

India's Quiet Economic Revolution
(The Columbia Journal of World Business- Spring 1994)
Montek S. Ahluwalia¹

Introduction

Jack Welch has named India as the "future of GE for the next century" along with China and Mexico. Welch is not alone in his optimism; a survey of the business press coverage over the past year reveals that the Indian liberalization process, started in June 1991, has been getting a lot of attention; the world appears to be bullish on the "emerging" markets in India. We decided to bring together the views of policy makers, business leaders and economists in a Focus Section to provide a historical perspective of what happened in India in the forgotten years and to evaluate how things are changing now.

Montek Singh Ahluwalia, a former World Bank economist, has been at the centre of the economic liberalization as the Finance Secretary of India. He provides a policy-maker's view of the future direction of liberalization. We are especially grateful to him for finding time to write this article in the midst of the budget session, the busiest time of the year for him.

N. Vaghul's analysis of the state of financial markets would be of interest to the financial investor moving into the Indian capital markets. Mr. T. Thomas, with his long and varied management experience at the head of two of the biggest multinationals in India, provides practical considerations for the manager faced with the difficult job of evaluating investment decisions.

Javad Khalilzadeh-Shirazi and Roberto Zaghera evaluate the progress made by the Indian government from their vantage point in the World Bank. They also point out the future agenda necessary to complete the liberalization process.

The student of economic development history would find the interview with Professor Jagdish Bhagwati an interesting survey of the Indian economic thinking over the past 50 years.

Though my name goes on this section as the focus section editor it was really a team effort. My teacher and guide at Columbia Business School, Professor Suresh Sundaresan, provided the initial motivation and enormous help along the way. Anupam Puri at McKinsey & Company helped in shaping this section with his valuable suggestions. Special thanks to Beth Janoff at the Business Development Associates for inviting me to the conference on the "Joint Ventures and Direct Investment Opportunities in the New India." Peter Erdmann and Cynthia Ho wells, editors of *Columbia Journal of World Business*, provided encouragement and all the resources to make this focus section possible. Finally, I must thank the student editorial board for their stimulating comments and all their help.

Sandeep Tyagi Student Editorial Board

Montek Singh Ahluwalia, an economist by profession, is the Finance Secretary to the government of India. He, along with the Finance Minister Dr. Manmohan Singh, is the most prominent member of the team which has designed the Indian liberalization program. Before joining the Indian Government he worked with the World Bank for 11 years. He has been advisor to four Prime Ministers: Rajiv Gandhi, V. P. Singh, Chandra Shekhar and P. V. Narasimha Rao

¹ *Montek S. Ahluwalia, Secretary of the Indian Finance Ministry, is one of the major architects of India's program of economic liberalization. Since June 1991, he has worked on gradual reforms that have enabled India's once floundering economy to "turn the corner" where other countries trying to reform more rapidly have not. Based on budget figures that the Finance Minister, Dr. Manmohan Singh presented to the Indian Parliament on February 28, 1994, Mr. Ahluwalia reviews the government's reforms in the tax, public, financial, and industrial sectors, in trade and exchange policies, and also examines the progress India has made toward macroeconomic stability.*

India's Quiet Economic Revolution :

The past three years have seen a quiet economic revolution underway in India. As the second largest economy in the Asian continent, India has implemented far reaching structural reforms that aim at deregulating the economy and shifting from a path of relatively protected inward looking industrialization to a new phase based on greater competition in the domestic markets, openness to trade and investment, and fuller integration with the global economy.

It is a quiet revolution that attracted relatively limited interest when it began in June 1991. Since then, the pace of change has been gradual. Critics have often said it is too slow compared with more dramatic changes taking place in Eastern Europe and the former Soviet Union. But while advocates of "shock therapy" may be impatient at the speed of reforms in India, the experience of the past three years shows that India's gradualist approach is delivering results. The economies of most of Eastern Europe, and especially the successor states of the former Soviet Union, are still engulfed by serious problems while India seems to have turned the corner.

