initiate sweeping reforms.

## **BIG BANG REFORMS**

It was at the Prime Minister's initiative that several breakthroughs were made in the weeks following the initial blockbuster announcements in mid-July 2000<sup>47</sup>. The Prime Minister of India declared his government's resolve to make India an Information Technology superpower and one of the largest generators and exporters of software in the world within 10 years<sup>48</sup>. Impatient with the slow pace of reforms, "held up mainly by the

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<sup>47</sup> Various sources, media reports, exclusive report by *Business India* July 24-August 6, 2000. Earlier, a high powered National Task Force on IT and Software Development had been set up by the Prime Minister's Office on May 22, 1998, under the Chairmanship of the Deputy Chairman of Planning Commission.

<sup>48</sup> IT Tasforce webpage.

tendency of various ministries to guard their turf” the PMO spearheaded “reforms in most sectors through a Group of Ministers” (according to Business India Intelligence, a newsletter on business and investment published by the EIU). The reforms announced in mid-July 2000 are described below in greater detail:

1. The government opened up national long distance services (NLDS) to unlimited private competition with an initial duration of 20 years, extendable by 10 years. The Prime Minister's decision on long distance services “preempted the Telecom Commission, which sought to limit the number of new players and adopt a long-drawn and contentious bidding procedure to select licensees<sup>49</sup>”, which would have duplicated the mistakes of 1994. The ceiling for foreign equity was fixed at 49%. Licenses for NLDS would be issued to Indian registered companies only, with a minimum paid-up capital of Rs. 2.5 billion.<sup>50</sup>
2. It was announced that the State-owned Videsh Sanchar Nigam Ltd (VSNL)’s monopoly on international telephone services would end by April 2002, 2 years ahead of the WTO-committed schedule. The government simultaneously approved a compensation package, which included granting a licence to run NLDS, the entry fee being returned to VSNL net of taxes and without insisting on performance bank guarantee; exemption from payment of licence fee while operating NLDS for 5 years starting from April 1, 2001 and permission to provide Internet access all over the country.
3. Another landmark announcement was the permission to private companies providing Internet Services to connect directly to international networks without going through VSNL, whose limited bandwidth *and* monopoly rights on access to international bandwidth providers, had become a serious obstacle in the way of fast growth of the software export and domestic Internet industry. Though VSNL had made its contribution to the improvement in high-speed data communication links<sup>51</sup>, much more was required if India aimed to emerge as *the* world’s major destination for software outsourcing. The IT industry had long been urging that private ISPs be permitted to access international gateways. After the passage of the Information Technology Bill, the late Dewang Mehta made Nasscom’s main objective to seek “adequate and reliable bandwidth”. He was quoted by the *Economic Times* to have said "The objective of having the Cyberlaws, is to make India an I.T. superpower. This shall not be achieved if the issues of telecom backbone and bandwidth are not addressed now". Nasscom warned that India's IT industry would lose a huge chunk of potential software business and target export markets because of inadequate uplinking facilities. Internet service providers (ISPs) were thus allowed to set up landing stations connecting directly to submarine OFCs, increasing international bandwidth connectivity to India. VSNL would accordingly lose its

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<sup>49</sup> *EIU India Business Intelligence*.

<sup>50</sup> Source: DOT webpage. The License Fee would be - revenue sharing of 10% plus the Universal Service Obligation (USO) Fund contribution, with a total cap of 15%; an entry fee of Rs.1.0 billion and 4 bank guarantees of Rs.1.0 billion each to be released on fulfillment of the roll out. The NLD operator (NLDO) was permitted to carry inter-circle long distance voice and data traffic. Intra circle traffic would however be subject to negotiation with the Fixed Service Provider. Critics have urged that this restriction, i.e., against carrying intra-circle traffic should be removed, on the grounds that it could encourage investment by NLDOs in providing last mile infrastructure, which are far more expensive than the long distance backbone. The idea is predictably being opposed by fixed service providers, which so far have exclusive rights to carry these calls. Thus firms like Hughes Tele.com, which have invested over Rs. 700 crores in laying a basic phone network in Maharashtra are apprehensive that opening up intra-circle long distance would hurt their revenues.

<sup>51</sup> On 31 March 2001, there were more than 1400 leased lines from Indian software companies providing 64 Kbps and higher speed data communication links for offshore software development; in 1992, there were only 10 such links. Source: *Nasscom*.

exclusive rights to Fibre-optic Link Around the Globe (FLAG)'s bandwidth (FLAG and potential users had also been lobbying for the right to enter into mutual business arrangements). The effect of this decision on VSNL's exclusive rights with the proposed \$600 million South Africa Far East (SAFE) submarine OFC project from Cape Town to Penang in Malaysia<sup>52</sup> is not known.

Whether the government had taken this decision or not, VSNL's refusal to part with monopoly landing rights had already prompted other corporations to build their own access infrastructure, bypassing VSNL's monopoly. *The Economic Times* reported that the Bharti Enterprises - SingTel joint venture Bharti Aquanet would lay a \$650 million 8.4-terabit-per-second bandwidth submarine cable to connect Mumbai and Chennai with Singapore. Dishnet, a Chennai-based national Internet Service Provider, announced its own plans to set up a submarine cable between Chennai and Singapore by 2002. The Tatas, Hinduja, BPL, and Reliance, who are laying OFC networks, plan to procure bandwidth from international companies as the next step.

4. On September 5, 2000 Communications Minister Mr. Ram Vilas Paswan announced that basic telecom services would be opened to unlimited competition. Licences would be given on the basis of a one-time entry fee, bank guarantees, and revenue share.
5. Free right of way to lay OFC networks along highways and roads was permitted. Earlier only public sector companies like PowerGrid, Gas Authority of India and state electricity boards had such rights of way. Now more Indian firms have nationwide plans to lay OFC.
6. The PM also declared a Universal Service Obligation would be charged to all operators to subsidise rural telephones and less profitable markets, to address concerns that private operators would focus only on lucrative segments of the market.
7. Licences for a fourth cellular operator in major cities and other telecom circles were offered in June 2001.

## **CORPORATISATION AND PRIVATISATION**

### *A. Bharat Sanchar Nigam Ltd. (BSNL) Corporatisation and Mahanagar Telephone Nigam Ltd. (MTNL) Disinvestment*

On October 1, 2000, the Department of Telecom Operations and Department of Telecom Services were converted into a public sector company - Bharat Sanchar Nigam Ltd. (BSNL) with an asset base of over Rs 63,000 crore (1 crore is 10 million), a paid up capital of Rs. 5000 crore, a huge workforce<sup>53</sup> and the obligation to serve 23.8 million telephone lines (except for Mumbai and Delhi which are under Mahanagar Telephone Nigam Ltd. or MTNL). It also owned an estimated 230,000 km of OFC network (estimates vary), 180,000 km of microwave system and 457 satellite stations. BSNL obtained rights to basic, cellular, domestic and international telephony and Internet services. The IT Minister Mr. Pramod Mahajan was quoted as stating that the Centre would compensate BSNL for meeting its social obligations in view of its obligations to service a loss-making rural sector (an estimated colossal 3 million lines laid in 50 years of Independence!). Its downside however was its huge workforce, accustomed to a bureaucratic approach to work and permanent job

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<sup>52</sup> A joint venture of 42 companies including VSNL from 35 countries; *Financial Express*, February 2001.

<sup>53</sup> "It's final: PSU garb for telecom services K.A. Badrinath : *Hindustan Times*, September 27

security. The workforce ultimately had to be placated with a Rs. 1000 per month pay hike to agree to the corporatisation which added an estimated additional salary liability of Rs 720 crore a year. Still, the step was on the whole welcomed by the media. The *Hindustan Times* called the “imminent birth of the gargantuan PSU a major step towards the government withdrawing from telecom services”.

According to reports, the Department of Disinvestment is planning to sell the government’s majority stake in (MTNL), which runs the lucrative Mumbai and Delhi phone systems, bringing down the government’s current stake of 56.25% in the company to 26%. The GDR portion of MTNL equity is just 11% compared to VSNL’s 30.4%, so MTNL may evoke greater foreign interest.

#### *B. Videsh Sanchar Nigam Ltd. (VSNL) Disinvestment*

GDRs in State-owned VSNL, India’s international telecommunications monopoly, had been offered twice before on foreign exchanges (February 1999 and March 1997), bringing foreign financial institutional holdings up to 30% of the total equity and substantially reducing the government’s ownership of around 65%. At the time the outlook for the company was fairly positive, with VSNL being considered one of India’s better companies, even though speculation on the abolition of VSNL’s international telephone monopoly had begun to cause concern. The government had earlier said VSNL would not be allowed to bid for cellular services as the national telecom policy did not allow two operators promoted by a single group to offer services in a single circle (the government controlled BSNL and MTNL were already offering mobile services). Diversification into cellular services would have offset the decline in VSNL’s attractiveness as its monopoly in international telephony ends in 2002. According to a report in the *Indian Express* dated July 19, 2001, the Bombay High Court has allowed VSNL to participate in the fourth cellular licence bidding process.

In February 2001 the government announced it would privatise VSNL with management control handed over to the strategic partner. Bids were invited from companies, with a minimum net worth of Rs 2,500 crores, for a 25% stake, out of the 52.97% equity held by the government. 1.97% was to be sold to VSNL employees, leaving the government with 26%<sup>54</sup>. On the issue of retrenchment of employees, the company would have the option of “right-sizing” manpower after one year with adequate compensation and voluntary retirement schemes.

VSNL has substantial real estate assets and telecom infrastructure spread all over the country, has been given the right to acquire any new license, is still India’s largest Internet Service Provider, and is not only profitable but has over Rs 4000 crore in cash reserves. It is also not encumbered with a huge workforce like other state-run organisations. Moreover, following Indian media reports that VSNL had finally taken a decision on its cash reserves by giving a 500% dividend (the government would be the largest beneficiary of the payout. The DoT had reportedly favoured withdrawal of the cash reserves as otherwise the strategic partner would gain control over the funds with only a 25% stake), VSNL’s stock rose as analysts felt that a more realistic valuation for the company’s shares could now be expected. Indeed one of the major potential buyers had voiced doubts over the cost effectiveness of acquiring VSNL at the inflated prices being quoted, over building his own network.

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<sup>54</sup> Source: Rajya Sabha Questions and Answers.

Expressions of interest from 6 Indian companies were initially obtained - Tatas, Reliance, Bharti- Singapore Telecom (SingTel), BPL-Sterling reportedly in alliance with US telecom companies Century and Tycom and Videocon-Toshiba<sup>55</sup>. Though BPL and Sterling generally compete against each other in telephone circles, they formed an alliance for the VSNL disinvestment. The Birla group subsequently withdrew from the process.

Major foreign telecom players were absent because of several factors: the low equity stake available for foreign investors; the evolutionary nature of the policy environment including the possibility that the government would eventually legalise Internet telephony, impending loss of monopoly status, a general trend of declining tariffs in the Indian market due to increasingly stiff competition, labour market rigidities and last but not least - the controversies surrounding the Balco privatisation in which Bharat Aluminium Company was sold to the Sterlite group. In contrast to Latin America, India seemed to have achieved the opposite of the “signaling” effect during that privatisation, which Prof. Ramamurti had highlighted in the Latin American case.

What foreign analysts and investors missed was that despite the blatant attempts to subvert the process for transparently partisan ends, at every step India’s institutions upheld the legality of the Privatisation – Parliament, the Supreme Court, even the Executive, which stood firm despite all attempts at intimidation. Foreigners are perhaps used to being kowtowed to in developing countries, an attitude absent in India and under-appreciated abroad. Paradoxically, it left the field open for domination of these important, even strategic sectors by Indian companies, which in the long term is not bad at all for the country. Quite the opposite<sup>56</sup>.

The government took extra care to ensure that unnecessary controversies did not dog this process. In fact, Credit Suisse First Boston (CSFB), which the Securities & Exchanges Board of India (SEBI) had indicted, among others, for its role in a stock scam - was removed as the global advisor for the privatisation of VSNL. Recently its investment banking CEO has been forced to resign because of questionable practices in other areas of business and the world as well.

Due diligence exercise at VSNL is supposed to start soon. The department of divestment has reportedly assured that the VSNL divestment is on a fast track and that the process will be completed by August.

### Critiques of the decision

Some media reports criticised the strategy of liberalisation. Ajay Jindal & Kiran Kallur, in the *Economic Times* of June 6, 2001 “Telecom scandal in the making” - alleged that the government placed its own companies - BSNL, MTNL and VSNL - at a disadvantage and that the correct strategy would have been to privatise them prior to liberalisation in order to help them adjust to the fiercely competitive scenario. MTNL, the basic service provider in the 2 most lucrative circles in the country (Delhi and Mumbai), was struggling to expand into other segments. VSNL’s ISP and bandwidth businesses had been

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<sup>55</sup> “Sterling, TyCom and CenturyTel jointly hold 74% stake in the consortium while the remaining 26% is with BPL. While TyCom is one of the largest providers of broadband capacity in the world, CenturyTel is one of the largest basic and cellular service providers in the US. TyCom and Sterling are partners in a submarine project linking India and the US. CenturyTel is an investor in Sterling’s existing telecom services”. *Economic Times*, April 11, 2001.

<sup>56</sup> I must here take the opportunity to deny any bias against foreign companies – they are most welcome especially when ours fail to do the job properly. But I do admit to a bias *in favour of* Indian companies.

opened to competition to be followed by its international telephone monopoly. Bids of all 3 companies in the recent round of basic services auctions were reportedly shot down because of universally applied antimonopoly rules which stipulated that no entity could be the majority shareholder in rival bids (the government is the majority shareholder in each). The ET article went on to state “So, as the situation now stands, MTNL cannot get beyond Delhi and Mumbai; BSNL cannot enter these; and VSNL cannot enter the basic service business. The same ‘government-holds-majority’ argument could even work against these companies in NLD and international telephony as well. So, major expansion routes are closed for these companies... For any company the key issues always are expand or protect current markets, and explore new markets. These companies appear to be in a bind as far as growth options go.” The obvious and ideal solution would be to merge these companies, which the authors also suggest.

Critics seem to have forgotten the strong departmental opposition to any kind of reform, let alone privatisation. Reforms had been crawling since the initial half-hearted steps in 1994. The authors’ contention that China privatised before letting in competition would amuse the Chinese. Chinese telecom service companies - China Telecom and Unicom are State-owned and as we have seen China has one of the most restrictive policies in the telecom sector of the examples studied, with no foreign participation.

Privatisation and transfer of management control in MTNL and VSNL to strategic partners was actually strongly recommended by the Disinvestment Department to the Cabinet Committee on Disinvestment<sup>57</sup>. The Disinvestment Department had also warned against the sharp drop in the share value of VSNL and sought the Prime Minister's intervention for an early decision on downsizing the government’s stake in the corporation. But several financial newspapers and the *Press Trust of India* reported that meetings of the Cabinet Committee on Disinvestment scheduled for November 10 and also November 18 were postponed due to resistance to reform in the communication ministry.

Thereafter, the proposed reforms met with a fierce reaction. 2 major telecom employees unions struck work in September 2000 causing a major nationwide disruption of services during the first strike that was called off on September 8. The unions opposed the corporatisation and simultaneous opening up of the telecom sector to multiple competition from the private sector. The Officers Association reportedly resorted to a ‘work-to- rule’ agitation - a euphemism for sabotaging operations. An editorial in the *Business Standard* dated September 26, 2000, “Justifying Privatisation” stated that strikes by any section of telecommunications employees could well be the proverbial last straw on the camel's back. It would convince the government and subscribers that “the decision to privatise basic telephone services, open up the long distance market and advance the end of VSNL's monopoly on international dialing by two years were the right decisions to take”.

Following protests and strikes, telecom unions were finally placated when commitments on pay hikes, post-retirement benefits and job security were provided by the government. All emoluments received as central government employees were protected. The lower categories (support staff) were also offered Rs 1000 per month extra for allowing the corporatisation to go ahead. The other demands related to BSNL’s financial viability and pensions, which were to be paid by the government (from the Consolidated Fund of India). They won substantial concessions, although it may prove to be a pyrrhic victory if the companies themselves turn sick as predicted by several commentators. Given their lack of

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<sup>57</sup> “Ministry moots privatisation of MTNL, VSNL”; *Economic Times*, November 11, 2000. Also TOI Nov 18 2000, CD defers discussion on MTNL, VSNL sell-off and many other media reports.

customer orientation (although MTNL and VSNL have made some progress in this regard), dated infrastructure, reliance on circuit switching, unionised workforce etc. - only a complete turnaround in customer services attitudes and huge investments in state of the art infrastructure could make a difference. Merging is also a solution.

### *Telecom Infrastructure*

While the telecommunications infrastructure scenario was bleak before the reforms, after liberalisation the private sector has stepped in to invest in telecommunications infrastructure. Several state firms - GAIL, PGI, and Railtel are also building OFC networks across the country. According to DOT sources, the long distance transmission network has 1,80,000 route kilometres of terrestrial microwave & co-axial cable. India now has more than 260,000 route kilometres of OFC. Of this BSNL has - 232, 000 kms, with plans to lay 126,000 km of optic fibre<sup>58</sup>. Railtel has plans to lay 33,000 km along its 62,800 km rail track, Gas Authority of India Limited (GAIL) will lay 9,500 km of OFC along its pipeline network while Power Grid Corporation of India will lay 15,000 km of OFC linking 35 cities<sup>59</sup>. Amongst private sector firms, Reliance has plans for laying 60,000 kms of OFC; Bharti Telecom - 3000 kms; Shyam Telecom - 500 kms.

### Reliance

Only 2 private companies in India currently have a national strategy - Bharti and Reliance<sup>60</sup>. Reliance plans to create a state of the art 1-terabit bandwidth 60,000 km optic fibre national network in 16 States with an investment of Rs. 30,000 crores. Reliance Chairman Dhirubhai Ambani is reported to have told his company at its annual general meeting in June 2000 (ET report) that this was a one-time opportunity for the Indian economy to leapfrog from its inadequate infrastructure to a super, world-class digital infrastructure (John Chambers must have been listening!). Reliance has a basic telecom licence for Gujarat, one of India's fastest growing States, licences for mobile services in 13 states, and recently won the right to operate basic services in 16 circles (July 22). It is permitted to offer mobility on basic telephones using wireless in local loop technology. It plans to offer national long distance services, and after VSNL's monopoly is disbanded in April 2002, it will enter international long distance (ILD) services. Reliance however basically dropped out of the race for the 4<sup>th</sup> cellular slot.

