Regulatory regime in India: 1947 to 1998

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In this appendix, we briefly describe the important stages in the evolution of policy in four areas: (i) Industrial policy, (ii) Foreign Direct Investment policy, (iii) Trade Policy, and (iii) Public Sector policy. Note that we do not discuss here the evolution of regulations and the reforms initiated in other important areas such as financial sector (including insurance and banking) policies, capital market (including foreign portfolio investment) policies, policies in various infrastructure sectors including, power, telecom, ports, roads, civil aviation, oil exploration, etc. Also there are detailed policies governing certain industries such as drugs, fertilizers, sugar, hotels and tourism, electronics and computers etc, which are not covered here.

1. Evolution of the Industrial regulatory regime, pre-1991

The key objective of the economic policy makers after independence in 1947, was to achieve self-reliance in all sectors of the economy. The other main objectives are reflected in the objectives set out for the public sector enterprises and included promoting redistribution of income and wealth, creating employment opportunities, assist in the development of small-scale industries and protect consumers against private sector monopolies. They decided to follow the approach of a planned economy, along other socialist regimes such as the Soviet Union, and designed a regulatory framework that attempted to address these objectives.

(i) Industrial Policy

The key legislation in this field was the Industrial Development Regulation Act, 1951, (IDRA, 1951) which gave powers to the government to regulate industry in a number of ways. The main instruments were the regulation of capacity (and hence output) and power to control prices. The IDRA, 1951 specified a schedule of industries that were subject to licensing. The next important policy statement was the Industrial Policy Resolution, 1956 (IPR, 1956), which reserved certain industries (Schedule A) for public sector monopoly and certain other industries (Schedule B) for public sector dominance. After reviewing the performance of the licensing regime, the government over the years made several modifications to this. The main policies are summarized in Table 1 below.

Table 1: Summary of key industrial policy changes, 1947-1990

Policy	Changes
Industries (Development & Regulation) Act, 1951	• Schedule I specified industries where licenses were required for firms with fixed investment above a certain level or import content of fixed investment above certain level.
Industrial Policy Resolution, 1956	• Schedule A of industries reserved exclusively for state enterprises; • Schedule B of industries where state enterprises were to acquire a dominant position.
Industrial policy notification, 1973	• Made licensing mandatory for all industries with investment above a certain level; • Schedules IV and V specified industries where licensing was mandatory irrespective of size; • Specified list of industries reserved for the small-scale sector (firms below certain fixed investment limits).
Industrial Policy Statement, 1973	• Appendix I specified industries to which business houses (large Indian conglomerates) and foreign companies were to be confined
Policy Announcements, 1985	• Removed restriction on business houses to Appendix I industries so long as they entered specified industrially backward areas; • Raised the minimum asset limit defining industrial houses from Rs 200 million to Rs 1 billion.

Some changes were made on some of the details of the policies over the years. The fixed investment limits for small-scale industries was raised and the list of products reserved for the small-scale sector was expanded. Further, the list of industries where business houses and foreign companies were allowed to operate (Appendix I, IPS, 1973) was expanded in 1978, 1982, 1985 and 1987 (subject to location restrictions or export commitments).

(ii) Foreign Direct Investment Policy

The objective of the regulation of foreign direct investment as stated in the Industrial Policy Regulation, 1948 was to ensure as far as possible that majority control was in Indian hands. Consistent with this objective, over the years the government introduced policies that discouraged foreign ownership in most industries. The key policy measures adopted over the years are summarized in Table 2 below.

Table 2: Summary of key policies relating to foreign direct investment, 1947-1991

Companies Act, 1951	• Restrictions on the operations of managing agencies[1], which affected the operations of many British companies in India.
Corporate Tax policies, 1957 to 1991	• Corporate tax rates on foreign companies (ie companies incorporated outside India) were about 15 to 20 percent above the rates for large Indian companies through the period 1956 to 1991.
Monopolies and Restrictive Trade Practices Act, 1969	• All applications for a license from companies belonging to a list of big business houses and subsidiaries of foreign companies were to be referred to a 'MRTP Commission', which invited objections and held public hearings before granting a license.
Industrial Policy Statement, 1973	• Appendix 1 specified industries where foreign firms would be allowed to operate; these were generally industries where products were not being produced in India or where the local sector was being dominated by a single (usually foreign) company; • Not allowed in the Appendix 1 industry if the industry was reserved for the government as per IPR, 1956.
Foreign Exchange Regulation Act, 1973	• Foreign companies operating in India asked to reduce share in equity capital of their Indian companies to below 40 per cent, unless they were engaged in specified 'core' activities (Appendix I, IPS, 1973), were using sophisticated technology or met certain export commitments (led to the withdrawal and/or sale of various foreign companies).
Amendment to MRTP Act, 1985	• Set lower limit of Rs 1 billion in assets for referring company to the MRTP Commission, limiting the applicability of the Act.

