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4/2008

Integrating India's Service Sector with the Global Economy

Introduction

The services sector scenario in India is complex and is characterised by uneven development in different types of services and across regions. In global perspective, the growing importance of services sector within the Indian economy cannot be denied. The growth in output in the sector in recent times has mostly come from the rapid development of skill intensive services in the information technology (IT) and professional services segments, mostly oriented towards the external market. However, not all services have shown equal dynamism in their growth. The star performer has been IT and IT enabled services (ITES), while other services that serve as crucial inputs to workings of the national economy (as support for agriculture and industry) have not developed as fast as expected.

When it comes to exports India's boom is attributed to the IT and ITES sectors, which grew by 485 percent between 2000 and 2006, while their output grew by 339 percent in the same period. As per the World Trade Organisation (WTO) data, India's total services exports grew by 354 percent during 2000-06. The destination for IT and ITES exports has largely been the US followed by the EU. Asia-Pacific region and the Gulf States are expected to become increasingly more important markets for Indian IT and ITES firms, though the US will continue to be the dominant market.

India's share in the global export market for services has also increased rapidly booming from just about 0.5 percent in 1990 to over 2.5 percent in 2006, overtaking all the major emerging market economies with the exception of China. Likewise, India's imports of services has increased from just under US$6bn in 1991 to US$69bn in 2006, making it an increasingly important importer of services. This Policy Brief examines the prospects of India's services sector *vis-à-vis* global economy. It explains India's market access commitments under General Agreement on Trade in Services (GATS), focusing on the regulatory and institutional environment in the country, especially those issues that are applicable to specific service sectors. Also, it provides a summary and discussion on policy implications.

Market Access Commitments under the GATS

From being a fierce opponent of the GATS, India is now a proponent of services trade liberalisation under it and is not averse to a GATS-plus approach if it can get concessions in its areas of strength. This drastic change of attitude towards GATS is a mere case of "learning by trading[1]" where experiences in the external sector have informed negotiating positions.

Market access commitments within the GATS are made at the horizontal level, while specific market access commitments are made at the sectoral level (and the sub-sectoral level). Also, commitments are made within each sector. However, a World Trade Organisation (WTO) Member can also choose not to make a commitment or leave its commitments 'unbound' for a certain sector. This does not imply that there is no market access for the sector to that Member's economy, but it simply means that market access is not guaranteed and can be restricted at any point by the member country. However, there is always the possibility of the importing member country cutting off market access as it brings a significant element of uncertainty and prevents the trade in services in that sector (or specific modes within that sector) from fully taking off.

Horizontal Commitments

Under Mode 1, 2 and 3, India has no horizontal (i.e. applicable to all sectors) restrictions to market access. However, under Mode 4, India allows the movement of personnel under four different categories (business visitors, intra-corporate transfers, contractual service suppliers and independent professionals), though it has restricted this movement with some predefined conditions. These restrictions under Mode 4 applied by India are more or less similar to the ones imposed by the G-7 economies and other large developing countries such as Brazil, Argentina and China, differing only in detail (for e.g. the number of days of stays allowed). However, the efficacy of such restrictions is limited to the monitoring system in place.

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Table 1: Sectoral Commitments			
Sector	**Liberal**	**Restrictive**	**Very Restrictive**
Business Services	Architecture services, urban planning and landscaping services, engineering services, integrated engineering services and veterinary services	Accounting and book-keeping services	Paramedical services (nursing, midwives and physiotherapists) and medical/dental services
Computer And Related Services	All sub-sectors of computer and related services		
Research And Development Services	Research and development services in humanities and social sciences	Research and development services in agricultural sciences	Research and development services in natural science and technology
Real Estate Services	All sub-sectors		
Other Business Services	Management consultancy services, technical testing and analysis services, fishing related services, services incidental to energy distribution (does not cover actual energy distribution), placement and supply of personnel, maintenance and repair of equipment building maintenance and cleaning, packaging services, convention services, specialty design services	Photographic services	
Financial Services	Services auxiliary to insurance (consultancy, actuarial and risk assessment) data processing, data transfer and software support for financial services	Venture capital services, financial leasing services, asset management services, financial consultancy services	Insurance (life, non-life and re-insurance) Banking (all forms of retail banking and related services)
Distribution Services	All sub-sectors		
Education Services		Higher education services	

The cost of verifying the actual purpose of visit (as opposed to the stated purpose) and the source of payments (personnel can be paid from offshore accounts of an Indian source) will be generally high. Moreover, as economies integrate globally the firms that operate in them too integrate, often connected through complex contractual arrangements. Under such circumstances, case-by-case verification of such restrictions will appear increasingly unfeasible.

