UNIT 23 POLICIES RELATING TO SERVICE SECTOR

Structure

23.0 OBJECTIVES

After reading this unit, you will be able to:

- discuss the operation of the service sector in India, beyond what you did in Unit-10;
- know about the policy response of the government to the growing influence of the service sector in the Indian economy;
- appreciate the fact that the government has facilitated the growth of the service sector in India;
- identify the issues that are working as barriers to the further progress of the service sector in India; and
- evaluate the policy response and make suggestions to overcome the barriers.

23.1 INTRODUCTION

We have learnt in Unit 10 that services sector plays a vital role in India for various reasons. The rate of growth of the services sector has been more than that of overall GDP growth in the recent time period. Even in 2008-09 when GDP growth was relatively low at 6.7 per cent, services sector growth was 9.7 per cent with its share in GDP at 57.3 per cent. The primary importance of services sector in the growth process in India and across various Indian states has been strongly established in the last two decades. Despite global recession, services exports grew by a respectable 12.4 per cent in 2008-09. The openness of the economy reflected by total trade including services as a per centage of GDP shows a remarkable increase from 27.4 per cent in 2000-01 to 57.9 per cent in 2011-12. Some services have been particularly important for India. Software is one sector in which India has a brand identity. Tourism and travel related services and transport services are also major items in India's services exports. Besides these, the potential services which are particularly important for India include many professional services, infrastructure related services and financial services. India also has great potential to be a major outsourcing destination for many services. However, to tap the full potential of the services sector, policy reforms are needed. These, in macro sense, are related to (i) domestic policy issues, (ii) domestic regulations and (iii) market access for sector. Besides, an integrated service sector policy, policy initiatives in individual sectors are required.

23.2 SERVICE SECTOR POLICY ENVIRONMENT

The policy environment for any specific sector of the economy, be it primary (agriculture), secondary (industry) or services (tertiary) is determined by and is to be in sync with the overall macro-economic environment of the economy; the three sectors have to move in the same direction.

As we have learned in Block 1 and 2 of this course, the Indian economic environment underwent a structural change with the onset of the 1990s, although powerful signals had began to emanate 10 to 15 years before the actual blow was lent to the old regime and new policy regime formally introduced in 1991.

In sync with the heavy-industry-led growth strategy pursued during the earlier plans, the policy environment before 1991 could be easily bracketed in three letters: CIA. **C** stood for controls; controls were all-pervasive and all-pervading. The economy-scene was controlled and monitored by the state. **I** stood for Indianisation. Again in pursuance of the heavy-industry-led growth strategy and broad goals of achieving rapid growth and self-reliance, the policy worked to set up a system of production and distribution which was by and large owned and controlled by the domestic capital, both public and private although foreign collaborations, technical or financial, were not shunned. **A** stood for abstinence. Consumption of consumer durables and even some basic necessities was discouraged. Heavy taxation, inadequate production and non-availability of such goods and fiscal incentives for financial savings, among others, were the instruments that were expected to ensure that the economy would move on the desired directions to achieve the goals of planned development. Until July 1991, the Government had pursued a package of conservative macro-economic policies.

- Fiscal policy aimed at mobilising resources from the private sector to finance development programmes and public investment in infrastructure.
- Monetary policy sought to regulate financial flows in accordance with the needs of the industrial sector and keep the rate of inflation under control.
- Foreign trade policy was formulated to protect domestic industry and keep the trade balance in manageable limits.

This policy regime of heavy taxation, high interest rates and tariffs, undoubtedly, created an environment that provided protection to the Indian industry and services to grow. But the overall growth of the Indian economy fell short of targeted and achievable goals. The Indian economy lagged behind many other developing and emerging economies of Asia and Latin America.

An effort was made to retrieve the lost ground. It took the shape of introduction of a new policy regime, which in common parlance is identified as LPG, liberalisation, privatisation and globalisation.

Beginning with new industrial policy statement of July 23, 1991, the new policy regime has sought to be spread to the primary and the tertiary sector of the economy.

23.3 CHARACTER OF SERVICE SECTOR

Though in shape and design service sector, a non-commodity producing sector, is distinct and different from both the primary and the secondary sectors, the commodity – producing sectors—the services sector is closely interwined with the other two sectors. At times, it is not possible to identify a policy measure with a particular sector alone; any reform measure introduced say in the agricultural sector will have implications for the services sector. Likewise, any reform measure introduced in the industrial sector will have implications for the services sector. In other words, it may not always be possible to distinguish and identify many a possible reform measures that impact the services sector alone. And in a broader sense, we need not feel much concerned about this characterisation of reforms.

Secondly, services sector bears a much larger canvass than either the agricultural sector or the industrial sector, while the industrial sector and the agricultural sector fundamentally produce private goods, output in the services sector has the characteristics of (i) public goods, (ii) externalities, (iii) natural monopoly, and (iv) indivisibilities.

