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Service Sector Liberalisation in India: Key Lessons and Challenges

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ABSTRACT

The service sector is one of the fastest-growing sectors in the Indian economy. It has been integral to India's overall liberalisation and structural reform programme, which was initiated in the 1980s and gained momentum after 1991. The increasing significance of India's service sector has, however, raised issues and concerns that need to be addressed domestically, in consultation with relevant stakeholders, and externally, in consultation with key trade and investment partners. The paper analyses the liberalisation and structural reform process carried out in India's service sector since 1991 and the key lessons to be learned. It considers a representative set of services from different subsectors, namely telecommunication (infrastructure), banking (financial), higher education (social) and retail distribution (commercial) services, to understand the liberalisation process and the challenges faced in undertaking various reform measures.

The paper shows that the liberalisation process has involved a series of regulatory and non-regulatory measures involving the government and other stakeholders. The reforms have been challenging and have evolved over time, often involving a process of learning through experience. In subsectors where liberalisation has been successful, this has resulted in increased efficiency and productivity in that service sector and often in related sectors. Where conflicting views of stakeholders have impeded the reforms process, only partial and halting liberalisation has been possible.

Overall, the paper reflects that the market structure and domestic policies and frameworks have shaped the pace and extent of liberalisation across different services in India. To be successful, liberalisation has to be supported by regulatory and legislative reforms, and a strengthening of regulatory and enforcement capacity. Instituting appropriate regulatory bodies, clearly defining their roles and improving governance are just as important as pursuing liberalisation.

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ABBREVIATIONS AND ACRONYMS

AtB	at the border
BiB	behind the border
BPO	business process outsourcing
DOT	Department of Telecommunications
DFI	development finance institution
FDI	foreign direct investment
FIPB	Foreign Investment Promotion Board
GATS	General Agreement on Trade in Services
GDP	gross domestic product
ICRIER	Indian Council for Research on International Economic Relations
INR	Indian rupee
IT	information technology
NPA	non performing asset
NTP	National Telecom Policy
RBI	Reserve Bank of India
TRAI	Telecom Regulatory Authority of India
TRI	trade restrictiveness index
UGC	University Grants Commission
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

INTRODUCTION

The rapid growth of India's service sector in the post-reform era has played a critical role in the country's emergence as one of the fastest-growing economies in the world in recent years. The service sector has also facilitated India's integration with the world economy through trade and investment. Its services exports have grown significantly, from less than \$10 billion in 1997 to over \$90 billion by 2009.¹ India's share in global services exports has risen from 0.5% in 1995 to over 2% in 2009.² The sector's share in the country's exports has risen from less than 18% in 1996 to over 35% in 2009³ and is expected to surpass merchandise exports by 2012.⁴

The current dynamism exhibited by India's service sector is largely a reflection of the liberalisation and reform process carried out in this sector and in the wider economy since the 1990s. However, this process has been fraught with debate and controversy over the desired pace, extent and implications of these reforms. These issues and concerns have varied across different kinds of services. Some have been liberalised rapidly and extensively for both domestic and foreign participants. Other services remain limited for private participation or have been opened up mainly for domestic players and remain closed to the presence of foreign establishments. Although considerable liberalisation and regulatory reforms have taken place over the past decade or more, the process has been slow and halting for some services. Key pieces of legislation have taken a number of years to be passed, owing to domestic stakeholders' sensitivities, a lack of political will and consensus, and a variety of social and economic concerns.

The paper provides an overview of the liberalisation and reforms carried out in India's service sector since 1991. It outlines recent trends in terms of the sector's growth performance and its contribution to the overall economy and trade. It then explores the nature of India's services liberalisation and reforms in selected service sectors, highlighting the outcomes, concerns and future challenges for each. The paper briefly discusses India's multilateral negotiations for various services, and concludes by highlighting the lessons to be learned from India's experiences of service sector liberalisation.

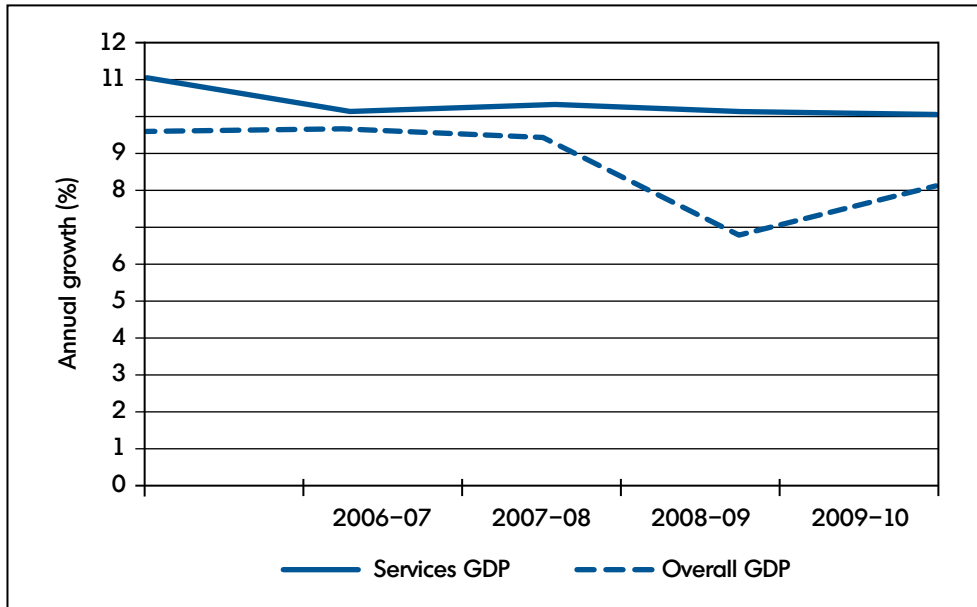
TRENDS IN INDIA'S SERVICE SECTOR

The service sector has been a major contributor to the high growth rates experienced by the Indian economy in recent years. The average annual growth rate of services rose from 7.7% in 1994–95⁵ to 10.1% in 2009–10.⁶ Figure 1 (see page 6) shows the annual growth rates of services and overall gross domestic product (GDP) from 2005–2010.

The sector registered superior performance compared to industry and agriculture, and exceeded the overall growth of the economy for the period under review. The changing sectoral profile of India's GDP and the growing significance of services is shown in Figure 2 (see page 6).

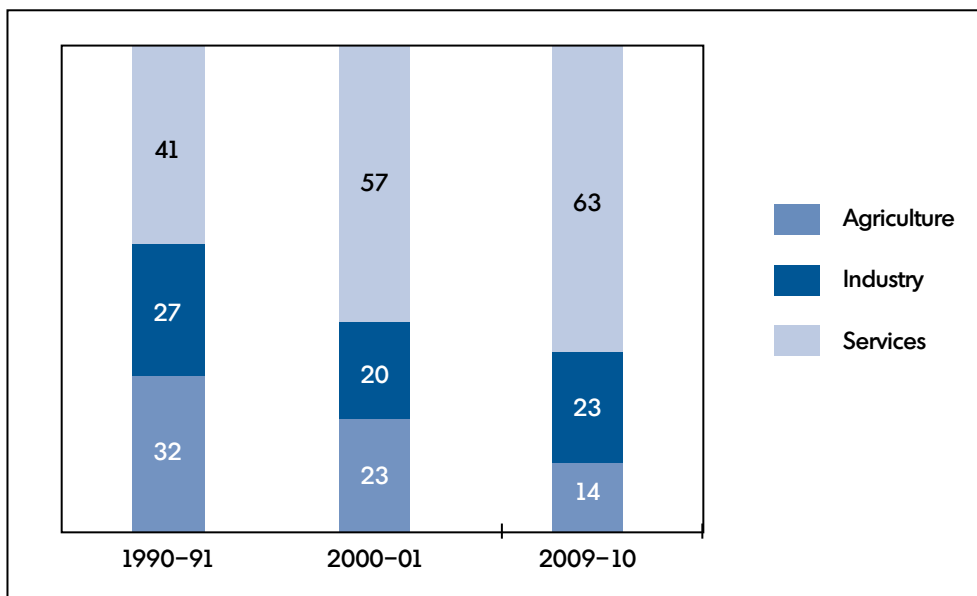
Given the performance of India's service sector, its contribution to overall GDP has increased sharply, from 41% in 1990–91 to 63% in 2009–10.⁷ The shares of agriculture and industry declined over this period. The growth performance within the service sector itself has, however, varied across subsectors. Table 1 (see page 7) shows the yearly growth rates for all the subsectors for the 2005–10 period.

