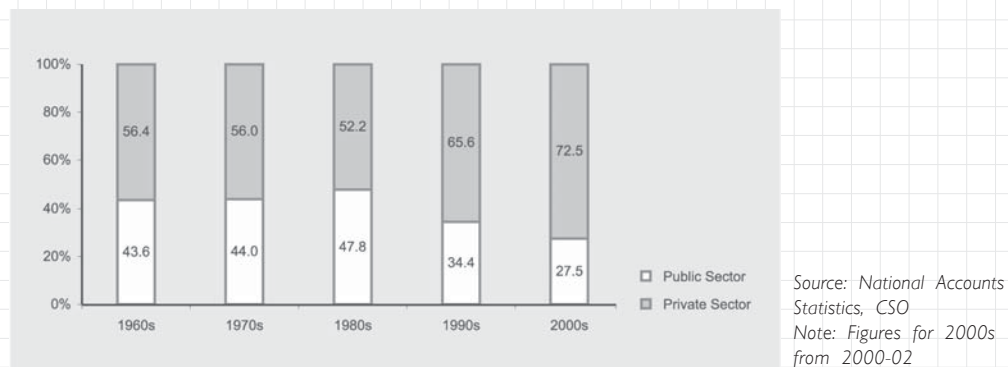


## CHAPTER 2: THE GOVERNMENT- INVESTMENT NEXUS

The Indian investment scenario has undergone a rapid transformation since independence. While the share of investment (measured as gross domestic capital formation) in overall GDP has risen from 14.7 per cent in 1960s to around 23.3 per cent in early 2000s, there have been massive shifts in the composition vis-a-vis public and private investment.

Until the 1980s, the policy framework encouraged the dominance of the public sector, while the private sector faced controls in the form of industrial licences, industry reservation and price and distribution controls on various industrial products, resulting in lower private sector investments. Liberalisation and the dismantling of controls gave a fillip to private sector investments. As a result, the percentage share of the private sector in total investment surged from 52.5 per cent in the 1980s to 65.6 per cent in the 1990s and further to 72.5 per cent in the early 2000's.

**Figure 2.1: Share in Investment**



### Industrial Policy Reforms and Investment

The new Industrial Policy of 1991 promoted investment, both domestic and foreign, through de-restriction of domestic production and investment. A number of measures have since been taken to further ease the process of private participation in investment. Of these, the two most critical ones were:

- First, industrial licensing was virtually abolished, except for industries where licensing continues purely on public health, safety and security considerations
- Second, the number of industries reserved for the public sector was reduced to just two [(a) atomic energy, and (b) railway transport]

Besides these, procedural delays were eliminated. Industries exempted from licensing are now required to file only the relevant information in the prescribed Industrial Entrepreneurs Memorandum (IEMs) with the Secretariat for Industrial Assistance (SIA) with no requirement of further approvals. At the State level, serious efforts for simplifying the rules and procedures for setting up and operating industrial units have been made. A 'single window' system is now in existence in most of the States for granting approval for setting up industrial units.

### Fiscal Incentives – Centre & States

The change in the industrial regime in the post liberalisation period was coupled with a range of fiscal incentives offered by both the Central and State Governments. Both the Centre and the States promote investment through general fiscal incentives for industries (see box 2.1). Tax holidays from the Centre in the form of deductions are available for various types of

investment. 100 per cent tax exemption is available in special economic zones and for export-oriented units.

Moreover, with a view to attract investors including those from overseas, many States are offering incentive packages in the form of various tax concessions, capital and interest subsidies, reduced power tariffs etc.

### **Box 2.1: Investment Incentives**

#### **Central Government investment incentives**

- 100 per cent profit deduction for developing, maintaining and operating infrastructure facilities
- Tax exemption of 100 per cent on export profits for ten years
- Deduction in respect of certain inter-corporate dividends to the extent of dividend declared
- Various capital subsidy schemes and fiscal incentives for expansion in the north-eastern region
- Tax deduction of 100 per cent of profits for 5 years and 50 per cent for next two years for undertakings in Special Economic Zones (SEZs)

#### **State Government investment incentives**

- Single window approval system for setting up industrial units
- Electricity duty, registration fee and stamp duty exemptions
- Reservation of plots for NRIs, EOUs and Foreign Investment Projects
- Rebate on land cost, tax concessions and octroi refunds
- Interest rate and fixed capital subsidy

### **Foreign Investment Policy**

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The liberalisation era also witnessed a spurt in foreign investments that buttressed the growth in private investment. A number of initiatives were taken to facilitate foreign investments. In addition to the fiscal incentives and delicensing, drastic changes in the Foreign Exchange Management Act (FEMA), FDI and foreign technology procedures were initiated to attract foreign investment into India.

