Indira Gandhi
National Open University
School of Social Sciences

BECE-202
Indian Economic Development: Issues and Perspectives

Block

5
INDUSTRY AND SERVICES SECTOR

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BLOCK 5 INDUSTRIAL AND SERVICE SECTOR

Introduction

The present block, the fifth in the course, is on industrial and services sector. The block consists of four units.

Unit 16 deals with the policies and strategies pursued for industrial development in India. Reviewing briefly the different industrial policies of pre-liberalisation period, the unit in particular discusses the post-liberalisation policy features like New Industrial Policy (1991), Competition Act (2003) and the SEZ Act (2005).

Unit 17 discusses, analytically, the different phases of industrial growth in India classified into four phases viz. 1951-66, 1966-80, 1981-90 and 1991-2007. It also discusses the linkage between economic reforms and economic outcomes in the context of country's fluctuating agricultural performance and declining public investment scenarios.

Unit 18 focuses on 'Foreign Investment'. In the context of the role of foreign investment in economic growth, the unit discusses the factors influencing the foreign investment flows to a country. Followed by a brief review of FDI policy in India, the unit presents an analytical appraisal of trends in FDI in India.

Unit 19, on Services Sector, specifies the factors promoting the growth of services sector in the context of the sector playing the role of an 'engine of growth' for the Indian economy. Presenting the changing profile of the composition of sectoral shares in the GDP of the country, it discusses the proposition of sustainability of service sector led growth. The significant contribution of 'trade in services', which has been the main driver of services sector growth in India in recent years, is also outlined.

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UNIT 16 INDUSTRIAL POLICY AND STRATEGY

Structure

16.0 OBJECTIVES

After reading this unit you will be able to:

- outline the relationship between development strategy and industrial policy;
- identify the areas of operation of industrial policy;
- explain the basic features of the industrial policy as it evolved during the early strategy of growth in India;
- enumerate the reasons for initiating the changes in the approach to industrial policy;

- bring out the significance of appropriate industrial policy in the changing environment of liberalisation, privatisation and globalisation;
- apprise the importance of small scale industry sector in the industrial landscape of the country;
- discuss the importance of competition in the era of liberalisation; and
- explain the new phase of industrial development as is being sought to be introduced through Special Economic Zones.

16.1 INTRODUCTION

There are several dimensions of industrial policy which influence the direction of industrial investment and production. Among these, the more important are as follows:

i) An approach to industrial licensing for regulating the setting up of new (large and medium) industrial undertakings and their expansion.

ii) A policy to control the monopoly and concentration.

iii) A policy regarding technology import including import of capital goods, components and raw materials.

iv) A range of financial and fiscal policies pertaining to the provision of industrial finance, development of the capital market, and fiscal incentives/disincentives to investment and production.

It is in this background that we have to study the evolution of industrial policy in India. Mainly we will try to see: (i) how far its basic contours have changed in tune with the developmental strategy envisaged?; and (ii) how far it has worked as a potential tool to realise the goal of 'planned development'? Our attention would be focused on those aspects of industrial policy other than fiscal and financial policies as these two issues have been separately covered in the units of Block 3 of this course. We will also pay a particular attention to aspects like competition policy, policy towards small-scale industries and policy relating to special economic zones in this unit.

16.2 INDUSTRIAL POLICY AND STRATEGY BEFORE 1991

Economic policy is conditioned by the paradigm of development and the strategy of growth. Each specific strategy of growth requires creation of institutions that would smoothen its pursuit. For instance, a strategy of growth that depends on the growth of agriculture would be different from the one to be pursued for the promotion of light-goods industry. Whatever the strategy, the involvement of the state would be necessary

to ensure a smooth functioning in which monopolistic tendencies leading to erosion of values of social concern are curbed.

India made a conscious decision to follow the heavy-industry-led-growth strategy, right from the time of its Second Five Years Plan. The strategy found its concrete expression in the Industrial Policy Resolution (IPR) of 1956. The adoption of the IPR 1956 was necessitated by a series of developments of which the more important ones are as follows:

1. New Constitution of India which guaranteed certain Fundamental Rights provided by the Directive Principles of State Policy.

2. Acceptance by Parliament of the socialist pattern of society as the objective of the country's socio-economic policy.

3. Completion of the First Five Year Plan and the commencement of the Second Plan incorporating the framework emphasising the path to heavy industry led growth strategy.

The industrial policy, like all other policies was, therefore, to be governed by the principles and directions enshrined in the constitutional provisions. The IPR, 1956 which came to be known as the 'Economic Constitution' of India laid emphasis on the following:

- the development of heavy machine industries to lay the foundation of the 'capital goods industries';

- the expansion of the heavy industry's base in the public sector showing the commitment of the state to actively involve itself in the pursuit of the objective stated above;

- encourage the participation of the private sector in the pursuit of the above to make them co-partners; and

- establish a large co-operative sector to promote the growth of cottage and small scale industries alongside the promotion of heavy industries.

16.2.1 Basic Features of Industrial Policy in the Pre-Liberalisation Phase

Demarcation of Industries

As said above, the IPR 1956 reiterated the promotion of cottage and small-scale industries with the aim of reducing the regional disparities. For this, the IPR 1956 classified the entire industrial sector specifying the groups of industries into three schedules as per which either the State (i.e. the public sector) or the private sector or both were expected to participate in the process of industrialisation. The demarcation of industries into the three schedules, in terms of numbers, were made as follows:

i) **Schedule A:** 17 new industries, to be set up only by the state except where permission had already been given earlier (e.g. Tata Steel Plant);

ii) **Schedule B:** 12 industries, where the private sector was expected to supplement the efforts of the state; and

iii) **Schedule C:** all other remaining industries, except for the 29 mentioned in schedule A and B above, in which the developmental initiative was left entirely to the private sector.

Notwithstanding the demarcation, it was always left open to the State to undertake industrial production in any of the areas keeping the national interest in mind.

Industrial Licensing

Industrial license is an important instrument of state policy. It is a written permission from the government to an industrial unit to manufacture goods specified in the permission letter. It also specifies such particulars as the location of the plant, goods to be produced, capacity of the unit, period within which the industrial capacity is to be established, etc. The primary objective of the licensing system is to give effect to the industrial policy of the government. The broad objectives of the licensing system will, therefore, have to be in consonance with those laid down in the industrial policy. Any major structural change in industrial policy would need a corresponding change in the objectives of industrial licensing.

Legislative Framework for Industrial Licensing

The legislative framework for industrial licensing is embodied in three different Acts viz. (a) Industries Development and Regulation Act, 1951; (B) Monopolies and Restrictive Trade Practices Act, 1969; and (c) Foreign Exchange Regulation Act, 1973.

(A) **Industries Development and Regulation (IDRA) Act, 1951:** The Act makes the registration of all industrial units in the scheduled industries compulsory requiring the units to obtain a certificate of registration within a prescribed time. It also requires the new industrial units to be established only after obtaining a license from the central government. A license from the government is required for any of the following purposes: (a) starting of a new industrial unit; (b) a major expansion of the existing unit; (c) the manufacture of a new 'article'; and (d) shifting the location of an industrial unit.

(B) **Monopolies and Restrictive Trade Practices (MRTP) Act, 1969 :** Conceived as a competition law, the Monopolies and Restrictive Trade Practices Act comprises of the following objectives:

(i) curbing the concentration of economic power and growth of monopolies;

ii) imposing restrictions on the acquisition and transfer of shares of, or by, certain corporate bodies;

iii) controlling monopolistic trade practices; and

iv) controlling restrictive and unfair trade practices.

Thus, apart from ensuring that the operation of the economic system does not result in the concentration of economic power in the private sector corporation, the Act seeks to promote competition among the private enterprises by controlling monopolistic and restrictive trade practices.

(C) **Foreign Exchange Regulation (FERA) Act, 1973:** FERA 1973 also had its origin in the Foreign Exchange Regulation Act, 1947. The FERA 1947 was the outcome of various ordinances promulgated during the Second World War and immediately thereafter regulating the foreign exchange transactions. The term foreign exchange includes foreign currency, deposits and balances payable in foreign currency and foreign securities.

The preamble to the FERA 1973 states the scope and purpose of the Act as 'to consolidate and amend the law regulating certain payments, dealings in foreign exchange and the import and export of currency and bullion'. The underlying objective is to conserve the foreign exchange resources of the country so as to ensure its proper utilisation in the interest of the economic development of the country.

The Act empowered the Reserve Bank of India and the central government to:

i) see that foreign exchange earned by exports or otherwise properly accounted for and realised;

ii) control the acquisition and holding of foreign exchange in any form and making of payments in foreign exchange;

iii) give directions to banks, travel agents and others; and

iv) make rules and issue notifications for this purpose.

The Act sought to impose restrictions on the establishment of place of a business by an Indian national residing outside India or a foreigner or a company which is not incorporated under any law in India or in which the non-resident interest is more than 40 percent. The Act required the permission of the Reserve Bank of India to be taken for carrying out any activity of a trade either commercial or industrial in nature. The permission was also required for the acquisition of any undertaking in India including the purchase of shares of any company.

The Act empowered the government to call for information, search suspected persons, seize documents, stop and search conveyances, search premises, etc. in connection with the enforcement of the Act.

16.2.2 Phase of Liberalisation

The industrial policy and its adjunct industrial licensing system served to protect the Indian industry, both against potential domestic and foreign competition. Protection was thus considered the right approach in the initial stage of industrialisation in a developing economy like India struggling to come out of the stranglehold posed by two-centuries of colonial domination.

The industrial landscape underwent a dramatic change within a period of about four decades of attaining independence. However, a failure of the policy of protection was that it did not build a mechanism that could prompt the industry to adapt itself to the fast-changing technological scenario in the outside world. The industrial structure of India, under the burden of protection, therefore turned out to be high-cost and low-quality lacking in the basic ingredients of international competitiveness.

(a) Mid-1970s Onwards: Experiments with domestic liberalisation began in the mid-1970s. In 1975, a scheme was introduced which provided for an increase in licensed capacity up to a maximum of 25 percent in a five-year period. Other measures included regularisation of capacities in excess of authorised capacities for certain specified industries and liberalisation from controls for units which exported 100 percent of their production. A more general scheme of re-endorsement of capacities was introduced in 1982 which raised the exemption limit for industrial licensing from the Rs. 3 crore set in 1978 to Rs. 5 crore. This limit was again raised in 1988 to Rs. 25 crore for the units set up in the non-backward areas and to Rs. 75 crore for units set up in the backward areas.

The main emphasis during the 1970s through the mid-1980s was thus on reducing the restrictive and complex features of the licensing policy.

Mid-1980s Onwards: The process of reorientation of industrial policy gathered momentum after the mid-1980s with the government setting up several committees to examine its fiscal, monetary and trade policies. The general outcome of their findings and recommendations can be expressed in two sets of interrelated propositions viz. (A) Requirement for Accelerated Growth, and (B) Requirement for Enhancing the Domestic Resource Situation.

A) Requirement for Accelerated Growth: The principal factors sequentially linked to meet the requirement for accelerated growth are as follows:

i) requirement of increased imports to boost production;

ii) increased exports to enable paying for increased imports owing to decreases in concessional aid and risks of onerous debt burden connected with large scale commercial borrowing;

iii) enhancing the competitive advantage of exportable goods to increase exports; and

iv) changes in industrial, trade and fiscal policies to increase the competitive advantage for exportable goods.

B) Requirements for Enhancing the Domestic Resource Situation: Its principal features were identified as follows:

i) the government budget is no longer an adequate source of finance for investment;

ii) reducing defence expenditure is not an option available to the government;

iii) subsidies can be reduced only gradually to avoid major social and political upsets; and

iv) the only way to raise additional resources is to make the tax system more responsive and make the public sector enterprises generate resources through greater efficiency.

In view of the above two propositions, the period beginning with 1985 saw the development of rule based industrial policies like dual prices, tax and tariff based interventions rather then direct price, output or capacity controls at the level of the firm, etc. With this, in general, the role of market and importance of private incentives came to be appreciated. Many concepts like broad-banding, minimum economic capacity and de-licensing made their appearance during this period. We will briefly outline these concepts before we proceed further.

Broad-banding: The licensed units were given the flexibility of the product-mix within the overall ceiling sanctioned in the licence. For instance, a producer may have the licence to produce 10,000 scooters, 20,000 motor-bikes, and 5,000 three-wheelers during a year making for an overall 35,000 units of output. Till broad-banding was introduced, the producer could not produce more than 10,000 scooters even though it chose to produce zero motor-bikes in view of the demand conditions. After broad-banding was introduced, if the producer so desired he could produce 35,000 scooters exclusively.

Minimum Economic Capacity: This means minimum scales of production were decided upon and fixed. If any production unit sought official assistance, it had to ensure that it would set up the capacity conforming to this minimum viable scale. More generally, there was no ceiling but only a threshold floor level prescribed.

Delicensing: This meant that certain products were exempted from licensing requirements.

Check Your Progress 1

1. What are the important factors on which the IPR 1956 laid its emphasis?

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2. What are the three basic features by which the Industrial policy Resolution, 1956 is governed?

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3. What were the major changes introduced in the early phase of liberalisation through the industrial policy of 1970s?

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4. What requirements were identified for achieving accelerated economic growth during the later part of 1980s?

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16.3 INDUSTRIAL POLICY AND STRATEGY AFTER 1991

By late 1980s, it had become clear that the growth strategy pursued in the past was unsustainable. Economic imbalances grew to critical levels

necessitating the taking of recourse to deficit financing. The monetised deficit quickly worked itself through the foreign trade multiplier to a current account deficit in the BOP. A rising BOP deficit could not be continuously financed within the domestic resource potential, resulting in a haemorrhage of the foreign exchange resources. This made it necessary to adopt external measures to adjust the budgetary deficit. The adjustments resulted in a slow down of the economy, as the public sector, owing to resource constraints, could not provide the required stimulus to demand creation. Thus, the tyranny of the twin deficits (viz. fiscal and BOP deficit) thwarted the hope of revival of the growth process.

To meet the emergent situation, the government responded with a well-crafted set of macro economic policies, including a new industrial policy. Based essentially on the neo-classical paradigm, the new industrial policy was designed to step up the growth momentum and help in the restoration of macro-economic and financial stability.

16.3.1 New Industrial Policy

Making a sharp departure from the Industrial Policy Resolution of 1956, the government announced a new industrial policy on July 24, 1991 with a new set of objectives and policy thrust.

Objectives

The principal objectives of the new industrial policy (NIP 1991) were identified as follows:

i) to consolidate the strengths gained during the four decades of economic planning over 1951-91;

ii) to correct the distortions (or weaknesses) that had crept in to the industrial structure (i.e. one of low productivity and high cost production);

iii) to improve and maintain sustained growth in industrial productivity with gainful employment creation; and

iv) to attain international competitiveness.

The pursuit of these objectives needed to be tempered with a need for: (a) sustainability concerns vis-a-vis protection of environment, and (b) efficient use of available resources.

Policy Changes

Important changes in the NIP 1991, including the subsequent changes, can be briefly stated as follows:

1. Industrial Licensing Policy:

a) Industrial licensing has been abolished for all projects except for a

short list of industries (e.g. industries of security and strategic concern, social concerns owing to usage or generation of hazardous substances creating environmental degradation or destruction, items of elitist consumption, etc.). Thus, the four industry groups which are specifically mentioned to require industrial licensing are:

i) distillation and brewing of alcoholic drinks;

ii) electronic aerospace and defence equipment, defence aircraft and warships, manufacture of aerospace substitutes;

iii) industrial explosives including detonating fuses, safety fuses, gun powder, nitro-cellulose and matches; and

iv) cigars and other tobacco products.

In addition, three industry groups where security and strategic concerns predominate and hence will be reserved exclusively for the public sector are:

i) generation of atomic energy;

ii) substances notified by the Department of Atomic Energy; and

iii) railway transport (where private capital is allowed for a limited extent)

b) In projects where imported capital goods are required, automatic clearance will be given:

i) where foreign exchange requirement is ensured through foreign equity; and

ii) where the value of imported capital goods required is less than 25 percent of the total value of plant and equipment subject to a maximum value of Rs. 2 crores;

c) Except for the Units or establishments mentioned under (a) and (b) above, all requirement for industrial approvals from the central government are freed provided the location of industries are not within 25 kms. of cities having population of more than one million.

d) Industries of non-polluting nature such as electronics, computer-software and printing are permitted to be located within 25 kms. of the periphery of cities with more than one million population. However, other industries are permitted only if they are located in designated industrial areas.

e) Till the announcement of this policy, any enterprise borrowing from a public development finance institution had to incorporate a clause i.e. ‘mandatory convertibility clause’ in the loan agreement that the lender had the right to convert loan into equity at his will. The

clause thus worked as a potential threat of takeover. The new policy provided that the mandatory convertibility clause will no longer be applicable for term loans from the financial institutions for new projects.

f) All existing registration schemes will be abolished.

g) Entrepreneurs will henceforth only be required to file an information memorandum on new projects and substantial expansion.

   i) The system of phased manufacturing programmes run on an administrative case-by-case basis will not be applicable to new projects.

   ii) The exemption from licensing will apply to all substantial expansions of existing units.

2. **Foreign Investment:** In regard to foreign investment, the principal features of the new policy are as follows:

   i) Automatic approval is available to FDI in almost all sectors except for a few sensitive ones. Automatic approval is available for 50 percent, 51 percent, 74 percent and 100 percent in specified industry groups.

   ii) To provide access to international markets, majority foreign equity holding of up to 51 percent will be allowed for trading companies primarily engaged in export activities.

   iii) A Foreign Investment Promotion Board has been constituted to negotiate with a number of large international firms and approve direct foreign investment in select areas.

3. **Foreign Technology Agreements:** The principal features of the policy on foreign technology agreements are:

   (a) Automatic permission will be given to foreign technology agreements in identified high priority industries up to a lump-sum payment of $ 2 million, 5 percent royalty for domestic sales and 8 percent for exports, subject to total payment of 8 percent of sales over a 10 year period from the date of agreement or 7 years from commencement of production.

   (ii) In respect of industries other than those specifically mentioned, automatic permission will be given subject to the same guidelines as in cases where no foreign exchange is required for any payment.

4. **Public Sector:** In regard to the public sector, the new industrial policy provides as follows:

   (i) Portfolio of public sector investments will be reviewed with a

view to focus its investments in strategic, high-tech and essential infrastructure. Whereas some reservation for the public sector is being retained, there would be no bar for areas of exclusivity to be opened up to the private sector selectively. Similarly, the public sector will also be allowed entry in areas not reserved for it.

ii) Public enterprises which are chronically sick and which are unlikely to be turned around will be referred to the Board of Industrial and Financial Reconstruction for revival/rehabilitation schemes.

iii) In order to raise resources and encourage wider public participation, a part of the government's shareholding in the public sector would be offered to mutual funds, financial institutions, general public and workers.

5. **MRTP Act:** With regard to the MRTP Act, the new industrial policy provides as follows:

   i) The MRPT Act has been amended to remove the threshold limits of assets in respect of MRTP companies and dominant undertakings.

   ii) Provisions relating to concentration of economic power, pre-entry restrictions with regard to prior approval of the central government for establishing a new undertaking, expanding an existing undertaking, amalgamations/mergers, etc. have been removed.

   iii) Emphasis will be placed on controlling and regulating monopolistic, restrictive and unfair trade practices.

16.4 EVALUATION OF NEW INDUSTRIAL POLICY

The new industrial policy has altered the industrial scenario in India. In intent and scope, the industrial policy is a watershed which has opened up a new era of industrialisation with both economies of scale and quality of products stressed. The two (viz. economies of scale and quality) virtually hold the key to higher productivity and competitiveness both in the domestic and the export markets for the Indian industry.

However, on the negative side, with the opening up of the economy, Indian industry has become far more unstable than before with the impact of this falling on the marginalised sections of the society. It is important, therefore, to focus specifically on the weaknesses of the new industrial policy. But first we list out its strengths.

16.4.1 Strengths of New Industrial Policy

The process of liberalisation got a strong push with the announcement of the NIP, 1991. It entered a new phase of what has been described as 'reform by storm' supplanting the approach of 'reform by stealth' of the later half of the 1970s and 'reform with reluctance' during the second half of the 1980s. The important strength of the new policy can be identified as follows.

1. The NIP made a bonfire of the industrial licensing system through various provisions. There has been a move away from extensive physical controls and an increase in the role of financial incentives in channelling investments in the desired direction. This, plus the lowering of the tax rates combined with better administration of the revenue collection system, is expected to attract more economic enterprise and investment. The role of the financial institutions becomes very important in the new regime.