Figure 1: Annual growth rates of services GDP and overall GDP in India (%), 2005–10



Source: India, Ministry of Finance, *Economic Survey 2010–11*. New Delhi: Government, 2011, p. 238; reproduced from Figure 10.1

Figure 2: Changing sectoral composition of India's GDP (%), 1990–2010



Source: Authors' calculations based on information from the Central Statistical Organisation and the Government of India's Economic Survey of various years

Table 1: Annual growth rates in service subsectors in India (%), 2005–10

Service Sector	2005–06	2006–07	2007–08	2008–09 ^a	2009–10 ^b
Construction	12.8	10.3	10.7	5.4	7.0
Trade, hotels and restaurants	12.2	11.0	10.0	5.5	6.7
Trade	11.7	10.7	9.7	6.5	7.2
Hotels and restaurants	17.5	14.4	13.1	-3.1	2.2
Transport, storage and communication	12.2	12.7	12.9	11.1	15.0
Railways	7.5	11.1	9.8	7.6	9.4
Transport by other means	9.3	9.0	8.7	5.2	7.0
Storage	4.7	10.9	3.4	10.5	10.7
Communication	25.5	24.9	25.4	25.8	32.1
Financing, insurance, real estate and business services	12.7	14.0	11.9	12.5	9.2
Banking and insurance	15.9	20.6	16.7	14.0	11.3
Real estate, ownership of dwellings, and business services	10.6	9.5	8.4	11.2	7.5
Community, social and personal services	7.0	2.9	6.9	12.7	11.8
Public administration and defence	4.2	2.0	7.6	20.2	13.0
Other services	9.1	3.5	6.3	7.4	10.9

a Provisional estimates showing government's figures based on analysis of raw data collected.

b Quick estimates showing government's preliminary findings based on raw data.

Source: India, Ministry of Finance, *Economic Survey 2010–11*. New Delhi: Government, 2011, p. 243

Communication services registered the highest growth rates during this period, with an average growth rate of 26.7%.⁸ Other subsectors, such as trade, hotels and restaurants, construction, financing, insurance, real estate and business services, have also grown rapidly in recent years.

Table 2 (see page 8) reflects the share of employment of the basic sectors in the Indian economy for the years 1993–94, 2004–05 and 2007–08.

Table 2: Share of employment per sector in India (%), 1993–94, 2004–05 and 2007–08

Year	Primary	Secondary	Tertiary
1993–94	64.5	14.3	21.2
2004–05	57.0	18.2	24.8
2007–08	55.9	18.7	25.4

Source: India, Ministry of Finance, *Economic Survey 2010–11*. New Delhi: Government, 2011, p. 238

Although the primary sector (predominantly agriculture) was the dominant employer, the share of employment in the tertiary sector (predominantly services) increased over the years. The share of the primary sector in employment fell sharply between 1993–94 and 2004–05. The consequent rise in the share of employment in the secondary (predominantly industry) and tertiary sectors was fairly balanced between the two.⁹

The contribution of the service sector to India's trade and foreign direct investment (FDI) flows has also grown significantly over the past decade, facilitating India's integration with the world economy. Table 3 shows India's service sector exports and imports and its share in world exports and imports of services from 1998–2009.

Table 3: India's services trade and share in world services exports and imports, 1998–2009

Year	Exports of India's services (\$ billion)	Imports of India's services (\$ billion)	India's share in world exports of services (%)	India's share in world imports of services (%)
1998	11.7	14.5	0.8	1.0
1999	14.5	17.3	1.0	1.2
2000	16.7	19.2	1.1	1.2
2001	17.3	20.1	1.1	1.3
2002	19.5	21.0	1.2	1.3
2003	23.9	24.9	1.3	1.3
2004	38.3	35.6	1.7	1.6
2005	52.5	47.3	2.1	1.9
2006	69.7	58.7	2.4	2.1
2007	87.0	70.5	2.5	2.2
2008	102.9	87.9	2.6	2.4
2009	91.1	74.4	2.7	2.3

Source: UNCTADStat, United Nations Conference on Trade and Development (UNCTAD) database, International Trade in Services, <http://unctadstat.unctad.org>, accessed 3 March 2011

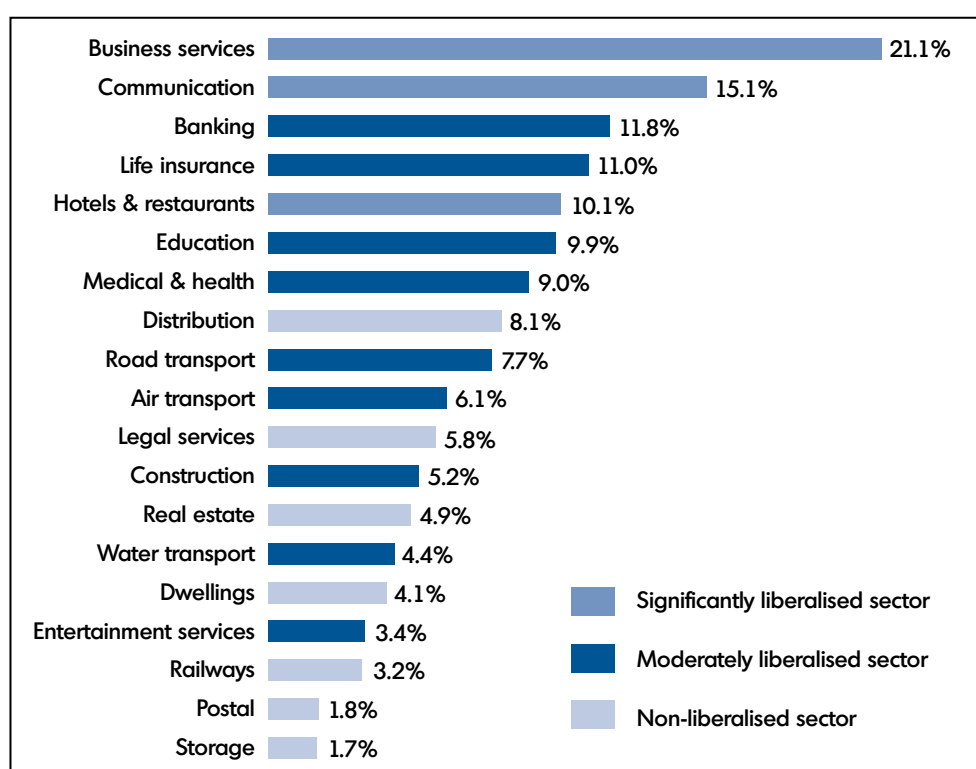
Owing to such dynamic growth in service sector exports, India's share in the world exports of services more than tripled from 1998 to 2009. It consistently exceeded India's share in world merchandise exports, which also increased from 0.6% in 1998 to 1.3% in 2009.¹⁰

The service sector increased its contribution not only to India's GDP but also to India's trade. It has proven integral to India's overall liberalisation and structural reform programme, which was initiated in the 1980s and gained momentum after 1991.

