I. ECONOMIC ENVIRONMENT

(1) RECENT ECONOMIC DEVELOPMENTS

(i) Economic performance

1. During the past decade, India's real GDP has grown rapidly, averaging some 6% annually. There has also been a corresponding decline in poverty, and improvement in the basic indicators of human development (declining death and infant mortality rates and improved literacy).[1] After achieving rates of almost 6.7% during the five-year period 1992/93 to 1996/97, however, real GDP growth fell to 4.8% in 1997/98, partly due to external shocks including the Asian financial crisis and fluctuations in international petroleum prices[2], before recovering to average around 5.5% during the four subsequent years. Although impressive, growth during this period has been somewhat slower than in the previous five-year period. Moreover, with population growing at almost 2% annually and unemployment ranging officially from 2.2% to 7.3% in 1999/00 (Table I.1)[3], depending on the measure used, the authorities acknowledge that economic growth must be stronger in order to significantly reduce poverty.[4] They also appear to recognize the need to employ international trade as an engine of growth.[5]

2. Accordingly, the Planning Commission has been examining the feasibility of doubling India's per capita income over the next decade. In its "Approach Paper to the Tenth Five Year Plan (2002-2007)", the Government appears to have set itself a growth target of some 8.7% for the Tenth and Eleventh Plan periods in order to attain this target. The Paper has proposed an indicative target of GDP growth of 8% over 2002-07 and a reduction of poverty by 5 percentage points by 2007 and by 15% by 2012. However, the authorities maintain that annual growth of 8% to 9% cannot be achieved without radical reforms and an increase in India's share of world trade from its present level of only 0.67% to 1% by 2007; this will require annual export growth of 11.9% (in dollar terms).[6] More generally, as exports and GDP seem to move in tandem and protectionist trade policies contribute to an anti-export bias, a more open trade and investment regime could hasten India's economic development and contribute to a further alleviation of poverty.

[1] According to the Government, poverty in India declined from roughly 34% to 26% between 1993/94 and 1999/2000 (Confederation of Indian Industry (2001)). The World Bank estimates that India's poverty level declined from over 50% in the 1970s to 35% in 1997 (only slightly lower than 38% in 1993/94); urban poverty, at around 30% is lower than rural poverty (World Bank, 2000, pp. 26-27).

[2] The earthquake that struck western India in 2001 may also have an impact on growth estimates for 2001/02. Preliminary estimates put the cost of lost assets and reconstruction at some US$2.3 billion (World Bank/Asian Development Bank, 2001.

[3] The rate of 2.2% for 1999/2000 is based on the measure of usual principle and subsidiary status (UPSS), whereas if the measure of current daily status (CDS) is used, the unemployment rate rises to 7.3%. According to a recent report published by the Planning Commission, the CDS measure of unemployment is widely agreed to be the one that most fully captures open unemployment in India (Planning Commission, 2001a, p. 16).

[4] The poverty rate is based on per capita consumption expenditure of Rs 49.09 (just over US$1 at current exchange rates) per month in rural areas and Rs 56.64 per month in urban areas at 1973/74 prices corresponding to a basket of goods and services anchored on a norm of per capita daily calorie requirements (2,400 kilocalories in rural and 2,100 kilocalories in urban areas).

[5] Directorate General of Foreign Trade online information. Available at: http://dgftcom.nic.in/exim/2000/speech.htm [03/04/2002].

[6] Directorate General of Foreign Trade online information. Available at: http://dgftcom.nic.in/exim/2000/speech.htm [03/04/2002].

Table I.1
Basic economic and social indicators, 1995-02

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
Current GDP at factor prices (rupees billion)	10,732.7	12,435.5	13,901.5	15,980.8	17,556.4	18,958.4	20,802.5
Constant GDP at factor cost (rupees billion) (1993/94 prices)	8,995.6	9,700.8	10,164.0	10,824.7	11,485.0	11,939.2	12,588.1
Net National Product (NNP) per capita							
At current market price (Rupees)	10,149.0	11,564.0	12,707.0	14,395.0	15,562.0	16,487.0	17,789.0
Share of main sectors in GDP, at current factor cost (%)							
Agriculture, forestry, and fishing	28.0	28.5	26.5	26.6	25.2	24.2	..
Agriculture	25.6	26.2	24.3	24.6	23.7	22.2	..
Mining and quarrying	2.6	2.4	2.5	2.4	2.3	2.3	..
Manufacturing	17.9	18.2	17.7	17.0	16.8	17.2	..
Electricity, gas, and water	2.5	2.4	2.5	2.5	2.5	2.5	..
Construction	5.1	4.8	5.0	5.0	5.1	5.3	..
Services	43.6	43.4	44.9	45.5	48.1	48.5	..
Wholesale and retail trade	13.1	13.1	13.4	13.4	13.7	13.6	..
Hotels and restaurants	0.9	0.9	0.9	1.0	1.0	1.0	..
Transport, storage, and communication	6.9	7.0	7.2	7.2	7.4	7.7	..
Banking and insurance	5.6	5.7	6.4	6.6	7.0	6.6	..
Real estate, ownership of dwellings, and business services	5.9	5.7	5.7	5.7	5.7	6.0	..
Community, social, and personal services	11.6	11.4	12.2	12.6	13.3	13.5	..
Employment (million persons)[a]							..
Agriculture, hunting, etc.	1.5	1.5	1.4	1.4	1.4	..	..
Mining and quarrying	1.1	1.1	1.0	1.0	1.0	..	..
Manufacturing	6.8	6.9	6.8	6.7	6.6	..	..
Services	18.7	18.9	18.8	19.1	18.9	..	..
Electricity, gas, and water	1.0	1.0	1.0	1.0	1.0	..	..
Construction	1.2	1.2	1.2	1.2	1.1	..	..
Wholesale and retail trade	0.5	0.5	0.5	0.5	0.5	..	..
Transport, storage, and communications	3.2	3.2	3.1	3.2	3.1	..	..
Finance, insurance, real estate, etc.	1.6	1.6	1.6	1.7	1.7	..	..
Community, social, and personal services	11.2	11.4	11.4	11.5	11.5	..	..
Social indicators							
Population (million, as of 1 October)	928.0	959.0	964.4	982.7	1,001.0	1,019.0	1,037.0
Unemployment (%)[b]							
Current daily status	..	..	..	..	7.3	..	..
Usual principal and subsidiary status	..	..	..	..	2.2	..	..
Birth rate (per 1,000 population)	27.5	27.2	26.5	26.1	..	..	..
Infant mortality (calendar year)	74	..	71	70	..	..	..
Literacy rate (calendar year)	59	..	62	..	65.4	..	..

