

# CHAPTER II

## Economic Reforms in Nutshell

There are many important years in the history of India, but as far as economic history is concerned, the year 1991 has definitely to be termed as a “landmark”. It saw fundamental changes in the economic policies of the country. In the beginning of the year, the country faced a severe economic crisis, which was partly triggered by serious balance of payments situation. The crisis made the government of the day to have a fresh look at the economic policies. The need for having drastic changes in the economic policies was realized and this led to the initiation of economic reforms. It was realized that the roles of state and market have to be redefined, if productivity and efficiency of the system have to be improved. Since its introduction in 1991, economic reforms have covered several areas. In the following paragraphs, the reforms that have been undertaken in some of the areas so far have been mentioned in brief.

### 1. Removal of Industrial Licensing

Industrial licensing in India is governed by the Industries (Development and Regulation) Act, 1951. In the pre-reforms era, the country practiced a system of industrial licensing under which a license was required before setting up any large industrial unit. It was thought the licensing system would enable best allocation of the available resources. However, the system only led to delay, harassment, lower production and inefficiency. This led to a change in the mindset and it was realized that in order to have a sustained growth in productivity, enhance gainful employment, attain optimum utilization of human resources, attain international competitiveness and transform India into a major partner in the global arena, industrial licensing policy need to be liberalized. Accordingly, the list of items requiring compulsory licensing has been coming down in the past few years. Today, all industrial undertakings are exempt from obtaining industrial license to manufacture, except for

(i) industries reserved for the Public Sector (ii) industries retained under compulsory licensing (iii) items of manufacture reserved for the small scale sector and (iv) if the proposal attracts locational restriction. As regards locational restrictions, it has to be noted that industries located within 25 km. of the periphery of the standard urban area limits of a city with a population of more than one million require a license. This condition, however, does not apply to electronics, computer software, printing and certain other non-polluting industries and units located within designated "industrial areas.

## **2. Removal of Restrictions on Foreign Investment**

In the pre-reforms era, foreign investment was not fully welcome. In fact, it was restrictive. In most areas, it was limited to 30%. Majority ownership was an exception rather than the rule. It was feared that foreign investment would restrict the growth of domestic industries. The result was lower investment and lesser growth. Today, the scenario is different and foreign investment is being welcomed in a big way. Promotion of foreign direct investment forms an integral part of India's economic policies. Everyone realizes that foreign direct investment can accelerate economic growth by infusing capital, technology and modern management practices. We now have a liberal and transparent foreign investment regime where most activities are opened to foreign investment on automatic route without any limit on the extent of foreign ownership. The Government has now allowed 100% FDI under automatic route in printing of scientific and technical magazines, periodicals and journals, petroleum product marketing, oil exploration in both small and medium sized fields and also for petroleum product pipeline. FDI up to 100% is now permitted for natural gas/LNG pipeline with prior Government approval. Some of the recent initiatives taken to further liberalize the FDI regime, inter alia, include opening up of sectors such as insurance (26%), development of integrated townships (100%), defence industry (26%) etc. In the telecom sector, foreign investment up to 74% is allowed now. The equity cap in the private sector banking has been raised to 74%. In the civil aviation sector, FDI up to 40% is allowed in domestic airlines. In case of airports, FDI can go up to 100% with Government's approval.

### **3. Reduction in Import Duties and Phasing out of Quantitative Restrictions**

In order to protect domestic industries, import substitution formed a major plank of India's foreign trade policy. The Indian economy was over-protected and inward looking till 1991. This policy only led to domestic industries producing low quality goods at high prices. The high cost of imports also adversely affected import of modern technology. This led to "technological lag" and the export industries also could not show good performance.

The fallacy of having high customs duties was realized and the government started undertaking reforms in this sector. The peak rate of customs duties, which was as high as 200 per cent in 1991, came down to 35% in 2000 due to progressive decline in the rates over the past few years. The average tariff duty in 1991-92 was 128%, along with a very large number of separate tariff rates across commodity groups and also coupled with many exemptions. In 2001-02, the average import duty (total) was 37.1% and this was reduced to 33.7% in 2002-03. The peak rate of customs duties now stands at 15% (as proposed in the Budget 2005-06). There are, however, a number of exceptions to the 'peak', especially for agricultural products, and hence, the peak rate of 15%, is actually for non-agricultural products. The quantitative controls have also been phased out. The government's policy is to bring down customs duties to ASEAN levels.

