POLICY FOR INVESTMENT REVIVAL:

Industrial & Investment Slowdown

by

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[#] Any views expressed in this paper are those of the author and should not be attributed to the organisation to which he belongs.

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I. INTRODUCTION

The data up to July, which came out at the beginning of September, showed a significant slow down in industrial growth arising from a slow down in manufacturing growth. Within this sector the primary reason for the growth slowdown was the negative growth rate in capital goods production. This slowdown was noted and policy actions suggested for consideration.[1] The Exchange rate note was also updated and modified to take account of the need to revive overall investment as a means of solving both this problems as well as increasing equity inflows.[2] The current paper analyses the industrial growth slowdown in more detail and makes policy recommendations for ensuring a revival of Investment demand and industrial growth at the earliest.[3]

II. INDUSTRIAL GROWTH

The rate of growth of industrial production for ***April-August*** period has declined from 6.2 per cent in 1999 to 5.3 per cent in 2000.[4] This is due to a decline in the rate of growth of manufacturing, from 6.8 per cent in 1999 to 5.6 per cent in 2000. Electricity generation has also contributed to the overall deceleration by declining by 2.4 per cent points to 3.7 per cent. The recovery in growth of mining from negative growth in 1999 to 4.7 per cent in 2000 (April-August) was the only accelerating sector.

A. Capital Goods

The growth pattern of the use-based sectors of industry helps us identify the problem within the manufacturing sector. Among the major economic categories Consumer goods, Producer goods (Intermediate & basic) and capital goods, growth performance improved for the first two but worsened dramatically for the last. For the April-August period, the rate of growth of consumer goods more than doubled to 7.5 per cent in 2000 from 3 per cent in 1999. The growth of producer goods more than tripled to 7.8 per cent in 2000 (from 2.5 per cent in 1999). The deceleration in growth of capital goods was however even more dramatic, from 11.8 per cent in 1999 to –0.8 in 2000 (April-August). Given that import of capital goods declined dramatically during 1999-2000, this decline

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[1] On the IIP monitoring file for this data, which came to me as CEA was on tour.
[2] Exchange Rate Policy & BOP Management, 2000-1, August 2000.
[3] It does not cover other sectors such as agriculture.

in production reflects a serious decline in the machinery & equipment component of investment.

If we look at the cyclical pattern of growth there is an interesting difference in pattern between the overall industrial growth cycle and that of capital goods production. The annual (m-o-m) growth rate of industrial production declined from November 1998 to October 1999 and then rose till February 2000 (figure 1). In contrast, the growth rate of Capital production rose from March 1998 to May 1999 and has been declining since then. Thus there was a lag of about six months between the first decline in overall production and its affect on investment as revealed by capital goods production. The accelerator theory of investment suggests that a rise in GDP growth would tend to lead to a rise in investment after a lag. We do not have information on inventory changes and the lag between production and supply of capital goods, so that the lag between industrial revival and capital goods production revival may be greater than six months. As the overall production (IIP) turned up in October 1999, we could have expected an up turn in capital goods production between April 2000 and December 2000. The fact that capital goods production continues to decline till August, a lag of nine months, is a cause for concern, even though capital goods production may still bottom out by December 2000.

Within the capital goods sector both sub-categories have decelerated. The rate of growth of machinery & equipment (mechanical & electrical) has halved to 10.6 per cent in 2000. The *production* of Transport equipment and parts has *declined* by 10.6 per cent in April-August 2000 after having grown by a couple of per cent in the corresponding period of 1999. Thus the latter is of greater concern as the growth rate of the former is still well above that of all other sectors & sub-sectors (except one).

III. INVESTMENT CLIMATE

A. Competition

Over the last two years or so Indian industry has finally been subjected to international competition. Because of the excess capacity resulting from the Asian crises and the collapse of euphoria, competitive pressures have been somewhat stronger than they would be in normal times. Prices of tradable goods have been equated to international prices plus protective tariffs, while the high virtual (quality or productivity

[4] Unless otherwise stated all growth rates relate to the five months from April to August.

adjusted) price of domestic non-tradable goods has put them at a competitive disadvantage. They have managed to respond to and meet the challenge so far by investing in improvement of productivity in existing production facilities. However uncertainty about future developments on both these fronts has tended to make them somewhat cautious about green-field investment.