In June 1991, India was in an economic crisis of exceptional severity triggered by the rise in oil prices after the Gulf war. Foreign exchange reserves had plummeted to \$1.2 billion, barely sufficient to pay for two weeks imports. Imports were subjected to tight control. Industrial production was falling and inflation was rising. International confidence had evaporated and international banks were shying away from fresh exposure. The new government that came into office in June 1991 responded to the situation by announcing a package of measures aimed at stabilization of the economy in the short term combined with structural reforms to accelerate growth in the medium term. Less than three years later the economic situation has been transformed. Inflation is half the peak level of 17% reached in August 1991, foreign exchange reserves are up to \$13 billion, exports are growing at over 20% in the first 10 months of the Fiscal Year 1993-1994 (April-January) and foreign investors are taking an active

interest in investing in India. The current account deficit in the Balance of Payments has declined from about \$5 billion in Fiscal Year 1992-1993 (April-March) to less than \$1 billion in 1993-1994.

How did this turn around in both reality and perception take place? It happened because the reform program, though gradualist in pace, has proved successful. Stabilization objectives have been fulfilled as evidenced by the moderation in inflationary pressures and reduction in the current account deficit. The program of structural reforms initiated in 1991 has also acquired "critical mass" and credibility. Economic policies affecting several sectors of the economy have been radically restructured in the past three years. The changes are dramatic in some areas and more modest in others, but the overall impact is one of an irreversible change in the system of economic management. These strides will enable a fuller exploitation of India's very considerable endowment of human, technical and managerial resources.

Industrial Policies

The most dramatic changes have been in the area of industrial policy. India's industrial policy was characterized by a complex system of industrial licensing under which new investors setting up new units, as well as existing investors undertaking major expansions, had to obtain an industrial license from the central government. These licenses were an instrument for government intervention on issues of technology choice and location which should otherwise have been left to entrepreneurial choice. This system was not only time consuming, it also discouraged competition in the industrial sector. Reforms in this area have been comprehensive. The requirement for government licensing has been abolished except for a small list of strategic and potentially hazardous industries and a few industries which are reserved for the small scale sector. For most industries however industrial investment has been effectively delicensed and investors are free to set up new units or expand existing units subject only to environmental clearances.

This liberalization of industrial licensing has been accompanied by a complete re-orientation of the policy towards foreign investment. India's earlier policy towards foreign investment was "selective" and therefore viewed by many investors as unfriendly. Foreign investment was typically allowed only in what were deemed to be high technology areas, and definitely discouraged in the so-called "low technology" consumer goods areas which were precisely the areas where India's markets were most attractive. Foreign investors were also limited to a maximum equity holding of 40%, with higher proportions of equity being allowed only in exceptional circumstances. Firms with foreign equity exceeding 40% were also subject to certain additional restrictions compared with other firms. The new policy actively seeks foreign investment and eliminates earlier restrictions on firms with foreign holdings. Foreign investment is now freely permitted up to 51% of equity in a defined list of 34 industries. For investments outside this list, and also where foreign investors seek an equity share exceeding 51%, investors are invited to apply to a new Foreign Investment Promotion Board under the Chairmanship of the Principal Secretary to the Prime Minister. The Board has established an excellent track record of speedy clearances. Restrictive provisions, earlier applicable on companies with more than 40% foreign equity, have been abolished and all companies incorporated in India are treated equally irrespective of the level of foreign equity holdings. India has joined the Multilateral Investment Guarantee Agency (MIGA) and is currently negotiating bilateral investment treaties with several countries.

The new policy has evoked a positive response from foreign investors. Approvals for direct foreign investment in 1990 amounted to foreign equity inflows of only \$73 million. This increased to \$235 million in 1991, \$1.3 billion in 1992 and an estimated \$2.4 billion in 1993. Actual inflows of foreign investment may of course be lower than approvals, but these figures definitely indicate a major change at the ground level in investors' perceptions of India as a future market. Leading international companies including

major American corporations such as General Electric, IBM, Pepsico, Coca Cola, Enron Corporation, Digital Corps, and Kellogs are investing in a wide range of projects from processed foods and software development to engineering plastics, electronic equipment, power generation and petroleum exploration.