SERVICE SECTOR LIBERALISATION AND REFORM¹¹

The growth witnessed in India's service sector is largely due to domestic liberalisation and growing linkages with external markets. A 2004 World Bank study¹² shows a positive correlation between the extent of liberalisation and growth in different service subsectors in India. Although this study shows growth rates of selected service sectors during the 1990s, it is still useful in highlighting the positive impact of service sector liberalisation on growth and employment. The study finds that services that have been liberalised the most in terms of trade and FDI policies have typically experienced higher growth rates and employment creation opportunities. Figure 3 shows the liberalisation and growth linkages in India's service sector for the 1990s.

Figure 3: Liberalisation and growth linkages in India's service sector (%), 1990s



Source: World Bank, *Sustaining India's Services Revolution: Access to Foreign Markets, Domestic Reform and International Negotiations*. Washington, DC: World Bank, 2004, p. 16, reproduced from Figure 6

The highest growth segments were business and communication services. This was followed by banking and life insurance services, which were also classified as significantly

liberalised sectors. Storage, postal and railways services registered the lowest growth rates, and were classified as non-liberalised or more-restricted sectors. Several services that experienced moderate growth rates had generally undergone moderate liberalisation. Some segments, such as distribution services, registered reasonably high growth rates despite their limited liberalisation, which was mainly due to the overall buoyancy of the Indian economy and growing domestic demand. The growth dynamics of India's service sector reflected domestic economic conditions and the outcome of liberalisation and reforms in the sector and in the wider economy.

The following discussion highlights the nature of liberalisation and regulatory reforms that have been undertaken in selected services, and the challenges that have arisen in the process.

TELECOMMUNICATION SERVICES¹³

The telecommunication service sector is perhaps the showpiece of India's liberalisation and reform programme. The roadmap for reforms was laid down by major national policy frameworks following the introduction of an extensive reform programme in 1991. The most significant aspect of these reforms has been the consistent liberalisation of FDI restrictions, in both the basic and value-added segments, and the gradual removal of restrictions on private participants. The Department of Telecommunications (DOT) has been restructured, with its monopoly status as a telecommunication service provider gradually reduced and eventually eliminated.

Liberalisation process

Telecommunication reforms commenced with the introduction of the National Telecom Policy (NTP) of 1994.¹⁴ This policy called for the systematic liberalisation of the sector by opening up basic services to private telecommunication companies and setting up an independent statutory regulatory body, the Telecom Regulatory Authority of India (TRAI), in 1997. The first major step in the sector's liberalisation was the entry of private participants into the basic telecommunication services segment in 1997, to supplement the DOT's services and to help achieve universal access targets. Entry was permitted on a duopoly basis, with both the DOT and private participants participating in this segment. Licences were rationed and foreign equity participation in both basic and cellular mobile services was permitted up to 49%.¹⁵

These initial years of telecommunication reforms, however, were not very successful owing to insufficient liberalisation and unmet targets. The DOT retained its monopoly over national long-distance telephony until the year 2000. Although the market was divided into separate zones, called 'telecommunication circles', private participants could only provide intra-circle long-distance services, while the government provider was permitted to provide both intra-circle and inter-circle long-distance calling services. Thus, although competition was permitted between the public provider and a limited number of private participants, an uneven playing field remained. The regulatory framework was also to blame. The DOT and TRAI experienced conflicts of interests on several occasions. This was because of the latter's lack of autonomy over issues such as the issuance of licences,

setting terms and conditions for service providers, setting tariffs, or overriding decisions taken by the DOT. Such conflicts adversely affected the credibility of the regulator in the initial years of liberalisation.

The second phase of telecommunication reforms began with the introduction of the NTP of 1999¹⁶ under a new government. The policy stated its commitment to an independent regulator and more clearly defined the role of TRAI. Several liberalisation initiatives and changes in telecommunication legislation have taken place since 1999. In August 2000 national long-distance telephony was opened up to private operators, as was intended under the NTP of 1999. In 2001 unlimited entry was permitted in each policy circle for the provision of basic and mobile services. The licence regime was migrated from a fixed fee scheme to one of revenue sharing. In April 2002 the international long-distance service was opened up to competition by privatising the public provider and removing restrictions on the number of operators in this segment. Other liberalisation measures undertaken after 1999 include the opening up of internet telephony; disinvestment and corporatisation of public sector telecommunication providers in some metros; introduction of new technologies and forms of service delivery; and approval for internet service providers to set up international internet gateways.

Since February 2005 the government has increased the foreign holding limit from an earlier limit of 49% to 74%. The affected services are fixed-line basic services, cellular services, unified access services, national and international long-distance telephony, public mobile trunked services, global mobile personal communication services, and various value-added services such as voice mail and e-mail services.¹⁷ Subsequently, FDI was permitted up to 100% in value-added services such as e-mail, voice mail, electronic data interchange, on-line information and data processing, and internet service provision without gateways.¹⁸ Competition was encouraged, with the entry of both local and foreign providers, the granting of greater flexibility to existing participants with the waiver of various obligations and permission to provide additional services, and substantial reductions in entry and licensing fee shares from providers.

Empirical estimation¹⁹

Doctoral research, titled 'Regulatory barriers affecting factor mobility in trade in services: Measurement and implications', by one of the authors of the paper quantifies the qualitative nature of regulatory barriers affecting telecommunication services to assess the trends of liberalisation in the sector. The regulatory barriers fall into two categories – 'at the border' or AtB barriers and 'behind the border' or BtB barriers. AtB barriers affect entry decisions of foreign firms, such as FDI limits and joint venture agreements, whereas BtB barriers affect ongoing operations of the foreign firms such as market structure, licensing requirements and tax structure. The empirical estimation differentiates between AtB and BtB barriers. Accordingly, two types of restrictiveness indices are calculated. These are the total trade restrictiveness index (Total TRI), showing quantification of regulatory barriers in both AtB and BtB categories, and the 'behind the border' trade restrictiveness index (BtB TRI), reflecting the quantification of the regulatory regime arising only from BtB regulations. The restrictiveness indices are calculated by assigning weights to various regulatory barriers and are calculated over a period of time from 1995 to 2010 at four different points, namely 1995, 2000, 2005 and 2010.

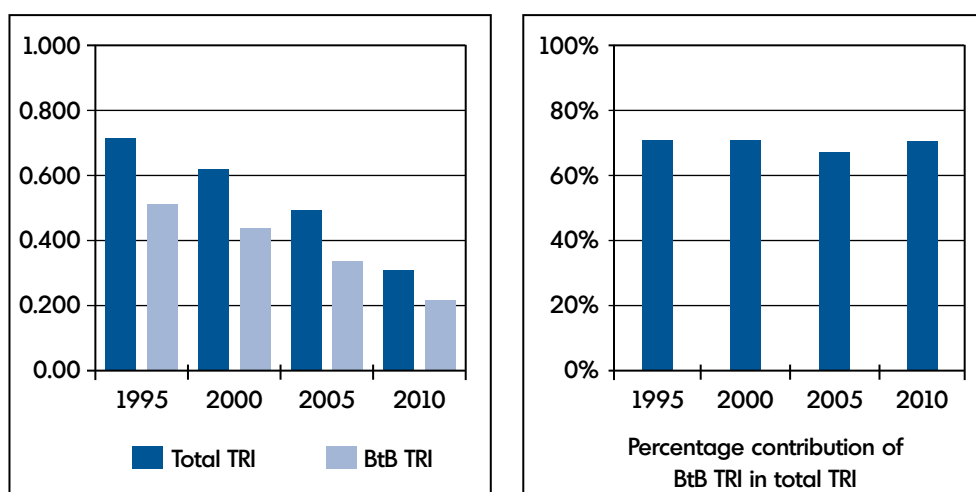
Tables 4 and 5 and Figures 4 and 5 present the Total TRI and BtB TRI, as constructed for fixed and mobile telecommunication services in India for 1995, 2000, 2005 and 2010.