B. **China**

One of the potential risks arises from China's export thrust into India. This has two components. One arises from labour intensive exports (considered subsequently) and the other from dumping by State owned enterprises (SOEs). With China's system of implicit and explicit subsidies to SOEs through State owned Banks (SOBs) completely obscure, there is a strong potential threat from subsidised exports by SOEs. A study quoted by Dr Sylvia Oestry[5] shows that India, other S. Asia and Indonesia are going to be the biggest losers from China's entry into the WTO. She also says that bringing "Transparency" in China's domestic policies with respect to International trade may take a very long time as even in the case of Japan it has taken over 100 years. Remedies under the WTO may be severely limited if China's accession agreement does not make "transparency" with respect to such subsidies a central focus of accession.

C. **Risk Perception**

The dramatic rise in oil prices over the last 18 months has contributed both to the rise in the trade deficit and increased perception of risk. The exchange rate instability and subsequent monetary moves enhanced this risk perception. The dramatic fall in the NASDEQ over the last six months or so similarly contributed to a decline in the Indian stock market and also to increased risk perception about the international economic environment in which India operates.

The initial burst of reform when the new government came into office led to excessively high expectations of accelerated reform and perhaps inevitable disappointment. The Central Value Added Tax conceptualised in earlier papers,[6] envisaged dramatic simplification of the excise tax system. An essential element of the proposed Central Value Added Tax, the universal & comprehensive applicability of the

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[5] Distinguished Research Fellow, Center for International Studies, Toronto.
[6] Central Value Added Tax, CENVAT, December 1999.

base rate to inputs and outputs, was somewhat diluted in the budget. The gains envisaged from simplification can only accrue if this is done along with change in forms & data systems. The spreading out of the capital goods set-off over two years raised the effective tax rate on capital goods by about 1.5% points besides again introducing complexity.[7] Controversies regarding the complete "pass through" for "Venture capital funds," etc. was not helpful in lifting post-budget sentiment. The agreement on minimum taxation by States has resulted in a rise in the average level of state sale taxes, with many items facing sharp increases and none or few being reduced.[8] To the extent that these increases have not been compensated by a change in SAD, the level of protective tariffs is reduced.

The effect of the proposed reduction in minimum govt holding in nationalised banks from 51 per cent to 33 per cent has been diluted by the decision to emphasise retention of "public character of banks". Similarly the expectations raised at the end of 1999-2000, about faster privatisation have not been adequately realised so far. Selective leaks and speculation about big ticket privatisation, such as in the petroleum and automobile sectors, have invariable served as a back drop to contrary or postponed decisions and a let down in sentiment. These have contributed to the general negative sentiment despite the excellent progress made in Telecom and Insurance reform.

IV. FISCAL STRUCTURE

The most important fiscal task (at present) is to change the structure of expenditures from consumption to investment. As many of us have said before, wasteful expenditure needs to be reduced and subsidies targeted on the poor. At the present time there is also a need to selectively raise investment expenditures in infrastructure. Thus the structure of expenditures need to be changed from revenue to capital expenditures from government consumption to government investment.

A paper on economic reforms had given a blue print of how the structure of government expenditures needs to be changed.[9] The expenditure commission has fleshed out many of these ideas and has also gone into departments like information & broadcasting that were not specifically examined in the paper. Some of these proposed

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[7] This was done on the basis of the views of an eminent outside tax expert who was critical of the 100% set-off for capital goods introduced by us several years ago.
[8] Orchestrated & strongly supported by NIPFP. The negative effect of a sharp rise in sales tax rates on certain goods like cars was not anticipated.
[9] Agenda for Reforms: Fiscal, October 1999.

measures can perhaps be taken up even before the next budget so that a concrete reduction in allocation can be shown at the time of the budget.