In this background of the character of the services sector, we will look at the set of policy reforms that have characterised the sector.

23.4 SERVICE SECTOR POLICY REFORMS

To appreciate the nature of service-sector reforms initiated during the last two decades, we prepare two catalogues: (1) Pre-reforms strategies, and (2) Post-reforms strategies as follows in Table 23.1. It may be observed that all these reform measures are comprehensive in their range and sweep as they cover all the sectors of the economy. But they have specific implications for the service sector, as the service sector conditions and is conditioned by production processes both in the primary and secondary sectors of the economy.

Table 23.1: Model of services sector strategies in India.

Pre-Reform Strategies	Reform Strategies
Closed economy	Open economy
Self-reliance	Integrate with world markets
State-led economic growth	Market-determined economic growth
Import substitution strategies	Export oriented strategies
Licence-dominated regime	Delicensing, deregulations, debureaucratisation

Frequent State interventions	Selective and effective State interventions
Politically administered prices	Market-determined prices at large
Not much concern for deficits	Contain all kinds of deficits
Development by inflationary process	Deflationary monetary and fiscal policies
PSUs as engines of growth	Private investment as growth engine
Dominance of PSUs	Withdrawal from the areas of private interest
Philosophy of natural monopoly	Minimise gap between public and private sectors
Restrictions on FDI and MNCs	Inducement to FDI and MNCs
Restrictions on currency movement	Liberalisation of restrictions
State-controlled interest rates	Deregulation of interest rates
State-controlled credit	Credit policy reforms
Underdeveloped capital market	Reforms in capital market
Huge public sector budgetary resources (PSBR liability on government)	Minimise PSBR
High tax rates	Tax reforms

Within the contours of this model of service sector reforms, we can enumerate the various reform-measures as follows:

Exchange Rate Policy

After a steep devaluation of about 22 per cent vis-à-vis dollar in July 1991, the rupee was floated in phased manner. In March 1992, rupee was partially floated. This was followed by shift to market-determined rate of rupee in March 1993.

Fiscal Policy

Tax reforms aim at reducing the dependence on indirect taxes for revenue, reduction in tax rates (excise, customs, corporation tax and personal income tax), and rationalisation (slabs for tax rates have been reduced to few levels from several levels), widening of tax base, reduction in the fiscal deficits, and curtailing monetisation of budget deficits.

Falling interest rates have ensured that the cost of servicing huge public debt is more manageable than before. Debt management is more sophisticated — the government raises more long-term debt today, while its dependence on short-term debt has fallen. Buoyant capital flows have helped fund the fiscal deficit with some ease. While the government has been on a huge internal borrowing, external debt is well under control.

Monetary and Financial Sector Policy

Objective has been to control inflation and stabilise the value of rupee in market system. Broad money growth brought down to reasonable levels from previously high levels. Reserve ratios for banks progressively reduced. Banks selectively allowed to access the capital market. New banks allowed to function parallel with the public sector banks. Interest rates have been progressively deregulated.

Trade Policy and FDI Policy

Tariffs progressively brought down (currently the average tariff rate is close to 10 per cent and maximum rate at 30 per cent). All quantitative restrictions on imports have been removed. Automatic approval is granted for foreign investment up to certain equity in selected sectors, 100 per cent equity is also allowed in these and all other sectors, but requires case-by-case approval by the Foreign Investment Promotion Board.

Short-term Foreign Investment Policy

Some restrictions exist on both inward and outward flows of short-term capital for loans, purchase of bonds and shares. Since September 1992, foreign institutional investors are allowed to invest in Indian capital market, but there are restrictions on acquisition of shares of companies by these investors. Selected companies allowed to raise equity in the international markets. Domestic residents and firms permitted to buy stocks and bonds, subject to ceilings from international markets.

Most of these steps were undertaken in the initial phase of the reforms programme. But, we could not complete the whole menu. A large part of the programme remained unaccomplished.

With the onset of the new millennium, a fresh phase of reforms has begun. This has come to be known as the phase of *second generation reforms*.

23.4.1 Features of Reforms

Some of the important features of the reforms process have been as follows:

i) The approach towards reforms has been cautious, with an appropriate sequencing of measures, complementary reforms across sectors (for example, the monetary, fiscal and external sectors) and the development of financial institutions and markets.

ii) The pace and sequencing of liberalisation has been responsive to domestic developments, especially in the monetary and financial sectors, and the evolving international financial architecture.

iii) The approach to reform was 'gradual but steady', rather than a 'big bang' approach.

iv) The major thrust driving the reform process was the quest for higher growth and efficiency, along with macro-economic stability. At the same time, the reforms had to be 'inclusive', in the sense that the benefits of reforms were to be shared by all sections, in particular the vulnerable ones.