Table 4: Total TRI and BtB TRI for telecommunication services (fixed) in India, 1995, 2000, 2005 and 2010

Year	Total TRI	BtB TRI	Contribution of BtB TRI in Total TRI (%)
1995	0.716	0.511	71
2000	0.621	0.441	71
2005	0.491	0.333	68
2010	0.309	0.219	71

Source: Authors' own calculations

Figure 4: Total TRI and BtB TRI for telecommunication services (fixed) in India, 1995, 2000, 2005 and 2010



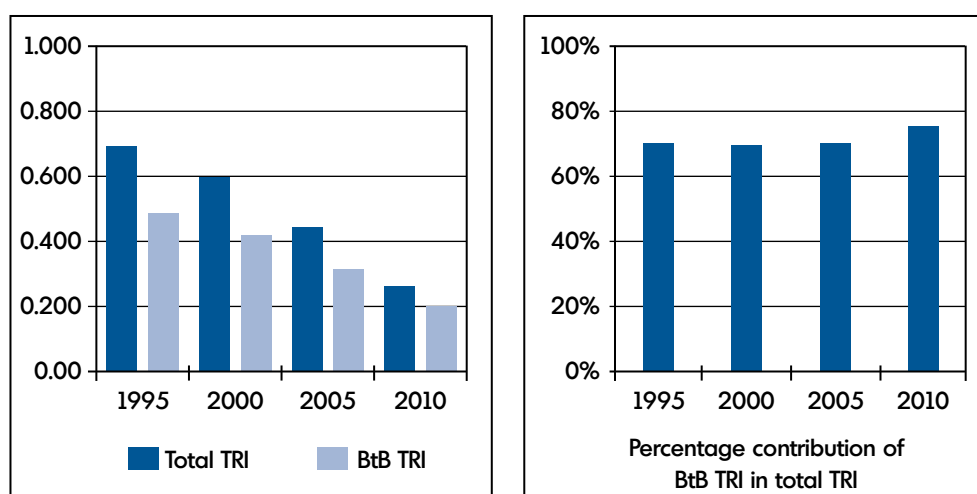
Source: Authors' own calculations

Table 5: Total TRI and BtB TRI for telecommunication services (mobile) in India, 1995, 2000, 2005 and 2010

Year	Total TRI	BtB TRI	Contribution of BtB TRI in Total TRI (%)
1995	0.697	0.492	71
2000	0.602	0.423	70
2005	0.447	0.315	70
2010	0.265	0.201	76

Source: Authors' own calculations

Figure 5: Total TRI and BtB TRI for telecommunication services (mobile) in India, 1995, 2000, 2005 and 2010



Source: Authors' own calculations

There was a significant decline in both the Total TRI and BtB TRI over the years. This indicated that both AtB and BtB regulations, which affected foreign commercial presence in Indian telecommunication services, had been liberalised considerably. The significant drop was because of increased FDI limits (74% in 2010), the simplification of the FDI-approval process, and an evolution of the competitive market structure.²⁰ The changes in the BtB TRI were due to the easing of licensing procedures, the removal of some restrictions on value-added services and the introduction of easier tax laws. The indices were very low in 2010, which showed a highly liberalised telecommunication sector in India.

Outcome

The outcome of reforms in telecommunication services has been striking. This is reflected in the network expansion, productivity improvements, increased number of lines in operation, reductions in prices and waiting lists, increased demand for basic and value-added services, and increased teledensity in rural and urban areas. Liberalisation has led to a growing number of telecommunication operators. The private sector outnumbers public sector providers, although the latter continues to dominate both the fixed services and cellular segments in terms of market share, particularly in the urban areas. Reform measures and technological advances have resulted in changes in the sector's profile. Value-added and mobile telephony have become the fastest-growing segments and growth drivers.

The liberalisation of the telecommunication sector in India has led to rapid growth and benefited consumers through lower tariffs and increased competition, with the telecommunication service price index falling from 100 in 2004–05 to 85.08 in 2007–08. The sector has grown from a level of 22.8 million telephone subscribers in 1999 to 54.6 million in 2003, and to a further 764.77 million at the end of November 2010. Wireless telephone connections have contributed to this growth. The number of wireless connections rose from 3.57 million in March 2001 to 729.58 million by November 2010. Teledensity, which was 2.32%, increased to 64.34%.²¹

Overall, the liberalisation and regulatory reform experience in the telecommunication sector has been a successful one. However, it has also been subject to various challenges, which have included the introduction of and changes in regulations and frameworks, redefining responsibilities for the regulator, and evolving approaches to market entry and equity.

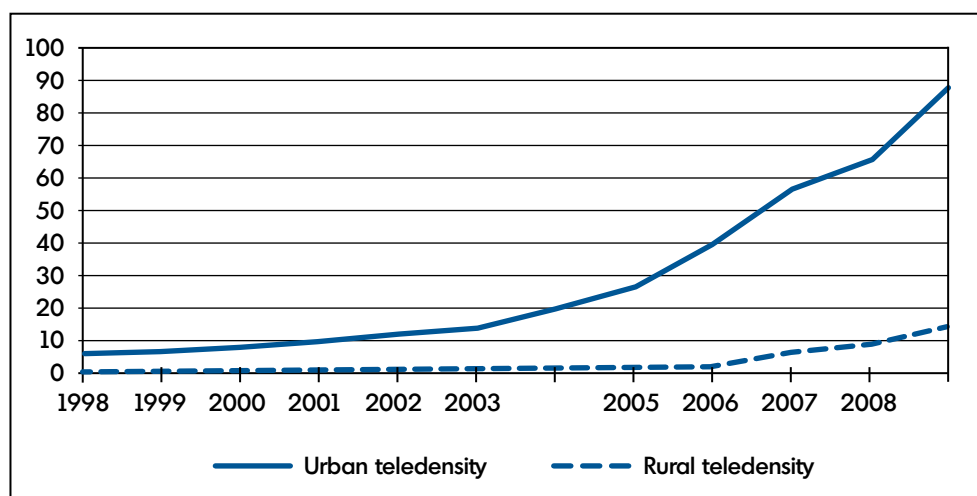
Concerns and future challenges

Notwithstanding such growth and benefits, certain critical issues remain in India's telecommunication sector. One challenge is infrastructure, particularly the availability of spectrum or the prescribed electromagnetic frequency range, which is currently in short supply. Further reductions in bandwidth costs are essential, as first-mile costs for Indian business process outsourcing (BPO) providers remain higher than those abroad. Lower bandwidth costs would help to increase the competitiveness of Indian BPO providers.

There is also a concern about transparency in spectrum allocation. The 2G spectrum allocation process, which is under the scrutiny of Indian investigation agencies, revealed the possible misuse of decision-making power by the concerned authorities. The licences were awarded on a first come, first served method, rather than through the process of auction, as stipulated under the NTP of 1999. Moreover, the ministry reduced the cut-off time for licence application without consulting and informing other related ministries, and without mandatory approval from the cabinet committee for such important decisions. According to estimates of the Comptroller and Auditor General of India, the changing policy stance and non-transparency in 2G spectrum allocation has resulted in a loss of approximately INR²² 1.7 trillion to the exchequer.²³

Another area of concern is the urban–rural divide, which has increased significantly post-liberalisation. This is mainly because of the largely urban coverage of the fast-growing mobile telephony segment, which has overtaken the fixed-line segment. This growing divide is shown in Figure 6.

