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Improving Product Market
Regulation in India: An
International and Cross-
State comparison

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By Paul Conway and Richard Herd

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ABSTRACT/RÉSUMÉ

Improving Product Market Regulation in India: An International and Cross-State comparison

Competition in product markets has been found to be an important determinant of economic performance in developed and developing countries. This paper uses the OECD's indicators of product market regulation (PMR) to assess the extent to which India's regulatory environment is supportive of competition in markets for goods and services. The results indicate that although liberalisation has improved the regulatory environment to international best practices in a few areas, the overall stance of product market regulation is still relatively restrictive. The regulatory environment is also found to vary markedly across the 21 Indian states for which the PMR indicators are estimated. The paper goes on to review various aspects of product market regulation in India and suggest a number of policy initiatives that would improve the degree to which competitive market forces are able to operate.

This working Paper relates to the *2007 Economic Survey of India* (www.oecd.org/eco/surveys/india).

JEL classification: K2, L5, 01, 025.

Keywords: Indicators; product market regulation; competition.

Améliorer la réglementation des marchés de produits en Inde : comparaison internationale et situation dans les différents États

On sait aujourd'hui que la concurrence sur les marchés de produits est un déterminant important de la performance économique des pays développés et en développement. Utilisant les indicateurs de réglementation des marchés de produits (RMP) mis au point par l'OCDE, la présente note examine dans quelle mesure les dispositions en vigueur en Inde permettent à la concurrence de s'exercer sur les marchés de biens et de services. Il ressort de cette analyse que, bien que l'environnement réglementaire ait été aligné sur les meilleures pratiques internationales dans quelques domaines grâce à des mesures de libéralisation, la réglementation des marchés de produits demeure relativement restrictive dans l'ensemble. Par ailleurs, la situation est très variable suivant les 21 États de la Fédération pour lesquels les indicateurs de RMP sont estimés. Après un examen de différents aspects de la réglementation des marchés de produits en Inde, un certain nombre d'initiatives sont proposées dans le but de faciliter le jeu des mécanismes concurrentiels du marché.

Ce document de travail se rapporte à l'Étude économique de l'Inde 2007 (www.oecd.org/eco/etudes/inde).

Classifications JEL : K2, L5, 01, 025.

Mots clés : Indicateurs ; réglementation des marchés de produits ; concurrence.

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IMPROVING PRODUCT MARKET REGULATION IN INDIA: AN INTERNATIONAL AND CROSS-STATE COMPARISON

Paul Conway and Richard Herd¹

1. Introduction

1. Successive waves of reform since the mid-1980s have progressively moved India away from its former *dirigiste* economic model towards a market-based system. The reform of regulations that shape the business environment in markets for goods and services – henceforth referred to as product market regulation – has been an integral part of this transformation. As in a number of developed and developing countries, this reform process has been closely intertwined with increasing the extent of competition in product markets. State intervention and control over economic activity has been significantly reduced and the role of private-sector entrepreneurship increased.

2. Although India has clearly made significant progress in liberalising product markets, the extent to which regulation is conducive to competition is still an important concern and a number of national and international business surveys have highlighted weaknesses in India's business environment.² As well as being an issue at the national level, the degree to which the regulatory environment is supportive of competition is also an important concern at the state level. India's constitution mandates direct responsibility for a number of areas of economic policy to the state governments as well as shared responsibility with central government in a number of other areas.³ Accordingly, state governments may implement their own laws in certain areas, or amend central legislation prior to implementation. Moreover, the state governments usually formulate and administer the rules and procedures through which all laws are enforced. As a result, differing views across state governments on the role of the public sector and the efficiency with which laws and regulations are administered can lead to considerable differences in the business environment across states.

3. This paper uses the OECD's indicators of Product Market Regulation (PMR) to assess the extent to which India's regulatory environment promotes or inhibits competition in areas of the product market where technology and market conditions make competition viable. These indicators summarise data covering most of the important aspects of general regulatory practice as well as some aspects of industry-specific regulatory policy. The regulatory areas covered by the PMR indicators can be classified into three broad groups: the extent of *state control* in the economy, the degree to which regulation acts a *barrier to entrepreneurship*, and the existence of regulatory *barriers to international trade and investment*. As well

1. OECD Economics department, 2 rue Andre Pascal, 75775 Paris Cedex 16, France. Email paul.conway@oecd.org. We would like to thank Willi Leibfritz, Sean Dougherty, Giuseppe Nicoletti, and Stefano Scarpetta for useful comments on an earlier draft of this paper. Thanks also go to Thomas Chalaux for statistical assistance and Nadine Dufour for secretarial support. We are also most grateful to Dr. Simrit Kaur who was the principle consultant based in Delhi working on the PMR indicators for India.

2. See, for example, World Bank, 2007 and World Bank-CII, 2002.

3. The Union List stipulates areas of regulatory responsibility that are the exclusive preview of the Government of India (for example, exit policy and bankruptcy procedures) whereas items on the State List come under the jurisdiction of the state governments (for example, inspections and compliance with regulation). A third list – the Concurrent List – covers areas where the centre and state governments have joint responsibility (for example, entry and labour regulation).

as being estimated at the national level, a modified version of the PMR indicators is estimated for 21 states, which collectively encompass around 98% of both India's GDP and population.

4. The PMR indicators have a number of characteristics that differentiate them from other indicators of the business environment. First, the low-level indicators only record 'objective' data about rules and regulations, as opposed to 'subjective' assessments of market participants as in indicators based on opinion surveys. This isolates the indicators from context-specific assessments and makes them comparable across time and countries or states in the case of India. Second, the PMR indicators follow a bottom-up approach, in which indicator values can be related to specific underlying policies. One of the advantages of this system is that the values of higher-level indicators can be traced with an increasing degree of detail to the values of the more disaggregated indicators and, eventually, to specific data points in the regulation database. This is not possible with indicator systems based on opinion surveys, which can identify perceived areas of policy weakness, but cannot attribute these to specific policy settings.

5. The results of applying the OECD's PMR indicator methodology to India suggest that there is considerable scope for improving the extent to which product market regulations allow competitive market forces to operate. Although reforms over the past 20 years have improved a few areas of the regulatory environment to international best practice, the overall stance of product market regulation remains much more restrictive than in a typical OECD country. For example, public sector involvement in product markets is significantly higher in India in comparison to OECD countries. Barriers to entrepreneurship are also typically higher in India than in OECD countries. Although these barriers are predominantly a reflection of high administrative burdens on business start ups, they could also be indicative of more widespread transaction costs in government administration. At the state level the PMR indicators confirm that cross-state differences in product market regulation are significant.

6. As well as assessing the extent to which India's regulatory environment supports competition, the paper also uses the results of the indicator analysis to outline a number of areas in which policy improvements would increase competition in product market. In broad terms, these include changes in the governance structure for public sector enterprises, reducing administrative burdens on enterprises, and ongoing consolidation of tariff rates and ceilings on foreign investment.

7. The remainder of the paper is structured as follows. Section 2 briefly describes the process of collecting the regulatory data used to estimate the PMR indicators in India. It also outlines the PMR indicator methodology and describes the way in which these indicators have been adapted to suit the Indian environment. Section 3 presents the overall PMR indicator results at the national and state levels and Section 4 uses the more detailed indicator results to outline a number of regulatory areas where policy changes would help increase competition in markets and improve economic performance.⁴

2. Measuring product market regulation

2.1 *Collecting data on product market regulation*

8. The regulatory database used to construct the PMR indicators covers regulations that affect the economy at large as well as some aspects of industry-specific regulatory policies that are representative of economy-wide regulatory approaches (in particular, in retail distribution, air and rail passenger transport, rail and road freight, telecommunications). In total, the PMR indicators summarise information on 139 economy-wide or industry-specific regulatory provisions that have a bearing on competition. These data

4. In a companion paper, Conway *et al.* 2008, relates the state-level PMR indicators to economic performance and finds that product market regulation is a significant determinant of state productivity through a number of important channels.

were primarily collected using a detailed questionnaire – the *OECD Regulatory Indicators Questionnaire* – that was answered by civil servants that have knowledge and/or responsibility related to the relevant policy area.

9. In the case of India, the questionnaire was split into two parts covering product market regulations under the jurisdiction of the central and state governments respectively. For the central government, the Ministry of Finance acted as a contact point and coordinated the responses of the various central Ministries that answered different sections of the questionnaire. At the state level, data collection was more challenging. Of the 21 states for which the PMR indicators were calculated the state capitals of the following nine states were visited in person: Assam, Bihar, Haryana, Jharkhand, National Capital Territories (Delhi), Punjab, Rajasthan, Uttar Pradesh, and West Bengal. The purpose of these visits was to meet with government officials, usually at the Principal or Deputy Secretary level, in various Departments of the state governments to collect data on state-level regulation.⁵ In total, meetings were held with over 50 state government officials during the course of these visits. For the remaining 12 states – Andhra Pradesh, Chhattisgarh, Goa, Gujarat, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Orissa, Tamil Nadu, and Uttaranchal – meetings were held with the Resident Commissioners, who are the state’s representatives in Delhi and acted as contact points for the completion of the *OECD Regulatory Indicators Questionnaire* for their state. As well as collecting data from the state governments, a law firm was also used to collect data on the requirements for setting up two different types of business in each of the 21 states.⁶ All of the questionnaire answers were then vetted by an independent consultant before being submitted to the OECD.

10. The quality of the regulatory data used to calculate the PMR indicators is clearly an extremely important consideration and a great deal of effort was put into ensuring the accuracy of the questionnaire responses. Namely:

- As well as meeting with state governments, a number of meetings were also held with business people in some of the state capitals that were visited. The purpose of these meetings was to identify perceived areas of policy weakness and corroborate the regulatory data collected from government. These meetings were usually organised by one of the Indian business associations (the Confederation of Indian Industry or the Federation of Indian Chambers of Commerce and Industry).
- To the extent possible, secondary data sources were used to corroborate regulatory data provided by government. For example, the Comptroller and Auditor General of India has a great deal of information on public sector enterprises, both at the central and state levels, and this was used to confirm data collected on the extent of state ownership in various sectors of the Indian economy. Data collected on the procedures for setting up different types of businesses across states were compared with the World Bank’s Doing Business data in the 12 states in which it has been collected (World Bank 2006).
- The websites of the state governments were also consulted extensively to confirm answers to the questionnaire and fill any holes in the database. The industrial policies of almost all of the states included in the study are available on the government websites.

5. Principal or Deputy Secretary is the third highest Indian Administrative Service grade. Discussions were typically held with administrators in the following departments: Public-Sector Undertakings (or Disinvestment), Industries, Power, Transport, Food and Civil Supplies, and Planning. In some states meeting were also held with people in the Finance and Development Departments.