.. Not available.

a Organized sector employment (this is estimated to be some 7% of total employment in the economy). Planning Commission (2001), *Report of the Task Force on Employment Opportunities*, June, p. 32 [Online]. Available at: http://planningcommission.nic.in [28 November 2001].

b Planning Commission.

Source: Ministry of Finance (2002a), *Economic Survey 1999/2000*; IMF (various years), *International Financial Statistics*; Asian Development Bank online information. Available at: http/www.adb.org; Reserve Bank of India (2001), *Bulletin*, November; and World Bank (2000), *India: Policies to Reduce Poverty and Accelerate Sustainable Development*, January.

3. In order to achieve these higher growth targets for GDP and exports, structural problems, which have become increasingly evident since the previous Review of India, should be addressed. These problems include infrastructure constraints, especially as regards power, communications, and transport, as well as regulatory bottlenecks, which continue to hamper trade and deter investment (including in infrastructure) (section (iii) below).

4. Investment is also deterred by high real interest rates; real prime lending rates (PLRs), for example, were between 7.3% and 9.2% in 2001/02 (Table I.2).[7] High real interest rates are partly due to the growing fiscal deficit and resulting rise in the combined public debt of Central and State Governments from 56.4% of GDP in 1996/97 to 85% in 2000/01.[8] The fiscal deficit remains high, despite the Central Government's stated intention of bringing its budget deficit down through reduced expenditure and improved tax collection. In 2000/01, the Central Government deficit was 5.1% of GDP and is expected to rise to 5.7% of GDP in 2001/02 (instead of falling to 4.7% as estimated in the 2001/02 Budget). The overall public sector deficit (which includes the deficits of the Centre, of states, central public sector enterprises, and the oil pool account) was 10.6% of GDP in 2001/02.

Table I.2
Economic performance, 1995-02

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01[a]	2001/02
Real GDP (at 1993/94 factor cost) (annual percentage change)	**7.3**	**7.8**	**4.8**	**6.6**	**6.1**	**4.0**	**5.4**
Agriculture, forestry and fishing	-0.9	9.6	-2.4	7.1	1.3	-0.2	5.7
Agriculture	-1.1	10.1	-2.8	7.9	1.0	0.4	..
Mining and quarrying	5.9	0.5	9.8	1.3	2.0	3.3	1.4
Manufacturing	14.9	9.7	1.5	2.5	4.2	6.7	3.3
Electricity, gas and water	6.8	5.4	7.9	6.4	6.1	6.2	5.2
Construction	6.2	2.1	10.2	6.1	8.1	6.8	2.9
Services	10.5	7.2	9.8	8.2	9.6	7.7	..
Whole sale and retail trade	14.0	7.7	7.6	6.6	7.0	3.6	..
Hotels and restaurants	20.8	6.6	8.2	12.5	11.2	6.1	..
Transport, storage and communication	11.0	8.2	7.8	7.3	8.3	8.2	..
Banking and insurance	10.9	9.7	17.9	10.5	13.4	-2.2	..
Real estate, ownership of dwellings and business services	5.7	4.3	5.4	6.1	7.4	9.0	..
Community, social and personal services	7.9	6.3	11.7	9.9	11.6	6.0	6.0
Savings and demand[b] (% of GDPM)							
Gross domestic savings	25.1	23.2	23.1	21.7	23.2	23.4	..
Gross domestic investment	26.9	24.5	24.6	22.7	24.3	24.0	..
Inflation and exchange rate							
GDP deflator (% increase)	9.0	7.4	6.7	9.1	3.9	3.9	4.1
CPI (1995=100)(calendar year)	100.0	104.5	109.2	115.6	119.6	127.5	..
Nominal effective exchange rate (1995=100)[c]	97.6	95.7	95.1	84.1	81.4	80.4	74.72[d]
Real effective exchange rate (1995=100)[c]	98.0	101.1	105.2	101.1	99.7	99.0	102.1[d]

Table I.2 (cont'd)

[7] Ministry of Finance (2001a), p. 74.
[8] Ministry of Finance (2001a), p. 30.