Figure 6: The urban–rural divide in the telecommunication sector in India, 1998–2009



Source: Authors' calculations based on Indiatat, database, <http://www.indiatat.com>

Universal service obligations and regulatory mechanisms that promote equity with efficiency are also an important concern as India's telecommunication sector is liberalised further. The new competition regime under the Competition Commission of India, and the existing regulatory body in the telecommunication sector, TRAI, will both need to ensure that profitability of telecommunication providers and efficiency are not at the cost of social obligations. It is also important that they avoid regulatory conflicts, especially given the growing convergence of communication services.

BANKING SERVICES²⁴

The banking system reforms and liberalisation began in the 1992–1997 period with a cautious and progressive approach. The subsequent reforms have been in line with the three broad objectives of relaxing external constraints affecting the banking sector, strengthening the banking system, and putting in place an institutional framework to oversee its functioning.

Liberalisation process

Key banking sector liberalisation measures include the phasing out of directed credit; deregulation of interest rates; introduction of BASEL/Bank for International Settlements norms for capital adequacy; tightening of prudential norms; allowing of participation by domestic private banks; reducing of restrictions on entry by foreign banks; sale of bank equity to the public; and phasing out of privileged access to funds by development finance institutions (DFIs) and increasing competition in lending between DFIs and banks. These measures have been implemented gradually to increase the efficiency and profitability of the public sector banks and to improve the safety and soundness of the banking system. Bank branching policy and entry norms for private domestic and foreign banks have been liberalised steadily. Since 1993 the Reserve Bank of India (RBI) – the Central Bank, which is the regulator of the banking system – has allowed entry of private sector banks to increase competition. In 1996 guidelines were issued for setting up new private local area banks to increase competition in rural banking.²⁵

FDI limits in the banking system have been raised slowly. Before, only minority participation of up to 20% was permitted for foreign banking companies or financial companies in private Indian banks. This could be accomplished through technical collaboration or through the Foreign Investment Promotion Board (FIPB) route. A 40% limit was set for non-resident Indians and associated borrowers from overseas commercial banks.²⁶ In May 2001 this limit was increased to 49% from all sources on the RBI's automatic route. This means that no prior approval would be required from the FIPB, subject to the Central Bank's guidelines. This limit was further raised to 74% in the 2004–05 budget, with the provision that at least 26% of the paid-up capital be held by residents, except in the case of wholly owned subsidiaries of a foreign bank. The form of establishment by foreign banks was also relaxed. Before, foreign banks were allowed to operate only through branches. Now, the current FDI policy allows foreign banks to operate in India through branches, wholly owned subsidiaries and subsidiaries.²⁷

Measures have also been introduced to improve the operating norms and practices of the banking system. Prudential norms have been implemented for capital adequacy, income recognition, asset classification, provisioning, accounting and valuation practices, exposure limits, and transparency and disclosure practices. The objective of these measures is to move the Indian banking system towards international best practices and standards.

Empirical estimation²⁸

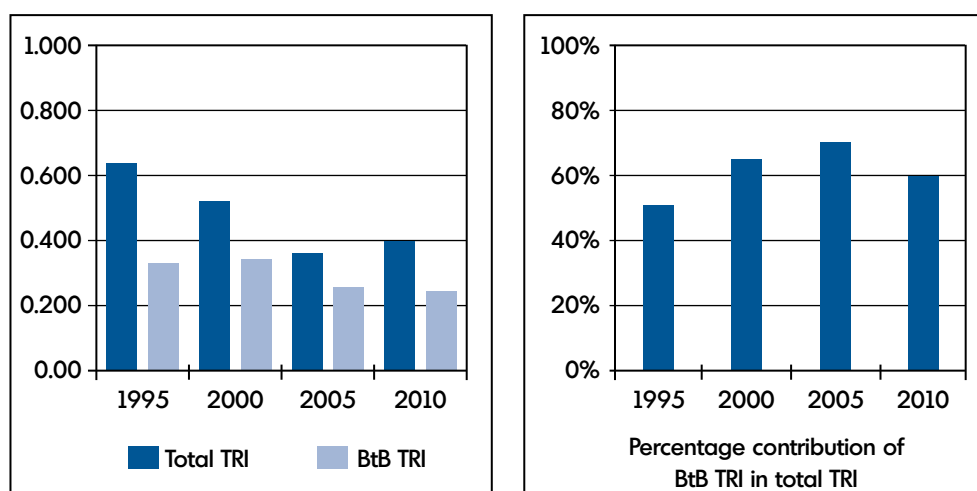
As with telecommunication services, restrictiveness indices have been estimated for banking services over a period of time from 1995 to 2010 at four different points, namely 1995, 2000, 2005 and 2010. These are given in Table 6 and Figure 7.

Table 6: Total TRI and BtB TRI for banking services in India, 1995, 2000, 2005 and 2010

Year	Total TRI	BtB TRI	Contribution of BtB TRI in Total TRI (%)
1995	0.639	0.329	51
2000	0.522	0.341	65
2005	0.360	0.254	70
2010	0.397	0.241	61

Source: Authors' own calculations

Figure 7: Total TRI and BtB TRI for banking services in India, 1995, 2000, 2005 and 2010



Source: Authors' own calculations

Table 6 and Figure 7 show a decreasing trend in the index for banking services. This trend was mainly because of the increased limit for foreign equity participation in private banks in India, easing of the FDI-approval process, and the granting of establishment rights to

wholly owned subsidiaries of foreign banks in India over the period under consideration. The RBI released a road map for the presence of foreign banks in India in February 2005, which proposed significant liberalisation of various AtB and BtB regulations.²⁹

Although Table 6 indicates a decreasing trend over time, the index value slightly increased in 2010 compared with 2005. This was because of an additional condition imposed on the FDI-approval process in 2010. Under the FDI policy of 2005,³⁰ FDI in banking services was allowed fully through the automatic route. In 2010 the government stipulated that FDI in banking services would be allowed through automatic route only up to 49%; and between 49% and 74% through the government route.³¹

Certain conditions remain for foreign investment in the banking sector. Foreign banks operating as subsidiaries are required to set up at least one-quarter of their total branches in rural and semi-urban areas; although licensed branches are not subject to rural branching requirements. Foreign banks, as with domestic banks, are subject to credit disbursement obligations to the priority sector. Moreover, the share of foreign bank assets in total banking assets is not allowed to exceed 15%, and FDI and portfolio investment in nationalised banks are subject to an overall 20% statutory limit. Voting rights for shareholders of foreign banks are restricted to 10%, although this restriction will probably be relaxed in the near future.

Outcome

The liberalisation of operations in the banking sector has affected this sector in many ways. It has resulted in both domestic and foreign structural changes, the most important being increasing private participation. The share of private sector banks in total banking system assets has risen over the years. However, public sector banks continue to dominate the banking system.

Banking sector reforms have helped to improve the profitability of the banking system. This is reflected in their operating and net profits, and improved intermediation indicators. The entry of private banks has resulted in greater competition for public sector banks for the loaning of funds. The entry of other financial institutions (such as non-banking financial companies and development finance institutions) has also led to increased competition for public sector banks in sourcing funds. The net result has been an improvement in the overall efficiency of the banking system. These include reductions in overhead expenses and interest margins for domestic banks, and greater pressure on the public sector banks to improve the quality of their services. The efficiency gains have been the most significant in the case of public sector banks. Deposit mobilisation and other indicators, such as disbursement of credit, per person deposits and per person credit availability, have shown considerable improvement. The spread of the banking sector has also increased.