6. This firm, Singhania & Partners, has its head office in Delhi and assess to a network of law practices throughout India. They have experience in collecting this type of data having worked with the World Bank on their Doing Business surveys in India on a number of occasions.

- Once all of the regulatory data had been compiled for the 21 states it was send back to the State Secretaries in the states that were visited in person and the Resident Commissioners of the other states so that they could vet the data and ensure its accuracy.

11. Most of the data used to calculate the national and state-level PMR indicators for India were collected over the period June to October 2006. In comparison, the most recent update of the PMR indicators for OECD countries, which is used in the international comparisons in Section 3, was based on regulatory data collected at the end of 2003.

2.2 The PMR indicator system⁷

12. The PMR indicator system is based on 16 low-level indicators that each captures a specific feature of the regulatory regime and collectively span most of the important aspects of general regulatory practice (Table 1). To calculate these low-level indicators, qualitative data on product market policy

Table 1. The PMR Indicators: Description and State/Centre Split

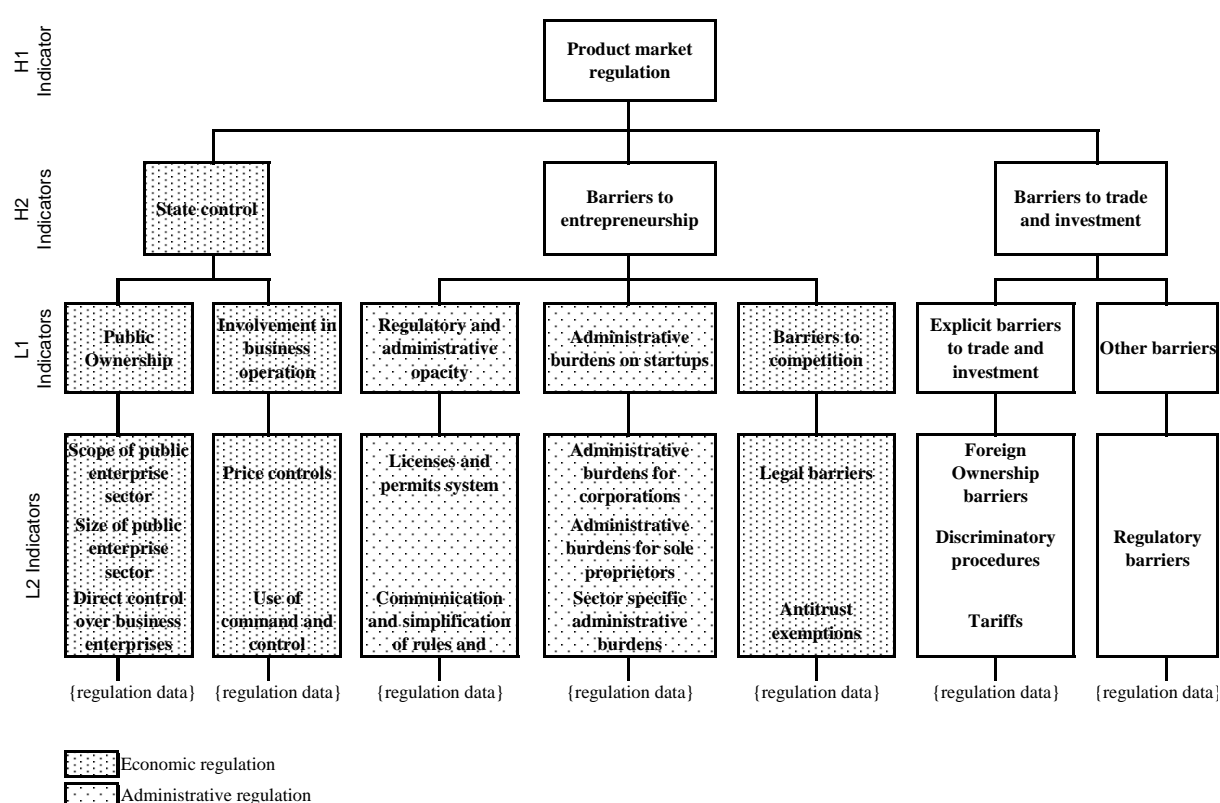
	L2 Indicator	Description	State-level PMR
State control	Scope of public enterprise sector	the pervasiveness of state ownership across business sectors	yes
	Size of public enterprise sector	overall size of PSEs relative to the size of the economy	yes
	Direct control over business enterprise	extent of government control over business over and above ownership (eg, special voting rights)	yes
	Use of command and control regulation	use of coercive, as opposed to incentive-based, regulation	no
	Price controls	extent of price controls in specific sectors	no
Barriers to entrepreneurship	License and permits system	use of 'one-stop shops' and silent is consent rules	yes
	Communication and simplification of rules and procedures	communication and efforts to reduce administrative burden of interacting with government	yes
	Administrative burdens for corporation	admin burden for setting up corporation	yes
	Administrative burdens for sole proprietor firms	admin burden for setting up sole trader	yes
	Sector specific administrative burdens	admin burden in retail and road transport sectors	yes
	Legal barriers	explicit legal entry barriers across a range of business sectors	no
	Antitrust exemptions	exemptions of public enterprises to competition law	no
Barriers to foreign trade and investment	Foreign ownership barriers	legal restrictions on foreign acquisition	no
	Discriminatory procedures	procedural discrimination against foreign firms	no
	Regulatory barriers	other barriers to international trade	no
	Tariffs	simple average of MFN tariffs	no

7. This section provides only a very brief summary of the PMR indicator methodology. For a detailed description of the PMR indicators and the results for OECD countries see Nicoletti *et al.* (1999) and Conway *et al.* (2005).

settings – such as YES/NO answers – are coded by assigning a numerical value to each of the possible responses to a given question. Quantitative information is subdivided into classes using a system of thresholds. This coded information is normalised over a scale of zero to six, reflecting increasing restrictiveness of regulatory provisions to competition. These data are then aggregated into the 16 low-level indicators by assigning subjective weights to the various regulatory provisions.

13. The 16 low-level L2 indicators are then aggregated in the form of a pyramid to create an overall indicator (Figure 1). There are four levels to the PMR indicator system.⁸ At each step up the pyramid the regulatory domain summarised by the indicators becomes broader. The L1 indicators, which are calculated as weighted averages of the L2 indicators, reflect policy settings in seven regulatory domains. At the next step up the pyramid the high-level H2 indicators summarise the stance of regulation in three broad areas: *state control*, *barriers to entrepreneurship*, and *barriers to international trade and investment*. Finally, the overall H1 indicator at the top of the structure summarises the main features of the regulatory framework in product markets. Higher-level indicators are calculated as weighted averages of their constituent lower-level indicators. The attribution of lower-level indicators to each higher-level indicator and the weights used in the averaging are derived using principal component analysis.⁹ In all cases the aggregation weights sum to one, which, in conjunction with the normalisation of the basic data, ensures that all the indicators have a scale of zero to six increasing in the restrictiveness of regulation.

Figure 1. The PMR Indicator System



8. Note that previous work using the PMR indicators (Nicoletti *et al.*, 1999 and Conway *et al.*, 2005) also included another level of indicators – inward-oriented and outward-oriented policies – that are not used in this paper.

9. To ensure comparability, the PMR indicators for India are calculated using the same set of weights as the indicators for OECD countries. More information on principle component analysis in the context of the PMR indicators can be found in Nicoletti *et al.* (1999).

14. As mentioned in the introduction, responsibility for different aspects of product market regulation is split between the central and state governments in India. Table 1 illustrates the way in which this demarcation of policy maps into the 16 L2 indicators. Eight of these indicators are estimated for the states – three of the indicators under the H2 domain of *state control* and five indicators under the H2 domain of *barriers to entrepreneurship*.¹⁰ The other eight L2 indicators reflect product market regulation that is set at the central level and the same across states. This includes all four of the L2 indicators that make up the H2 indicator of *barriers to international trade and investment*. Under the domain of *barriers to entrepreneurship*, the L2 indicators of *legal barriers to entry* – which in the Indian context primarily reflects reservations for small-scale industry – and *antitrust exemptions* also reflect the policies of central government. In terms of *state control*, the L2 indicators of *price controls* and *use of command and control regulation* are also primarily driven by central government.

15. The construction of two of the eight L2 indicators estimated at the state level has been altered somewhat in comparison to the standard construction for OECD countries. Reflecting data availability, the indicator of the *size of the public enterprise sector* is based on the amount of government capital invested in public enterprises as a share of state GDP. At the national level and in OECD countries this indicator is calculated using data on the value added share of state-owned enterprises and privatisation proceeds. The indicator of *communication and simplification of rules and procedures* has also been modified at the state level to suit the Indian context. Four questions, out of a total of eight, on administrative reform have been changed to more accurately assess reform efforts at the state level. In particular, these new questions assess whether: state governments have an administrative reform committee (or similar) to oversee the reengineering of government administrative processes; there is a system of self-certification in place to reduce inspector visits; the state government has a visible policy on implementing e-governance to improve coordination between government department and reduce administrative burden; composite application forms are used.

16. To calculate higher level PMR indicators for the state governments, the eight L2 indicators that reflect central government policies are excluded from the system. Accordingly, there is no estimate of the H2 indicator of *barriers to international trade and investment* in the state-level PMR indicators and the indicators of *state control* and *barriers to entrepreneurship* are calculated using three and five L2 indicators respectively. To ensure that the weights used in the averaging still sum to one, the weights on the indicators excluded from the system are proportionally redistributed to the remaining L2 state-level indicators. This, in conjunction with modifications to two of the L2 indicators, means that the higher-level state PMR indicators are not directly comparable with the national indicators. They do, however, provide a consistent assessment of the extent to which policies promote or inhibit competition in the regulatory areas under the control of the state governments.

17. At the national level the PMR indicators are calculated in exactly the same way as for OECD and other countries.¹¹ National level estimates of the eight H2 indicators applied at the state level are either calculated based on the regulatory policies of the central government if there is overlapping jurisdiction or as averages of the state-level indicators.

10. Note that Under the PMR methodology, and as depicted in Figure 1, the five L2 indicators of *barriers to entrepreneurship* that are estimated at the state level can be grouped together into a measure of *administrative regulation*.

11. As well as India, the OECD Secretariat has estimated the PMR indicators for the following non-member countries: Brazil, Chile, and Romania (OECD 2005a, OECD 2003a and OECD 2002 respectively). The World Bank has also recently estimated the PMR indicators for Bulgaria and updated the Romanian indicator values (see De Rosa *et al.*, 2007a and De Rosa *et al.*, 2007b).