Regulation and Services: An Overview

GATS mandated market access does not alone determine the level of effective market access, it is also a function of the regulatory and procedural[2] regime applicable to such services. The regulatory and procedural environment in an economy can be judged by analysing the broad indicators, namely: administrative burden; transparency; substantive presence of state-owned enterprises (SOEs); entry barriers; and exit barriers. In addition, in a large federal system like India's, an added feature of the regulatory environment is the quality of the regulatory mechanism at the sub-national level and variation in the quality of such sub-national governance across states.

Administrative burden: The Indian economy, despite reforms, is characterised by excessive administrative burdens on firms[3]. Table 2 highlights the hurdles in dealing with the number of procedures involved from the Doing Business Indicators[4] as proxy for administrative burden.

Table 2 shows that India does not do too badly; however, it is still behind the Organisation for Economic Cooperation and Development (OECD) and business friendly, efficient administrations like US and Singapore. The Product Marker Regulation (PMR) index published by OECD, a more comprehensive index of regulatory burden, also shows that India does not do very well.

Table 2: Days and Procedures for Dealing with Licences		
Country	**Days Taken**	**No. of Procedures**
Brazil	411	18
China	336	37
India	224	20
OECD	153	14
Singapore	102	11
US	40	19

Source: Doing Business Indicators, World Bank

Transparency: The overall level of administrative transparency which is a vital component for a free market and for the prevention of unnecessary barriers has tended to be low in India. However, part of the reason for India's better record at regulatory transparency in recent years has been continued administrative reforms that have accompanied the economic liberalisation process. Yet, there are still some problem areas that need to be tackled. It has been pointed out that India still lacks a comprehensive regulatory oversight body that can effectively deal with complaints of regulatory arbitrariness, corruption and other violation of market rights[5].

Presence of SOEs: When it comes to SOEs, India has a substantial presence of it in the non-farm business sector accounting for about 21 percent of the net value added and 38 percent of the capital stock[6]. This is mainly due to the dominance of SOEs in some very large infrastructure-oriented sectors such as electricity production and distribution, rail transport, ports, and pipelines. Their presence distorts the market and prevents the development of a level playing field. However, many of these SOEs serve social and developmental goals of the state and whether a market based system can deliver on such social goals is an issue that is still open to debate. Given this dominance, foreign service providers often have limited access to input services from these sectors.

Entry Barrier: Reforms in India over the past two decades have successfully removed formal legal barriers to market entry such as licences to enter a particular sector which in prior decades had reduced competition and protected incumbents. These formal legal barriers are now on par with those in the most liberal OECD countries[7]. However, as evinced by the PMR indicators, India still imposes a high administrative burden on new entrants. Thus, while formal legal barriers have been reduced, procedural barriers continue to favor incumbents over new entrants.

Exit Barriers: Barriers to firm exit in India are still formidable across all sectors. Table 3 illustrates that India is by far one of the worst places in terms of the regulatory transaction costs imposed for closing a business. New laws were passed in 2002 and 2003 to simplify this procedure and repeal the legislation, but are yet to take effect.

What more, studies do show that there is a wide variation amongst Indian states in terms of regulatory environment, thus adding a further layer of complexity for prospective foreign service providers.

Regulations in Some Vital Sectors

Electricity Supply: Electricity supply in India, dominated by SOEs, is notoriously inefficient. The transmission and distribution losses are as high as 40 percent in some states. Despite full market access, automatic approval for foreign direct investment (FDI) and substantial tax related incentives, foreign private participation has been limited. The dominance of SOEs and the complicated electricity tariff related regulations along with the extreme high cost of exit from this sector are some of the reasons that have kept foreign participation in this industry low.

Financial Services: India's banking sector continues to be dominated by public sector banks, which account for approximately 72 percent of the sector's total assets. By March 2006, of the 89 scheduled commercial banks, there were 28 public sector banks, 28 private banks, 29 foreign banks, and 4 local area banks. The Reserve Bank of India (RBI) had also formulated a Roadmap for Presence of Foreign Banks in India and the Guidelines on Ownership and Governance in Private Banks in 2005.

At the same time, the insurance sector in India has had significant liberalisation and has opened itself up to private competition. In terms of market share, private companies controlled 26.5 percent of the life insurance segment and 26.3 percent of the general insurance segment in India in 2006[9]. However, a proper regulatory framework that supports a risk-based system is yet to be developed in India. This sector is also constrained by relatively high entry barriers. The minimum capital required to set up an insurance company is Rs. 1 billion (US$27.7mn) and that for a reinsurance company is Rs. 2 billion (US$49.3mn).

Telecommunications: The heavily regulated and SOEs-dominated telecommunication sector in India has seen rapid liberalisation in the last 10 years. Private sector companies

Table 3: Average Number of Years for Closing a Business	
India	10.0
Brazil	4.0
China	1.7
US	1.5
OECD average	1.3
Singapore	0.8

Source: World Bank, Doing Business Indicators 2007

Box 1: Tertiary Education Services

The Indian higher education system has been growing substantially since post-Independence. A high level of investment in higher education was a political-economic decision designed to create a self-reliant economy in terms of human capital requirements. In recent years, the private sector has overtaken the government in certain segments of the higher education sector.