Table 7 (see page 18) shows the trends in some of the major performance indicators of the scheduled commercial banks in India between 1996–97 and 2006–07.

The RBI, which regulates the banking system, has also taken steps to address governance and ownership issues in private sector banks. This is in response to problems created by poor risk management and lending practices of some private sector banks following deregulation, which caused a decline in their asset quality and posed risks to depositors. In July 2004 the RBI issued guidelines to ensure a diversified ownership structure in private sector banks, better capitalisation, and fair and transparent processes.

The guidelines restrict the ownership of private banks through cross holdings by capping the stake of private and foreign banks operating in India in other private banks to 5% (previously 30%). They also put a 10% cap on a single entity with regard to the ownership structure, which restricts promoter holding to 10%.³²

Thus banking sector reforms have included prudential measures, competition-enhancing measures, steps to increase the role of market forces, and the introduction of institutional, legal, supervisory, and technology-related measures. These have led to considerable improvements in profitability, asset quality and operating conditions.

Table 7: Major performance indicators of commercial banks, 1996–97 and 2006–07

Performance indicator	Foreign banks		Private sector banks		Nationalised banks	
	1996–97	2006–07	1996–97	2006–07	1996–97	2006–07
Business per employee (INR Lakhs^a)	474.02	996.08	210.43	697.75	72.91	490.21
Capital risk-weighted assets ratio (%)	62.58	12.00	12.47	12.10	8.67	12.50
Net NPA^b as percent to net advances	3.69	0.80	5.24	1.00	10.41	1.00
Profit per employee (INR Lakhs)	9.68	16.46	2.47	4.69	0.47	2.87
Return on assets (%)	1.10	2.27	1.49	1.03	0.58	0.94

a One Lakh is equal to 100,000 rupees.

b Non performing asset.

Source: Sengupta A, 'Banking and insurance services: Liberalisation in the context of an Indo–EU trade and investment agreement', New Delhi: Indian Council for Research on International Economic Relations (ICRIER), 2008, Table 4, p. 5

Concerns and future challenges

Although India's banking sector reforms have resulted in competition and efficiency gains, certain problems still exist. Despite improvements in the quality of bank assets, some banks still have higher than the 5% target level for NPAs. Some of the private sector banks have been subject to fraud and poor risk management practices. Although steps have been taken to better regulate such entities, concerns about investor protection remain.³³

There is also the problem of the continued interference of the government in the banking system. Efficiency and growth in financial intermediation continues to be hampered by the government's pre-emption of banking system assets through required investments in government securities and mandated credit allocation requirements, and by government influence on the public sector banks through guarantees and subsidies.

In turn, Indian banks continue to rely on returns from government securities. Such government interference creates problems of administrative autonomy, regulatory failures and conflicts of interests. A key element of financial sector reform in India will be to reduce the government's stake in financial sector institutions by divesting government ownership in public sector banks. The latter largely depends on progress with fiscal consolidation.

The fragmented structure of India's banking system is another issue. Consolidation in the banking system, which is the global trend, is yet to take off in India. A large number of commercial banks, with thousands of branches including many regional rural branches, exist in India. The government has introduced regulations on ownership structures of private banks to encourage the acquisition of stakes by foreign banks, private banks and financial institutions in the private banking system. However, consolidation has been slow and fraught with concerns over retrenchment of workers and protests by unions.

The reform and liberalisation agenda in India's banking sector remains unfinished, and future structural changes are likely. Further regulatory strengthening is also required. Most importantly, fiscal and financial reforms have to go hand in hand. Given the current political economy in India, a lack of fiscal reform may ultimately be the biggest obstacle for the further progress of India's banking sector reforms.

HIGHER EDUCATION SERVICES³⁴

Higher education in India has witnessed rapid growth in recent years. This is because of a rising demand for higher education, improvements in school education, and the changing structure of the Indian economy that requires new and varied skills. The most striking characteristic of India's higher education sector and its transformation has been the growing role of the private participants in response to an increasing supply-and-demand gap and a rising demand for professionally oriented programmes.

Liberalisation process

Partial liberalisation has taken place in India's higher education service sector. Since 2000 the government has allowed foreign equity participation up to 100% for entry through franchises, twinning arrangements, study centres and programme collaboration, and up to 49% for research and teaching activities. However, there has been limited investment in the education sector because of regulatory conditions, which require that the entity establishing the school, college or university should be a non-profit one. This means that the service provider in this sector must be a trust, society or a Section 25 Company. A foreign university seeking to establish an educational institution in India needs to register under either of these forms. The regulations also require that surplus funds generated by formal schools should be ploughed back into the same school, and not distributed as dividends.

An important recent development in the liberalisation process of India's education sector is the approval of the Foreign Educational Institutions Regulation of Entry and Operations, (Maintenance of Quality and Prevention of Commercialisation) Bill, 2010 by the central government on 15 March 2010. The bill is under the consideration of the

Parliamentary Standing Committee on Human Resource Development before it becomes a law. The bill proposes to allow foreign education providers to set up campuses in India and to offer degrees and diplomas to students. It contains specific clauses to help prevent potential misuse. The bill also prescribes a time-bound format to grant approval to foreign educational institutions and requires foreign education providers to be registered with the regulatory body, at present the University Grants Commission (UGC).³⁵

The bill requires a foreign university seeking to set up a campus to deposit INR 500 million as a corpus fund. The foreign university cannot take any surplus generated from education activities in India out of the country. The bill requires that a foreign education provider should utilise up to 75% of the income received from the corpus fund for the development of its institutions in India. The remaining income should be deposited in the corpus fund.³⁶ The bill states that a foreign institution 'shall not impart education in India unless it is recognised and notified by the central government as a foreign education provider under the proposed legislation'.³⁷ The bill also states that the foreign education provider must offer education in conformity with the standards laid down by the statutory authority, and of comparable quality.³⁸

Overall, liberalisation in this sector has been difficult because of the lack of political will and concerns over regulatory issues. However, recently the government has introduced new measures to reform this sector and to attract quality foreign providers to provide educational services in India.

Outcome

The partial liberalisation of higher education services has resulted in the entry of foreign education providers through various forms of delivery. A 2005 study by the National University of Educational Planning and Administration acknowledges the presence of foreign education providers' study centres, programme collaboration, franchising and twinning arrangements, in which foreign providers have a minimum stake while the Indian counterparts provide the infrastructure. Most are engaged in commercially oriented programmes, such as management and information technology (IT), and aim to fulfil growing demand among Indian students to earn a foreign degree at a lower cost. Many domestic private participants have taken advantage of tie-ups with foreign universities to circumvent onerous regulations in India and to use the brand name of the foreign university.

Education providers are also devising new ways and structures to circumvent the stipulated government regulations. One such structure is to create a trust, society or a Section 25 Company, as required by the law to run the educational institute, and then to create a subsidiary to which educational and infrastructure services are outsourced. Foreign investments are then made into these subsidiaries instead of into the trusts, societies or Section 25 Companies running the school. Various services provided by such subsidiaries include management services, teacher training and curriculum designing.

Another important outcome, linked to the development of the real estate sector in India, is that many entities are now establishing schools in joint ventures with real estate developers. This helps in ensuring quality schools within residential complexes, which makes the properties more attractive and reduces the requirement for investing huge funds to acquire land.