3. The overall stance of product market regulation in India

18. The overall stance of product market regulation at the national level in India is more restrictive of competition than in OECD member countries, including the emerging market economies within the OECD area (Table 2a). Regulation in India is also less supportive of competition than in the Eastern European and Latin American countries for which the PMR indicators have been calculated. All three of the high-level sub-components of the overall PMR index – that is, *state control*, *barriers to entrepreneurship*, and *barriers to international trade and investment* – are found to be high in India relative to comparator countries.

Table 2. High-level PMR indicators, National and State level

The indicator score runs from 0-6, representing the least to most restrictive regulatory regime

Panel A: National

	India	OECD average	OECD emerging markets ¹	Euro area ²	Eastern Europe ³	Latin America ⁴	United States
Overall indicator	2.85	1.49	1.98	1.49	1.82	2.08	1.03
State control	3.47	2.12	2.46	2.40	2.74	2.16	1.19
Barriers to entrepreneurship	2.57	1.46	1.89	1.43	1.44	1.94	1.20
Barriers to trade and foreign investment	2.56	0.97	1.66	0.75	1.35	2.31	0.73
Indicators by functional areas							
Administrative regulation	3.02	1.64	2.17	1.68	1.69	1.99	1.09
Economic regulation	2.70	1.77	2.04	1.91	2.16	2.10	1.30

1. Czech Republic, Hungary, Korea, Mexico, Poland, Slovak Republic, Turkey.

2. Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain.

3. Bulgaria, Czech Republic, Hungary, Romania, Slovak Republic, Turkey.

4. Brazil, Chile, Mexico.

Panel B: State

	Andhra Pradesh	Assam	Bihar	Chhattisgarh	Delhi	Goa	Gujarat
Overall indicator	2.14	2.23	2.22	2.31	1.95	1.71	2.40
State control	2.43	1.96	1.94	1.46	1.90	1.64	2.50
Barriers to entrepreneurship	1.37	2.10	2.12	2.84	1.28	0.81	2.11

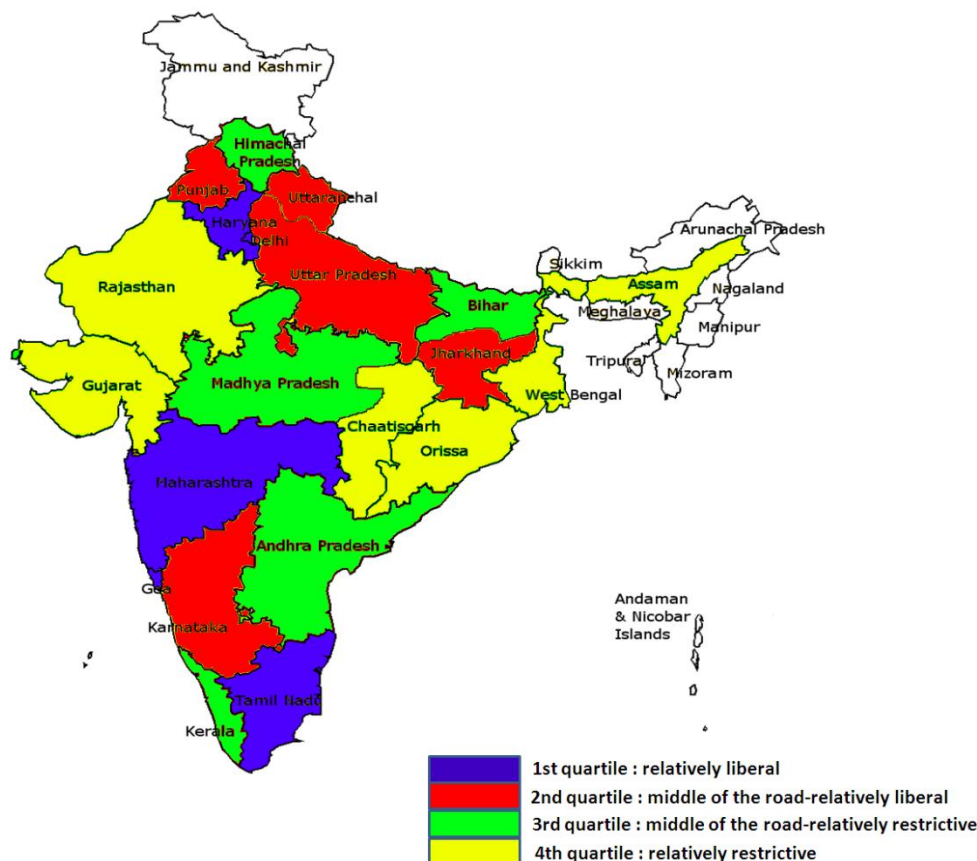
	Haryana	Himachal Pradesh	Jharkhand	Karnataka	Kerala	Madhya Pradesh	Maharashtra
Overall indicator	1.89	2.19	2.08	2.03	2.22	2.11	1.95
State control	2.05	2.34	1.34	2.56	2.46	1.76	2.04
Barriers to entrepreneurship	0.96	1.60	2.25	0.89	1.58	1.94	1.14

	Orissa	Punjab	Rajasthan	Tamil Nadu	Uttar Pradesh	Uttaranchal	West Bengal
Overall indicator	2.31	2.00	2.29	1.97	2.11	2.01	2.58
State control	2.57	2.33	1.97	2.03	1.89	1.96	2.58
Barriers to entrepreneurship	1.74	1.01	2.30	1.23	1.79	1.42	2.58

19. At the state level the PMR indicators highlight notable differences in the extent to which state government policies are supportive of competition (Table 2b). This cross-state variation reflects differences in the extent of both *state control* and *barriers to entrepreneurship*. In broad terms, according to the PMR indicators, the regulatory environment in some of the southern and north-eastern states is relatively more supportive of competition, whereas states in the east and west of the country have regulatory frameworks that are relatively restrictive of competition (Figure 2). As shown in Conway *et al.* (2008), the state rankings suggested by the PMR indicators are generally consistent with perceptions of the

relative competitiveness of the business environment across states, particularly if the affect of policy enforcement is taken into account.

Figure 2. Overall PMR Indicator by State



4. The low-level indicators and areas in need of reform

20. Notwithstanding significant progress in product market reform over the last 20 years, the high-level PMR indicators for India imply that there is still considerable scope for improving the regulatory environment through ongoing convergence towards best practice. Experience in developed and developing countries suggests that liberalising markets and increasing competition enhances economic performance through a variety of channels. In particular, increased competition has been found to improve resource allocation and stimulate innovation and technological diffusion of new technologies from more to less productive economies (for example, Aghion *et al.*, 2001 and Conway *et al.*, 2006). These are potentially key sources of productivity growth in India and the extent to which regulations and laws governing economic activity are conducive to competition in goods and services markets will be a central determinant of India's future growth rate. Within India, Conway *et al.* (2008) finds that product market regulation at the state level is a significant determinant of productivity growth, implying an urgent need for lagging states to make regulation more consistent with competition and thereby improve economic growth, which is an important key to reducing poverty.

21. In 2004, the Government of India announced that it was considering a policy to ensure that all levels of government and regulatory agencies take the competition dimension into account when formulating policy. Subsequently, the Planning Commission has released a report considering the merits of an Act of Parliament that cuts across different sectors and lays down overarching regulatory principles “to serve the objective of enhancing competition, improving efficiencies and reducing costs” (Planning Commission, 2006). The introduction of such a policy would be a key event in improving the regulatory environment. A properly designed policy to support free and fair market competition would need to emphasise the removal of entry barriers, ensure competitive neutrality between public and private sector enterprises, establish access regimes for network facilities, provide for justification and notification when it is necessary to deviate from established principles of competition, and require all government bodies to undertake a competition audit of all existing and proposed policies.

22. This section uses the results of the PMR benchmarking exercise to outline a number of specific areas in which the regulatory environment in India could be made more consistent with increased product market competition. It uses the indicators results at the national and state levels and is divided into the three broad categories of the PMR indicators: state control, barriers to entrepreneurship, and barriers to international trade and investment.

4.1. State control

23. In comparison to other countries, the extent of state control in product markets is relatively high in India at the national level. On the positive side, the sub-indicators used in the construction of this indicator imply that direct government interference in the conduct of private sector firms is minimal. Price setting, for example, is free of government interference in most segments of the Indian retail market and the degree of direct government control over private firms is broadly comparable with that in emerging OECD economies (Table 3a). This reflects the absence of government-owned special voting rights, notwithstanding restrictions on the voting rights of private shareholders in government-owned banks. On the other hand, according to the low-level PMR indicators, the size of the public enterprise sector is relatively large in India and Public Sector Enterprises (PSEs) operate across a broad range of sectors. In addition, there is also a relatively high level of command and control regulation for private firms reflecting, for example, the imposition of universal service obligations.

Table 3. State Control: National and State level

Panel A: National							
	India	OECD average	OECD emerging markets	Euro area	Eastern Europe	Latin America	United States
State control	3.47	2.12	2.46	2.40	2.74	2.16	1.19
Public ownership	3.82	2.42	2.88	2.72	3.22	2.16	1.20
Scope of public enterprise sector	4.91	3.14	3.48	3.34	3.36	3.06	2.50
Size of public enterprise sector	4.58	2.53	3.09	3.03	3.15	2.13	0.59
Direct Control over business enterprises	2.45	1.86	2.33	2.06	3.20	1.95	0.75
Involvement in business operations	3.03	1.73	1.92	2.00	2.12	1.79	1.18
Use of command and control regulation	5.00	2.16	2.17	2.78	2.48	3.13	1.50
Price controls	0.75	1.01	1.27	0.92	1.12	1.08	0.80

Panel B: State Level							
	Andhra Pradesh	Assam	Bihar	Chhattisgarh	Delhi	Goa	Gujarat
State control	2.43	1.96	1.94	1.46	1.90	1.64	2.50
Public ownership	2.25	1.47	1.39	0.60	1.39	0.94	2.40
Scope of public enterprise sector	1.91	1.36	1.64	1.09	1.09	0.82	1.64
Size of public enterprise sector	4.19	2.45	1.77	0.00	2.62	1.56	5.12
Direct Control over business enterprises	0.95	0.68	0.82	0.55	0.55	0.41	0.82