Reliance is extending the group strategy of vertical integration within an industry to the telecom sector. As per the *Business Today* analysis, its gigantic infrastructure project follows the same pattern as its oil and petrochemicals business strategies based on "positioning itself at all links of the value chain (oil, refining, fibre intermediates, fibre and textiles)... it wants to be a full service communications player. From back-end bandwidth to *last-mile access* (emphasis added), from fixed-line telephony to high-speed voice- and data-networks for corporates, and from submarine cables to cellular telephony, the Reliance gameplan ...is all-encompassing" (*The Empire Strikes Back*). Its strategy is therefore clear – setting up a fibre optic backbone is excellent strategy for a company targeting multiple revenue streams. All of the debt of its lightly leveraged companies will reportedly be raised domestically, an impressive testimony to the profitability of this company.

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<sup>58</sup>D P S Seth, chairman and managing director, BSNL's quoted in "Indian telecom sweeps stakes" by Pooja Kothari; *Economic Times*, July 8.

<sup>59</sup> *Economic Times*, July 8.

<sup>60</sup> The Rs 1,50,000 crore Reliance Group (petrochemicals, refineries, telecom) has overtaken the Tatas as India's largest and most profitable industrial group - *Business Today*: The Empire Strikes Back, April 24, 2001.



The *Business Today* article also points out the downsides to following a vertically integrated approach, chiefly that it has not been profitable in other parts of the world, which has forced some of the international full-service players to unbundle their operations. For example, regulators have forced operators to break up their businesses to address monopoly concerns, and more nimble, specialised operators have cut into market shares. However in the Indian context, a service provider with an optical fibre network can afford to think big, especially if it overcomes the last mile problem and is able to provide the entire range of basic and value added services including Internet on its own networks. Anil Ambani himself reportedly pointed out that the "unbundling phenomenon"... "is more relevant in mature western markets where teledensity has reached saturation levels" (*Business Today*).

## Bharti

The only other private company with similar ambitions is the Bharti Group. Bharti owns the cellular service Airtel in Delhi, the ISP Mantra Online and basic services in one State. It has applied for 8 basic circles and has obtained LoIs for long distance telephony. Prompted by the expansion and diversification of its business scope across a range of new operations, the Bharti group is planning a major restructuring and consolidation. Its Chairman Sunil Mittal has reportedly termed the group's plans to build submarine cables and other infrastructure a strategic underpinning for all its e-commerce, cellular, basic services, national long-distance and international long-distance business plans. The Bharti Group also has a strategic alliance with Singapore Telecom. Together with venture capital firm Warburg Pincus they recently raised over US\$400 million for expansion plans.

## *Convergence Bill*

Further reforms are on the anvil as the technology for provision of all voice and data services by a single operator/medium is available now. Thus everyone is aware that although India lags in teledensity, it is either No. 2 or No. 3 in the world (China claims it is number 1) for cable TV connections. Convergence would thus help India catch up with other countries as with better bandwidth, cable would be a far more efficient vehicle for e-connecting India. The Bill on Convergence, which has reportedly been finalised after consideration of a group of ministers before its introduction in Parliament, envisages the creation of a Communications Commission of India (CCI) as a super regulator for telecommunications, Internet and broadcasting. The draft Convergence Bill also proposes that licensing be handled by the CCI and not by the DoT. Apparently the draft subsumes the Broadcast Bill prepared earlier by the government, the seriously outdated Indian Telegraph Act of 1885, the Cable TV Network (Registration) Act of 1995 and the TRAI Act of 1997<sup>61</sup>. The telecom industry has appealed to the Prime Minister for immediate clearance of the Convergence Bill, provision of composite licenses and staying the grant of separate licenses, which ignore the emerging convergence regime<sup>62</sup>.

Meanwhile reports in the Chinese State-controlled media<sup>63</sup> state that China's Ministry of Information Industry (MII) is actively considering network convergence of telecom and cable broadcasting, leveraging its world-class cable broadcasting *and* telecom network -- "the biggest subscriber base in the world", both being "technologically updated fibre lines, which have the capacity to transmit ...telecom and TV signals". Convergence "would help avoid duplicated construction and upgrade the utilization of both networks" and... "A nationwide

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<sup>61</sup> "Draft convergence Bill proposes omnibus regulator" by Vinay Pandey, *Times of India*, 31 May 2000.

<sup>62</sup> "Telecom sector for fast clearance of Convergence Bill", *Economic Times*, Dec 15, 2000.

<sup>63</sup> "MII hints at further sector liberalisation" July 12, 2001, *Chinadaily.com.cn*.

communications group unifying China's wireless, cable and satellite broadcasting services is set to be launched before the end of the year.”

## LESSONS FROM THE REFORM STRATEGIES OF OTHER COUNTRIES

1. The analysis above shows that China established national domination for its giant State-owned firms<sup>64</sup> in the services and equipment-manufacturing sector, allowing only limited competition. It also promoted a booming hardware sector. Latin America achieved its goals through privatisation against the background of a macroeconomic crisis.
2. In India's case, IT was the stimulant for the reforms package, which consisted of deregulation, entry of the private sector, re-regulation and privatisation of Public Sector Units (or firms, termed PSUs). There were no labour reforms. On the contrary, the behemoth labour force won massive concessions, pay raises, life-long job security followed by handsome pensions to be funded by the Government. Privatisation was only one of the elements of the reforms strategy pursued, as the Departments in charge resisted reform to the very end and agreed to privatisation only when faced with its inevitability. All sectors were opened to competition and foreign investment norms were liberalized. Services were unbundled and licences were required for each separate category on a non-exclusive basis. Strong regulatory institutions were put in place, which is necessary in a transition phase before external competition imposes self-regulation. This strategy carried risks, as the spate of litigation that broke out between different categories of service providers including State “firms” like Bharat Sanchar Nigam Ltd (BSNL), testifies. Unbundling services in an era when a profusion of technological solutions blur the lines between different telecom services and carry the potential to generate multiple disputes between different service providers, and this is what is happening in India<sup>vi</sup>. The Latin American strategy of giving licences for multiple services to one operator prevented such disputes and bloodletting.
3. The consumer has so far been the primary beneficiary of this approach. Discernible trends include greater competition, improved consumer orientation, less corruption and greater pressure on the public sector firms to perform. India achieved all this while liberalising its sector, something China has not done. The orderly nature of the transition is a tribute to the soundness of Indian institutions and its domestic firms. It could serve as a model for reforms in all other sectors.
4. Another unintended consequence of the reforms is that Indian firms have retained firm control. In contrast to China and Latin America, Indian companies are buying out the stakes of foreign companies (Reliance Infocom reportedly plans to buy out Verizon Communications' 10% stake in Reliance Telecom prior to the latter's merger with Reliance Infocom, which is slated to implement all future telecom projects<sup>65</sup>. Bharti also bought out British Telecom's 44% stake in Bharti Cellular, the second such buyout - SingTel is now its partner). This says two things – Indian companies are dominant on their home turf; and two, foreign companies have discounted their short-term prospects in the Indian market, despite or ironically because of extremely open and transparent policies and low margins.

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<sup>64</sup> In a nod to modern market norms, it “corporatised” them through listings in domestic and offshore exchanges.

<sup>65</sup> *The Economic Times*, May 1, 2000.

5. It is gratifying to see that without recourse to any overt bans like the Chinese, Indian telecom networks and services have stayed in Indian hands, and funding for infrastructure expansion and upgradation has been raised without any trouble. Partnership with companies from friendly countries like Singapore complements our foreign policy and strategic goals. The success of private Indian firms following the telecom reforms proves beyond doubt that the right policies can lead to a boom for indigenous enterprise and reinforces arguments for privatisation.

## RECOMMENDATIONS

The McKinsey presentation<sup>66</sup> made at the CII 'CEO Policy Forum on Communications' on April 25, 2001 made the following assessment – “The Indian telecom market is likely to go through tough times over the next 3-5 years during which operators will find it difficult to grow their business and create value ...due to a limited and price-sensitive customer base... highly competitive operator market”, and huge funding requirements. “Fourthly, Indian telecom regulatory policy has tended to be inconsistent detracting from the investment climate... several areas still lack clear regulation and forthcoming regulation in these areas is bound to impact existing players who would have reason to be wary”.

The cautionary advice of analysts like McKinsey, EIU and Indian industry representatives should be taken seriously, especially McKinsey’s observation that “the regulator needs to define clear-cut objectives that drive policy”. We need to think in strategic terms, identify the weaknesses in the current scenario and define our goals. These are to rapidly expand and upgrade the network and services and develop a strong telecom equipment/IT hardware manufacturing base. We should accordingly:

1. **Clear up the Regulatory Environment and Pass the Convergence Bill:** Convergence is clearly the need of the hour, as the objectives of telephone density and Internet access can be solved overnight through this means, help India catch up with other countries, encourage further investment and bring an end to the blood-lettings and bickerings in the market-place. There is also an urgent need to simplify regulations blocking technological innovation and upgradation. The Convergence Bill should be adopted without further delay, and provision of multiple services allowed as industry is urging. The requisite entry fees could even be waived in the interests of speedier upgradation and ceilings on tariffs could be stipulated instead.
2. **Adopt Pro-Active Policies to Encourage an Electronics Hardware Manufacturing Base:** As in the rest of the manufacturing sector, lack of movement in reforms in the power sector and labour market and removal of all burdensome bureaucratic interference in economic processes – is hampering any serious domestic and particularly foreign investment in the telecom equipment sector. The lack of a strong information technology and telecommunications hardware sector will keep us on the back-foot compared to China forever, a realisation that has finally dawned on us. A hardware base has to be nurtured with the right policies.
3. **Attract More Foreign Investment in Production:** As seen above, no matter how many obstacles China placed in the path of foreign investors, they persist in trying to enter the booming market. We have to ensure our market shows similar potential, for which the above policies should be implemented.

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<sup>66</sup> “Telecom blues for India”, April 26, 2001. *Economictimes.Com Bureau*.

4. **Forge Public-Private Partnership:** China has very strong corporatised but State-owned firms in the telecom sector. But private Indian companies could outperform them given the right policy environment. Latin America's experience of the better performance of private vs. public sector firms *even under monopoly conditions* confirms this. In India we are moving towards a market oriented economy but our earlier strengths should also be leveraged. Strategic alliance between State firms, such as a VSNL- BSNL - MTNL merger so they can leverage their huge clout in the market, or between private and public sectors should be encouraged. This would help both sectors face the tough global scenario, building on each other's strengths. The current adversarial stand-offs help no one and the endless disputes give the impression that the old licence raj has been resurrected in a different form.
  
5. **Increase Investment in Telecom R &D:** The USO model could be used to raise resources for this. Work could be subcontracted to premier engineering institutes, which would also help contain the brain drain.

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## 5. PRIVATISATION

*“A common mistake that people make when trying to design something completely foolproof is to underestimate the ingenuity of complete fools” –Unknown.*

Opponents of privatisation in India have been able to undermine India’s external image through their single-minded antagonism, damaging investor confidence and achieving the opposite of the “signaling” effect the process is supposed to convey. Michael Porter convincingly showed more than a decade ago that the only way to craft a winning economic strategy was to create a highly competitive economic environment that rewarded technological innovation and constant upgrading of skills. The historical lack of industrial competitiveness and efficiency in India was due in large part to the domination of a mostly unaccountable public sector with bloated workforces, fenced off from reality through high protective tariffs. Public sector units (PSUs) were also used as milch cows and a source of patronage by the political class; hence the high decibel level of opposition from a certain class of politicians (which the public sees through and *knows* has little to do with public good). Shri Arun Shourie, Minister for Disinvestment is reported to have candidly stated on the Balco controversy that “there was a lot of noise but not a single substantive point was made”.

The feudal mentality that this system fostered militated against establishment of a dynamic, competitive environment in which firms found the incentives to upgrade themselves. For all these reasons it was essential to speed up privatisation unless the firms genuinely upgraded their professionalism, efficiency and consumer orientation, to international standards, as *extremely few* had; thus public sector companies continued to record a decline in returns on investment in 1999-2000 for the third year in a row, confirming that a large proportion of PSUs in India were chronic loss makers, contributing to India’s fiscal deficit and crowding out both private investment and Government expenditure on social and physical infrastructure.

Arguments for privatisation in the above context were not difficult to make in India – a very articulate public, fed up with ever deteriorating services, welcomed the prospect of reduction of political patronage and rent seeking, together with improvement in services, efficiency and productivity of the economy.

As Professor Ramamurti, expert on privatisation pointed out in his “Privatising Monopolies”, Latin America accounted for two-thirds of the US\$ 60 billion raised through privatisation in the developing world between 1988-92, thus becoming “the developing world’s laboratory for large-scale privatization”. Of interest to India is that through privatisation, enormous funds flowed into the infrastructure sectors. Infrastructure sectors - power, telecom, transport, and water accounted for 33% of developing countries’ proceeds from privatisation. Within infrastructure, telecom accounted for more than half of the total. As pointed out earlier, some of the compromises with efficiency-enhancing goals made to attract FDI would not be acceptable to the Indian public<sup>67</sup>. But there is still enormous scope to attract foreign investment through privatisation especially in non-strategic sectors where PSUs proliferate and have no unique competitive advantage.

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<sup>67</sup> However even in Latin America there were large variations and issues of national patrimony were never far from the surface. Those countries which sacrificed efficiency goals did so under duress- macroeconomic destabilisation and balance of payments crises or “Shotgun Privatisation.”

For the Indian Government, there is also the expectation of a direct fiscal pay-off from privatisation, which will mitigate the fiscal deficit and lead to an improvement in the investment environment. The Government has to structure privatisation in an open and transparent manner, ensure competition, elaborate a fail-safe regulatory framework, protect the rights of workers, *and* get a fair price for its equity. In most other countries these goals are considered mutually incompatible, and it has usually been impossible to fulfill all objectives simultaneously.

Hence privatisation in India has to overcome numerous obstacles and tremendous political opposition, which have seriously delayed progress. Another factor in delay is the reluctance of individual Ministries to give up political patronage and turf is also a common thread running through 4 different administrations. As Ravi Ramamurti argued - “no matter what the economic advantages of Privatization it will not happen in a country where politicians in power are not motivated to take on vested interests”<sup>68</sup>.

Until 2001 the Government had been following a cautious policy of “disinvestment” of partial government equity. A Cabinet Committee on Disinvestment (CCD) headed by the Prime Minister and a Department of Disinvestment was established. Between 1991-2000, several rounds of disinvestment of government share holdings were undertaken and an amount of Rs. 20,261 crore or approximately US \$ 4.4 billion at current exchange rates, realised from the sale of 16% equity in 42 PSUs <sup>69</sup>. The general policy was to reduce Government equity holdings to 26% except where strategic considerations were involved. The disinvestment programme for 1999-2000 included MTNL, GAIL, IOC, Hindustan Zinc Limited, Madras Fertilisers Limited, Hindustan Latex Limited (HLL), VSNL and GAIL. However except for Modern Foods (sold to consumer goods giant Hindustan Lever - HLL) in 2000 and also Lagan Jute Machinery Company Limited, **only minority stakes were sold till 2000.**

## **BALCO**

The programme really went into high gear in February 2001. Faced with low realisations from privatisation, the Government modified its policy. The Union Budget presented on February 28, 2001 declared that the approach to privatisation had “shifted from the disinvestment of small lots of shares to strategic sales of blocks of shares to strategic investors to maximise returns to government”. Privatisation was to be accelerated through mobilisation of Rs. 12,000 crore through disinvestment of 27 PSUs including Maruti Udyog, VSNL and Air-India during 2001-02. Rs 7,000 crore out of this amount would be used for restructuring assistance to PSUs, safety net to workers and reduction of debt burden. Rs 5,000 crore would be used for the social and infrastructure sectors. The section on privatisation followed those on fiscal consolidation and expenditure management, showing the connection between the two issues in the minds of policy makers.

In February also the Government finalised sale of its 51% stake in Bharat Aluminium Company (Balco) to Sterlite Industries Ltd for Rs 551.5 crore or about US \$120 million. There was an immediate uproar, sponsored mainly by the State politicians in which the newly privatised enterprise was located. The Opposition also questioned the move, as Balco was profit making, implying that the Government should not sell profit-making PSUs. It also alleged that Balco had been sold off cheap.

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<sup>68</sup> *Multilevel Model of Privatization in Emerging Economies* – article by Prof. Ramamurti.

<sup>69</sup> Disinvestment Department’s home page.

The issue was dragged through Parliament and the Courts. The nearly 7000 strong worker force went on strike. The State Government threatened to close down the plant. The Government rebutted criticism in Parliament by pointing out that the entire process had been conducted in a transparent manner and bids were made through open competitive bidding. Moreover independent valuations of the company yielded figures far below what Sterlite paid. The only other party (a third party, the US aluminium company Alcoa, dropped out) - Birla's Hindalco bid Rs 275 crore, less than half Sterlite's bid. Fortunately, owing to the transparent nature of the transaction and the fact that Sterlite had clearly paid a fair price for the equity, the Courts could not find anything wrong with the privatisation.

The Government's masterstroke was in agreeing to let the issue be voted on in the Lok Sabha, the Lower House. Although an important regional partner, the Telugu Desam Party (TDP) and the fundamentalist Shiv Sena had initially expressed opposition, the governing coalition closed its ranks in time. The Opposition sponsored motion against the privatisation was defeated on March 1 by 119 for and 239 against.

All 3 petitions filed against the privatisation in the Chhattisgarh and Delhi High Courts were referred to the Supreme Court, which ordered the striking workers to resume work by May 8 after securing assurances from Sterlite that it would not retrench any workers and would pay the 2 months' salary during the strike. Central trade unions called off the proposed nationwide strike on May 18 in support of the Balco workers after the latter called off their strike, although they warned that their opposition to the "retrograde policy of privatisation" would continue.

The uproar achieved little. It further undermined investor perceptions about India as a country too risky and a labour force too contentious for manufacturing investment. The privatisation process slowed down. However, the fact that the courts, Parliament and the public through the press, registered their approval showed the direction the wind was blowing. It also demonstrated the strength of India's institutions, and once again proved that if the Government stood firm, it could achieve far-reaching reforms.

## **AIRLINE PRIVATISATION - AIR INDIA AND INDIAN AIRLINES**

Following the contentious but ultimately successful Balco sale to Sterlite, focus shifted to the privatisation of the two national airlines - Air-India, the national flag-carrier, and Indian Airlines, the domestic carrier. While Indian Airlines operates in a growing domestic market, Air India's assets are its potential as a regional strategic hub, a popular brand name, bilateral flying rights to more than 90 destinations, and real estate. Of these its bilateral traffic rights are said to be its most important asset. These rights will remain with the airline for a few years after privatisation, although the terms of the shareholders agreement are not known as yet.