2. There is considerable internal deregulation aimed at strengthening the more efficient domestic firms and encouraging them to invest and expand. This is expected to inject much more competition into the system, creating incentives for reducing costs. Scientists tell us that the diamond sparkles because of a phenomenon called total internal reflection. If our economy is to sparkle, total internal liberalisation is the key.

3. Measures have also been taken to improve the legal framework. The Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 gives powers to banks and financial institutions to enforce their claims on collateral for delinquent secured credit, without going through a long and cumbersome judicial process. The Competition Act 2003, aims at promoting competition through prohibition of anti-competitive practices, abuse of dominance and through regulation of companies beyond a particular size. In Companies (Second Amendment) Act 2002, industrial sickness has been redefined, a revival and rehabilitation fund has been set up, and protection from creditors has been withdrawn.

4. The internal liberalisation has been accompanied by a policy of maintaining an open access to imports to permit modernisation and technological upgrading in Indian industry which again will reduce costs and promote international competition.

5. An important feature of the process of policy reform underway in India is that it is gradualist as against the 'big bang' type adopted in some other countries. The system is being subjected to much stronger pressures for efficiency and modernisation, but at a controlled pace. The rationale for this gradualist approach lies in the perception that the system should be subjected to pressure commensurate with its ability to respond. Pressure beyond this point will only be disruptive.

In sum, the aim of the sweeping policy changes is to evolve an integrated economic package that can be implemented in stages to create an appropriate environment so as to encourage and promote greater efficiency, higher productivity and faster industrial growth in desired directions through a well-coordinated system of incentives.

16.4.2 Weaknesses of New Industrial Policy

The new industrial policy suffers from a number of weaknesses. Among these, the more important are as follows:

1. **Absence of suitable policy for exports:** Today, the high-tech industries are receiving a similar emphasis as was granted to their basic industry counterparts in the past based on the infant industry argument. In the environment of limited export incentives and regulated labour markets there seems little reason to believe that today's infants will provide an engine for growth consistent with the present targets.

2. **Distortions in industrial pattern owing to selective inflow of investments:** In the current phase of investment following liberalisation, while substantial investments have been flowing into a few industries, there is concern over the slow pace of investments in many basic and strategic industries such as engineering, power, machine tools, etc. This is mainly due to the low rate of return in these sectors which is less than that in the new or 'sunrise' industries (e.g. IT sectors). Such distortions in the investment pattern need to be rectified for ensuring balanced growth of industries in the country.

3. N**eed for strengthening inter-linkages between new and old sectors:** New sectors should have strong linkages with the old ones and should push up the latter towards modernisation and new product development. Unless such inter-linkages are strengthened, a part of the impetus given by the new sectors could be lost through leakage to other countries where the comparative advantage is stronger.

4. **Labour questions:** Restructuring and modernisation of industries as a sequel to the new industrial policy, often leads to displacement of labour. This would call for redeployment of labour through rehabilitation schemes. Thus, while modernising a particular industry, simultaneous efforts should also be made to identify areas of operations in which labour could become redundant. Identifying and developing the areas of growth in which such surplus labour could be absorbed should be simultaneously provisioned so as to avoid labour displacement and rehabilitation problems.

5. **Absence of incentives for raising efficiency:** Studies have shown that the incentive structure in the 1980s was some what perverse leading to industrial growth moving away from the sectors in which the country had comparative advantage and strength. Such policies encouraged industries with high domestic resource cost. Focussing attention on internal liberalisation without adequate emphasis on trade

policy reforms, resulted in 'consumption-led-growth' rather than 'investment' or 'export-led-growth'. The resultant growth-process was therefore not sustainable in a longer time framework. Lessons from this should have been provisioned for in the New Industrial Policy which is lacking as the following point shows.

6. **Absence of incentives for technological innovations:** The policy of liberalisation appears to have failed to achieve one of its major objectives viz. creating more innovative firms. This is evidenced by the industrial structure which has led to greater technology imports than to greater in-house innovative efforts.

7. **Improperly-defined industrial location policy:** The NIP, while emphasised the detrimental effects of damage to environment, failed to define a proper industrial location policy which could ensure a pollution free development of industrial climate. In its absence, the new industries have gravitated towards the already well-established industrial centres with a well-developed infrastructure.

8. **Distributional consequences:** If the industrial growth has to be sustained, the policy reforms have to address the distributional issues from a fundamental sense. Evidence from Latin American countries show that countries with highly skewed income distribution also have a highly volatile growth process. The NIP, failed to adequately draw from such experiences of other countries. We will see a specific instance of this nature, in the SEZ policy of the government, in section 16.7 of the unit.

To sum up, there is a need for reviewing certain provisions of the policy to make it more meaningful and effective. With suitable reorientation, the new industrial policy has the potential to provide a strong growth push to the country's industrial growth.

Check Your Progress 2

1. What are the five areas in which 'policy changes' were introduced in the NIP, 1991?

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2. Enumerate the major weaknesses of new industrial policy (NIP 1991).

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16.5 SMALL SCALE INDUSTRY (SSI) POLICY

India has the longest history of small enterprise development policy both in Asia and the world. Over the last six decades, India has built up one of the world's most elaborate small enterprise development programmes for providing assistance to individuals and institutions, both in the urban and rural areas, for setting up small-scale enterprises. In the post-reforms period, there has been a shift in focus from 'protection' to 'promotion'.

The Micro, Small and Medium Enterprises Development Act, 2006, defines small enterprises as those manufacturing units which have investment above Rs. 25 lakh and up to Rs. 5 crore. It takes into account investments in plant and machinery only and does not consider money invested for effluent treatment, quality control, fire-fighting equipment and safety. It also excludes the 'standby' investment in land and buildings. A separate category of medium enterprises up to a capital investment of Rs. 10 crore has also been recognised in the Act.

16.5.1 Basic Features of the SSI Policy

As earlier stated, in the pre-reforms era before 1990, the focus of the small-industry policy was on extending 'protection' to the sector. The various dimensions of the protective framework for SSI sector have been presented in Table 16.1.

Table 16.1: Protective Framework for SSI

Sl. No.	Policy Measure	Implication
1.	Demarcation Through Definition	Eligibility limits to avail concessions, benefits and incentives meant for SSI
2.	Concessional Finance	Lower cost of capital
3.	Priority Sector Lending	Ensures the flow of a certain percentage of bank credits to SSI
4.	Fiscal Incentives	Wide ranging tax benefits. As a result, low or negligible tax payment.
5.	Price Preference	If quality is comparable, SSI products are preferred to large industry products by government departments even if prices of the former are higher than that of the latter to an extent of 16 percent.
6.	Reservation of items for exclusive government purchases	Assured market for SSI manufactures of reserved items.

Sl.No.	Policy Measure	Implication
7.	Reservation of items for exclusive manufacturing in SSI	Virtually prevents any kind of competition from large scale units who have to export 75 percent of the output if obtained license to manufacture a reserved item.
8.	Preferential access to raw materials and liberal import policy	Assured supply of scarce raw materials, both domestic and foreign and easier access to capital goods imports.
9.	Exemption from industrial licensing and labour policy	More operational freedom and further protection from competition since the rest of industry is subjected to industrial licensing and labour policy.

Constraints for SSI in a Liberalised Regime: The growth of SSIs under a liberalised regime is, however, constrained by a number of factors, among which the more important are as follows: (i) change in consumer preference, (ii) outmoded technology, (iii) uneconomic scales of operation, (iv) lack of organisation, (v) total disregard to environmental standards, (vi) high incidence of sickness, and (vii) problems of market access and organised market network facilities. To improve the situation on these fronts, the government announced on August 6, 1991, a new policy for small industries. The new policy proposed clear cut guidelines to deal with the four major areas of concern viz. (i) quality, (ii) technology, (iii) finance and (iv) marketing.

The problems of small industry in all these areas are closely inter-linked. Firstly, it is due to the lack of quality that the small industry units face the problem of marketing. To improve quality, technology up-gradation and modernisation of SSI units are required. This, is turn, demands enormous amount of funds. Even after modernisation, to sustain competitiveness, small industry should have access to changing technology and re-financing for quality up-gradation by modernisation. Thus, once the three specific aspects of quality, finance and technology are taken care of all that the small-scale industry needs is marketing assistance or information on marketing opportunities. The major features of the new small industry policy are presented in Table 16.2.

Table 16.2 : New Small Industry Policy : Major Thrust Areas

Sl. No.	Major Features	Objectives
1.	Emphasis to shift from subsidies/ Cheap credit to adequate credit	To meet the emerging demand for credit
2.	Equity participation by other undertakings domestic/foreign	

Sl. No.	Major Features	Objectives
3.	Preferential credit from banks	To strengthen small industry promotional measures
4.	Marketing of mass consumption goods under a common brand name	
5.	Industry associations to be involved in setting up Sub-Contracting Exchanges	
6.	Technology Development Cell in small Industry Development Organisation	To upgrade technology and promote modernisation
7.	Industry association to establish quality counselling and common testing facilities	
8.	Technology information centres	
9.	Reoriented modernisation and technology up-gradation programmes by a cluster based approach	

In pursuance of the policy measures outlined above, a comprehensive new policy package for small-scale industry was announced in March 1994. This was supplemented by a set of policy initiatives announced in June 1998 and August 2000, based on the recommendations of S. P. Gupta committee and other inputs from various sources. The new policy package aims at giving SSIs a level playing field vis-à-vis the large and medium sector in respect of availability of raw materials, credit and infrastructure facilities. The package will provide faster mechanism for review of list of items reserved for SSIs keeping in view the changing situation. It will also facilitate integration of the SSIs with other sectors, accelerate modernisation and technology up-gradation.

The success of the new SSI policy depends to a great extent on the quality of the downstream action required. This specifically includes some of the linked schemes like single window clearance scheme for composite loans, de-bureaucratisation, establishment of new marketing schemes, programmes for technology up-gradation and compulsory quality control, the nature of the legislation to ensure payment of bills of small-scale units, etc.

16.6 COMPETITION POLICY

In the pre-reforms era, various restraints to competition existed. These can be briefly recapitulated as follows:

i) investment restraints (licensing);

ii) entry restrictions for new enterprises;

iii) control over acquisition of economic power through MRTP;

iv) public sector reservation for infrastructure and other industries creating monopolies in various areas;

v) product reservation for the small-scale sector;

vi) procurement policies favouring public and small-scale industries;

vii) trade restrictions and high tariffs; and

vii) restrictions on foreign direct investment.

Competition is the foundation of an efficient production and market system. For increasing the competitive strength of the Indian economy, two factors are recognised as vitally important. These are: (i) enabling the Indian Players to become competitive globally, and (ii) creating a user-oriented and user-friendly environment in the domestic market.

The key issue in the current phase of transition being competition, a competition policy with its supporting laws are necessary to secure the gains brought about by national and international competitiveness. The contours of such a competition policy should seek to prevent restrictive business practices and controlled market structures that significantly lessen competition. The objective of such a policy should thus be to encourage competition in order to foster greater efficiency in resource allocation and maximise consumer welfare. Such objectives of the policy can be effectively realised only if there is a compatible interface with other economic policies and laws. The other economic policies include those relating to infrastructure, international trade, FDI, intellectual property rights, financial markets, etc.

If such harmonious balance of mutually supporting laws and institutional structures are established, the expected benefits of such composite laws that ensure competition are many [e.g. (i) stronger market forces, (ii) lower costs and prices, etc.]. In realisation of this, a Competition Act was passed in 2003.

16.6.1 Competition Act, 2003

In the light of international developments and the need to promote competition, the Government of India constituted a nine-member committee under the chairmanship of Shri S.V.S. Raghavan in October 1999 to recommend a suitable legislative and administrative framework relating to competition law. The committee submitted its report in May 2000. In line with the recommendations of this committee, the government enacted the Competition Act, 2003. The Act replaced the MRTP Act, with the aim of promoting competition through prohibition of anti-competitive practices.

Competition Commission of India (CCI)

The Competition Act, 2003 provides for the setting up of a Competition Commission of India (CCI) with a view to: (i) prevent practices having adverse effect on competition, (ii) curtail abuse of dominance, (iii) promote and sustain competition in market, (iv) ensure quality of products and services, (v) protect the interest of consumers and (vi) ensure freedom of trade carried on by other participants in domestic markets.

A subsequent Competition Amendment Bill (2007) seeks to make the CCI function as a regulator and give impetus to factors like: (i) quality of products and services, (ii) healthy competition, (iii) faster mergers and acquisitions of companies, (iv) regulation of acquisitions and mergers coming within the threshold limits, (v) allowing dominance with prevention of its abuse to give effect to the second generation economic reforms on the pattern of the global standards set by the more developed countries, etc. To cover these aspects, the key provisions of the Act include five sections (Sections 3 to 7): Section 3 to deal with anti-competitive agreements; Section 4 covering abuse of dominance; Sections 5 and 6 dealing with combinations (i.e. mergers and amalgamations) and Section 7 creating the CCI, the new national anti-trust agency charged with both the enforcement and advocacy functions. A brief description of these sections, by their themes, is provided below.

a) **Anti-Competitive Agreements**: This covers both the horizontal and vertical agreements. It states that four types of horizontal agreements between enterprises involved in the same industry would be applied. These agreements are those that: (i) lead to price fixing; (ii) limit or control quantities; (iii) share or divide markets; and (iv) result in bid-rigging. It also identifies a number of vertical agreements subject to review under 'rule of reach' test, defined as a test of whether the agreement will lead to an 'appreciable adverse effect on competition in India'.

b) **Abuse of Dominance**: A dominant position is defined in terms of a 'position of strength' enjoyed by an enterprise in the relevant market in India. The Act lists five categories of abuse: (i) imposing unfair/discriminatory conditions in purchase of sale of goods or services (including predatory pricing); (ii) limiting or restricting production, or technical or scientific development; (iii) denial of market access; (iv) making any contract subject to obligations unrelated to the subject of the contract; and (v) using a dominant position in one market to enter or protect another.

c) **Combinations Regulation (Merger and Amalgamation)**: 'Combinations' include mergers, amalgamation and acquisition of shares/control, when these are above the specified threshold size. The Act states that any combination that exceeds the threshold limits in terms of value of assets or turnover can be scrutinised by the

CCI to determine whether it will cause or is likely to cause an appreciable adverse effect on competition within the relevant market in India.

d) Enforcement: The CCI, the authority entrusted with the powers to enforce the provisions of the Act, can enquire into possibly anti-competitive agreements or abuse of dominance either on its own initiative or on receipt of a complaint or information from any person, consumer, consumer's association, a trade association or on a reference by any statutory authority. It can issue 'cease and desist' orders and impose penalties. The CCI can also order the break-up of a dominant firm.

First time contravention of the order of the CCI shall lead to imposition of monetary penalties. If non-compliance continues or the person does not pay the monetary penalties then it shall be treated as criminal offence, which may be punishable with imprisonment and/or steep monetary penalty.

The new competition law in India, despite some concerns expressed in certain quarters, is much more consistent with the current anti-trust thinking than the outgoing MRTP Act. Although the success of the new Indian model will now turn on its implementation, India would appear to have taken a very substantial step towards the adoption of a modern competition policy.

Check Your Progress 3

1. Outline the basic features of government policy towards small-scale industry sector in India.

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2. What are the two factors recognised as crucial for increasing the competitive strength of the Indian economy?

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3. Enumerate the principal features of the competition Act 2003 vis-a-vis the specific objectives set out for the Competition Commission of India.

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16.7 SPECIAL ECONOMIC ZONES

In 1980, barely a year after the Chinese strongman Deng Xiaoping initiated his country's switch over to a market economy, a non-descript town in the Guangdong province in southern China, Shenzhen, was designated as special economic zone (SEZ) by the Chinese authorities. It had virtually no modern industries worth speaking of with all the slow-paced lifestyle characteristics of backward district. Today, 28 years later, Shenzhen is a modern, sprawling metropolis with a population of more than 10.5 million and home to some elite global brands and Fortune 500 companies. In other words, crammed to the full with industries of every hue, it is now the economic heartland of China. More importantly, it showcases a model of growth that leapfrogs an underdeveloped region to a high-growth export-led powerhouse that is the envy of the world.

Today, India Inc. hopes to replicate the Chinese success story by creating its own brands of Special Economic Zones (SEZs).

16.7.1 Concept and Background

In simple terms, an SEZ is a designated free trade enclave that is deemed as a 'foreign territory' for trade operations, duties and tariffs. It has more liberal economic and labour laws than those in the rest of the country and hence has the capacity to attract foreign investments, help promote exports and create a level-playing field for domestic enterprises and manufactures to compete in the global market.

SEZ, however, is not a new concept. Since the end of World War II, SEZs, export-processing zones (EPZs) and free trade zones (FTZs) have been considered as a solution to jump-start economic development in the developing countries to catch up with their more developed western counterparts. India, too, has a long history of experimenting with varieties of export promotion schemes. Asia's first EPZ was set up in Kandla in 1965. It was followed by the Santa Cruz EPZ in 1973. Including these, a total of about eight EPZs were successively established in the country. Their performance have remained unimpressive for long owing to multiplicity of controls and clearances, lack of infrastructure and an unstable fiscal structure. In short, the very bottlenecks, which thwarted

the industrial progress elsewhere in the country, hampered the performance of these EPZs too.

EPZs and SEZs

While the EPZs are just exclusive industrial estates, SEZs are industrial townships that provide supportive infrastructure such as housing, roads, ports and telecommunication. The EPZs had little protection from cumbersome procedures and paperwork, not reducing in any way the transaction costs and procedural hassles involved. EPZs enjoyed no benefits in terms of relaxation of labour laws. In contrast, besides fast clearance for SEZ proposals, the SEZ Act allows state governments to relax the labour laws in units falling within the jurisdiction of the SEZs.

16.7.2 Debate Over SEZs

The SEZs have been an issue of intense debate. Arguments have been advanced both for and against.

Arguments for SEZs: Considering the country's creaking infrastructure, poor state of public finances and massive unemployment, getting private investment in infrastructure through FDI and setting up of labour intensive manufacturing units, should be the primary objectives of the policy-makers. **The major arguments for SEZs are therefore the following**:

- can attract global manufacturing companies;
- can bring investment into the infrastructure sector;
- can help create jobs across the country particularly for the low-skilled if labour intensive units can be promoted;
- can ease pressure on metros by creating new centres of employment;
- can ensure that risks of failure are minimised due to the stake holder interest of the private investor;
- domestic companies competing to set up units in the SEZs can have easier access to funds from foreign and Indian banks;
- can bring down transaction costs for companies;
- can make units competitive through flexible labour laws; and
- can bring in along with foreign investment, technology and managerial talent.

The major arguments made against SEZs are that the SEZs:

- lead to exploitation of the policy by fly-by-night developers;
- could result in significant revenue losses for governments;

- divert large tracts of farmland into non-performing SEZs;
- result in domestic markets becoming under-served;
- not produce world class facilities in all cases;
- not guarantee the future of units in unsuccessful zones;
- distort taxation structure, making domestic units uncompetitive in comparison;
- may not be WTO-compatible all the time.

16.7.3 SEZ Policy and Progress

The various incentives provided to manufacturers and developers under the SEZ policy are as follows.

Different incentives for manufactures include:

- Duty-free import of capital goods, raw materials, consumables and spares;
- 100% exemption on export profits for the first five years;
- 50% tax exemption on export profits for the next five years;
- 50% tax exemption for another five years on reinvested profits;
- Exemption from minimum alternate tax (MAT);
- Goods purchased from domestic tariff area (DTA) are exempt from central sales tax; and
- Exemption from service tax and capital gains on transfer from an urban area to SEZ.

Incentives for developers include:

- No duty on goods imported either from the DTA or abroad;
- Income tax exemption for the first 10 years;
- Service tax exemption for all services rendered within the SEZ;
- Exemptions from purchase, sales and turnover tax on all transactions;
- Exemption from stamp duty, registration fee and electricity duty;
- No tax on income from dividends and long-term capital gains tax; and
- 100% FDI allowed for developers.

