

**How wrong has the Indian Left been about economic reforms?**

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## **Executive Summary**

The research paper is an attempt to analyze the economic reforms which were initiated from 1991 onwards. It looks into five different yet interlinked areas of our nation's economy and the way reforms spelt a fresh breath of life for them. The emphasis is on five different yet interlinked components.

1. Labour
2. Small Scale Industry (SSI) Reservation
3. Trade
4. Industry
5. Financial Sector Reforms

The Indian Left, at that time, had vociferously opposed the 'capitalist' reforms and had predicted a rapid descent of the Indian economy. One-and-a-half decades later their doomsday prophesies lie forgotten as the nation revels in its new bout of economic freedom.

The nature of research which has gone into the making of this paper has been primarily secondary. Numerous articles and previous studies have been referred to in an effort to present a cohesive account of the benefits of reforms. The only fieldwork was a visit to the dusty CPI office in Delhi which yielded a 19<sup>th</sup> century viewpoint and an allergy to dust-mites.

(For further details, settle down in that comfortable chair and read on!)

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## Introduction

Our experience with the British left us embittered and disillusioned. Having witnessed their thoughtless exploitation of our resources, the Indian conscience deemed capitalism as 'bad' and started afresh on a socialist path with the good wishes of several countries and bright predictions from several economists who, at that time, favoured such a shift in focus.

But somewhere along the way we got lost in the dreary cobwebs of bureaucracy, our 'welfare' goals were reduced to mere vote-gathering methods and our policies became stifling. The Indian Left, however, went on tightening controls relentlessly under the pretext of several 'patriotic' arguments which were more populist than practical. As a result initiative, entrepreneurship and efficiency suffered major setbacks and, as many scholars say, India had to contend with the miserable 'Hindu rate of growth'.

The 1991 reforms finally unshackled the economy in a big way when the license-permit-quota raj gave way to the LPG growth model --- Liberalisation, Privatisation and Globalisation. Major reforms swept through the economy creating a profound impact on all facets of the nation ranging from the industries to the common masses. Many archaic laws were repealed, industries were given a fresh breath of life and tariff walls were broken down.

While it is indeed true that the post-reform era has not been without its share of problems it would be pertinent to note that the Indian economy got a much-needed fillip. Today, India is poised to become an economic power to reckon with and it owes this near-magical transformation to, what else, reforms.

So read on, pause at intervals and ponder about what you have read. You may not agree with some or many of my arguments but if this paper at least makes you think about the magnitude of change which our nation's economy has lived through, then this paper has achieved its objective.

## Labour: Getting 'Work'ed Up

*While you were sleeping*

Once upon a time, in 1984, a man was fired because he was sleeping. A bit unfair, wouldn't you think?

Not really. He was at work.

Uttam Nakate was found at 11:40 AM sleeping soundly on the floor of the factory in Pune where he worked. This was the fourth occasion when this had happened. Earlier, he had been let off with a warning but this was the last straw. His employer, Bharat Forge (an auto-parts factory), began disciplinary proceedings against him and after five months of hearings he was found guilty and sacked.

But did Nakate despair?

No. He went to the Maharashtra labour court and pleaded that he was a victim of an unfair trade practice. The court agreed and forced the factory to take him back and pay him 50 percent of his lost wages. On an appeal, the industrial tribunal set aside the labour court order and upheld the dismissal. But Bombay High Court reversed it and directed payment of Rs 2.5 lakh to the worker and reinstatement. Finally, 17 years later, after appeals to the Bombay High Court and the national Supreme Court, did the factory finally win the right to fire an employee who was simply following the results of a Harvard study --- volunteers who were allowed a mid-day nap performed better after it than those who did not have one<sup>1</sup>.

The main reason for citing this case is to instill hope in those who are firm supporters of the concept of a 'power nap'. Go right ahead and snore, our nation's laws are there to take care of those who dare to wake you up.

Jokes apart, this case highlights the effect of many absurd, outmoded laws that are a legacy of the socialist, pre-reform era. We discuss it in the light of all the leftist assertions of providing security to the employees from the assault and exploitation of the companies and firms. However who is harassed in this case is evident. This is one of the many examples from daily lives where laws have been sabotaged in order to subvert them to one's own unethical purposes. There have been many more cases of rich businessmen trying to strangle the laws and regulation for their own benefit, however what is important here is that such laws hinder the same 'working' class that they had set out to protect. As these laws become more stringent and gain a stronghold among unions, many companies want to keep their staff small enough to avoid unionization or big firms try to make such rules that harass employees and also make them more vulnerable. It is in this light that it is important to see such leftist protection veil on the poor section of the country. Are they really helping them?

*The Cider House Rules*

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<sup>1</sup> <http://www.foreignaffairs.org/20060701faessay85401/gurcharan-das/the-india-model.html?mode=print>

Take a quick look at the key issues and concerns relating to labour legislation given in the table below<sup>2</sup>:

Legislation	Concerns
Industrial Dispute Act, 1947	<ul style="list-style-type: none"> <li>• Procedural formalities that hamper quick implementation of productivity-related changes</li> <li>• Restructuring operations/unit issues relating to lay-off, retrenchment, closure – prior permission</li> <li>• Absence of time limit for disposal of industrial disputes</li> <li>• Definition of 'Workman'</li> <li>• Procedure for lay-off/closure of unviable units</li> <li>• Definition of 'Fixed Term' employment</li> </ul>
Contract Labour Act, 1970	<ul style="list-style-type: none"> <li>• Lack of clarity in the definition of 'non-core' areas</li> <li>• Prohibition of employment of contract labour in both 'core' and 'non-core' activities</li> <li>• Registration and License provision of contractors</li> </ul>
Minimum Wages Act, 1948	<ul style="list-style-type: none"> <li>• Non-enactment of minimum wages for temporary unskilled workers wherever applicable</li> <li>• Impact on small-scale industry</li> </ul>
Factories Act, 1948	<ul style="list-style-type: none"> <li>• Definition of 'Occupier'</li> <li>• Mitigation of the harassment of inspections</li> <li>• Time limit for approval of plans for buildings</li> <li>• Simplification of returns</li> <li>• Self Certification</li> </ul>
Trade Unions Act	<ul style="list-style-type: none"> <li>• Periodicity of Union elections</li> <li>• Role of outside leadership</li> <li>• Multiplicity of Unions</li> </ul>