In the post-2000 period, foreign players also entered the sector as the country allowed 100 percent market access into this segment as a part of its GATS commitments. However, this liberalisation has been subject to the condition that their fees would be fixed by the government. Thus, till the end of 2004, there were only 131 foreign education providers in India enrolling not more than a few thousand students which is a very small portion of the total market[8]. Partner WTO countries continue to seek greater market access into the Indian higher education sector.

Regulations

Applicable to Foreign Higher Education Providers in India

Many of the foreign education providers operated in Indian market outside the regulatory framework affecting the end consumers who have no means of verifying the claims of the multitude of service providers. To rectify this system the (All India Council for Technical Education (AICTE) issued a notification in 2005 bringing foreign providers of technical higher education in India under a set of specific guidelines which are potentially a barrier for foreign education service providers to enter Indian market. However, this regulation governs technical education only and the need has been felt for a more comprehensive regulatory system.

Hence, the CNR Rao Committee was appointed by the Ministry of Human Resources whose report has been submitted but not published yet. It is expected that the report will recommend the setting up a two-phase approval system for foreign universities. In the first phase, foreign universities will be given a limited period trial, a sort of probation period. On the basis of performance in the trial period these universities will be allowed to set up long-term operations.

Applicable to all (Domestic and Foreign) Private Education Service Provider

Currently, there are no uniform guidelines in India to regulate the establishment and operations of private universities. Education being subject to state-level jurisdiction, individual states in India has their own legislations which regulate the establishment and operation of private universities. An attempt was made to create a uniform regulatory environment in India, with the Private Universities Establishment and Regulation Bill (2005), however this bill did not get political support and was allowed to lapse in Parliament.

have added millions of new subscribers between 2000 and 2007, especially in mobile telephony that has exhibited one of the fastest growth rates in the world. This process of liberalisation received a further boost with the simplification of the licensing regime. However, Telephone Regulatory Authority of India (TRAI) still regulates tariffs for services where it considers markets to be non-competitive. According to TRAI, these non-competitive markets are rural fixed line telephone calls, national roaming in mobile phone calls, and leased circuits. Tariffs for all other telecom services have been liberalised.

Road Transport: Road passenger transport sector in India is subject to significant entry barriers. The state governments determine the issuing of operator licences, the routes, and the times that operators are permitted to run. The state also determines the fares that operators can charge on a particular route. While there is ease of entry and exit in road freight transport, the inefficiencies in this sector are predominantly the result of cartels and price fixing by industry participants. Such inefficiencies have been a constraint on the development of an integrated national freight system in India[10]. Government has plans to introduce a new Carriage by Road Bill which would require all freight booking companies to be registered and have a record of the movement and type of cargo, and to declare taxed and untaxed cargo. Furthermore, as per the bill transport/booking companies would be made liable for the safe delivery of goods based on their invoice value[11].

Engineering Services: The main clients for engineering services are end-user industries such as power, utilities, refineries, construction, mining, steel and petrochemicals. Many of such end-user industries in India are dominated by SOEs whose procurement policies are often informally biased towards indigenous companies. Thus, foreign firms often find such informal policies limiting their market access in this sector in India. Another regulatory barrier is that many engineering projects in the construction sector are offered only on a non-convertible rupee payment basis. Only government projects financed by international development agencies permit payments in foreign currency[12].

Box 2: Wholesale Services

The development of the wholesale function of distribution services and its maturing is extremely important for the Indian economy. The opening up of the wholesale sector of the Indian economy to foreign capital will bring managerial expertise, capital and technology that will lead to the development of efficient supply chains that will benefit retailers, both big and small, as well as producers. However, there are several problems with India's domestic regulatory systems governing wholesale services.

Regulatory Barriers

Applicable to Foreign Wholesale Service Providers in India

Though India allows 100 percent FDI in wholesale services, the approvals for establishing commercial presence in wholesale trade are provided by the Foreign Investment Promotion Board (FIPB) on a case-by-case basis. This potentially can introduce a degree of arbitrariness in the system and impose uncertainty on prospective investors. But, India's product restrictions for wholesale trade are not significantly different from most other economies including OECD economies[13].

Applicable to all (Domestic and Foreign) Wholesale Service Providers

The wholesale services sector in India is constrained by several regulatory measures, especially in the wholesale trade of agricultural commodities. The Essential Commodities Act of 1951 is the most significant piece of regulation at the central level affecting wholesale trade. Under this Act, the government reserves the right to control the production, distribution, transportation and distribution of commodities. The government can also intervene if it feels that the trade of products covered by the Act is not taking place in at 'fair prices', the definition of 'fair price' being open to the government's interpretation.