At the same time capital expenditure on infrastructure needs to be stepped up. Expenditure of sanctioned funds on highways and power can be expedited by removing bottlenecks. The Plan allocation for roads and highways could also be enhanced if necessary.

Over a period of time (3-5 years), the primary deficit of the Government (Centre and States) has also to be brought down to zero so that the government debt GDP ratio can be put on a firm down trend.

V. INDUSTRIAL POLICY REFORM

A. Electricity

The power sector was one of the first to be opened up to private investment in the nineties. Given the maze of controls and regulations that effect its inputs and output and the dependence on 'State by State' reform, the pace of reform in the electricity sector has been painfully slow. A paper titled, "Policy Framework for Power", had outlined in June 1996 a policy direction for power sector reform.[10] More than four years have passed since than. Electricity growth has slackened. Many fast-track projects have been stuck because of the problem of fuel supply and transportation. With oil prices rising even the option of using private standby generators has become more costly, adding to the already excessive cost of electricity. Large-scale theft of power continues despite former power minister Kumaramangalam having identified the DESU/DVB as a Mafia organisation.[11] The time has now come for more drastic solutions.

The essential ingredients of this new policy with respect to the output and input sides are:

1. Production & Supply

a) Complete de-control of Power Generation. Any individual, company, co-operative or organisation would be free to produce and sell power to anyone willing to buy it. No investment licence or permission would be required for

[10] A copy of this paper can be seen at http://finance.nic.in/avirmani). This paper was presented to the Power minister at that time.

[11] Many other SEBs are almost as bad though less notorious.

generation or sale of power.[12] The state electricity boards and state power generation companies would also be free to generate or sell power in any other state.

b) Complete De-control of distribution for ten years. Any individual, company, co-operative or other organisation would be able to distribute power produced by it or bought from some one else, to any one who chooses to buy power from it. No license or permission would be required from anyone for this purpose for a period of ten years. No price controls would apply to the new distribution systems for this ten-year period. *Price regulation would continue to apply to the existing distribution networks*. All states must set up strong independent electricity regulatory agencies within 10 years, so as to regain regulatory authority over these new distribution networks at the end of the decade.

c) De-control of transmission linkages between the new distribution networks for a co-terminal period of ten years. These could also remain outside the regulatory system for the ten-year duration. If the same transmission system connects to the existing transmission or distribution network it would, however be subject to existing regulatory oversight.

2. Fuel Input

Several Fast track power projects have been held up because of failure to reach agreement on supply of fuel and its transport from the supplier to the user. The following measures can eliminate this bottleneck.

a) Urgent amendment (through an ordinance if necessary) of the Coal Nationalisation Act to allow private production and sale of coal to all buyers.[13]
b) De-canalisation of Natural Gas import in any form (ship-terminal, cross-country pipeline) and de-control of gas terminals.[14]
c) De-control of internal gas pipelines and distribution for a period of 5-10 years.
d) Allow the setting up of private railway service companies for the transport of bulk commodities like coal, petroleum fuel and feedstock (details below).

[12] Needless to say the environmental, pollution, health & safety laws of the land would apply as they do to every other economic activity.
[13] The amendment legislation is currently with parliament.
[14] Tax exemption should however be available only to those who operate on the "public carrier" principle with non-discriminatory access.

B. Transport

As production of transport equipment and parts has become strongly negative, policy reforms need to be expedited so as to stimulate demand in an efficient and sustainable way.[15]

1. Highway construction

All contracts for construction of Central & State highways should include a maintenance contract for 10 years. This is essential for upgrading the durability and quality of Indian roads and improving fuel efficiency. The urgency for this has increased with higher oil prices.

2. Automobile Import Policy

The new Automobile policy should be announced quickly to avoid negative expectation effects on automobile purchases, as economic agents delay purchases in the expectation of potentially more favourable conditions. The new policy should include strict environment protection and safety standards for import of second hand cars. The tariff rate on these cars should not, however be higher than on new cars. For the purpose of tariff imposition the old cars could be priced using the dealer's "blue book" price.