Trade and Exchange Rate Policies

Trade and exchange rate policies have been substantially restructured in keeping with the objective of creating a more open and competitive economy. Three years ago India's trade regime displayed all the features of inward oriented industrialization: an overvalued exchange rate, pervasive quantitative restrictions on imports, high import tariffs and a complex system of export subsidies. A complete overhaul in trade policy has occurred since then. Import restrictions have been virtually dismantled, except for final consumer goods. Almost all raw materials, other inputs into production and machinery can now be freely imported without a license. There is a short list for which imports still require a license, and it is expected that even this list will be pruned down progressively. Tariff levels which were among the highest in the world have been reduced substantially for all items and especially on capital goods and machinery. In June 1991, the peak level of import duties was as high as 200% on some items. Intermediates were subject to an average duty of around 110% and capital goods were subject to average duty rates of 95%. With the most recent tariff reductions in the Budget for 1994-1995, the peak rate is now 65%, intermediates are subject to an average duty of 30% and duties on capital goods have been reduced to 35%. Further reductions are needed to bring the structure closer in line with other developing countries, but this can now be accomplished relatively easily in the next two years.

The exchange rate was initially devalued by 24% in June 1991 and export subsidies were simultaneously abolished. There was a brief experiment with a dual exchange rate system in 1992, but in March 1993 the exchange rate was unified and effectively floated to be a market determined rate. Despite the virtual

elimination of trade restrictions (except for continuing restrictions on final consumer goods) and a substantial reduction in tariffs, the exchange rate has been remarkably stable in the course of the past year. Most recently, the government has announced its intention to move towards convertibility for current account transactions, which implies substantial further liberalization of foreign exchange markets. Capital controls are however expected to remain in place for the present.

Tax Reforms

Tax reform has been a critical element in India's reform program and a far reaching agenda for tax reform has been outlined by the Tax Reforms Committee which was appointed by the new government in 1991. The Committee has recommended that the tax system be simplified with moderate rates of tax in both direct and indirect taxes, fewer exemptions and a broadening of the tax base. Substantial progress has been made in these directions in the four budgets that have been presented since the reforms began.

- The maximum marginal rate of personal income tax was 56% in June 1991 and has now been reduced to 40%.
- The incentive structure for savings in the form of financial assets has been strengthened. The "wealth Tax, which was earlier applicable to all personal assets, has been modified to exempt all financial assets including shares and other corporate securities.
- The rates of corporate income tax, which were 51.75% for a publicly listed company and 57.5% for a closely held company have been unified and reduced to 46%. All these rates include a 15% surcharge. Without the surcharge, corporate tax rates would be 40%.
- Customs duties, as noted above, have been significantly reduced over the past three years and further reductions are expected to be implemented in phases to bring the rates in line with those prevailing in other developing countries.
- Excise duties on domestic manufactured goods were charged at

varying rates on different commodities with most of the duties being specific rather than *ad valorem*. A system of tax credit for taxes paid on inputs called "Modified Value Added Tax" or MODVAT was in force. In the budget presented in February 1994, the system has been greatly simplified with the bulk of the taxes shifted to an *ad valorem* basis. The coverage of the tax credit system has been extended to include some sectors earlier excluded and the number of excise duty rates has been reduced from 21 to 9. A start has also been made in extending indirect taxation to a few services. The longer term objective of the government is to move to a Value Added Tax. This is still a distant prospect since it involves integration of the taxes on production, which under the Constitution are levied by the central government, with taxes on sales which are levied by state governments.

The reforms in the tax system are expected to achieve the objective of microeconomic efficiency, in the sense of creating a tax system which avoids economic distortions, and also macroeconomic stability in the sense of ensuring buoyancy of tax revenues. There is scope for further action in the coming years. There is a reasonable expectation that the surcharge on corporate tax will be removed which would establish the corporate rate of tax at 40%, the same rate as the maximum marginal income tax rate. The Chelliah Committee had recommended a customs duty structure of 10% on capital goods, 15% on raw materials and 30% on other intermediates, and these rates could be achieved over the next two years. There is also considerable scope for further simplification of domestic indirect taxes while extending the tax to services, with the hope of ultimately moving to a unified VAT system.