While, initially, most investments were subject to prior approval from the Foreign Investment Promotion Board (FIPB), even those activities were progressively opened up to foreign investment that required only post-facto reporting to the RBI. The FIPB has been set up to streamline the procedures at the Central Government level to decide on the proposals within of fifteen days. Most sectors now come under this automatic route. To liberalise the FDI regime further, even sectors considered sensitive such as insurance (up to 26 per cent); integrated township development (up to 100 per cent); defence industry (up to 26 per cent); tea plantation (upto 100 per cent subject to divestment of 26 per cent within five years to FDI) and private banking (up to 74 per cent) were opened up.

The Foreign Investment Implementation Authority (FIIA) was set up to facilitate the quick translation of approval into implementation.

## **Other Economic Reforms and their Impact on Investment**

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Reforms affect the quality of the investment environment, not merely through direct measures to facilitate investments but also through the more indirect measures aimed at improving the quality of the 'operating environment' for firms and businesses. Some other key reform measures taken by the Indian Government that have played a role in improving the investment environment are:

- Full national treatment of foreign companies incorporated in India
- Large tariff reductions and a stable tax regime with just 3 rates for both excise as well as customs duties
- Foreign nationals have the option of being taxed under the tax treaties that India may have signed with their country of residence
- Simplification of the earnings repatriation procedure
- Financial sector reforms included decontrolling of interest rates, resulting in a large decline in interest rates, particularly since 2001, further promoting private investment
- Import of capital goods and other intermediaries liberalised to expose the industry to external competition
- Concerted efforts at increasing public sector investment in strategic, hi-tech and essential infrastructure and encouraging private sector, as budgetary constraints limited public spending

As a consequence of the above reforms, the period from 1991 to 1996 saw a boom as lifting of controls on licensing, technology import and foreign investment led to a dramatic rise in industrial investment. Industrial intentions peaked at 6,900 proposals worth US\$ 42 billion in 1995. While there was a slowdown subsequently, triggered by both global and domestic factors such as high interest rates, current indicators point to an incipient recovery in investments fuelled by a turnaround in the manufacturing sector and a steady decline in interest rates.

The reforms process has been instrumental in bringing about four key changes in the relationship of foreign firms with India:

- (a) Foreign firms now invest more freely in India
- (b) Indian firms are considered cost-competitive
- (c) The rise in competition has led to an increase in demand for investing in new technology in India
- (d) The Indian market is perceived as one of the largest untapped markets with a large number of middle class consumers

Hence, economic reforms in general have played a key role in the emergent price mechanism, greater efficiency, enormous investment opportunities, lesser bureaucratic controls and a greater role for private initiative. Government policies have facilitated investments. Moreover, the adverse impact of a decline in public investment is outweighed by the decline in the cost of capital and favourable investor perceptions.

## **The Role of the Government**

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Over the years, while the role of the Government as a direct investor has diminished with the advent of liberalisation, it remains an active player in the investment domain. Four critical roles of the Government have emerged in the current scenario:

- As an 'enabler' of private investment activity by nurturing an environment that is conducive to private interest
- As a provider of critical infrastructure that can support production activity and thereby encourage investment

- As a partner of the private sector in 'public-private' partnerships
- As an investor in sectors such as health and education where private interest and participation may not be adequate to serve the needs of society

### **The Role as 'Enabler' and the Importance of Governance**

Governance refers to the management of all such processes which in any society define the environment that enables individuals to increase their capability levels and provide opportunities to realise their potential and enlarge the set of available choices. It spans an entire range of issues and activities including the quality of regulation, the delivery of public goods and services, the efficiency of resource mobilisation, the management of public finances, the empowerment of the public and the quality of judiciary. The three pillars on which the edifice of governance stands are institutions (parliament, judiciary etc), delivery mechanisms (primarily the executive apparatus) and the supportive framework of rules, procedures and laws.