3. Polluting Vehicles

The link between age of vehicle and emission of pollutants by various types of domestically produced vehicles needs to be established. Once this is done age can be used as a proxy for pollution potential and vehicles above a certain age (T) banned from urban areas. A total ban can also be considered for vehicles above a higher age T'=T+t. This would have the dual effect of reducing pollution and increasing demand for vehicles.

4. CPWD

The Central Public Works Department should be converted into a company (or companies), that will compete for construction contracts in all parts of the country. The rules and procedures for procurement & tendering need also to be modernised.

5. Private Railways

Allow private entry into provision of railway transport services. In other word private companies would be allowed to set up railway transport companies with their own trains and supporting equipment, but would use the existing railway track network to transport goods. The Indian railways would charge the private railway companies for the use of the rail tracks. The pricing would be based on economic principles such as unused or excess rail line capacity, average maintenance cost and long run marginal cost (as applicable). This could lead to a boom in production of railway equipment & parts particularly if accompanied by "publicisation" (sale of shares to public) or strategic sale of Indian Railway production units.

6. State Road Policy

a) A model State Road policy should be drawn up for entry of private construction companies (corporations) into the building and maintenance of state roads.
b) State Public Works Departments should be converted into public limited companies and allowed to compete against each other in all states for contracts. Shares in these companies should be sold to the public while initially keeping management control.
c) 'Publicise' State Road transport corporations by selling all shares to the public. Allow free entry of private urban & interstate bus transport companies (i.e. de-license). This could result in boom in organised bus services and improvement in its quality.

C. Handicaps: Unshackling Producers

Our basic approach to economic reforms since 1991 has been to put competitive pressure on Indian industry & infrastructure services and at the same time strengthen the ability to compete by removing the plethora of controls and restrictions circumscribing them.[16] Though the former has become effective in the last few years, some critical domestic constraints on the Indian economy's competitive ability have not been touched. These must be addressed urgently if the hope and enthusiasm for investment is to be revived. Some of the specific policy reforms needed are listed below.

1. Labour

China's per capita income is about double that of India's. This means that on average the real wage in China must be about twice that in India. Yet China's labour intensive exports have flooded the world markets, while the same exports from India have a miniscule share of the market sometimes even less than that of countries, which are a tenth to a hundredth of its size. That this is not due solely to the all round technological,

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[15] In addition to fiscal measures mentioned earlier
[16] Spelled out in several talks at the National Defence College, Delhi since 1992.

management & marketing support provided by FDI (by overseas Chinese & others) is shown by the fact that these same products are now entering India and seriously challenging domestic producers even in the domestic market. The most important reason is that China's labour is much more productive than Indian labour as it is not debilitated by rigid & ossified, labour laws and procedures. There is no doubt in any ones mind in China that only hard working and productive workers can expect to get and hold their jobs.

It is perhaps not possible to address the entire gamut of labour laws, rules & procedures at one go, so start could be made with the Contract Labour act. The "Contract Labour act," as interpreted by the courts is more like a social security act and unlike any contract labour legislation in the world. Urgent steps must therefore be taken to modernise this act, so that it supports specialisation and encourages the creation of jobs. Though this will not solve the problem of inability to fire irresponsible and uncaring workers (a serious competitive disadvantage vis-à-vis China & Indonesia) it will give a strong signal of hope to both industry and unskilled youth. It could subsequently be followed by changes in the Industrial Disputes Act and associated procedures so as to impart greater flexibility.

2. SSI

The second important reason for China's success and its strong competitive challenge in India is that it has never had SSI reservation. China's producers of labour intensive products have therefore been able to fully exploit economies of scale and scope in production, procurement, distribution and marketing. It is therefore no surprise that the greatest threat from Chinese exports is to SSI reserved products in India.

Though socio-political constraints may not allow complete reservation in one go, we must urgently de-reserve labour intensive importable and exportable goods if we are to meet the challenge of Chinese competition. An immediate start must be made by de-reserving the previously identified exportable goods (apparel/garments, toys, shoes, leather goods) and raising the asset limit to 3/5 crore on the set of goods already identified as having higher scale economies than the current asset limit.