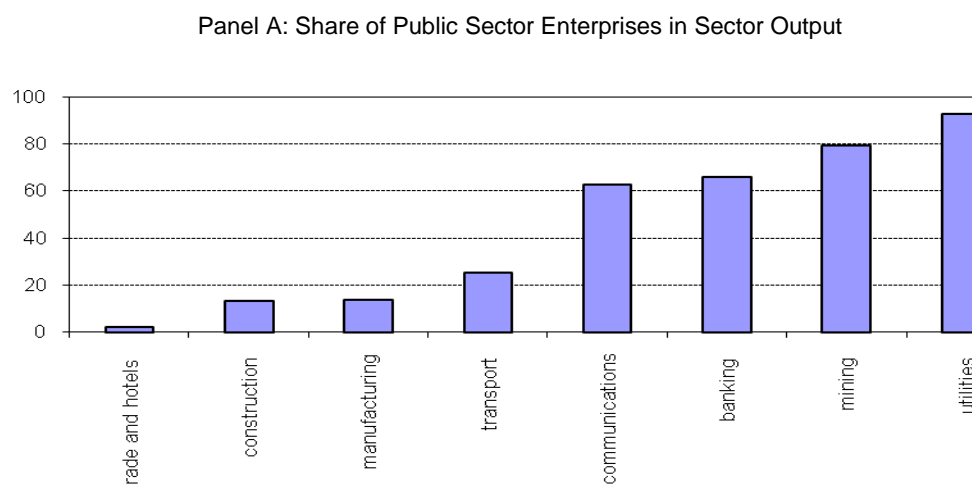
	Haryana	Himachal Pradesh	Jharkhand	Karnataka	Kerala	Madhya Pradesh	Maharashtra
State control	2.05	2.34	1.34	2.56	2.46	1.76	2.04
Public ownership	1.62	2.14	0.43	2.53	2.22	1.10	1.53
Scope of public enterprise sector	1.36	1.36	0.55	1.36	2.73	1.36	2.18
Size of public enterprise sector	2.94	4.70	0.30	6.00	2.75	1.24	1.35
Direct Control over business enterprises	0.68	0.68	0.27	0.68	1.36	0.68	1.09

	Orissa	Punjab	Rajasthan	Tamil Nadu	Uttar Pradesh	Uttaranchal	West Bengal
State control	2.57	2.33	1.97	2.03	1.89	1.96	2.58
Public ownership	2.48	2.09	1.50	1.53	1.34	1.47	2.46
Scope of public enterprise sector	2.18	1.64	1.09	1.91	1.36	1.36	2.45
Size of public enterprise sector	4.50	4.09	3.00	1.79	2.01	2.45	4.00
Direct Control over business enterprises	1.09	0.82	0.55	0.95	0.68	0.68	1.23

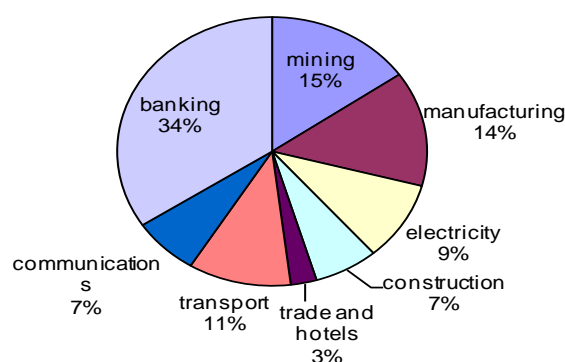
Public Ownership

24. Until the 1990s the public sector was widely seen as the mechanism to bring about India's industrialisation and modernisation through control of the "commanding heights of the economy". Since then, despite some initiatives to sell stakes in public companies, the size of the public sector has changed little. PSEs produce 21% of net value added and account for 38% of the capital stock of the non-farm business sector. Their dominance in the formal business sector is even larger, accounting for 36% and 55% of value-added and capital respectively. This is relatively high in comparison to the average of OECD countries (OECD, 2005b).

25. As well as being large in size, the public enterprise sector is broad in scope with PSEs operating across a diverse range of sectors. In addition to the network sectors, PSEs also operate in, and in some cases dominate, sectors that are inherently competitive (Figure 3a). Within the industrial sector, PSEs have a strong presence in the production of coal and lignite, electricity, petroleum, metal industries and fertiliser while finance is the predominant sector in the central government portfolio (Figure 3b).

Figure 3. Involvement of Public Sector Enterprises in the Economy, 2003

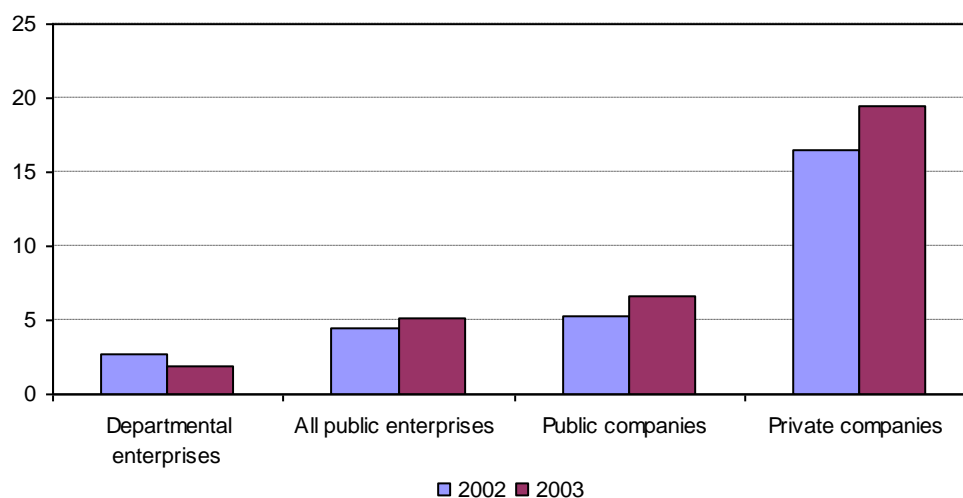
Panel B. Distribution of total value added of the public enterprises by sector



Source: Central Statistical Organisation, National Accounts Statistics

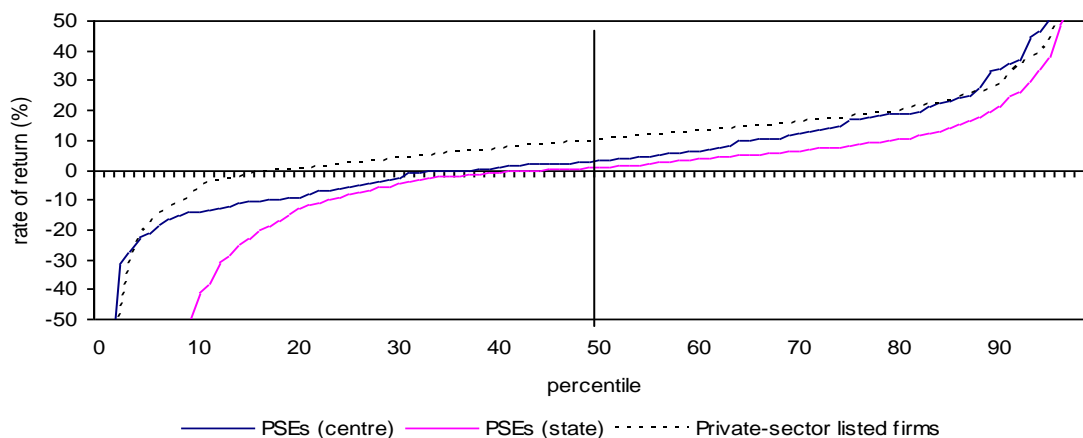
26. Over the period 1990 to 2006 private firms were, on average, as much as one third more productive than public sector enterprises (OECD, 2007). The relatively low level of productivity for PSEs is reflected in low rates of return. In 2003, the return before interest, tax and subsidies on capital invested in PSEs owned by the central government was only one third that of private companies (Figure 4). There has recently been some improvement in profitability, with the proportion of loss-making non-financial PSEs controlled by the centre government falling from 43% to 33% between 1991/92 and 2004/05. This improvement brought only a modest increase in the return earned by the median public company to 3% in 2005 (after subsidies). In comparison, the rate of return for the median private sector company was almost 10% (Figure 5). The total losses of the loss-making PSEs controlled by the central government amounted to 0.3% of GDP in 2005.

Figure 4. Rate of return of public enterprises before interest, tax and subsidies



Source: Central Statistical Organisation, National Accounts Statistics.

Figure 5. Distribution of rates of return of central enterprises



Source: Authors calculations based on data from the Comptroller and Auditor General and Prowess database.

27. At the state level the PMR indicators suggest that there is wide variation in the degree of state control (Table 3b). This arises predominantly as a result of differences in the size and scope of the public enterprise sector, reflecting different starting points and commitments to privatisation by state governments. As a share of state GDP, the amount of capital and loans invested in state-level PSEs ranges from just 0.2% in Jharkhand to 26.2% in Karnataka (Table 4).¹² In comparison to central government, the state governments collectively control a much larger number of PSEs – just over 1 000 in 2003 in

12. In 2000 three new states were created. Jharkhand was created out of the southern districts of Bihar, Chhattisgarh was created out of eastern Madhya Pradesh and Uttaranchal was created out of north-western Uttar Pradesh.

comparison to 245 at the centre. However, the average size of the state-level PSEs is much smaller than at the centre, with state governments collectively controlling slightly more than 50% of the total capital stock of the public enterprise sector. At the state level, investment in PSEs is often concentrated in the electricity sector, underlying the importance of ongoing regulatory reform in this sector.¹³

28. Although there is significant variation across states, the financial health of the state-owned PSEs is, on average, poor and worse than that of the central enterprises. The proportion of loss-making PSEs ranges from 15% in Andhra Pradesh to 77% in Assam (Table 4). The total losses of loss-making PSEs at the state-level amount to a further 0.6% of GDP and there is a large tail of highly unprofitable public-sector firms (Figure 5). Some of the worst performing PSEs at the state level are in the power sector, indicative of enormous (implicit) electricity subsidies and high transmission and distribution losses. In addition to “working” PSEs most state governments also have a number of “non-working” PSEs on their books. These firms no longer produce output but, given the difficulties of retrenching staff and closing down in India, still exist as corporate entities. The ever increasing liabilities that result from these non-working PSEs can have severe fiscal implications. Restructuring may be a partial solution for some of these firms, but many are non-viable and should go through an insolvency process.