23.4.2 Second Generation Service Sector Policy Reforms

As we are in the second decade of the twenty-first century, it is necessary now to launch the new wave of reforms or what may also be called Operation 2-G.

Table 23.2 compares the two stages of reforms on various rounds:

Table 23.2: Two stages of service sector reforms.

	Stage 1	Stage 2
Priorities	• Reduce inflation • Restore growth • Dismantle institutions of protectionism and statism	• Improve social conditions • Increase international competitiveness • Maintain macro-economic stability
Reform Strategy	• Change macroeconomic rules • Reduce size and scope of the State	• Boost competitiveness of the private sector • Reform production, financing and delivery of health care, education, and other public services
Typical Instruments	• Drastic budget cuts and tax reform • Price liberalisation • Trade and foreign investment liberalisation • Private sector deregulation • 'Easier' privatisations	• Reform of labour markets • Restructuring of government • Upgrading regulatory capacities • Sectoral conversion and restructuring 'Complex' privatisations • Restructuring relations between States and Central government
Public Impact of Reforms	• Immediate • High visibility	• Medium and long-term • Low public visibility
Administrative Complexity of Reforms	• Moderate to low	• Very High
Nature of Political Costs	• Temporary corrections widely distributed among population	• Permanent elimination of special advantages for specific groups

One set of reforms becomes outdated after its implementation and with passage of time. Second generation reforms is about getting into the details. By definition, it is tedious and more difficult. The first phase of reforms was relatively easy as the required changes in trade, finance and fiscal areas were known. In the second phase, issues of equity, regional and sectoral allocation, good governance, institutional changes, etc. will become more prominent. Hard decisions on competition policy, labour policy, disinvestment and prvatisation will have to be taken.

The nature of the needed measures are well known but efforts to implement them are stalled by fierce opposition from the well-to-do and the middle classes (which benefit most from huge implicit subsidies on public services as well as the opportunities arising from globalisation), middle and large peasants (who benefit from subsidised inputs and artificially high support prices), from employees of the public sector (who are loath to give up their sinecures) and from State and Central level politicians (whose control over public resources gives them immense scope for political and personal patronage).

The first generation reforms were essentially crisis-driven. This time round we can have consensus-driven reforms so that we can act in anticipation of a crisis which would definitely visit upon us if present trends are allowed to continue.

We will need to improve the quality of reforms, *per se*. This requires good analysis to identify the critical bottlenecks to higher growth and poverty reduction, innovative design of policy, taking account of socio-political constraints and supportive institutional changes. These steps improve the efficiency and sustainability of reforms.

23.4.3 Regulation of the Service Sector

The paradox of a free market system is that it requires tough regulations to ensure freedom and fairness. Independent regulation has become a part of the language of economic reforms.

Regulation in its broadest sense can be defined as "establishing specific rules of behaviour, or regulatory aspects *per se*, monitoring or tracking observance of the compliance with special rules in the overall behaviour along with disincentives and penal provisions for non-compliance,

Regulations should ensure that—

i) Only sound, serious players enter the sectors.

ii) There is transparency in their working.

iii) No restrictive practices are resorted to by them.

iv) Minimum prescribed standards of performance are adhered to in production and supply.

v) Prices charged are consistent with development of the sector.

But the nature of regulations in a liberalised economy is of a different kind. Its principal characteristics can be identified as follows:

a) The regulatory function should have a sharp objective of fostering fair competition and correcting market deficiencies and irregularities with a view to bring about healthy growth of the sector and protection of participants.

b) The regulatory body should be autonomous and fragmentation of regulating agencies and laws should be avoided.

c) While enactments empowering a regulatory body are important, the practices of regulations as well as the organisation of the regulatory body are much more so.

d) No amount of regulation can be a substitute for efficient and honest management of regulated entities and for an internal system of checks and balances.

Any regulatory framework would need to be clear about its objectives, coverage, operational effectiveness, skills required and accountability and harness the strengths of the existing regulatory infrastructure. The test of effective regulation lies in creating the right incentives for good behaviour and promotion of competition while staying clear of the perils of 'micro-management'.

In short, what we are advocating is the need for removing chains, but putting 'watchdogs' in order, with the qualifying remark that over-regulation drives away the goose that lays golden eggs.

Limitations of Regulation

Regulation cannot always solve problems it is meant to solve.

a) Regulation can go haywire or be ineffective if it is applied without thinking things through.

b) It becomes ineffective if it is caught in what is known as 'regulatory capture'. This happens when business interests which the watchdog is supposed to regulate turn around and begin exercising influence on regulators. The obvious reason why this should happen is corruption. However, there are instances of regulatory capture and failure that can also be due to political interference, poorly drafted legislation, the lack of clarity of mandate, and, of course, incompetence and oversight.

Most of these problems dog regulation in India presently.