3. SICA

Numerous experts (and observers of BIFR) have suggested abolition of SICA as it has become non-functional or worse. This will facilitate exit of bad management so that, potentially productive assets are not wastefully tied up in BIFR. Every Bank has long experience of defaulting firms rushing to BIFR to avoid re-paying loans. BIFR firms, freed of their loan obligations, often become an unfair competitive threat to healthy companies, thus leading to further sickness. Elements of Bankruptcy law and Insolvency procedures (as recommended by various committees) can be incorporated in the company law. If SICA cannot be abolished it should at least be reformed urgently.

4. Sales Tax

Reduction of excessively high tax rates is, in my view more important than the drive for elimination of tax competition. Total indirect tax rate (excise plus sales) on any commodity should not in general exceed 50 per cent. Sales tax rates must be rationalised, in addition to merely setting common minimum rates. There is a need for an urgent review of all sales tax rates of 15% and higher. Rationalisation of sales taxes will also allow a simpler & more rational SAD for providing a level playing field. This will make it easier to reduce protective import duties.

Some states have imposed a sales tax on internally generated power. Under no circumstances should this exceed the tax rate on power purchased from the SEB. Other wise we will be closing of the only safety valve available to units having atrocious power supply.

D. Creating positive Sentiment

Other reforms with relatively low economic costs that may help in creating a positive reform atmosphere and improve expectations are the following:

1. Privatisation

The existing Privatisation policy needs to be firmly and quickly rolled out. Observers will only be convinced about the government's sincerity and determination if strategic sales start taking place at regular intervals.

2. Petroleum

Accelerate decontrol of the petroleum sector including pricing, marketing and imports. This will also remove one factor hindering competition & efficiency in the power and fertiliser industry.

3. Fertiliser

There is currently excess supply of fertiliser in the domestic market. Accelerate de-control of fertiliser sector as this will currently benefit farmers. The fact that the international price was recently about the same as the factory/farm-gate price is also helpful.

4. Sugar

There is currently a glut of sugar. Complete de-control of sugar coupled with removal of sugar from the PDS will actually benefit the poorest consumers while eliminating subsidies. It could also stimulate exports and thus minimise the current (glut) effect on farmers. The effect on farmers can be further reduced, by either eliminating excise duty or zero rating sugarcane.[17]

5. Drugs

The committee on Competition Law has very wisely rejected the anti-deluvian approach to defining monopoly & competition. The modern approach of focussing on "explicit & identifiable misuse of market power" needs to be applied to "Drug policy" if we were to obtain the full benefits of the "bio-technology" revolution (a la information technology). Perhaps about 90% of the currently price controlled drugs can be de-controlled immediately if this approach is used. Only about 10 per cent of drugs with price controls would perhaps have to be analysed more thoroughly from the perspective of modern competition policy, to determine the appropriate course of action.[18]

6. Freedom & Hope

Completion of de-control in these four remaining controlled sectors along with substantial progress on SSI de-reservation would allow us to say that we have completed de-control of the manufacturing sector. Sale of public sector units in the manufacturing sector (including those in these 4 sectors), along with any Merger & Acquisition activity that follows, would improve competitiveness vis-à-vis imports and enhance the image of freedom.

[17] The case for this has been made in the context of a (genuine) Central Value Added Tax.

[18] It should be noted that "usage by the poor" argument can only apply to the UN list of drugs used by the poor & the drugs supplied through the govt health program. Even in this case the correct fiscal practice is to subsidise them directly from the budget if so desired.

VI. SERVICES

A. Telecom

Telecom has been one of the fastest growing sectors of the Indian economy since the 1991 reforms. To ensure that Telecom continues to act as a leading sector for another 5-10 years and propels (rather than holds back) the IT revolution some remaining flaws in telecom policy have to be addressed.