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01[a]	2001/02
Money and credit (rupees billion)							
Broad money (M3)	5,991.1	6,960.1	8,213.3	9,809.6	11,241.7	13,115.8	..
Credit to public sector	2,577.8	2,886.2	3,306.0	3,866.8	4,413.8	5,123.8	..
Credit to private sector	3,446.5	3,763.1	4,333.1	4,960.0	5,865.6	6,732.2	..
Interest rate (%, period average)[e]							
Deposit rate	12.0	11.0-12.0	10.5-11.0	9.0-11.8	8.5-9.5	8.5-9.0	8.0-8.5[f]
Nominal prime lending rate	16.5	14.5	14.0	12.0	12.0	11.5	11.5
Real prime lending rate[g]	8.5	9.9	9.6	6.1	8.7	4.3	7.3
Balance of trade and payments (US$ million)							
Exports, f.o.b.	32,311.0	34,133.0	35,680.0	34,298.0	44,894.0	44,894.0	..
Imports, c.i.f.	43,670.0	48,948.0	51,187.0	47,544.0	59,264.0	59,264.0	..
Trade balance	-11,359.0	-14,815.0	-15,507.0	-13,246.0	-14,370.0	-14,370.0	..
Services balance	-197.0	726.0	1,319.0	2,165.0	2,478.0	2,478.0	..
Income, net	-3,205.0	-3,307.0	-3,521.0	-3,544.0	-3,821.0	-3,821.0	..
Current transfers, net	8,851.0	12,777.0	12,209.0	10,587.0	13,134.0	13,134,9	..
Current account balance	-5,910.0	-4,619.0	-5,500.0	-4,038.0	-2,579.0	-2,579.0	..
Balance of payments	-1,221.0	6,793.0	4,511.0	4,222.0	5,856.0	5,856.0	..
International reserves and debt							
Foreign exchange reserves (US$ million)[h]	17,044.0	22,367.0	25,975.0	29,522.0	39,554.0	39,554.0	45,251[i]
Gross external debt (US$ million)[j]	93,730.0	93,470.0	93,531.0	96,886.0	98,263.0	99,606.0	..

.. Not available.

a Provisional.
b As per 2001 NAS, and as given in *Economic Survey 2000-2001*.
c Five-country REER and NEER.
d Average of eight months (April-November 2001).
e On deposits of maturity of one to three years.
f As on 30 November 2001.
g Based on WPI.
h Excluding gold and SDRs.
i As at the end of December 2001.
j As at the end of March.

Source: Reserve Bank of India (various issues); Asian Development Bank; Ministry of Finance, *Economic Survey 1999/2000 and 2001/02.*

5. The weak fiscal situation not only tends to crowd out private investment (through higher interest rates)[9], it also hampers the Government's efforts to invest in basic infrastructure and social sectors, thereby impeding economic growth. Management of the fiscal deficit remains a problem, however, in part because of its links with tariff reform. Along with excise duties, the customs tariff is one of the main sources of tax revenue for the Central Government. As a result of a policy to foster efficiency and integration into the world economy by lowering the relatively high customs tariffs, their share of the Central Government's net tax revenue (and GDP) has declined considerably, from 45.6% in 1996/97 to a little over 30% in 2001/02; budget estimates suggest that the share will fall further to 26% in 2002/03. Given its relatively heavy reliance on customs tariffs for tax revenue, it is not clear how the Central Government intends to fulfil its target of reducing its customs tariffs, which

[9] See for example, Acharya (2001a).

are among the highest in the world, to the considerably lower levels in ASEAN countries.[10] The authorities have a stated goal of raising direct tax revenue to 10% of GDP (from 3.4% in 2000/01)[11], but it is unclear how this goal is to be attained in the near future. Redressing the fiscal balance is also closely linked to expenditure reform.

(ii) Macroeconomic policies

(a) Monetary policy

6. Although the Reserve Bank of India (RBI) targets broad monetary indicators, an important objective of monetary policy is to manage volatility while allowing the underlying demand and supply conditions to determine the exchange rate over a period of time, in an orderly manner. Thus, increased downward pressure on the Indian rupee experienced in late 1997 as a result of various factors, including the Asian crisis and economic sanctions imposed by international donors following the nuclear tests, led to a tighter monetary policy. Since late 1998, however, with a noticeable weakening in industrial activity, the RBI has shifted its policy towards supporting economic recovery in the sector, including through a gradual reduction in the cash reserve ratio (CRR) from 11% in August 1998 to 5.5% by December 2001. Interest rates, while declining, have not fallen sufficiently to keep pace with slower inflation (which declined from 7.2% in 2000 to 4.7% in 2001), as a result of which real interest rates remain high. Interest rates in India have also traditionally been high, in part because they were administered until 1994.[12] In October 1994 controls on the lending rate were removed except for small loans with a value of up to Rs 200,000; since April 2001 prime lending rates are treated as a benchmark for banks to follow rather than as a minimum rate.[13] The (nominal) prime lending rate (PLR) of public sector banks declined to a range of 10%-12.5% by December 2001 from 12%-14% in March 1999. Inflation is currently very low, at some 1.3% at end January 2002.[14]

7. Some monetary tightening was experienced in 2000 as a result of inflationary pressure from higher oil prices, although lower domestic demand and international prices for oil have again permitted the RBI to concentrate on boosting industrial activity through an easing of monetary conditions. The Bank rate was cut to 7% in April 2000, following which banks cut their PLRs to 11.25%-12.50%. The looser monetary policy has continued into 2001 with the RBI cutting its bank rate further to 6.5% and the CRR to 5.5% in October 2001. The RBI has indicated in its Mid-Term Policy Review that the overall stance of monetary policy for the rest of the fiscal year is likely to continue to support industrial growth, while emphasizing the need for price and interest rate stability with a preference for softening of interest rates to the extent warranted.[15]

---

[10] According to tariff data reported in recent Trade Policy Reviews, the simple average applied MFN tariff in selected ASEAN countries was considerably lower: Indonesia 8.8% (1999); Malaysia 10.2% (1997); Philippines 9.7% (1999); Singapore 0% (2000); and Thailand 17.1% (1999).

[11] Confederation of Indian Industry (2001).

[12] Between 1975/76 and 1980/81 the Reserve Bank of India (RBI) prescribed both minimum lending and ceiling rates of interest, followed by only ceiling rates between 1981/82 and 1987/88. From 1988/89 to 1994/95, the RBI administered minimum lending rates.

[13] Ministry of Finance (2002a), p. 74. Real interest rates in India may also be high due to certain structural characteristics of the financial system such as the practice of offering fixed interest rates on long-term bank deposits, the high rate of non-performing loans among banks and the large government borrowing requirement (Chapter IV(4)(iv)).

[14] Wholesale price index (Ministry of Finance, 2002a, p. 3).

[15] Reserve Bank of India (2001a).