A large number of independent regulatory authorities have been appointed, e.g., SEBI to regulate capital markets, RBI to regulate financial markets, Telecom Regulatory Authority of India to regulate telecommunication business, 'Electricity Regulatory Authority at Central as well as State levels to regulate power sector, Tariff Authority of Major Ports to regulate ports, Insurance Regulatory and Development Authority to develop insurance sector, Petroleum and Natural Gas Regulatory Board for the petroleum and gas sector, National Pharmaceutical Pricing Authority for drugs, Pension Fund Regulatory and Development Authority to regulate pension funds, Forward Markets Commission to regulate commodities markets, etc. Given the growing number of regulators in India, the varying statutes of these regulators both at the Central and State level and their approaches to regulation of various sectors, the government is in process of framing of a national approach towards regulation.

23.4.4 Evaluation of the Policy Reforms

Of the three sectors of the economy the biggest benefactor of the reform measures has been the services sector. As already discussed in Unit 10, the service sector has recorded phenomenal growth during the last two decades, much higher than what has been recorded in the primary and the secondary sectors. As a result, the share of the service sector in India's GDP has been continuously rising. The service sector has become the dominant sector of the economy. The growth of service sector, however, has not been smooth. It has, from time to time, come against strong barriers and boulevards; these have involved legislative amendments, bureaucratic interventions and judicial reviews. These have involved policy changes and reforms. We will have a brief review of the major policy issues facing the service sector.

Check Your Progress 1

1) Discuss in brief the features of the economic environment in which service sector worked in India during the first four decades of economic growth.

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2) Discuss in brief the character of the service sector in India.

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3) Name the various regulatory authorities constituted to regulate the affairs of services secor.

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23.5 SERVICE SECTOR POLICY ISSUES

Accelerating growth and exports of services is important for India. For this many policies are needed. The policy issues can be seen under the following headings.

1) Domestic Policy Issues
   i) FDI
   ii) Disinvestment
   iii) Tariff and tax related issues
   iv) Credit and finance related issues
   v) Other policy issues - General
   vi) Other policy issues - sector specific
2) Domestic Regulations
   i) Sector specific
   ii) General
3) Market access issues
   i) Due to domestic regulations
   ii) Due to subsidies
   iii) Other barriers
4) Other issues like bilateral, regional and multilateral negotiations and policies of multilateral institutions.

23.5.1 Domestic Policy Issues

1] **Foreign Direct Investment (FDI)**

Some important policy issues in the case of FDI in Services sector for India are the following:

a) **Opening retail trade,** where FDI is prohibited (except single brand product retailing subject to 51 per cent cap) where there is a large unorganised sector with low tax compliance. Along with allowing FDI in retail in a phased way beginning with metros, the existing mom and pop shops (kirana shops) could be incentivised to modernise and compete effectively with the retail shops foreign or domestic.

b) **Raising FDI cap in the insurance sector** from 26 per cent has been in the Government's agenda for long but could not be implemented for various reasons. Given the practical difficulty in raising FDI Cap in the insurance sector as a whole, at least some segments of the insurance sector can be opened up further. One such segment is health insurance and FDI cap at least in health insurance can be raised in India on a priority basis as it will also help the export of super-speciality hospital services. There is also a 10 year disinvestment clause in the insurance sector which could be removed. FDI restrictions in reinsurance sector could also be removed and foreign re-insurance companies should be allowed to set up their representative offices and function in India through a network of branches and divisions.

c) **In the Banking sector** there is scope for further liberalisation. Though foreign investment (FDI+FII) of 74 per cent is allowed, there are licensing requirements. There is also a limit of ten per cent on voting rights in respect of banking companies. While many concerns have to be addressed here particularly in the light of the recent global financial crisis, at least some segments of this sector could be opened up to foreign investment in areas like rural banking with the help of mobile technology.

d) **In Construction Sector,** though 100 per cent FDI is allowed under automatic route, there are conditions like minimum capitalisation norms of US$10 million for wholly owned subsidiaries and US$5 million for joint venture, minimum area norms under each project — 10 hectares in case of development of services, housing plots and built-up area of 50,000 sq. mts. in case of construction development project and any of the above in case of a combination project. Besides, original investment cannot be repatriated before a period of three years from completion of minimum capitalisation, some of these conditions could be relaxed.

e) **Telecommunications:** In the case of ISP without gateway, the 26 per cent disinvestment clause in 5 years to companies listed in other parts of the world could be relaxed.

f) **Air Transport Services:** 49 per cent FDI is allowed (100 per cent for NRI investment) subject to no direct or indirect participation by foreign airlines thus preventing those with experience from operating in this sector. Ministry of Civil Aviation's initiative to liberalise this sector needs to be taken to its logical conclusion, while security concerns are also addressed.