(iii) Trade Policy

The main objective of the trade policy was to accelerate India's self reliance, by discouraging imports except in specific products or technologies deemed important for the country's development. The two instruments of policy were import (and export) licensing and tariffs.

In the initial period (upto 1978), the former was used to a greater extent to restrict imports into India. A number of government departments were designated as sponsoring authorities; import licenses would be

[1] Managing agencies were a form of corporate management where one 'managing firm' managed a large number of companies, in return for a commission paid on the basis of sales, costs or profits. This arrangement was evolved in the nineteenth century to manage British investments in India; the managing agency would be a joint stock company floated in Britain with British shareholders and would run the operations of a number of companies in India.

granted only if these sponsoring authorities certified that the imports were "essential" and gave "indigenous clearance "(ie certified that these goods could not be purchased domestically). Over time, import licenses were preferentially given to 'actual users', negatively impacting trading houses. Government owned companies were given a monopoly on the import of certain goods (called 'canalized goods', eg steel, oil and fertilizers), where imports enjoyed economies of scale, and domestic users were too small to directly import efficiently. While domestic producers were generally discouraged from importing, in order alleviate shortage of foreign exchange, exporters were allowed to import inputs duty-free under various schemes.

As the number of domestic producers grew, certifying 'indigenous clearance' became increasingly difficult for government departments. The government set up the Directorate General of Technical Development (DGTD), which tracked capacities and production in Indian industry. They generated data for the central planners to grant industrial licenses and also provided indigenous clearance for licensed companies to import goods. The DGTD tried to ensure that imports were allowed only if domestic producers could not meet the needs of the importer (which they ascertained through various procedures). The government published an import policy annually (sometimes biannually) listing all the products that could be imported and including various details on who could import, quantities to be imported, sponsoring authority permissions required, restrictions on sources of import etc.

In 1978, subsequent to an easing of the foreign exchange shortage in the country, the system was reorganized. Instead of announcing a policy every few months for hundreds of goods, they were organized into broadly four lists: (i) Banned goods (later called 'restricted' goods) whose imports were banned, (ii) Restricted goods (later called 'limited permissible' goods) whose imports were allowed only if they were not domestically available, (iii) Open General License (OGL) goods, whose imports were permitted without a license by actual users, and (iv) Canalized goods, whose imports were allowed to be undertaken only by government monopolies.

Over the 80s, the list of OGL goods increased considerable, but so did the list of restricted goods. At the same time, the tariff levels on most goods were raised throughput the 80s. Import substitution was encouraged also through Phased Manufacturing Programs, where licenses were given to new plans on the condition that they would reduce dependence on imported inputs within a fixed timeframe.

(iv) Public Sector Policy

After independence in 1947, India subscribed to a model which placed a strong emphasis on central planning and a big role for government owned Public Sector Enterprises (PSEs) who were established to control the "commanding heights" of the economy. The major objectives of setting up of public enterprises were broadly (i) to help in rapid economic growth and industrialization of the country and create necessary infrastructure for economic development; (ii) to earn a return on investment and thus generate resources for economic development; (iii) to promote redistribution of income and wealth; (iv) to create employment opportunities; (v) to promote balanced regional development; (vi) to assist the development of small scale and ancillary industries; and (vii) to promote import substitutions, save and earn foreign exchange for the economy.

With these objectives in mind, the government reserved the 'core' industrial sectors for either public sector monopoly (schedule A of IPR, 1956; refer section on industrial policy above) or for public sector dominance (schedule B of IPR, 1956; refer section on industrial policy above). No significant changes were made to these lists over the years, until July 1991. By reserving these sectors for PSEs, the government was able to effectively regulate output and prices in these sectors.