(b) Exchange rate and the balance of payments

8. The exchange rate of the Indian rupee is determined in the interbank market, with the Reserve Bank of India purchasing and selling spot and forward foreign exchange in the interbank market at the market exchange rate to even out what it considers to be excessive movements in the exchange rate.[16] The currency of intervention is usually the U.S. dollar. According to the authorities, there are no predetermined targets for the exchange rate. Other than interventions in the spot and forward markets, the RBI also uses administrative measures such as a 15 percentage point surcharge on interest charged on import finance in December 1997; surcharges on interest charged on import finance were reimposed in May 2000 when the rupee came under pressure. The real effective exchange rate depreciated between 1997/98 and 2000/01, since when it has experienced upward pressure (Table I.2).[17]

9. Reflecting the decline in the savings investment gap, with gross domestic investment having declined faster than national savings, India's current account deficit has fallen, from around 1.7% of GDP in 1995/96 to 0.5% in 2000/01 (Table I.3); the improvement, despite a sharp increase in international petroleum prices in 1999/2000, appears to have been largely due to strong export growth, both by merchandise and services exports, led by information technology (miscellaneous services) supported by continued buoyancy in private transfers. The capital balance account has also remained stable over the last few years as foreign investment inflows (especially portfolio investment) picked up as the region began its recovery after the regional economic and financial crisis in 1997/98.

Table I.3
Balance of payments, 1995-01
(US$ million and per cent of GDP)

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01
Current account balance	-5,910.0	-4,619.0	-5,500.0	-4,038.0	-4,698.0	-2,579.0
(Per cent of GDP)	(-1.7)	(-1.2)	(-1.4)	(-1.0)	(-1.0)	(-0.5)
Trade balance	-11,359.0	-14,815.0	-15,507.0	-13,246.0	-17,841.0	-14,370.0
Exports f.o.b.	32,311.0	34,133.0	35,680.0	34,298.0	37,542.0	44,894.0
Imports c.i.f.	43,670.0	48,948.0	51,187.0	47,544.0	55,383.0	59,264.0
Petroleum	7,500.0	10,000.0	8,200.0	6,400.0	12,600.0	12,500.0
Invisibles, net	5,449.0	10,196.0	10,007.0	9,208.0	13,143.0	11,791.0
Services	-197.0	726.0	1,319.0	2,165.0	4,064.0	2,478.0
Exports	7,346.0	7,474.0	9,429.0	13,186.0	15,709.0	18,870.0
Imports	7,543.0	6,748.0	8,110.0	11,021.0	11,645.0	16,392.0
Income	-3,205.0	-3,307.0	-3,521.0	-3,544.0	-3,559.0	-3,821.0
Credit	1,429.0	1,073.0	1,561.0	1,935.0	1,931.0	2,366.0
Debit	4,634.0	4,380.0	5,082.0	5,479.0	5,490.0	6,187.0
Transfers	8,851.0	12,777.0	12,209.0	10,587.0	12,638.0	13,134.0
Credit	8,890.0	12,858.0	12,254.0	10,649.0	12,672.0	13,211.0
Debit	39.0	81.0	45.0	62.0	34.0	77.0

Table I.3 (cont'd)

[16] The exchange rate was unified and officially floated in 1993.
[17] The REER is based on the wholesale price index for India.

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01
Capital account balance	4,089.0	12,006.0	9,844.0	8,435.0	10,444.0	9,023.0
(Per cent of GDP)	(1.2)	(3.1)	(2.4)	(2.0)	(2.3)	(1.7)
Foreign investment, net	4,615.0	5,963.0	5,353.0	2,312.0	5,117.0	4,588.0
In India	4,805.0	6,153.0	5,390.0	2,412.0	5,191.0	5,102.0
Abroad	-190.0	-190.0	-37.0	-100.0	-74.0	-514.0
Loans	2,201.0	4,795.0	4,799.0	4,418.0	1,601.0	4,531.0
External Assistance	867.0	1,101.0	885.0	799.0	891.0	410.0
Commercial borrowings, net	1,285.0	2,856.0	4,010.0	4,367.0	333.0	4,016.0
Short-term credit, net	49.0	838.0	-96.0	-748.0	377.0	105.0
Banking Capital	762.0	2,229.0	-893.0	698.0	2,127.0	811.0
Commercial Banks	937.0	2,225.0	-1,260.0	-448.0	2,304.0	885.0
Assets	-384.0	-870.0	-2,195.0	-1,397.0	790.0	-1,468.0
Liabilities	218.0	-255.0	-190.0	-11.0	-26.0	36.0
Non-resident deposits	1,103.0	3,350.0	1,125.0	960.0	1,540.0	2,317.0
Other	-175.0	4.0	367.0	1,146.0	-177.0	-74.0
Rupee debt service, net	-952.0	-727.0	-767.0	-802.0	-711.0	-617.0
Other capital, net	-2,537.0	-254.0	1,352.0	1,809.0	2,310.0	-290.0
Errors and omissions	600.0	-594.0	167.0	-175.0	656.0	-588.0
Overall balance-of-payments	-1,221.0	6,793.0	4,511.0	4,222.0	6,402.0	5,856.0
(Per cent of GDP)	(-0.3)	(1.8)	(1.1)	(1.0)	(1.4)	(1.3)
Gross reserves (US$ billion)	21.7	26.4	29.4	32.5	38.0	42.3
(In months of imports of goods and services)	..	5.7	5.9	6.7	6.8	6.7

.. Not available.

Source: Reserve Bank of India, *Bulletin* (various issues); and IMF.

10. The overall balance of payments has gradually improved from 1.1% of GDP in 1997/98 to 1.4% in 1999/2000 and to 1.3% in 2000/01. India continues to maintain reasonably healthy gross reserves, which in 2000/01 were estimated to be equivalent to 6.7 months of imports of goods and services.