The downsides however are many. The international airlines sector particularly is characterised by both endogenous and exogenous difficulties. Both airlines are characterised by poor facilities, patchy services, ageing aircraft, frequent delays, technical problems, powerful trade unions, chronic losses, a whole host of policy induced distortions and political interference. They are also overstaffed, since Government restrictions have reportedly forbidden outsourcing services such as in-flight catering and ground handling, leading to a higher than international average aircraft-personnel ratio. Air India has drastically reduced the number of routes it flies, as these routes are "hemorrhaging money", doubtless because of fierce competition on many. The administered oil price mechanism (APM) has traditionally

placed a greater burden on airline companies, which cross-subsidise cheaper domestic fuels such as kerosene and diesel. The external hike in oil prices has further affected bottomlines.

Foreign carriers have already cornered 69% of the Indian market. Out of India's international traffic, only 30% is with Air-India and Indian Airlines, despite the fact that bilateral rights held by both sides are equal. According to the Directorate General of Civil Aviation, Air-India's market share is around 19.5% while Indian Airlines has 11.3%. Gulf Air, Singapore Airlines, British Airways, Saudi Arab Airlines, Emirates and Lufthansa follow in that order.

To its credit the Government is tackling some of the distortions and has a timetable for dismantling the oil price control regime by 2002, a commitment recently reiterated in the Budget. Tenders have also been given out for ground-handling business, which contributes 8% of AI's revenues, but which will in the short term create the twin headache of removing a source of revenue as well as further render surplus Air India staff engaged in these operations.

Exogenous structural drawbacks of the international air sector compound the international carrier's problems. Foreign equity in emotive national flag-carriers should thus be structured very carefully, especially in a sector as fraught with cutthroat competition as the international air travel sector. Experts in North America and UK regularly point this out. According to Editor T. Ninan of *Business Standard*, airlines are profitable only in regulated markets. American airlines are therefore constantly going out of business whereas the EU regulates and protects its operating carriers on the European sector. He thinks that a misplaced conviction that efficient, private sector management can actually turn these companies around leads them to ignore the perils and – “has got the better of sound commercial judgement of the bidders.” But “In the airline business, investors cannot hope to make money unless there is some form of regulated competition, perhaps in the form of restricted entry policies that regulate the number of airlines in a market.”

Secondly, according to a report in *The ET* by Ganapathy Subramaniam, the airline market is suffering from over supply. More than 30 State-owned airlines are being privatised (Air China, Thai Airways, Biman Bangladesh, Royal Jordanian, Alitalia, Austrian Airlines, Aer Lingus, El Al, Garuda Indonesia, Kuwait Airlines, Cyprus Airways, Air Afrique, Air Baltic, Uganda Airlines, Sudan Airlines, Royal Air Maoc, Nigeria Airways etc.). Other private carriers like Philippines Airlines, Malaysian Airlines, Hazelton Airline and Grand Air, are also on sale. In the Biman Bangladesh case, the sole 2 bidders reportedly backed out and in the second round there were no bidders at all. In Latin America also typically only one or 2 bids were received for each Privatisation.

The experience of other countries, which privatised their air companies, is instructive. For example in Latin America, privatisations of national airlines did not attract many bids. No American carrier bid for the airlines on sale. In several privatisations, governments received only one bid - very similar to the Indian situation as we shall see. As Prof. Ramamurti points out, had it not been for Iberia, there would have been no privatisation of airlines - Iberia being the sole bidder in Argentina and Venezuela which bought 2 of the 5 airlines put up for sale<sup>70</sup>. Airline privatisations in Latin America also raised smaller amounts than the telecom privatisations.

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<sup>70</sup> Even the Argentinian-Iberia deal went sour. An ongoing dispute on the heavily indebted Aerolineas Argentinas, which was bought by the Spanish airline Iberia, is threatening to sour relations between the two countries. The dispute revolves around Spain's refusal to continue pouring money into the loss making



The above reinforces the feeling that airlines privatisations are very complex processes with many potential minefields. Bids offering a 60% stake in Air India (AI) were invited, out of which 40% was reserved for a strategic partner. Of this foreign airlines were permitted to individually bid for 26%, or a 40% holding in partnership with an Indian company, while employees/retail investors and financial institutions would get 10% each. In the case of Indian Airlines (IA), the government would divest 51%. Of this a strategic partner would buy 26% while 25% would be off-loaded to financial institutions, employees and the public.

However before inviting bids, attempts at restructuring the airlines were stymied by the powerful unions. A draft VRS scheme (voluntary retirement scheme, which has been very popular in India's State banking sector) is pending approval. The terms of privatisation for IA are even more unattractive, which explains the paucity of bidders for the airline. The Department of Disinvestment is preparing a shareholders agreement for Air-India to spell out how much management control the winning bidder would enjoy. The Government could have clarified this key issue at the outset, which may be one of the reasons foreign airlines pulled out of the bidding process, as without management control it would be impossible to overhaul the airline and turn it into a profitable company. Thus the government received only two bids for Air-India - one from the Hindujas, and the other from the Tata-Singapore Airlines combine (the Tatas pulled out of the IA race after submitting their initial expression of interest for both AI and IA). Air France-Delta Air opted out of the race as they could not find an Indian partner and were also looking at other, presumably more attractive options.

The privatisation process came up against another hurdle when Disinvestment Minister Arun Shourie was forced to seek the Cabinet Committee on Disinvestment's views on participation in the privatisation process by firms (Videocon, Sterlite and BPL) barred by SEBI from accessing the capital market on charges of stock price manipulation. In addition the Cabinet Committee on Security's views were sought on the Hindujas' bids for Indian Airlines and Air-India (Hindujas were charge-sheeted in the Bofors case). Tata-Singapore Airlines consortium, the other bidder for Air-India, completed the due diligence exercise after having reportedly indicated that the Tata group would hold 21% stake in Air-India, with Singapore Airlines holding the remaining 19%.

The Government is likely to take the disinvestment process for Air India (AI) and Indian Airlines (IA) forward even if there is only one bid, as long as it exceeds the reserve price to be set for each airline. A precedent of proceeding on a single bid exists in the privatisation of Modern Food Industries. Though the Government is pressing ahead with the Air-India sale process, analysts have said ultimately political issues will dominate this emotive privatisation.

### *Suggestions*

At least one expert (*Airfinance Journal* Mar 1999; Dominic Jones) has questioned why the Government does not exploit the obvious synergies between the 2 national airlines. India has a natural competitive advantage which it can leverage - its huge and growing domestic market, which it is under no obligation to open up to foreign ownership. Potential synergies and cost savings that could be realized through closer cooperation with Indian

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Argentinean airline after seeking nearly US\$ 2 billion into it over the years since its privatisation, while Argentinians blame Iberia for ruining their national airline. The Malaysian airline was sold to a politically connected businessman who also made losses.

Airlines lie in exploiting the domestic and international market, thus diversifying risk, information technology, e-nabling solutions and marketing, route scheduling, fares, engineering, use of property, advertising, ground-handling and tie-ups with tourist destinations.

Another option worth considering but probably not practical in the Indian context is to raise equity ceilings for foreign investment. We have the Indian Air Force for our strategic requirements, and some arrangements for special ceremonial purposes could be stipulated, although these should really be curtailed under the current expenditure reduction exercise. But beyond that there does not seem to be any need for a national international airline, unless the first option, a merger of AI and IA, is considered.

## **PRIVATISATION IN OTHER SECTORS**

*IBP privatization:* In late 2000 the Cabinet Committee on Disinvestment (CCD) chaired by the Prime Minister decided to reduce its nearly 60% stake in the oil marketing company IBP Co Ltd<sup>vii</sup>, to 26% to a strategic partner through international competitive bidding. Private participation would be allowed for the first time in the marketing of fuels, in advance of the dismantling of the Administered Price Mechanism for oil prices in 2002 (subsidisation and cross-subsidisation of petro-products -- ATF, diesel, kerosene, LPG and petrol is done through the APM). Bids were invited on January 16, 2001<sup>viii</sup>. Expressions of Interest (EOIs) from 13 Indian and foreign companies - Indian Oil Corporation, Reliance, Bharat Petroleum Corporation Ltd, Mangalore Refineries & Petrochemicals Ltd, Videocon, Shell, Caltex, TotalFina Elf and Petronas - were received. The final decision was reportedly delayed because of complications in spinning off Balmer Lawrie.

*Privatisation of utilities:* Privatisation of utilities has begun. The privatisation of water supply has become necessary because the existing machinery is unable to enforce economic use of water and treatment. According to a *Times of India* web report Bangalore will soon be the first city in India where drinking water supply is managed by 2 private *and* French companies - Vivendi Water and Northumbrian Water Group (NLI). Mumbai, Chennai and Hyderabad have recently initiated similar plans. According to a *The Hindu* report dated February 4, 2001, the Hyderabad Metropolitan Water Supply and Sewerage Board (HMWSSB) is considering privatising water supply in Kukatpally as a pilot project and is evolving a consensus on privatisation with its employees.

*Computer Maintenance Corporation of India:* Financial bids for CMC and Hindustan Teleprinters Ltd. will soon be initiated. The Cabinet Committee on Disinvestment reportedly approved the shareholders' agreement for the 2 companies on July 4, 2001. CMC is very attractive, being a well-run company in the IT, high-tech sector and it is understood many companies are keen to buy the total 57.3% stake on offer to a strategic partner, employees and others.

*Hotels:* 26 hotel properties of ITDC are being divested following the approval of the Cabinet Committee for Disinvestment. The process is nearing completion in the case of Air-India, CMC, etc.

*State level privatization:* Meanwhile State governments appear to be making some progress in privatisation of 184 State level enterprises. There were 946 State level public enterprises (SLPEs), in which disinvestment/ winding up process had been initiated in 47 (details are on the Department of Disinvestment webpage - <http://divest.nic.in/disistates4.htm>).

## **POLITICAL OPPOSITION**

Since political opposition is one of the main hurdles to privatisation and frequent recourse is taken to populist slogans, one way to silence the critics is to mobilise popular support for privatisation. One way would be to set up a separate fund for spending the proceeds on social infrastructure such as mass education and health-care programmes, implemented through responsible and tested NGOs. The Associated Chambers of Commerce and Industry (Assocham) have reportedly suggested that a part of the privatisation proceeds should be utilised to fund productive or social welfare activities at locations where such units are based to make it more "politically acceptable". Thus, disinvestment proceeds of state-specific public sector companies could be used for social sector investment in the states where they are located. Prof. Devesh Kapur has an excellent analysis in his articles on privatisation in *The Hindu*, August 18, 2000, suggesting politically acceptable solutions and a criteria for sequencing privatisation.

The Disinvestment Minister reportedly favours this approach. But the Finance Ministry reportedly rejected a proposal mooted by the Disinvestment Ministry to create a separate fund out of privatisation proceeds outside the Consolidated Fund of India. After all there is a precedent –the Cess Fund set up to finance part of the national highway network. An eye-catching social investment programme would help the Government regain the offensive politically and also do good to the poor.

The issue of departmental opposition to privatisation also needs to be tackled speedily. A report that the PSUs on the block could be shifted to the administrative control of the Finance Ministry could be a good solution. Private vested interests should not be allowed to sabotage the public good.

Finally, as suggested earlier, merging of PSUs in complementary sector (BSNL, VSNL and MTNL, and Ai and IA for example) to enable them to jointly leverage their resources and markets should be considered.

## **ROLE OF THE STATE SECTOR AND “PRIVATISATION” IN CHINA**

While India is advancing towards a regulated market economy with private firms as its basic unit and driver of growth, China has adopted a different strategy which it claims is compatible with an increasingly market oriented economy. The *China Business Weekly* dated 3<sup>rd</sup> December 2000, reported that the non-State sector accounted for 46.58% of total fixed investment, 71.79% of the aggregate industrial output, and 49.23% of tax revenues in 1999. Estimates of the role of the public sector and by inference of the private sector, in the Indian and Chinese economies are as follows<sup>71</sup>:

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<sup>71</sup> “Rethinking Asia: Sickly India's Lesson for China” Rajiv Lall, MD of E.M. Warburg, Pincus & Co. in Hong Kong FEER, Issue cover-dated April 22, 1999. While these figures are more or less corroborated by other sources, interestingly the Chinese Government claims that the role of the public sector is much greater, nearly 80%, because most firms' ownership structures are still not clearly in the “private sector-owned” category. Thus even FIEs are categorised as being in the public sector on account of their partners being SOEs.

Table 3

	<b>GDP Share</b>	<b>Share of Domestic Investment</b>	<b>Share of Employment</b>	<b>Public sector deficits/ GDP</b>	<b>Deficit as proportion of nationalised banking system assets</b>
<b>India</b>	25%	30%	70% - organised sector	9-10% (Central and State)	More than 70%
<b>China</b>	35%	50-70%	70% -formal urban sector	8% (counting loans to SOEs)	More than 70%

Though State-owned Enterprises (SOEs, the equivalent of PSUs) are beneficiaries of numerous preferential policies, subsidies and interest rates, absorbing the major bulk of state funding and Bank loans, they have been loss-making over several years<sup>ix</sup>. Because of poor SOE performance and gains by the private sector there has been a faster rate of decline in the role of the public sector in China to its current 35% share when compared to India, where it has remained steady. Though China does *not* officially accept privatisation as a solution to the problem, dynamic firms in coastal provinces like Guangdong are taking over state firms, and back-door privatisation is taking place.

China explicitly accords the dominant role in the economy to the State sector, while equally explicitly bemoaning its poor performance. Change may be in the offing however. Till recently, privatisation per se had not been endorsed at the ideological level. However Prime Minister Zhu and President Jiang Zemin had both opined in public that SOEs should withdraw from certain economic fields *for the good of the country*, according to a report by Willy Wo-Lap Lam, former outspoken Editor of the South China Morning Post and now CNN senior China analyst<sup>72</sup>. He also reported that researchers from the State Statistical Bureau, led by senior economist Qiu Xiaohua, had urged late last year that SOEs make a “strategic retreat” from 146 out of 196 industrial sectors, provoking a strong conservative reaction.

At the 80<sup>th</sup> anniversary of the founding of China's Communist Party, President and General Secretary Jiang Zemin surprised everyone by calling for recognising “the country's changing reality by embracing the membership of private businessmen” and other members of China's increasingly diverse society<sup>73</sup>, whose role in creating employment and in improving competitiveness was crucial. He however added that Communist party rule was a “must” - otherwise the country would “fall into a mess and break up. It would not only fail to realise its modernisation but also sink into a chaotic abyss”.<sup>74</sup> Mr. Jiang also reportedly stated that given the changes in the Chinese economy, “We cannot simplistically use whether people have property and how much property they have as a criterion to determine whether they are politically advanced or backward.”

### **ATTEMPTS AT SOE REFORM**

Several attempts at reform have been made since 1993, while preserving the central role of the SOEs especially in strategic industries. As the problem is too large to be addressed, in 1997 the State announced it would concentrate on 1000 key enterprises to - “Seize the Big and let go of the Small”, and “select the superior while eliminating the inferior”. Major SOEs would be supported while exit barriers to the weaker, under-performing ones would be lowered, the hopeless cases being allowed to go bankrupt.

<sup>72</sup> “Hoisting the Red Flag to counter the Red Flag”, May 9, 2001, CNN. Willy Wo Lap Lam was removed after 12 years as China Editor of the SCMP following Hong Kong's takeover by China.

<sup>73</sup> June 30, 2001, Great Hall of the People.

<sup>74</sup> TV and media reports: “China celebrates Communism” By James Kynge in Beijing FT July 1 2001. “Chinese Leader Urges Widening Communist Party Membership”, Craig S. Smith, New York Times, July 2, 2001.

Simultaneously a social security system would be elaborated to take care of redundant workers. According to the *EIU Country Report 2000* the reforms reduced the number of “SOEs from 118,000 in 1995 to 61,300 by 2000, with the number of employees reduced to 24.1 million from 44 million in 1995”. The *EIU* report concluded that “a hybrid economy” was envisaged, “one in which ownership of the most important firms remained with the State, but smaller firms could be subject to private, collective and other hybrid ownership structures including foreign ownership”. The reforms extended to corporatisation of key SOEs and listings of gargantuan companies like Sinopec, Bao Steel and others on domestic and foreign stock exchanges, which gave a boost to China’s stock markets.

An indication of State/ Party control in Chinese economic life is the requirement that all major State enterprises should have Communist Party Cells or Committees. These Cells may be helping in creating a sense of national unity and purpose and also providing the vital link between the firm’s and the Party and national leadership’s agenda. Thus no one is working at cross-purposes, unlike in India, where workers are instigated for opportunistic reasons and the so-called national consensus on economic goals is subordinated to sectional interest. China thus has a major advantage over India – the ability to pursue a macro-vision through these institutions. Cooperation means the various actors can think big, across sectors and industries to promote the common good. In India the process resembles hit or miss, usually miss. Many in the Indian political sphere and government are suspicious of business, whereas in China, Government *is* in business.

## CHINA’S STOCK MARKETS

China’s stock exchanges were set up on an experimental basis in Shanghai and Shenzhen in 1990 to test the waters for mobilising capital for SOEs. China’s domestic market capitalisation at over US \$ 600 billion has overtaken India’s by a factor of perhaps 4 or 5, reflecting the larger size of its economy and its SOEs. According to a *Financial Times* report, Asia’s biggest company by market capitalisation at US \$99.4 billion was China Telecom. SOEs have raised billions of dollars through listings in Hong Kong and New York.

The downsides are the fragmented nature of China’s markets (see below) and speculative activity (like India?). Chinese stock markets have been characterised by speculation, low transparency and high volatility from the very beginning. The enthusiasm displayed by the public has however demonstrated their potential to mobilise funds which the Government recognises. Several reforms are under consideration. But analysts of China’s stock markets, while brimming with anticipation at their potential, come up against the paradox that while the macroeconomic indices are brilliant, individual firms do not give comparable returns. SOEs are tackling the issues of “lousy micro, rosy macro<sup>75</sup>”. Many SOEs are experimenting with stock options and improved corporate management. Joint ventures with foreign fund managers have been forged to avail of international expertise. Some SOEs and sectors are considered as sound investment bets – the energy sector for example, benefiting from higher oil prices, property stocks following recent incentives extended to the private housing sector, companies in the booming electronics and telecommunications sectors like Legend, China Unicom, and so on.

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<sup>75</sup> “What you have in China is rosy macro, but lousy micro,” according to Joan Zheng, deputy head of economic research at JP Morgan in Hong Kong. “From the macroeconomic perspective, you should certainly invest in China. But when it comes down to choosing specific stocks to buy, then it’s not so easy.” from “Between Hype And a Hard Place” by Tom Holland, FEER Issue cover-dated June 28, 2001.