Public Sector Reform

Public sector reform is a critical element in economic reform in most developing countries and this is the case in India also. However, the Indian approach differs significantly from the recipe followed by many other countries. India has not embarked on an aggressive program of privatizing the public sector in the sense of

transferring ownership and management of these enterprises to the private sector. Instead the approach is one of reforming the public sector while maintaining its public character by ensuring that the government's share in equity does not fall below 51%. Government ownership is being diluted through sale of government equity, which generates funds for the government budget, and also through fresh issue of capital to the public which mobilizes funds for the public sector unit's own investment plans. The impact of dilution of government equity and the induction of private shareholders is expected to be substantial even if the government's share remains 51%. The induction of private shareholders and the trading of the stock in the stock markets is expected to make public sector companies much more concerned about profitability and commercial performance, and this is expected to create a new culture of accountability.

The incentive to improve performance is also being increased by a conscious policy of phasing out budgetary support to fund losses in loss making public sector enterprises and also by encouraging private companies to enter into competition with public sector companies wherever possible. Areas such as civil aviation, petroleum exploration and refining, and parts of telecommunication which were earlier reserved for the public sector have been opened up to new private sector entrants. Within the past year, a number of small private sector airlines have begun to operate on domestic routes in competition with the public sector Indian Airlines, which earlier had a monopoly position. Similarly several new private investors have entered the field of petroleum exploration and development. New private sector refineries are also on the way.

Financial Sector Reform

Far reaching reforms are also underway in the financial sector aimed at creating a modern, competitive and efficient financial system. India's banking system was characterized by several large public sector banks (which dominated the banking system accounting for 87% of total deposits) coexisting with several small private sector banks, and a number

of foreign banks operating through branches mainly in the larger metropolitan areas. The system was burdened with heavy mandatory reserves requirements designed to support government borrowing at below market rates and regulated interest rates with a number of rates fixed at uneconomic levels. The financial health of the banking system had also deteriorated due to poor accounting practices and inadequate prudential norms. These problems are being systematically addressed by reforms announced in 1992. Mandatory reserve requirements are to be reduced from their present high levels to more reasonable levels over a three year period. The government has also embarked upon a phased process of rationalizing the regulated interest rate structure by first reducing the prevalence of subsidized rate and gradually moving to deregulation of interest rates. Along with these developments the prudential norms relating to provision for non-performing assets and capital adequacy in relation to risk weighted assets are being tightened to bring them up to the Basel Accord standards by March 1996.¹

These changes are being accompanied by a change in the structure of the banking industry. New private sector banks have been licensed which will inject much needed competition into the banking sector. The nationalized banks are also changing their structure as the more successful of the public sector banks are planning to raise fresh capital in the market to meet the new capital adequacy requirements. This will dilute government ownership by induction of new private shareholders although the share of the government will not be reduced below 51%. This change in the ownership structure, though it falls short of full scale privatization of banks as practiced in some countries, is expected to have a favourable impact on overall performance and accountability.

Looking beyond the banking system, the agenda for reform of the financial sector includes reform of the capital markets also. India's capital markets are in some respects fairly well developed. The Bombay Stock Exchange has been in operation for more than a 100 years and

has more than 3,500 companies listed on the exchange, with a total capitalization of \$125 billion. Most important, there is a growing investor base which exhibits a high rate of confidence in financial assets. At the same time, the capital market has not adequately enforced standards of disclosure, trading practices, speed of settlement and transparency of transactions through regulation. Major changes are being brought about in all these areas. The Securities and Exchange Board of India (SEBI) was established as a statutory body in February 1992, and charged with overseeing the functioning of the capital markets. In this short period, SEBI has introduced the basic framework of regulations within which a healthy stock market should function. A new National Stock Exchange, with computerized screen based trading, is expected to commence operation in April 1994. Plans to computerize and otherwise modernize the Bombay Stock Exchange are also well underway. The government proposes to introduce legislation for the establishment of National Depositories to facilitate electronic trading without cumbersome procedures of physical transfer and registration of share certificates at each sale.