Out of the above, the first two Acts have been a collective pain in the neck for employers since decades<sup>3</sup>:

<sup>2</sup>

[http://72.14.253.104/search?q=cache:eT6YArg4\\_eAJ:www.ciionline.org/southern/images/labour.pdf+protectionist+labour+laws&hl=en&gl=in&ct=clnk&cd=1](http://72.14.253.104/search?q=cache:eT6YArg4_eAJ:www.ciionline.org/southern/images/labour.pdf+protectionist+labour+laws&hl=en&gl=in&ct=clnk&cd=1)

<sup>3</sup> [http://www.financialexpress.com/fe\\_full\\_story.php?content\\_id=81732](http://www.financialexpress.com/fe_full_story.php?content_id=81732)

1. **The Industrial Disputes Act, 1947** requires companies employing more than 100 workers to seek government approval before they can fire employees or close down. Since the permission is seldom granted, employers are shy to hire workers even in good times.
2. **The Contract Labour Act, 1970** prohibits companies from farming out core activities to temporary workers, crimping their ability to meet sudden spurts in demand. Women aren't allowed to work night shifts.

It isn't therefore a surprise that India's garment manufacturing industry opts for labour-saving technology even when hourly wages are as low as 38 cents, compared with 88 cents in coastal China. It has been observed that most of the reasoning behind the labour regulation was wrong headed and were responsible for outcomes that were antithetical to their original objectives.<sup>4</sup>

Manish Sabharwal of TeamLease, who campaigns for labour law reform, condemns Section 5B of the Industrial Disputes Act, 1947 which bars establishments with more than 100 workers from retrenching employees without the permission of the state government. This deters employment and encourages the substitution of capital for labour. Mr Sabharwal, whose firm is currently providing about 42,000 workers on back-to-back contracts with employers, and is adding about 3,000 a month, clearly has an interest in seeing the laws relaxed.

On a bigger scale, Bharat Forge's Mr Kalyani cites the same reasons—"archaic" labour laws and the lack of political will to change them—for his "high-value" business model. But it is in labour-intensive industries, or rather the relative lack of them, that the pernicious effect of the rules is most apparent. Rajendra Hinduja, a director of Gokaldas Exports in Bangalore, India's biggest exporter of ready-made garments, says labour laws are his "problem number one". His business is seasonal, but he doesn't want to take on extra staff to meet surges in demand because he cannot lay them off in slack periods. Gokaldas employs about 42,000 workers. The point to be noted here is that these are precisely the sorts of jobs that India needs in the greatest number: for people who have had no more than a basic education and may be only barely literate. But the very laws that were designed to help them have, instead, become a hindrance.

In January, 2005, The Confederation of Indian Textile Industry (CITI) wrote to India's finance minister, giving warning that their production targets would be in jeopardy if the industry could not hire workers on short-term contracts (of five or six months). It pointed to the government's flagship policy—a national rural employment guarantee scheme that promises 100 days' work at the minimum wage at the state's expense to every household in poor districts. Many textile and garment firms, it wrote, would happily give 150 days' employment if they were free to let surplus staff go.

It is not just garment factories that face difficulties. Jukka Lehtela, who runs the new Nokia factory outside Chennai, would like to be able to scale up and down week by week, but the labour laws get in the way. They also, in effect, force the factory to work

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<sup>4</sup> Besley, Timothy. Burgess, Robin. Can labour Regulation Hinder Economic Performance? Evidence from India. London School of Economics & Political Science

eight-hour shifts, because anything longer attracts compulsory overtime rates. Nokia would like to work 12-hour shifts, compensating its staff with more days off. That might well appeal to the workers too, because many are commuting long distances.

One provision hampering its growth bars companies from employing contractors on “core and perennial” activities: so a manufacturer can hire contract security guards, for example, but not shop-floor workers. A factory outside Delhi built by LG, a Korean firm, manages to employ 1,000-1,400 casual workers to meet seasonal demand for its air-conditioners by deploying them in “subsidiary jobs”, such as packing and loading. Even for non-core workers, however, there are regulatory hurdles. G4S (formerly Group 4 Securicor) has been a remarkable success story in India. It now has 92,000 workers, all of them permanent employees. So it is providing long-term jobs where either no such jobs existed before or where they were filled by casual employees with no rights. Yet the government now wants the firm to comply to the letter with section 12 of the Contract Labour Act, 1970 and obtain a license for each establishment in each location where it provides labour, ie, for every single customer.

Labour-law reform, despite its obvious benefits, has always been politically difficult. Communist parties, which are beholden to the trade unions, vigorously oppose them. In effect, this means that the unemployed and even most workers in the “unorganised” sector are being held to ransom by the tiny minority—some 30 million, or about 7%—in “organised” employment. Labour is a “concurrent” subject under India's constitution, which means that responsibility for it is shared by the central and state governments. The business community observes and asserts that it should be made a state issue but trade unions say that it might be a “race to the bottom”, But the real race would be to create more jobs and more employment, especially to those kind of people who need it the most - the unorganized and the seasonal workers<sup>5</sup>.

With employers reluctant to add to their workforce, nine out of 10 Indian workers are forced into low-productivity occupations that pay poorly and offer no benefits or legal protection. And the Left thinks that such policies ‘help’ the poor.