(c) Fiscal policy

11. India's fiscal position remains weak. The Central Government's fiscal deficit as a percentage of GDP has risen from 4.1% in 1996/97 to 5.7% in 2001/02 (Chart I.1 and Table AI.1), despite commitments from successive governments to contain it; indeed, Budget estimates for 2001/02 predicted that the Central Government's fiscal deficit would be 4.7%. The overall public sector deficit, which includes the deficits of state governments[18], the central public sector enterprises, and the oil pool account (Box I.1), is considerably higher, at 10.6% of GDP in 2000/01 (Table AI.1).[19] At the same time, the combined public debt of central and state governments has risen from 56.4% of GDP in 1996/97 to 85% in 2000/01.[20] The high and growing level of public sector debt in combination with high interest rates have resulted in a situation where interest payments on this debt now account

[18] The Central Government shares taxation powers and expenditure responsibilities with state governments.

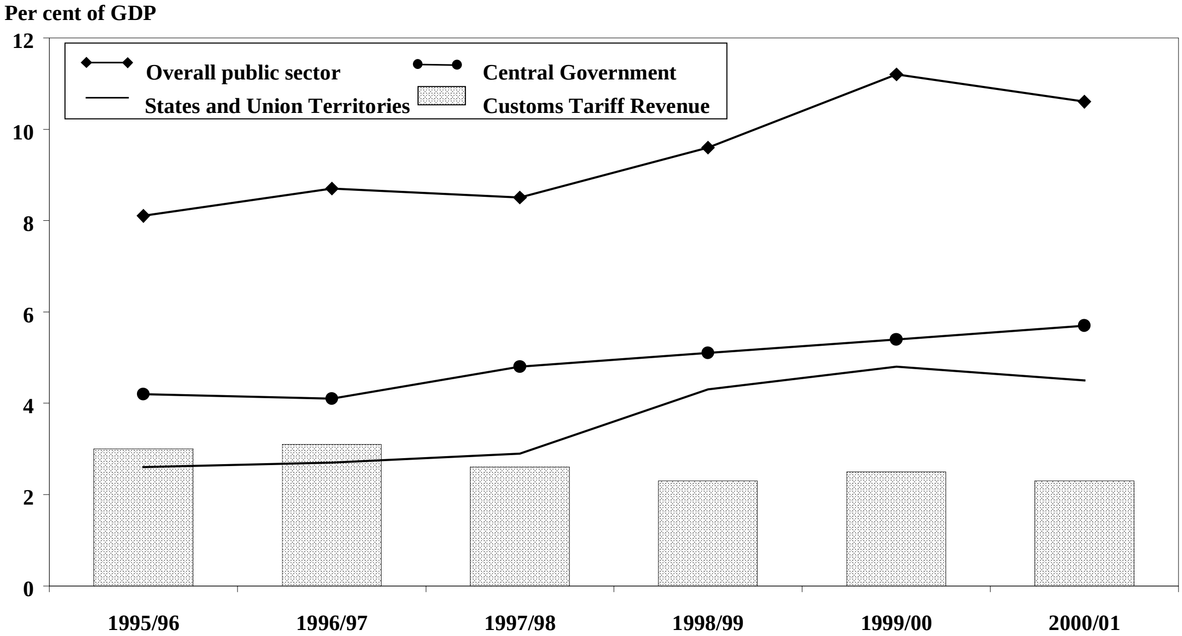
[19] This does not reflect contingent liabilities in the form of guarantees by the central and state governments, which at the end of March 2000 were 10.7% of GDP (for only the 17 major states), implicit guarantees of off-budget state enterprises, the arrears of public state utilities or implicit liabilities related to government pensions.

[20] Ministry of Finance (2001a), p. 30.

for over one third of the Central Government's current expenditure. Other major expenditures are the increasing level of subsidies (especially for food and fertilizer) and the long-term implications of the Fifth Pay Commission recommendations, including the surge in pension payments.[21] Another matter contributing to fiscal weakness is the indirect effect on the exchequer of inadequate user charges for most public services, such as power, irrigation, and road transport, at both the central and state levels.[22]

12. Efforts to reduce expenditure and to raise revenue, especially through better tax collection, have not been as successful as expected. Tax revenue collected by the Central Government as a percentage of GDP has remained relatively stable, in the range 6-7% (Table AI.1). The tariff remains an important source of revenue for the Central Government with an estimated share of 1.9% of GDP (some 30% of total central government net tax revenue) in 2001/02, considerably lower than the 1996/97 figure of 3.1% of GDP (45% of total central government net tax revenue) (Chart I.1). This suggests that additional tariff reductions will require far-reaching reform of internal taxes, their administration, and collection (Chapter III(4)(ii)).

Chart I.1
Public accounts, 1995-01



Source: Ministry of Finance, *Union Budget* (various years).

[21] Ministry of Finance (2001a), p. 18.
[22] Ministry of Finance (2001a), p. 31.

Box I.1: The oil pool accounts

The Oil Coordination Committee (OCC) Accounts, or oil pool accounts, are maintained to coordinate the cross-subsidization of petroleum products such as diesel, kerosene, LPG, motor spirit, and aviation turbine fuel, and to maintain price stability for consumers while ensuring reasonable profit margins for India's public sector oil companies. Over the years, petroleum price fluctuations and a time lag before domestic prices of petroleum products were adjusted accordingly, have resulted in a steady increase in the "oil pool deficit", from some 0.2% of GDP in 1995/96 to 1% in 1999/2000. The deficit is estimated to have increased to some Rs 236 billion, or around 1.6% of GDP, by 31 March 2001, as a result of a sharp increase in international oil prices in 2000/01. The OCC's debt stock, which consists mainly of arrears to state-owned oil companies, is some 0.6% of GDP.