As we have pointed out some years ago, there is a fundamental flaw in our approach to licensing fees.[19] This flaw originates in the artificial public monopoly over Telecom services created by the ante-deluvian Telegraph Act.[20] Because of this "created" monopoly, our approach has been to use this provision to extract the maximum rents from private suppliers. In doing this, the DOT has acted exactly as the rapacious private monopolist we routinely decry in the media & elsewhere. Government has a natural right to tax telecom services (along with other goods & services), and to auction scarce spectrum in metropolitan areas & large towns.[21] It does not have any natural right to charge huge licence fees for private provision of telecom services, thus harming the development of this infrastructure service.

The charging of a USO fee is legitimate if and only if the fee goes into a fund used to subsidise the fulfilment of Universal Service obligations. One of the Universal Service Obligations often mentioned is the provision of connectivity in rural areas. It is illogical & inconsistent to charge private providers in rural areas a licence fee or even a USO fee and then justify the imposition of a USO fee on the need to provide rural telecom. The rational & efficient rural telecom policy is to de-license investment and eliminate all licence fees on provision of every telecom service (basic, mobile, WLL, PCO, Internet) in rural areas.[22] A cut-off size level for urban areas must also be determined with a view to doing the same for urban areas below the cut-off size. The USO fee should logically be charged only in Urban areas above this cut-off.

The compartmentalisation of service providers into basic, mobile, STD etc and into separate circles can be removed quickly even in the other urban areas, so that any

[19] New Telecom policy, November 1998.
[20] Telecom Policy: Comments & further suggestions, 1994-5.
[21] As there is no scarcity of spectrum in rural areas & small towns the scarcity value & auction price is zero.
[22] So that a single provider can provide all telecom services if this makes it more efficient & viable.

service provider is free to provide any telecom service anywhere inside the country. This is best done through de-licensing of all telecom services.[23] Given revenue imperatives the integration of ILD & reduction of license fees in large-medium urban areas can be phased in more gradually. There would be a single uniform revenue share (r = USO fee rate + x) and separate spectrum charges (Si) depending on scarcity value of spectrum in the metro or large city (i). For simplicity the existing mobile provider's (urban) spectrum charge could be set as the existing fee (F) minus the new uniform share (Si = Fi - r). The excess license fee (x) would then be phased out over a period of 10 years and taxation of telecom services integrated into the CENVAT or VAT. New spectrum permits would be issued for large urban conglomerations through auctions, while others where the scarcity value is zero should be free.

The approval & announcement of such a policy will unleash a new boom in telecom investment and FDI, and set the set the stage for attaining the target of one trillion USD of export of IT enabled services (per decade) from India.[24]

B. Real Estate

The real estate sector has the potential of being a leading sector for economic growth and employment generation.[25] In China this sector was opened up early to FDI and a substantial proportion of FDI went into this sector in the eighties. This in turn laid the basis for a leap in FDI during the nineties. With the exception of individual houses, buildings and factories, the sector can be opened up to FDI.[26] If accompanied by a repeal of the Rent Control Act it can play a role in catalysing a construction boom that will unambiguously favour the poorest citizens including those living in urban slums. It will also solve the problem of low demand fore steel and cement.

VII. CONCLUSION

The decline in Investment demand from the middle of 1999 is primarily responsible for aborting the cyclical recovery, which was underway from November 1998 to February 2000. Supply side shocks, like the rise in oil prices and the drought and

[23] Pricing and supply would still be under the purview of TRAI.
[24] Back of the envelope estimate made by Michael Dertouzos, Director of the MIT computer lab.
[25] India: Crises Reform and Growth, Economic and Political Weekly, Volume XXXII, No. 32, August 9-15, 1997, pp. 2064-2068.
[26] Along the lines suggested in, "FDI in Urban Infrastructure and Real Estate", December 1999.

floods in parts of the country, will accentuate this problem by slowing down the growth of consumption.

Given the large fiscal deficit, the best way to revive investment is by reviving "animal spirits" through de-control and policy reforms. A number of suggestions have been made in this regard, which need to be implemented quickly if the cyclical downturn is to be reversed within the current year 2000-1.