### **Small Scale Industry Reservation: A ‘Little’ Problem**

#### *The Leftist Angle*

As the Indian Left is notorious, oops, famous for taking up the case of the underdog, its tremendous support for Small Scale Industry (SSI) reservation doesn't really raise eyebrows. The reasons advanced for such a policy can be broadly comprised under the umbrella of ‘Factor market distortions’. Consider the following:

1. Capital costs faced by SSEs (Small Scale Enterprises) are typically higher because of market imperfections in the availability of information for investors and lenders.
2. Transaction costs in bank lending exhibit pronounced economies of scale with respect to loan size. Thus, the unit transaction costs for SSEs are higher than those for large firms. Moreover, provision of collateral or other risk-reducing securities is

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<sup>5</sup> [http://www.economist.com/research/backgrounders/displaystory.cfm?story\\_id=6969795](http://www.economist.com/research/backgrounders/displaystory.cfm?story_id=6969795)

often difficult for SSEs

3. The per unit cost of regulatory hurdles usually present in achieving appropriate access to land also makes the unit land cost higher for SSEs. Urban land markets are typically subject to a plethora of zoning and other regulations.
4. Finally, regarding labour, labour market regulations usually distort the prices of labour making it higher for larger firms and lower for small firms in the unorganized sector. Larger firms compensate for such higher wages by using high capital intensity in production and employing higher productivity labour. Smaller firms, facing a higher cost of capital and lower cost of labour than the optimal ratio, would exhibit overall higher cost of unit output due to sub-optimal production efficiency.

The Left therefore believes that in the face of factor market distortions special support policies for SSEs would remove the various factor market distortions at their source. However, it turned out, in practice it is difficult to remove such distortions through direct intervention.

### *Truly India*

Many countries all over the world have faced these problems from time to time and various remedial measures have been adopted which include:

- Product reservations
- Fiscal Concessions
- Preferential allocation of credit
- Interest subsidy in a credit rationing framework
- Extension of business and technical services by the Government
- Preferential procurement by the Government

However, it is only India where one finds the one-of-its-kind policy of intensive reservation for SSEs. This is often attributed to the 19<sup>th</sup> century perception that the import of mass-manufactured products had affected millions of handloom textile workers and other craftspeople. And we must also remember the 'Gandhian' concern for the welfare of the handicraft and the village-based industry. It wouldn't be far off the mark to note that India's failure to achieve a broad industrial transformation stems from such misguided policies.

To quote Gurcharan Das from his article 'The Indian Model'<sup>6</sup>

"Post-independence, Nehru attempted a state-directed industrial revolution. Since he didn't trust the private sector, he tried to replace the entrepreneur with the government with unhappy results. He shackled private enterprise with byzantine controls and denied autonomy to the public sector. Perhaps the most egregious policy was reserving around 800 industries, designated "small-scale industries" (SSI), for tiny companies that were unable to compete against the large firms of competitor nations. Large firms were barred from making products

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<sup>6</sup> <http://www.foreignaffairs.org/20060701faessay85401/gurcharan-das/the-india-model.html>

such as pencils, boot polish, candles, shoes, garments, and toys -- all the products that helped East Asia create millions of jobs. Even since 1991, Indian governments have been afraid to touch this "SSI holy cow" for fear of a backlash from the SSI lobby. Fortunately, that lobby has turned out to be mostly a phantom -- little more than the bureaucrats who kept scaring politicians by warning of a backlash. Over the past five years, the government has been pruning the list of protected industries incrementally with no adverse reaction."

### *Reservedly Yours*

1967 saw the beginning of SSE reservation in earnest. Under this policy, selected products are identified for exclusive production in the small-scale sector. The following are the determinants for reservation:

1. Whether it is technically feasible to produce that item in the small-scale sector
2. Whether the manufacturing process is of a simple nature (i.e. is essentially labour intensive)
3. Whether the small-scale units can meet the requirements of consumers, both in terms of quantity and quality.

The basic features of reservation policy are as follows:<sup>7</sup>

1. The policy is applicable only to the manufacturing sector. It does not take into account the service sector, including product repair.
2. No new unit in the medium- or large-scale sector is allowed to be set up after the date of reservation, nor is any further capacity expansion in the existing medium- or large-scale units permitted. All further expansion or capacity creation is reserved for the small-sector only.
3. Existing large-scale units that were manufacturing these reserved items at the time of reservation were allowed to continue their activities indefinitely but their capacity was frozen at the existing levels --- they were prohibited from expanding further.
4. Creation of new capacity in the reserved areas is permitted among medium- or large-scale units if they undertake to export a minimum of 75 percent of their production (50 percent in the case of ready-made garments).
5. There is no restriction on the marketing by large units of big companies of products reserved for manufacture in the SSI sector.
6. A statutory Advisory Committee on Reservation was established to undertake the review of firms from time-to-time for de-reservation of items which are already reserved, reservation of new or additional items, and change the nomenclature of items.

Table 1 encapsulates the gradual escalation in the reservation of products:

### **Table 1: Progressive Reservation of Items for Exclusive Manufacture in the Small-Scale Sector**

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<sup>7</sup> Mohan, Rakesh (2003), 'SSI Policy in India: A Critical Evaluation' in A.O. Krueger (ed), Economic Policy Reforms and The Indian Economy, University of Chicago Press

Year	No. of items reserved
1967	47
1970	55
1974	177
1978	504
1980	833
1986	863
1989	836

*Source: Rakesh Mohan(2003), 'SSI Policy in India: A Critical Evaluation'*

The products included were typically labour-intensive (where India was supposed to enjoy a comparative advantage) and included all kinds of clothing, knitted textiles, shoes and leather products, and the like. This policy is today believed to be the single most important reason which constrained the growth of labour-using production of such goods and led to a stunted growth of manufacturing employment in India.