Concerns and future challenges

Despite the rapid growth and privatisation of the higher education services in India, the sector remains plagued by deficiencies in infrastructure, resources, quality and regulatory frameworks. The main problem is the inadequacy and uneven distribution of public funding. Nearly one-third of the institutions receive no government funds at all. Only about half of the remaining two-thirds receive central (federal) government funding.

There is also a lack of equitable access to quality higher education. Relatively well-off students are able to access highly subsidised and reputed public higher education institutions. The poor and less advantaged are forced to seek expensive private education, which is often of dubious quality. The regulatory system has been unable to protect students and prevent private providers from charging exorbitant fees.

The regulatory framework is complicated, with the responsibility for higher education being shared between the central (federal) government and the state governments. The central government has the responsibility of co-ordinating and determining standards in higher education. The state governments are responsible for all administrative and operational matters. A plethora of institutions and councils involved in standard setting and implementation exist in India. To eliminate the administrative and co-ordination problems arising from this multiplicity of institutions, the Human Resource Development Ministry recently made public the draft bill on the creation of a National Commission for Higher Education and Research. This will replace existing statutory bodies such as the UGC, the All India Council for Technical Education and the National Council for Teacher Education. However, concerns remain that the bill may tend towards the centralisation of powers and control over academic initiatives.

Capacity and distribution is another concern. Significant unmet social demand exists not only for higher education but also for certain vocational and professional streams of higher education, particularly engineering and management. There is also growing political interference and a lack of financial, operational and administrative autonomy, particularly in public sector institutions.

Owing to the lack of registration requirements, it has not been possible to keep track of the existence and operations of foreign providers through their non-campus modes of delivery. There is insufficient enforcement of existing regulations on the quality and relevance of the education provided, consumer protection, and on equivalence and accreditation issues. Such poor regulation could lead to profiteering, exploitation and dishonest operators, and little or no spillover effects in educational infrastructure and curriculum development.

Reform in India's higher education services is a difficult task, which has been exacerbated by ad hoc liberalisation. Serious thought should be given to the kind of foreign providers that are being sought, the scope of regulation, the role and structure of different regulatory bodies, and legislative and administrative measures. It is also important to address issues of standards and the provision of quality education; the criteria for approvals and registration of foreign service providers; and equivalence and recognition of degrees provided by such providers.

RETAIL DISTRIBUTION SERVICES³⁹

The retail distribution sector in India is characterised by the presence of a large number of intermediaries and a fragmented supply chain. Most retail outlets are family-run stores offering limited choice to consumers. They are low profit stores that survive on unpaid or cheap labour and free land use. The retail service sector is estimated to contribute 6–7% of India's total employment sector.⁴⁰ It forms the largest portion of India's service sector GDP and employment. However, given the fragmented and largely unorganised nature of retail distribution in India, it is difficult to capture the full extent of output and employment in this sector.

Liberalisation process

Modern distribution networks started developing in India after liberalisation and reforms in the 1990s. However, it is only recently that the sector has undergone major changes. These are a result of high income growth, a growing working class population, growing consumerism, easy access to credit, and growing competition and foreign investment in manufacturing. The nature and extent of liberalisation of the distribution service sector have varied across the different segments. Non-retail segments, such as wholesale trading, export trading, cash-and-carry, and franchising, are far more liberalised than the retail segment.

In the non-retail segments, FDI of up to 100 % with FIPB approval is allowed for the trading of items that are sourced from the medium-scale sector. It is also allowed for the test marketing of items for which the company has approval for manufacturing, subject to certain conditions. FDI up to 100% through automatic route is permitted for the trading for exports and e-commerce activities (only on a business-to-business basis and not in retail trading). FDI participation up to 100% through automatic route is also allowed in cash-and-carry wholesale trading.⁴¹

In the retail segment, the government has allowed 51% FDI in single-brand retailing since 2006, subject to FIPB approval and certain conditions. These conditions are that only single brand products should be sold; products should be sold under the same brand internationally; single-brand product retailing should only cover products that are branded during manufacturing; and that any addition to product categories sold under the single brand would require fresh approval from the government.⁴² In 2005 the government also allowed FDI in real estate to facilitate the growth of retail infrastructure. The actual extent of FDI in single-brand retailing has, however, been meagre. From April 2006 to March 2010, FDI inflows valued at \$194.69 million have entered the sector, accounting for 0.21% of total FDI inflows during this period.⁴³

Although FDI in cash-and-carry wholesale trading and single-brand retailing is permitted in India, FDI in multi-brand retailing is prohibited. The Economic Survey for 2010–11⁴⁴ proposed that FDI should be allowed in multi-brand retailing, but in a phased manner. It also suggested that the phased approach, beginning with metros and incentivising modernisation of existing retail shops, is likely to help in addressing concerns of farmers and the consumers.

Outcome

Liberalisation and reforms and changing economic and demographic structure have resulted in the emergence of new retail formats in India like department stores, supermarkets, hypermarkets and other retail channels such as direct selling, e-commerce and television shopping. The concept of branding has evolved, and a rising number of manufacturers are branding their products. Many foreign brands have entered the Indian market and Indian business houses are increasingly investing in this sector. Some large domestic participants have already emerged in retail distribution sector. The sector developments extend beyond the cities, with retailers venturing into smaller cities and sourcing their products from local small-scale industries. Some companies are entering rural markets to source directly from farmers to ensure product quality and to set up the supply chain from the rural to the urban market.

Foreign entry into India's retail segment has occurred in many forms. Examples include local sourcing, franchising, setting up manufacturing units, wholesale cash-and-carry trade, and joint ventures with local companies. Since FDI is partially allowed but with conditions, most international brands have established a retail presence in India through the franchising route. A large number of foreign brands have also entered into shop-in-shop arrangements with leading department stores in India. Some brands have distribution offices in India that supply products to local Indian retailers. Thus, the FDI restrictions on single-brand retail and the ban on multi-brand retail have been bypassed to some extent, given the more liberal conditions in other segments of distribution services.

Concerns and future challenges

There is ongoing debate among various stakeholders about further liberalisation of single-brand retail, from 51% to 74% or 100%; and in particular, about the positive and negative effects of liberalising the multi-brand retail segment. The main concern is the potential impact of the market entry by large foreign participants (such as Walmart and Carrefour) and large organised domestic participants (such as Reliance) on the unorganised retail businesses. Critics argue that the entry of large foreign retailers would lead to the displacement of small traders. This would result in unemployment among low-skilled workers, who would not have the requisite skills or training to find jobs in the modern retail formats. Proponents of liberalisation, however, argue that foreign entry would force consolidation within the sector. This would lead to co-existence of large domestic participants and foreign participants. The extent of competition from foreign participants would in any case be limited by domestic constraints, such as infrastructure and lack of quality manpower.

It is difficult to determine the validity of concerns over the employment displacement and negative repercussions for family-run stores as a consequence of further liberalisation of the retail service sector. Recent studies on the impact of modernisation and foreign entry into India's retail sector suggest that the outcome may not be as negative as initially thought, and that the unorganised segment is already adjusting to the changes brought about by modernisation. A 2008 study of ICRIER⁴⁵ on the impact of organised retail sector on the current unorganised retail sector found that both sectors would co-exist and continue to grow. The study also found that productivity improvements in agriculture and

industry would be constrained in the event of the retail sector remaining dominated by the unorganised segment.