The growing deficit of the oil pool account led to reforms in the administered price mechanism for several petroleum products in the late 1990s, including a timetable for phasing out administered pricing, and price increases for petroleum products. More recently, the phasing in of import parity for petroleum products by 1 April 2002 and the discontinuation of the OCC were announced in the 2001/02 Budget speech. The Government has also affirmed that subsidies for kerosene and LPG, which are not reflected in budgetary expenditures, would be moved into the central government budget. In 1999/2000, it is estimated that the total subsidy provided for kerosene (for the PDS), LPG and diesel, was some Rs 180 billion (around 0.8% of GDP).

In the budget speech for 2002/03, the Minister of Finance announced further changes to the administered price mechanism for petroleum and the oil pool account. These include: the dismantling of the oil pool account on 1 April 2002 (with outstanding balances liquidated through the issue of oil bonds) with a subsequent decline in diesel and petrol prices; reduction in the subsidy for LPG and kerosene through an increase in the price of these products and an eventual phasing out of the subsidy over the next three to five years; permitting private sector companies in distribution; and the establishment of a Petroleum Regulatory Board to oversee the sector.

Source: Ministry of Finance (2001a), *Economic Survey 2000/01*; and Ministry of Finance (2002b), *Budget Speech 2002/03, Part A*, paragraph 55.

13. In order to redress the fiscal imbalance at the central level, the authorities have proposed the Fiscal Responsibility and Budget Management (FRBM) bill, which was introduced in Parliament in December 2000 and referred to the Parliamentary Standing Committee on Finance; the latter's recommendations are currently being considered by the Government. The bill would, *inter alia,* require that the central fiscal deficit be reduced annually by at least 0.5% of GDP with a view to achieving a deficit of not more than 2% of GDP by 31 March 2006, and that central government debt, which was 62% of GDP in 2000/01[23], not exceed 50% of GDP in March 2011.[24] The Central Government would be prohibited from borrowing directly from the RBI (except by way of advances to meet temporary need in certain circumstances) after 2004, and new central government guarantees would be capped at 0.5% of GDP each year.[25] The legislation would also improve fiscal discipline by enhancing transparency and requiring automatic expenditure cuts in the event of budget shortfalls. The Central Government has also taken steps to reduce expenditure, notably through the Expenditure Reform Commission; reform of the Public Distribution System; and abolition of the Administrative Pricing Mechanism (APM) in the petroleum sector.

14. The challenge of fiscal management is equally acute at the state level.[26] Accordingly, the Central Government has been working jointly with the states through the Fiscal Reforms Incentive

[23] Ministry of Finance (2001a), p. 46.
[24] Ministry of Finance (2001a).
[25] Most states have also apparently agreed to limit their guarantees.
[26] Minister of Finance (2002b).

Fund, established on the recommendation of the Eleventh Finance Commission.[27] For their part, the States have undertaken corrective measures to ensure greater financial stability. Measures taken include limits on extending guarantees for borrowing through public sector companies and financial corporations[28], and the creation of guarantee redemption funds.[29]

15. Furthermore, in January 2001, the Prime Minister's Economic Advisory Council (EAC), as part of it comprehensive programme of "second-generation" reforms, stressed that a sharp reduction in the fiscal deficit and public sector debt together with broad-based structural reforms were essential for India to benefit fully from globalization and achieve its full growth potential. Although the programme was not formally endorsed by the Government, many of its policy recommendations were reflected in the 2001/02 budget speech. The latter targeted the overall central government deficit for 2001/02 at 4.7% of GDP (although the actual deficit was 1 percentage point higher). The main fiscal and structural measures contained in this Budget included various measures recommended by the Expenditure Reform Commission (ERC): namely a reduction and rationalization of the civil service and cuts in food and fertilizer subsidies (wages and salaries accounted for almost 12% of the Central Government's current expenditures in 2000/01, while major subsidies accounted for a further 9.2%.[30])

16. Moreover, in line with a recommendation by the EAC, the Eleventh Finance Commission (EFC) has apparently set the objective of raising the tax-to-GDP ratio by 2 percentage points with a view to reducing the combined fiscal deficit of the central and state governments to 5% of GDP by 2006/07. With this objective in mind, efforts are being made to reform the tax system; thus the 2001/02 and 2002/03 Budgets include broadening the tax base, by gradually reducing various exemptions and bringing additional services into the tax net[31], and strengthening tax administration. Achievement of this objective poses a major challenge, given the Central Government's intention of reducing its reliance on border taxes for revenues. Other reforms recommended by the EAC relate to labour markets, education and health, social policy, trade policy, industrial policy, privatization, corporate governance, agriculture, and infrastructure.

(iii) Structural measures

17. Measures to liberalize and reduce over-regulation in the economy have been pursued since the previous Review of India. However, the pace of liberalization has slowed. Trade-related reforms have been pursued mainly in the area of import licensing, where India was bound by an agreement with the United States to remove all restrictions maintained for balance-of-payment reasons by 1 April 2001; and some attempts to rationalize the tariff, although the overall average has fallen very slightly (Chapter III(2)). The Budget for 2002/03, if approved, will reduce tariff rates, rationalize the structure of excise rates, and further reduce licensing requirements, for example, for the small-scale sector.[32] In addition, the current Export Import Policy (2002-2007) has reduced the number of exports subject to restrictions. Foreign investment liberalization has also been pursued and most sectors, including those previously reserved for the small-scale sector are now open to FDI of up to 100% (with some exceptions); in some sectors FDI restrictions apply mainly due to considerations of a strategic or security-based nature. In addition, in some service sectors, such as financial services

[27] The EFC was set up to give recommendations on central-state fiscal relations.
[28] In Gujarat, Rajasthna, Karnataka, and Tamil Nadu.
[29] In Rajasthan and Tripura.
[30] Major subsidies amounted to around 1.2% of GDP in 2000/01. However, total implicit and explicit subsidies provided by both central and state governments are believed to be far higher (14.5% of GDP in 1994/95).
[31] Despite the growing share of services in GDP, only a small percentage of them are subject to indirect taxes.
[32] Ministry of Finance (2002b).