India passed the SEZ Act in February 2005. The existing 8 EPZs were converted into SEZs. Since then, 20 more SEZs have become operational, 172 SEZs have been notified and 263 are awaiting notification. In principle, approval has also been extended to other 362 proposals. But it has not been a smooth drive. The events that unfolded in some states like West Bengal and Orissa were eye openers. These brought to the fore issues like:

i) **The issue concerned with the settlement of displaced populace**: In most of the cases, agricultural land had been sought to be acquired for raising the SEZs. The question arises as to what is to be done to those who are displaced from their land? What could be the source of subsistence and habitation for them?

ii) **Land is the only asset of value that the rural poor possess**: If land is to be acquired, how much compensation should be paid? What should be the mode of compensation? How to make sure that the compensation is not wasted away?

iii) **Is industrialisation at the cost of poor desirable?** Whether this is the right course of development that the rapidly globalising Indian economy has to go for, was the question raised here.

The above issues forced the government to revisit the SEZ policy. The new policy amended to strike a balance between the need for land for development purposes and protecting the interests of land owners and other displaced persons. It was specified that job would be provided to at least one person from each affected family. The other provisions would include training and capacity building for taking up suitable jobs and for self-employment, scholarship for education of the eligible persons from the affected families and preference to groups of cooperatives of the affected persons in the allotment of contracts and other economic opportunities in or around the project site. Adequate provisions have also been made for financial support to the affected families for construction of cattle sheds, shops and working sheds; transportation costs, temporary and transitional accommodation; and comprehensive infrastructural facilities and amenities in the resettlement area including education, health care, drinking water, roads, electricity, sanitation, religious activities, cattle grazing, and other community services. A strong grievance redressal mechanism has been prescribed, which includes Standing Rehabilitation and Resettlement (R&R) Committees at the district level, R&R committees at the project level, and the appointment of an Ombudsman duly empowered in this regard.

16.8 LET US SUM UP

Having made a conscious decision to follow the heavy-industry-led-growth strategy, India designed its industrial policy accordingly. This found expression in the form of the Industrial Policy Resolution, 1956.

Following this, the industrial landscape underwent a significant change over a period of about four decades. But the major failure of the policy was that it did not have a built-in mechanism to prompt the industry to adapt itself to the fast-changing technological scene. It therefore became imperative to liberalise the industrial sector from the multidimensional controls it was subjected to. The process of liberalisation began in late 1970s and gathered momentum with the announcement of the New Industrial Policy in 1991. Under the NIP, liberalisation, privatisation and globalisation became the three catch phrases to express its spirit. Responding to the complementary needs of liberalisation and globalisation, there has been a paradigm shift in adjunct areas of industrial policy. These find expression in the new policy by way of provisions for the small-scale industry sector, competition policy and policy relating to Special Economic Zones.

16.9 KEY WORDS

Industrial Policy : A blue print of governmental policy specifying the provisions for the industrial expansion in the country.

New Industrial Policy 1991 : A modified version of IPR 1956, in which the focus was on liberalising the industries sector from the kind of regulation and control that was the rule of law before. The underlying rationale is that by creating an atmosphere of healthy competition and support systems, productivity and efficiency of the industrial sector would be unleashed.

Competition Policy : A policy to encourage competition resulting in greater efficiency in resource mobilisation, allocation and for the achievement of maximum consumer welfare.

Special Economic Zones (SEZs) : A designated free trade enclave with liberal economic and labour laws than those in the rest of the country. Are designed to accelerate industrial growth leading to higher economic growth path.

16.10 SOME USEFUL BOOKS

Kaushik Basu (ed.), *The Oxford Companion to Economics in India*, Oxford University Press (OUP), 2008.

Bhatt V. V., *Perspectives on Development*, Academic Foundation, 2008.

Nagaraj R, *Aspects of India's Economic Growth and Reforms*, Academic

Foundation, 2008.

Reddy Y. V., *Economic Policy in India*, UBSPD, New Delhi, 2003.

Srinivasan T. N. and Suresh D. Tendulkar, *Reintegrating India with the World Economy*, OUP, 2003.

16.11 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1. See Section 16.2 and answer.
2. See Section 16.2.1 and answer.
3. See Section 16.2.2 and answer.
4. See Section 16.2.2 and answer.

Check Your Progress 2

1. See Section 16.3.1 and answer.
2. See Section 16.4.2 and answer.

Check Your Progress 3

1. See Section 16.5.1 and answer.
2. See Section 16.6 and answer.
3. See Section 16.6.1 and answer.

UNIT 17 INDUSTRIAL GROWTH AND STRUCTURE

Structure

17.0 OBJECTIVES

After going through this unit, you will be in a position to:

- delineate the evolutionary features of India's industrial development in the immediate post-independent years (decades);
- indicate the direction of industrial development envisaged in the initial years of planning with a thrust on import substitution leading to a phase of controlled regime;
- explain the growth and structural composition of Indian industry as it evolved over time;
- critically describe the phase-wise developmental performance of the Indian industry;
- discuss the overall performance of industrial development identifying the reasons for the variations in industrial performance during the five decade period of 1950s to 2000s; and

- provide a balanced picture based on the experience of five decades on what is required to achieve a sustained industrial growth suiting the conditions of the Indian economy.

17.1 INTRODUCTION

As you are by now well aware, development of industry is regarded as critical for increasing the employment potential and thereby the competitive strength of a country. Although this view can be regarded as conventional [particularly because a service sector led growth, bypassing the Lewisian stylisation (of a transition from agriculture to industry and then to services), is now seen as possible even in a labour surplus agrarian economy], it is nevertheless an accepted fact that the industrial base of a country should be strengthened by focused policy measures. The early thinkers and planners of independent India duly recognised this fact and laid a firm foundation for its industrial base. What was the direction and emphasis accorded for establishing an industrial base in the initial years of planning in the country? How did the industrial sector grow and what structure it came to acquire during the course of next two to three decades? To what extent it served the long term interests of the country? At which stage, a change in the direction and approach in the industrial promotion policy of the country was perceived essential? What has been the experience of adopting a radical change in the policy pursued in the initial few decades, as seen by the outcomes of the industrial performance during the course of last ten to fifteen years (i.e. 1990s and post-2000 years) in India? These are some of the questions to which the present unit addresses itself in the context of industrial performance in India.

17.2 RATIONALE FOR PLANNING AND PRIORITY FOR HEAVY INDUSTRY BASE

A study of the evolution of Indian industrial structure and its growth should imperatively begin with examining the pattern of Indian planning process immediately after independence. At the time of independence, the debate on planning was never on whether there should be planning, but about what sort of planning there should be? The broad agreement on the need for planning was in tune with the intellectual ambience of the period which reflected the state of the international economy. The Great Depression of the inter-war period had destroyed any faith in the virtue of the free market, and Keynesianism, a product of the Depression, advocated not just State intervention in demand management but the necessity of socialising investment decision. The vision of the Indian economic regime established in the 1950s had its roots in the freedom struggle. The economy had been dominated by imperial capital (i.e. international in nature and metropolitan by character) and hence

metropolitan commodity composition (undermining the needs of the large rural base) was the prevailing commodity structure in the economy. Freedom for the nationalist thinkers, who played a leading role first in the freedom struggle and later in the formulation of economic policies, therefore, meant freedom from this domination. This could not be ensured without giving priority for building up infrastructure, expanding and strengthening the productive base of the economy, setting up new financial institutions, and, regulating and coordinating economic activity to achieve the overall growth path envisaged. In terms of the strategy elaborated at that time, the State would not merely ensure a sharp increase in the rate of savings in the system, but also ensure an enhanced allocation of that savings to the heavy industrial sector in general and machine tools in particular, so as to reduce the economy's dependence on international capital and commodity markets.

When we look at the industrial scene at independence, the industrial sector was extremely underdeveloped with a very weak infrastructure base. The lack of government intervention in favour of the industrial sector was considered as an important cause of this underdevelopment. Keeping in tune with this line of thinking, export orientation was not considered to favour the country's interests. The structure of ownership was highly concentrated and technical and managerial skills were in short supply. As a result, the national consensus was that economic sovereignty and economic independence, focusing particularly on the promotion of industrial infrastructure, should be the guiding factors in the foundation to rapid industrialisation in the country.

The First Five Year-Year Plan, was essentially a collection of several projects. The plan sought to fix the growth rates in GDP to be achieved and specify the required savings rate to achieve the targeted GDP growth. This approach was based on the framework provided by Harrod –Domar Model which, in nut shell, specified the following: given the capital-output ratio and given the growth target, what is the required savings rate? The H-D model thus, in effect, gave ample scope for targeting the economic growth using *three macro parameters: viz. capital-output ratio, savings rate and growth rate of GDP.* The Second Five Year Plan marked a distinct shift in favour of heavy capital goods industries. The approach to the Second Five-Year Plan was slightly different in that it also incorporated the essentials of the Feldman-Mahalanobis structural model which emphasised on the physical aspects of investment needs. This approach, in essence, accorded importance to physical targets to be achieved subject to restrictive assumptions about transformation possibilities in terms of the three macro parameters as held forth by the H-D approach. The transformation was sought to be achieved by focusing on both domestic and foreign trade for which a certain rate of investment required was kept in view to support the domestic manufacture of capital goods. The underlying causes which pushed for such a developmental strategy were the following. **Firstly**, the basic constraint on development was seen as being an acute deficiency of material capital which prevented

the introduction of more productive technologies. **Secondly**, the limitation on the rate or pace of capital accumulation was seen to lie in the low capacity to save. **Thirdly**, it was assumed that even if the domestic capacity to save is raised by means of suitable fiscal and monetary policies, there were structural limitations preventing conversion of savings into productive investment. **Fourthly**, it was assumed that whereas agriculture was subject to diminishing returns, industrialisation would allow surplus labour currently underemployed in agriculture to be more productively employed in industries which operated according to increasing returns to scale. A **fifth** assumption was that if market mechanism were accorded primacy, this would result in excessive consumption by the upper income groups, along with relative under-investment in sectors essential to the accelerated development of the economy. Given all these perceptions, it was felt that the basic questions relating to how much to save, where to invest (i.e. the sub-sectoral thrust) and in what form to invest (i.e. in labour-intensive or capital-intensive industries) could be best handled with the help of a plan and the initial step should lay a foundation for heavy industrial base with simultaneous thrust also laid on other forms of industrial structure.

17.3 DIRECTION OF INDUSTRIAL DEVELOPMENT AND EVOLUTION OF CONTROL REGIME

The direction of industrial development in India is traced to several industrial promotion policies viz. the statement of Industrial Policy of 1945; the Industrial Policy Resolution of 1948, the enactment of the Industries (Development and Regulation) Act, 1951, the First and the Second Five-Year Plan documents and the Industrial Policy Resolution of 1956. The 1945 statement of Industrial Policy is remarkable as a originator of all the thinking on the other key industrial policy resolutions after independence. The statement also mentioned the concept of industrial licensing. Special importance was given to the development of steel, heavy engineering, machine tools and heavy chemical industries. The idea of licensing was mainly thought to be an instrument for the dispersal of industries preventing the establishment of excess capacity in only some industries and regions.

The First Five-Year Plan stated the objective of industrial planning as making good the deficiencies in production of key industrial items and initiate a developmental process which would enable the cumulative expansion of such basic production. The scope and need for development of India's industries was felt to be so great that it was necessary for public sector to develop those industries in which private enterprise would either be unable or unwilling to invest the resources required taking the risks involved. The industrial Policy Resolution of 1948 had identified certain industries to be reserved for production by the central/ state governments. For instance, production and control of atomic energy

and ownership and management of railways were to be the sole preserve of the central government. However, coal, iron and steel, aircraft manufacturing, shipbuilding, manufacture of telegraph and wireless equipment (except radios) and minerals were reserved for production by both the central and the state government undertakings.

The system of Indian industrial licensing has its origins in experiences of situations like: the post-war situation, nationalistic aspirations, socialistic leanings of the founding fathers of the country, etc. The planners and policy makers in India therefore felt the need for using a wide variety of instruments and controls to steer the course of Indian industrial development in a desired direction. However, there was always a mismatch between the expressed intentions and the outcomes from the instruments adopted for realising the plan intentions. For instance, the original intention of licensing was to use the power selectively for the promotion of important industries. It was, however, later used to control almost all industries with the result that regulation rather than development became the norm. Thus, until the recent industrial and trade policy reforms initiated in period of economic liberalisation i.e. the post-1990s, establishment of an industrial enterprise in India required many approvals from the government. Again, for instance, before making an investment, an entrepreneur had to first obtain approval from the Ministry of Industry. The granting of this approval resulted in a Letter of Intent (LoI) using which the entrepreneur could tie up the other requirements for setting up the project. If there was a need of imported capital goods, the entrepreneur had to obtain a capital goods import license from the Chief Controller of Imports & Exports (CCI & E) in the Ministry of Commerce. If there was a need for foreign technology collaboration, the entrepreneur had to obtain specific approval from Ministry of Commerce. If an entrepreneur wanted to raise capital from the capital market for raising funds for the project, he needed an approval from the Controller of Capital Issues in the Ministry of Finance. Imports of raw material and components required separate licenses which had to be obtained on an annual basis from the CCI & E. In addition to these approvals, with the enactment of the monopolies and restrictive trade practices (MRTP) Act in 1969, the firms covered under this needed to obtain separate MRTP clearance from the Department of Company Affairs. Further, resulting from the desire to promote small scale industries, as many as 836 items had been reserved for production in the small-scale enterprises. Since 1956, there was also a list of industries reserved for exclusive production in the public sector.

Around 1960s, it was realised that the system of approvals and licenses was unsuited for directing investments. The government appointed several committees to examine the industrial licensing system. Most of them identified that the licensing mechanism was not serving its purpose of channelising investments in the desired directions. For instance, the Hazari Committee (1967) observed that:

- the extent up to which the industrial licensing has served to channelise investment in the desired directions appears extremely doubtful;
- the gains in terms of balanced regional development and wider distribution of entrepreneurship are at best moderate;
- there is very little follow-up of licensing system to verify whether the approved projects fructified in time; and
- in attempting to cover almost the whole range of large-scale industrial development, licensing and other such legislative provisions have lost sight of the relative importance of different projects /products. This is to say that all applications have been treated by a similar processing process without any regard to the criticality of the projects to the economy.

The stagnation of Indian industrial production between the mid-1960s up to the late 1970s induced some serious new thinking. Towards the end of 1970s and by the early 1980s, there emerged a growing consensus that Indian industry was exhibiting a slow-down in growth due to low productivity, high costs, low quality of production and obsolete technology. Several committees were set up to suggest measures required for boosting up the industrial performance in the country. Of these, we will refer to four important committees which were set-up in the late 1970s and early 1980s which paved the way for liberalisation and in ushering an era of competition and growth.

The first is the P. C. Alexander Committee on Import-Export Policies and Procedures set up in 1977. The main recommendations of this committee included: (i) import licensing should be gradually liberalised; (ii) the scope of open general licensing (OGL) for import and sale should be expanded; (iii) actual user condition should be gradually relaxed by substituting, in the first instance, licensing with equivalent tariffs and later by focusing on reducing the 'equivalent tariffs' more and more ; (iv) the developmental role of imports should be recognised and imports should not be regarded only as a negative element in the BOP accounts and always controlled; (v) the name of Chief Controller of Imports and Exports be changed to Director General of Foreign Trade (DGFT) whose role should be one of promoting exports and managing imports so as to serve the developmental needs of the economy; (vi) the DGTD (Director General of Technical Development) and other bodies connected with licensing and control should be revamped; (vii) export subsidies should be phased out to the minimum level so that exports become competitive on their own after the initial hurdles of new markets and products are overcome; and (viii) commercial representatives (CRs) in the Indian embassies abroad should be made more professional by drawing the personnel from the business world. The liberalisation of the import policies began with this Alexander Committee Report submitted in 1978.

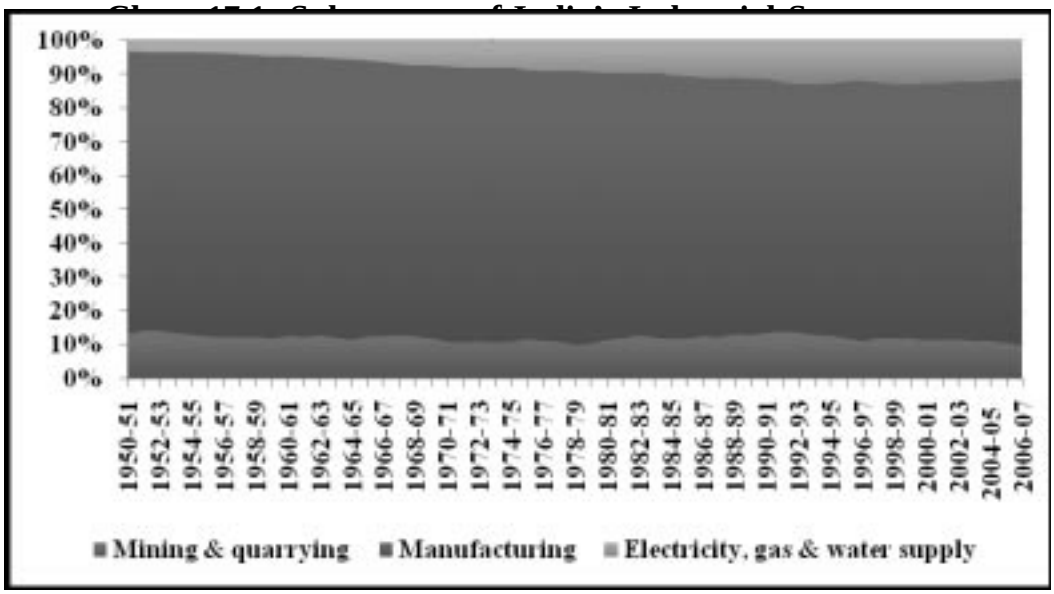
The other three important committees which are mentioned merely as illustrations of the seriousness on the part of the government (as there were indeed many more committees all of which cannot be referred here) are as follows: the Abid Hussain Committee on trade policy (1984), the Narasimham Committee on the shift from physical to fiscal control (1985) and the Sengupta Committee on public sector reforms. Each of these committees recommended an easing up of their respective area of focus i.e. trade policy, substitution of physical and quantitative controls by fiscal and other means of macroeconomic management and promotion of greater public sector autonomy in order to enhance productive efficiency and modernisation. The result of such thinking was that there was some progress in the process of deregulation during the 1980s. Under this, two kinds of delicensing activity took place. **First**, thirty-two groups of industries were delicensed without any investment limit. **Second**, in 1988, all industries were exempted from licensing except for a specific negative list of twenty-six industries. This exemption from licensing was, however, subject to investment and locational limitations.

The year 1991 was an important landmark in the economic history of post-independent India. The country went through a severe economic crisis triggered by a serious balance of payment situation. The crisis was converted into an opportunity to introduce some fundamental changes in the content and approach to economic policy- which generally began to be referred to as New Economic Policy. The response to the crisis was to put in place a set of policies aimed at stabilisation and structural adjustments. While the stabilisation policies were aimed at correcting the weaknesses that had developed on the fiscal and balance of payment fronts, the structural adjustment policies sought to remove the rigidities that had entered into the various segments of the economy. The structural reform measures introduced in the early 1990s broadly covered the areas of industrial licensing, foreign trade, foreign investment, exchange rate management and the financial sector. From the point of view of industrialisation, changes in the areas of licensing and foreign trade and investment had important implications. The thrust of the New Economic Policy has been towards creating a more competitive environment in the economy as a means to improve the productive efficiency of the system. This was to be achieved by removing the barriers to entry and the restriction of growth of firms. While the Industrial Policy of 1991 sought to bring about greater competitive environment domestically, its counterpart on Trade Policy set out in the same year, sought to improve international competitiveness subject to the degree of protection offered by the tariffs. The private sector was to be given a larger space to operate to the extent that some of the areas, earlier reserved exclusively for the public sector, were opened up to the private sector. In the New Industrial Policy of 1991, industrial licensing got abolished, irrespective of level of investment for all industries except certain specified industries for reasons related to security and strategic concerns, social concerns, issues relating to safety, overriding environmental issues, etc. The policy measures, right from its evolution to the liberalisation phase, had a distinct implication on how the entire industrial structure had evolved

and grew. The subsequent section will discuss the evolution of India's industrial structure and growth.