### **4. Determination of Exchange Rate by Market Forces**

Exchange rate (between currency) is no more determined by the government but by the forces of demand and supply. This has been made possible by the introduction of almost full convertibility on the current account and also partial convertibility on the capital account. The RBI, however, monitors closely the development in the financial markets at home and abroad and coordinates the market operations with suitable regulatory measures, as considered necessary from time to time.

### **5. Reforms in Financial Sector**

Banks and insurance companies were mainly owned by the state in the pre-reforms era. The scenario is different today. Private banks and insurance companies are in place. The state owned banks have been given autonomy in many areas to improve their efficiency to compete with private banks. The statutory

liquidity requirements through which banks were required to invest in government securities have been drastically reduced. Commercial banks are increasingly entering new businesses such as merchant banking, underwriting, mutual funds and leasing, usually through subsidiaries. Computerization of bank operations has been taken up on a very large scale. To enhance competition, many new private sector banks, including some more foreign banks have been allowed entry into the market. RBI supervision over commercial banks and other financial institutions including non-bank financial companies has been strengthened. Issues relating to autonomy of bank managements are being given due attention.

## **6. Liberalisation of Capital Market**

Capital market is a major vehicle for converting savings into investment. It is also the preferred investment destination of foreign savings. The capital market has been considerably liberalized. Corporates are now free to issue capital and price their issues. Foreign Institutional Investors (FIIs) are now permitted to invest in the Indian market. The Indian companies have been allowed to access foreign markets for raising equity and debt finance.

There was a “free for all” atmosphere in the stock market prior to the introduction of regulation of capital market. There were many “scandals” and “scams” in the stock market, which pauperized many small investors, before the stock market came under the control of the government. The setting up of SEBI (Stock Exchange Board of India) has greatly helped the government to keep an eye on the stock market and regulate it to protect small investors. SEBI has been able to control insider trading, regulate large acquisition of shares and improve the trading practices in stock exchanges. It has been able to revamp the governing boards of stock exchanges, which till recently were predominantly the domain of the broker community. The dematerialization of shares has been introduced. Stock Exchanges have introduced screen-based trading.

## **7. Entry of Private Sector in Public Sector Areas**

The most laudable measure taken under the process of economic reforms, is the opening up of areas to private sector hitherto reserved for the public sector. A few of these areas are the telecom, power, T.V and Radio broadcasting, and the civil

aviation. Today, there are many players in the telecom and civil aviation sectors, and T.V and Radio broadcasting.

Power sector reforms were initiated in 1991 to encourage competition in each sub element of the sector, namely, generation, transmission and distribution under an independent and transparent regulatory regime. The Central Electricity Regulatory Commission (CERC) has been set up at the national level and State Electricity Regulatory Commissions (SERC) has been set up at state levels. Today, private sector can involve itself in generation, transmission and distribution.

## **8. Privatisation**

In the post Independence era, till the beginning of economic reforms, the industrial scenario was dominated by the public sector. It was believed that if the country has to be economically self-reliant, then public sector should play a dominant role in the economy. The Industrial Policy Resolution of 1956 and the adoption of the socialist pattern of society led to deliberate enlargement of public sector. The general thinking in the government was that a dominant public sector would go a long way in reducing the inequality of income and wealth and also advance the general prosperity of the nation. This was because the goal of public sector is public-good and not profits. Further, since, in the first few years of Independence, private capital was lacking, the Central government had to make large investment in heavy industry, fuel and infrastructure. There was also a school of thought that profits made by public enterprises can be ploughed back into the economy and this can push up growth of industrial sector further. The different and flexible pricing policy with regard to public sector undertakings was also advanced as an argument for having more and more undertakings in the public sector. The government can follow a policy of average price being equal to or higher or lower than the average cost depending on the type of commodity being manufactured by the public enterprise.

With the passage of time, many of the public undertakings started making losses and had to depend on budgetary support for their survival. The reasons were poor management, non-accountability, corruption, political interference, lackadaisical attitude of workers etc. The losses started mounting and this changed the mindset of the government with regard to public enterprises. It was realized that government should move away from manufacturing activities and concentrate more on social sectors. Many eminent economists argued that the government must not venture into

those areas where the private sector can undertake the job efficiently. The government also started feeling that the role of state should be that of a regulator and a facilitator rather than of the producer. Accordingly, the government initiated reforms in the public sector, through privatization and disinvestments of public sector enterprises. So far (June, 2005), 14 public enterprises have been privatized. Some of these are Modern Food Industries Limited, Bharat Aluminum Company Limited, CMC Limited, IBP Company Limited, VSNL, ITDC, Maruti Udyog Limited, Indian Petrochemical Corporation Limited etc. The disinvestments done from 1991-92 to 2004-05 generated total revenue of about Rs. 47.6 thousand crore against a target of about Rs. 96.8 thousand crore.