2] **Disinvestment**

There is plenty of scope for disinvestment in the case of Public Sector Units (PSUs) in services sector under both the Central and State governments. Around 27 PSU's in different segments of the Services sector can be considered for disinvestment. Among the 27 companies, disinvestment could possibly be initiated immediately in the case of some companies. In some cases, there can be even full sale of the companies. In the case of the companies, where there are issues related to labour, etc., some per centage of the government shares could be offloaded. The above disinvestments can not only yield sizeable revenue for the government, but also make these companies more efficient contributing to the growth process.

3] **Tariff and Tax related**

In some significant segments of services which need to be examined and addressed to make Indian services more competitive compared to our competitors. Some important tariff and tax related suggestions can be as follows:

A. Shipping Services:

Strengthening Indian fleet by rationalising the taxes in Shipping Sector: Studies show a positive contribution by the Indian Shipping Industry to the Indian economy, with a 1 per cent change in Gross Tonnage (GT) likely to bring about 0.0068 per cent change in GDP. While trade has increased, India's Shipping has not kept pace with it. This would require an estimated investment of US$ 4 to 5 billion. Though the Indian shipping industry has benefited due to the introduction of tonnage tax, Indian flag vessels are gradually diminishing and even Indian owners are increasingly opting to own vessels outside India by paying, virtually zero tax, employing shipboard personnel of any nationality, while accessing India's booming cargo base. This calls for rationalisation of the taxes in the shipping sector.

B. Tourism Services:

a) <u>Rationalising the tax structure for tourism</u> as the overall tax impact on tourism is around 30-35 per cent.

b) <u>Reduction in taxation on ATF</u> which directly affects airfares. It is better to bring ATF under "Declared goods" which will reduce duty to 4 per cent.

c) <u>Rationalising state luxury tax</u> at around 5 per cent which at present varies from 5 per cent to 20 per cent in different states with some states charging not on the actual rate but on rack rates (published rate) which affect tourists when the former is lower than the latter.

d) <u>Addressing the anomalies in the per seat passenger tax</u> which affects tourist buses not plying with full capacity and penalises buses carrying more passengers and reducing pollution compared to other vehicles like cars.

e) <u>Rationalising the fees for entry to monuments</u> and using the fees for their maintenance. Private sector could also be allowed to maintain monuments and collect fees on the lines of toll taxes.

C. Entertainment Services:

<u>Tax credit issue:</u> UK gives 25 per cent tax credit for films i.e. 25 per cent of expenditure of budget of films is rebated (though subject to a limit). Though this is actually a subsidy, it is disguised as tax credit and is not at all related to the usual taxes which have to be paid. This type of subsidy given by UK and other countries led to investment in film production companies in these countries. India does not give such benefits and many film production of India produce films in UK to avail of this benefit and show only a part of their work from India where there is no benefit and taxes are high. The options with India are two. Either, give such tax credits and gain from huge investments along with multiplier effects while usual taxes can continue, or else, raise this issue in the WTO and other fora as there is an unfair advantage for providers of these services in countries giving subsidies.

D. Engineering, Construction and Infrastructure Services:

a) Taxing each member's share of profits/losses instead of tax as Association of Persons since infrastructure construction contracts are generally executed through a prime contractor or a consortium of companies or established through Joint Ventures (JVs).

b) Allowing advance tax instead of TDS as it creates a severe cash flow problem in a business where margins are low.

c) Customs and Excise issue: To give a big boost to infrastructure projects, all imports including spares and parts, can be lowered or made duty free.

d) Procedural changes: Liberal import of high tech equipment is permitted for infrastructure projects but the procedures require fine-tuning.

e) Need to re-think over the restoration of income tax sops for infrastructure withdrawn w.e.f. 01.04.2007 as infrastructure is now more or less well defined. This includes restoration of 10(23) G of the Income Tax Act under which banks get an exemption on their interest income for financing infrastructure.

f) The issue of high stamp duties in some states needs to be addressed.

E. Healthcare:

a) At the central government level zero customs duty for all equipment/spares to enable hospitals to provide the latest technology as available in the West; lower excise duty to the indigenous manufactures of medical equipment, drugs and other consumables; higher depreciation allowance to counter the high rate of obsolescence of technology and to generate internal accrual for replacement.

b) At the state level, measures could include exemptions of sales tax and octroi for capital goods items used in hospitals including super specialty hospitals exporting healthcare and research centers.

F. IT Services and Telecom:

a) Addressing the issue of customs bonding as Companies operating under the STP scheme are required to get their premises customs bond necessitating multiple approvals from DOE-STP and also the Customs and the Excise departments resulting in delay of movement of computer and other equipments from STP to another.

b) Resolving the difference of opinion between the Central Government and State governments on taxability of certain items like SIM cards, recharge coupons, bill plan rental, handsets/modems, IT software, etc. leading to double taxation on the same transaction.

c) Need for clarity on applicability of sales tax or service tax on IT Software.