(banking and insurance) and telecommunications, efforts have been made to develop or strengthen regulatory frameworks and introduce competition (Box I.2).

Box I.2: Regulatory and structural changes

Tariffs
Tariff reduction and rationalization the tariff structure continues, notably by reducing the number of tariff bands and by removing the special duty and surcharge, of 5% and 10%, respectively. The "peak" rate of tariff was reduced from 45% at the time of the last Review to 30%. However, a special additional duty (SAD) of 4% was introduced apparently in place of state taxes, which are applied only to domestically produced goods. The tariff also continues to have a number of "exemptions", which are targeted at particular industries or end users, making its administration difficult. The Government aims to reduce tariffs to "Asian levels" by 2005; for this purpose, tax reforms have been undertaken to broaden the tax base, modernize tax administration, and bring a larger number of services under the tax system, which could offset the likely loss of revenue from lower customs tariffs.

Non-tariff measures
India removed all import licensing restrictions maintained for balance-of-payment reasons (some 32% of the tariff was restricted at the time of India's last Review). The remaining restrictions appear to be maintained for health, safety, and moral conduct reasons; in addition, certain goods are subject to state-trading.

Foreign investment
Liberalization has continued and most sectors are currently open for FDI (with differing degrees of foreign equity participation); foreigners may not invest in a few sectors, including agriculture, print media, and railways. The number of sectors in which foreign investment may take place automatically (by registering with the Reserve Bank of India) has increased.

Industrial licensing policies
There has been a decline in the number of industries requiring compulsory industrial licensing (sugar, coal and lignite, and non-crude petroleum have been liberalized), and those reserved for the public sector (from six at the time of the last Review to three currently) and for the small-scale sector (from 821 at the time of the last Review to 799). Progress has been slow, however, in other areas of industrial policy such as the restructuring of public-sector companies, and disinvestment of government shares in public-sector companies.

Taxation
India's total tax-to-GDP ratio fell to 14% in 1999/00 from 16% in the late 1980s. India has high tax rates although revenue yields are low because tax bases tend to be narrow owing to numerous incentives and exemptions. The states were supposed to convert their sales taxes to a value-added tax by 1 April 2001; this has been postponed to 1 April 2003.

Financial services
Reforms in banking continue to improve the efficiency and health of the banking sector, with the strengthening of prudential measures and efforts to restructure weak banks. Additional disclosure requirements were prescribed to enhance transparency and improve governance. The level of non-performing assets, especially in the state-owned banks, has declined as a result of some of these efforts, although it remains relatively high. The insurance sector, previously a state monopoly was de-regulated and private sector investment was permitted; a regulatory agency (the Insurance Regulatory and Development Authority) was established.

Box I.2 (cont'd)

Infrastructure

Considerable progress was made in opening the telecommunications sector to international competition, including through the establishment of a regulator, and a separation of the main public-sector service provider from the licensing body. Domestic long-distance fixed-line services have also been liberalized, with no limit set on the number of operators, and the main public-sector fixed-line service providers have been allowed to provide cellular services. Problems associated with high tariffs and licence fees have been addressed to some extent.

In road transport, a cess of Re 1 per litre of petrol and diesel purchased was imposed in December 2000 to raise money for improving the road network; increased use is also being made of tolls to finance, operate and maintain national highways. Efforts have been made to rationalize the tariff structure in railways and to address the cross-subsidy between passenger and freight transport. In air transport, a decision was made to reduce government equity in the national carriers Air India (international services) and Indian Airlines (national services), although this has not taken place to date.

In the power sector, an Electricity Regulatory Commission Act was passed in 1998, establishing a central regulatory authority; several states have also passed similar legislation and set up state regulatory bodies. In addition, the Central Government has offered financial assistance for State Electricity Boards that restructure their operations.

Source: WTO Secretariat.

(2) DEVELOPMENTS IN TRADE

18. India's total trade as a share of GDP has remained relatively unchanged since its previous Review, at some 21% in 1999/00, and around 22% in 1996/97. Exports and imports of goods and services as a share of GDP appear also to be relatively unchanged from the previous Review: exports grew from 11.1% of GDP in 1997/98 to 11.8% in 1999/00, and imports were 14.8% and 14.6% of GDP in these two years. In contrast, growth in services exports has been particularly rapid, accounting for almost 30% of exports of goods and services in 2000/01, compared with 21% in 1997/98 (Table I.3).

(i) Composition of trade in goods and services

19. A notable aspect of India's composition of trade is the continuing decline in agriculture's share in merchandise exports, from 20% in 1997/98 to 14% in 2000/01 (Table AI.2). The share of manufactures rose from 74% to 76% during this period; textiles and clothing continues to form the largest share of manufactures at 27% (27.5% in 1997/98). India imports mainly manufactures, including machinery and transport equipment and other semi-manufactures; the share of fuels, however, has risen significantly (Table AI.3).

20. India's exports of services have been expanding rapidly. The largest share of its services receipts is accounted for by "miscellaneous" services (some 47% in 2000/01); miscellaneous services include software services (US$4 billion in 1999/00), communication services (US$1.1 billion in 1999/00), and management services (US$0.6 billion) (Table AI.4). Other important service receipts are travel (some 17% of the total in 2000/01) and transport (10% in 2000/01). Imports of services are similarly dominated by miscellaneous services (financial services and management services worth some US$1.3 billion and US$0.8 billion, respectively, in 1999/00), which accounted for 60% of services payments in 2000/01; this is followed by transport (19.3%) and travel (17.5%).