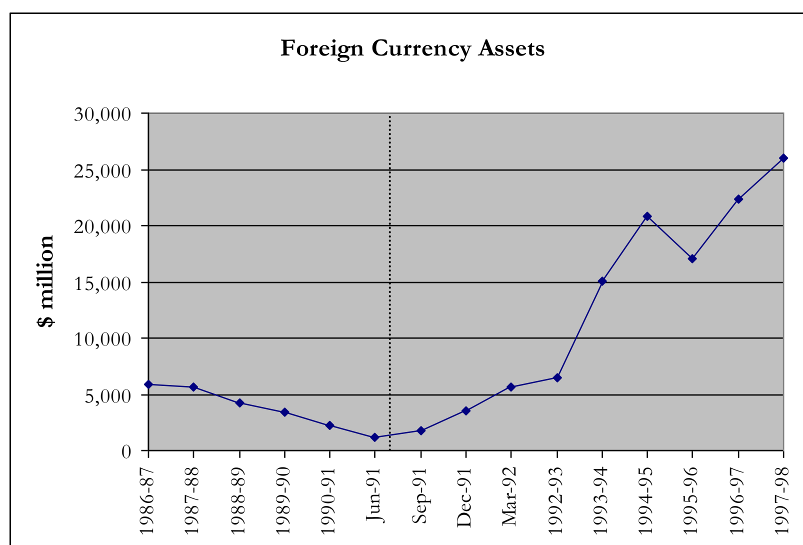
In 1988-89, the government introduced the concept of Memorandum of Understanding, in order to improve the performance of the PSEs. The MOU was an attempt to grant greater autonomy to the PSEs in their day-to-day operations, while increasing accountability by rating the PSEs based on agreed performance measures. The 1988-89 MOUs contained only performance indicators (mostly financial and physical targets) without negotiated 'weights' and 'values' for the different performance measures. In 1989-90, the list of measures

were broadened to include qualitative aspects of performance (eg 'on-time performance' for Indian Airlines) and measures of "dynamic efficiency" (eg 'corporate planning', 'preventive maintenance', etc). Also, weights were attached to these performance measures to arrive at a composite measure of the performance. The focus on a broad range of criterion continued in 1990-91. After the reforms in July 1991, the emphasis shifted to profitability (see discussion below).

2. Immediate cause for the 1991-92 reforms[2]

The short-term impetus for the reforms announced in July 1991 (which is in the fiscal year 1991-92 and hence referred to as 1992 elsewhere) was the severe balance of payments (BOP) crisis that occurred in this period (refer Figure 1). The immediate cause of the loss of reserves beginning September 1990 was the rise in oil import costs, as result of the sharp spurt in oil prices after the annexation of Kuwait by Iraq. Indian workers in Kuwait had to be airlifted and inflows from Non-resident Indians (NRIs) in the Middle East were reduced considerably. Further, cessation of exports to Iraq and Kuwait also reduced the inflow of foreign exchange. The payments crisis was worsened by a deterioration of the capital account. Short term credits for imports dipped as creditors were concerned about the government's ability to manage the situation. Amount of foreign currency medium term loans used by financial institutions and PSEs to finance imports declined and net outflow of NRI deposits, which began in October 1990, continued in 1991.

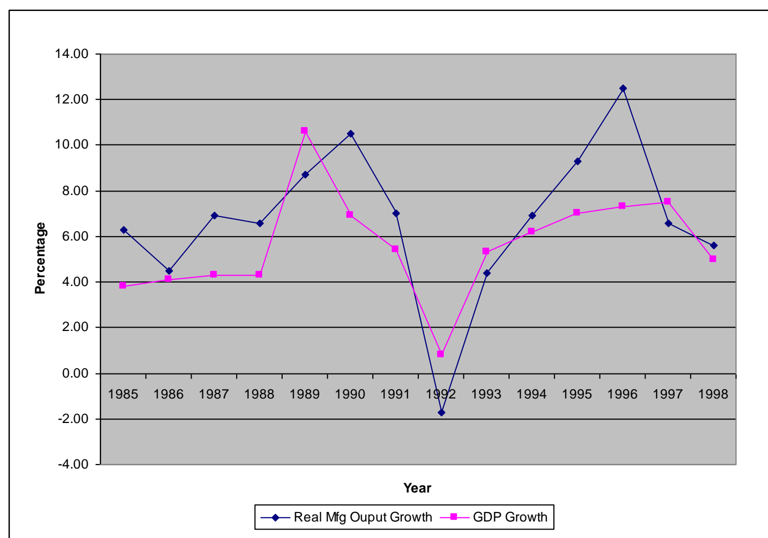
Figure 1: Foreign currency assets



The rapid loss of reserves in the second half of 1990-91 prompted the government to take several short-term measures, restricting imports and raising price of petroleum products. At the same time, there was a significant dip in industrial production, which was negative for most months of 1991-92 (see figure 2). The government presented this as evidence that the import compression policies were counter-productive; it argued that "import compression had reached a stage when it threatened widespread loss of production and employment, and verged on economic chaos." and that "the economy needed substantial reforms if the crisis was to be fully overcome". The government initiated a program of structural reforms of the trade, industrial and public sector policies with the objective of evolving "an industrial and trade policy framework which would promote efficiency, reduce the bias in favor of excessive capital intensity and encourage employment-oriented pattern of industrialization".