Table 4. State-level public sector enterprises

2004

	Number of PSEs	Assets of PSEs	Proportion of loss making PSEs	Losses of loss making PSEs	Proportion of capital in 'non-working' PSEs	Proportion of PSEs with negative net worth	Rate of Return on Capital	
		% SGDP	%	% SGDP	%	%	medium	average
Andhra Pradesh	54	18.3	15	-0.06	2.3	14.8	5.6	10.0
Assam	43	10.8	77	-3.47	1.6	20.9	-3.3	-16.4
Bihar	54	7.9	70	-1.38	13.0	11.1	-2.5	-7.7
Chhattisgarh	11	0.2	36	-0.02	0.0	9.1	5.1	4.6
Delhi	11	11.5	45	-4.21	0.0	9.1	3.6	-27.8
Goa	16	6.9	63	-0.57	0.0	0.0	-0.1	-11.0
Gujarat	51	22.4	39	-0.38	50.5	17.6	2.2	-8.9
Haryana	29	12.9	59	-0.05	1.4	13.8	5.5	5.0
Himachal Pradesh	21	20.5	62	-0.50	27.8	23.8	3.3	5.7
Jharkhand	6	1.5	17	-0.15	0.0	0.0	33.6	43.1
Karnataka	82	26.2	41	-0.28	1.5	7.3	3.6	31.2
Kerala	114	12.1	61	-0.39	1.1	14.0	1.7	-15.3
Madhya Pradesh	42	5.6	33	-0.13	3.8	14.3	1.3	2.2
Maharashtra	82	6.1	68	-0.38	3.2	20.7	-0.3	-4.6
Orissa	69	19.7	70	-0.28	1.1	21.7	-1.3	-35.0
Punjab	57	17.9	44	-0.23	0.3	15.8	-1.2	-12.0
Rajasthan	24	13.2	38	-0.06	0.1	20.8	7.4	20.6
Tamil Nadu	68	8.0	53	-0.14	0.6	29.4	2.4	-1.6
Uttar Pradesh	94	8.9	62	-0.94	51.1	17.0	-1.0	-29.9
Uttaranchal	25	10.8	60	-0.32	47.7	12.0	-2.3	-16.4
West Bengal	86	17.5	72	-0.50	0.8	44.2	1.4	-45.2

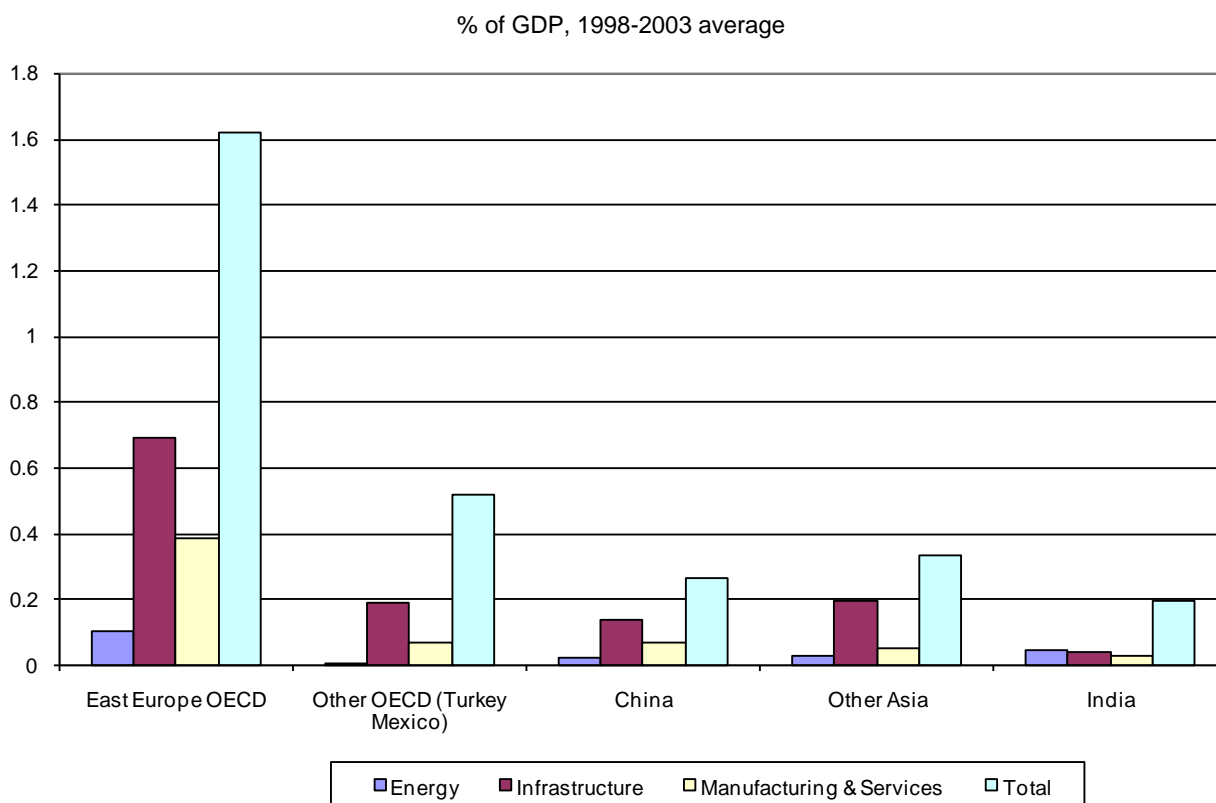
Source: Author's analysis of data from the Comptroller and Auditor General.

13. The share of state government investment in the electricity industry is over 80% of total investment in the following states: Jharkhand, Chhattisgarh, Haryana, Rajasthan, Punjab and Orissa. It is between 60 and 80% in: Assam, Andhra Pradesh, Madhya Pradesh, Tamil Nadu, Delhi and Maharashtra.

29. Since the late 1980s, the privatisation experiences of many developed and developing countries have shown that private ownership typically leads to improvements in firm profitability, real output, and efficiency (*e.g.* Megginson and Netter, 2001 and Kikeri and Nellis, 2004). In network sectors with monopoly elements, the regulatory environment needs to be consistent with private ownership for the gains from privatisation to arise. In the case of India, the proceeds from privatisations by the central government have been 50% below target since 1991/92 and relatively low in comparison to some other developing countries. Indeed, in contrast to India, privatisation programs in a number of developing countries have gone as far as selling state-owned enterprises in the network/infrastructure sectors (Figure 6).

30. As well as a relatively low level of privatisation, the privatisation method, which typically involves selling small tranches of shares to the private sector, may also be sub-optimal. Although partial privatisation can lead to improvements in firm performance, cross-country studies of privatisations in OECD countries indicate that the gains in profitability and productivity are typically larger in firms that are fully privatised (OECD, 2003b). The disadvantage of partial privatisation is that it does not usually result in management control being passed to private owners or an infusion of new technology necessary to improve firm performance to that of the private sector.¹⁴

Figure 6. Privatisation Proceeds by Country and Sector



14. For the Indian experience see, for example, Gupta (2005) and Kaur (2003).

Involvement in business operations

31. There are a number of ways in which India's large public enterprise sector negatively impacts on the extent of competition in product market. First and foremost, because government can be a major market player as well as policymaker (and regulator in some of the infrastructure sectors) there is often no clear separation between the ownership function and other functions that influence market conditions.¹⁵ For example, PSEs are often required to fulfil social and public policy obligations and are subject to political interference and civil servants as board members. In many of the states strategic commercial choices of PSEs often have to be cleared by the state assembly. The procurement policies of the central and state governments, which typically include a price or quantity preference for PSEs, are also biased against the private sector. Because they dominate some markets, political interference in the operation of PSEs not only threatens their profitability but also adversely influences overall market conditions.

32. Although some steps have been taken to commercialise the activities of the PSEs – such as granting more operational freedom to relatively successful PSEs and increasing limits for investments that do not need to be cleared by parliament – more could be done to ensure a level playing field and government neutrality in its dealings with the private sector. Moving towards a more centralised model of PSE management where PSEs are put under the responsibility of an investment agency would be a good step in this direction. Currently, at the centre, responsibility for the PSEs rests primarily with the line ministry while the Department of Public Enterprises plays a coordinating role. A more centralised approach would distance PSEs from political control and achieve a clearer separation between policy and commercial functions. It would also facilitate a more unified and consistent ownership policy, simplify the often elaborate committee structures that currently supervise and control PSEs, and ensure equitable treatment of non-state shareholders by preventing government from pursuing objectives outside the commercial interests of the PSE. By improving governance, centralising the ownership function within government would ensure a more level playing field between public and private sector companies and increase competition.

33. OECD countries began moving towards a centralised ownership approach during the first wave of public sector reforms in the 1970s. With the shift from industry-specific policies to more framework-oriented and market liberalisation policies, the main advantage of decentralised ownership of allowing a more activist industrial policy vanished. This, together with the tendency to locate regulatory duties in specialised institutions, has been the main driving force towards a more centralised ownership model (Box 1). In India, the public administration will ultimately need to be reorganised to be more consistent with a focus on general framework conditions instead of the current 'command and control' approach. This would entail a significant consolidation and reduction in the number of ministries and departments in central and state governments.

Box 1. Corporate Governance of State-Owned Enterprises in OECD Countries

The characteristics of state-owned enterprises (SOEs) raise specific challenges for their governance. Firstly, SOEs are often protected from two major threats that are essential in policing management behaviour: the threat of takeover and bankruptcy. Secondly, accounting and disclosure may be oriented towards public expenditure control and not up to private sector standards. Without appropriate governance arrangements to counter these characteristics the management of SOEs may have more discretion than in the case of private firms and demands on the government's budget for investment and expansion programmes may become excessive.

Governments of OECD countries have faced complex issues and trade-offs in reforming the corporate governance of state-owned enterprises (SOEs). Achieving a sound organisation and effective exercise of the ownership function

¹⁵ Note that the issue of the most appropriate regulatory framework for encouraging competition in infrastructure sectors is not dealt with in detail in this paper. It is discussed in detail in OECD 2007.

within the state administration requires an ownership policy that is active while at the same time avoids undue interference in day-to-day management. In addition, the chain of accountability needs to ensure that the boards and management of SOEs make responsible decisions with appropriate information disclosure to the public. It is also necessary to clearly separate state ownership from the regulatory and policymaking roles and ensure that efficient decision making processes are in place.

The report *Corporate Governance of State-Owned Enterprises: A Survey of OECD Countries* (OECD, 2005b) provides a comprehensive inventory of current practices and recent experiences in reforming governance arrangements for SOEs in OECD countries. Reform has focused on a number of areas including the way in which the boards of SOEs are nominated, their composition, functions, and the way they perform their main tasks. Disclosure rules, for the SOEs themselves and the ownership entity within government, have also been reformed in a number of countries as have provisions to protect minority shareholders, where they exist, and the way in which SOEs relate to stakeholders. Incentive structures and the ways in which senior executives in SOEs are nominated and remunerated has also been the target of reform.

Provided they are soundly structured and effectively implemented, governance reform can improve SOE efficiency and access to capital, while contributing to fair competition by ensuring a level-playing field between companies in the private and public sectors. Better corporate governance of SOEs can also strengthen overall public governance through better transparency and improve fiscal discipline. OECD experience has also shown that good corporate governance of SOEs is an important prerequisite for effective privatisation, since it makes the enterprises more attractive to prospective buyers and enhances their commercial value.