### *Impact*

The SSI experience has not been a fruitful one as the following findings show<sup>8</sup>:

1. The second census of SSIs revealed that out of 200 major products of the small sector reserved products accounted for only 21 percent.
2. Only 210,000 small-scale units (less than half of a total of 582,000 units) manufactured reserved products at all.
3. 233 reserved items out of 1,076 were found not to be manufactured at all.
4. Very few of the reserved products attracted significant levels of participation from small scale units. Clearly, substantial growth in SSI took place outside of the reserved categories.

### **Trade: Not Too 'Tariff'ic**

#### *The Others*

Apart from having the Taj Mahal, India was famous for another thing: Its trade regime was reputedly one of the world's most complex. As John Williamson and Roberto Zaghera remark in their paper 'From the Hindu Rate of Growth to the Hindu Rate of Reform':

1. It was characterized by severe licensing restrictions on imports, and very high import tariffs—with an average of 87 percent. Draconian foreign exchange regulations (for example, possession of foreign exchange was a crime) complemented restrictive trade regulations.
2. The import-licensing regime was based on 26 lists classifying all the items that were importable. Each list had its own approval procedures. Imports on some lists, notably of consumer goods, were simply banned.

<sup>8</sup> Mohan, Rakesh (2003), 'SSI Policy in India: A Critical Evaluation' in A.O. Krueger (ed), Economic Policy Reforms and The Indian Economy, University of Chicago Press

3. The licensing regime was complemented by a variety of special import schemes that increased its complexity.
4. "Canalization" policies reserved imports of specified items to designated State trading agencies.
5. Basic duties were as high as 355 percent; there were surcharges up to an additional 95 percent. These high tariffs were somewhat diluted by exemptions which reduced the effective tariff to below the nominal rate.
6. Exemption notifications were changed frequently, and often varied among different users. Notwithstanding the exemptions, average effective rates were extremely high for all categories of imports.

### *Why Tariffs Though?*

Tariffs, or customs duties on imported items, have two main functions, to serve as a source of revenue, and to protect domestic industry. Governments use the income from tariffs as a source of funding. Earlier, revenue was one of the major reasons for applying tariffs but with economic development this feature has ceased to be of great consequence. India generates Rs 321 billion in tariff revenue, which accounted for 10.5 % of total tax revenue during 2004-2005.<sup>9</sup> This figure is small and, in fact, is reducing in the Indian context. But in many developing and poor countries it is still an important source of revenue.

The major reason which was put forth by the Left was mainly to protect the domestic industry by placing competitive imports at a disadvantage. In some cases, 'tariff quotas' are used to strike a balance between market access and the protection of domestic industry. Tariff quotas work by assigning low or no duties to imports up to a certain volume (primary duties) and then higher rates (secondary duties) to any imports that exceed that level. The post-independence history of India's external sector policies may be divided into phases:

- 1950 to 1975---trend was towards tightening controls.
- 1976 to 1991---some liberalisation took place, especially during the last five to seven years.
- 1992 to 1998---tariff liberalisation was driven by multilateral concerns.

### *A Stifled Period*

Believe it or not, the Planning Commission in its First Five-Year Plan (1951 to 1955-56) called the diversion of any investment to trade a "misdirection of resources". It is pertinent to note here that trade expansion was never the basis for policies regarding import tariffs and import licensing during the early years of the planning period. Although India was a founder member of the General Agreement on Tariffs and Trade (GATT, the precursor to the WTO) since 1948, it did not leverage its position to gain advantage in trade or improve relations for itself.

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<sup>9</sup> **Industrial Tariffs In India: 1951-2005** <http://www.centad.org/relatedinfo6.asp>

It took a balance-of-payments crisis in 1956-57 to push the Indian government into applying comprehensive import controls which remained in place until 1966. In June 1966, under pressure from the World Bank, India devalued the rupee from Rs 4.7 to Rs 7.5 to a dollar<sup>10</sup> and took steps towards liberalising import licensing and lowering import duties and export subsidies. But all good things come to an end. Intense domestic criticism of the devaluation led to a reversal of the policy within a year as import controls were tightened once again.

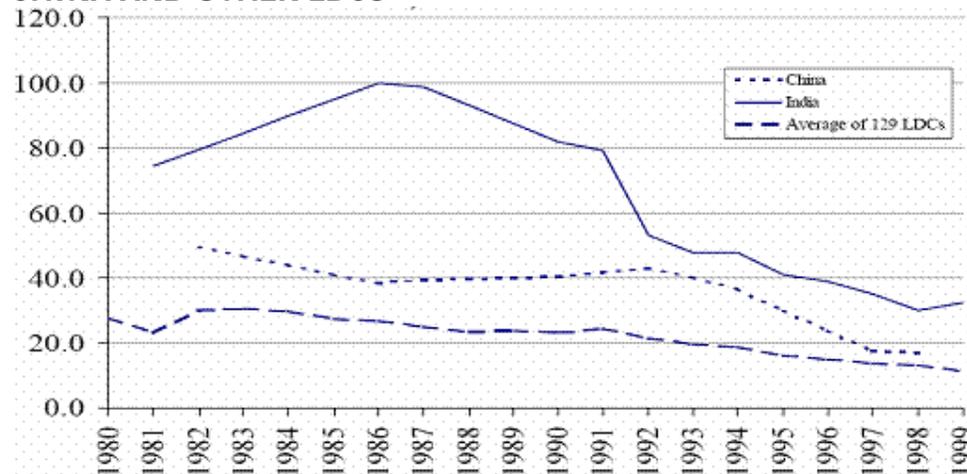
### *A Hint Of Change*

By the 1970s, not surprisingly, a plethora of quantitative restrictions, import licensing regimes and high import duties had resulted in a complex, costly and rent-seeking bureaucratic system, which stunted entrepreneurial talent in both, manufacturing and agriculture. These policies continued into the mid-'80s and resulted in the creation of:

- A strong set of public sector companies that generated skilled employment and laid a solid foundation for future industrial growth **but** never really paid attention to producing globally competitive items including capital goods.
- A technologically **unsound** and skill **deficient** manufacturing sector in the private domain that engaged in unethical and **illegitimate** methods of erecting higher import tariff walls to prevent the erosion of domestic market share and profits.
- An industry-political-bureaucracy complex that thrived on the erection of such barriers.

