

India: The changing face of legislation



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CONTRARY TO GENERAL BELIEF, INDIAN legislation is not archaic, stubborn and hostile. Sweeping reforms are changing the face of legislation, the judiciary and law enforcement authorities. This article seeks to introduce the general reform scenario. Each topic will then be discussed in more detail in follow-up articles.

BACKGROUND

Back in 1990, India had to pledge gold reserves to ensure international financial commitments. Over the past 15 years, the situation has been reversed, and India is now ready for full rupee convertibility. India has emerged as the third most-favoured destination for international investment money, the others being the US and China. In 2006/07, total Foreign Direct Investment (FDI) in India was pegged at \$16bn. It is expected to reach \$25bn by 2009.

Companies all over the world favour India, not only because of the possible economic return on their investments, but also because it affords a greater degree of legal protection than other jurisdictions. The world has been in denial about China's fragile systems –

both political and economic. India, on the other hand, offers a well-documented legal system, vibrant financial markets and a stable political system. What China must build from scratch, India has up and running, and Western investors may therefore choose India over China.

The story of India's upturn began in 1995, when engineers at Tata Consultancy Services found that a set of software tools called CasePac, developed to convert code for IBM, could be used to change the date field in other programs. They realised this could be used for the Y2K problem. Companies from around the world sought Tata's outsourced services to fix the millennium bug. Since then, the company's annual revenue has climbed from less than \$170m to \$2.24bn.

This quickly altered India's fortunes. In just a few years the country emerged as a technological giant. India now provides high-end technological services at a fraction of the cost of Western counterparts. Building on this foundation, India is entering an important new phase in its economic evolution.

Indian companies used to be fairly anonymous organisations, hired to run support desks, develop server applications, and supply low-technology mass components for large multinational corporations. They are now raising their profile as brand-name suppliers of hardware design, software development, consulting services and virtually anything else in technology. Infused with new blood from a young, tech-savvy workforce, the new movement is a major advance towards economic independence. This carries broad ramifications for a country whose past includes colonial rule, experiments in socialism and devastating poverty.

For example, Tata recently won a deal to create an environmentally friendly mobile phone for a US carrier. One of its rivals, Wipro Technologies, is designing MP3 players for Europe and a flat-panel TV for an American company, while Mumbai-based Celetronix produces set-top boxes for a US-based satellite TV carrier.

Meanwhile, Indian engineers have completed the Giant Metrewave Radio Telescope (GMRT) – the world's largest, low-frequency radio telescope, and India's biggest science project. Located at Khodad near Pune, the GMRT consists of 30 tracking antennas, each of which has a diameter of 45m. According to the *New Scientist*, the engineers 'created a revolutionary, low-cost design' – the entire telescope was built for \$12m. Radio astronomers planning the next-generation radio telescope, the Square Kilometre Array (SKA), are looking to the GMRT for inspiration. Astronomer Paulo Freire of Cornell University told the *New Scientist*: 'The beauty of GMRT's design is deeply influencing the construction of the SKA'.

FUTURE OF LEGAL REFORMS

The Indian government has been aware for some time that these events can be replicated in almost all sectors of the economy to fuel growth. The process of economic and legal reform began in 1991, and almost all of the relevant legislation has since been modified. Statutes and regulations have been amended and, in some cases, totally replaced to reflect the intent of economic reforms.

The Indian government is agile. The red tape of the past has been replaced with an open system. Age-old legislation on foreign exchange management, intellectual property, labour, property and companies is being replaced with energetic and transparent systems that are on a par with international standards. The government not only welcomes FDI, but actively encourages international participation in almost all sectors of the economy. Now, companies around the world can set up projects in India, infuse capital into them, reap rich dividends and take their money back at will.

FOREIGN EXCHANGE MANAGEMENT ACT SEEKS TO PREPARE FOR FULL RUPEE CONVERTIBILITY

The Foreign Exchange Management Act (FEMA) has done away with all restrictions on inflow and remittance of foreign exchange. The rupee is now fully convertible on current account transactions, and very few restrictions

remain on capital account transactions. Soon, the rupee will be fully convertible.

Foreign participation in all economic activities is generally permitted, with the exception of retail trading (except single-brand product retailing), atomic energy, lottery business, and gambling and betting.

All other activities/sectors only require prior government approval for FDI if the foreign company has an existing venture (except the IT sector) and if more than 24% foreign equity is to be introduced for the manufacture of items reserved for the small-scale sector.