To help governments meet the challenges of public sector governance the OECD has published guidelines on the corporate governance of SOEs (*OECD Guidelines on Corporate Governance of State-owned Enterprises*, OECD 2005c). In broad terms, these guidelines cover the following areas: *i)* Ensuring an Effective Legal and Regulatory Framework for SOEs; *ii)* The State Acting as an Owner; *iii)* Equitable Treatment of Shareholders; *iv)* Relations with Stakeholders; *v)* Transparency and Disclosure; *vi)* The Responsibilities of Boards of State-Owned Enterprises. These guidelines complement the OECD's Corporate Governance Principles (Revised 2004) and have been widely endorsed and welcomed by OECD and non-OECD governments.

4.2. Barriers to entrepreneurship

34. At the national level India performs well in some of the regulatory areas covered the PMR indicators of *barriers to entrepreneurship* (Table 5a). In particular, reforms over the past two decades have been successful in removing most of the *legal barriers* to market entry, such as licenses to enter a particular sector, which had previously reduced competition and protected incumbents. In addition, the indicator of *regulatory and administrative opacity* is broadly comparable with those in emerging OECD countries, reflecting the recent introduction of one-stop shops for issuing licences and permits in some states and other initiatives designed to simplify the rules and procedures that enterprises must comply with. Notwithstanding these improvements, however, the indicator of *barriers to entrepreneurship* is high in comparison to other countries, predominantly reflecting high administrative burdens on firms. These high indicator values could be indicative of more widespread inefficiencies in government administration and imply that efforts to improve the government bureaucracy are yet to pay significant dividends.

35. Many cross-country studies find that removing administrative bottlenecks and improving the transparency of regulation facilitates market entry and can have a pronounced positive impact on the overall competitiveness of the economy through a variety of channels, including enhanced foreign direct investment (Kurtzman *et al.*, 2004). Overly complex administrative procedures also increase discretion within government bureaucracy, thereby facilitating corruption. In a study of 194 countries, Bellver and Kaufmann (2005) find that institutional and political transparency are strongly correlated with competitiveness and strongly *negatively* correlated with corruption. In Transparency International's Corruption Perceptions Index, India ranks 70 out of 163 countries in 2006.

Table 5. Barriers to Entrepreneurship

Panel A. National

	India	OECD average	OECD emerging markets	Euro area	Eastern Europe	Latin America	United States
Barriers to entrepreneurship	2.57	1.46	1.89	1.43	1.44	1.94	1.20
Regulatory and administrative opacity	1.55	1.43	1.41	1.31	1.35	1.49	1.28
Licenses and permit system	1.81	2.20	2.00	1.83	2.00	2.00	2.00
Communication and simplification of rules and procedures	0.92	0.49	0.55	0.62	0.54	1.27	0.39
Administrative burdens on start ups	3.82	1.77	2.61	1.89	1.89	2.14	1.02
Administrative burdens for corporations	4.25	1.90	2.82	2.06	1.95	1.85	0.75
Administrative burdens for sole proprietor firms	4.75	1.91	2.73	2.10	1.91	3.17	1.25
Sector-specific administrative burdens	3.25	1.64	2.64	1.69	1.98	1.67	1.03
Barriers to competition	1.18	0.76	0.93	0.56	0.55	1.87	1.50
Legal barriers	0.86	1.41	1.34	1.33	1.35	2.06	1.36
Antitrust exemptions	1.25	0.45	0.71	0.18	0.14	1.16	1.63

Panel B. States

	Andhra Pradesh	Assam	Bihar	Chhattisgarh	Delhi	Goa	Gujarat
Barriers to entrepreneurship	1.37	2.10	2.12	2.84	1.28	0.81	2.11
Regulatory and administrative opacity	0.28	2.49	1.44	3.74	1.24	1.27	1.33
Licenses and permit system	0.00	4.00	0.00	6.00	2.00	2.00	2.00
Communication and simplification of rules and procedures	0.25	0.75	3.00	1.25	0.25	0.50	0.25
Administrative burdens on start ups	2.17	2.26	2.93	2.98	1.38	0.39	3.02
Administrative burdens for corporations	2.83	2.94	3.60	3.55	1.37	0.60	3.78
Administrative burdens for sole proprietor firms	2.61	2.60	3.64	3.72	2.15	0.43	3.72
Sector-specific administrative burdens	1.47	1.51	2.08	2.09	0.83	0.00	2.16

	Haryana	Himachal Pradesh	Jharkhand	Karnataka	Kerala	Madhya Pradesh	Maharashtra
Barriers to entrepreneurship	0.96	1.60	2.25	0.89	1.58	1.94	1.14
Regulatory and administrative opacity	0.14	2.43	3.10	0.23	1.46	1.51	0.43
Licenses and permit system	0.00	4.00	4.00	0.00	2.00	2.00	0.00
Communication and simplification of rules and procedures	0.00	0.75	2.25	0.25	0.75	0.75	0.75
Administrative burdens on start ups	1.42	1.27	2.15	1.22	1.84	2.55	1.60
Administrative burdens for corporations	1.72	1.48	2.30	1.40	2.66	3.08	2.66
Administrative burdens for sole proprietor firms	1.93	1.66	3.00	1.75	1.89	3.24	1.29
Sector-specific administrative burdens	0.87	0.71	1.43	0.71	1.17	1.77	0.98

	Orissa	Punjab	Rajasthan	Tamil Nadu	Uttar Pradesh	Uttaranchal	West Bengal
Barriers to entrepreneurship	1.74	1.01	2.30	1.23	1.79	1.42	2.58
Regulatory and administrative opacity	0.42	0.34	2.13	1.23	0.53	0.48	3.62
Licenses and permit system	0.00	0.00	2.00	2.00	0.00	0.00	6.00
Communication and simplification of rules and procedures	0.50	0.50	2.25	0.25	0.75	0.75	1.00
Administrative burdens on start ups	2.84	1.40	2.87	1.28	2.88	2.15	2.53
Administrative burdens for corporations	3.82	1.74	3.60	1.42	3.58	2.99	2.87
Administrative burdens for sole proprietor firms	3.24	1.82	3.46	1.82	3.59	2.36	3.33
Sector-specific administrative burdens	2.02	0.85	2.02	0.74	2.05	1.44	1.73

Barriers to competition:

36. Although formal legal barrier to entry have been removed in most sectors there are still a few areas in which they could be reduced further to encourage market entry and competition. In particular, a range of policies are in place that favour small companies whose investment in plant and machinery is less than INR 10 million. These policies are designed to promote small industry, which contributes almost 40% of industrial value added, and compensate for the disadvantages of producing below efficient scale. The principal policy, which reserves certain manufacturing products to small firms, will be phased out by 2009. By 2006, reservation was down to 336 products from a peak of over 800 at the beginning of the decade.¹⁶ Small firms also get fiscal benefits, as they pay a lower rate of excise tax on the goods they produce. Government procurement also favours small firms, with 338 products reserved for small suppliers who also win tenders for other products if their price is less than 15% above the lowest quote. Finally, banks are obliged to make 10% of their advances to small firms.

37. These policies skew the production structure towards small firms, thereby lowering the scope for productivity gains from producing at efficient scale. A number of government committees and research studies have argued that preferences for small firms have led to the fragmentation of production chains and inefficient scale.¹⁷ It has also been noted that some entrepreneurs will split the production process between several small firms so as to retain the associated fiscal benefits. The policy of reducing reservation has so far been done by consensus with industrial groups and should be further pursued and widened to include reducing the other advantages accorded to small firms.

38. The road passenger transport sector also is subject to significant entry barriers. As well as issuing operator licenses, state governments also determine the routes and times that operators are permitted to run. Even the fares that operators can charge on a particular route are determined by government. These licensing arrangements are susceptible to corruption and insulate the state transport corporations, which typically make large losses, from competition. The associated licence fees, however, are a major source of revenue for state governments, implying that reform in this sector needs to be coupled with efforts to increase the tax base (See OECD, 2007).

16. Large firms can obtain a licence to manufacture products reserved for small-scale industry provided 50% of their production is exported. In practice, the administrative burden of obtaining the necessary licenses has acted as a constraint on entry. See World Bank (2000).

17. See the Abid Husain Report (1997).

39. In the road freight transport sector, the Motor Vehicles Act only mandates vehicle registration and a permit for operation and there is generally ease of entry and exit. However, Mehta (2006) reports that inefficiencies in this sector, which have been a constraint on the development of an integrated national market in India, are predominantly the result of cartels and price fixing by industry participants. This example underlies the importance of India's new Competition Policy which is close to "state of the art" but only recently been made operational (Box 2).

Box 2. India's New Competition Policy

A good competition policy framework is a vital ingredient in ensuring a dynamic and competitive business environment. With this objective in mind, the Government of India passed a new Competition Act in 2002 and the Competition Commission of India (CCI), which is the principal enforcement institution of the Act, was established in October 2003. However, after judicial review, the Act was determined to need amendment in order to establish a Competition Appellate Tribunal, headed by a member of the judiciary, to hear appeals against CCI decisions. Consequently, The Competition (Amendment) Act was passed in 2007 and the CCI was made operational.

India's new competition law includes many of the same principles found in competition frameworks in OECD countries. The Act prohibits agreements between firms that result in an appreciable adverse effect on competition, and it presumes such an adverse effect in the case of horizontal price fixing agreements and bid rigging. Secondly, the Act prohibits dominant firms from abusing their market power through, for example, predatory pricing, price discrimination, and denial of market access. The Act also regulates company mergers and acquisitions (M&A) if the aggregate assets of the combining parties have a value in excess of INR 10 billion (US\$220 million) or turnover in excess of INR 30 billion (US\$660 million). A merger of that magnitude that is likely to cause an appreciable adverse effect on competition is void, but notification of the proposed merger for prior review by the CCI is voluntary, not compulsory.¹⁸ These thresholds are high relative to the average firm size and carry the risk that the merger control rules might not prevent some M&A activity that may have an appreciable adverse impact on competition. These arrangements may need to be revisited once the CCI is fully operational and has gained some experience in merger control.

The CCI is statutorily independent and does not receive any instructions from government. However, the CCI has to seek money from the government, who can overrule its budget requests. In addition, the Central Government can issue directions on questions of policy which are binding on the CCI. The CCI can report on sectors, policy issues (for example, privatisation), and laws or regulations issued by the legislature or administrative bodies only in response to requests; it cannot engage in such studies on its own initiative. The law authorises the CCI to impose substantial fines on firms and individuals but does not provide for imprisonment. In most cases, the top fine is 10% of average annual turnover; however, that limit does not apply in cases of price fixing, where the fine could be up to twice the profit from the violation. The CCI can grant leniency to firms that confess and co-operate. Public sector enterprises are covered by this law, which is essential given the extent to which they dominate certain industries.