### **9. Reduction in Excise Duties**

In the pre-reforms era, tax structure relating to excise duties was pretty miserable. In the mid-1970s, excise duties were levied on virtually all manufactured products at the manufacturing stage and the rates varied from 2 to 100%. There were 24 separate rates into which commodities were grouped. Today, the maximum rate of excise is 16%, except for a few items, which attract 24%. There may ultimately be a single CENVAT (Central Value Added Tax) of 16% on all commodities, except for a few luxury consumer products on which additional excise duties may be levied.

### **10. Reduction in Income and Corporate Taxes**

The direct taxation in the pre-reforms era, especially in the 1970s, was influenced by socialist ideals. High progressive rates of direct taxation was considered indispensable to bring in 'socialistic pattern of society' as well as to raise high tax revenues to finance public expenditure. Income tax rates were high and progressive. In 1973-74, there were 11 different tax slabs with rates ranging from 10 to 85%. There was also a surcharge of 15% on the tax payable pushing the top marginal rate to 97.75%. Corporate rates were also high at around 60% with rate differentials across "widely-held" and "closely held" companies. The high rates of taxation, far from bringing high tax revenues for the government, resulted in large scale tax evasion and growth of black money. In fact, a parallel economy was operating with black money as the medium of exchange. With ushering in of reforms, tax rates started falling and today, as proposed in the budget for 2005-06, there are

only three tax slabs as far as income tax is concerned. The minimum rate is 10% and the maximum is 30%. There is a surcharge of 10%, but the same is leviable only on taxable income of Rs.10 lakh and above. There is no tax on annual income up to Rs.1 lakh. As far as corporate tax is concerned, it is now 30% for domestic companies. There is also a surcharge of 10%.

## **11. Introduction of Service Tax**

Service tax was introduced in 1994 in order to explore new avenues for taxation and bring more people into the tax net. In the beginning, the service tax rate was 5% and was levied only on three services, viz., service rendered by the telegraph authorities to the subscribers in relation to telephone connections, service provided by the insurer to the policyholder in relation to general insurance business, and service provided by a stockbroker. Service tax is now firmly on board today and covers more than 60 services. The rate has been increased to 10%. The service tax generated revenue of only Rs.400 crore in 1994-95 for the central government but the revenue has been going up very sharply every year. The total revenue from central service tax was Rs.2612 crore in 2000-01 and was expected to fetch Rs. 13,500 crore in 2004-05.

## **12. Urban Reforms**

In order to give fillip to the growth of housing sector by freeing the urban land market, the central government has repealed the Urban Land (Ceiling and Regulation) Act, 1976 at the central level and the states have been advised to do the same at the state level. Many state governments have already repealed the law existing in their states.

Rent control and tenancy laws come in the way of the development of rental housing and thereby contract the housing stock. It is now well recognized that rent control at absurdly low levels with virtually no relation to market rates and extraordinary protection to tenants not only hinder the development of rental housing but also act as deterrent to the growth of cities. Keeping this in view, the central government has made it mandatory for the states to amend their Rent Control Laws to stimulate private investment in rental housing schemes.

The central government has also laid emphasis on rationalization of stamp duty and reform of property tax laws. It is proposed to reduce Stamp Duty to 5 per

cent by the end of the Eleventh Five Year Plan. Many states have already reduced the rate of Stamp Duty. With regard to rationalization of property tax, not only the rate has been brought down in Delhi, but the methodology for assessing the property tax has also been changed from ratable value to plinth area of the property.

### **13. Downsizing Staff in Government**

The implementation of recommendations of the Fifth Pay Commission led to a sharp increase in government wage bills, resulting in a high growth rate of non-developmental expenditure thereby causing a large fiscal deficit. The mounting non-developmental expenditure became a matter of deep concern for the central government and therefore, the government set up an Expenditure Reforms Commission in February, 2000 to go into various aspects of government expenditure and make recommendations to bring down government's expenditure. The Expenditure Reforms Commission submitted its report in 10 volumes. Some of its recommendations are being implemented, which includes downsizing the staff in central government. The central government has already reduced its staff strength in many of its departments and the exercise is continuing.