(ii) Direction of trade in goods and services

21. The main regional destinations for India's exports are the European Union (23.4%) and East Asia (20.7%); the United States accounts for 20.9% of exports (Table AI.5). For imports, India has tended in recent years to diversify its sources to East Asian countries, with shares rising from 20.4% in 1997/98 to 23% in 1999/00 (Table AI.6); data are not available on the breakdown of shares by origin of some 31% of India's imports for 2000/01.[33]

22. No equivalent data on the direction of trade are available for services.

(3) TRENDS IN FOREIGN DIRECT INVESTMENT

23. The liberalization policies pursued in the early 1990s initially led to a surge in inflows of foreign direct investment (FDI). Thus, as the last Trade Policy Review of India noted, FDI inflows increased from an insignificant amount in 1990/91 to some US$2.8 billion (just under 1% of GDP) in 1996/97. Since peaking in 1997/98 at US$3.6 billion, however, FDI inflows have been falling (to some US$2.3 billion in 2000/01, with an additional US$2.8 billion entering as portfolio investment), despite liberalization of foreign investment, including allowing FDI in a larger number of sectors and raising foreign equity limits in several sectors (Table I.4). Estimates for the period April-October 2001 indicate a slight improvement in FDI inflows (US$2 billion) over the corresponding period in the previous year (US$1.4 billion). There has also been an improvement in the discrepancy between FDI approved and actual inflows. At the time of the last Review of India, it was estimated that some 22% of approved FDI was actually invested[34]; more recent data show a gradual improvement in this share with some 52% of approved FDI entering the country.[35]

24. Evidence suggests that domestic firms in India tend to export more when foreign ownership is 51% or more; this level of ownership enables foreign investors to exercise operational and strategic control over the firm, thereby ensuring that intellectual and other property rights devolve unambiguously to the foreign shareholder.[36] Further liberalization might enhance FDI flows and contribute to export growth.

25. The largest foreign investors are Mauritius (some 44% in 2000/01), followed by the United States (16.8%); the sectors targeted by foreign investors appear to be mainly those that are growing rapidly, such as computers, whose share of the total increased from 3.7% to 16% between 1995/96 and 2000/01.

26. The fact that FDI has not increased, and indeed has declined slightly since the mid-1990s despite further liberalization of foreign investment policies, may indicate the need for further regulatory reform. It has also been suggested that India has failed to attract as much FDI in export-oriented industries as many other developing countries. The reasons for this, other than the remaining FDI restrictions, include the anti-export bias of foreign trade policies, the unusual rigidity of labour

[33] The data for which origin of imports are not indicated relate mainly to petroleum imports.

[34] At the time of the last Trade Policy Review of India, it was suggested by the OECD that this may be due to the fact that although many sectors were formally open to foreign investment, state-level policies and regulatory frameworks may not have been sufficiently developed to cope with the increased FDI approvals. The authorities also suggested that in certain sectors with long gestation periods, inflows may take time to materialize given that approvals did not oblige investment (WTO, 1998, p. 14).

[35] In 2001 (January-September) this share was higher (72%).

[36] Chhibber and Majumdar (1999).

laws, the policy of reservations for the small-scale sector, the weakness of infrastructure (especially power, ports, roads, and railways), and slow and cumbersome administrative procedures.[37]

Table I.4
Foreign investment by source and activity, 1995-01
(US$ million and per cent)

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01
Foreign direct investment, net (US$ million)	2,144	2,821	3,557	2,462	2,155	2,339[a]
Portfolio, net (US$ million)	2,748	3,312	1,828	-61	3,026	2,760
of which						
Foreign institutional investors[b]	2,009	1,926	979	-390	2,135	1,847
Euro-equitities[c]	683	1,366	645	270	768	831
Other[d]	56	20	204	59	123	82
Total (US$ million)	4,892	6,133	5,385	2,401	5,181	5,099
Total as per cent of GDP	1.4	1.6	1.3	0.6	1.1	1.1
Foreign investment by country[e] (% of total)						
Germany	7.1	8.1	5.1	5.7	2.0	5.9
Italy	0.8	1.4	1.5	5.8	7.9	1.5
Japan	4.3	4.7	5.6	11.8	9.0	8.2
Mauritius	35.8	41.1	30.5	29.5	31.7	44.1
Netherlands	3.5	6.0	5.4	2.7	5.2	4.0
Korea, Rep. of	1.7	0.3	11.3	4.3	0.5	1.3
United States	13.8	11.8	23.2	22.7	22.5	16.8
Others	33.2	26.6	17.5	17.7	21.3	18.3
Total (US$ million)	1,418	2,057	2,956	2,000	1,581	1,910[a]
Foreign investment by activity[e] (% of total)						
Chemical and allied products	9.0	14.8	8.9	18.8	7.6	7.2
Engineering products	17.8	35.5	19.6	21.4	20.6	14.3
Electronics and electrical equipment	9.2	7.5	21.8	11.4	10.9	11.2
Services	7.1	0.7	10.9	18.4	7.3	11.8
Food and dairy products	6.0	11.6	3.8	1.0	7.7	3.9
Computers	3.7	2.9	4.7	5.3	6.3	16.0
Pharmaceuticals	3.9	2.3	1.2	1.4	3.4	3.3
Finance	19.0	10.6	5.0	9.3	1.3	2.1
Others	24.5	14.2	24.4	13.1	35.0	30.3
Total (US$ million)	1,418	2,057	2,956	2,000	1,581	1,910

a The data on total foreign investment by country and by activity are different from total FDI figures reported on a balance-of-payments basis. The reason for this substantial difference was not clear to the Secretariat.
b Represents fresh inflow/outflow of funds by FIIs.
c Figures include GDRs/ADRs amounts raised abroad by the Indian corporates.
d Including off-shore and others.
e Excludes inflows under the NRI direct investment route through Reserve Bank and inflows due to acquisition of shares under Section 29 of FERA.

Source: Ministry of Finance (2001a), *Economic Survey 2000-2001* (Table 6.8); and data provided by the authorities.

[37] Acharya (2001).