[2] This section draws extensively on the Economic Survey, 1991-92

<u>Figure 2</u>: Real GDP and manufacturing output growth



Another impetus for the reform (not explicitly acknowledged in the Economic Survey) came from multilateral aid agencies. Consequent to the BOP crisis, the government had to borrow from the IMF and the World Bank, who negotiated stabilization measures and structural reforms as part of the loan package.

It must be noted that the reforms announced in 1991 were not completely contradictory to the general trend in policy. Concerns about the lack of competitiveness of Indian industry and consequent poor export performance (and poor growth record compared to the east Asian economies that had focused on export-led growth) had led to some liberalization of both the licensing and trade policies in the late 70s and 80s (see discussion in section 1 above). However, the reforms in 1991 did make significant changes in industrial, trade and public sector policies.

3. Regulatory regime, post-1991

The significant changes in industrial, foreign investment, trade and public sector policies announced in July 1991 (and thereafter) are summarized below.

(i) <u>Industrial Policy</u>

<u>Table 3</u>: Summary of key industrial policy changes, 1991-1998

New Industrial Policy, July 1991	• Abolished licensing for all projects except in 18 industries. • MRTP Act amended to eliminate prior approval for large companies for capacity expansions. • The requirement of Phased Manufacturing Programs (PMP) discontinued for all new projects. • Schedule A of industries reserved exclusively for state enterprises cut down from 17 to 8. • Schedule B of industries where state enterprises were to acquire a dominant position abolished. • Small scale enterprises allowed to offer upto 24 per cent of shareholding to large

	enterprises.
1992-93	• List of delicensed industries expanded. • Oil exploration and refining removed from list of industries reserved for the public sector. • Power sector opened to foreign and domestic private investment.
1993-94	• Minerals removed from list of industries reserved for Public Sector, bringing the number down to 6. • List of industries where licensing is necessary reduced to 15 (motor car, white goods and leather delicensed). • Readymade garments removed from list of industries reserved for the small-scale sector, subject to certain restrictions.
1994-95	• Licensing for bulk drugs abolished; also added to list of industries with automatic approval of foreign equity. • Basic telecom opened to private participation, including foreign investments. • Reduction in tax rates on foreign and domestic companies. • Major overhaul of excise tax structure.
1995-96	• Number of measures to attract private investment in infrastructure announced. • Policy for drugs and pharmaceuticals liberalized and span of price control reduced.
1996-97	• Delicensed consumer electronics, bringing list of licensed industries to 14. • Investment limit for defining small-scale company raised from Rs7.5 million to Rs 30 million; export obligation on non-SSI firm manufacturing products reserved for SSI reduced from 75% t0 50%. • Pricing of coal deregulated; coal to be removed from list of industries reserved for public sector. • List of industries in list for automatic approval expanded.
1997-98	• Number of industries requiring compulsory licensing reduced from 14 to 9. • 15 items removed from the list of industries reserved for the small scale sector. • Corporate tax rates reduced; tax on dividends removed.

(ii) Foreign Direct Investment Policy

Table 4: Summary of key foreign direct investment policy changes, 1991-1998

New Industrial Policy, July 1991	• Limit on foreign equity holdings raised from 40% to 51% in a wide range of industries; foreign exchange outflow as dividends to be balanced by export earnings. • Procedures for foreign direct investment streamlined by creating a Foreign Investment Promotion Board, which would consider individual applications case-by-case. • Technology imports liberalized by increasing royalty limits.
1992-93	• 'Automatic' approval for FDI applications in Appendix III (high priority) industries. • Power sector opened to foreign and domestic private investment.
1993-94	• Basic telecom opened to private participation, including foreign investments. • Reduction in tax rates on foreign and domestic companies.
1994-95	• Basic telecom opened to private participation, including foreign investments.
1995-96	• Pricing norms for raising level of foreign equity liberalized.
1996-97	• Automatic approval of FDI up to 74 per cent by the Reserve Bank of India in nine categories of industries • The list of items for automatic approvals of foreign equity by the RBI expanded by adding three industries.

	• Issued guidelines for expeditious approval of foreign investment in areas not covered under automatic approval.
1997-98	• The list of industries eligible for automatic approval expanded. • Taxes on royalties reduced.