Thus, even as a country like China was engaging in a steady reduction of average tariffs during the first half of the 1980s, the Indian import tariff regime continued on a path of ascendancy (see diagram 1).

**DIAGRAM 1: TRENDS IN AVERAGE UNWEIGHTED TARIFF RATES -- INDIA, CHINA AND OTHER LDCs**



Source: <http://www.centad.org/relatedinfo6.asp>

<sup>10</sup> Industrial Tariffs In India: 1951-2005 <http://www.centad.org/relatedinfo6.asp>

Also take a look at Tables 2 and 3 which compare nominal tariff rates across other countries, during the year 1985, on intermediate, capital and consumer goods, and reflect the status of various imports. The data clearly shows that nominal tariff rates in India across these categories are significantly higher compared with any other country included in the table.

**TABLE 2: THE INDIAN TARIFF WALL (1985)**

Country	Intermediate Goods	Capital Goods	Consumer Goods
Hungary	14.2	15	22.6
Yugoslavia	18	20.7	20
Argentina	21.2	25	21.9
Morocco	21.6	18.1	43
Philippines	21.8	24.5	39
Mexico	25.5	23.5	32.2
Thailand	27.8	24.8	8.5
Turkey	29.4	54.9	55.3
Pakistan	75	73.8	127.3
China	78.9	62.5	130.7
Bangladesh	97.9	80.5	116.1
India	146.4	107.3	140.9

*Source: World Bank, cited in The Economist May 4, 1991, Survey*

**TABLE 3: STATUS OF IMPORTS (1985)**

TYPE	REGULATION	LICENSE
Consumer Goods Inessential	Banned	
Consumer Goods Essential (Medicines)	Permitted	
Capital Goods Restricted	Permitted	Certification of Being Essential Indigenous Clearance Angle License
Capital Goods Open General License	Permitted	No License required
Intermediate		

Goods Banned		
Intermediate Goods Restricted		License Required
Intermediate Goods Limited Permissible		License Required
Intermediate Goods Open General License		No License Required

Source: 'Economic History and The Economy of India'  
<http://www.sjsu.edu/faculty/watkins/india.htm>

The liberalisation process was initiated in 1976 through the re-introduction of the so-called Open General Licensing (OGL) list. It escalated after 1985, and by 1988 the OGL list covered 1,170 capital goods items and 949 intermediate input items. Quantitative controls on imports of industrial machinery were eliminated and tariffs on imports of capital goods were cut by 60%. By April 1990, OGL imports accounted for approximately 30% of total imports. Alongside, 31 sectors were freed from industrial licensing. This measure had a trade-liberalising dimension as well since it freed machinery imports in these sectors from industrial licensing clearance. Import flows were also helped by improved agricultural performance and the discovery of oil, which made room for non-oil, non-food imports, mainly machinery and intermediate inputs. During 1985–90, non-oil imports grew at an annual rate of 12.3%.<sup>11</sup>

### *Full Steam Ahead*

Two factors are believed to be responsible for the paradigm shift:

1. The government was preoccupied with resolving the crisis with respect to balance of payments.
2. Tough opposition from various political and bureaucratic factions to the Dunkel Draft during 1992-93 that did not allow the government space to come out with a cogent position on its WTO membership and consequent commitments.

Finally, when the government caved in and accepted the text being discussed at the GATT towards launching a new round at the beginning of 1994 (when India was completely isolated), there was very little positive offensive input in the text to reflect the aspirations of the Indian manufacturing sector in multilateral trade. This made our proposal on a host of trade policy issues, including those on reduction of tariffs on non-agricultural products, highly reactive rather than proactive.

<sup>11</sup> **Industrial Tariffs In India: 1951-2005** <http://www.centad.org/relatedinfo6.asp>

It was during this period that India attended the first Ministerial Conference of the WTO in Singapore in 1996, wherein a group of countries decided to sign the Information Technology Agreement thereby agreeing to reduce the tariffs on critical information technology items to zero latest by the end of 2004.

**TABLE 4: THE CHANGED FACE OF THE INDIAN TARIFF WALL**

ISIC code	Sector	1990	1992	1997	1999+
311	Food products	85.15	47.47	28.32	31.47
313	Beverages	190.71	181.90	124.76	116.67
321	Textiles	93.88	62.08	38.05	38.36
322	Wearing apparel	99.84	64.98	39.88	39.92
323	Leather products	82.13	55.32	19.36	29.79
324	Footwear, except rubber, plastic	100.00	65.00	40.00	40.00
341	Paper and products	90.48	58.45	23.47	31.94
351	Industrial chemicals	77.09	63.43	29.07	33.99
355	Rubber products	95.00	63.37	39.26	40.00
356	Plastic products	100.69	64.90	31.67	35.20
371	Iron and steel	84.55	64.77	28.55	33.97

*Source: 'India in the World Trading System', Romain Wacziarg, Stanford University Publication, 2003*

### **Industrial Licensing: 'Raj' uventaed Rule**

#### *Rewind*

Economic policies regarding industrialisation have undergone a sea change from the time they were introduced in the 1950s. In the pre-reform era the strategy adopted was a restrictive one of public sector dominated autarchic investment planning of industrialisation with direct discretionary controls on private investment. However, two factors contrasted with this strategy, namely:

1. The institutional framework of functioning markets
2. Predominant private ownership of means of production

Naturally, the combination of all these resulted in an economy with a persistently low rate of growth.