The quality of governance is a critical determinant of the investment climate. Good governance can improve the incentive to invest in the following ways:

- Establishing credibility – Credibility and continuity of policy are critical to investment flows. Investors will agree to invest only if they believe that policies will remain unchanged and independent of the regime in power, particularly for infrastructure projects that have longer gestation periods
- Fostering public trust: Governance has to improve the mutual trust between Government and industry. The absence of trust in Government with respect to industry can lead to excessive regulation which in turn breeds rent-seeking behaviour. On the other hand, mistrust of the Government by investors can lead to an aversion to invest and attempts to circumvent the regulatory or policy environment in taking business decisions.

At a fundamental level, India's superiority in the governance domain lies in the robustness of its institutions. It is a functioning democracy with an established civil service and independent judiciary. However, it is now an accepted fact that in the pre-liberalisation era, excessive intervention or the 'license permit raj' skewed the incentive structure considerably.

The key step in reducing the impact of excessive regulation was to reduce the degree of intervention in the economy. Steps like the abolition of licensing, removing import quotas, as well as reservations are an integral part of improving governance. Current industrial, trade and investment policy aim at 'facilitation' rather than control

#### **Box 2.2: The rise of e-governance**

The current emphasis in the Government's e-governance initiative is on providing connectivity, networking, technology upgradation, and selective delivery systems for information. The real challenge however lies in re-engineering procedures and rules, making them simpler and easier to implement.

##### **National e-Governance Action Plan (2003-07) - (NeGAP)**

To implement a comprehensive programme to accelerate e-Governance at all levels of the Government to improve efficiency, transparency and accountability, the Government of India has initiated the National e-Governance Action Plan for implementation during 2003-2007. The plan seeks to create the right governance and institutional mechanisms, set up the core infrastructure and policies and implement a number of Mission Mode Projects at the Centre, State and integrated service levels to create a citizen-centric and business-centric environment for governance.

The e-Governance framework would include Back-ends (databases of the different Government agencies, service providers, State Governments etc.), Middleware and the Front-end delivery channels (home PCs, mobile phones, kiosks, integrated citizen service centres etc.) for citizens and businesses. The Middleware comprises of communication and security infrastructure, gateways and integrated services, facilitating integration of inter-departmental services.

### **e-Biz**

e-Biz is one of the five integrated services projects that are part of the NeGAP. The main purpose is to provide a single window Business to Government portal, offering services to investors, industries and businesses regarding information on forms & procedures, approvals, clearances and permissions, reporting, filing, payments and compliances throughout their lifecycle. The pilot e-Biz project is planned to be implemented in Andhra Pradesh, Maharashtra, Haryana and Uttar Pradesh.

#### **The other core integrated services projects include:**

##### **India Portal**

Single window web based delivery of information and Government services at the National level

##### **State Portals**

Single window web based delivery of information and State Government services at the State level

##### **Electronic Document Interchange**

Formatted transaction of business documents (invoice and purchase) electronically

##### **e-Procurement**

Publishing of tenders, bidding online, block tendering, empanelment of agencies etc.

##### **Payment Gateway**

Facilitating transactions involving payments etc.

Policy-making in the post-liberalisation phase has focused on a long-term perspective and has signalled a commitment to the process of reform – a process of continuous improvement. Despite changes of Government at both the Centre and States, there has been no reversal of any major reform initiatives that affect investments.

### **Box 2.3: Governance Initiatives in Intellectual Property Rights**

The smooth functioning of the Intellectual Property Rights (IPR) regime is critical to the growth and development of knowledge intensive sectors such as pharmaceuticals and Information Technology (IT). The government has recently taken a number of initiatives in modernising and revamping the IPR regime in the country:

- India will recognise both product and process patents from 2005
- Indian IPR laws have been made TRIPS compliant
- The Intellectual Property Appellate Tribunal was made functional from September 15, 2003
- Major initiatives are underway for modernising Intellectual Property Administration such as computerisation of intellectual property administration and creation of a digital database of patents, trademarks, liquidation of backlog and design records

This is not to suggest that further improvement is not warranted. Despite the mechanism of 'single-window' clearance in the process of setting up a production unit, there can be significant

delays in getting projects cleared. Surveys reveal that the number of days taken to set up a new business in India is higher than that of peer economies like China. The percentage of management time spent in dealing with regulators is also significantly higher. Both Central and State Governments are aware of these problems and are exploring strategies for reforming the administrative structure.