The various state-level Agriculture Produce Marketing Acts creates a huge plethora of regulations and tend to be different from state to state. This plethora of restrictions and inherent differentials across the country prevent rational and uniform pricing strategies. The Public Distribution System (PDS), while not directly a regulatory measure that impacts wholesale services, distorts market prices and production incentives through heavy government intervention in terms of price and supply control mechanisms (i.e. quantitative restrictions).

Other regulatory mechanisms that impact wholesale trade in India have to do with local laws related to permits and businesses licences to operate large markets and/or warehouses. India has significant regulatory impediments in all of the different categories, including wholesale trade (see Table 4). Thus, the 100 percent market access in wholesale does not translate to into incentives for investment in this sector, given the regulatory burden imposed upon it. It is just not FDI, but domestic investment in this sector which is also being stifled by such regulatory mechanisms.

Table 4: Regulatory Measures Impacting Wholesale Services

Regulatory Measure Impacting Wholesale Services	Existence of such measure in India
Price controls on commodities	Yes
Quantitative restrictions on sale and purchase of commodities	Yes
Local government requirements and restrictions	Yes
Restrictions on acquiring land for operating businesses	Yes
Presence of large State Owned Enterprises in the product market	Yes

Conclusion

India's commitments under GATS form the basis of its policies in the services sector. It is argued that the nature of India's commitments restricts policy space "*in fairly sensible ways*[14]." For example, a commonly followed practice to aid agricultural production has been to provide farmers with subsidised (and sometimes) free electrocity. Such practices boost agricultural production in the short-run but are unsustainable in the long run. This is because crop allocation does not reflect the true opportunity cost (scarcity value) of use. The policy distorts crop choices in favour of water-intensive agricultural products even in regions where water is scarce with obvious implications for groundwater and soil salinity.

The Electricity Act of 2003, which comes out of the commitments under GATS and seeks to curb resource allocation that is out of tune with relative scarcity values. However, this law does not curb policy space in the sense that a subsidy on power could still be given only when: the state government would have to directly bear a higher percentage of the subsidy bill than that borne by the State Electricity Boards (SEBs); and ensuring that the latter's financial health is not adversely affected by a developmental policy. The Act arguably is also a step forward in making this sector more attractive to FDI although this was not the primary intention of the Act. However, as policy measures go, it is generally conceded that such interventions are self-defeating. For example, there is evidence that regular power supply is more important for agricultural production than free power.

Similarly, policy space requirements with reference to the services sector when it comes to the primary economic goal for the 11th Plan, i.e. inclusive economic growth, do not have to clash with India's commitments made so far. Indeed, it is foreign players who have developed the necessary mechanism designs that might serve India's purpose. Brazilian bank *Unibanco's* exposure to the informal sector in Brazil is several times bigger than the entire size of the organised micro-finance sector of India. Also, Bangladesh's Grameen Bank's expertise and consequent success may not be easily replicated by Indian players. Allowing such players therefore may be in consonance with the stated national goals, as enunciated in the approach paper to the 11th Plan, the quality and type of agents in a service sector are crucial to these goals. This precludes the need for kinds of interventions that may violate commitments. Indeed the entry of these agents as a consequence of India's commitments enhances policy space by adding a method by which a stated national goal can be addressed.

Similarly, in the field of higher education under an appropriate regulatory regime, the entry of foreign players may actually serve to enhance the supply of skilled professionals.

What becomes clear is that India's commitments may actually add new players to its policy space in such a way that instead of being adversely affected it might become enhanced. In so far as this is true, India's commitments themselves serve to become elements of policy.

Endnotes

1 Debashis Chakraborty and Dipankar Sengupta, "Learning through Trading? India's Decade Long Experience at WTO", South Asian Survey, 12(2), 2005.

2 By procedural regime reference is made to the administrative processes applicable to the regulatory regime and the nature of its implementation, i.e. the levels of arbitrariness, lack of transparency and complexity in inherent in the system

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13 For a detailed country by country product restrictions for foreign service providers in Wholesale services refer to Mukherjee (2002), Distribution Services: India and the GATS 2000 Negotiations, ICRIER Working Paper No. 80

14 See interview of Alan Winters and Ricardo Melendez-Ortiz by Keith Rockwell, transcript downloadable from http://www.wto.org/english/forums_e/debates_e/debate5_e.htm

This Briefing Paper is an abridged version of India's country background paper prepared by Pritam Banerjee, George Mason University, Debashis Chakraborty, IIFT, New Delhi and Dipankar Sengupta, University of Jammu, with support from the Economic Affairs Division of the Commonwealth Secretariat, London under the project entitled, 'Services Trade and Domestic Regulation: A Multi – Country Study in Commonwealth Asia, Africa and the Caribbean'.

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