G. Some other common tax related Issues:

a) Need for clarity in service tax refund policy on input services as many companies are not able to get refund.

b) Transfer Pricing issue. The Budget 2009-10 has proposed the creation of an alternative dispute resolution mechanism within the Income Tax Department for the resolution of transfer pricing disputes. It was proposed in the Budget to empower the CBDT to formulate "safe harbour" rules. These initiatives need to be expedited and taken to their logical conclusion.

c) Having a single return for service tax and excise tax administered by same Department.

d) Reduction of the TDS rate of 10 per cent for professional and technical services sector which is too high.

e) Making TDS uniform for all heads of income with exemptions for small incomes upto a certain threshold limit.

4] **Credit and Finance related Issues**

Some of the important credit and finance related issues for selected significant segments of the service sectors are as follows:

a) Addressing the issue of withholding tax on interest paid on ECBs. The requirement of overseas lenders/investors is that interest due to them be paid without deducting any withholding tax in India. Exemptions could be considered atleast for foreign currency borrowings raised for financing all export related activities and overseas acquisitions.

b) Venture capital funding, given the difficulty of arranging security/ collateral especially by first time entrepreneurs, as in the case of software sector in US where more than 20 per cent of the investments has been due to venture capital since the 1980s. The venture industry not only provides the capital to create some of the most innovative and successful companies, but also becomes actively engaged with a company, typically taking a board seat. With a startup, daily interaction with the management team is common. Given the fact that some of the renowned venture capital backed companies include Intel Corporation, Microsoft, Apple, Google and Starbucks Corporation among others, there is a need to focus on Venture Capital for services sector.

c) Extending specific dedicated lines of credit focusing on promotion of service exports like construction services, IT related services and education services.

5] Other policy issues – General

There are many other policy issues of a general nature. These include the following:

a) Increasing visibility of India in services by showcasing India's services overseas by workshops, buyer-seller meets and positioning people in some major markets for services including by sectors or regions and a sincere effort to reorient our foreign missions to focus on India's commercial interests by placing professionals and experts on services in these missions. Supplier companies must make sure that they appear on the first page of Google and other search engines in response to the relevant key words entered into a search engine.

b) Facilitating measures for promoting services exports including setting up joint offices with common facilities to help professional services as in Hong Kong, devoting some SEZs exclusively for services, facilitating Indian companies to set up subsidiaries in EU as it is difficult to enter EU market, etc.

c) Standardisation of services on the lines of National Manufacturing standard.

d) Setting up an institutional mechanism as lack of a single nodal department/division/institution is one of the weaknesses of the services sector, particularly for domestic policy making. Since, coordinated policy action is needed, there is a need for a nodal department or division, preferably in the Department of Economic Affairs, Ministry of Finance which can look into all aspects related to services, while the individual departments dealing with some services or some aspects of services can continue their usual work as is being done by them at present.

e) Having a preferential system for overseas investors in domestic market and government procurement for services.

f) Setting up a portal for services to provide useful information for Foreign Service providers who intend to do business with India in this sector. This can also help in increasing the visibility of India in terms of its capability.

g) Consolidation of the service providers in each sector to face international standards.

Check Your Progress 2

1) Make suggestions to encourage foreign direct investment in India's service sector.

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2) Highlight the different tax-related issues facing the service sector in India.

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3) Examine the tax-related issues being faced by the health sector in India.

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23.5.2 Domestic Regulations

One major issue in services is the domestic regulations in India. Using the strict definition as indicated in the WTO documents, domestic regulations basically include licensing requirements, licensing procedures, qualification requirements, qualification procedures and technical standards. Since domestic regulations perform the role of tariffs in regulating services, we have to list the domestic regulations in India which need to be disciplined to help growth of the sector and exports, while retaining those domestic regulations which need to be retained at this stage.

As per the World Bank and IFC publication "Doing Business 2010" India ranks 133 among 183 countries in the ease of doing business. Though in trading across borders, India was the top reformer, India's poor ranking in most of the sub indicators is mainly due to domestic regulations like licensing and procedural delays. The difference between different cities in India is sharper. Domestic regulations not only affect manufacturing but also services. An indicative list of some important domestic regulations in India which need to be examined for suitable policy reforms in different service sectors are given below.

A. Transport Services

Restrictions on inter-state movement of goods and coordination issues between government departments in the case of multimodal transportation and need for changes in merchant shipping Act and multimodal Transportation of Goods Act, 1993. There are also restrictions on free movement of cargo between ICDs, CFSs and Ports.