### **The Role as a Provider of Infrastructure**

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While the Government has taken a number of measures in the past to improve the availability and the quality of infrastructure, there is little doubt that infrastructure facilities are below what could be termed optimal to support India's growth potential (Ch 3 and 4 discuss this issue in detail). Sunrise sectors like IT have their specific infrastructure needs that have to be met if their growth momentum is to be sustained.

Given these pressures, the Government has to play an active role in improving infrastructural facilities. Given the quantum of the need, it is impossible for the Government to attempt to provide everything on its own and a large amount of both domestic private and external funds are necessary to bridge the gap.

In the past, the desired amount of private domestic or Foreign Direct Investment did not flow to the infrastructure sector for a number of reasons. User charges in key infrastructure sectors like power have not been determined by the market, entry norms in these sectors have not been clearly defined. However regulation had potential for large scale improvements and over the last few years, the Government has taken a number of initiatives to rectify these problems and create a healthy environment for investment inflows. Independent regulators for sectors like power and telecom have been set up both at the Central and State levels, who are given the freedom to set tariffs. Entry norms have been simplified with particular emphasis on enabling private sector participation. FDI norms have also been eased considerably. The recently enacted Electricity Act, for instance, introduces a comprehensive framework for reform in virtually every aspect of the sector (See Chapter 3).

### **The Role as Investor in Social Sectors**

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Social sectors like health and education are critical to the development process. However, these sectors are susceptible to 'market failure' in the sense that the market, on its own, cannot ensure that optimal amounts of these public goods & services are provided. Returns on projects in these sectors are often too low to invite significant participation and charging market rates may mean that the sections of society which need these goods and services the most may not be able to afford them. Besides, the Government needs to focus on programmes specifically targeted at vulnerable groups. Thus, it needs to undertake investments in programmes aimed at poverty alleviation or providing employment in times of crisis such as crop failure.

Therefore, in these sectors, the Government needs to be an active investor. Total investment by the Central Government in community, social & personal services was US\$ 7.3 billion in 2001-02 and by the State Governments' (on developmental expenditure on social services) was US\$ 29 billion in 2003-04. As the Government steps out of other sectors, it should ideally step up the investment levels in the social sectors. While there is no mechanical yardstick by which the 'optimal quantum' of social sector investments can be determined, the National Common Minimum Programme of the Government targets investments in these sectors at 6 per cent of GDP over the medium term.

The Government has historically been a key participant in investments in social sectors, spanning an entire range of sectors and activities. Table 2.1 lists some of the key programmes that the Government has undertaken along with allocations made to them.

**Table 2.1: Social Sector Initiatives**

Sector	Programme	Objective	Outlay /Period
Education	Janshala	To make primary education more accessible and effective, especially for girls and children in deprived communities, covering 139 blocks in 9 states	US\$ 21.4 mn (1998-2002)
	Sarva Shiksha Abhiyan	<ul style="list-style-type: none"> <li>All children (in age group 6-14) in school by 2003</li> <li>All children (6-14) to complete 5 years of primary education by 2007</li> <li>All children (6-14) to complete 8 years of schooling by 2010</li> </ul>	US\$ 198 mn (2000/01 to 2001/02)
Rural Development	Jawahar Gram Samridhi Yojana	To create need-based rural infrastructure at village levels; to boost rural economy in general and improvement of quality of life in particular. Also provides individual assets to the poorest of the poor SC/ST families	US\$ 5487 mn (1990/91 - 2001/02)
Food and Nutrition	Integrated Child Development Scheme	To improve the nutritional status of pre-school children and pregnant and lactating women. The initial geographic focus was on drought-prone areas and blocks with a significant proportion of SC/ST population	US\$ 925 mn (1995/96-2000/01)
Poverty	Swarnjayanti Gram Swarozgar Yojana (SGSY)	To bring the poor families above the poverty line by organising them into Self Help Groups (SHGs) through the process of social mobilisation, training and capacity building and provision of income generating assets through a mix of bank credit and government subsidy	US\$ 162 mn (2001/02)

Source: Government Documents

The budget for the current fiscal year 2004-05 also has a number of measures for the social sectors that are in keeping with the National Common Minimum Programme. Some of the major initiatives are as follows:

- Antyodaya Anna Yojana to cover 20 million families with a subsidy of nearly US\$ 730 million
- National Employment Guarantee Act to guarantee an employment of 100 days in a year to one able-bodied person in every poor household
- Food for Work programme in 150 districts classified as most backward and identified as areas in immediate need of such a programme
- The allocation for programmes concerning the Scheduled Castes is US\$ 246 million and for Scheduled Tribes is US\$ 240 million
- Additional allocation of US\$ 10.4 million made for the National Minorities Development and Finance Corporation
- About US\$ 1 billion in a full year to be earmarked for education, including provision of a nutritious, cooked mid-day meal
- Universal Health Insurance Scheme exclusively for persons and families below the poverty line with an outlay of US\$ 8.3 million

## **The Government as Partner in Investment Schemes**

In a number of instances, both public and private participation - on their own, have been found inadequate in providing the quantum of infrastructure required. In urban development, for instance, the private sector may face hurdles in assembling large chunks of contiguous land, face delays in approvals from local authority etc. On the other hand, the public sector could face constraints with lack of expertise or lack of commitment to quality. Thus there is potential for a synergistic partnership between the public and private sectors in infrastructure projects of this nature and the Public-Private Partnership (PPP) model is an important way of tapping these synergies.

To encourage the above synergies, the Indian Government has recently issued guidelines for support to public-private partnerships in infrastructure. It has proposed provision of support through 'viability gap funding' (Box).

### **Box 2.4: Guidelines for Support to PPP in Infrastructure**

#### **Criteria**

To be eligible for funding under PPP, the project must be implemented with at least 40 per cent private equity and must be related to road, railways, seaports, airports, power, water supply and sewerage or international convention centres. The total support from the Government, States and other agencies, must not exceed 20 per cent of the total project cost. The extent of viability gap funding shall be determined on the basis of the net present value of the actual viability gap, where the interest rate on 10-year gilts will be the rate of discount.

#### **Funding**

- Viability gap funding can be in the form of capital grant, subordinated loans, Operations & Management (O&M) support grants or interest subsidy
- Funding will be contingent on physical and performance levels achieved
- Funding will be provided in instalments with at least 15 per cent of the funding to be disbursed only after the project is fully functioning

#### **Appraisal and Approval procedures**

An empowered committee will consider the project proposals with viability gap funding of up to US\$ 11 million. The Finance Minister will approve viability gap funding beyond US\$ 11 million. The project proposal should be accompanied by an appraisal by a public financial institution and a letter of commitment on behalf of the lending institutions.

One of the most successful applications of public-private partnerships has been in the roads sector. The following box encapsulates the modes of this partnership.

### **Box 2.5: PPP in India – the Roads Sector**

The roads sector in India is a good example of PPP in Indian infrastructure. Of the various modes of collaboration between the public and private sectors in the roads sector, two examples are:

#### **The SPV model:**

In this model, the National Highways Authority of India, the government agency invests around 30 per cent of the project as equity, with the clear intention of offloading its stake after the project is completed. The private sector partner contributes 5-10 per cent and the balance is raised from the market. Till date about 13 projects have been implemented through the SPV route.

### **BOT- Annuity Based Projects**

Under this model, the private concessionaire is responsible for the construction and maintenance of the project highway and NHAI makes a semi-annual payment to the concessionaire. The concession contract is awarded to the bidder quoting the lowest annuity amount. Under this approach, there is no direct reference to the number of vehicles using the highway and hence the traffic risk is borne by the Government. Eight projects have been awarded by the NHAI under this scheme.

### **The Government Investment Nexus: Conclusion**

Though in the post liberalisation environment, the Government has withdrawn from a number of production activities, it is still a major participant in the investment process. It remains the provider of public goods in social sectors that are known to be prone to market failure. It is also an enabler of private investment and can improve the investment environment for the private sector through governance initiatives. The steps towards improving governance include measures to reduce the regulation and make the process of entry easier, for both domestic private investors and foreign investors. This is particularly true of the infrastructure sector where there is a wide gap between actual investments and the optimal or desirable levels to support a higher growth momentum. Finally, it has to be an active partner of the private sector in public-private partnership projects in order to bring together the synergies of the government and the private sector to a fruitful fusion.