There are mainly two types of stocks - A shares, which are meant for Chinese investors, and B shares, which before February 20, 2001 were restricted to foreign investors to permit them to invest in the Chinese stock market without circumventing convertibility restrictions. However poor results in the B share market led to a very low market capitalisation and huge differences in the valuations of A and B shares in the *same* companies. China therefore lifted the restrictions on its nationals permitting them to buy B shares on February 21, 2001. To prevent violations of foreign exchange controls only legally acquired foreign exchange deposited in bank accounts, and not cash, can be used to buy B-shares. While the Government stated that this was done in response to an improvement in foreign exchange reserves, the decision to liberalise the B-share market was taken to stem the outflow of foreign currency held by domestic residents, estimated at around US\$75 billion. This also acknowledged that nationals *had* in any case been illegally investing in B-shares. In typical Chinese style it was also probably meant to test the waters ahead of further reforms, though a full merger can be ruled out until China implements greater convertibility.

A second, potentially more revolutionary announcement was made by the China Securities Regulatory Commission (CSRC) within a few days of the above– it would delist loss making SOEs.

The current volatile nature of the stock markets has indirectly delayed China's plans to launch a National Social Security scheme - which was to be funded through capital market investments and pay-as-you-go schemes. China opted for a smaller experimental project in Liaoning province<sup>76</sup> because of the immaturity of the stock markets. Currently China's welfare system is unfunded like India's with pensions and unemployment benefits being paid by SOEs/ Government.

## **EFFECTS ON THE BANKING SYSTEM**

State-owned Banks were directed to supplant direct infusions from the Government Budget to the SOEs and become their life support. Consequently they were burdened with mountains of non-performing debt, creating the Chinese equivalent of the Asian moral hazard. Payment defaults created a triangular debt chain through the economy, starving healthier firms of funds. The PBC reportedly recently estimated the banks' nominal capital at only 4.4% of assets, much lower than the 8% international capital adequacy ratio. Recapitalisation helped to increase the ratio but the ensuing fiscal expansion mandated by Premier Zhu Rongji to combat a possible slowdown of economic growth further depleted reserves. China created 4 asset management companies (AMCs) to recover approximately RMB 1 trillion in non-performing loans through debt-equity swaps, eventually rehabilitating the SOEs and selling their shares. However, "eligible" companies were chosen by administrative fiat and the jury is still out on the effectiveness of this reform. Analysts doubt whether the banks will find buyers for these "assets".

It is a little known fact that China does not permit foreign banks to engage in local currency operations, nor its citizens to park their renminbi deposits with foreign banks. Why is that? Because China's Banks need all the huge private savings to be deposited exclusively with them to keep the system lubricated. As a British commentator once put it, if enough water comes pouring in from the tap into a leaking tub, the level remains constant. Individual savings are therefore funding the continued operations of loss-making enterprises through deposits in the State Banks. Since banking systems operate on trust, Chinese savings diverted to foreign banks would dry up the funding sources of the State banks, setting off a chain

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<sup>76</sup> *China's financial reforms delayed*, by James Kynge, Financial Times, February 8, 2001.

reaction through the economy. Hence the ban on local currency operations by foreign banks, which would place the embattled State sector, including the State banks, under further stress. China's Finance Minister and Prime Minister identified the continued chaos in the financial system as a serious problem at the National People's Congress in 1997.

An interesting sidelight on probable causes for China's high savings rate is that the Chinese consumer until recently did not have big-ticket items to spend on: the Chinese consumer could not buy private housing; travel abroad was restricted; Chinese banks did not extend loans for housing and car purchases, perhaps because personal savings were the mainstay of Bank deposits (this had contributed to under-performance of the private auto market). The state owned 99% of the car park. So naturally with rising prosperity and limited outlets for spending the Chinese public saved a lot.

Recently exhortations to encourage individual purchases of private housing - identified as a new growth pole for stimulating economic activity - have become routine. Credit and mortgages have become available and new residential complexes are reported to be mushrooming across China in response to this policy initiative. The Chinese Government wants the public to contribute to stimulating demand in the economy and has introduced disincentives on savings by cutting interest rates on deposits and introducing a tax on interest, which has prompted investment in the stock markets. This could mean two things - the economy is slowing down and needs a healthier source for stimulus besides Government pump-priming. It also implies some improvement in the health of the banking system.

The above sketches the penalties China pays in choosing the State directed economic model. It is clear that it imposes heavy costs on the other, more dynamic sectors of the economy, the stock markets and the banking sector, and affects the quality of growth. It is also not very clear that the system can evolve smoothly towards a more efficient model. If it does, one can expect China's high growth rates to escalate even further, but it is doubtful whether the transition will be painless. The high personal savings underpin the financial system, and are funneled into the State bank-State sector, which is responsible for the economy's dissavings. Part of these resources are therefore not utilized optimally. Strong FDI inflows, fiscal expansion by increasing Government expenditure on infrastructure development, and strong export performances underpin China's high growth rates. As we shall see, this has an impact on the FDI dynamic also.

## **INDIAN BANKING AND INSURANCE SECTOR REFORMS**

India has in contrast tried to recapitalise its banks, further opened up the banking sector and in 1999 the insurance sector both to the private sector and to foreign investment. There has been a perceptible improvement in services of even the nationalised banks following liberalisation. Private sector banks have taken the lead in introducing new services in India and are doing extremely well. Foreign investors are also attracted to this sector. Substantial staff retrenchments have taken place through voluntary retirement schemes. Further, a Bill to amend the Banking Companies Acts 1970/80 and reduce government equity in public sector banks from 51 to 33% was introduced in Parliament. The unionized bank staff protested strongly against the perceived privatisation, and there was opposition in Parliament also.

An Insurance Regulatory and Development Act (IRDA) permitting private sector entry into insurance and foreign equity in domestic private insurance companies upto a maximum of 26% - was passed by Parliament in December 1999. FDI was placed under the automatic route since in any case licenses from IRDA were required for entry into this sector.

The insurance and banking sectors having been opened to private/ foreign participation, this could help channel funds into infrastructure development. The concern in India, as elsewhere, is how to make the stock markets deep and stable enough to sustain the earnings of the insurance companies, with 5 out of 10 having applied for licences having been granted licences. The problems of the stock markets are receiving some attention. Moreover, the Finance Minister was quoted at some point by the *Economic Times* as having said that the insurance industry can support a social security system for the first time in India and the government has created enabling provisions for pension funds to invest in stock markets.

In China a few selected foreign banks and insurance companies were allowed to set up branches or equity joint ventures in selected geographic areas only and with extremely circumscribed mandates for operation. Significantly one of the conditions for China's entry into the WTO is to open up the local currency business and insurance markets and national treatment of foreign enterprises.

The above should explain why China's opening up of the financial sector to foreign investment has been more limited than India's. China's banking system is worse off than India's because Indian State banks are no longer forced to lend to "priority" State-owned enterprises at subsidized rates. Instead they are expected to purchase large volumes of the ever increasing government debt, which nevertheless carry a sovereign guarantee, so "more than a quarter of the assets of Indian banks are today tied up in government bonds or securities bearing a sovereign guarantee" according to Rajiv Lall<sup>77</sup>.

He points out however that there is no reason for India to be complacent - the share of the public sector in China is decreasing at a rapid rate while it has remained static over the past 3 decades in India. The annual fiscal deficit of central and state governments together is 10% of GDP. The ratio of cumulative public debt to GDP is approaching astronomical levels. India has also till "quite recently, used a nationalised banking system to forcibly allocate private savings into government debt instruments. This has allowed the government to keep the interest burden on its debt artificially depressed. Along with a commitment to a freer capital account, India has been attracting dollar deposits by NRIs at special, high interest rates" (the India Millennium Deposit issue, which was severely criticised in India's financial press as it raised foreign exchange at a very high cost). "One wonders in a crisis of confidence, how these funds will behave."

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<sup>77</sup> Hong Kong-based Managing Director of investment firm E.M. Warburg Pincus & Co in India: An Asian Brazil?" FEER Issue cover-dated February 25, 1999.



## **6. INFRASTRUCTURE**

China funded its own infrastructure development with spectacular results. One of the reasons for high growth rates is Government pump priming - SEZ development, airports, ports, roads, power, telecom infrastructure etc. The telecommunications and civil aviation sectors underwent the greatest internal restructuring and consequently expanded at breathtaking rates. Roads were primarily funded by wealthier local and provincial Governments. Foreign investment was not encouraged in these sectors, but was nevertheless forthcoming in some. While western companies preferred the power and telecom sectors, overseas Chinese flooded into real estate, property development, ports, and department retail stores through different investment vehicles, changing the urban landscape beyond recognition. Growth engenders more growth. Today's China is completely unrecognizable from the China of 1985, a scant 17 years ago.

Investment in infrastructure in India in contrast has so far been unforthcoming despite liberalisation because of lack of public funds, politicised user charges and policy confusion as to how to get out of the mess. However the situation is changing. The 2001 Budget recognised that rapid development depends on investment in infrastructure. The Government has acknowledged that private and foreign funding is required and user charges need to be commercially viable for infrastructure investment to take place. Where investment is not forthcoming, usually because of structural booby-traps such as in the power sector, the Government is considering pro-active measures to restructure the sector or fund development.

As a result significant movement in infrastructure development - in airports, roads, and ports barring the power sector – is taking place. Even in the power sector, reforms are proceeding incrementally.

The 2001 Union Budget of India provided for 10-year tax holidays for roads, railways, water treatment and supply, irrigation, sanitation and solid waste management systems, airports, ports, inland ports and waterways, generation and distribution of power, developers of industrial parks and Special Economic Zones, including full exemption on the income of investors committing long term funds. In a boost to rural infrastructure, the Budget also provided a 5-year tax holiday and 30% deduction of profits for the next five years to firms dealing with handling, transportation and storage of food-grains.

There is little scope to derive specific lessons from China's strategy, except to applaud their foresight and bemoan its lack in India. Since infrastructure is still largely in the State sector in China, the returns on it are not known. India's strategy of involving the private sector may be a more viable one in the long term, but it is really a Hobson's choice for India. Meanwhile infrastructure investment in China has yielded handsome pay-offs by making the place more attractive for investors and lowering costs for industry - significant returns in themselves.

### **POWER SECTOR REFORMS**

The need for reforms in the power sector is so evident for the manufacturing, IT and agriculture sectors and this issue is so well analysed that it does not bear repetition here. Against China's installed capacity of over 319 Gigawatts (GW), India's is only just over 1 GW. The rate of capacity addition bears no comparison – against India's 83 GW in 1995,

China had 214 GW. China has followed a cautious policy for FDI in infrastructure, preferring to invest heavily in infrastructure from its own resources, making it clear that it would invite foreign investment on its own terms. It installed more than 12,000 MW of generating capacity per year over the last 13 years. Concerns over the rate of return, foreign exchange outgo and power tariffs in a system characterised by subsidies moulded this approach. Reports have been seen regarding the Chinese Government's intentions to rescind guaranteed rates of return on foreign invested power projects, now that it finds itself in a comfortable supply position.

India privatised power generation through the Independent Power Projects (IPP) policy in 1991 and opened it to 100% foreign investment. However potential investors faced a scenario characterized by a poor transmission and distribution system and bankrupt State government-owned electric utilities - the State Electricity Boards (SEBs). The only purchasers' permitted under law, SEBs were insolvent, as *their* users did not pay bills due to numerous exemptions (agricultural lobbies), subsidies, and outright power theft. Losses of the state electricity boards amounted to Rs. 24,000 crores.

India's mega power deal with Enron ran into serious trouble with the concerned state utility board the Maharashtra SEB or MSEB having first defaulted then ceased to buy power and the entire project having gone into litigation. While the tariff calculation formula<sup>78</sup> -- which was heavily tipped in favour of Enron and tariffs predictably quadrupled since the project was launched -- was a major cause for the failure of the deal, the inability to collect sensible tariffs was also a major contributory factor. **This prompted a search for solutions in reforming the distribution and purchase aspects before seeking fresh investment.**

The central government entered into MOUs with 5 willing State Governments which included commercialisation of distribution, SEB restructuring, reduction and eventual elimination of power theft (a time-bound programme of installation of 100% metering by December 2001), tariff determination by SERCs and compliance thereof. Central assistance under the Accelerated Power Development Programme (APDP) as well as other schemes would be linked to progress in power reforms. Some States went ahead with power sector reforms, with Gujarat actively considering direct sales, Orissa having unbundled power generation and T &D (however its reforms have run into trouble), and Andhra Pradesh levying user charges. A new Electricity Bill 2001 which would end state utilities' monopoly on electricity distribution, allowing independent power producers to sell power directly to consumers, and make theft of electricity punishable, is to be introduced in the monsoon session of Parliament.

Government investment has also been resumed in the sector. Thus the public sector National Thermal Power Corporation (NTPC) is engaged in constructing power generation facilities. The public sector Power Grid Corporation of India has also been mandated to form a national transmission grid and may even team up with a foreign partner. The Government is basically seized of the urgency of addressing this matter but reforms are proceeding very slowly.

## ROADS

As in telecommunications so in roads, the Prime Minister, Mr. Atal Bihari Vajpayee, took the initiative in 1998 by announcing the development of a 13,000 km transnational

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<sup>78</sup> Components of the formula included part dollar payments leading to currency depreciation risks and costs of imported raw material supplies – naphtha - which had jumped with the hike in oil prices.

highway project -- the National Highway Development Project (NHDP). This is being implemented by the new National Highways Authority of India (NHAI) and foresees construction of around 6000 km of national highways connecting India's mega cities Delhi, Mumbai, Calcutta and Chennai and 7000 km of North-South and East-West corridors linking the 4 corners of the country. Currently existing roads are being 4-laned.

Funding is from 3 sources – market borrowings through bond issues, a National Highway Development Cess (a charge of Re 1 per litre on transport fuels credited to a separate fund for road development outside regular government finances), bilateral (Japanese) and multilateral (World Bank - US\$1 billion loan, and Asian Development Bank - US\$180-million loan) funding. The World Bank assistance routed through the Government of India is 80% grant and 20% loan. *The repayment of 20% of World Bank assistance would be effected through tolling – a novel concept in India. Approval for tolling the national highways has been given.* Part of the toll proceeds may be used to develop real estate along the highways on World Bank advice, which also enjoins NHAI to maintain international standards of maintenance and environmental conservation. BOT projects have not taken off, although this option is permitted. Foreigners are also participating in road building, with reports of a Malaysian consortium winning a construction contract. Government has provided several favourable and forward-looking incentives which are worth looking up on the NHAI webpage - [www.nhai.org](http://www.nhai.org).

## **PORTS**

Guidelines for joint ventures were issued in June 1998, and necessary amendments to the Major Port Trusts Act 1963, were made. Private sector participation in the development of major ports has taken off with 17 projects, and an investment of about US\$ 1 billion as economic tariff levels, decided in a transparent manner are set by the Tariff Authority for Major Ports. Following the successful corporatisation of Ennore port in the South, Jawaharlal Nehru Port, New Mangalore Port, Mormugao Port and Tuticorin Port are undergoing corporatisation. Tuticorin, under the management of the Singapore Port Authority, now offers competitive rates comparable to Colombo.

## **AIRPORTS**

The Siemens-Zurich airport - L&T India consortium has been selected for the US\$ 300 million joint venture international airport for Bangalore. The Andhra Pradesh government reportedly selected the GMR Infrastructure and Malaysia Airports Holdings consortia for developing an international airport. While the state and central governments would have a 13% stake each in the equity of the joint venture, the selected bidder would have 74%.

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## 7. OTHER REFORMS IN INDIA

### SMALL SCALE INDUSTRY (SSI) DERESERVATION

*'... a leading cartoonist in a 1980s comic strip depicted the industry minister telling his staff,' "We shouldn't encourage big industry — that is our policy, I know. But I say we shouldn't encourage small industries either. If we do, they are bound to become big..."*

Taken from Arvind Panagariya; Professor of Economics at the University of Maryland, USA, writing in the Economic Times of July 23, 2001 “Favouring a decade of reforms”

The above says it all. Pre-reforms, the Indian small scale sector was protected and thus grew up stunted and highly uncompetitive in contrast to the same industries in China, which suffered from no such restrictions. Entire sectors enjoying a competitive advantage were shuttered off from investment by bigger players. The results are there for everyone to see, an embattled small-scale sector is unable to compete with cheap Chinese imports and efforts to reform have come in very, very late.

The 1991 reforms neglected this festering issue. The small-scale sector is estimated to account for nearly 40% of manufacturing sector output and 35% of exports. It is also the largest employer after agriculture, although employment growth has shrunk to zero due to the high cost of raw materials, competition from large industry and cheaper Chinese alternatives, outdated manufacturing technology, lack of professional management etc. It also suffers from the problems plaguing manufacturing in general - poor infrastructure, high costs of power and capital, *licence or inspector raj*. CII estimated the number of annual inspections at over 200 depending on the state, adding to their costs. The opening up of the economy and imports of consumer goods after the dismantling of the last remaining import barriers in April 2001 must have been the last straw.

Piecemeal reforms such as improvement in access to credit and hikes in the exemption limits for small-scale industries (from Rs 50 lakh to Rs 1 crore in September 2000) did not address the fundamental issue<sup>x</sup>. Finally policy makers woke up to the problem and dereserved the garment industry in the National Textile Policy in September 2000. In the 2001 Budget dereservation of 14 items (leather goods, shoes and toys in the SSI sector) was finally announced. This will enable big players to enter the reserved sectors, modernisation and upgradation of production facilities and achievement of economies of scale – one of the prime reasons China beats us hollow in export markets, and create employment opportunities. Only this, together with the freedom to hire and fire will enable Indian firms to compete with China.

### LABOUR REFORMS

The Economic Survey unambiguously warned that greater flexibility in labour laws was essential if Indian industry was to compete with Chinese industry and generate as many new jobs. The excessive power of unionised labour in the organised sector in India has led to an inexorable rise in wages and perks while relative international productivity declined and managers hesitated to expand the labour force.