### **14. Pension Reforms**

The upward revision of pay and allowances of Central Government Employees due to recommendations of various Pay Commissions has definitely been increasing the non-developmental expenditure of the government. In this connection, the sharp escalation in the wage bill and pension payments of Central Government made the government not only to start downsizing the staff, but also find resources for payment of pensions. Consequent to the implementation of the recommendations of the Fifth Central Pay Commission, the salary bill and pension outgo of the Central Government civil ministries and departments including defence services (excluding Telecom, Post & Railways) escalated sharply by 33.6 per cent and 35 per cent respectively. As a proportion of net revenue receipts (of Central Government), expenditure on pensions after increasing from 3.9 per cent in 1990-91 to 7.9% in 1999-2000, started declining from 2001-02 to reach 5.8 per cent in 2003-04 (Revised Estimates). The compound annual average growth rate of the pension outgo of the Central Government was 21% during the 1990s.

Unfunded pensions have been a major fiscal drag world over. Keeping in view the ever-increasing burden of pension payments, the Central Government, in order to lessen its burden, has introduced a new restructured defined contribution pension system. The New Pension System (NPS), which has been introduced with effect from January 2004, is applicable to all new entrants to Government service, except armed forces. The NPS will be available, on voluntary basis, to all persons including self-employed professionals and others in the unorganized sector.

### **15. Introduction of Value Added Tax**

One of the important tax reforms that has been undertaken recently is the introduction of State-level Value Added Tax to replace the sales tax. VAT is considered as one of the best practices in taxation all over the world. The VAT system has been introduced in India with effect from April 2005. The underlying principle behind adoption of VAT is that taxes on commodities and services must be based on consumption (on consumers) and not on sales (traders). One of the major advantages of VAT over sales tax is that the former is non-cascading. VAT is a multi-point levy on each of the entities in the supply chain with the facility of set-off of input tax – that is, the tax paid at the stage of purchase of goods by a trader and on purchase of raw materials by a manufacturer. Only the value addition in the hands of each of the entities is subject to tax. For instance, if a dealer purchases goods for Rs.100 from another dealer and a tax of Rs.10 has been charged in the bill, and he sells the goods for Rs.120 on which the dealer will charge a tax of Rs.12 at 10 per cent, the tax payable by the dealer will be only Rs.2, being the difference between the tax collected and the tax of Rs.10 already paid on the purchases of Rs.100. Thus, the dealer has paid tax at 10 per cent on Rs.20 being the value addition in his hands.

### **16. Reduction in Subsidies**

Subsidies have always formed a major component of non-development expenditure of the government. Over the years, a number of subsidies, both direct and indirect, have come into existence. Subsidies exist in almost all the sectors of the economy. Realizing that the economy cannot continue to bear the burden of subsidies and that many of the subsidies are accruing to the non-intended beneficiaries, the Central Government has adopted a target-oriented approach and

is slowly bringing down non-transparent and non-targeted subsidies. The Tenth Plan has emphasized the need for progressive reduction in fertilizer subsidy as well as elimination of petroleum subsidy. The subsidy on LPG has been drastically reduced. The need for identifying subsidy element in irrigation, water charges, bus fares etc., and reducing the subsidy element in a phased manner, has also been emphasized in the Tenth Plan.

#### **17. Enactment of Fiscal Responsibility and Budget Management (FRBM) Act, 2003**

A landmark step taken by the Central Government for the purpose of bringing down fiscal deficit is the enactment of Fiscal Responsibility and Budget Management (FRBM) Act, 2003 (as amended). The FRBM Act has been operationalised with the notification of rules in July 2004. Under the provisions of the Act and the rules, the Government is mandated to eliminate revenue deficit by March 2009 and reduce fiscal deficit to an amount equivalent to 3 percent of GDP by March 2008. Revenue deficit constituted more than 70% of fiscal deficit in the past few years. Rising interest payments, expenditure on subsidies, pay and allowances, and pensions coupled with a near stagnant tax-GDP ratio have mainly contributed to the worsening of revenue balance. The revenue deficit reached a peak of 4.4 per cent of GDP in 2001-02 and remained at the same level in 2002-03. It declined to 3.6 per cent of GDP in 2003-04 (provisional). Since the FRBM Act has been operationalised, the revenue deficit may start earning down and may be fully eliminated by 2009.