Overall, economic growth and further liberalisation should encourage the growth of India's retail services. However, several areas of weakness could inhibit growth and the extent to which the opportunities arising from further liberalisation can be exploited. The lack of economies of scale in sourcing due to the presence of several intermediaries in the supply chain is one such weakness. Another relates to the lack of supporting infrastructure and facilities in other segments of the distribution service sector. Studies have shown that 40% of fresh fruits and vegetables are wasted in the supply chain because of inefficient distribution networks and poor storage facilities.⁴⁶

Significant restrictions on trade in some commodities also remain, with different Indian states having their own policies on production, distribution and taxation. Multi-point taxation makes it difficult to set up a centralised sourcing infrastructure. As a result, most retailers tend to source their products locally, which affects the economies of scale in sourcing. Another barrier faced by the Indian distribution service sector is access to institutional funding. Few banks are willing to invest in this sector because of its unorganised nature. The lack of trained and quality manpower and low productivity levels are further constraints. This is compounded by India's rigid labour laws that make it difficult for retailers and franchisees to employ staff.

Overall, India's retail service sector is likely to grow in the future with improvements in organisation and consolidation. Large Indian retailers can be expected to turn their focus from the domestic market to international operations, once the former becomes saturated and consolidation has taken place. Liberalisation of multi-brand retailing and further liberalisation of single-brand retailing will play an important role in determining future trade and investment prospects in this sector.

INDIA'S BILATERAL, MULTILATERAL AND REGIONAL NEGOTIATIONS IN SERVICES

The service sector has been an integral part of India's negotiating agenda in the World Trade Organization (WTO). India is also increasingly engaging in discussions on services in the context of its bilateral and regional initiatives agreements. It recognises the role such agreements can play in enhancing India's export interests in the service sector, while helping to induce much-needed FDI and technology transfer in key services, such as telecommunications, transport, logistics and construction.

India's multilateral commitments and offers under the General Agreement on Trade in Services⁴⁷

India has been an important participant in the General Agreement on Trade in Services (GATS) negotiations. India made limited commitments in the Uruguay Round that concluded in 1994, and its multilateral commitments in services reflected a conservative approach. It did not schedule sectors such as energy, distribution, education and environmental services. When it did present important sectors such as financial

and telecommunication services, key subsectors and activities such as insurance or international long-distance telephony were not committed.

In the ensuing Doha Round services negotiations, which were based on bilateral requests and offers, India received requests in most service sectors from all the major WTO member countries. In response to these requests, India submitted its initial offer of services in January 2004. This offer, however, differed little from its earlier Uruguay Round commitment. This was mainly because of a lack of progress in the commitments by other member countries in the modes and sectors that were of interest to India. However, in the revised offer of August 2005, India significantly improved upon its Uruguay Round commitment. It presented several new service sectors and subsectors, and indicated a willingness to remove commercial presence restrictions in key areas that had been autonomously liberalised since the Uruguay Round. New service sectors included education, distribution, accountancy and environmental services.

India's general approach has thus been to initiate unilateral liberalisation and then extend this multilaterally, either to the full extent or below the autonomous level of liberalisation. This reflects a cautious, gradualist and conservative approach of learning through experience. Political economy considerations have also shaped the multilateral negotiating strategy.

India's bilateral and regional initiatives in the service sector⁴⁸

India is also pursuing its interests in the service sector through bilateral and regional agreements. In recent years, India has entered into wide-ranging trade negotiations that go beyond goods to cover services, investment, labour mobility and other issues that have a bearing on the services trade. These include the India–Singapore Comprehensive Economic Co-operation Agreement signed in 2005, the India–Korea Comprehensive Economic Partnership Agreement signed in 2009, and the India–Malaysia Comprehensive Economic Co-operation Agreement signed in 2011. Other agreements are at different stages of negotiation, including those with the EU, Australia and New Zealand. In all these agreements, India aims to facilitate investments in various services from its partner countries in return for securing its own interests in certain sectors. These sectors include IT–BPO, engineering, healthcare and other professional services, and easier access for Indian service suppliers to these markets. The comprehensive agreements recognise that India's main interest and competitive advantage lies in the service sector. The concessions India makes on goods can be traded off against concessions it can secure from partner countries in areas, such as software services, and on key issues, such as mode 4 and mode 1.⁴⁹

CONCLUSION AND KEY LESSONS

The paper highlights several common issues that emerged out of India's liberalisation experience across the infrastructure, commercial and social service subsectors.

The reform experience in all services has not been smooth. It has taken time to introduce new legislation on reforms and liberalisation. Proposals and bills have been delayed for long periods and have not passed into acts. This can be attributed largely to a lack of political will and the absence of a strong central government.

In several services, the liberalisation and reform process has been an evolving one of learning through experience. Regulatory frameworks have evolved, the roles of regulators have been defined and redefined, and legislation and policies have been amended.

There have also been conflicts of interests among different stakeholders. These conflicts have been between the government and private participants; the government and independent regulators; public sector entities and private participants; large and small private domestic participants; large domestic and large foreign participants; and regulatory bodies or professional councils and the government or foreign participants.

The market structure and domestic policies and frameworks have shaped the pace and extent of liberalisation across different services. The presence of fragmented market structures, with a large number of small unorganised participants and related concerns about displacement following liberalisation, have hindered liberalisation in retail services. In other service subsectors, such as telecommunication and financial services, the dominance of public sector entities and the government's reluctance to relinquish control have been the main stumbling block. The main challenge in some service sectors, such as higher education, has been the regulatory framework and regulatory capacity.

There has been difficulty in balancing equity and efficiency concerns, and public and private interests. This also extends to ensuring the right balance between institutional autonomy and regulation, so that while participants are not burdened with onerous regulations, they also do not function in ways that undermine the larger public interest.

Liberalisation has to be supported by regulatory and legislative reforms. Instituting appropriate regulatory bodies, clearly defining their roles and improving governance are just as important as pursuing liberalisation. There also needs to be a strengthening of regulatory and enforcement capacity. In the absence of this, liberalisation can lead to undesirable outcomes.

The analysis of India's liberalisation strategy in relation to its multilateral, regional and bilateral commitments shows that the latter were not catalysts for India's liberalisation process. Liberalisation of services has been undertaken as part of India's general economic reform programme and has been shaped by domestic needs. Multilateral commitments and offers have generally been less than the status quo. This indicates an overall conservatism in the negotiating strategy, and an allowance for leverage in negotiations for certain services in the future. Although regional or bilateral commitments have been occasionally more liberal than those made multilaterally, autonomous and non-binding reforms have led the way in almost all services.

The service sector has contributed to the economy's growth prospects. However, it is uncertain whether the current pattern of service sector growth can be sustained. There has been an insignificant increase in the service sector's share in employment, considering a very large increase in its share in GDP during the last two decades. More broad-based growth within the sector is required to ensure balanced, equitable and employment-oriented growth that is linked to the rest of the economy. Further reforms in infrastructure, regulation and FDI liberalisation will help to diversify the sources of growth, thereby increasing employment opportunities and providing the required momentum for further growth.

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- 49 As per the WTO classification, international trade in services can occur via four modes. Mode 1 or cross-border supply is defined as services flows from the territory of one member into the territory of another member (eg banking or architectural services transmitted via telecommunications or mail). Mode 2 or consumption abroad occurs when a consumer (eg tourist or patient) moves into another member's territory to obtain a service. Mode 3 or commercial presence occurs when a service supplier of one member establishes a territorial presence, including through investment, ownership or lease of premises, in another member's territory to provide a service (eg domestic subsidiaries of foreign insurance companies or hotel chains). Mode 4 or movement of natural persons consists of people of one member entering the territory of another member to supply a service (eg accountants, doctors or teachers). It is to be noted that Mode 4 only covers people moving temporarily, although the WTO classification does not define 'temporary' by specifying any time period.

SAIIA'S FUNDING PROFILE

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