17.4 GROWTH AND STRUCTURAL COMPOSITION OF INDIAN INDUSTRY

The performance of industries can be assessed in terms of the rate at which the industrial output has grown over time and the changes in the structural composition of industries that have marked the industrial scene. For this, we need to understand the different sub-sectors of Indian industrial structure. The industrial sector consists of three broad sub-sectors viz. (i) manufacturing, (ii) mining and quarrying and (iii) electricity, gas and water supply. The manufacturing sub-sector, with its output share of about 80 percent in the total industrial sector, has two broad sub-divisions. One is the Factory Sector (referred to as the Registered Sector registered under the Indian Factories Act, 1948 also called as the Organised Manufacturing Sector; also called as the Unorganised Manufacturing Sector) consisting of all manufacturing enterprises. The other is the Non-Factory Sector (or the Unregistered Manufacturing Sector; also called as the Unorganised Manufacturing Sector) consisting of all manufacturing enterprises which are not registered under the Indian Factories Act. The non-factory sector covers all manufacturing units employing less than 10 workers, if using power, and less than 20 workers if not using power. It, thus, includes the household enterprises and the small-scale non-household enterprises. The share of manufacturing sub-sector in industrial output has gone down somewhat from 84 percent in 1950-51 to 80 percent in 2006-07. The share of electricity, gas and water supply has increased from 3 percent to 11 percent during the above period while in case of mining and quarrying it has declined from 13 percent in 1950-51 to 9 percent in 2006-07. The growth rates of Gross Value Added (GVA) in the sub-sectors of the industrial sector, in the agricultural sector and in the entire economy over the period 1950-51 to 2006-07 are presented in Table 17.1.



Source: Handbook of Statistics on Indian Economy, RBI

Table 17.1: Sectoral Growth of GDP at Factor Cost

(percent per annum)

Sector	1950-51to 1980-81	1980-81to 1989-90	1994-95	1999-00	2003-04	2006-07
Agriculture, Forestry & Fishing	2.1	2.9	5.0	0.3	10.0	3.8
Mining & Quarrying	4.5	6.4	9.3	3.3	3.1	5.7
Manufacturing	5.1	6.8	12.0	4.0	6.6	12.0
(a) Registered	6.0	7.5	14.4	3.7	7.2	12.0
(b) Unregistered	4.2	6.7	7.3	4.6	5.6	12.0
Electricity, Gas and Water Supply	9.5	8.8	9.4	5.2	4.8	6.0
Total Economy	3.5	5.2	7.3	6.1	8.5	9.6

Source: *National Account Statistics various issues*

It is observed that over the periods 1950-1980 and 1980-1989, each of the sub-sectors within industrial sector grew faster than the economy as a whole and the agricultural sector. Within the industrial sector the electricity, gas and water supply sub-sector displayed the highest growth of 9.5 and 8.8 percent per annum in respective periods. Although, registered manufacturing out-performed the unregistered manufacturing in both the periods, it is important to note that with much lower capital and technological inputs, the unregistered manufacturing has performed better than the agricultural and the aggregate economy's growth rates. The growth rate in the 1980s was far above than that in the earlier three decades, in all sub-sectors of industry, except electricity. The performance of the industrial sector and its sub-sectors show a distinct change in trend after the New Economic Policy of 1991 got implemented. The growth in value added for the manufacturing sector in general and its factory sub-sector sector in particular doubled in 1994-95. It, however, declined by 1999-00 but again picked up by 2007. More significantly, the unregistered sector performance equalled that of its registered counterpart in 2006-07. The experience of 1990s, particularly in the second half of that decade, needs an explanation for the sudden decline in the rate of growth in all the sub-sectors of Indian industry. This we will pick up when we look at the underlying causes of observed trends in growth rates in Section 17.5.

The most striking feature of Indian industrialisation is the extent of diversification achieved in a relatively short period. Self-reliance through the building of heavy industry was emphasised in the strategy formulated by Mahalanobis in the mid-fifties and India launched a major drive for industrial diversification. Steps were taken for the establishment of machine tool industries, heavy electricals, machine building and other branches of heavy engineering industries. In spite of some setbacks around 1965, progress in regard to diversification of the industrial structure was maintained. For quite long, since the second plan (1956-

61), the basic and capital goods industries witnessed a rapid growth during the period 1960-66. It, in fact, remained higher than the general growth rate of industries (Table 17.2). As a result, the industrial structure leaned heavily towards the capacity-building industries. This trend which started since the Second Plan was due to the high priority accorded to these industries. As against this, till 1980s, the growth of intermediate goods and consumer goods industries was moderate. Of the two type of consumer goods, namely, durable and non-durable consumer goods, the durable goods segment witnessed higher rate, comparing well with that of basic and capital goods industries.

Table 17. 2: Growth Rate of Industrial Production by Use Based Classification

(Percent)

	1959-60 to 1965-66	1966-67 to 1979-80	1981-82	1990-91	1994-95	1998-99	2002-03	2006-07
Basic goods	11.0	5.9	10.9	3.8	9.6	1.6	4.9	10.3
Capital goods	15.4	6.6	6.7	17.4	9.2	12.6	10.5	18.2
Intermediate goods	5.7	4.5	3.7	6.1	5.3	6.1	3.9	12.0
Consumer goods	4.7	5.0	13.8	10.4	12.1	2.2	7.1	10.1
Durables	11.5	10.8	10.9	14.8	16.2	5.6	-6.3	9.2
Non-durables	4.2	5.0	14.1	9.4	11.	1.2	12.0	10.4

Source: *Economic Surveys, GOI various issues*

The high growth rates in respect of capital goods and consumer durable goods industries, appear high only because the initial starting base of these industries was very low. This is to say, that a faster growth which was necessary to correct the imbalance in the industrial structure was made good by the high growth of these industries. The net result was, in fact, more than a mere correction of the imbalance with the overall industrial capacity for production becoming quite sizeable. The fast growth of the basic and capital goods industries thus contributed to the expansion of the country's capacity for production of industrial goods in general. This is indicated by the fact that the weightage to the basic and capital goods industries in the index of industrial production was (and has still remained) quite high [e.g. in the index with base 1993-94, it was 44.9%; in the index with 1980-81 base it was 55.8%]. This is a significant structural feature as it allows a country to build infrastructure facilitating other productive activities as it means larger possibilities of producing consumer goods. In fact, it is for this reason that the country is no longer dependent on imports of goods of basic importance for the economy. This has also increased the capacity of the country to produce goods which cannot be imported easily.

In this unit we are focusing on bringing out the efforts made to improve the industrial base in the country. You are already familiar from the units in the first block that plan-wise, the first plan laid exclusive emphasis

on agriculture. Also, this emphasis on the agricultural sector continued in the subsequent plans too with the emphasis on agriculture during 1970s shifting to promotion of agro-industries, agricultural infrastructure, etc. This emphasis on public agricultural investment, however, suffered during the 1990s contributing to the registering of lower growth rates in the agricultural sector in recent years.

Check Your Progress 1

1. What was the basic approach followed in the I and the II Five Year Plans to achieve the envisaged economic/industrial growth in India?

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2. What were the observations of the Hazari Committee (1967) on the industrial licensing procedure followed in India?

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3. What marked the two specific years of 1994-95 and 2006-07 in respect of growth performance of the manufacturing sector in India?

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4. What were the main recommendations of the P. C. Alexander committee on trade policies which laid the foundation for the reform process of the later periods?

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17.5 PHASES OF INDUSTRIAL GROWTH

It is necessary to understand the ups and downs of India's industrial performance by looking into the factors responsible for it. We can analyse this in four phases: the first phase of rapid growth from 1951 to 1966, the second phase of low growth (and deceleration) from 1966-80, the third phase of recovery and revival of growth in the1980s and the fourth phase of growth with a renewed vigour during the period of New Economic Policy (or economic reforms) in the1990s and beyond. An analysis of the underlying causes will enable us to understand the measures that can help promote industrial growth in a faster, efficient and equitable manner.

17.5.1 The First Phase of Rapid Growth (1950-51 to 1965-66)

There were several factors that influenced the industrial growth during this period. These factors emerged in the changed political context after the country's independence. The anti-industry attitude of the British Government before 1947 was replaced by the strongly pro-industry aims of the Indian Government. Planning came to be the medium of development. Beginning with the Second Five-Year Plan, the government gave a very high priority to the development of industries with a particular emphasis on basic and capital goods industries. This strategy dominated the scene till very recently.

Government's key role: During this phase the government played the most important role in which a number of industries were set up in the public sector. Most of these were basic and capital goods industries (see Key Words) like electricity, steel, machinery, etc. These were the industries in which the gestation period was long and required investment levels were very high, and therefore the fruits could be realised over a long term time frame. The government simultaneously undertook measures to ensure that these (and other) industries in the private sector also developed. Although little was provided in the First Plan (1951-56) for industries, the second (1956-61) and the third plans (1961-66) laid a firm foundation for industrial development. The amount of resources was stepped up from a small 3 percent of total outlay in the First Plan to as much as 30 percent in the Second Plan and 35 percent in the Third Plan. Apart from setting up industries, the government provided resources and facilities for the private sector to start industries on its own or jointly with the government, in the areas ear-marked for the private sector. Such help was extended by the establishment of public financial institutions to provide capital, large protection to domestic industries through high import duties including quantitative restrictions on imports, regulation of the use of resources to direct them along the lines laid down, etc. Activities in respect of industrial research and development were also undertaken by the government which benefited both the private as well as the public sector industries.

Expansion of private sector: The private sector also contributed considerably to industrial growth. Expansion of private sector took place principally on three counts. **One**, the entrepreneurial class, which had emerged before the freedom of the country, found further opportunities to investment as they had already gained experience in the running of many consumer goods industries. Private industries were also set up in the basic sectors like steels, machinery , etc. This enabled them to expand in the existing industries and also set up new ones. **Two**, profitability of the investment in industries increased due to measures like restriction on imports which enabled private entrepreneurs to tap domestic market without fear of foreign competition. Oddly enough, for a capital scarce country, interest rates remained low, keeping cost of investment also low. There were also many inducements in the form of tax concessions for the establishment of new industries. Large funds were also made available to this sector by the new financial institutions set up by government. **Three**, owing to industrial policy of India which permitted the entry of foreign capital under reasonable conditions, the inflow of ***private*** foreign capital increased. Most of the aid (in the form of loan on concessional terms) received from foreign countries was for industrial development. The twin benefits that India got from such aids were funds in the form of foreign exchange (which enabled India to tackle its balance of payment position which arose due to lack of exportable items) and technical know-how. A fact of important relevance in this respect is that there was spectacular growth in educational infrastructure, in the form of engineering colleges, IITs, management institutions, and entrepreneurship development institutions. This institutional infrastructural growth gave India the required strength in generating skilled manpower. The role of both the government and the private sector is notable in this regard.

It is thus evident that the state not only acted as the catalyst for the industrial growth by undertaking the task of developing industries itself, but also created an environment conducive for the private sector to contribute to the industrial development of the country. It was thus a state engineered growth.

17.5.2 The Second Phase of Deceleration (1965-66 to 1979-80)

The industrial growth experienced during the Second and the Third Five Year Plan periods could not be sustained. In fact, there was discernible reduction in the growth rates. There are several reasons put forward for this downturn which can be broadly classified into two broad categories, namely, the supply side constraints and the demand side constraints.

Supply Side Constraints

In the **first** place there were some major disturbances caused by wars (with China in 1962 and with Pakistan in 1965 & 1971), the draughts in 1965 & 1966 and the steep rise in oil prices in 1973 (first ‘oil’ shock).

Second was the reduced availability of critical inputs for production like power, infrastructure and raw material. Imports became costlier and fluctuations in agricultural production adversely affected the agro-based industries.

Third was the organisational weakness due to which many industries fell sick. Many industries were functioning at sub-optimal capacity owing to poor inventory control and financial management. There were losses due to work stoppage which adversely affected the production.

A **fourth** factor was the controls and regulatory measures. In the earlier years, these controls and regulatory measures were essential when saving/ investments were low. With improvement in the saving/investment ratio the controls and regulatory measures had become restrictive in character acting as impediments to industrial growth.

Demand Side Constraints Among the demand side factors inhibiting industrial growth, the principal ones are the following.

One was the declining demand due to policies of import substitution. For instance, till about the mid-1960s, industries were setup to replace imported goods. With time, the policies on this front resulted in the slow-down of industrial production. There was need for additional generation of domestic demand which did not take place. This affected the capital goods industries as it was the import of these goods which were replaced under the policy of import substitution initiated in the Second Plan.

Two, there was a decline in the growth of public sector investment resulting in a corresponding decline in the private sector investment. The gross fixed investment which grew at the rate of 12.2 percent during the period 1951-66, came down steeply registering negative growth (- 0.47 percent) during the period 1966-72. It, however, recovered to 8.0 percent during 1971-78. Since the public sector acted as the leader, there was a general slackening of investment level in the economy. Associated with this trend, there was a rise in the incremental capital-output ratio for the industrial output. What it actually amounted to was that the relative share of material and depreciation cost per unit of output went up.

Three, the weak performance of agriculture adversely affected the demand for industrial goods. The slow growth in agricultural output, for many years since mid-1960s, resulted in a decline in the demand for the products of the industrial sector. To an extent, the terms of trade, favourable to agriculture (as a result of relatively higher rise in agricultural prices in comparison with the price of manufactures), acted adversely for the industry. Barring large farmers having large surpluses to sell and benefit from it, vast number of the poor had to spend more on the purchase of food, resulting in reduced demand for industrial consumption. This also affected the demand for capital goods via saving and investment.

Four, the small rise in the per capita income and the worsening of inequalities in income distribution also caused a slow-down in the demand for industrial goods. On the one hand, there was a trend in the stabilisation of demand for consumer goods, particularly durable goods, owing to the small proportion of rich people in the country. On the other hand, large proportion of population with low buying power for industrial goods, were increasingly finding it difficult to keep up the pressure for industrial demand. As a result, the already narrow market for the industrial goods shrank further. It needs, however, to be added that these causes had operated at different times, for different periods and with varied intensities. However, cumulatively, their adverse impact on the economy was significant.

17.5.3 The Third Phase of Recovery and Revival (1980-81 to 1989-90)

The factors behind the resurgence of growth in the 1980s were exactly similar to those that contributed for its deceleration in the mid-sixties. Empirical evidence which pointed out to favourable trends included:

i) improvement in the rate of growth (and pattern) of gross domestic capital formation in general and public investment in particular;

ii) step-up in infrastructure investment and more efficient management of the infrastructure facilities;

iii) trends in the inter-sectoral terms of trade favouring the agricultural sector;

iv) increase in the use of manufactured inputs in crop production;

v) growth in per capita agriculture incomes and

vi) reforms in industrial and trade policies contributing to revival of growth in industrial output.

As a result of the above factors, there was an improvement in Total Factor Productivity which contributed significantly to growth in value added. Two other factors which contributed to the revival process are:

- role of technology and increased R&D activity and better access to imported technology under technical collaboration projects; and
- massive flow of remittances from the middle east during 1974-1980 resulting in large foreign exchange reserves which led to further liberalisation of imports.

Thus, from 1980 onwards, due to the above factors coupled with improvement in domestic political environment, industrial policy witnessed greater pragmatism. This process was further assisted by factors like: (i) a gradual loosening of controls, (ii) greater freedom to import technology, (iii) flow of foreign private capital facilitating modernisation of the manufacturing sector, etc. Greater realism in policy-making also included: (i) stepping up of public investment in infrastructure and energy

production and (ii) investment in rural development for diffusion of green revolution technology and for a 'direct' attack on poverty. The 'second oil shock' was successfully met by increasing domestic oil production and import substitution in fertilisers in a short time. The second half of the 1980s also witnessed considerable de-licensing and relaxation of import controls facilitating up-gradation of industrial technology. This was achieved by a greater reliance on the private corporate sector with fiscal incentives extended for stock market-based financing of industrial investment. Also, in the 1980s, many branches of manufacturing like automotive industry, cement, cotton spinning, food processing, and polyester filament yarn, witnessed modernisation and expansion of scales of production. As a result, industrial export growth also improved in the second half of the 1980s. Thus, the turnaround in the industrial output growth in the decade of 1980s is variedly attributed to liberalisation, improvement in public investment and private sector performance.

17.5.4 The Phase of Industrial Growth Under New Economic Policy (1991-2007)

During this phase, industry and trade policy reforms were accelerated. Public investment contracted sharply to reign in the fiscal imbalance. Financing of industrial development changed considerably as part of the financial sector reform which cut into directed lending. Although formal changes in industrial labour laws were avoided due to lack of political consensus, there were adequate signals to employers that the government would not come in the way of restructuring the industrial relations.

While the trend in the growth rate in the 1990s is the same as in the previous decade of 1980s, the yearly growth rates showed a marked difference. After an expected contraction in response to the external payment crisis in 1991-92, industrial output rebounded rapidly in the following four years, reaching a new peak in 1995-96 with an annual growth rate in output of over 14 per cent. The sharp upturn is widely credited to policy reforms leading to a liberalised and competitive industrial atmosphere. However, the expectation of further acceleration with more reforms was short-lived as the growth rate steadily decelerated in the following seven years, except for a minor improvement in the year1999-2000.

The policy initiatives of the 1990s were based in theory from the mainstream economics. They were, in principle, expected to set right what was widely believed to have been wrong with India's industrialisation effort. As the noted economist, T N Srinivasan argued, the reforms were based on an understanding of the experience of Indian development strategy since the 1950s that delivered 'neither rapid growth nor appreciably greater equity'. In the words of an yet another leading economist, Jagdish Bhagwati's views, the three main elements of India's policy framework that stifled growth and efficiency were: (i) extensive

bureaucratic controls over production, investment and trade; (ii) inward looking trade and foreign investment policies, and (iii) a substantial public sector going well beyond the conventional confines of public utilities and infrastructure. The control system followed by India has also been argued differently to imply that the industrial policy pursued was responsible for persistent fiscal deficits and periodic balance of payment crises. Although in broad terms, none of these features of the policy framework remained any more after 1991, the question that still remains to be answered is one of ***'why the growth of the industrial sector, especially the manufacturing sector's growth, slowed down in the mid-1990s'?***

The slowdown (or lack of sustained improvement witnessed in some years of 1990s) is also attributed to the delayed reforms in other complementing areas of the economy. It is argued that measures like: (i) a quick and sharp reduction in tariffs to the average levels of many Asian economies; (ii) scaling down the remaining restrictions on foreign direct investment, and (iii) removal of rigidities in the industrial labour market would deliver better fruits of reforms. If this argument is given credence, then the hastening of the reforms in the post-1990s, compared with the moderate liberalisation policies practiced during the decade of late 1970s and early1980s, ought to have improved the industrial growth rate during the 1990s. However, this has not happened as the industrial growth rates of 1980s (6.5%) and the period in post-1990s, from

Table 17.3 Growth in Agriculture, Industry and Overall GDP in India (% p.a.): 1980-2004

Period/Sector	1980-90	1991-2004
Agriculture	3.9	3.0
Industry	6.5	5.8
GDP	5.8	5.6

Source: *Atul Kohli (2006), EPW, April 1, p-1254.*

1991-2004 (5.8%), presented in Table 17.3 reveals. Notwithstanding the lower long term average in the latter period as compared to the former, it is relevant to recall from the data presented earlier in Table 17.1 that the year 2006-07 marked an yet another solitary year when both the registered and the unregistered segment of manufacturing recorded significantly high growth rates. Thus, although high sustained growth rates in the industrial performance is not observed during the post 1991-years, with the reforms in the complementary sectors (e.g. finance, insurance) introduced in the post-2000 years, the industrial growth of the decade 2001-2010, compared with the decade of 1991-2000, should be higher if the positive relationship between the pace of reforms and the economic outcomes, argued by many, holds good.

17.6 LINKAGE BETWEEN ECONOMIC REFORMS AND ECONOMIC OUTCOMES

The relevant question is therefore whether there is any evidence from theory or empirical results to suggest that we could expect a positive relationship between the pace of reforms and its economic outcomes. In a comparative experience, there is little evidence to suggest an unambiguously positive association between the scope (and speed) of reforms on the one hand and economic outcomes on the other. If one can cite cases from Asian economies as successful examples of following the expected trends, there are equally compelling cases from Latin America with adverse outcomes. Thus, there are no clear signals as to how to reverse the trend of decelerating industrial growth, for achieving sustained growths, except for the expectation that further relaxation of rigidities governing the use of capital (domestic and foreign) and labour would yield better results. Thus, the view that 'reforms have not gone far enough' bears similarity with the argument of earlier times that repeated failure of the five-year plans to meet the targets is attributable to 'inadequate planning' and 'inefficient implementation'.