Let us do a quick recap.

Extensive government control (i.e. a Leftist move) began right after independence in 1947. In 1948 the Government introduced the Industrial Policy Resolution which created state monopolies in 'core' sectors of the economy from which the private sector was excluded. The reason given was to secure a continuous increase in production and ensure its equitable distribution.

The Industrial Policy Resolution, 1948 laid out the basic framework for the development of the Indian version of socialism. It divided Industry into four categories:

1. State Monopoly
  - a. Defence
  - b. Atomic Energy
  - c. Railway
2. Mixed Sector
  - a. Aircraft
  - b. Ship building
  - c. Telecom
  - d. Mineral Oil
  - e. Coal
  - f. Iron
3. Government Control (18 industries)
4. Private Enterprise

But, after the adoption of the Constitution and the socio-economic goals, the Industrial Policy was comprehensively revised. The Industries Development and Regulation Act, 1952 gave the state legal power to implement this approach.

In 1954, the Parliament passed a resolution committing India to a socialist pattern of development. And in 1956 a second Industrial Policy Resolution was adopted with the objective of 'accelerating the rate of economic growth and speeding up of industrialisation as a means of achieving a socialist pattern of society'. It also dwelt on the objective of developing heavy industry and machine building sectors and re-emphasised the objective of expanding the public sector and assisting the small and cottage industries through direct and indirect means. Most importantly, it expanded the State Monopoly from a minor 3 to a scary 17 industries (!) and doubled the mixed sector to 12 industries.

The Industrial Policy Resolution, 1956 classified Industry into three categories:

1. State Monopoly: Out of the 17 industries 4 were to be exclusively under the government (defence, atomic energy, railway, air transport). In 13 all new units were to be set up by the government but existing private units could continue.
2. Mixed Sector: 12 industries where the State would increasingly establish new units and increase production but private sector could also set up new units.
3. Private Enterprise

It's quite evident that the Industrial Policy Resolution, 1956 gave primacy to the role of the State to assume a predominant and direct responsibility for industrial development. Moreover, it increased the number of sectors reserved for public sector investment. This Left-supported plan has now been termed as 'self-reliant industrialisation'. It emphasised on basic and heavy industries and adopted public sector as a major instrument in the institutional framework of a mixed economy where private ownership of means of production was permitted in a democratic environment.

In retrospect, it's evident that there was an inherent unfounded assumption that market failure was a serious problem, that the private sector couldn't be trusted and that the public sector would produce economic and socially superior outcomes. The obvious drawback of this plan (which mysteriously escaped the notice of quite a few brainy economists) was that the 'activist state' assumed the weighty responsibility of not only initiating the economic development (the private sector, in case you are wondering, was labeled 'unwilling' to do that) but also controlling the entire pattern of investment. The consequence, as you must have guessed by now, was seen in the form of heavily regulated markets and private economic activities not to mention a drastic extension of public sector into diverse economic activities which were not really its purview. In other words, the government was interfering in areas where it wasn't supposed to. Nayyar cleverly summed up this strategy of self-reliant industrialisation as 'economic nationalism'.

While the trade policy regime was characterized by import-substitution (discussed earlier in this paper), the domestic industrial policy reserved the 'commanding heights' of the economy like iron and steel, machine tools, heavy machinery and minerals for exclusive development in the public sector. Usually, the public sector enters the market arena in case of market failures, namely, electricity, telecommunications, rail, road and air transport where initially the conditions are not favourable and thus, not attractive to private players. However, the Industrial Policy Resolution of 1956 extended the boundary of the public sector activities well beyond those justified by perceived market failures.

One must also bear in mind that the IDRA (Industrial Development and Regulation Act), 1951 had already given the government a greater degree of control in guiding private industrial activities. The important policy instruments used for this purpose included industrial licensing, controls over capital issues, price and distribution controls, and restrictions on foreign collaborations as well as imports of technology.

The activist state needed to transfer financial resources from private savers to itself in order to finance its own expanded activities as also to finance private sector activities in the priority sector. Initially, indirect taxes (excise and customs) were used as instruments to mobilize resources while allocation of private investment was controlled through industrial licensing.

Here is a small example of the draconian 'License Raj'<sup>12</sup>:

Without an industrial license from the Ministry of Industry allowing new investment to take place, the Ministry of Commerce would not provide a license to import capital goods, and the RBI would not authorize the sale of foreign currency to buy them. And even if capital goods could be purchased domestically banks would not provide financing and the Comptroller of Capital Issues would not allow equity to be allowed. Public sector monopoly over key industrial inputs such as steel, power, petrochemicals and coal provided an added influence over private sector business decisions.

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<sup>12</sup> Williamson, John. Zagher, Robert 'From the Hindu Rate of Growth to the Hindu Rate of Reform'

### *Changes: Act I*

In the early 1980s India, which had a considerably inadequate production for its population, was suffering under a system in which any action to expand, relocate or change an industry required a license. It is believed that upto 50 or 60 percent of the applications were rejected on flimsy grounds<sup>13</sup>. The truth was that the existing producers did not want to face additional competition so they also used to apply for licenses. Therefore, a substantial number of potential competitors couldn't get the licenses. It was the 1980s which saw the first wave of industrial reforms. The reforms tried to address the visibly harmful features of the previous framework.

The Industrial Policy Statement, 1980 focussed attention on the need for promoting competition in the domestic market, technological upgradation and modernisation. The policy laid the foundation for an increasingly competitive export based economy and for encouraging foreign investment in high-technology areas.