Recognising the imperative of reforms, the 2001 Union Budget announced major initiatives on labour reforms. Stating that “existing provisions in the Industrial Disputes Act have made it almost impossible for industrial firms to exercise any labour flexibility. ...henceforth only industrial establishments employing over 1,000 workers instead of 100 as

stipulated in the Act, would need to obtain prior approval of the government for lay-offs, retrenchment and closure. At the same time the retrenchment compensation would be increased from 15 to 45 days for every completed year of service. Similarly, rigidities in the legislation on Contract Labour inhibited growth in employment in many service activities. An amendment to facilitate outsourcing of activities without any restrictions as well as to offer contract appointments and larger compensation based on last drawn wages as retrenchment compensation would be effected". The Finance Minister stated that "These measures will promote industrial investment in labour intensive, and export oriented activities providing for renewed industrial growth, while, at the same time safeguarding the interest of workers. My colleague, the minister for labour will introduce appropriate legislation to amend the Industrial Disputes Act and Contract Labour Act within this session." He also introduced a new group insurance scheme – the "Ashraya Bima Yojana" for affected workers, which would provide compensation. However, sensing the gathering storm of opposition, the Government has been soft-pedaling this sensitive reform. It will most likely be implemented once a few other contentious reforms are completed. But again, it is clear that such reforms can only be implemented if the economy is expanding and creating new employment opportunities; otherwise, pushing these through would be politically unfeasible.

## **PENSION REFORMS**

The government's pension liabilities rose sharply after the Fifth Pay Commission awards, to 0.96% of GDP, at Rs 21,400 crore in 2000-01 or US\$4.5 billion. A working group headed by the Controller General of Accounts on pension reforms recommended a funded system and "using modern investment management techniques to obtain a reasonable real rate of return on accumulated balances" to reduce the pension liability to 0.5% of GDP or Rs 29,500 crore by 2009-10 (assuming a 9% rate of growth). Currently, government employees do not contribute towards their pension. However the 2001 Union Budget stipulated that the new batch entering central government services after October 1, 2001, would receive pension through a new pension programme based on defined contributions, and that the IRDA would look into social security issues of the unorganised sector and provide a roadmap for pension reforms by October 1, 2001.

## **FISCAL SITUATION AND FISCAL RESPONSIBILITY AND BUDGET MANAGEMENT BILL**

While the Union Budget 2001 announced that the fiscal deficit had been contained at 5.1% of GDP in 2000-01, a trend improvement over earlier years – it also identified the most serious problem confronting the economy as the combined fiscal deficit of Central and State Governments at 10% of GDP, and control of non-productive government expenditure, improvement in its quality and rationalisation of subsidies as priorities. Total liabilities of the Central Government were Rs. 12,00,000 crores, or over US \$255 billion, "to which over Rs. 1,00,000 crores is being added every year..." as annual interest. The Central Government was also financing current expenditure through its borrowings. The Budget announced that user charges for services provided by government would be revised, government downsized through attrition (this specific term was not used – it is called 'rightsizing' in India to avoid offending the bureaucrats), the number of redundant departments would be reduced, and some perks enjoyed by government employees would be curtailed. Privatisation proceeds of Rs 120 billion were targeted. Administered interest rates on a whole range of instruments were reduced, bringing down at least some of the interest burden on the deficit (which was more than made up by fresh borrowings however). The forthcoming dismantling of administered pricing (the APM) of petro-products, slated for March 2002, would help to

greatly reduce the deficit, as the subsidy would be replaced by substantial realisations from taxation instead. Some reforms to reduce the “food subsidy” bill were announced (see the section on Agriculture).

In addition, the Fiscal Responsibility and Budget Management Bill was introduced in the Lok Sabha on December 20, 2000 by the Finance Minister, which sought to curtail the fiscal deficit to 2% of GDP by March 31, 2006 and prohibit direct borrowings by the Central Government from the Reserve Bank of India after 3 years except for temporary advances in certain circumstances, and to ensure greater transparency in fiscal matters. However, the Bill was opposed as other Parties did not want to tie the hands of future governments on decisions of expenditure.

In terms of downsizing, China claims to have abolished several ministries and merged others. However these personnel and functions are usually subsumed under different departments or spun off as corporatised entities, so it is not clear what impact the downsizing has had, though corporatisation must have introduced greater accountability than encountered in a normal government department<sup>xi</sup>. The corporatisation of BSNL follows the same principles, and the Chinese model deserves a closer look especially if its leads to greater productivity.

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## 8. THE EXTERNAL SECTOR

### TRENDS IN THE FDI SCENARIO IN INDIA

When compared to China's success in attracting FDI, FDI flows to India have yet to pick up momentum. By the early 1990s, FDI had started to flood into China as per the following figures<sup>79</sup> (US\$ billion):

Table 4 - FDI into China and India – US\$ billion.

YEAR	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
China	3.5	4.4	11.3	27.8	34.0	37.4	42.4	43.0	45.5	40.3	40.8
India <sup>80</sup>								3.6	2.5	2.2	2.3

It is now 10 years since reforms were launched in July 1991 in India, but a similar upsurge in FDI inflows has not taken place. In fact, despite the liberalisation of the policy environment and the eagerness of the Government to attract it, FDI inflows have declined since 1997. Yet the regulatory and facilitatory environment in India has improved considerably, with the automatic route for FDI progressively widened since 1991<sup>xii</sup>. The data and trends for 1991-97 are taken from Nagesh Kumar's excellent analysis<sup>81</sup>.

**1. A large proportion (31%) of post reform FDI has been directed at the service sector,** while the share of manufacturing has fallen to 37%. This was to be expected given the fact that this sector was largely outside the purview of the licence raj even in the pre-reforms period, faster rate of liberalisation of this sector, and its larger share in the Indian economy. This confirms the earlier conclusion that investment, foreign or domestic flows into those sectors where the business environment and factor prices are favourable. Again, the inevitable conclusion is that an overall revival of the Indian economy, focused on reviving the manufacturing sector, will be the solution to this problem (i.e. FDI inflows). The bulk of the inflows in the 1990s were directed to the non-manufacturing/ infrastructure sectors such as energy (29%) and telecommunication services - 20%. According to a *Press Trust of India* report dated December 2, 2000, FDI in India in the first 6 months of the 2000-01 financial year was the highest in the telecommunications sector, with an inflow of Rs 8,251.78 crore or approximately US\$1.75 billion during April-October 2000, accounting for over 34% of the total approvals.

As the *Business Standard* once commented, "even if all the irritants — bureaucracy, infrastructure, etc. — were to be removed, India has a distinct geographical disadvantage as an export base. Countries competing for FDI — China, Brazil and Mexico, for instance — are all better located with respect to the USA. Further, Mexico has preferential access because of NAFTA, and Brazil is an important component of a relatively effective trading bloc, Mercosur. How can India overcome these natural and political disadvantages? By exporting things whose competitiveness is not eroded by distance, such as knowledge and services." Hence the rising share of FDI in services, call centres and back office operations

<sup>79</sup> Source: *China Statistical Yearbook, 1997-8. 1998-99 - EIU Country Report. For Year 2000 - World Bank.* There was a sharp rise in commitments in 2000 to over US\$ 60 billion which is expected to show up later.

<sup>80</sup> The year of accounting is the Indian financial year, so 1997 actually represents 1997-98 and so on. Sources are the *Economic Survey 1999-2000* and the Reserve Bank of India (RBI). Figures for 2000-01 are provisional.

<sup>81</sup> *Liberalization and Changing Patterns of Foreign Direct Investments: Has India's Relative Attractiveness as a Host of FDI Improved?* Nagesh Kumar, *Economic and Political Weekly*, 33(22), 30 May 1998.

of multinationals is a positive trend for the mass white-collar employment opportunities it offers and should be encouraged.

2. **There is greater diversification in the origins of FDI into India.** From being major sources of FDI inflows to India until 1990, European countries' share declined to 18% of FDI approved between 1991-97, with the US emerging as the most important source with 27%. Countries like Korea, Singapore and Israel increasingly replaced traditional sources of FDI (Europe, USA and Japan) whose combined share fell to 50% of the total compared to 90% in earlier periods. The emerging importance of Asian countries seemed to follow the pattern of intra-Asian FDI witnessed in other Asian countries, except that Japan's share did not pick up substantially. However some of these new investments could not be sustained. After the 1997 financial crisis, for example, Korea's investments are expected to fall and pick up only after it has successfully completed its own restructuring. Singapore however is eyeing a wide range of sectors - telecommunications, infrastructure, property, and retail for possible investment. A few proposals have come in from Taiwan, which has large investible surpluses and with which we can build important synergies in the high-tech and Information Technology sectors. With improvement of relations with Singapore, there has been an upsurge of interest in India from Singaporean companies. Singapore Airlines in partnership with the Tatas bid in the privatisation of Air-India. SingTel partnered with Bharti to build an undersea fibre optic cable, and participated with it in other telecom projects. Singapore companies are actively involved in India's increasingly privatised ports sector.

Another category is overseas Indians and Mauritius. Taking advantage of bilateral tax incentives, investors have routed around 17% of total FDI inflows through Mauritius into India over the last 10 years. In a sense Mauritius is fulfilling the role that direct tax incentives play for China. Indeed, one of India's multinationals, Essel Packaging, in partnership with a Swiss firm Propack, used Mauritius as a base to create a special vehicle to channel funds for worldwide acquisitions.

3. **FDI in high-tech activities:** As is clear from the section on Information Technology, major multinationals are locating R & D Centres in India, with their Indian centres sometimes becoming also their crown jewels. This is something other developing countries in the region including China have not been able to achieve.

Thus the high levels of prosperity in Malaysia compared to India are very much a result of its more open, export-oriented and FDI policies. But Dr. Anuwar Ali, Vice Chancellor, Malaysian University and key development expert who has written many papers on issues of technology transfer, points out that the extent of technology assimilation through FDI has been sub-optimal. In contrast during "Japan's early industrial development and South Korea's experience" they successfully adapted technologies from more industrialized countries through licensing. He also points out that "the effectiveness of this approach greatly depends upon the industrial infrastructure and science and technology capabilities in the national economy". While "Malaysian manufacturing enterprises resorted to similar methods to acquire technologies from more industrialised countries... given the country's narrow industrial base and dominance of FDI in key industries, technology acquisition and assimilation was much more difficult". FDI indeed discouraged "meaningful technology transfers and development of domestic innovative capacity. R&D centres were in the home country". The top management in Malaysia performed "only managerial and organisational functions and not innovation as in Japan."

Acquiring a technological advantage will ultimately depend on the host country's resource endowments and skills, which FDI can only add to but not create *de novo*,



something that Michael Porter demonstrated conclusively in his 1990 “*Competitive Advantage of Nations*”. India has prospects of attracting FDI in the high tech/ R & D areas of IT, biotech, and even pharmaceuticals once the necessary patent legislation is passed, having some advantages on account of its extensive R&D network and scientific pool in these and other areas, and must learn to leverage it more effectively, if necessary through a public-private partnership. China is moving fast in this direction.

4. **Regional hub:** India may also slowly emerge as a regional hub in the strategic expansion plans of some companies, for South Asia and even for regions beyond. General Electric (GE) is even prepared to make India the global hub for its medical systems business, with half the projected turnover being exported, according to media reports. Delphi Automotive Systems Ltd is planning to make India the production and sourcing hub for aftermarket operations for the Asia-Pacific region. Xerox Corporation has identified India as a hi-tech hub for Asia, the Middle East and Africa and plans to set up a competence centre in India, Xerox's second such centre in the developing world after Brazil.

5. **India as a long-term destination:** While the domestic market has great potential, it still does not yield the economies of scale required for large investments. So, many investors see India mainly as an attractive long-term destination. It is worth reading A.T. Kearney's survey of a 1000 CEOs and top decision makers of the world's most prominent companies posted on the Web<sup>82</sup> – to compile the FDI Confidence Index, in which India once again figured in the top 10 favourite destinations for FDI. In the short term, foreign investors perceived that the “Chinese and Brazilian markets are not just more attractive, but they are more likely to convert this positive investor outlook into actual investment commitments” (for China -70%; for Brazil - 65% and for India - 42%). For long term horizons, China scored in the attractive category at 80%, Brazil at 72%, and India just under 70%. Size of domestic market and potential as an export platform led to China being ranked ahead of Brazil and India (India's negative image as an export platform was cited and needs to be specifically addressed). Interestingly, the survey found that “India's attractiveness grows at a dramatic rate when investors lengthen their time horizons --a rate of growth that actually surpasses China and Brazil. The difference between short and long-term perceptions of India reflects the considerable preference investors assign to the country once expected deregulation, privatization and application of WTO guidelines are implemented.”<sup>xiii</sup> This confirms what most observers of the Indian scene intuitively feel.

## THE IMPORTANCE OF FOREIGN INVESTED ENTERPRISES IN THE CHINESE ECONOMY

Over 67-70% of FDI in China is from overseas Chinese, rather than from western multinationals (the latter being more market seeking than export oriented) -- in labour-intensive, export processing sectors - shoes, toys, electronics sub-assemblies, food processing, textiles, Christmas decorations and other items in demand in export markets - and real estate. By exploiting China's comparative advantages in abundant, skilled and cheap labour and light industry, FDI has led to enormous increases in productivity. FDI in the consumer goods sector has catalysed a vibrant domestic market and led to a visible relaxation in people's lives. A concomitant influx of tourists, businessmen and visitors (over 40 million a year) as China has opened up, has led to expansion and upgradation of China's tourism and services infrastructure.

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<sup>82</sup> *FDI Confidence Index*, Global Business Policy Council, A.T. Kearney Inc., February 2000.

FDI has built up a huge export sector in China. In 1996 the foreign trade of Foreign Invested Enterprises (FIEs) at US\$ 137.1 billion was 47% of China's total trade (official figures), albeit the import intensity of exports was rather high. A total of 17 million workers were directly employed by FIEs in 1996 and FIEs accounted for 14.5% of China's gross industrial output. Figures in more recent EIU reports indicate that in 1999 FIEs' contribution to industrial output had risen to 15.9%. In contrast the state-owned industrial sector saw its share of total output decline from 54.6% in 1990 to 28.2% in 1999. The share of the "collective" sector remained roughly the same. Data in Prof. Yasheng Huang's "*Why is there so much Demand for Foreign Equity Capital in China?*" (March 1999) – corroborates this:

1. The compound annual growth of FDI between 1990-97 was 44%.
2. Foreign Invested Enterprises (FIEs) also eclipsed any other sector in their profitability, in their relative contribution to the nation's exports and rapidly gained market shares in the light, electronics and chemical industries. Moreover, unlike TVEs, which challenged small and medium-sized SOEs in the light industry sector (which, as we have seen, are relatively expendable from the economic strategic point of view) - FIEs increasingly targeted sectors dominated by the big, strategic SOEs, after having acquired a significant presence in China's "pillar" or flagship industries (automotive, electronics and telecommunications)<sup>83</sup>.

### *FDI - a Chinese success story?*

The above notwithstanding, hyperbolic assessments of China's FDI success story should be qualified. The positive effects of FDI on economic well-being and its contribution to greater openness in Chinese society, especially when compared to current levels of FDI inflows into India which fall well short of the amounts required to achieve *our* targeted growth rate of 9% - are not under dispute. It may however be pointed out that eminent Chinese experts have critiqued this phenomenon<sup>84</sup>.

### Round-tripping

First of all, the figures have to be qualified. FDI is exaggerated by the practice of lumping the foreign/total debt portion together with foreign equity to increase the final foreign investment figures. It is also widely acknowledged that the phenomenon of round tripping (that is, Chinese capital going abroad and returning to take advantage of tax breaks given to foreign firms in China) inflates FDI estimates. The extent of China's illegal capital flight has traditionally been measured under the category of "errors and omissions" in the People's Bank of China documents, which set off net foreign exchange inflows against net increases in the country's foreign-exchange reserves. These have ranged from US \$ 12 billion and upwards annually for several years and have implicitly been taken to be an official estimate of "round tripping".

A more startling figure is suggested in an article in the *Far Eastern Economic Review* (FEER)<sup>85</sup>, which states "the staggering increase in so-called foreign direct investment into Hong Kong last year suggests a growing flight of capital out of China with Hong Kong providing a conduit for the transfer of hot money". Thus FDI in Hong Kong in 2000 measured US \$64.3 billion as per figures reportedly released by the Census and Statistics

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<sup>83</sup> It may be noted that while foreign investment in the manufacturing sector is assiduously courted and accorded preferential treatment, China *does not* allow foreign participation in the telecommunications and electronics *services* sectors, in contrast to India, although some breakthroughs have been reported here too.

<sup>84</sup> I must also give credit to my colleague Shri Biren Nanda, then Counsellor in the Indian Embassy in Beijing for sharing his insights on the subject with me.

<sup>85</sup> *China's Money Laundry* By David Lague, Issue cover-dated June 21, 2001.

Department on March 29, 2001, *closely tracked by an FDI outflow of US \$62.9 billion in "what makes Hong Kong's FDI figures suspect to some analysts"*. The article quotes Raymond W. Baker from Washington's Centre for International Policy "that most of what is coming into Hong Kong represents Chinese illegal flight capital that has gone abroad and re-established itself as a foreign entity.... A big proportion of it then goes back to China." Officials guess that money from tax havens and the mainland made up almost 70% of Hong Kong's FDI inflows in 1999, together with Taiwanese investment in the mainland as Taiwanese businesses have to "avoid Taipei's restrictions on cross-strait economic ties".

To an Indian, the plus side is that the funds return to the originating country and do not remain parked abroad, even if it is to take advantage of favourable tax breaks and other incentives. In contrast one is not aware whether capital flight from India ever returns as equity investment, except in response to the special high-interest yielding bonds on foreign exchange deposits offered from time to time to shore up the Government's foreign exchange position. The obvious difference is that China's FDI inflows create real assets on the ground. One suggestion was to use the expensive IMD proceeds for infrastructure development, but this did not materialise.

### Why does China need so much FDI?

Professor Yasheng Huang of the Harvard Business School's critique of China's FDI phenomenon is particularly thought provoking. He credits the huge FDI inflows to certain peculiarities of the Chinese economic system, and not only to supply side factors drawn by China's booming market and inexpensive, literate and disciplined labor force. Discounting the capital, technology and management skills imports arguments for China's appetite for FDI, he poses 3 important questions. Since the acceleration in the domestic savings rate (from around 36% in 1986-92 to 40.6% between 1993-97) has coincided with the explosive growth of FDI, "China should be awash with capital". So he asks –

1. Why *does* China require so much FDI?
2. Why do Chinese firms uniformly prefer FDI over arms-length contracts such as technology licensing agreements, as South Korea did, through which they can get the same benefits without ceding equity control to foreigners?
3. While strong economic growth may explain "the absolute size of FDI inflows into China", it does not explain why "the relative size of FDI—i.e., FDI/capital formation ratio—has also grown" -- since domestic *and* foreign firms should be equally motivated to invest in a booming market. Instead the ratio between foreign and domestic investments has changed "drastically ... from nil at the beginning of the decade to about 18% in 1994 and to around 12% in 1999"<sup>86</sup>.