Nonetheless, evidence of the economy's structural weaknesses coupled with heavy-handed bureaucracy have no doubt been among the main contributors for the stifled industrial performance in the country. The onset of slowdown can therefore be most possibly attributed to the satiation of the pent-up domestic demand for a host of import-intensive goods which could be domestically produced following trade liberalisation. The increase in domestic demand was evidently facilitated by easy access to credit, including consumer credit, in the wake of financial liberalisation. Once that pent-up demand of a transitory nature was met, industry entered the phase of slowdown in the absence of demand support (domestic or export). From a classical economic view, explanation could be related to the question raised by Arthur Lewis on manufacturing sector. His question was: 'What limits the size of the manufacturing sector?' His preliminary answer was, 'productivity of farmers whose marketable surplus will exchange for manufactures'. As India is still a large and poor agrarian economy with 3/5th of workforce still dependent on agriculture (in Bihar it is close to 3/4th), with land productivity being one-third of China's, per capita value added in manufacturing is the lowest among the newly industrialising economies and one-fourth of China's. Following Chenery's stylised fact, large countries in general have low trade ratios. India relatively has less abundant natural resources for exports and therefore industrial growth largely boils down to the size (and growth) of the domestic market. This, in turn, depends on how agriculture performs. The explanation on India's industrialisation experience of ups and downs therefore comes down to inadequate boost to domestic demand as a large volume of industrial base is rooted to agricultural inputs. This therefore poses a binding constraint on industrial growth of at least a short and medium term nature.

The long-term constraint in a developing economy is one of low savings for investment. Thus, from a variety of analytical perspectives, autonomous public investment has the potential to generate demand for industrial goods as well as improve the infrastructural inadequacies. Macro-econometric evidence also unambiguously supports the view that public investment 'crowds-in' private investment. Combining all the arguments, it can be asserted that industrial growth in India is largely dependent on the twin engines of agriculture productivity and public investment. Neither of these was functioning well in the 1990s which explains the swings experienced in the industrial performance during the decade of 1990s. Thus, before concluding the unit, we can briefly refer to the two specific performance of agriculture and public investment scenarios in support of the 'poor agriculture-low public investment' contention in explaining the industrial performance of 1990s.

Agricultural Performance: When we compare the performance of agricultural production between 1980s and 1990s, we observe that except wheat, the rate of growth of production of all other crops viz. food-grains, non-food grains, cereals, as well as rice went down. The poor agricultural performance in the 1990s was associated with the much-commented slowdown in public investment in this sector. Although an improvement in private investment partially compensated for the decline in public investment, there was a clear decline in agricultural investment. The lagged effect of the negative agricultural growth has contributed to the slow down in the growth of rural demand for consumer durables and non-durables. As the demand for industrial products, particularly the consumer durables, is significantly influenced by the rural demand, fluctuations in agricultural production has adversely impacted the industrial growth.

Public Investment: In the initial years of economic reforms, public investment – over one-half of which is in infrastructure – was deliberately reduced. The decline in infrastructure's share which had started in the second half of the 1980s particularly became sharp in the mid-1990s. Its impact was seen in the manufacturing sector's share in gross fixed capital formation (GFCF). If we take a longer time-period, we see that the share of public investment in the late 1990s, at about 30 per cent of total GFCF, had fallen close to the level at which it was in the early 1950s. The decline in public investment is seen in the precipitous fall in the growth of electricity generation (the most crucial infrastructural need for industry) from the 8-10 per cent growth per year in the 1980s to 4-6 per cent in the 1990s. This can also be seen in terms of decline in fixed investment in industry in terms of over-expansion of capacities during the manufacturing boom, slump in the capital market for new issues and rise in the real interest rates during the mid-1990s. The increase in real fixed investment in manufacturing from 6.8 percent of GDP in 1990-91 to 13 percent in 1995-96 and its subsequent decline to 7.9 percent in 2000-01 reflects the pattern of investment in manufacturing during this period.

Thus, the fluctuating industrial performance of 1990s was not only the result of exogenous factors. It is very much a consequence of the type of economic policies in general, and the gaps in the policies in the complementing sectors in particular, pursued in the country. A basic reason behind the disappointing performance is the adverse impact of import liberalisation and the decline in the role of the government in demand generation. Poor export growth in the mid-1990s made it worse. If import liberalisation results in higher efficiency through higher exports, higher production and higher employment the rationale for import liberalisation gets vindicated. But if import liberalisation (and other policies) result in inefficient production leading to lower demand with the consequent lower production and employment, then the policy needs to be seriously re-examined. If export demand is not high enough, then there is need to generate demand through other means by more government expenditure. This is what our early Indian planners had argued on the demand question. Such arguments are very relevant even today.

Check Your Progress 2

1. Mention the important demand side factors which contributed to the poor industrial performance during the 1960s?

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2. What factors induced greater pragmatism for the performance of Indian industry during the 1980s?

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3. To which factors the industrial slowdown of 1990s are attributed?

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17.7 LET US SUM UP

Over the last five decades, Indian industry has experienced major change both in its structure and growth. We saw that the Indian industry's growth experience can be divided into four different phases each of which is associated with different policy orientation. The first two decades (i.e. 1950s & 1960s) saw the importance laid on basic and capital goods industry under the Nehruvian import substitution strategy. In the subsequent decades, the intermediates and consumer goods industries grew steadily. In the initial stages the government acted as the catalyst for industrial growth by undertaking to lead the industrial development by a major public sector presence. This created a favourable environment for the private sector also to establish industries securing, in the process, foreign capital from its own account. It was thus a state engineered growth. But after mid 1960s, Indian industry experienced decline in growth due to constraints of demand and supply. The Industrial License Policy didn't serve to sufficiently channelise investment in the desired direction. During the 1980s, industrial policy witnessed greater pragmatism following a gradual loosening of controls, and a greater willingness to import technology and foreign private capital to modernise the manufacturing sector. The second half of the 1980s thus witnessed considerable de-licensing and relaxation of import controls and capital flows, contributing to the up-gradation in the industrial technology. The experience under New Economic Policy, during the 1990s, suggests that what is required for sustained growth is to nurture the demand for industrial goods, comprising of both the domestic demand (for consumer goods and investment goods) and the foreign demand (for exports). Towards this end, the growth in rural economy, both agricultural and the non-farm industrial growth, were recognised for their importance. In sum, in order that demand is fully tapped and the supply-position is also improved, it is essential that the industrial atmosphere is made efficient and competitive. This needs to be achieved by a combination of measures like abolition of controls, improvement of fiscal and monetary structure, prudency in public investment, etc. and suitable labour reforms.

17.8 KEY WORDS

Gross Value Added (GVA) : Refers to the value of total Output minus total material Inputs. If depreciation is also deducted from GVA, the value figure thus obtained is Net Value Added.

Total Factor Productivity : Refers to the residual growth i.e. growth in output minus the combined weighted growth rates of labour and capital. This is taken to indicate a host of factors ranging from technology, R&D, training, etc.

Gross Fixed Capital Formation (GFCF) : Capital formation which takes place in production units, consists of additions less disposals, to fixed assets and change in inventories. Additions to fixed assets are called fixed capital formation (which refers to the assets produced as outputs from the process of production which are themselves used in other processes of production for more than one year). Inventories consist of materials and supplies meant for intermediate input in production. The total fixed capital used in production loses its productive capacity in course of time due to wear and tear or obsolescence. The extent of loss of its productive potential is known as Consumption of Fixed Capital (CFC) which is to be compensated by acquisition of an equal amount of fixed capital in the current year. Fixed Capital Formation computed without netting for CFC is known as Gross Fixed Capital Formation (GFCF). Put simply, the term Gross Capital Formation (GCF) refers to the sum of GFCF and change in inventories. GCF less CFC is known as Net Capital Formation (NCF).

Basic Industries : Includes mining and quarrying, manufacture of fertilisers, heavy organic chemicals, cement, iron & steel, non-ferrous basic metal and electricity, etc.

Capital Goods : Includes industries like hand tools and small tools, specialised equipments, machine tools, agricultural machinery, heavy electrical equipment, electric motors, electrical cables and wires, rail-road equipment, etc.

Intermediate Goods : Includes industries like cotton spinning, jute textiles, tyres and tubes, synthetic resins and plastics, man-made fibres, dyes stuffs, products of petroleum and coal, bolts, nuts, etc.

Consumer Goods : Includes industries both consumer durable goods like automobiles, white goods, furniture, etc. and consumer non-durable goods like foods stuffs, cosmetics, toiletries etc.

17.9 SOME REFERENCES FOR FURTHER READING

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17.10 ANSWERS/HINTS TO CYP EXERCISES

Check Your Progress 1

1. See Sections 17.2 and 17.3 and answer.
2. See Section 17.3 and answer.
3. See Sections 17.4 and Table 17.1 and answer.

Check Your Progress 2

1. See Section 17.5.2 and answer.
2. See Section 17.5.3 and answer.
3. See Sections 17.5.4 & 17.6 and answer.

UNIT 18 FOREIGN INVESTMENT

Structure

18.0 OBJECTIVES

After going through this unit you will be in a position to

- describe the role of foreign investment in economic growth;
- distinguish between the two concepts of foreign direct investment and foreign institutional investment;
- explain the policy towards the foreign direct investment in India;
- outline the factors influencing foreign investment; and
- identify the role of MNCs in influencing the flow of foreign investment to a country.

18.1 INTRODUCTION

As you are by now aware, a country needs to make lot of investment to achieve its growth targets. The first source of investment comes from 'domestic savings'. This may not be, however, adequate to meet the demand for investment. Also, in a globalised economic system, movement of capital is also liberalised. But such movements or flight of capital has a destabilising effect on the economic health of the host country. In this context, the present unit deals with the economic implications of foreign capital in India. Beginning with an outline of some commonly used terms like foreign direct investment (FDI), foreign institutional investment (FII), equity capital, portfolio investment, etc.

the unit proceeds to outline the FDI policy in India. The factors promoting the inflow of FDI and the trends (growth and pattern) of FDI flows to the country are discussed next. The importance of multinational corporations (MNCs) in contributing towards a sustained developmental process and the role of an institutional mechanism in the host country to safeguard its interest against the profiteering objectives of the MNCs is discussed towards the end of the unit.

18.2 ROLE OF FOREIGN INVESTMENT IN ECONOMIC GROWTH

Capital is one of the key inputs to economic growth. Conventional growth models (such as the Harrod Domar model) directly relate the rate of economic growth to the rate of capital accumulation in an economy. Rostow's Stages of Growth theory characterises a nation's 'take-off into sustained economic growth path' as a stage when the economy is able to enhance its national savings from under 5% of the GDP to about 10-12%. Empirical evidence also suggests that the accumulation of capital has played a very important role in the development of economies, both directly as a factor input, and indirectly, as an embodiment of technology. The importance of foreign capital thus derives theoretically from these works. Countries that are unable to save sufficiently face a capital constraint. One of the ways in which this constraint could be eased is through the import of capital from other countries. While international movement of capital gained prominence after the 1820s, the developmental role of foreign capital got recognised during the post World War II reconstruction of Europe under the Marshall Plan. Foreign capital came to be seen not only as a source for supplementing domestic capital formation, but also got recognised as an important mechanism for the transfer of technology including business organisation and institutions.

While mainstream economic theory focuses on the benefits of foreign capital to recipient countries, a significant contribution on the subject has been sharply critical of the impact of foreign capital on developing economies. In this literature, foreign capital is seen variously as an instrument of imperialism, or as a perpetrator of dependency, or of creating dualism in developing economies. They argue that the imperialists have an eye on exploiting the natural resources in the investing countries without having any real developmental objectives for those countries. They, therefore, view foreign capital as an agent for increasing the inequality both between nations and within nations. You will read more about these arguments later in section 18.7 of the unit.

18.3 CONCEPTS FREQUENTLY USED: AN OUTLINE

Foreign Investment (FI) refers to investments made by the residents of

one country in the capital assets of another country. In its strictest sense, the term 'investment' in Economics refers to changes in the stock of capital i.e. plants, machinery, construction, etc. Thus, when foreign nationals invest in establishing capital equipment in India, it constitutes foreign investment. In common parlance, this has come to be termed as *Foreign Direct Investment* (FDI). These are medium to long term investments, which add to a country's productive capacity.

Characteristically, FDI thus brings along with financial investment, access to technology and export market. Since FDI involves setting up of production base (in terms of factories, power plant, etc.) it generates direct employment in the recipient country. There is also multiplier effect of employment and income because of further domestic investment propelled in the downstream and upstream projects that gets generated in a host of other services. An example of such FDI in India is Maruti Suzuki which has been a trend setter in the automobile sector.

The above definition of FDI can thus be interpreted to characterise FDIs as lasting interest acquired in enterprises operating outside the economy of the investor. In this sense, FDI refers to a relationship between a parent enterprise and its foreign affiliate, the two together forming a *multinational corporation* (MNC). In such a situation, definitionally, for the investment to qualify as FDI, the parent enterprise should have *control* over its foreign affiliate. The international monetary fund (IMF) defines such control as owning '10% or more of the ordinary shares in the corporation' [or voting power of an incorporated firm (or its equivalent) in the destination country]. FDI can, thus, be more specifically defined as investment equal to or greater than a 10 percent *equity share* in a single firm. By contrast, portfolio investment is defined as acquisition of an equity stake of less than 10 percent.

A substantial portion of foreign funds that flow into countries these days, however, flow into secondary markets through financial instruments like equity, bonds, mutual funds, etc. Investments in such *secondary market* instruments are referred to as *Foreign Institutional Investment (FII)*. The FIIs are also referred to as *portfolio investments* which are characterised by the features of investments made in secondary market with their total stake in a firm at below 10 percent. It is also important to note that the FIIs are characterised by their typically short term nature of investment, and therefore that, unlike the FDIs, are not intended to enhance the productive capacity of an economy by the creation of capital assets. On the contrary, they are made to make financial gains from differences in rates of return prevailing in the financial markets of different countries. The FIIs or the portfolio investments thus carry a potentially destabilising effect by virtue of their short term investment nature. Nevertheless, the confidence reposed by the foreign investors by way of volume of trading done in the stock exchanges plays an important role in boosting the domestic small investor's confidence in the state of health of the economy.

Equity Capital Flows: Foreign investment (FI) which flow into the country through FIIs are in the form of *equity capital flows*. The name acquires connotation from the fact that shares purchased are in terms of equity capital i.e. a percentage equity share where each share is valued at a certain rate in its current market value. Since the investments are made in the secondary market, the shares purchased are at a price higher than its original issued price i.e. at its current market value. Such purchases, which have a potential to alter the ownership structure, and carry with it implications for domestic interest like employment of workers engaged in such establishments, warrant a careful regulation, particularly in the small scale sector (or the labour intensive sector) where the majority of workers are from the '*unorganised sector*'. There is , however, a strong case being made by the private sector for '*labour flexibility*' which means that the companies should be given a free hand in their hiring and firing policies. While most Indian industries have been fully opened to FDI, with foreigners or foreign companies permitted to own up to 100 percent equity in Indian companies, India continues to limit FDI in some industries, particularly those in which the large unorganised sector of workers are engaged, by enforcing overall caps on total foreign-owned equity shares. For instance, as of March 2007, foreign investors were allowed to control a maximum of 51 percent equity in the Indian retail ventures.

The new equity capital flows in the form of FDI generally take one of two forms viz. (i) mergers and acquisitions (M&A) and (ii) green field investment. In a *merger or acquisition*, one firm acquires an equity stake in an existing foreign firm. In *green field investment*, FDI takes the form of establishment of a new overseas affiliate by a parent company. For most developing countries, the green field route is more prominent, as there are fewer existing companies available and attractive to acquire, as compared with the developed countries. You will read more about these two type of FDI, in the section on 'Trends in FDI/FIIs' in section 8.6 later.

Check Your Progress 1

1. Mention two theoretical arguments made in favour of foreign investment (FI) to developing economies like India?

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2. On what grounds do the opponents of foreign investment criticise the flow of FI to developing countries?

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3. Distinguish between FDI and FII in terms of limits on their 'equity shares/stakes'.

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4. Which of the two types of FIs (FDI or FII) is called as 'portfolio investment'? What is the implication of 'portfolio investment' to the recipient economy for its market stability?

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5. What do you understand by the term 'equity capital flow'? Distinguish between the two forms that the equity capital flows by way of FDI generally take?

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18.4 FACTORS INFLUENCING FOREIGN INVESTMENT FLOWS

Factors influencing foreign investment can be discussed under two heads: (i) those that attract or encourage FI; and (ii) those that repel or discourage FI. We discuss briefly some of the major factors that prevail in India under each of these two heads in this section of the unit.

a) Factors Favouring FI

i) *Strong Economic Growth*: The Indian economy has grown by more

than 7 percent for a number of years in the last decade. This has contributed to making India the fourth largest economy in the world in *purchasing power parity* terms. One of the main impacts of this growth is an expanding section of middle class population with higher purchasing power than the average. Even the overall (i.e. average) per capita income (by the nominal-GDP method; not the '*PPP method*'- see Key Words for a distinction) has also more than doubled since mid-1980s when it was around $310 to about $620 in 2004. The per capita income by this nominal-GDP method for India in 2007 has increased to around $ 1,000 ($ 942 by the IMF calculation for 2007 and $ 1,042 by the WB calculation for 2008). India's imports has almost tripled between 2001 and 2005, from $50.1 billion to $138.4 billion, while exports more than doubled, from $43.3 billion to $99.7 billion. The economic dynamism demonstrated by India has thus been a strong positive factor in favour of attracting FDI.

ii) *Huge Labour Force and High Educated Workforce*: With a huge labour force of close to 430 million, India has one of the largest labour force in the world. With significant facilities for education, particularly higher education, India has also the third largest number of students in higher education in the world (trailing only behind the United States and China). English is the primary language of instruction in all these institutions, which means that most educated Indian workers speak at least some English. The annual outturn of educated persons is estimated at more than 200,000 engineering graduates, more than 300,000 post graduates from non-engineering streams, and 2.1 million other graduates besides 9,000 PhDs. Although the number of educated persons are large in terms of their numbers, a significant number of workforce are uneducated forming the large 'unorganised sector' workers in the country. While this segment of workers may not be directly benefiting from the FDI flow, the fact is that the dichotomy has led to the prevalence of relatively low labour costs, particularly in the labour intensive sectors of the economy. But a majority of them are on-the-job-trained (i.e. uncertified but skilled/semi-skilled from work experience) which itself can be viewed in positive terms from the point of view of their potential for re-training, etc. This, therefore, is a positive factor in attracting FDI even to the many labour intensive sectors of the economy.

iii) *Access to Capital and Institutional Support*: While it is true that the capital market is unfriendly to the needs of a large number of poor, it is nevertheless a fact that India has a large banking system with deep inroads into its large rural country side. It is also a fact that many new schemes have been launched particularly to meet the credit needs of the large sections of the poor. This speaks for many supportive institutional arrangements in terms of promoting self employment pursuits. Thus, while the foreign investment introduces a competitive environment to 'include' the more enabled

segments of the Indian population, many programmes already in operation should be suitably strengthened to support the other part of the non-beneficiary segment who are otherwise 'excluded' from the growth related benefits accelerated by the FI inflow.