One drawback with the Act is that it contains no provisions relating to unfair marketing practices affecting consumers. These are covered by the Monopolies and Restrictive Practices Commission (the institution preceding the Competition Commission) and cases will be transferred to the National Consumer Commission when the former is finally wound up. Experience in OECD countries suggests that combining competition policy and law enforcement and consumer protection within the same agency can create significant synergies. Consideration could therefore be given to installing the consumer protection agency under the same roof as the CCI.

18. In the event either of the combining parties is outside India or both are outside, the threshold limits are US\$500 million for assets and US\$1 500 million for turnover. If one of the merging parties belongs to a group, which controls it, the threshold limits are IRP 40 billion (US\$880 million) in terms of assets and IRP 120 billion (US\$2 640 million) in terms of turnover. The Act states that the threshold limits of assets and of turnover would be revised every two years based on the Wholesale Price Index or fluctuations in exchange rate of rupee or foreign currencies.

Regulatory and Administrative opacity:

40. The indicators of *regulatory and administrative opacity* in India compare favourably in an international comparison reflecting ongoing effort at the national and state levels to improve the efficiency of the public bureaucracy (Table 5). One common initiative for reducing red tape, which has been introduced in 19 of the 21 states for which the PMR indicators have been calculated, is the “one-stop shop” (OSS) for providing information and, in some cases, applying for the necessary licenses and notifications.¹⁹ The essential idea of the OSS is that potential investors only need to be in contact with a single entity to complete all the necessary paperwork and applications in a streamlined and coordinated process, rather than having to go through a labyrinth of different government bodies. In practice, given the impracticalities of assuming full control of the approval process, OSSs tend to act as a coordination mechanism between relevant government authorities.

41. To be effective in reducing administrative burdens, OSSs should be implemented along with other reforms geared towards cutting red tape (Sader, 2000). In the absence of such measures, OSSs run the risk of simply adding another layer of bureaucracy to the approvals process. Indeed, because OSSs provide a focal point for investment clearance, they can act as important catalysts for process reengineering and better cooperation across government departments.

42. Closely related to the OSS concept is the idea of “deemed clearance” under which licenses are issued automatically if the licensing office does not act by the end of the statutory response period. Deemed clearance regimes have been implemented in 10 of the 21 states for which the PMR indicators have been calculated. Deemed clearances can be an effective method of giving teeth to the single window concept if they are set and implemented judiciously. However, the administrative system must be reformed to the point where it is capable of meeting these statutory response periods. The objective is not to circumvent regulation but to implement and enforce it in the most efficient way possible.

43. A number of state governments have also tried to improve the interface with the private sector by simplifying and consolidating various application forms and registers. However, simply combining all existing application forms into a single document, as has been done in a few states, is not enough. Instead, a composite application form should be the final outcome of a process to coordinate and improve the administrative function of government departments. There is also potential for reducing administrative burdens by better integrating the administrative functions of the central and state governments, which both process applications and collect information for areas in which they have concurrent responsibility.

44. Information and communications technology (ICT) offers enormous potential for reducing administrative burdens in India and has been successfully integrated into the administrative procedures of some of the state governments. At the central level, government is using Indian ICT firms to introduce electronic data interchange systems for customs clearance and providing interfaces so that the progress of documents can be checked. The tax administrations are also implementing ICT in a similar capacity. A technology infrastructure of open information on shared networks with standardised data and applications would go a long way towards improving integration across government departments and state and central government. It would also reduce opportunities for corruption by reducing subjectivity and discretion in government administrative processes. However, the introduction of ICT must be linked to reengineering

19. The OSSs in Indian states typically involve three levels depending on the size of the proposed investment. For example, in Haryana, new investment proposals of a value up to IRP 50 million (US\$1 million) are dealt with by a district-level committee. Investment proposals of a value between IRP 50 million and IRP 30 million (US\$6.5 million) are dealt with by a state-level committee and investment proposals of a value of more than IRP 30 million are dealt with by a high-level committee.

processes. Automating existing inefficient processes or using ICT to simply disseminate information will only produce a limited payoff.

45. Another useful ICT-related technique for improving administrative process is to make all the forms and procedural requirements of various government departments available on the Internet. Although most state governments publish their policies on line, there is very little information available on the steps and forms that must be completed to, for example, register a business. This results in opaque regulations that are not known or understood by the public. Publication would increase transparency, elicit suggestions for refinement, and reduce the scope for government arbitrariness.

46. An important consideration with all efforts to simplify and improve government administration is that they filter down department hierarchies and are effectively implemented at the lower levels. Otherwise, administrative processes will remain uncertain and the extent of subjective decision making and corruption opportunities will remain unchanged. Training seminars, performance based pay scales, and promotions based on merit would all help in this regard.

Administrative burdens on start ups

47. Despite recent efforts to improve the functioning of the public bureaucracy, administrative burdens, as measured by the PMR indicators, are still high in comparison to other countries. Although these indicators are primarily a reflection of the complexities involved in starting up a business, they may also reflect more widespread inefficiencies in government. These inefficiencies deter firm entry into established markets and thus discourage competition and innovation.

48. With an interventionist tradition and administrative structures that have in many cases not kept pace with economic liberalisation, a significant reengineering of administrative processes is needed to improve service delivery and simplify the interaction between government and firms. A crucial aspect of reengineering administrative processes, especially within some of the state governments, is improving the coordination of administrative functions across government departments. In many states, departments within government operate in “silos” with minimal information flows between them. Given a lack of coordination, administrative procedures often duplicate the same function across a number of departments. Firms and citizens interacting with government find themselves in a complex maze of regulations and administrative requirements that are repetitive with different departments collecting essentially the same information, non-transparent, and sometimes contradictory. This increases compliance costs, especially for small firms, and discourages firm expansion into the formal sector, thus restraining competition and productivity.²⁰

49. A high-quality administrative system is transparent, accountable, and efficient. Establishing a coordinated programme of administrative reform to imbue public bureaucracies with these characteristics requires institutional change and is complex and time consuming. Recognising the scope of this challenge, most OECD governments have established regulatory oversight bodies with “whole of government” responsibility for regulatory policy (OECD, 2002b). One advantage of this approach is that it promotes a consistent and systematic method of reform across the entire administration. In addition, the OECD experience has been that regulatory reform will often fail if left entirely to ministries, implying that a degree of centralisation can improve the chances of successful reform.

20. There is a growing body of research that finds that poor quality government administration creates particular problems for small and medium-sized firms, which are often less able to bear the costs of bureaucratic burden than larger more established – and in some cases more influential – businesses.

50. The Indian government is also well aware of the importance of improving the quality of public administration and has moved a long way towards becoming a more service-oriented facilitator of private-sector entrepreneurship. From the centre, the Department of Administrative Reforms and Public Grievances works with central ministries and state administrations on a number of projects aimed at improving government functioning. One of the most far-reaching recent initiatives enacted at the central level is the Right to Information Act (2005), which gives citizens access to information under the control of public authorities and should greatly improve the transparency of the public administration. Ten of the 21 state governments surveyed have also established centralised institutions for managing and coordinating regulation and its reform.

51. At present, however, there is no centralised oversight body charged with reviewing regulatory proposals to ensure they do not impose unnecessary or unreasonable administrative burdens on firms and citizens. This important task would involve the use of Regulatory Impact Analysis (RIA) to assess the benefits and costs of significant proposed new regulation. A regulatory oversight body would also develop guidelines on the standards of good regulation and the use of alternatives to traditional command and control regulation. New ways of measuring the impact of administrative regulation would also need to be developed to identify areas of high administrative burden (OECD, 2006). Given the existing expertise within the Department of Administrative Reforms and Public Grievances and some of the state-level departments, these institutions are best placed to perform this important role.

52. A centralised and fully-functional regulatory oversight body would go against a tradition of ministerial independence in regulatory matters and could meet with strong resistance. This implies the need for a careful balancing act between cooperation and confrontational relationships with ministries. The need for political support means that the relevance of regulatory reform to larger social and economic goals must be clarified and clearly communicated to all concerned. Ideally, the objectives of the regulatory oversight body should be outlined as part of an explicit regulatory policy that sets out reform priorities and the tools and institutions used by government to shape their regulatory power. The OECD experience has been that countries consistently make greater progress when they have an explicit regulatory policy (OECD, 2003). Malyshev (2006) notes that “the more complete the principles, and the more concrete and accountable the action programme, the wider and more effective the reform”.

53. There is currently momentum in central and state governments to improve the public bureaucracy and reforms in some areas are lowering administrative burdens. Many of the industrial policies and other laws setting up “one-stop shops” and administrative reform committees are only a few years old and it is too early to say whether they are having a positive impact. If these efforts are successful, they will help reduce the duality between the formal and informal sectors, increase the growth potential of the whole economy, broaden the tax base, and level the playing field for doing business in India. However, there is still a long way to go and efforts to reduce administrative burdens need to be strengthened further.

4.3. *Barriers to international trade and investment*

54. Although the Indian economy has become much more open over the period of economic reform, the indicator of *barriers to trade and investment* still signals a relatively high degree of restrictiveness in international comparison (Table 6). Given that India is some distance behind the world technological leader, the adoption of production techniques and know-how developed in other more productive countries will be an important catalyst for economic development and source of future productivity improvements. Both international trade and foreign direct investment encourage domestic firms to incorporate foreign technologies into the production process, thereby facilitating technological diffusion. Equally, foreign affiliates tend to be more capital and skill intensive and invest more in research and development than domestic firms in the same industry (Keller, 2004; Keller and Yeaple, 2003). As a result, foreign affiliates tend to grow more quickly and make a larger direct contribution to productivity growth in comparison to

domestic firms (Criscuolo, 2005) and more outward-oriented countries consistently grow more quickly than relatively closed countries (Srinivasan and Bhagwati, 1999).