There are other peculiarities that are pointed out by Prof. Yasheng Huang. Citing an article in the *AWSJ*<sup>87</sup>, which I also recollect seeing several years ago, China reinvests about 40% of its foreign exchange reserves in US treasury bonds on which it gets a lower return than it pays out on its foreign debt. As Prof. Huang points out, the "Chinese are striving to give up ownership of their economy only to use the capital surpluses to invest in low yielding government bonds in America". He also found that:

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<sup>86</sup> The ratio of FDI to domestic investment was at par with the open economies of the UK and Holland despite the fact that China was not viewed alongwith them as an open economy. FDI/DI ratio for developing countries in the early '90s was approximately 5% -2% for Thailand, 1.5% for Indonesia, 0.2% for South Korea etc.

<sup>87</sup> Cited in *Why is there so Much Demand for Foreign Equity Capital in China? An Institutional and Policy perspective*, by Yasheng Huang, Weatherhead Centre for International Affairs, Harvard.

1. FDI is not found to be a significant conduit for technology imports. Case studies show that “technological levels in mainland Chinese industry are still behind those of Korea and other East Asian economies. Moreover the vast majority of FIEs is formed with small firms in Hong Kong and Taiwan with little technological content”, “while Taiwanese firms investing in Southeast Asia and other regions are mostly large firms”<sup>88</sup>. Apparently “Many Hong Kong and Taiwanese ...capitalized their standard and mature equipment and machinery as equity stakes in FIEs in China” whereas buying this machinery would have been simpler. Prof. Huang concedes that in angel ventures, loan capital is indeed difficult to obtain because of the banks’ risk perceptions of such investments, and recourse therefore has to be made to equity capital. But the venture capitalist paradigm does not apply to the vast majority of Chinese firms seeking FDI.

Prof. Huang goes on to explain the Industrial Organisation (IO) reasoning for FDI, which predicts that MNCs would be prevalent in those industries that involve a heavy use of ownership specific advantages over domestic rivals which are usually technology, management skills, marketing expertise etc. FDI also takes place when assets such as trademark, patent or critical know-how cannot be transacted via an arms-length arrangement, and ownership stakes are required before these are shared. Thus MNCs should be prevalent in those industries that involve a heavy use of these assets, since “financial and physical capital is supposed to constitute one of the very important ownership-specific advantages of the MNCs”. Instead the data suggests that FDI is spread over a broad range of sectors, and not focused in sectors in which foreign firms have specific advantages. FIEs are also more dominant in industries of low capital intensity. Finally the sheer magnitude of FDI inflows into China and the very large scale of concessions conferred on FIEs – “defies common sense that all the FDI cases involve proprietary assets that cannot be obtained via alternative means of firm alliances such as licensing”. Also unusual is that FDI is pervasive even in those relatively low-tech areas “in which China possesses a huge comparative advantage (such as garment and shoe making)” and in the handicraft industry, in which average foreign equity shares have been calculated by Professor Huang to be 88% of the total.

2. The level of management skills acquired through FDI is also not of a high standard, and the same technology and skills may be acquired through royalty and licensing agreements.

3. China’s cheap labor supply is supposedly another motivating factor. But foreign firms have the alternative to subcontract or outsource production to China.

4. While the extent of SOEs’ insolvency is well known, Prof. Huang points out that “less familiar is the fact that SOEs have built up a potentially valuable asset base during the reform era, which the banking system financed through a generous infusion of subsidized credit... rendering them potential acquisition targets... because the government explicitly shuns a privatization stance, the only viable acquirers end up being foreign firms.” **FDI rises on this account, and good assets are snapped up inexpensively by foreign firms.**

So he feels we should ask what are the factors encouraging FDI relative to domestic investments, and he offers the following explanations:

1. While private domestic firms are discriminated against vis-à-vis SOEs (they do not enjoy equal access to State Bank loans for example), foreign investors are actively courted

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<sup>88</sup> Source: Publications by Professor Yasheng Huang, Harvard Business School, *Why is Foreign Direct Investment Too Much of a Good Thing for China?* and presentation at a Seminar at Harvard University.

through special tax rates (some of these are being withdrawn), infrastructure and other incentives. It would be impossible to imagine special treatment and tax cuts of the above kind given to foreign enterprises in India. The “Bombay Club” of major Indian industrialists (joined by the Leftist intelligentsia *and* fundamentalist outfits!) had loudly protested any move to favour foreign enterprises on Indian soil and demanded a level playing field for domestic and foreign investors even before any significant foreign investment had begun to trickle in!<sup>89</sup>. SOEs therefore have enormous investment appetites because of their soft budget constraints and preferential access to State Bank loans, which may also explain their attraction to FDI.

2. *Domestic private firms* enter into equity alliances with foreign firms “to access the better legal protection afforded to foreign firms”.
3. *SOEs* forge equity alliances with foreign firms because FIE managers enjoy greater “autonomy and protection from state interference”.
4. Another incentive is the lack of rights to access and retention of foreign exchange by private firms (China’s foreign exchange market is still evolving, from swap centres to a more liquid but still restricted current account convertibility). A joint venture is frequently the easiest way to circumvent this obstacle.
5. Because of intra-provincial competition for capital, provincial protectionism and restrictions on inter-provincial exports of capital, foreign firms serve “as a source of financial intermediation”, “liquid capital”, and “arbitrage” especially “to firms that are fundamentally sound but suffer from an externally imposed liquidity crunch”. “Foreign companies have thus acquired a greater financing role in the Chinese economy” given the “financial market inefficiency” in the form of financial segmentation along regional lines, which would not materialize if capital was allowed to flow freely.

Prof. Huang concludes “the financing roles of MNCs arise not because China is short of capital but because its financial allocation is ...inefficient” and a more viable method would be to speed up privatisation and to support the domestic private sector, but this would go counter to State ideology.

#### *Lessons for India*

The above critical examination of one of the hottest FDI success stories on the planet was to ensure that we in India (a) derive the right conclusions and learn the right lessons and (b) identify where we need to improve the scenario in India so that we attract the right FDI and do not jeopardise the growth of our own companies. It is not meant to run down the Chinese phenomenon, which is admirable in many respects.

#### *What’s sauce for the goose...*

First of all, while there is much that needs to be emulated, there should be no blind copying of China’s policies. We must attract FDI for the right reasons. Some of the reasons FDI does not jump into India may after all be the “right reasons” - it does not need to play the role of a financial intermediate, it does not find domestic firms a push-over because we have refused to deliberately place our own companies on a weak wicket, it does not come in

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<sup>89</sup> While I am on the side of the liberalisers, I could see the other side's point. No nation should surrender its crown jewels without a good *and fair* fight. In India unfortunately we are putting up too good a fight. We need the competition that sheer exposure to FIEs will bring. Yet as Prof. Huang pointed out in an April 21, 2001 Seminar in Coolidge Hall, Harvard University, given the US \$ 40 billion of the world's investment flowing into China per year, and a much higher savings rate, India’s growth rate was surprisingly not far behind China’s, suggesting we were getting some things right, something my colleague Mr. Biren Nanda, had pointed out to me earlier.

because we require low-grade management skills or technology. India is also inhibited from offering the tax incentives and other preferential treatment accorded to FIEs in China, which under India's national treatment laws are not possible, besides the uproar that would be caused if any such move were contemplated. These are our strengths.

No one is suggesting that we revert to the autarkic policies of yesteryear. But a country as large as India must have its own crown jewels –strong, homegrown Indian firms. So another reason not to blindly follow China's way is the consequences of too much FDI which I quote in full from Prof. Yasheng Huang's essay because they contain important lessons for India - "Much of the export channels are in the hands of foreign firms already, so is the control of the most dynamic firms in the electronic, garment, machinery, and automobile industries. What the WTO is going to bring about is foreign encroachment on state-owned service monopolies, notably in banking, wholesale and retail, and telecommunication industries, industries in which the state has fiercely resisted opening up until now. Had the government chosen an entirely different reform sequence, by first opening up the financial service providers to both foreign and domestic private entities, it is quite plausible that Chinese control over its manufacturing operations would have been greater. Had the financial resources and corporate opportunities been allocated to firms with good business acumen and the right mix of performance incentives, there would have been world-class Chinese private firms, most likely in household appliances and electronics, such as those in Korea and Japan emerging from their economic takeoff eras."

My assessment is not as bleak, because a good majority of these firms are partnerships with overseas Chinese from Hong Kong, Taiwan etc., who are frequently ready not only to take their profits in the local currency, but also to reinvest profits in the Mainland. After all those assets would have to be left behind should the investor decide to cut and run. Thus, Prof. Huang's apprehension of permanently alienating assets to foreigners may need to be qualified, especially if Taiwan gives in and reunites with the mainland, which Hong Kong has already done. In addition, despite the skewed nature of the FDI scenario, China's manufacturing sector is flourishing while ours is not and more recently Taiwanese investors have started to bring in high technology too.

**Lesson 1.** Ultimately the lesson for us is that the option of Indian firms mobilising the funds, making the necessary investments and bringing in the required technology, is preferable. Only then can we build the necessary competitive core of our economy to enable us to attract high-quality FDI, and face foreign competition at home and abroad confidently and on equal terms. We come back again to the basic issue of implementing the required reforms to help the Indian manufacturing sector. This brings us to the **importance of privatisation.**

It is clear from China's experience that we must try to strengthen our own companies. Privatisation will create a leaner (but not meaner) economy with high productivity. This will also encourage FDI. Latin American countries attracted enormous amounts of FDI through privatisation, and we should also not eschew the prospect of high FDI realisations from privatisation, particularly in non-strategic sectors. However, there is no need to structure the privatisation at the cost of efficiency enhancing measures, as these rebound in the long-term.

**Lesson 2:** We must not allow the privatisation programme to be stalled, otherwise the only companies which will win shares in the Indian market-place will be foreign as is happening in China. It is not a contradiction to simultaneously desire high FDI inflows through this route. Strong companies, both foreign and domestic, will make the entire

economy stronger. If we don't privatise, weak companies will be left facing foreign competition and the domestic sector may be swallowed up.

*Missed the Big Boat*

Shakespeare rightly observed - "*There is a tide in the affairs of men, which taken at the flood, leads on to fortune; Omitted, all the voyage of their life, is bound in shallows and in miseries*" – *Julius Caesar*

Hopefully the above quote will cease to apply to FDI inflows into India. But China certainly had several advantages, which India will never have. These include a large and wealthy Diaspora with an inclination to invest its surpluses in manufacturing in the motherland. The overseas Chinese did not chaff at foreign exchange restrictions and earning obligations, or at the prospect of earning their profits in the local currency, and were quite comfortable with other limitations in the policy environment because they moved into the export sector.

China opened up at the same time as countries and economies like Japan, Taiwan, Hong Kong and South Korea were looking for investment destinations for their capital surpluses and to relocate sunset industries, while India missed out on the era in which labour intensive production was being relocated to cheaper bases in China and South East Asia. As Taiwan's economy matured, it relocated huge manufacturing facilities to the mainland. Hong Kong acted both as a source of original investment as well as a conduit for "round-tripping".

**Lesson 3:** So for both reasons it is unreasonable to expect India to approach the levels of FDI inflows China has.

*A rising tide lifts all boats*

The decline of FDI inflows in the late nineties mirrored the corresponding decline in domestic investment caused by a host of factors already analysed earlier. While the restricted nature of the domestic market has not created the economies of scale for large foreign investments, the economic slump in India, especially in the manufacturing sector, has introduced additional disincentives to FDI. The real improvement will come when the remaining shackles on the economy – fiscal overhang, poor infrastructure, expensive power and labour rigidities are removed - and domestic market deficiencies are ironed out, in short, all the factors holding back domestic investment and over which the media and industry have been crying themselves hoarse – are addressed.

**Lesson 4.** We need to emulate China's example with massive investments in infrastructure, power, introduce labour market flexibility and economies of scale, which will help our own industry too. This is the real lesson, not preferential policies in favour of foreign investors - that we *should* act upon.

### **Chinese incentives**

Besides the above, factors that countries cite when choosing China as a preferred destination, from the politically incorrect flexibility of labour laws, to the conducive environment for doing business, are simply absent in India. Chinese special economic zones look like enclaves from the first world. We are entranced by China's tax breaks and preferential treatment policies and forget that other crucial aspects are *assured* power supplies, water connections, special personal accommodation facilities (entire up-market

housing colonies are reserved for FIE managers), fast-track decision-making mechanisms including greater provincial autonomy in economic decision-making, easy land acquisition policies and above all a genuine one-window FDI processing facility to create the hassle-free environment investors are used to in their own countries.

India's attempts to genuinely liberalise its foreign investment scenario is not succeeding because red tape continues to plague foreign investors, making FDI in India more trouble than it is worth. As it is, lowering of tariffs is making tariff jumping, market seeking FDI unattractive (China maintained a fairly opaque trading system while liberalising its FDI policies).

**Lesson 5. We have not only to match China's operating environment but give extra incentives to attract foreign investors (and incidentally retain our own).**

## **CHINA'S SUCCESS IN FOREIGN TRADE**

China follows a classical mercantilist policy in its external trade regime, fully supporting and subsidizing exports while regulating imports in accordance with its specific objectives. The Chinese market is therefore actually highly protected, barring smuggled goods which gain surprisingly easy entry. Any opening up of its import regime has been made mainly due to external pressure in the WTO entry negotiations or if warranted by its own interests. An indirect proof of the fact that China is still closed in many ways is provided by the fact that while practically *all* countries in the world are suffering an economic slowdown, China is the only growing economy besides India.

To go back a little, in the March 1997 negotiations in Geneva on China's entry to the WTO, China pledged that it would make its foreign trade rights freely available to domestic and foreign investors within 3 years. It is instructive to read the terms of the *current* US-China agreement on WTO entry. Very little has changed on the assurances front. Assurances spanning many areas (agriculture, industrial products, tariffs, elimination of quotas and licences, right to import and distribute, services, telecommunications, insurance, banking, audiovisual, travel and tourism, textiles, anti-dumping and subsidies methodology and product specific safeguards) to open the market *after* it joins the WTO have been made, whose consequences would indeed be revolutionary for China. Meanwhile very little movement on any of these issues, including opening up of services sectors such as telecommunications, banking and insurance, has taken place. China has therefore bought time, continuing to enjoy the fruits of full export access to other markets while the WTO talks drag on and China's markets remain relatively closed.

The import regime is still very complex, characterized by a host of licenses and import quotas, stringent regulatory controls, registration, commodity inspection, phytosanitary and quarantine rules, high tariffs including customs duties, VAT and other levies on finished goods. Average tariffs are low because China (very sensibly) levies very low tariffs on inputs and raw materials for its domestic industry and tariffs on raw materials and inputs for export processing are non-existent. Escalation on value added is steep, almost exponential, and competitive products thus find it difficult to break into the market. The best way to sell in China is to manufacture there. It is because of these onerous conditions and others (foreign exchange balancing for Foreign Invested Enterprises, bans on domestic distribution, limited foreign trade rights, export obligations) that the major part of foreign investment in China was from Hong Kong and Taiwan i.e. the Chinese diaspora rather than MNCs, as the former did not mind investing for export since it coincided with their own interest in relocating to a neighbouring, low-cost manufacturing base next door. The



impenetrability of the Chinese market once prompted an American wit to characterise US exports as having the penetrative ability of a wet noodle.

The above policy has been very successful. During 1978-94, international trade grew at an average annual rate of 16.5%, making China one of the top trading powers in the world and increasing its share of world trade to over 4%. China developed a highly vigorous export sector which has profoundly stimulated its economy.

Official Chinese studies have however found that value added on China's exports is not very high. Also since imported inputs for exports are allowed to enter duty free, there is diversion and little value added before the final product is exported. These are reflected in China's trade statistics to an extent, with imports closely tracking exports. Considering that FDI enterprises account for a vast proportion of China's exports, a matter of concern for China is that foreigners reap a large part of the profits from them. Still, some portion is reinvested, technology is upgraded, over the years the production base has become more sophisticated leading to creation of more virtuous cycles, vast employment is created and the general volume of economic activity is higher.

Amongst other barriers to imports is the fact that domestic distribution of exports to China remains closed to exporters. Traditional State monopolies of distribution networks present high non-tariff barriers for foreign firms trying to access the Chinese market. This, together with denial of the right to deal directly with the end-buyer, had driven many foreign firms to opt for joint ventures in order to sell their products in China, a classic case of tariff jumping. Thus, one of the major demands of some of China's negotiating partners in the WTO is to open up its wholesale and distribution sectors to foreign investment and participation.

China has agreed to limited opening in services sectors after it accedes to the WTO. China has its cake and is eating it too, reaping the advantages of an open trade system while postponing concessions of its own. The merits in this approach are that it allows the Chinese economy to restructure, just as India is doing, behind protective walls. The demerits are that restructuring decisions in several sectors are put off, in a classic Waiting for Godot mentality that all this can be achieved after WTO admission.

### *Lessons for India*

China's foreign trade and foreign investment regimes are complementary. The former ensures cheap inputs for the export processing/manufacturing sector, while the latter ensures funding and technology to achieve the required standards. At the same time the domestic market is protected so FIEs have an additional incentive to invest. The results have been predictable - FIEs are powering growth and exports and making up for the State-owned sector deficit. India must also attract more FDI though the mercantilist option is definitely out – that era is over. We have eschewed the opportunity to attract tariff-jumping FDI (Prem Shankar Jha, the brilliant Indian columnist, is one of the advocates of this strategy). In the long term, opening up will force our own companies to gear up instead of ceding the advantage to foreign firms. It will also further expose the futility of propping up the public sector. In short, we have little to learn, besides rationalizing our duty structures and all the other measures already elaborated to revive growth, some of which we are in the process of implementing, from China in this area. The success of our export effort will depend on domestic growth and technological upgradation, so that A.T. Kearney's observation that India suffers from a poor image as an export base is obliterated from people's memories.

## 9. AGRICULTURE

The legacy of colonialism (regular famines and chronic food shortages) was overcome through the Green Revolution. Current foodgrains production is 206 million tonnes, from 51 million tonnes in the early fifties. India has become one of the world's leading producers of rice, wheat, coarse grains, pulses, cotton, tea, spices, cashew nuts, mangoes, bananas and vegetables, with exportable horticultural products rising sharply in recent years. India is the world's biggest producer of milk. From a massive food importer India has become a net exporter of agricultural products.

### IS THERE A NEED FOR AGRICULTURAL REFORMS?

Today, many bemoan that Indian agriculture has been neglected in the reform process. Others contend that "the proposition that there are serious regulatory impediments in agriculture is far from self evident – it is sometimes argued that the agriculture sector does not offer opportunities for reforms as production has remained in private hands and been exempt from direct controls<sup>90</sup>". Still others point out that suggestions to liberalise agriculture seem to be more contentious than reforms in other sectors – that the political economy of Indian agriculture prevents the Government from undertaking reforms.