B. Construction, Engineering and related Services

a) Restrictions like minimum capitalisation norms, some restrictions on repatriation, minimum area norms and a general umbrella clause that all applicable rules/ bye laws/ regulations of the state government/ municipal/ local body concerned have to be complied with.

b) Restrictions under the Urban Land Ceiling and Regulation Act. As a result of this Act, construction services firms in India operate at a small scale, and do not exploit economies of scale.

C. Healthcare Services

Restrictions on foreigners providing healthcare services: While there is no cap on FDI in health services, foreign individuals are prohibited from providing services for profit and their movement is subject to registration by Medical/ Dental/ Nursing council of India.

D. Infrastructure Services

Reforming the regulatory framework which include efficient, transparent and standardised bid process/ procurement; clarity in contractual structure/ concessions/ incentives and adoption of equitable contract as under International Federation of Consulting Engineers (FIDIC) or Construction Industry Development Council (CIDC) guidelines; well defined pre-qualification norms; single window regulatory approvals; effective dispute resolution mechanism; harmonised legal definition of infrastructure; and liberalised investment guidelines for debt and equity instruments.

E. Financial Services

Many regulations under the Banking Regulation Act which at present has the requirement that banks obtain regulatory approval for a range of routine business matters including opening branches, remuneration to board members and even payment of fees to investment bankers managing equal capital offerings as pointed out by the Raghuram Rajan Committee report.

In the case of insurance, besides, cap on foreign investment of 26 per cent/ other restrictions like minimum capitalisation norms, funds of policy holders to be retained within the country, compulsory exposure to rural and social sectors and backward classes.

F. Others – General

a) Need for a competition policy for 'Services' in India and a regulatory body. While there are regulators for some services like Banking, Insurance, Telecom and Ports, there are no independent regulators for most professional services with de facto regulation taking place through a combination of statutes provided in law and by professional all-India and state councils. There is need for strengthened regulation, to protect the interests of Indian consumers and to get recognition for the qualifications by foreign governments and regulators in sectors like education and healthcare services where regulatory regimes and current enforcement of regulations have resulted in a huge disparity in the quality of services and the abilities of domestic service providers.

b) Transfer pricing which is aggressively attacked by India as mentioned earlier.

c) Indian laws like prohibiting night shifts for women and laws related to contract labour which affect different services.

23.5.3 Market Access Issues

This is another important issue as domestic regulations and policies in India's major services markets deny market access for India's services exports. Market access barriers can be due to domestic regulations, subsidies or other barriers. However, we do not deal with them in detail and give only some examples under the different categories. These are as follows:

a) **Market access barriers due to domestic regulations in the US** include state level licensing and the 'Buy American' provisions in the case of business services and IT services, and many others. The latest protectionist policies in US and other economies like the conditions in U.S. bailout package related to employment of non- U.S. nationals and moves against outsourcing are the new domestic regulations denying market access to other countries.

b) **Market Access barriers due to subsidies** include the huge subsidies in the Civil Aviation sector to aircraft in both US and EU; the subsidy programme in shipping providing an operating cost subsidy of $100 million a year for a period of ten years for US registered ships meeting certain requirements; etc.

c) **Other Market Access barriers** include a 50 per cent ad valorem tax on the cost of equipment and non-emergency repairs for US flag vessels done outside US which is an example of tariff barrier on shipping services by the US; the provision of free medical services to all UK citizens under the NHS system which acts as an invisible market entry barrier in healthcare services and possibly even helps the export wing of the NHS.

Check Your Progress 3

1) Examine some of the important domestic regulations on service sector in India.

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2) Make suggestions on improving domestic regulations relating to infrastructure services in India.

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3) Make suggestions on improving financial services in India.

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4) Identify the market access barriers to services sector.

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23.6 LET US SUM UP

The unit throws light on the different suggestions for reforms in the services sector. Among these suggestions, there are many reforms given in Box 1, which need to be initiated and implemented in the short term. Some policies like opening retail trade, opening insurance sector, liberalising air transport services, FDI in railways, disinvestment of those PSUs involving labour issues, etc. may need more time. Nevertheless, it is worth making efforts to push these reforms as well.

Box 1: Policy suggestions for services sector in the short term

FDI

- Opening some segments of insurance sector like health insurance and removing the 10 year disinvestment clause.
- Liberalising foreign investment in rural banking with the help of mobile technology.
- Liberalising FDI in animation sector.
- Relaxing the minimum area norm in construction sector.
- Raising foreign investment cap for uplinking news and current affairs TV channel from 26 per cent.
- Making available FDI policy in the website in a user friendly way.

Disinvestment

- Initiating disinvestment in atleast 9 PSUs (out of 27), namely, SCI, EIL, RITES, EPIL, ITPO, STC, MMTC, NBCC and NFDC.