Paradox of growth related opportunities: The above enumerated advantages, however, pose a situation that can be described as a paradox of growth related opportunities. This is because, each one of the positive factors enumerated in favour of FI inflow, has also a simultaneous negative side to it. To recapitulate: (i) significant stock of educated persons is contrasted with huge illiterate and semi-skilled on-the-job-trained workforce; (ii) growing affluent middle class section is contrasted with a huge 250 million persons (25% population) subsisting below the poverty line; (iii) a small 'organised' sector presence is contrasted in the face of a predominant 'unorganised' sector labour force; (iv) well established credit market to cater to the more advantaged is contrasted with very little credit assistance available to the large disadvantaged; etc. In the face of such a dual scenario, a moot question, as the opponents to FI argue, could be on whether to encourage Foreign Investment which would only benefit the more privileged sections to the exclusion of the large underprivileged segment of the population? But as we are also aware, huge investment needed for supporting the country's growth potential cannot be met by domestic saving alone. Also, the indirect benefit which '*trickles down*' to the lower segment of the population following development at the top rung is also not something to be trivialised. In view of this, having noted the positive side of the Indian economy to promote FI inflow, we now turn to see the many critical areas of concern which thwart or discourage the flow of FIs into the country.

b) Factors Discouraging FI Inflow

i) *Poor Infrastructure*: The poor condition of India's infrastructure, in respect of insufficient power, poor roads, antiquated ports, and an overburdened rail system make it difficult for many firms to produce and deliver goods and services in a timely and efficient manner. Although the central and the state governments have achieved some success in expanding and modernising infrastructure, a significantly higher level of investment will be necessary to modernise and maintain infrastructure commensurate with international standards. India's capacity to produce electricity has fallen short of demand with the demand for electricity currently exceeding supply by 30 percent. This has led to frequent shortages and blackouts and increased costs of production. India's transport system has also lagged behind the country's rapid growth with most Indian roads being narrow, congested, and poorly maintained. Only 41 percent of the roads are paved, and of these, only 34 percent are 2-lane roads and only 1 percent are 4-lane roads. Forty percent of the rural population does not have access to all-weather roads and is thus isolated during periods of bad weather, particularly during the monsoon season. Urban areas suffer

from severe congestion with rapid growth in automobile ownership compounding the problem of inadequate roads. Insufficient funds for road maintenance leads to further deterioration of the roads. The capacity of the railway system, particularly in the highly-travelled urban areas, has also lagged behind the growth in demand for its services. Indian seaports have experienced dramatic increases in container cargo but have not expanded its handling capacity commensurately. A similar situation has occurred at Indian airports, particularly at the major international airports, where annual growth in air traffic is more than 15 percent in recent years. It has been estimated that India needs to invest at least 8 percent of its GDP annually (approximately $62 billion) in infrastructure to maintain its high rate of economic growth. Actual investment in infrastructure is estimated at around 3–4 percent of gross domestic product during the past decade. In addition, infrastructure projects are frequently plagued by long delays and large cost overruns. Projects are often started but not completed, or completed and not sufficiently maintained in the ensuing years. As infrastructure lags the economy, the effects are felt throughout the country, particularly in the manufacturing sector, where flexibility in production, low costs, and speedy transportation to market are particularly hampered by clogged roads, rail, ports and power outages.

ii) *Rigidity in the Labour Market*: Despite India's strong economic growth in recent years, the increase in employment in the organised sector of the economy has not kept pace with the growth of the labour force. This has generated national concern that the benefits of India's economic development have not been spread widely enough. The inability of the Indian economy to generate sufficient jobs in the organised sector is due, at least in part, to cumbersome and bureaucratic labour policies at the central and state levels. There are numerous federal and state laws covering labour issues, leading to administrative overlap and excessive bureaucracy. The federal (i.e. central) and state labour agencies also generally focus their enforcement activities on the organised sector, even though this sector accounts for only a small percentage (less than 10 percent) of the total Indian work force. One of the biggest difficulties for employers in India is their inability to lay off workers. The Industrial Disputes Act of 1947 and subsequent amendments govern the layoffs of workers and the closure of plants. Firms with 100 or more employees must obtain approval from the government to shut down plants and lay off workers. Approval is often difficult to obtain, although firms on occasion are able to reduce the number of employees by offering voluntary severance and retirement packages. In the past few years, however, as the Indian economy has experienced greater trade liberalisation, the governments, in an attempt to increase the flexibility and competitiveness of Indian firms, have reduced their enforcement of the Industrial Disputes Act particularly with respect to layoffs and plant closures.

iii) *Bureaucracy and Corruption*: Excessive bureaucracy and corruption discourage FDI by distorting the efficient allocation of resources, increasing the cost of doing business, and breeding mistrust of government officials. Although India has taken steps in recent years to open up more sectors of its economy to FDI, FDI inflow into the country remains hindered by government bureaucracy and corruption. Investment decisions and approval by Indian government ministries take lengthy periods of time.

iv) *State Level Obstacles*: Taxes levied on transportation of goods from State to State (such as octroi and entry tax) adversely impact the economic environment for export production. Such taxes impose both cost and time delays on movement of inputs used in production of export products as well as in transport of the latter to the ports. Differential sale and excise taxes (States and Centre) on small and large companies are a deterrent to FDI in sectors such as textiles. Investments that could raise the productivity and quality of textiles and thus make them competitive in global markets remain unprofitable. This is because they cannot overcome the tax advantage given to small producers in the domestic market. Other serious state level bureaucratic issues include land-use and environmental regulations. There are also regulatory burden of other forms like long delays in getting new connections from public sector utilities, frequent visits by government inspectors, and the payment of bribes to avoid bureaucratic red tape. The central government has made efforts to establish independent regulators in sectors such as telecommunications, securities, and insurance in order to streamline supervision below the federal level.

v) *Legal Delays*: Though India's legal system is considered by many legal experts to be superior to that of many other emerging economies, in practice, it is often found to be an obstacle to investment. One of the reasons for this is the inordinate delay in the interlocutory procedures that characterise the judicial procedures. As a result, the 'Rule of law' which has often been cited as one of the attractive features of the Indian economy for foreign investors, is often found to be a major impediment in disputes settlement by a large number of investors.

18.5 FDI POLICY IN INDIA

The Government of India, as early as in 1949, declared that it would not discriminate against foreign capital. However, in practice, right from 1951 onwards, extensive controls were imposed by the government on the flow of foreign capital, severely restricting its inflow to India. This was in line with the conscious inward looking industrial policy adopted by India in the immediate years after independence. The policy was aimed at limiting its dependence on other economies. As a result, the movement of foreign capital (and even currency) into and out of the

country was restricted leaving limited scope for foreign investment to flow into the country. Thus, in the early decades after independence, whatever financial support was received by foreign countries came in as 'foreign aid'. Consequent to the adoption of such an inward looking approach, although a certain diversified industrial structure was achieved during the early decades of independence (i.e. 1950s and 1960s), the Indian economy came to be characterised as internationally non-competitive and high-cost.

The first major shift in the policy was made in 1972, when the government permitted wholly owned subsidiaries of foreign companies to operate in India. It, however, imposed the restriction that such companies must undertake to export 100 percent of their products. With this shift, the government recognised that foreign capital was an important supplement to domestic savings for achieving technological up-gradation and industrial development in India. Despite this recognition, a focused policy to attract foreign investment for industrial expansion was not announced till 1991. The industrial policy of 1991 specifically made the following provisions to encourage the flow of foreign investment into the country.

- Approval would be given to direct investment up to 51% foreign equity in high priority industries. Such approvals would get quicker clearance if the foreign equity covered the foreign exchange requirement for the imported capital.
- Majority foreign equity of 51% holding would also be allowed in trading companies engaged in export activities.
- Automatic permission would be given for foreign technology agreements in high priority industries subject to specified limits on payment of royalty for domestic sales and exports for a period of 10 years from the date of agreement or 7 years from the commencement of the production.

A 'dividend balancing condition' for monitoring the payment of dividend was introduced initially. This was meant to ensure that outflows on account of dividend payments are balanced by export earnings. This condition was subsequently removed. Further, in 1999-2000, foreign equity limit in manufacturing was eliminated. The pace of FDI policy for industry liberalisation is affected due to resistance to speedier liberalisation from the industry and other civic/public supporters. However, liberalisation for infrastructure sector has been reasonably fast due to universal agreement on the need for FDI in this sector. Reform of domestic investment policy as well as the FDI in sectors like manufacturing and real estate has also picked up pace as the following account shows.

Special Economic Zones (SEZs): A major area of drawback in promoting FDI inflow into the country, as you read in Section 18.4 above, is poor

infrastructure. The government, by passing the SEZ Act in 2005, has taken a major initiative to remove the obstacle on the infrastructure front. In the SEZs, export oriented production units are assured of power supply and other infrastructural support (like water, good roads, transportation facility, etc.) without interruption. The SEZs also provide tax, tariff, and financial incentives by defining SEZs as free trade enclaves. SEZs allow investors to avoid many bureaucratic and administrative barriers as well. **First**, the limits on foreign equity ownership that apply to certain sectors in India are eliminated in SEZs. **Second**, all investments in SEZs are administered through the automatic route, which empowers the Reserve Bank of India (RBI) to automatically approve the investment within a period of two weeks. **Third**, firms operating in SEZs do not need a license to import goods. Customs inspections are kept to a minimum in order to eliminate delays in product availability. Other administrative barriers have also been eliminated. In general, separate documentation is no longer required for customs and the administration of the Export-Import Policy. Firms in SEZs also have an exemption from industrial licensing requirements that is normally provided only to small scale industries. The simplification of these administrative procedures makes the investment process much simpler in SEZs compared to other areas of India.

Investment incentives have also been extended outside of SEZs. These are designed to channel FDI to specific industries, promote development of economically impoverished regions, and encourage exports. For instance, beginning March 2005, the government has allowed 100 percent FDI in infrastructure and construction development projects, as well as townships and housing projects, subject to minimum capitalisation requirements. However, outside of the SEZs, India's average tariff rates are still among the highest in the world. This makes India a much less attractive destination for export-oriented firms that depend on imported inputs.

18.6 TRENDS IN FDI/FII IN INDIA

FDI capital flows into India have increased since 1991, when India opened its economy. The inflows have particularly accelerated since 2000 (Table 18.1). Notwithstanding this, in 2005, India accounted for only around 2% of total FDI inflow ($334.3 billion) to the developing countries. In contrast, China in the same year could attract 22% of this total FDI. However, there has been an increasing trend in the FDI inflow to India since then (i.e. 2005). It touched $9 billion in a single year 2006 and the provisional figures for the year 2006-07 is nearly three times that of the inflow for the year 2005-06. The FDI inflow for 4 years from mid-2000s, is thus, consistently following an increasing trend.

FDI Inflow by Sectors of Investment: The distribution of FDI by its two components viz. mergers & acquisitions and green field investments

Table 18.1: FDI Inflows – 1991-2009

($ million US)

Sl. No.	Period [Financial Year: April-March]	Equity (through the FIPB-automatic route	Others*	Total FDI Inflows	%age growth over previous year
1	1991-2000	15,483		15,483	
2	2000-01	2,339	1,690	4,029	
3	2001-02	3,904	2,226	6,130	(+) 52%
3	2002-03	2,574	2,461	5,035	(-) 18%
4	2003-04	2,197	2,125	4,322	(-) 14%
5	2004-05	3,250	2,801	6,051	(+) 40%
6	2005-06	5,540	3,421	8,961	(+) 48%
7	2006-07 (P)	15,585	6,494	22,079	(+) 146%
8	2007-08 (P)	24,575	7,860	32,435	(+) 47%
9	2008-09 (April-Aug)	14,648	2,085	16,733	
	Cumulative Total	90,095	31,163	105,775	

* (includes equity capital from unincorporated bodies, reinvested earnings, etc.)
Source: *RBI Bulletin, October 2008: Table No. 46 – Foreign Investment Inflows.*

gives us a further idea on the specific sector into which the FDI flow is going. In respect of *Mergers & Acquisitions*, between 2002 and 2006, the value of top 15 major acquisitions of Indian companies by foreign companies has totalled $6.5 billion. They are split almost evenly between services and manufacturing, with 8 service sector transactions, 6 manufacturing deals, and 1 utility acquisition. In respect of *Green Field Investments,* the number of green field FDI projects in India rose from 247 in 2002 to 980 in 2006, increasing at an average annual rate of 41 percent. These projects were concentrated in heavy industry, electronics, property, tourism, and leisure sectors. By business function, the projects are spread among manufacturing, construction, resource extraction, and R&D.

Distribution of FDI by Cities: FDI inflows within India are heavily concentrated around two major cities, Mumbai and New Delhi (Table 18.2). Between 2002 and 2006, the two Cities accounted for nearly 50 percent of FDI investment. For statistical purposes, India's Department of Industrial Policy and Promotion (DIPP) divides the country into 16 regional offices. Of these, between 2000 and 2006, the top 6 regions (viz. Mumbai, New Delhi, Chennai, Bangalore, Hyderabad and Ahmedabad), accounted for more than two-thirds of all FDI inflows to India (70%) with the Mumbai and New Delhi regions together accounting for 48.3% of the total.

Table 18.2: FDI Equity Inflows by Region (Jan. 2000-Dec. 2006)

Rank	Region	FDI Inflows ($ million)	Percentage Share
1	Mumbai	7,486.6	24.9
2	New Delhi	7,045.0	23.4
3	Chennai	2,295.1	7.6
4	Bangalore	2,052.4	6.8
5	Hyderabad	1,572.2	3.9
6	Ahmedabad	970.3	3.7
	Others	8,999.6	30.1
	Total	**32,152.2**	**100.0**

Note: *Due to rounding, figures may not add up to the totals shown. Maharashtra region includes Dadra & Haveli, Daman and Diu. Delhi region includes U.P. and Haryana.*

FDI Inflow by Country

Data in Table 18.3 shows that Mauritius accounts for the largest share of cumulative FDI inflows to India, accounting for nearly 33 percent between 1991 and 2006. However, only four green field FDI projects (all from 2002) list Mauritius as the source country. This is because many companies based outside of India utilise Mauritian holding companies to take advantage of the India-Mauritius Double Taxation Avoidance Agreement (DTAA). The DTAA allows foreign firms to bypass Indian capital gains taxes, allowing them to route through a process known as '*round tripping*'. Round-tripping is, thus, a process by which a company operating in India registers a subsidiary in Mauritius, and then routes profits through the subsidiary to avoid paying capital gains taxes on its profits in India. Double Tax Avoiding Agreements (DTAAs) is thus a policy tool employed to promote its FDI inflow. These tax treaties provide relief from double taxation of income by offering exemptions for taxes in one of the partner countries. In other words, when an entity has income arising from both India and the partner country, the entity will be taxed under the tax laws of the country of residence. Under the DTAA, Mauritius has emerged as the most prominent beneficiary of India's bilateral tax treaties. Due to the local tax benefits it provides and its close historic and cultural ties (68 percent of Mauritius' population is of Indian descent) Mauritius has been a primary destination for entities interested in entering the Indian market. Operationally, under DTAA, companies planning to invest in India first establish a *holding company* in Mauritius, which offers zero-tax status to overseas corporate bodies (OCBs) and obtain a tax residency certificate to qualify for the tax treaty between Mauritius and India.

Table 18.3: FDI Equity Inflows by Country

Country	FDI Inflows April-December 2007 (US $ millions)	FDI Inflow 1991-2006 (US $ millions)	% to total of figures in column 3
Mauritius	4,215	16,000	33
U.S.	607	5,645	12
U.K.	1,682	3,662	8
Netherlands	488	2,482	5
Japan	52	2,176	5
Singapore	533	1,583	3
Germany	70	1,652	3
France	80	858	2
South Korea	62	814	2
Switzerland	47	683	1
Others	1,434	12,617	26
Total	**9,270**	**48,172**	

Source: *FDI Statistics, 2006, DIPP, GoI, Ministry of Commerce & Industry.*

It is important to note that trends in FDI is highly susceptible to market conditions which are themselves affected by factors of political and regional dimensions. We are presently witnessing a major global economic recession following a financial system collapse in the US and some western economies. You will read more about this in a post-script unit to the course: Unit 28. The consequence of this situation would alter the FDI flows in an inestimable manner whereas there was no hint or clue that such a situation would strike a few months back. For this kind of reason, the data presented in the section has not been discussed for many years of the past but kept confined to the recent few years of this decade. In an integrated economic system of the present type, national and international events has the potential to impact the flow of FDI greatly. This fact needs to be recognised in the context of analysing the trends in FDI in any country.

Check Your Progress 2

1. Mention the three factors identifiable for favouring the FI inflow to India. Write a line on each of these three factors indicating how it is favourable to FI inflow?

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2. What do you understand by ‘paradox of growth related objectives’ in case of India? Do you feel that the case for opposing FDI draws support from this paradox?

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3. What are the five factors identifiable for discouraging the FI inflow to India?

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4. In which year FI in India was as a matter of policy invited for the first time? What were the conditions imposed for this at that time?

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5. What are the specific provisions contained in the Industrial Policy of 1991 to attract FI to India ?

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6. How is the policy of SEZs helpful in encouraging the flow of FI to India? What are the three specific provisions by which the bureaucratic and administrative barriers are sought to be overcome in the SEZ Act of 2005?

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7. What are the five major sectors in which the 'green field investments' are concentrated in the FDI inflow to India during the years 2002-06? Which are the major cities into which the investments has largely flown into during this period?

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8. How is Double Taxation Avoidance Agreement helpful as a policy tool in promoting FDI inflow into a country?

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9. Do you think that the FDI inflow witnessed during the years 2004-08, would continue during 2008-12? If not, why not? Briefly explain in 50-60 words.

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18.7 ROLE OF MNCs IN PROMOTING FDI

Importance: MNCs are those which own or control income generating assets in more than one country. Before 1970s, MNCs were not viewed as healthy economic entities. With the changing times, MNCs have come to constitute a powerful force in the world economy. As per one estimate, the biggest 500 MNCs control about 10 percent of world trade, 80 percent of foreign investment and about 30 percent of global GDP.

Rationale: MNCs are companies incorporated in one country but located and carrying on their activities in any other country. Their decision to locate themselves in a different country is guided by the element of comparative advantage they perceive. This could be in the form of:

i) *lower costs* due to low-cost labour or laxity in rules of labour standards or environmental protection;

ii) *availability* of natural resources; and

iii) *access* to markets especially if the host country markets are protected by high import tariffs.

Case For and Against MNCs: The advantages for encouraging the MNCs to operate in a country flow from the following factors:

- The less developed countries (LDCs) have less investment potential due to which they cannot enjoy the benefits of technological superiority that comes with higher investment. The MNCs are expected to facilitate transfer of technology, besides investment, to the host country.

- The operations of MNCs are expected to have a favourable impact on the host country's balance of payment position. As 'global scanners' they possess a global marketing network through which they can promote the exports from the host countries.

- Employment generation being a function of 'rate of growth of investment and technology', MNCs are expected to generate employment opportunities especially to the more educated. There also could be indirect employment generated in the lower end services sector occupations thereby catering to an extent even to the less educated and unskilled persons. And where production units are established, there would be possibility for the promotion of ancillary units resulting in job creation and skill development for the workers engaged in those units.

- In a situation where the host country is in severe debt, the flow of foreign exchange owing to the operation of MNCs would help in debt servicing.

- Competition resulting from better work culture norms and higher productivity standards could also induce productivity related awareness for the units in the domestic economy (i.e. the host country's economy). In this context, the MNCs are known to serve as 'knowledge base' contributing to human resources development in general.

The advantages listed above are based on expectations from the functioning of MNCs. Parallel arguments may therefore be made for opposing the operation of MNCs in a developing country. Some of the arguments made in this connection are:

- ***Clash of objectives***: MNCs being private entrepreneurs, would have profit maximisation as their ultimate objective. They would therefore invest in capital intensive methods of production and service which would help the more educated and generate fewer jobs. The basic problems of addressing poverty and unemployment, the two crucial areas of concern for the LDCs, would thus not get addressed from this kind of investment from the MNCs. In effect, the already existing income inequality would accentuate further in the host country.

- ***Inappropriate Technology to Local Conditions***: The MNCs would not bother to adopt or develop a technology suitable to the conditions of the host country, but bring in the technology developed and suitable in their own country. The dependency on further supplies for services on the MNC would thus have to be contended with by the host country.

- ***Drain on Foreign Exchange***: The transfer of technology and capacity building of the human resource in the host country can, due to the above mentioned factor, remain unrealised. Further, expenses incurred by the MNCs like high fees, royalty and other charges might put a drain on the foreign exchange reserves of the host country. Thus, the expected benefits from an ease in the balance of payment situation might remain unrealised or narrowed down.

- ***Accentuating Regional Disparity***: The flow of FI, as we saw earlier from the data presented in 18.2, would be towards the regions or states which are well endowed in terms of infrastructure and availability of natural resources. This has the potential to accentuate regional disparity. In other words, it could create 'islands of development and prosperity in an ocean of underdevelopment'.

- ***Imbalanced Industrial Development***: Strong MNCs may make it difficult to compete for the local industries. This might therefore prove detrimental to the long term interests of the industrial development of the host country.

- ***Doubtful Long Term Benefit to Host Country***: As performance of MNCs testify, expenditure on scientific research or R&D could be negligible. In view of this, developing economies may not really benefit from their presence in a sustainable manner.

- ***Market Distortion***: Business operations by MNCs are observed to be anti-ethical as they frequently resort to methods like aggressive advertising, rigging bids, price fixing, etc. Such practices would induce market distortions. There are also instances of diverting high profit activities to their 100% owned subsidiaries from the simple majority equity stake affiliates.

- ***Promotion of Distorted (or undesirable) Consumption/Investment Pattern***: Production could get concentrated in items of popular consumption and non-essential items. From this sense, investments could be distortive.

- ***Capital Movement***: With freer mobility of capital, there could be frequent flight of profits and capital from one country to the other. This carries a market destabilisation effect. MNCs are often accused of indulging in 'transfer pricing techniques'. This technique refers to an accounting procedure used to register lower profits in high tax countries and transfer them to low-tax countries to disguise capital outflow and minimise tax liability.