The Seventh Plan recognised the need to build on these strengths and to take initiatives to prepare Indian industry to respond effectively to the emerging challenges. A number of policy and procedural changes were introduced in 1985 and 1986 under the leadership of Rajiv Gandhi aimed at increasing productivity, reducing costs and improving quality. The focus was on opening the domestic market to increased competition and readying our industry to stand on its own in the face of international competition. The technological and managerial modernisation of industry was pursued as the key instrument for increasing productivity and improving our competitiveness in the world.

There was a gradual liberalization of controls on prices, production, distribution and investment. Some of the reforms were:

1. Price and distribution control on two important industries, cement and aluminium, was removed.
2. 'Broad-banding' i.e. expanding the variants and range of products that a given firm (licensed previously for a specific product) could produce. Thus firms could realize economies of scope for the first time.
3. The upper limits on how much an IDRA licensee could produce was gradually raised thereby enabling firms to realize potential economies of scale.
4. The value limit on investment, below which no license was required, was raised

The impact of these reforms was to greatly increase the degree of domestic competition in the economy. The dismantling of price controls meant achieving efficiency gains. These successful price liberalizations coupled with the fact that competition drove prices down (and not, as the Left thought, push prices up due to a lack of control) proved that competitive market forces did not imply impoverishment of consumers. The net result of all these changes was that Indian industry grew by an impressive average annual growth rate of 8.5% in the Seventh Plan period.

### *Changes: Act II*

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<sup>13</sup> 'Economic History and The Economy of India' [www.sjsu.edu/faculty/watkins/india.htm](http://www.sjsu.edu/faculty/watkins/india.htm)

In the 1991 reforms, the Government decided to continue pursuing this policy of encouraging entrepreneurship, developing indigenous technology through investment in research and development, bringing in new technology, dismantling of the regulatory system, development of the capital markets and increasing competitiveness for the benefit of the common man. The spread of industrialisation to backward areas of the country was actively promoted through appropriate incentives, institutions and infrastructure investments. Moreover, foreign investment and technology collaboration were welcomed to obtain higher technology, to increase exports and to expand the production base.

The major objectives of the new industrial policy package were to basically build on the gains already made and correct the distortions or weaknesses that may have crept in. A sustained growth in productivity, gainful employment and international competitiveness were other related goals.

To achieve these objectives the Government took a series of initiatives in respect of the policies regarding industrial licensing to actively encourage Indian entrepreneurs to meet the emerging domestic and global opportunities. It was realized that entrepreneurs needed to make investment decisions on their own commercial judgement. Technological dynamism and international competitiveness required that enterprises must be able to swiftly respond to fast changing external conditions, a characteristic of today's industrial world.

The Government decided to adopt a series of measures to unshackle the Indian industrial economy from the cobwebs of bureaucratic control. These measures were complementary to the other series of measures being taken by Government in the areas of trade, fiscal policy, financial sector reform and overall macro economic management. The major ones are:

1. Industrial licensing was abolished for all projects except for a short list of industries related to strategic concerns, social reasons, overriding environmental reasons and items of elitist consumption
2. In projects where imported capital goods were required, automatic clearance would now be given. In a few other cases, imports of capital goods would require clearance from the Secretariat for Industrial Approvals (SIA) in the Department of Industrial Development according to availability of foreign exchange resources.
3. Existing units would be provided with a new broad banding facility to enable them to produce any article without additional investment.
4. The exemption from licensing will apply to all substantial expansions of existing units.

## Financial Sector: An 'Interest'ing Problem

Since nationalizations in the late 1960s and the early 1970s, the public sector has dominated India's financial system. John Williamson and Robert Zagher identified three serious problems in the system (as highlighted in their study 'From the Hindu rate of growth to the Hindu rate of reform'). The first problem was government ownership and lack of competition. The government and the domestic private sector owned 28 banks each while foreign investors owned another 24. The public sector also owned many large specialized development finance institutions such as ICICI, IDBI, NABARD and HUDCO.

Public sector banks accounted for 90 percent of commercial bank deposits and ran most of the network of 60,000 bank branches. Government policies discouraged the entry of new banks and controlled the expansion, closure and location of branches. The government also owned the only 2 insurance companies in the country.

The second problem was the control of interest rates and terms. Except for interest rates in the inter-bank market the government regulated all basic interest rates on loans and deposits. Banks could issue certificates of deposit only up to 5 percent of their deposits. The third problem was regulation of the direction of credit and other forms of financial savings which excluded the market forces. There were severe restrictions and inflexible guidelines regarding commercial banks' use of funds.

Therefore, before financial reforms, in the 1980s, the environment in the financial sector was characterized by:

1. Fragmented and underdeveloped financial markets
2. A lack of suitable policy instruments
3. A complicated interest rate structure

By the end of the eighties a further lack of transparency, accountability and efficiency of banks led to a rising burden of non-performing assets.

### Financial Sector Reform

The financial sector has seen the introduction of several reforms. The beginning was made by the Narasimham Committee appointed in 1991 which made a wide range of recommendations to improve the soundness and competitiveness of the banking system. Presently, India adopted wide-ranging reforms in the banking system and the capital markets. Banking sector reforms included<sup>14</sup>:

1. Liberalization measures like dismantling the complex system of interest rate controls, eliminating prior approval of the Reserve Bank of India for large loans, and reducing the statutory requirements to invest in government securities.

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<sup>14</sup> Ahluwalia, Montek S. 'Economic Reforms in India since 1991: Has Gradualism Worked?'

2. Measures designed to increase financial soundness, like introducing capital adequacy requirements and other prudential norms for banks and strengthening banking supervision.
3. Measures for increasing competition like more liberal licensing of private banks and freer expansion by foreign banks. A sharp reduction in the share of non-performing assets in the portfolio followed and more than 90 percent of the banks now meet the new capital adequacy standards.