(iii) Trade Policy

Table 5: Summary of key trade policy changes, 1991-1998

1991-1992	• Administered licensing of imports replaced by import entitlements linked to export earnings. These entitlements, called exim scrips made freely tradable. • Exim scrips can be used for all OGL items for actual users, limited permissible list, non-sensitive canalized list and non-OGL capital goods not in the restricted list. • Permission to import capital goods without 'indigenous clearance' provided import covered by foreign equity or was 25% of value of plant and machinery (subject to a limit of Rs 200 mn). • Scope of canalization narrowed. • Actual user requirements for import of capital goods, raw materials and components under OGL were removed. • Short term import compression measures (interest surcharge on bank credit, cash margin on import payments, etc) were introduced.
1992-93	• Peak tariff reduced to 110%. • General reduction in tariff rates.
1993-94	• Peak tariff reduced to 85% (duties on baggage cut from 255 to 150 per cent). • De-canalized imports of certain petroleum products and fertilizers. • Pruned negative list of imports by removing 146 entries. • Encouragement for export of agricultural products (rice, sunflower seeds and superior quality wheat).
1994-95	• Peak rate reduced from 85 to 65 percent (with a few exceptions); • Major reform of structure of tariffs (including pruning of notifications, end-use exemptions etc) initiated.
1995-96	• Peak customs duty reduced to 50 percent. • List of freely importable goods (especially consumer goods) expanded. • Transferability of import licenses liberalized.
1996-97	• Large number of consumer goods shifted from negative list to the export-linked special import license list. • 488 items were moved from the restricted list to the OGL. • Basic import duties on a large range of goods reduced to 30 or 40 percent.
1997-98	• 128 items, mainly textiles moved to the OGL list; additional 340 items shifted from restricted to OGL in April 98. • Import of gold and silver liberalized. • Peak customs duties reduced from 50 percent to 40 percent.

(iv) Public Sector Policy

Table 6: Summary of key public sector policy changes, 1991-1998

New Industrial	• List of industries reserved for the Public Sector (Schedule A) reduced from 17 to 8.

Policy, July 1991	• List of sectors reserved for dominance by public sector (Schedule B) effectively abolished. • Disinvestment in selected public sector enterprises to raise finances for development, bring in greater accountability and help create a new culture in their working which would improve efficiency. • Government equity ranging from 5% to 20% in 31 PSEs with 'good track record' disinvested to public sector mutual funds and Financial institutions. • Implementation of the MOU system extended; attempt to attain congruence between profits and MOU scores by attaching higher weights to profits.
1992-93	• Oil exploration and refining removed from list of industries reserved for the public sector. • Around 5 percent of equity in 16 enterprises (overlap of 14 enterprises with earlier list, bringing total number of PSEs where shares were divested to 32). • Provisions of SICA extended to public sector undertakings.
1993-94	• Minerals removed from list of industries reserved for Public Sector, bringing the number down to 6. • Unfavorable stock market conditions sighted for suspension of disinvestment in 1993-94. • The weight for profit-related criteria set at 50%; two criteria, Gross Margin and Net Profit to have weight of 20% and 30% respectively in every MOU.
1994-95	• Shares in 16 companies sold in total of 3 rounds (some overlap with the earlier list of 32 companies; total number now at 39).
1995-96	• Due to adverse market conditions, only one round of disinvestment in October 1995, in 4 PSEs (all overlap with earlier list of PSEs). • 75% weight to MOU performance in the Annual Confidence Reports of the MOU signing PSE chief executives. • 60% weight to financial performance measures • Decision to extend MOUs to loss making PSEs from 1996-97
1996-97	• Disinvestment Commission set up for identifying PSEs (Public Sector Enterprises) for equity disinvestment as well as for working out the modalities of disinvestment. • Pricing of coal deregulated; coal to be removed from list of industries reserved for public sector.
1997-98	• The Government has granted enhanced autonomy to nine selected PSEs referred to as "Navaratnas". These are IOC, IPCL, ONGC, BPCL, HPCL, NTPC, SAIL, VSNL and BHEL. Two more enterprises, GAIL and MTNL, were given same status. • 696 guidelines, issued for PSEs over the last three decades were withdrawn to provide greater effective autonomy to the PSEs. • The Disinvestment Commission submitted seven reports on the 41 out of the 50 PSEs referred to it. It recommended varying levels of disinvestment for 12 companies, strategic sale for 21 companies and no disinvestment for 8 companies. • Dismantling of the Administered Pricing Mechanism (APM) for petroleum products initiated, as recommended by the Disinvestment Commission as pre-condition for sale of equity of companies dealing with petroleum products.