The past year has been a year of exceptional developments in the stock market. The market recovered remarkably rapidly from the setback in 1992, when a securities scam involving illegal siphoning of bank funds into the stock market was detected and caused a temporary loss of confidence. This loss of confidence was quickly overcome, and in 1993, Indian companies raised about \$6 billion from new issues in the Indian capital markets compared to only \$2.5 billion in 1991. The year 1993 also saw a large inflow of portfolio investment into India responding to a conscious policy decision in 1992 to open up the capital markets to such flows and introduce tax incentives to attract a share of the emerging markets flow to India. One source of portfolio investment was foreign institutional investors who are now allowed to invest in the capital market subject to registration with SEBI. About 175 foreign institutional investors, representing pension funds and other broad based funds, have been registered

as approved investors and about 70 of these have started investing. The total inflow in 1993, the first year of operation, is estimated at about \$1 billion. A second route for portfolio investment has been the issue of shares abroad by Indian companies through the mechanism of GDRs and convertible bonds. This has mobilized about \$1 billion in 1993; and there are several Indian corporations currently expecting to mobilize substantially larger amounts in the next six months. The volume of portfolio flows through these two routes could therefore be substantially higher in 1994.

Macroeconomic Stability

The structural reforms enumerated above give an indication of the broad scope of the economic restructuring underway in India. They will undoubtedly create conditions conducive to greater economic efficiency and will encourage allocation of resources to more efficient sectors and firms. However the success of these reforms will depend crucially upon the maintenance of a stable macroeconomic environment. This is especially so as the country makes its transition from a regime of pervasive direct controls over various aspects of the economy to a more open regime with a liberalized current account and large windows for possible capital account flows from of the build up of portfolio investment, which is potentially volatile.

Macroeconomic stability was the centre piece of the structural adjustment effort in 1991 when inflation was rising and the current account appeared unmanageable. The fiscal deficit of the central government was reduced from 8.4% of GDP in 1990-1991 to around 6.5% in 1991-1992 and 5.6% in 1992-1993. The trend of improvement in the fiscal deficit has been interrupted in 1993-1994 when the fiscal deficit increased again to 7.3%. This is partly because of a large shortfall in tax revenues, reflecting a slower pace of industrial revival than originally anticipated, and has led to low imports and customs revenue. The industrial sector is taking time to readjust its corporate plans to the new and more competitive environment, and especially to phasing out of high levels of protection. This has depressed private investment,

leading to some demand deficiency in the industrial sector. There are indications however that corporate restructuring is now underway and a revival of investment in the corporate sector is expected in 1994-1995. This will lead to improved tax revenues in 1994-1995. The deterioration in the fiscal deficit was not however entirely due to revenue shortfalls. Larger levels of development expenditure were also responsible for the worsening fiscal deficit in 1993-1994. The deterioration in the fiscal deficit in 1993-1994 has not been as damaging as might have been feared because of the existence of considerable underutilized capacity and the fact that the government recognized the deterioration and did not allow it to continue. The budget for 1994-1995 therefore sets a target for the fiscal deficit at 6% of GDE. A major source of fiscal strength in the years ahead will be the simplification and rationalization in the structure of indirect taxes which is

expected to increase the buoyancy of tax revenues substantially.

Three years is a short time to judge the success of any program of structural adjustment. The policy changes described above constitute a radical departure in the system of economic management and it will be some years before the full effect of these changes, which are not yet complete will be felt in terms of economic performance. The reforms have to be further strengthened and deepened in the years ahead and constant vigilance is necessary to ensure fiscal stability. However, if early results are anything to judge by, the prospects for the future are very favourable. India has already shown the capacity to achieve a steady growth rate of around 5.5% per year in the 1980s. We expect these reforms now underway to increase efficiency enough to enhance this growth to at least 6.5% in the 1990s.

Notes

1 The Basel Accord is an international, multilateral agreement signed by the Group of 10 (G-10) in Basel, Switzerland, that clearly stated its purpose: by 1992, all international commercial banks from the G-10 (plus Luxembourg) must achieve a ratio of capital/risk-weighted assets of 8%. To assist G-10 members to achieve this goal, the Accord comprises three parts:

- 1) a definition of the capital of commercial banks;
- 2) the application of risk weights to different categories of commercial bank assets;
- 3) the treatment of off-balance sheet activities. Underlying the theory of the Accord is that the amount of capital a commercial bank is required to hold should be directly related to the credit risks of its asset portfolio. [Lewis A. Presner, *The International Business Dictionary and Reference* (New York: John Wiley & Sons, Inc., 1991) 21-22.]