But it is evident that despite talk of “surpluses” and huge buffer stocks, mass malnutrition persists, vast land tracts are rain fed and reforms have not extended to the countryside. Earlier critiques of the long-term unsustainability of a high input-cost, capital and chemical-intensive agricultural strategy have found partial vindication as input subsidies (and fiscal deficits) burgeon on account of a subsidised food distribution system. Attention *has* therefore become focused on the need for urgent reforms.

India's achievements are firstly placed in a relative context in Table 5<sup>91</sup>. Comparative statistics on India and China's foodgrains and meat production suggest that China has higher yields<sup>92</sup>.

The primary cause for relative poverty in India is rural inequality and inequitable landholdings (65% of the total arable land is in the hands of 10% of the farmers). China's land reforms were more evenly implemented than India's. Agricultural productivity in China however stalled after the initial surge following reforms in the early 1980s, as productivity gains petered out, external funding was not available, and controls and levies were reintroduced. This was similar to the Indian system, leading to similar problems of mounting budget deficits and distorted price structures. However China's overall production is higher than India's, especially in foods higher up in the value chain.

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<sup>90</sup> Taken from the excellent essay "Economic Reforms in Agriculture and Rural Growth", by Ashok Kotwal and Bharat Ramaswami in "India in the Era of Economic Reforms" -edited by Jeffrey D Sachs, Ashutosh Varshney, Nirupam Bajpai. They argue in fact that there are several areas in which reforms can be implemented especially in freeing internal trade and marketing restrictions.

<sup>91</sup> Source for India: ERS Dec 20, 2000; China: ERS, 1999 except as otherwise indicated. \*RBI Annual Report, August 2000 -Agriculture and Allied Activities.

<sup>92</sup> However some other productivity statistics compiled by the WDR seem to show greater value added per worker in India. This could be explained by the finding that "Secret satellite images show that China grows crops on 47% more land than China officially admits." (Cited from: MacKenzie, D.: China Crisis. New Scientist, Vol. 158, No. 2131. MEDEA (led by McElroy, Michael) – spied (excuse the pun) on a web reference.

**Table 5: India and China Agriculture Compared**

India		China	
Agriculture's Share of GDP			
<b>2000</b>	25.5%*	1998	31%
Population Rural	750 million		870.2 million
<b>Proportion</b>	74%	Proportion	69%
<b>Labor force</b>	Employs 68%*		Employs 50%
<b>Land area (million hectares)</b>			
<b>Total</b>	297.4	Arable land	130
<b>Cropped</b>	185.5	Sown area	156.4
<b>Irrigated</b>	66.14	Grain	113.2
<b>Major crops (million metric tons)</b>			
<b>Total</b>	206 -current		N.A.
<b>Rice</b>	84.7		198.5
<b>Wheat</b>	71.0		113.9
<b>Coarse grains</b>	31.0	Corn	128.1
<b>Total oilseeds</b>	26.5	Peanuts	12.6
<b>Groundnut</b>	7.5	Rapeseed	10.1
<b>Soybean</b>	6.0		14.3
<b>Total oils</b>	5.6	Other grains	12.6
<b>Total oilseed meals</b>	13.0	Tubers	36.4
<b>Cotton</b>	2.8		3.8
<b>Sugar</b>	15.0		
<b>Tea</b>	0.81		
<b>Livestock products (million tons)</b>			
<b>Milk</b>	74.5		
<b>Eggs (billions)</b>	33.1	Beef	5.1
		Pork	40.46
<b>Poultry</b>	0.67	Poultry	11.26
<b>Mutton</b>	0.91		2.5
<b>Agricultural productivity –value added per agricultural worker –source World Development Report 1999/2000) 1995-97 – 1995 US \$</b>			
	343		296
<b>Foodgrain production index 189-91-100 (WDR)</b>			
<b>1979-81</b>	1995-97	1979-81	1995-97
<b>68.4</b>	117.1	61	155.8

To encourage higher foodgrains production in India, the government instituted the new agricultural strategy in the 1960s - or the Green Revolution: The last 14 consecutively good monsoons led to swelling stocks, stretching the carrying capacity of central agencies to the full. The food subsidy<sup>93</sup> in fiscal 2000-01 exceeded the already bloated budgetary allocation by 50%. A targeted public distribution system (PDS, or TPDS) with higher issue prices for the above-the-poverty-line (APL, BPL stands for Below-the-Poverty-Line) consumers was launched to recoup part of the costs. But the narrowing of the gap between APL and market prices and quality differentials led to an exodus of buyers to the private market and a decline in PDS wheat offtake by APL families! Thus the "food subsidy" was not contained.

<sup>93</sup> The so-called food subsidy in the central budget is a misnomer as it is not a subsidy to consumers - it is the difference between FCI's sales realisations through the PDS and the cost of grain procurement, storage and distribution. A steadily rising element in FCI's costs is the *procurement price* set by the Central Government - at which rice and wheat are purchased, and is therefore a *producer subsidy* as the Expenditure Reforms Commission or ERC has correctly pointed out. There is also diversion of perhaps as much as a third of the stocks into the open market.

As Ashok Mitra, former Finance Minister, West Bengal<sup>94</sup>, and others have pointed out, big farmers and rich peasants represent a powerful political lobby that compels Governments to fix above-market procurement prices. The Agricultural Prices and Costs Commission which fixes minimum support prices, is frequently bypassed, a practice strongly criticised by the Expenditure Reforms Commission (ERC), which has made pertinent recommendations on agricultural reforms and on downsizing food sector subsidies. Prem Shankar Jha repeatedly pointed out in the year 2001<sup>95</sup> that the Punjab Government had instructed its procurement agencies to buy up all foodgrains at higher support prices. Since the Centre was dependent for political support on grain-producing areas, it could not refuse the demand to raise the MSP.

The Central Cabinet Committee on Economic Affairs predictably fixed the minimum support prices for wheat for the 2001-02 marketing year at Rs. 6100 per metric tonne, Rs. 300 more than the previous year<sup>96</sup>. The decision followed lobbying by the Chief Ministers of Punjab and Haryana, who had vigorously opposed the CACP recommendation and lobbied instead for an increase. An attempted immolation by a farmer, one of the thousands gathered to protest against a possible adverse decision by the Government, provided the tragic backdrop to the drama. Noted activist Vandana Shiva is sympathetic to the farmers' plight, pointing out that costs in a chemical-intensive agriculture have inevitably become higher than support prices, and that farmers have been pushed into a negative economy reflected in debts, suicides and kidney sales.

Vandana Shiva also points out that growing food stocks are *pseudo surpluses* as they reflect the decreasing purchasing power of the poor, following increases in issue prices in the 1990s. While these pseudo-surpluses reflect increases in production of wheat and rice, they do not reflect decreases in the production of other equally important crops like pulses and oilseeds. Nutritionally valuable crops are thus being displaced as the incentives regime favours foodgrains production.

Kotwal and Ramaswami<sup>97</sup> correctly point out that though many recommend equalisation of domestic and international prices by removing external trade controls including canalisation (channeling) through State-trading agencies, domestic marketing and processing is also subject to many controls, which are:

- Procurement levies (sugar)
- Monopoly procurement scheme in cotton
- Laws to curtail storage of commodities
- Prohibition of futures markets
- Formal and informal controls on movements of commodities
- Licensing of milling activities such as in sugar
- In many agro-processing activities production is reserved for small-scale units only (e.g., poultry feed manufacturing, crushing of certain edible oils).

Over 90% of fruits, vegetables and milk are consumed fresh or wasted, with great regional-cum-seasonal disparities over prices. Processed food demand is growing at 8-10% per annum. Perhaps this explains why even though India is the world's second largest producer of fruits, vegetables and milk, only about 5% of output is processed and consumed

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<sup>94</sup> Rediff Page, December 22, 2000.

<sup>95</sup> Several articles in *The Hindu*, 2001.

<sup>96</sup> *The Hindu*, March 24, 2001.

<sup>97</sup> "Economic Reforms in Agriculture and Rural Growth", by Ashok Kotwal and Bharat Ramaswami in "*India in the Era of Economic Reforms*".

in packaged form. This highlights both the potential for the food processing industry and the lack of a policy to promote this sector. The Union Budget 2001 has however initiated some reforms to address this situation.

## REFORMS

The issues seem to be understood by policymakers. In a key development, the Finance Minister in his Budget speech (Feb 28, 2001) announced a potentially major change in procurement policy by shifting responsibility for procurement from the Central to the State Governments. Financial assistance would be provided to the latter to procure and distribute foodgrains to BPL families at subsidised rates. FCI would continue to procure foodgrains for the food security reserves and for such State Governments who assigned it this task. State governments would henceforth be required to produce utilisation certificates for foodgrains supplied for underprivileged sections by the Centre. Earlier, it was available on the entire quantity of grains for distribution under the PDS.

This **has the potential to impact the subsidy in a big way**. Such a shift also opens the way for decentralisation of policy regarding fixing of the MSP, and a consequent shift of lobbying with State Governments rather than the Centre. Needless to say this change has the potential to raise a great deal of controversy if it is perceived as inimical to local interests.

The Finance Minister in his Budget Speech of 2001 stated that “*Our policy has to be transformed to deal with surpluses rather than only shortages*”. The Budget gave incentives to build rural infrastructure to market produce and removed excise duty on fruit and vegetables preparations to boost the food processing sector. Lending rates were cut, and an assurance given to remove restrictions on the inter-state movement of food grains under the Essential Commodities Act (1955) *and* reduce the number of commodities under the Act. The National Agriculture Policy had talked about enlarging the coverage of futures markets in all important agricultural products to minimise the wide fluctuations in commodity prices and for hedging risks. A beginning was made in the Budget by announcing introduction of futures/forward trading in sugar within the coming year (2001-2002) before full decontrol.

## CHINA LIBERALISES

The above reforms are in the right direction. The Government has not tackled the issues of fertilizer and power supplies subsidies however. China is already moving fast to withdraw ruinous and unsustainable support to the sector and its example is once again instructive. According to the Economic Research Service of the US Department of Agriculture, the Chinese government on September 1, 1999 abolished both the officially set prices for cotton and levies (mandatory cotton sales to government) for the 1999/2000 crop year, leaving it to the market to determine prices<sup>98</sup>. Years of mounting cotton surpluses as farmers ignored international market signals and a growing financial burden on the government had compelled it to liberalise the cotton sector. Following these reforms, the *Economic Times* reported that world cotton prices crashed due to very high recent production in China. In India in contrast the Government has decided to perpetuate the Maharashtra monopoly cotton procurement scheme for 5 years.

The Chinese government has also liberalised the grain sector, where it has similar food security compulsions as the Indian government. For the year 2000, government support and purchase prices for lower-quality rice, wheat, and corn procured under fixed levies has

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<sup>98</sup> <http://www.ers.usda.gov/briefing/china/jumptobody>.

been reduced. A gradual drawing down of China's enormous stockpile of grain is expected to more than offset any resulting decline in grain output and moderate prices.

## **DIRECTIONS**

Increased investment in agriculture, greater market orientation, building the necessary physical infrastructure to bind market and producer, gradual reduction of the MSP and producer subsidies, reform and downsizing of the FCI, greater non-fiscal incentives for crop diversification and lifting of marketing restrictions are clearly where the reforms should be headed. Reforms to land ownership to enable commercial investment to flow into agriculture must be considered, since Chinese-style land reforms would only lead to extreme fragmentation of already uneconomic holdings. It could lead to rationalization of incentives and dilution of the power of agricultural lobbies.

Exports of produce and investment should be encouraged. The ERC Report noted that current production and a comfortable foreign exchange balance provided a window of opportunity for exports, with the assurance that shortfalls would be made up through imports. It would lead to greater market responsiveness, development of assured export markets, elimination of discretionary power over agricultural trade and diversification as export markets open up new options. Thus the government decided to export 5 million tonnes of subsidised wheat in 2001-02. The move can be justified when seen against the urgent need to draw down stocks as a short-term measure. Much faster reform on the unfinished agenda summarised above is required.

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## 10. OTHER ISSUES

### POVERTY

China's impressive achievements in universal primary education and health are praiseworthy. But economic growth has also been accompanied by significant increases in inequality - between the urban/ coastal and rural/ inland areas of China. Recent World Bank calculations show that India, with a Gini co-efficient of 0.29 is among the twenty least unequal economies in the world, while Brazil is among the most unequal, with a Gini co-efficient of 0.47<sup>99</sup>. China's is 0.39, surprisingly worse than India's. The *People's Daily* dated March 16, 2001 carried the text of a Press Conference with Premier Zhu Rongji, in which he stated that the Gini co-efficient of China stood at 0.39 in 1999, "close to the international danger level".

India's per capita growth in the last 2 decades has increased from 1.3% in the 1950s-1970s to 4% annually. Also, on the basis of a new sampling methodology based on weekly recall, India's population below the poverty line is said to have decreased since the reforms began. On the basis of additional anecdotal evidence, the possession of material goods has spread to a much larger proportion of the population, and there are signs of increased prosperity in many parts of the country. The concern is over the widening gap between some States and the increase in relative inequality as not all sections have benefited equally from reforms. It is important for this reason to implement the whole range of policies advocated above for improving mass welfare. Only faster economic growth will solve this perennial problem.

### COMPARISONS WITH SOUTH KOREA

I was briefly fascinated by South Korea's economic success, particularly when I found out that it achieved its astounding growth without any significant FDI inflows. While most experts attributed its economic growth to the adoption of an export-oriented strategy, Prof. Dani Rodrik of Harvard University preferred to give pride of place to massive capital investment by the State. Having seen what difference good infrastructure made in China and in South East Asian countries, I was very much inclined to agree. However, the importance of an outward-oriented strategy cannot be dismissed. Prof. Jagdish Bhagwati pointed out this was the crucial difference between the failure of the Indian experiment and the Korean success story. Korea also initially built on its core competitive advantage and embarked on the heavy chemical industry promotion binge much later, in the 1970s, after having built up the momentum, requisite savings rates and export orientation.

Prof. Dani Rodrik also suggested that the prevalence of greater homogeneity, lack of deep class divisions within Korean society and greater equity meant that the Korean government was not obliged to implement redistributive policies, which were used to justify a huge state apparatus and misdirected subsidies in India. The Japanese left behind a primary education system, an area neglected by the British and not sufficiently addressed by the Indian State. The *chaebol* also were patterned on the *keiretsu* model of Japan.

However, even the Korean model suffered from distortions brought about by State intervention. It appears that State intervention, which is normal enough for late development economies, is never an unmixed blessing and carries heavy costs. Taiwan presented a more even pattern of development, as the State was not as ubiquitous as in Korea. In the Korean

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<sup>99</sup> *World Development Report 1999-2000*, World Bank, Table 5.

case, the State allocated funding through banks and decided the overall industrial strategy, to say, develop industries in sectors which were to face global overcapacity. This set the stage for the moral hazard that built up in the Korean system and which made it vulnerable during the 1997 Asian financial crisis. Also, like India because of the co-existence of a flourishing private sector and the Korean State taking an active interest in the economy, there were opportunities for rent seeking. However this was not as serious a problem as in India as explained earlier. Another difference of course was that it was easier for pro-market philosophies to be adopted in Korea than in India, given the then strategic outlook of the 2 countries. Finally, it seems that an authoritarian structure facilitates policy implementation if the leadership is committed to the national good, as it was in the first few decades of South Korea's development, and hinders it when the latter is not.

Despite its massive, indigenously inspired success, Korea also is now opening up to foreign capital, with many flagship companies under foreign majority control. Does it mean that Korea is going the Chinese way?

As an aside, perhaps Globalisation's deeper significance is that all models are slowly unraveling and being unpackaged under its leveling influence, and converging to the so-called Anglo Saxon model from whichever starting point they came from. So, India is finding its own way towards this model rather than the Korean, or the Chinese, or the South East Asian. After consideration, I think the Koreans are also heading that way. So are the Taiwanese, and so will the South East Asians.

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## 11. DANGERS AHEAD

**Unfinished legislation and delayed decision-making:** Comparing with China's orderly decision-making structures - India's institutional and constitutional arrangements create far too many tiers of decision-making, or veto points as Prof. Devesh Kapur calls them, which lead to serious delays. A fractious polity which has traditionally not been united in a common vision of India's greatness, and which plays football with economic decisions, adds to the problem. Amongst legislation which has waited or will wait through several Parliament sessions to see the light of day are amendments to the Industrial Disputes Act promised in the Budget (labour reforms), the Banking amendment bill which was to reduce the government's stake in the nationalised banks to 33% etc. Nor has the government concluded internal consideration of crucial legislation - the Electricity Bill, the Fiscal Responsibility and Budget Management Bill, which is being opposed by the Opposition in the concerned Parliamentary Standing Committee to forestall imposition of any curbs on the future ability of governments to spend - and the all important Convergence Bill. Many of these Bills are unlikely to receive general support, especially in the Rajya Sabha.

On the other hand many institutions to encourage inter-State consultation and speedy decision-making have been set up. The latter include the IT task force, the group on telecom, PM's economic advisory council, the Cabinet Committee on Disinvestment and others.

**Dangers to the economy:** If not addressed current trends could accentuate the shrinkage of India's manufacturing sector. In "The spectre of de-industrialisation"<sup>100</sup>, Prem Shankar Jha has warned of the dangers of slowing job creation and the de-industrialisation of the country with the final removal of quantitative restrictions on imports since April 1, 2001 fulfilling WTO commitments. The Business Standard reported that the usually mild Director General of the Confederation of Indian Industry (CII), Tarun Das, conveyed the industry's disillusionment with the government on the economic front - the slow pace of the disinvestment process and implementation of various infrastructure projects. The lack of progress in tackling corruption also means that this black hole sucking out the vitality of the economy and creating an irreversible decline in value systems keeps claiming new victims.

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<sup>100</sup> *The Hindu*, July 24, 2001.

## WELL THEN, CAN WE?

To sum up, the reason for India trailing China are the self-defeating policies followed in the first few decades after independence, the inordinate time it took to break out of that mould, and the slow, limited and hesitant nature of reforms thereafter.

Meanwhile China has devised a model in which the State directs the market reforms and plays a pervasive role in the economy. One proof of the fact that China is still closed in many ways is provided by the fact that while practically all countries in the world are suffering an economic slowdown, China is the only economy besides India that is still growing. A strategic role for the State sector, a highly controlled foreign trade regime reinforcing China's export juggernaut, and a selective but effective policy to attract FDI in manufacturing adds up to an engine for growth, whose mechanisms are constantly evolving in order to keep up with changing circumstances. Thus the restructuring drive in its State-owned sector has the potential to vastly improve economic efficiency. The private sector is gaining in strength despite its disadvantages. WTO entry (when that comes) would bring about revolutionary changes in its economy through the need to radically change and open up the foreign trade, agriculture, telecom services, insurance and banking sectors.