Tariff and Tax related

- Addressing the issue of multiple levies and duties in telecom.
- Rationalising taxes in shipping sector.
- Resolving advance tax instead of tax deduction at source (TDS) in some services like engineering and construction.
- Introducing electronic system of tax payment for tourist vehicles.
- Rationalising the entry fees for monuments and privatization of these services.
- Addressing the tax credit issue in the case of films.
- Addressing the issue of Royalty/ Turnover tax by Airport authorities on service centers.
- Addressing the inverted duty issue in printing sector.
- Allowing advance tax instead of TDS in Engineering and Construction sector.
- Procedural changes for capital goods used in hospitals including super specialty hospital exporting healthcare services and in health-related research centers.
- Resolving the differences in the case of taxability of items like SIM Cards, recharge coupons, IT software, etc.
- Making TDS uniform for all heads of income with exemptions for small incomes upto a certain threshold limit.
- Expediting the measures related to transfer pricing.
- Single return for service tax and excise tax which are being administered by the same Department.
- Reduction of TDS for professional and technical services.

Credit and Finance related issues

- Exempting interest paid to ECBs from withholding tax for financing export related activities and overseas acquisition including of ships.
- Encouraging venture capital in services.
- Operationalising offshore financial centers.

Other policies – General

- Increasing visibility of India in services through trade fairs, buyers-sellers meets and setting up convention centers.
- Facilitating services exports by setting up joint offices with common facilities and devoting some SEZs exclusively for services.
- Standardisation of services.
- Institutional mechanism for services by a nodal department/ division for services in Ministry of Finance.
- Setting up a portal for services.

Other policies – sector specific

- Speeding up auctioning of 3 G technology.

- Utilising USO funds for construction of towers across villages.
- Strengthening Indian fleet and providing long term contracts for Indian flags.
- Promoting ship repair services.
- Rationalisation of port dues.
- Modernising port infrastructure on priority basis.
- Preparing a standard contract document and setting up consortiums in construction sector.
- Resolving the issue of precondition in most of the overseas tenders wherein equipment to be supplied by the contracting company should necessarily be sourced from an approved list of suppliers from developed countries.
- Exploring the opportunity for low-energy buildings.
- International accreditation for health services.
- Tapping the demand for outsourcing financial and accounting services in healthcare sector.
- Changes in CGHS system with the help of outsourcing to private sector.
- Tapping outsourcing in niche areas like actuarial and accounting services.
- Mergers and acquisitions and coordination policy for setting up bank branches.
- Introducing climate change related financial schemes/instruments.
- Creating holiday homes by utilising idle resources in public sector units.
- Implementing the IT amendment Act including Data protection.
- Totalisation agreements with target countries and making necessary changes in domestic laws.
- Reviewing built in space norms and patient load factors to be in tune with present day equipment intensive care and modern practices and procedures.
- Revamping the system of teaching, research, etc. in universities/institutions, phased introduction of education reforms and allowing foreign educational institutions in higher education with proper checks and balances.
- Privatisation of sewage services.
- Skill certifying unskilled labour.

Domestic regulation

- Addressing restrictions on inter-state movement of goods.
- Resolving the issue of ban on use of logs of accounting firms.
- Removing the unnecessary regulations under Banking Regulation Act.
- Competition policy for services and regulatory body for services other than banking, insurance, telecom and ports.

Immediate and time-bound reforms in the services sector could not only help in attaining our targeted GDP growth rates, but also give a fillip to growth and exports of this services led economy.

23.7 EXERCISES

1) Make a critical evaluation of the economic environment in which the service sector has developed in India since 1990.

2) Suggest measures to improve domestic regulations relating to the service sector in India.

3) Examine the different tax-related issues in the service sector in India.

23.8 SOME USEFUL BOOKS

H.A.C. Prasad and R. Sathish, (2010): *Policy For India's Service Sector, Working Paper* NC. 1/2010—DEA, Ministry of Finance, Government of India.

Seema Joshi, (2006): Growth and Structure of Tertiary Sector in Developing Economies, Academic Foundation, New Delhi.

Ishwar C. Dhingra, (2012): *The Indian Economy, Environment and Policy*, Sultan Chand and Suns, New Delhi.

Kaushik Basu (ed), (2010): *The Oxford Companion to Economics in India*. Oxford University Press, New Delhi.

Government of India, Eleventh Five year Plan 2007-2012, Planning Commission, New Delhi.

World Bank, (2006): Sustaining India's Services Revolution, Washington DC.

Government of India, Report of The High Level Group on Services Sector, Planning Commission, New Delhi, 2008.

23.9 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) See Section 23.2

2) See Section 23.3

3) See Sub-section 23.4.3

Check Your Progress 2

1) See Sub-section 23.5.1

2) See Sub-section 23.5.1

3) See Sub-section 23.5.1 under E, 'Health Care'

Check Your Progress 3

1) See Sub-section 23.5.2

2) See Sub-section 23.5.2

3) See Sub-section 23.5.2