The above arguments made against MNCs are argued to be old and irrelevant in the modern context. They are termed as 'value based and ideological' not supported adequately by empirical evidence. While in the face of growing capital requirement, international capital is a must, what is needed may be a regulatory body which can streamline investment to sectors and areas where they would be beneficial to the host economy. As we are aware, even domestic private entrepreneurs would need regulation in the absence of which they too show the tendency to involve in anti-ethical and people unfriendly practices. We therefore briefly note in conclusion the regulatory dimension of MNCs as this is what ultimately determines the degree of congruence (i.e. harmonious balance) between the profit maximisation motive of MNCs and the developmental objective of LDCs.

Regulating MNCs – Investment Commission: India has appointed an investment commission to interact with the industrial groups in India and large companies abroad. The interaction is aimed at facilitating the identification and flow of investment to sectors where adequate investment has not taken place so far. The commission also sets FDI targets and advices the government on the suitable course of action to be taken for regulating the flow of FDI to the country. For instance, on allowing the operation of MNCs in the retail sector, where there is a strong debate on its negative effects on local small traders, the commission in its report in 2006 suggested allowing FDI in retails with an investment cap of 49 percent. The commission has favoured promotion of special economic zones in areas like auto components, textiles, electronics and chemicals. It has also suggested the creation of a special high-level fast track mechanism for priority sector projects.

Thus, among the specific measures to regulate the operation of MNCs in India, the methods adopted include the following:

- **One**, the threat of nationalisation, though resorted to only in the extreme, is used to make the MNCs act in a disciplined manner;
- **Two**, allowing collaboration in certain selected sectors/industries/ regions where the operation of MNCs is favoured;
- **Three**, allowing specific period investment by including provision for gradual disinvestment after the expiry of the specified period;
- **Four**, laying down criteria for exports and following multi-tax system to suitably motivate the MNCs; and
- **Five**, to suggest carrying out a minimum fixed share of the MNCs overall R & D activities in India to ensure technology development and transfer.

Check Your Progress 3

1. Briefly state the importance and rationale of MNCs to indicate the desire of the government to allow and the interest of the MNCs in opting to invest in other countries.

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2. Mention the important reasons for which the operation of MNCs are favoured but at the same time feared by a developing country like India.

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3. On balance, taking the arguments both for and against the MNCs, what do you think should be the stand of a developing country like India in allowing the operation of MNCs in their country?

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18.8 LET US SUM UP

The importance of FI to an emerging economy like India is crucial to support its high growth potential. The policy of the Indian government has recognised this aspect, particularly during the last two decades, and taken measures to promote the FI inflow into the country. While there has been a spurt in the inflow of FDI to India since the year 2004, the overall inflow is still very low when compared to the relative flow of FDI to other developing countries in the world. The unit has discussed the factors which influence the flow of FI, the pitfalls that exist in this respect, the imperativeness of an institutional mechanism to regulate its flow in the desired directions, and the policy initiatives taken to promote the flow of FI to India.

18.9 KEY WORDS

Foreign Investment : Refers to investments made by the residents of one country in the capital assets of another country. More specifically, such investments is referred to as foreign direct investment (FDI).

Foreign Institutional Investment : Refers to investments in secondary markets through financial instruments like equity, bonds, mutual funds etc. Such investments are also referred to as 'portfolio investment'.

Equity Capital : Refers to investment made by the foreign institutional investors through the purchase of shares in terms of equity capital expressed as the percentage of ownership gained over the company by such purchases or investment.

Unorganised Sector : Refers to that part of the employees (or workers) whose employment contract is not governed by any social security provision to safe guard against illness or old age. They signify a large vulnerable section of the huge Indian labour force. To rectify this anomaly of all labour welfare measures being applicable only for the small organised sector employees, the government has recently passed a legislation to bring them under a minimum social security coverage. The long term goal of any developmental policy is to increase the share of organised sector workers meaning thereby that the

employment contracts should provide assured wages in addition to social security.

Labour Flexibility : Refers to the operational flexibility in hiring and terminating of employees depending on the need for the continued engagement of the persons in work. It is held that the Indian labour laws are unfavourable to employers in that the provisions for termination of employees' services is complex and legally binding.

PPP (purchasing power parity) per capita : Refers to the method of estimating the final value of goods and services produced with a reference to the cost of living in the country. Such an estimation is then used to arrive at the PPP per capita by dividing the estimate from the mid-year population in the country. The method is in contrast to the other method of arriving at the estimate of per capita income derived by taking the nominal value of GDP of a country. For India, the current PPP per capita is around $2600 where as the non-PPP indexed per capita is about $1000.

Trickle Down Theory : Refers to the hypothesis that development of even the top rung of the society, representing a small section of the population, allows the percolation of its benefits to those in the lower rungs by the multiplier effects of growth related benefits. In the matter of tackling poverty in India, the government in the 1970s, abandoned its faith in the effects of this trickle down theory and began an approach for its 'direct attack' through its various anti-poverty programmes.

Holding Company : Is a company that owns part (majority or all) of other company's outstanding stock.

18.10 REFERENCES

Reserve Bank of India, Annual Bulletin, 2008.

Report of the Steering Group on Foreign Direct Investment (2002), Planning Commission, Government of India, New Delhi, August, 2002.

Staff Research Study (30), Office of Industries, U. S. International Trade Commission, Competitive Conditions for Foreign Direct Investment in India, Publication 3931, July 2007.

18.11 ANSWERS/HINTS TO CYP EXERCISES

Check Your Progress 1

1. See Section 18.2 and answer.
2. See Section 18.2 and answer.
3. See Section 18.3 and answer.
4. See Section 18.3 and answer.
5. See Section 18.3 and answer.

Check Your Progress 2

1. See Section 18.4 (a) and answer.
2. See Section 18.4 (a) and answer.
3. See Section 18.4 (b) and answer.
4. See Section 18.5 and answer.
5. See Section 18.5 and answer.
6. See Section 18.5 and answer.
7. See Section 18.6 and answer.
8. See Section 18.6 and answer.
9. See Section 18.6 and answer.

Check Your Progress 3

1. See Section 18.7 and answer.
2. See Section 18.7 and answer.
3. See Section 18.7 and answer.

UNIT 19 SERVICE SECTOR

Structure

19.0 OBJECTIVES

After going through this unit you will be able to:

- describe the nature of service sector in terms of its concept & characteristics;
- outline the framework specifying the classification of the activities of the 'service sector';
- describe the trends in the share of service sector in GDP vis-à-vis those of primary and secondary sector;
- present the composition of the service sector (in terms of its share and growth profiles) for the sub-sectoral constituents of the service sector in India;
- explain the factors contributing to the growth of service sector;
- discuss the importance of focusing on the promotion of service sector with a thrust on its specific constituents like social and infrastructure sectors;
- explain the concept of 'service sector acting as engine of growth' vis-à-vis its sustainability arguments; and
- discuss the prospects identifying the critical need in promoting the 'trade in services' in India.

19.1 INTRODUCTION

In a trichotomised classification of the aggregate economy, the total economy is classified into three sectors viz. the primary sector, the secondary sector and the tertiary or the 'service sector'. The 'primary sector' refers to those activities which are based on the products derived from natural resources like land, water and animals. Thus, activities like agriculture, animal husbandry, forestry, fishery, and mining/quarrying are included in the primary sector. The 'secondary sector' refers to products derived by a process (e.g. manufacturing) on the products extracted from the primary sector. Thus, activities like processing, manufacturing, generation of electricity, gas, water, and construction are included in the secondary sector. The 'service sector', as the residual of the economy in this trichotomised classification, includes all those activities in which the products derived from the primary and secondary sectors are *distributed to various intermediate and final points of consumption (besides providing various other services to producers and consumers)*. Thus, the service sector includes various sub-sectors like transportation, communications, trade, commerce, education, health, finance, law & order, judiciary, etc. More generally, although the three broad sectors (viz. primary, secondary and tertiary sectors) encompass many sub-sectors under each, it is conventional to connote these three sectors by the activities of agriculture, industry and services respectively. The underlying rationale for this connotation comes either from the origins of resource for production or the basic source of inputs used for deriving the sector's output. Since most of the natural products we get are from agriculture, dairy, forestry, fishing, mining, etc. the primary sector is also called as the 'agriculture & allied sectors'. Since the secondary sector is associated with different kinds of industries, it is also broadly called as the 'industrial sector'. Since the activities of tertiary sector generate 'services' rather than goods, the tertiary sector is also called as the 'services sector'.

The present unit is focused on 'service sector'. It deals with, among others, the following aspects: (i) provide a distinction of the service sector activities in terms of its characteristics; (ii) present the composition (i.e. percentage shares) of each of the broad three sectors in the GDP of economies, and employment, with a reference to the 'stage of development of the economy' (iii) discuss the growth profile of the overall service sector and its constituent sub-sectors with a specific reference to its contribution in employment and capital formation in India; (iv) explain the importance of focusing on some of the crucial service sector constituents like 'education and health'; and (v) outline the role of its other constituents like transport, communications, etc. in providing a strong 'infrastructural base' to aid the process of economic development.

19.2 NATURE OF SERVICE SECTOR

Conceptual Evolution: Conceptually, the service sector, has been identified with the prefixed phrase '*goods and services*'. It was thus recognised as an entity having a subsequent role to servicing the goods produced or manufactured. In other words, the '*logical categories*' of their availability for consumption was accorded recognition (Hill, 1977). This specification also gave weightage to the factor of *physical proximity* between a service provider and service seeker. The subsequent developments on the service sector relaxed this notion of physical proximity (Bhagwati: 1984, 1985). The need for this relaxation was recognised because of two distinct situations observed – one that necessarily required the physical proximity and, the other, that did not essentially require it. Situations which essentially required the physical proximity were further *categorised into three groups* viz. (i) mobile provider and immobile user (e.g. shifting labour in construction sites), (ii) mobile user and immobile provider (e.g. hospital services) and (iii) mobile user and mobile provider (e.g. lectures). Still later, due to technological developments, services for which physical proximity was inessential were identified to be on the rise (e.g. banking and insurance). Such '*long distance services*' got revolutionised by the developments of communication technologies in the recent years.

The notion of services being completely *distinct from goods* has since been particularly recognised in the realm of trade. Services were here pointed out to fall into one of the three possible types viz. complementary, substitutive and independent. The three types may be exemplified by the following:

- Complementary to trade in goods: e.g. transport, insurance, banking, etc.
- Substitutive for trade in goods: e.g. maintenance and refurbishing services substituting for new goods, recorded CDs substituting for live musical performances, etc.
- Independent to trade in goods but significant to economic development in general e.g. health and education.

Characteristics: The basic characteristics of service sector are its (i) non-transferability; (ii) non-storability; and (iii) heterogeneity. The characteristic of *non-transferability* is obvious when we take the example of social sector services viz. health and education. These services are quite unlike the benefit or the utility derived from those of a good like vegetables or cars. We cannot transfer the benefits of health and education acquired by one individual to the other (or others) as they need to be *acquired by each individual* independently. We can relate the characteristic of non-transferability of the other service sectors like transportation, communication, etc. in a similar manner. Likewise, we

cannot store up the consultations of a doctor as in the case of a good. Further, the nature of consultancy on health given by a doctor, varies depending on the skill or competency of a doctor. This is to say that the nature of health service rendered is not only *heterogeneous* but are also characterised by *imperfect competition*.

Classification: The United Nations (UN) classification of service sector activities includes the following sub-sectoral distinctions identified under it:

- Electricity, gas and water;
- Construction;
- Wholesale and retail trade;
- Transport, storage and warehousing;
- Post and telecommunication;
- Financial institutions;
- Insurance;
- Real estate;
- Business services;
- Rental and leasing of machinery and equipment;
- Public administration and defence;
- Sanitary and social services;
- Community services including education, research, scientific institutions, medical, professional and labour associations, radio and television broadcasting, entertainment services; and
- Personal and household services.

19.3 GLOBAL TREND IN SHARE OF SERVICE SECTOR EMPLOYMENT AND GDP

Development theory identifies three stages of sectoral transition (Clark and Fourastie). The first stage is when the primary sector is the dominant sector both in respect of labour-share (i.e. employment) and contribution to GDP. The second stage is the one in which manufacturing sector assumes dominance. In the third stage, the tertiary sector takes the

lead. The three stages, particularly in respect of employment share, are theorised to follow the sequence of primary to secondary and then on to tertiary. The underlying rationale in the proposition is that the agricultural sector would initially support large labour, though with lower productivity. After a certain stage, however, owing to lower productivity of agriculture based occupations, the continued dominance of agriculture sector would become unsustainable. This is the stage in which the industrial sector would take over to provide more jobs with incomes higher than those in the agricultural sector. In the third stage, the demand for more 'services' would increase. This stage of service sector dominance is more observed to be in its contribution to GDP rather than employment. This is particularly the case in developing economies like India where the proportion of skilled workers is less. An underlying condition for the effective transfer of labour, along with the contribution of income to output (i.e. GDP) is therefore that, the labour force of the country should be more skilled. Such skills are defined to require minimum of eight years of schooling followed by some vocational skill considered 'marketable'. This is basically attributed to higher technological inputs in the modern sector jobs generated first in the industry, and then in the service sector. Economies would therefore have to plan for expanding the educational and training services (besides the health services) in the absence of which the sectoral labour transfers with the expected productivity improvements would not materialise. The evolution of sectoral shares in income and employment, over the decades of 1950s and 60s (studied by Kuznets and Chenery, among others) supported the above proposition of the income transition from the primary to the secondary followed by a service sector led growth.

Analysis of more data on development which became available for the post-1970s, however, suggested that as the economy matures, the sectoral shares of income given up by agriculture is taken up more by the service sector than by the industries. The share of industries, although would increase in the first instance, either gets stabilised or even declines in some cases. In this path of development, which is different from the Kuznets-Chenery observed path, there would be two stages of development corresponding to the level of income (per capita income) enjoyed by the economy. The economies, for the purpose of this classification, are classified into four stages viz. the low income stage, the lower middle income stage, the upper middle income stage and the high income stage. In the first stage of transition, from the 'low income' stage to the 'lower middle income stage', the share of income of both industry and services would increase. In the second stage of transition, from the upper middle income to higher income levels, the share of industries would either stabilise or even decline while that of only the services would increase. One possible explanation provided for this is

that in an integrated economic system (or globalisation), manufacture could get based wherever there is comparative advantage for setting up the production base. A popular example is the setting up of Maruti Udyog Limited as also many other BPO (business processing outsourcing) units in India known for its relatively cheap labour and good English speaking youth population. This path of development is thus one in which two trends are evidenced: (i) the industrial employment and its income contribution to GDP would first increase but then get stabilised at a certain level, and (ii) any employment generated in the services sector, when it becomes the dominant contributor to GDP, would go to the more educated workforce in the economy. The experience of India, as will be revealed by the data presented in the subsequent section, shows that the Indian economy has followed this path of sectoral transition in which although the service sector has come to dominate in terms of its contribution to GDP, no significant shift in the sectoral distribution of workforce towards the industrial and service sector has resulted. In other words, the economy continues to be dominated by a huge workforce subsisting in the low productive agricultural sector with moderate shift in industrial employment and income.

19.4 SERVICE SECTOR IN INDIA

Depending on the share of income in the GDP of a country between the three sectors of agriculture, industry and services, a broad classification of global economies is made by the World Bank and published in its World Development Report. The source classifies the economies into four segments viz. (i) low income economies; (ii) lower middle income economies; (iii) upper middle income economies; and (iv) high income economies. The benchmark adopted is the per capita GDP of the countries. For transition from the low income stage to the lower middle income stage the benchmark adopted in 2006 was $935. The per capita GDP is measured by two methods viz. (i) the nominal GDP method and (ii) the PPP (purchasing power parity) GDP method. The PPP method is considered more realistic as it is adjusted for differences in the cost of living of the countries. India's per capita GDP, for the year 2007, as per these two methods was $942 and $2,563 respectively. India thus falls in the 'lower middle income' stage of economic development irrespective of the method by which the estimated per capita GDP is considered (vide note to Table 19.1). The global average of the share in income by the 'service sector' to the GDP of a country, in the course of transition from the 'low income stage' to the 'lower middle income' stage, is 48 percent. The sectoral income share of GDP by the service sector for India crossed this stage in the late 1990s (Table 19.2). However, the sectoral share of GDP of the primary sector, till the early 2000s)

Table 19.1: Global Averages of Sectoral Shares in GDP (%)

Income Level	Broad Economic Sector			Transition Stage
	Agriculture	Industry	Service	
Low Income	24	32	45	Stage I
Lower Middle Income	12	40	48	
Upper Middle Income	7	33	60	Stage II
High Income	2	29	70	
India's sectoral distribution (early 2000s)	24.3	21.6	54.2	

***Source**: WDI (world development indicators), World Bank.*

***Note**: In 2006 (Source: WDI, 2008) , the classification was based on the following incomes range: low income countries: $935 or less; lower middle income countries: $936-$3,705; upper middle income countries: $3,706-$11,455; and high income countries: $11,456 or more.*

Table 19.2: Sectoral Share of GDP in India (%): 2000-2006

Year	Primary	Secondary	Tertiary	Share of Manufacturing in Secondary
2000	25.3	25.4	49.3	14.7
2001	24.3	25.9	49.8	15.2
2002	24.4	25.2	50.5	14.8
2003	21.9	25.9	52.2	15.2
2004	22.2	25.7	52.0	15.0
2005	22.8	26.0	51.2	15.1
2006	19.9	26.1	54.0	15.2

***Source:** CSO (Ministry of Statistics and Programme Implementation)*

was two times and that of the secondary sector nearly half of the global average. However, since then, there has been a further reduction in the primary sector's share and a marginal increase in the secondary sector's contribution to the GDP of the country (19.9 and 26.1 percent in 2006 respectively: Table 19.2). Further, although the share of primary sector employment has come down over the years, the sector still supports a

Table 19.3: Sectoral Share (UPS/CDS) in Employment in India (%): 1983-2005

Year	Primary	Secondary	Tertiary
1983	65.6 (66.1)	14.4 (14.2)	20.0 (19.7)
1988	63.3	16.1	20.6
1994	61.9 (61.8)	15.2 (15.1)	23.0 (23.1)
2000	59.1 (57.3)	16.2 (16.9)	24.7 (25.9)
2005	55.1 (52.7)	18.8 (18.8)	25.9 (28.5)

Source: *NSSO.*

Note: (i) Figures within brackets are of the CDS segment; those outside, are for the UPS segment. (ii) For a distinction of these two concepts of measuring employment, see Unit 25 of the course.

significant 55 percent of population (in 2005). The secondary sector's share of employment, on the other hand, has increased by about 4.5 percent over the last two decades. The change compares unfavourably with the corresponding changes in the other Asian economies over the period 1970-2000 [e.g. Korea, 14.5%; Thailand, 10.2%; China, 9.2%; Phillipines, 7.2%; India, 2.4%; Mazumdar, (2006)]. The magnitude of change in employment share for the service sector is higher (5.9 percent for the UPS segment, and 8.8 percent for the CDS segment: Table 19.3) than that in the secondary sector (4.4% & 4.6% respectively). However, as mentioned before, new jobs generated in industry and services are more skill intensive for which focusing on the educational sector needs of the country is crucially required. We will revert to this aspect in a subsequent section of this unit.

19.4.1 Sub-Sectoral Performance in Services

The sub-sectoral performance of service sector constituents, for the period 1981-82 to 2006-07, shows that only two sub-sectors viz. communications and banking & insurance have improved their income shares (contribution to GDP). While communications has increased its share from 1.8% in 1981-82 to 7.5% in 2006-07, banking & insurance has increased its share from 6.5% to 11.3% during this period of quarter century. Barring these two sectors all other sub-sectors (viz. trade, hotels & restaurants, railways, other transport, storage, real estate, public administration, other services) have either declined in their share or at the most maintained their levels. However, plan-wise estimates of growth rates show that the 'overall service sector' consistently grew at 7 percent during both the Eighth (1992-97) and the Ninth (1997-02) plan periods and at 7.6 percent during the Tenth Plan period (2002-07). Such a consistent overall growth for a fairly long period of 15 years speaks of the continued demand for the service sector activities (or industries) matching the trend in the increased income generation in its constituent

sectors. In particular, during the recently concluded Tenth Plan Period, the important sub-sectors which posted higher than this overall average of 7.6% growth are: communications (22.1%), transport other than railways (11.4%), trade and banking & insurance (9.3% each), hotels & restaurants (9%), real estate (8.3%) and railways (7.7%). Thus, barring the sub-sectors of storage and public administration (which grew at 5.6% and 5.2% respectively), all other sub-sectors have grown at more than the average growth of the service sector in general.