While the Left wing continues to stress the importance of government control one wonders whether government control can be made consistent with efficient commercial banking because bank managers are bound to respond to political directions if their career advancement depends upon the government. Even if the government does not interfere directly in credit decisions, government ownership means managers of public sector banks are held to standards of accountability which tend to emphasize compliance with rules and procedures and therefore discourage innovative decision making.

Regulatory control is also difficult to exercise. The unwritten law that public sector banks cannot be shut down means that public sector banks that perform poorly are regularly recapitalized rather than weeded out. This obviously weakens market discipline, since more efficient banks are not able to expand market share. Another major factor limiting the efficiency of banks was (and still is) the legal framework, which makes it very difficult for creditors to enforce their claims. But we still need reforms in court procedures to cut the delays which are a major weakness of the legal system at present.

Reforms in the stock market were accelerated by a stock market scam in 1992 that revealed serious weaknesses in the regulatory mechanism. Reforms implemented include:

1. Establishment of a statutory regulator.
2. Promulgation of rules and regulations governing various types of participants in the capital market and also activities like insider trading and takeover bids.
3. Introduction of electronic trading to improve transparency in establishing prices.
4. Dematerialization of shares to eliminate the need for physical movement and storage of paper securities.

Effective regulation of stock markets requires the development of institutional expertise, which necessarily requires time, but a good start has been made and India's stock market is much better regulated today than in the past. This is to some extent reflected in the fact that foreign institutional investors have invested a cumulative \$21 billion in Indian stocks since 1993, when this avenue for investment was opened.

Another important reform was curtailing the special privileges enjoyed by the Unit Trust of India, a public sector mutual fund (which was the dominant mutual fund investment vehicle when the reforms began). The Trust had to be bailed out once in 1998, when its net asset value fell below the declared redemption price of the units, and again in 2001 when the problem recurred. It has now been decided that in future investors in the Unit Trust of India will bear the full risk of any loss in capital value. This removes a

major distortion in the capital market, in which one of the investment schemes was seen as having a preferred position.

If you remember, the insurance sector was a public sector monopoly at the start of the reforms. The Malhotra Committee (in 1994) stressed the need to open the sector to private insurance companies but there was strong political resistance. It was only in 2000 that the law was finally amended to allow private sector insurance companies, with foreign equity allowed up to 26 percent, to enter the field.

Moreover, an independent Insurance Development and Regulatory Authority was established and ten new life insurance companies and six general insurance companies started operations. The development of an active insurance and pensions industry offering attractive products tailored to different types of requirements are hoped to stimulate long term savings.

### **Conclusions**

It is interesting to see how so many significant variables that affect the economy have been juggled and knotted by the left in 60 years of free India. The impact on the economy through more market orientation is for all to see. However, it is important to understand that there needs to be a more united effort in making sound policies that are based on rationale than compromise is an imperative tool for economy's success.

Labour laws present an interesting paradox as they thwart the chances of the very people for whom they were made. They were developed to enhance job security and confer at least some power to the workers but their restrictive nature has led employers to employ labour-substituting measures. The growth of trade unions which proclaim strikes at the drop of the hat has also been a major drawback

Small Scale Industry reservations might have played a limited role in promoting SSIs but the more harmful impact was the exclusion of large companies into these industries. Realistic policies, which would have provided better support to SSIs, were nipped in the bud. The investment limit was a great hindrance as the growth of a SSI unit would mean the loss of various facilities and incentives which were available to it as a small-scale unit. Since this policy also prevents successful firms from growing it acts as a dampener on entrepreneurship. Thus, there is indeed a strong case for the abolition of reservation of products for the small-scale sector. If only the Left could see it.

India's journey from the restrictive import substitution era to the relatively free times of import liberalization today has been a ponderous and rocky one. Political backlash and populist arguments led to the creation of a highly myopic view which missed the wood for the trees. Thankfully, we can look forward to an improved trade policy ahead as more and more people acquire a growing awareness of the benefits of trade liberalization.

The industrial licensing system thus gradually moved away from the concept of capacity licensing. The system of reservations for public sector undertakings has become more flexible and private sector enterprise has been gradually allowed to enter

into many of these areas on a case-by-case basis. Further impetus can push us towards attaining entrepreneurial and industrial potential. The exemption from licensing will be particularly helpful to the many dynamic small and medium entrepreneurs who have been unnecessarily hampered by the licensing system. As a whole the Indian economy will benefit by becoming more competitive, more efficient and modern.

Hence, as we've seen, the financial system and capital markets were gradually de-controlled and the private sector was allowed a relatively free hand. The virtual government monopoly of nationalized banking is gradually eroding with the entry of private banks in the competitive arena. The most important reforms were the ones related to the removal of interest rate ceilings on bank lendings and a battery of controls over banks.

Despite such realities, I ask what is the way forward. While it's true that the post-reform era has not been completely trouble free, most of the Leftist fears have been disproved. Contrary to their expectations, liberalizing trade, freeing industries, de-reserving items under SSI lists, all have had a tremendous positive impact.

It is high time that the Left discards its archaic notions and stops acting as a major pitfall whenever even a mention of reforms is made. What every policymaker must remember is that, as time passes, laws can and do become obsolete. The economy of a nation like India is always in a state of flux thereby requiring policies and regulations to be constantly monitored, evaluated and upgraded. In an era when 'dynamism' is a byword we must not remain constrained by rules which have far outlived their usefulness.

But in the process of helping the economy people must neither become unmindful of the interests of the marginalized sections nor adopt overly restrictive policies which stifle economic growth by alienating economic agents and lead to shrinking markets. Thus, what is required is a healthy combination of social awareness, an acute knowledge of economic processes and intelligent foresight while designing future strategies and changing present ones. Only then can we have ideal growth in every sphere of the economy as well as the nation.