Institutional foundations *independent* of the State for this growth are however still fairly rudimentary. China's dynamic economy is evolving within the confines of a preset institutional framework, some of whose axioms are inviolable. This form of 'straitjacketing' inevitably imposes some penalties. State control is not being reduced in core areas, with the result that this Atlas carries a heavy burden - the beleaguered State and banking sectors (the reason China will not open up these sectors unlike India), the indigenous sector not being as robust as the foreign-owned and finally the risks perceived in economic models with too pervasive a State presence. Countries with a strong role for the State have experienced some bumps along the way and the outcome has not always been predictable. We can call these deviations from the orthodox liberal economic model *characteristics* of the Chinese economy, a favourite term with the Chinese themselves.

But systemic judgements are passé and it is better to examine the specific issue, which is - how well can China's leadership manage its paradoxes *and simultaneously* sustain high growth rates. So far they have proved it can be done. At a time when we have been unable to invest in social or physical infrastructure, China continues to devote massive resources for the same. China's economy is growing and its people are in an exuberant, optimistic mood.

**China's greatest advantage is built on its robust manufacturing sector - questions of ownership and institutional frameworks aside - and focused State direction of its reforms.** How they grew manufacturing is given on page 5. **The two important lessons from China are to have strong State direction in order to carry out the difficult reforms and to revive and flourish the manufacturing sector.**

Having seen the pitfalls and adverse side of Government intervention in the economy, India is however ideologically inclined to favour its dilution. The State's lack of liquidity facilitates this process. But for some reason the gradual withdrawal of the State from non-essential areas and downsizing of Government, which should have indirectly facilitated the reforms, has instead led to a massive rise in personal corruption as the old parasitic classes created during *licence raj* bleed the new entrepreneurs white. **It is essential for us to ensure that remaining State structures are strengthened where necessary to make reforms a success, while downsizing the State in areas where its presence is superfluous. PM is**

quoted by the *Business Standard* to have stated that if the experience of the past ten years of reform has taught any lesson, it is that reform of the implementation system must be made an integral part of the reform process itself.

The other key to success is that while we must maintain a conducive environment for the growth of the service sector, we must focus on reviving the Indian manufacturing sector. A lot of the problems across the economy, both current and future, arise from its neglect. In nearly all the preceding chapters - the implications of not addressing this issue have come out loud and clear – in IT, Telecommunications, or for creating an expanding economy to attract more FDI, generate larger exports and push through labour reforms. It is necessary to implement the necessary reforms to strengthen a competitive core manufacturing sector. In manufacturing, India is in fact just beginning to implement some of the policies that ensured Chinese success, but more than 20 years later.

Implementing the right policies will not create a broad-based, flourishing manufacturing sector overnight. But even if it is not as large as China's, it will be established on a sounder footing, with Indian firms equal and efficient players in the market. Indian firms may eventually hope to eclipse the performance of China's State-owned firms. Coupled with our advantage in the services sector, we *can* swiftly narrow the gap with China. India can achieve a steadier, higher rate of growth both in quantitative *and* qualitative terms.

At the same time, while we can learn from China in terms of broad objectives, the specifics will have to be elaborated by us to suit our own requirements. Wholesale copying is neither feasible nor viable. India has demonstrated that it can move forward in its own way and on its own terms, as the above chapters on Information Technology, Telecommunications, Privatisation and others have shown. In each sector there is evidence of thoughtful policy formulation, arrived at after exhaustive (*and exhausting*) debate. We have developed a competitive advantage at the top end of the technology spectrum in IT at the outset. What can we not achieve if we apply ourselves similarly to other sectors of the economy?

There are many other portents of hope. The dismantling of the APM will bring in fresh revenues for the Government, while Information Technology exports have been compared to oil as generators of revenue. Services exports/ outsourcing is another potentially lucrative area. Pharmaceuticals and biotechnology beckon as sectors with great potential, although the issue of patents has to be settled. The freeing of agriculture including establishment of direct links between producer and market should help to rejuvenate this sector.

The reforms in the last year have been nothing short of breathtaking. But they come after a long period of inaction and barely make up for lost time. If we implement appropriate reforms as we did in the telecom sector across the economy, we can hope to achieve our goals. A strategy based on the following reforms will create a very dynamic, low-cost economy capable of very rapid growth:

- h) Privatisation
- i) Labour reforms
- j) Power sector reforms
- k) Infrastructure investment in public transportation systems, roads, airports, ports, railways, education and health
- l) Property market reforms
- m) Government deficit reduction and

n) An export oriented economy attracting higher FDI inflows

Otherwise India's potential will remain just that - potential. We are clearly very far behind China and a lot of other countries not only in most macroeconomic indices but also in quotidian matters citizens of many other countries take for granted (such as public transport, or roads, or assured power supplies which don't ruin domestic electrical appliances every time there is a massive voltage fluctuation). Closing the gap would require both very strong commitment and national effort.

The Opposition *must* be involved in this process, as the present Government needs its support in the Rajya Sabha and the States. After all, Prof. Manmohan Singh pioneered the initial path-breaking reforms, changing India's mindset forever (at a seminar at the IIC in 2000 I told him he had been India's answer to Deng Xiao Ping). It should not be difficult to convince it to join in a national effort. The country will be forever grateful.

One solution would be to take opponents of reforms on a tour of all the successful Tiger Economies of East Asia and Japan, with the express purpose of forging a political consensus on the required reforms and driving home the point that far-sighted policies *can* transform the economic fortunes of a country<sup>101</sup>.

The only lasting foundation for a country to play a meaningful international role is economic power. Few people have seemed to link India's increasing diplomatic marginalisation before the reforms to its declining international competitiveness, but clearly the two phenomena have gone hand in hand. However after the reforms were launched, India's confident democracy, liberalised economy and reforming mindset have encouraged the hope that India can achieve these goals and surpass other countries' performance.

Lastly, Government must not forget its duty to create a "kindler, gentler society", by investing heavily in social infrastructure. At the risk of sounding naive, we have a precious historical legacy, our culture, to protect, which must not be swept away in a blind copying of any model –Anglo-Saxon, Japanese, Korean or whatever. The elements of our culture -- warmth, a value system that manages to reconcile individualism with duty to the community, our beliefs in personal freedoms, and pursuit of educational excellence provide a refuge in a world fast losing touch with its roots. At the same time, we must learn how to unravel this package, discard its feudal and negative elements and create a society in which each citizen has equal opportunity.

I am very much aware that in the time (2 and 1/2 months) it took to write this essay, I have been unable to cover several important issues and topics, have misplaced notes and maybe even some quotes, committed the inevitable mistakes for which I accept full responsibility. But perhaps the overall flavour has been captured, on the basis of which my conclusion, is that the answer to the title question is a qualified but nevertheless optimistic 'yes, of course it is possible, if only...!' We have to make the several 'if only's come true.

Smita Purushottam  
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Thursday, August 19, 2001

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<sup>101</sup> I owe this idea to Shri Shekhar Datta, then President of CII who had planted it during a CII visit to China.

<sup>i</sup> I've just seen an interview given by Prof. Manmohan Singh to the *Times of India* dated July 25, in which he describes the opposition within his own party and the Left to reforms. Here is what he is quoted to have said:

“Q. Then how does one explain China's success?”

A. I don't know much about China. But I do believe their leadership is much more focused on economic reforms. Even in the Congress government, a sizeable group of people were opposed to reforms. When the first opportunity arose, when we lost a few states, people said it was because of the reforms. As a result, within our five years, we only had two real years of reforms, the rest was just papering over.

The Left too was so opposed to what we were doing. In fact, when I presented the second Budget in 1992-93, opposition leaders said I should be impeached because according to them, I had leaked the budget and made it under pressure from the IMF. One newspaper had launched a campaign against me 15 days before the budget. But when the United Front came to power, they had no choice but to follow the Congress paradigm. And the Bharatiya Janata Party, which decried liberalisation as a sellout and fought elections in the name of swadeshi, followed the same policies as us when they took office.

India does not have a man like Deng Xiaoping, who launched China on a single-minded pursuit of economic objectives. In many ways, Deng's achievements in building modern China were greater than Mao's. We lack that sort of political leadership. Maybe it is the result of democracy. Before politicians can become statesmen, they want to be re-elected. That shortens their horizon. But without long-term vision, this country's development potential cannot be realised. Of course, vision not backed by a strategy and programme often leads to hallucination. We need a broad national agreement on vision, strategy and programme. Only that will enable India to realise its chosen destiny.”

<sup>ii</sup> A few out of the rapidly proliferating examples taken from *Business today* are— Reliance's mega infocom plans; the Aditya Birla group's plans to create a mega IT company out of their Birla Consultancy and Software Services, which will acquire firms in the US, UK and central Europe; Tata Steel's plans to build an online steel alliance with SAIL and exploration of global online alliances with US partners; Tata Engineering's use of an Internet-enabled supply chain management module developed by Tata Technologies; Tata Chemicals' geographical intelligence, satellite Internet-enabled links with distributors; Tata Electric's plans to expand into national broadband networks; Indiaconstruction.com's plans for strategic alliances with other portals and with HDFC. Other examples are HLL (nation-wide supply-chain management and consumer services), ITC (agri-exports and hotels), LG Electronics (B2B), Shoppers' Stop (online shopping, inventory management), HDFC (financial products), ICICI, Citibank etc. 8 auto-companies have forged an alliance to set up a B2B exchange. Kirloskar Oil Engines, a solid Old Economy manufacturer of diesel engines, has Internet enabled its supply chain with 24 hour tracking facility patterned on the best American services model. Many hotel industry and small service companies are digitalising their operations. The Tatas and Birlas, traditional rivals, are collaborating with online alliances in strategic areas such as mobile phones.

<sup>iii</sup> John Chambers, President, Cisco:

- In 1985, annual productivity growth in companies (from the networking revolution) was a mere 1.5%....Today, this has jumped to 35%.
- You have a chance of being the leader of the second Industrial Revolution... a leader in IT, software and the networking world given your talent in software engineering....If it hurries up, India could become the world's No 1 software player. But nobody's going to sit around and watch us take markets away from them. So, instead of playing catch-up, India should learn to leapfrog.
- India must skip a generation and build the network of the future.... You have a wonderful opportunity of building a network, which combines voice, video and data, instead of building an old telecom network.
- Highways, harbours and roads were the network of the first Industrial Revolution. Similarly, the Internet is the network of the second Industrial Revolution. Why build one network for voice communication, one for data communication, one for video communication? Why build three or four highways? India doesn't have the burden of a legacy system. ...About 97% of the country doesn't have telephone connectivity. So you have a wonderful opportunity of building a network, which combines voice, video and data, instead of building an old telecom network....
- India has to skip a generation and that's why my focus is on the Internet and education. India must focus on education as much as the Internet. And that's where Cisco plans to step in, through its network academies in every state and union territory, which will churn out 100,000 - maybe more - graduates.
- India has about half of the software engineers in this world. You also have a top-notch education system for the higher level. If you can't leverage on this asset, you will miss a crucial lifetime opportunity.”

<sup>iv</sup> I am indebted for many elements of this analysis to insights obtained while attending Prof. Lee's Spring 2001 course on *Privatisation* at the Kennedy School of Government, Harvard University.

<sup>vi</sup> Existing telecommunications departments and monopoly private firms the world over have tried to stall reform, or use their existing infrastructure to charge higher than justified access charges from new providers. As Prof. Ramamurti describes it, “in each country firms adopted textbook tactics to make life difficult for companies wishing to offer new telecom services - terms for connecting to monopolists' network had to be negotiated” etc. In India also the public sector's strategy is to try to leverage its existing network for profit maximisation prior to the impending loss of its monopoly status. Thus the media reported<sup>vi</sup> that BSNL suddenly announced an increase in inter-connection charges (share in revenues from traffic originating from private basic telecom operators' networks ending in BSNL's network) from June 1, 2001 - from 55:45 to 80:20 for ISD calls, from 40:60 to 70:30 for NLD calls, and from 0:100 to 50:50 for local calls, on the grounds that the extension of the local call range to 200 kms had led to heavy losses for the carriage of local calls in its network, since traffic from the private operators networks into BSNL's network exceeded the traffic in the reverse direction. Private operators do not receive any share for calls from BSNL's network terminating in theirs. The Association of Basic Telecom

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Operators (ABTO) referred the matter to TRAI stating that the hikes would drive them out of business. The matter is now under the consideration of the Telecom Dispute Settlement Appellate Tribunal (TDSAT)...Other issues are net telephony, with reports that the government is leaning in favour of legalising it, 'Calling Party Pays' schemes for cellular mobile services, intra-circle long distance calls etc. WiLL mobility has been permitted to basic service providers which would adversely impact the profitability of cellular operators. The introduction of each new facility hurts the revenue streams of one or the other group of operators.

<sup>vii</sup> IBP's principal business is in storage, marketing and distribution of petroleum products - petrol, diesel, fuel oil, naphtha, LPG, etc, through 1,500 outlets (BL Dec 3<sup>©</sup>). It has several joint ventures besides a subsidiary, Balmer Lawrie and Co Ltd, which, in turn, has several joint ventures. It also has business interests in the engineering and chemical sectors. The chemicals business sells bulk and cartridge explosives - IBP is the largest manufacturer of explosives and cryogenic containers in India. IBP's joint ventures include Numaligarh Refineries Ltd, IBP Caltex, Indian Oiltanking and Petronet India. The equity held by IBP in Balmer Lawrie *and* Numaligarh Refinery would be excluded from IBP and the disinvestment.

<sup>viii</sup> A Business Line report of October 2 stated that the bidders would be required to commit an investment of Rs 2,000 crore in oil exploration and marketing, refining, pipelines or terminals. This expanded the list of potential suitors as existing norms specified that marketing rights for transport fuels -- petrol, diesel and ATF -- could be given only to private sector companies owning a 3 mtpa refinery with an investment of at least Rs 2,000 crore or to oil exploration and production companies producing at least 3 million tonnes of crude annually. Only Reliance Petroleum Ltd (RPL) and Mangalore Refineries and Petrochemicals Ltd (MRPL) besides the public sector refining and exploration companies would have fulfilled these criteria.

<sup>ix</sup> Following the reforms, industrial output increased at rates averaging 12.6% a year in real terms (several sources, EIU). But this growth was led by TVEs in the 1980s as local agricultural surpluses found their way into manufacturing. In the 90s private and foreign invested enterprises overtook both the TVEs and the State sector.

<sup>x</sup> Even the Economic Survey 2001 has this to say: "Other gaps in the reform process, such as those relating to labour laws and procedures, bankruptcy, land ceiling and rent control and small scale industry reservation, inhibit industrial restructuring, raise costs and reduce international competitiveness. The high industrial and GDP growth rates seen during 1994-95 to 1996-97 can be replicated only if these critical gaps in the reform process are attended to. ...Small-scale industry reservation is a variant of investment control. Whereas special support policies for small and medium enterprises are found in most countries of the world, developed and developing alike, the policy of small-scale industry reservation is unique to India. In view of the imminent removal of all restrictions on imports in April 2001, the time has come to give up reliance on reservation as an instrument for supporting SSI. Labour intensive industry can then exploit economies of scale and scope and thus reduce unit cost of production to those of Chinese imports. As many SSI reserved goods (like bicycles, agricultural implements, and garments) are used by the bottom half of the population, dereservation will also raise the real income of the poor and generate further demand for these goods.

1.126 This reform, along with the previous three, will enable organised industry to move out of capital intensive manufacturing and enter labour intensive manufacturing, and generate new employment at a much faster pace. Its ability to compete with Chinese imports will strengthen manifold and exports of labour-intensive goods will expand."

<sup>xi</sup> Thus the functions of the most recently abolished State Internal Trade Bureau, Ministry of Coal Industry, Ministry of Machinery Industry, Ministry of Metallurgical Industry, State Petroleum and Chemical Industry Bureau, State Light Industry Bureau, State Textile Industry Bureau, State Construction Materials Industry Bureau, State Non-Ferrous Metals Industry Bureau, would be absorbed into the State Economic and Trade Commission. The last major restructuring of the central government was reportedly in 1998, which included the merger of more than 20 ministries and a restructuring of the People's Bank of China, the central bank.

<sup>xii</sup> There are 2 routes for FDI approvals in India - automatic and formal approval, the latter being routed through the Foreign Investment Promotion Board (FIPB). FDI has been permitted through the automatic route for all industries except for a few specified items and situations (items still requiring industrial licences or locational/ environmental clearances, FDI over 24% in the small scale sector, a few other stipulations etc.). The ceiling for FDI under the automatic route in oil refining and for most manufacturing activities in Special Economic zones (SEZs) has been increased to 100%. 100% foreign equity in Internet Service Providers not providing gateways and telecom infrastructure providers providing dark fibre, electronic mail and voice mail, power, roads and ports sectors, and 49% foreign equity in satellite-based global mobile personal communications systems (GMPCS) have been permitted. 26% equity is permitted in the insurance sector. Dividend balancing requirements in 22 consumer goods industries have been removed. Norms and ceilings for investment by Foreign Institutional Investors (FIIs) in the primary and secondary markets, External Commercial Borrowing (ECB) policies and international offerings through ADR/GDR by Indian companies, and policies to encourage investment by overseas Indians and for overseas acquisitions by Indian software companies were recently further liberalised. New guidelines permitting foreign companies to buy out the equity stake of their Indian partners if the latter are unwilling to come forward with the required funds have been announced, which may act as an indirect incentive if foreign companies are confident that they can buy out the stake of their Indian partner if the relationship sours, as it has in several joint ventures in the automobile industry.

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<sup>xiii</sup> As the World Investment Report 2000 (WIR) states, “as with private sector investment, the benefits from FDI are enhanced in an environment characterised by an open trade and investment regime, an active competition policy, macroeconomic stability and privatisation and deregulation. In this environment, FDI can play a key role in improving the capacity of the host country to respond to the opportunities offered by global economic integration... Many of the remaining barriers to inward investment were erected at a time when foreign firms were investing in economies distorted by trade barriers, a lack of effective competition in product markets, under-developed financial markets and by many other policies associated with import substitution. In this environment, host countries sometimes justified restrictions on inward investment on the basis of the theory of second best which argues that liberalisation in one area in the presence of distortions elsewhere may make the economy worse off. In the more competitive environment in many host countries today as a result of roughly a decade of economic reforms, many restrictions are at best ineffective and at worst counter-productive”.