While the sub-sectoral growth rates indicated above are with respect to income (i.e. GDP share), for a labour-surplus economy like India, the employment content of growth in income is more important. This is provided by employment elasticity defined as 'the ratio of growth rate in employment to that in income/output'. During the period 1999-2000 to 2004-05, the latest periods for which data by NSSO are available at present, the sectors which have registered highest employment elasticity are: (i) financing, insurance, real estate and business services (0.94%); (ii) construction (0.88%); and (iii) trade, hotels & restaurants (0.59%). Although 'construction' is a part of secondary sector, it provides boost to many service sector industries principally 'transportation'. Further, despite the increased capital intensive methods being adopted in construction particularly in the urban side, quite an amount of unskilled labour find jobs in many public work projects in rural areas. Given that jobs in sectors like finance, banking and IT are likely to be more skill intensive, service sub-sectors like (i) transportation (through construction), (ii) real estate and business services, and (iii) trade, hotels & restaurants are more suitable for jobs to the less skilled.

Check Your Progress 1

1. Distinguish between the primary, secondary and the tertiary sectors of the economy.

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2. Mention the different characteristics of the services sector? What is the particularly significant distinction accorded to the services sector by the developments in the 'realm of trade'?

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3. In what respect the pattern of economic transition of the post-1970s differ from that suggested by Clark and Fourastie?

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4. What is the income level in which India can be placed in the global classification of economies? What position has the 'services sector' in India occupied in this respect?

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5. Mention the service sector sub-sectors which have registered higher growth in the recent years. Which of these show a higher employment content and why?

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19.5 FACTORS PROMOTING GROWTH OF SERVICE SECTOR

Factors determining or promoting service sector can be broadly classified under three heads viz. (i) demand side factors; (ii) supply side factors; and (iii) other factors.

Demand Side Factors: Under this, the following factors have an influencing effect on the growth of service sector.

- *High income elasticity of demand* for service sector oriented goods has a positive effect in boosting the demand for services. For instance, automobile industry has both forward and backward linkage for services. Outsourcing of spare parts required would generate demand linked to backward linkage while the after sales service needs would generate demand linked to the forward linkage. With a rise in income, the demand

for such goods would increase. With increased demand, the service sector related activities also would get a boost.

- As economies grow and become more specialised, firms increasingly *contract out* several functions which they were earlier carrying out themselves. The process of contracting out jobs to industries (such as in the case of automobile industry) leading to first coming up and then their further expansion over time is called '*ancillarisation*'. Likewise, jobs contracted out (e.g. security, accounting, legal services, office maintenance, housekeeping, etc.) are referred to as '*splintering*'. Splintering, by increasing the demand for services inputs in production, boosts the growth of service sector in two dimensions. **One**, by contributing to the growth of service sector faster than that of other sectors in the economy, and **two**, by increasing the share of service sector in GDP even if the GDP itself is not growing.

- Increased *trade* is another factor which can contribute to boosting the demand for service sector activities. Trade promotes the setting up of multinational companies in a free market economy. *Changes in technology* which is a feature of greater trade promotion, and which in the recent past has enabled the delivery of services across countries at a very low cost, has contributed to expansion of world trade significantly. A popular example in this respect is the outsourcing of IT related services which depends upon the demand generated through the policies in other countries.

Supply Side Factors: The supply side factors influencing the growth of service sector include the following:

- *Higher inflow of FDI* in services lead to higher demand for services. This could be by way of enhancing the scope for locally produced services deriving the benefit of *scale economies*. This could, however, be also viewed as a demand side factor contributing to the growth of services.

- *Availability of improved technology* results in reduction in costs of providing services which, in turn, boosts the share of services in GDP.

- *Availability of trained/skilled/English knowing labour force*, which is vitally required to take advantage of the emerging opportunities in the service sector.

Other Factors which can provide a boost for the growth of service sector include: (i) new activities or products emerging out of technological developments (e.g. internet services, cellular telephony, credit cards, etc.); (ii) policy changes removing impediments to the growth of the sector (e.g. increasing the FDI cap, lowering of import tariffs, etc.).

19.6 SERVICE SECTOR AS ENGINE OF GROWTH

A sector is regarded as the 'engine of growth' (or a key sector promoting growth), if it generates maximum impulses (backward and forward linkages based) for further growth in the economy. Viewed from this angle, the factors from both the demand and supply sides discussed in section 19.5, accord the service sector in India the status of the engine of growth. Further, as observed from Table 19.3, the increase in the 'current daily status' (CDS) employment of the service sector between the years 2000 and 2005 is higher (2.6%) than in the 'usual principal status' (UPS) employment (1.2%). While you will be studying the conceptual aspects of the employment measurement later in Unit 25, you may note at this stage that while the UPS employment refers to its more regular feature, that of CDS refers to its hourly employment characteristic. The trend in CDS employment growth is therefore supportive of the growth in employment suitable to the less skilled workers (many of whom subsist on hourly employment income) such as those engaged in sectors of trade and transport. Thus, in a comparative perspective of inter-sectoral shares, the service sector in India has not only come to occupy a significant share in income, but its share in employment also has increased particularly during the post-reform years (to 28.5% in 2005 from 20% in the beginning of 1990s: Table 19.3). More particularly, the increase in the CDS employment of service sector between the years 1994-2005 is higher (5.4%) than in the secondary sector (3.7%).

19.6.1 Reform Measures Needed to Boost Expansion of Employment

Notwithstanding the trends in CDS employment, there is a contention that the growth in jobs in the service sector is biased towards 'knowledge intensive jobs'. This contention is made in the context of service sector growth propelled by IT revolution. Although it is true that the Indian service sector has gained its 'engine of growth' position due to the significant contribution of IT sector (including IT exports), it is also true that less skill intensive service sector constituents have also grown significantly during the recent years (vide Section 19.4: transport other than railways, 11.4%; hotels & restaurants, 9%). Nonetheless, as of now, the workforce distribution in India continues to be heavily concentrated in the primary sector. The ability for higher absorption of the surplus workers presently dependent on the primary sector is considered higher in labour intensive manufacturing than in services. The underlying rationale for this view is that on-the-job training of the less educated is possible more in manufacturing than in services. With this in view, the *areas which are required to be focused upon* for job expansion in a manner which caters to the needs of the current labour force in India are the following.

- In the context of Indian economy, much of the growth in the service has come from the 'informal services' where the wages and productivity are often low. Six largest service sector industries which have accounted for the bulk of the service sector's contribution to GDP are: distribution services, public administration, real estate, community services, transport (other than railways) and banking. Since bulk of the Indian workforce continues to depend on primary sector activities, job creation concentrated in service industries like banking, insurance, public administration, and IT (information technology) cannot absorb the vast majority of surplus primary sector workers in the economy. This requires policy to promote faster expansion of the traditional labour intensive industries along with suitable measures to promote high end sectors like that of IT to cater to the needs of our huge educated workforce.

- Promotion of labour intensive manufacturing requires suitable measures to remove the current provisions in the laws that discourage its expansion. Under the Industrial Disputes Act (IDA) (amended in 1982), firms that employ 100 or more workers cannot layoff or retrench the workers easily. This has deterred large scale investment in labour intensive manufacturing segments in India. To circumvent this hurdle, large firms have focused on promotion of skilled-labour intensive or capital intensive sectors. Workers of such skill intensive sectors are basically white-collared who are not covered by the provisions of the IDA. To promote investment in labour intensive technology, labour flexibility measures allowing the right to retrench workers with 'reasonable severance compensation' are needed at least selectively. Increased labour flexibility norms would no doubt contribute to increased casualisation of workforce reducing the overall job security in the labour surplus economy. A policy taking into account the need for a balanced view in this regard is needed.

- Although industrial output is far more tradable than services in general, in particular, the IT services have a large tradable component. However, the share of IT and IT-enabled services account for only 0.3% of India's GDP. Given this tiny share, the IT and the IT-enabled sector has by itself made only a miniscule contribution to the growth of services in terms of its overall employment share in the economy. Notwithstanding this, a most important potential bottleneck faced by the Indian IT sector is the state of higher education in the country. Only 6% of Indian youth between the age of 18 and 24 years go to college. A tinier fraction of these emerge out with the skills necessary to perform the tasks related to software and IT-enabled services. If the growth in the IT sector is to be sustained, fundamental changes in India's higher education policy is required.

- Any expansion in the education sector reforms would bring us to the issue of government's ability to invest more. Questions that arise are: whether it is the responsibility of the government alone to invest

in education and whether or how to allow the private sector to play its part in the education sector? The fiscal deficit of more than 10%, despite the increasing savings rate beyond the 35% GDP level, is leaving very little scope for enhanced governmental investment in the education sector. Under the circumstances, the proportion of GDP spent on education has progressively declined over the last several decades. Two complementary options in this respect are: (i) allowing the entry of private universities into the market and (ii) introduction of tuition fees in public universities for those who are capable of paying. In the light of acknowledged high private returns to higher education, it is argued that there is a good case for the introduction of significant tuition fees in public universities to generate funds for the expansion and improvement of the quality of higher education in the country. Introduction of 'student loans' through banks is an important step initiated in the recent past in this regard.

- Indian industry, to compete internationally, needs better infrastructure. In labour-abundant economies such as China and India, FDI is attracted principally to industry to take advantage of lower wages. *Poor infrastructure (like power, communications, transport) not only hinders rapid industrialisation but also imply lower level of FDI inflow*. Speedier movement of goods requires construction of reliable roads, a modern trucking industry, and the removal of restrictions on interstate movement of freight carriers. It is therefore important to focus on improving the infrastructural sector in India to attract more investment.

- Lastly, along with educational sector reforms, we need to focus on improving the health determinants of our vast undernourished population. Social sector reforms, a term used to indicate the educational and the health sectors combined, are thus crucial. You will read more on this sector in Unit 24 of this course on 'Education and Health'. Thus, as mentioned in the beginning of this unit, focusing on the social and infrastructural sector reforms is very important to sustain the growth under the prevailing socio-economic circumstances in India.

Check Your Progress 2

1. What are the three factors identified from the demand and supply sides to influence the growth of service sector in India?

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2. Do you think it is justified to regard the 'service sector' as the 'engine of growth' of the Indian economy?

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3. Mention the six important areas in which reform measures are needed to accord the desired sectoral thrust for the Indian economy.

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19.7 SUSTAINABILITY OF SERVICE SECTOR LED GROWTH

The sectoral increases in income in the developed economies have always been accompanied by its simultaneous ascendancy in employment. This has given rise to the apprehension that since the industrial sector in India has lagged behind in assuming its fair share of employment and income, the present trend of 'service sector led growth in income' may possibly be reversed sometime in future. Moreover, the manufacturing sector in India is strongly dichotomised into a large and significant 'unorganised sector' (significant because it supports three-fourths of total employment in manufacturing) coexisting with a small but dominant 'organised sector' (dominant because it accounts for two-thirds of income-share in total manufacturing). The service conditions and income of the two segments are highly variant with the unorganised sector having survived entirely on its own quite often under adverse circumstances (e.g. trade, hotels & restaurants, transportation). A strong view of the planners and thinkers was that the growth in the 'organised manufacturing sector' (OMS) would sustain the growth in the 'unorganised manufacturing sector' (UMS) by virtue of their backward linkages. This growth was expected to contribute to increased employment share of service sector as manufactured goods would generate demand for services. The experience of last two decades has, however, shown that the growth of OMS has been largely 'job-less'. In the light of this, the growth of service sector witnessed in India, attributed mainly to IT sector progress, is not considered suitable to generate employment of a type needed for the large low skilled numbers in the labour force. This has given an added dimension to suspect the

sustainability of service-sector led growth in the Indian economy. Whether such a growth path is leading to higher income inequality and wealth has been among the factors for the concern on the 'sustainability proposition' of the service sector in India. In the light of these factors, it is necessary to know the arguments for and against made on the sustainability of service sector led growth in India.

19.7.1 Arguments for Sustainability

- The ability to compensate for industrial failure with services success is a strength and not a weakness. In a globalised economic system, rather than services following and supporting manufacturing, manufacturing is seen to flow to those countries where services infrastructure is well developed and efficient.

- The argument that services lack innovation and are merely consumers of innovation in manufacturing is not true. On the contrary, innovation in services have come to take the form of 'how, where and when a service can be delivered more efficiently'. Productivity enhancing investment in ICT (information and communication technology), growing tradability in services, etc. are among the factors contributing to innovation in services.

- The increased use of consumer durables is expected to increase the demand for intermediate services like servicing and repairing of household equipments. The emergence of a broad based prosperous middle class (in India) and an ageing population in developed economies has the potential to generate additional employment in the services. An example for the latter is the demand for health services due to the relative low cost of healthcare services in India.

- The externalisation of non-core activities, which is one of the contributing factors for the growth of service sector, is believed to be the engine of service sector growth. Such externalisation influences the growth of small business services leading to employment generation of the less skilled type.

- With the increased complexities of modern industrial organisations, manufacturing has become more service intensive both upstream (e.g. design and R&D) and downstream (e.g. marketing and advertising). Competitive advantage of a firm depends more on providing specialised services like after-sales facilities.

- Increasing incomes would lead to change in lifestyle inclined towards higher leisure spending. This would generate multiplier effect of employment in services by the promotion of tourism, hospitality and transport sectors.

19.7.2 Arguments Against Sustainability

- Historically, argument against sustainability of services dates back to

Adam Smith who held that 'services perish at the very instant of performance'. However, the concept and scope of the service sector of Adam Smith's time are quite different from those of today. Thus, although the view of the classical economists on the present day service sector is no longer absolutely relevant, their view nevertheless needs to be noted as in many cases they continue to be relevant even today (e.g. doctor's advice to a patient, goods transported from one place to the other, etc.).

- The simultaneous ascendancy of employment in the sectors, witnessed in the developed countries, is pointed out by Fisher and Clark as due to the low productivity characteristic of service sector. Higher productivity in industry was visualised to raise wages in services disproportionate to its own productivity level. This could lead to increased costs and prices of services relative to goods.

- Growth of income faster than employment could have serious implications for inflation and income distribution.

- The dominance of services is attributed to factors such as increasing role of government in economic planning and administration. We have to therefore separate this kind of service sector from the other categories such as banking, finance, IT and communications (ITC) sectors which are essential for sustaining high growth in the economy.

Notwithstanding the above arguments for and against the service sector led growth and its sustainability, there is a realisation that the system of estimating national income is geared more towards the measurement of goods than that of the services. There are also difficulties like: (i) difficulty in capturing the service activity or the problem of its quantification; (ii) difficulty in aggregation of service sector activities due to their characteristic of heterogeneity; (iii) non availability of market prices for some publicly provided services; (iv) difficulty of identification rendered further complicated by non-availability of appropriate deflators (which are required for making temporal assessments of change in the value of the services); and (v) poor quality of data on services as a consequence of the reasons spelt out above. Thus, all these factors have contributed to the low measured productivity particularly in many of the IT-enabled services. This situation is known as the *Solow Productivity Paradox*.

19.8 TRADE IN SERVICES

Trade in IT and IT-enabled services, the latter referring largely to BPO services, has been the main driver of growth in India's 'trade in services' in recent years. The total turnover of the industry is estimated to have increased ten-fold between 1998-99 and 2007-08, from about US $ 6 billion to nearly US $ 64 billion. Exports too have shown phenomenal growth from US $ 2.7 billion to over US $ 40 billion during this period.

Direct employment is estimated to have risen from 2,30,000 in 1998-99 to nearly 2 million in 2007-08. Of this, the export segment accounted for over 1.5 million. Projections of growth during the XI Plan indicate that the exports in the year 2011-12 will be US $ 86 billion with a direct employment potential from exports of 3.4 million. IT and BPO services revenue as a percentage of the overall GDP is estimated to have grown from about 1 percent in 1999-2000 to over 4 percent in 2007-08. Including IT hardware the percentage of revenue has increased from 1.8% to 5.5% during this period.

IT services constitute more than half of total IT exports with BPO accounting for about 27 percent. Beginning with basic data entry tasks, the BPO sector has acquired a reputation as the primary low-cost destination for voice-based customer contact/support services, finance and accounting, and a range of back-office processing activities. Among the sectors serviced by India's IT-BPO sector, those that account for the largest share of revenue are banking, financial services and insurance (40%), hi-tech/telecom (19%), manufacturing (15%), and retail (8%). Other important industries being serviced by the BPO segment are travel and hospitality, auto manufacturing and pharmaceuticals.

The IT and BPO industries have a large growth potential as only about 20 per cent of the 'potentially addressable market' had been captured in 2007. The addressable market in global offshore IT industry is estimated to be of the order of US $ 220-250 billion and in the BPO segment US $ 160-190 billion.

The estimates of critical manpower required by India to support the IT-BPO sector is placed at about 1.8 million graduates. This is more than the combined talent pool in China and Russia. However, even to enable India to maintain its current share of worldwide IT-BPO business, a gap between the demand and supply of suitable graduates is expected to be faced soon. One reason for this is the low proportion of fresh graduates who are employable in the sector. Assuming that about 25% of engineers are suitable for IT jobs, 15 % of commerce graduates for employment in BPO finance and accounting work, and 10 % general graduates for other BPO work, the industry assessment is that 100,000 additional graduates will have to be available beyond the projected supply each year. If India is to enhance its competitiveness and increase its share of worldwide IT- BPO business, the requirement will be a far larger number of graduates. This calls for expansion of relevant higher education and training facilities in the country.

Check Your Progress 3

1. What are the factors put forward to support the 'sustainability proposition' of service sector led growth in an economy?

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2. What are the factors based on which the 'sustainability proposition' of the service sector led growth is doubted in an economy?

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3. Which are the two sub-sectors that are in the fore front of driving the growth of India's 'trade in services'? What supportive or encouraging trends are evidenced from this quarter in the post-2000 years in India?

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4. Which critical area is identified to limit the growth potential of 'trade in services' in India? What education sector reforms are needed to meet this challenge?

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19.9 LET US SUM UP

The service sector in India has come to occupy increasing share of output/income in the GDP of the country touching the 55% mark. Its share in employment has also increased from about 20% in the 1980s to about 28.5% in 2005. The sector is therefore considered as the 'engine of growth' for the country. However, because of the service sector's backward linkages with manufacturing, and the large proportion of un/low-skilled workers in the Indian labour force, policies to promote both the labour-intensive manufacture and the skill intensive service

sector are vitally needed. This includes a dual approach aimed at removing the bottlenecks on the infrastructure sector front, on the one hand, and the education sector inadequacies, on the other.

19.10 KEY WORDS

Sectoral Labour : Refers to the absorption of surplus labour engaged in agriculture or primary sector activities in the more productive modern sector activities. As per the 3-sector hypothesis of Clark and Fourastie, the path of the sectoral shift is from the primary to the secondary and then on to the tertiary sector.

Marketable Skill : A concept introduced in the national sample surveys of NSSO in its 50th round. It refers to the content of vocational skills in the training or educational programmes which will assist the trainees to set up some self employment avenues. In the context of decreasing opportunities for wage employment, promotion of self-employment avenues is a preferred employment policy option in India.

Organised Sector (OS) : Refers to government and public sector organisations, and large private sector organisations, where service benefits like paid leave and other social security provisions are present. The proportion of OS employment is about 6-7 percent in India. Having a huge labour force of about 450 million, this proportion glares wickedly at the huge unorganised sector segment who do not enjoy any such benefits. The government has recently enacted a Bill to cater to the needs of the huge unorganised sector workers in India.

Solow Productivity Paradox : Refers to the problem of measuring service sector productivity correctly due to which the sector's contribution may be getting under-estimated.

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19.12 ANSWERS OR HINTS TO CYP EXERCISES

Check Your Progress 1

1. See Section 19.1 and answer.
2. See Section 19.2 and answer.
3. See Section 19.3 and answer.
4. See Section 19.4 and answer.
5. See Section 19.4.1 and answer.

Check Your Progress 2

1. See Section 19.5 and answer.
2. See Section 19.6 and answer.
3. See Section 19.6.1 and answer.

Check Your Progress 3

1. See Section 19.7.1 and answer.
2. See Section 19.7.2 and answer.
3. See Section 19.8 and answer.
4. See Section 19.8 and answer.