Table 6. Barriers to foreign trade and investment

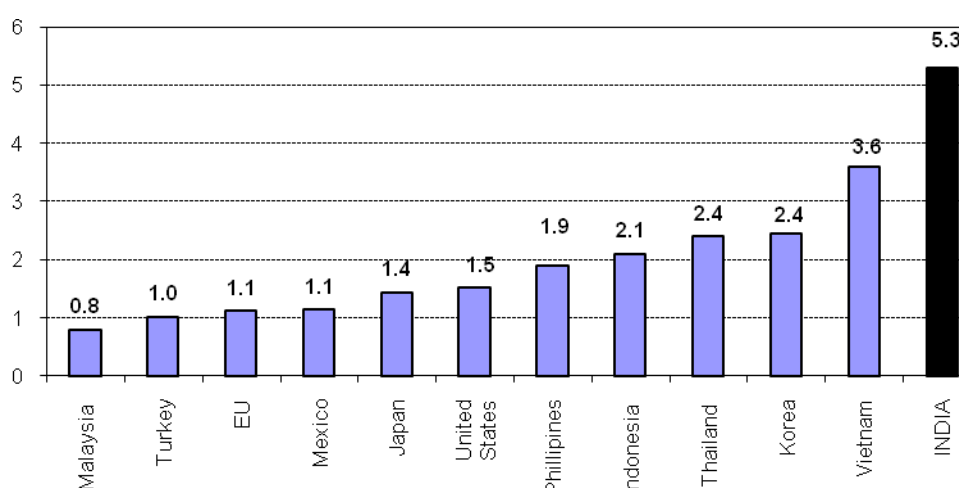
The indicator score runs from 0-6, representing the least to most restrictive regulatory regime

	India	OECD average	OECD emerging markets	Euro area	Eastern Europe	Latin America	United States
Barriers to trade and investment	2.56	0.97	1.66	0.75	1.35	2.31	0.73
Explicit barriers to trade and investment	3.02	1.36	2.26	1.04	1.90	1.92	1.14
Foreign ownership barriers	2.89	1.80	2.55	1.36	2.17	1.57	1.83
Discriminatory procedures	2.00	0.49	0.75	0.49	0.60	1.45	0.00
Tariffs	4.00	1.40	3.00	1.00	2.50	3.67	1.00
Other barriers	1.98	0.47	0.88	0.37	0.66	2.17	0.21
Regulatory barriers	1.60	0.22	0.46	0.17	0.27	2.21	0.00

Explicit Barriers to Trade and Investment

55. The Indian economy has become much more open over the period of economic reform. Tariff revenue as a proportion of import value, which is a broad measure of tariff barriers, has fallen by a factor of six in just under two decades and the government has progressively reduced the

Figure 7. Tariff revenue relative to import value in selected countries
2005, tariff revenue (excluding domestic taxes) as percentage of import value

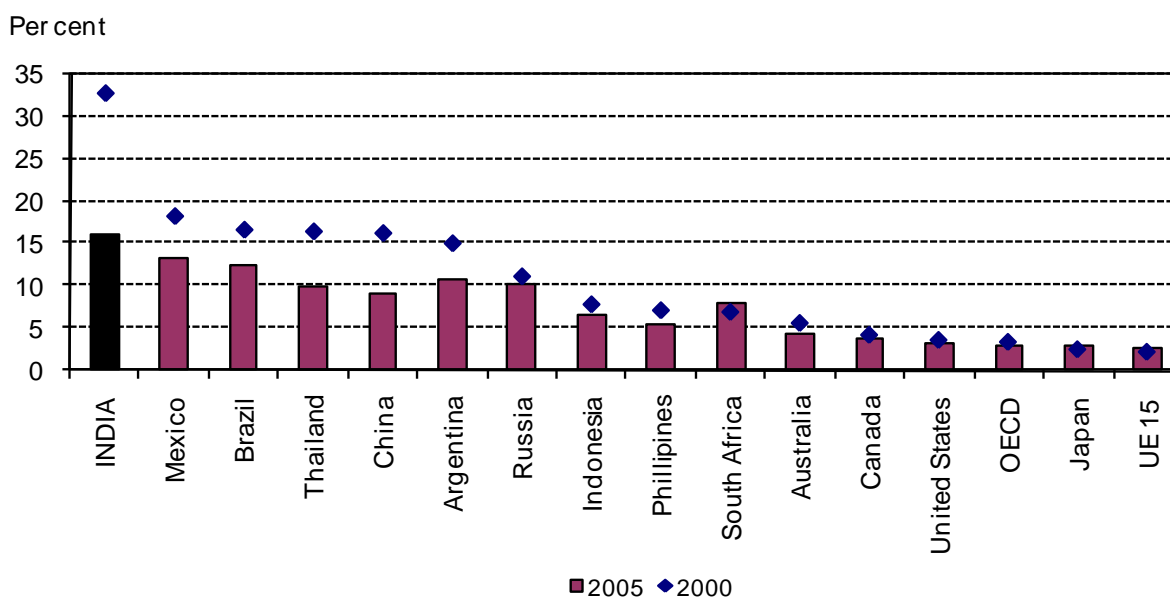


¹ This figure excludes the so-called countervailing duty (CVD). This tax is levied on imported goods that are produced domestically at the same rate as the central value-added (excise) tax on domestic goods. The CVD can be offset against payment of the value-added tax. Given that the CVD can be offset, it should not be regarded as part of the tariff in much the same way that the levy of a normal value-added tax on an imported product is not regarded as a tariff. The CVD accounted for almost half of total receipts of taxes on imported goods in FY 2005.

Source: OECD Revenue Statistics, European Court of Auditors, Public Finance Statistics of India, various national publications.

highest standard tariff rate for non-agricultural products from 35% in 2001 to 10% in 2007. The objective of the current programme of tariff reductions, which began in 2002, is to lower the peak tariff rate to the average peak rate in ASEAN countries, which is currently around 7%. However, despite these significant improvements, tariff revenues and the average most favoured nation (MFN) tariff rate, and the associated PMR indicator, are still much higher than in OECD and a number of emerging countries (Figures 7 and 8).

Figure 8. A cross-country comparison of simple-average tariffs



Source: UNCTAD, Trains database.

56. As a result of substantial derogations from the standard tariff rates, the yield from tariffs, at 5%, is considerably lower than the simple average of the MFN tariff (13% in 2007). In other countries, such as Mexico and Turkey, these derogations arise as the result of regional trade agreements. In India, however, these derogations are domestic in nature. There are currently 134 duty exemption Acts in place that cover a wide range of activities including restaurants, agriculture, handlooms, leather and footwear, and gems and jewellery. In sectors reserved for small firms, instruments are in place to channel duty-free imports through trade associations. Other schemes mandate a 5% import duty on capital goods subject to an export obligation equivalent to eight times the duty saved over a period of eight years. Agri-export zones also grant duty-free imports of capital goods. These exemptions are partially offset by the use of anti-dumping levies, of which India is one of the largest users. In addition, India has one of the highest dispersions of actual tariff rates in WTO member countries (Dihel *et al.*, 2007). Widespread exemptions and the variability of the tariff structure result in an inefficient allocation of resources. In addition to the gains from lower average tariffs, substantial efficiency gains would result from moving just one tariff rate.

57. As with its tariff policy, India adopted a highly restrictive FDI policy after independence, which was then liberalised somewhat during the reforms in the early 1990s. Over more recent years, the policy framework has improved further with the creation of a system of automatic clearances for FDI inflows and increases in caps on foreign ownership across a range of sectors. Currently, foreign ownership of up to 100% is permitted in many sectors (Table 7) with only the need to notify the authorities. In areas reserved for small scale industries, FDI is limited to 24%. In a number of sectors – alcoholic drinks, cigarettes and

tobacco products; electronic, aerospace and defence equipment – government permission for FDI is required on a case-by-case basis.

Table 7. Foreign direct investment: ceiling on investment in a given company by sector

	Percentage of equity permitted to be held by a foreign company
Agriculture	0
Coal mining (own use)	100
Coal mining (other)	0
Manufacturing	100
Newspaper publication	26
Electricity generation	100
Airports ¹	100
Distribution of petroleum products	100
Pipelines	100
Roads, highways, ports	100
Civil aviation ²	49
Internet service providers (without gateways) ³	100
Internet service providers (with gateways)	74
Telecommunication services	74
Banking	74
Insurance	26
Retail distribution	0
Retail distribution (single brand)	51
Wholesale cash and carry distribution	100

1 FDI of more than 74% in existing airports requires government approval.

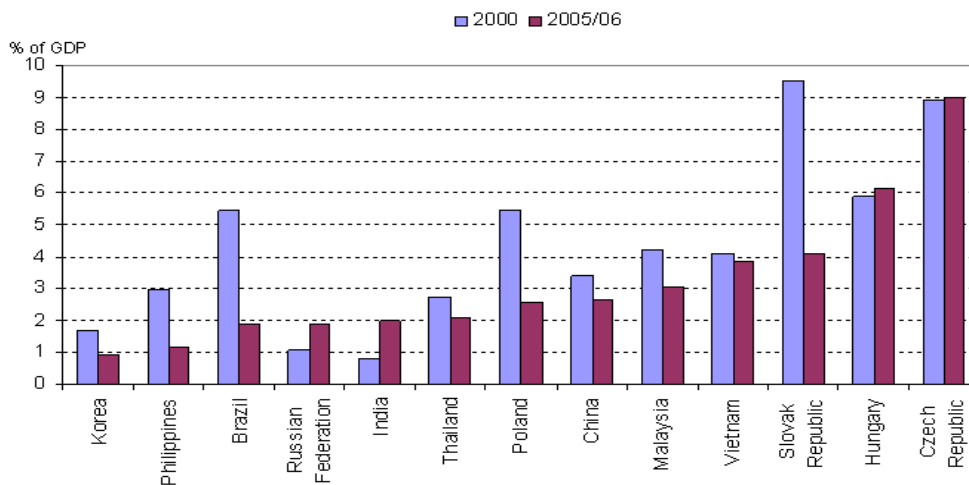
2 Provided there is no direct or indirect participation by foreign airlines.

3 Subject to divestment of 26% of equity after five years if the investing company is listed in another part of the world.

Source: Department of Economic Affairs, Gol.

58. At least partly as a result of recent reforms, FDI inflows have been growing rapidly since 2004, including a threefold increase in the year to March 2007. Investor sentiment has also improved significantly with a recent survey of executives of multinational corporations ranking India second behind China in an index of FDI confidence (ATKearney, 2005). However, inflows are still relatively modest in comparison to some Asia and Eastern European countries (Figure 9).

Figure 9. Inflows of Foreign Direct Investment¹



1 For India, China, and Brazil the more recent data is for 2006. For all other countries it refers to 2005.

Source: UNCTAD and OECD calculations.

59. Despite substantial recent improvements in policy and actual FDI flows, the policy framework for FDI in India is still restrictive in comparison with OECD countries (Koyama and Golub, 2006). In addition, many of the FDI restrictions in place apply to potentially fast growing sectors with low productivity that would benefit from increased investment. Relaxing FDI restrictions in banking, insurance and retail distribution would seem likely to improve real incomes, given the poor productivity levels in these industries. In addition, allowing FDI into the retail sector would result in the modernisation of supply chains and substantially reduce the amount of food produce that rots before getting to market. In turn, this would improve incomes in the agricultural sector.

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