Foreign companies can invest in the following activities without prior approval if the foreign equity does not exceed the limits stated in brackets:

- asset reconstruction companies (49%);
- atomic minerals (74%);
- private sector banking (74%);
- broadcasting (26% to 49%);
- defence production (26%);
- insurance (26%);
- investment companies in infrastructure (except telecoms) (49%);
- print media (26%);
- single-brand retailing (51%); and
- satellite establishment (74%).

All other activities/sectors are fully open. Foreign companies can set up wholly owned subsidiaries, joint ventures and technical collaborations without prior approval of the Indian government or the Reserve Bank of India.

COMPANIES ACT AMENDED TO ENCOURAGE INTERNATIONAL STANDARDS OF CORPORATE MANAGEMENT

The FEMA reforms encourage foreign companies to set up joint ventures and subsidiaries in India. The key piece of legislation governing ownership, control and management of companies is the Companies Act 1956. This has been remodelled in line with the latest developments in corporate law and governance.

The reforms promote good corporate governance and focus on decentralisation, simplification, transparency, accountability and e-governance.

The Ministry of Company Affairs (MCA) is moving ahead in its endeavour to create an environment that is able to support a modern corporate culture. For example, through its MCA 21 Program it has done away with paper filings for documents relating to limited companies, creating electronic filings instead.

This activity is coupled with changes to the Competition Act 2002, the Chartered Accountants Act 1949, the Cost and Works Accountants Act 1959 and the Company Secretaries Act 1980.

CAPITAL MARKET REFORMS HAVE CATAPULTED INDIAN FINANCIAL MARKETS INTO THE BIG LEAGUE

An economy can only sustain continual growth if it can facilitate a robust capital market. India has initiated extensive capital market reforms since the 1990s, encompassing regulatory and institutional changes.

The Securities Exchange Board of India (SEBI) (the statutory market regulator) was created in 1992. The SEBI draws its strength from compliance and enforcement powers, including search and seizure rights. The SEBI Act was substantially amended in 2002 to make the regulator more effective.

Dematerialisation started in 1997 after the legal foundations for electronic bookkeeping and depositories were created. Until 2001 India was the only sophisticated market to have account period settlement alongside derivative products. From the middle of 2001, uniform rolling settlement and same settlement cycles were prescribed, creating a true spot market.

Amendments to the Securities Contract Regulation Act provided a framework for derivatives trading in 1999. Derivatives trading started in a gradual manner with stock index futures in June 2000. Options and single stock futures were introduced in 2000/01, and now India's derivatives market turnover is more than the cash

market. India is one of the largest single stock futures markets in the world.

India's risk-management systems have always been modern and effective. The Value at Risk (VaR)-based margining system was introduced in mid-2001. The risk-management systems withstood huge volatility in May 2003 and May 2004.

India was one of the first countries to start the screen-based trading of government securities (in January 2003). In June 2003 interest-rate futures contracts were introduced on the screen-based trading platform. India is one of the few countries to have started Straight Through Processing (STP), which has completely automated the process of order flow and clearing and settlement on the stock exchanges.

INDUSTRIAL LAWS ARE CHANGING THE WAY FACTORIES ARE CONTROLLED BY GOVERNMENT

Workplace reforms include an initiative to end the 'inspector raj', whereby factories and establishments are subject to an average of 37 inspections by government functionaries each year. Some factories countenance as many as 67 inspections each year. Anywhere between 9 and 24 different inspectors (15 on average) will carry out these inspections. The environment officer, the labour officer and officials from the State Pollution Control Board visit factories more often than other government authorities.

Some of these inspectors are vested with wide-ranging powers, such as:

- the power to order between six months' and seven years' imprisonment;
- sealing the unit and stopping its operations;
- imposing a penalty (up to 100,000 rupees (around £1,250));
- disconnecting the water and electricity supply;
- filing a court case; and
- denying the renewal of or cancelling the operating licence.

To end the inspector raj, the Federation of Indian Chambers of Commerce &

Industry has proposed a series of amendments to almost all the laws relating to working in factories, including labour laws, the Factories Act, pollution control rules and the Explosives Act. The inspector raj will soon be replaced with an administrative system that ensures compliance with legislation based on mutual trust and respect.

LABOUR LAW REFORMS REDEFINE RELATIONSHIPS WITH WORKERS

No economy can thrive without a dedicated and trained labour force. India has a large pool of talented young workers. It now needs a legislative framework that can facilitate the application of labour in industry to produce economic value.

Labour reforms are not just about facilitating the closure of a 'sick' industrial unit (a company whose accumulated losses are equal to or more than its net worth) or laying off employees. The reforms focus on several major issues:

- wage policy;
- employment security;
- redundancy;
- industrial relations;
- labour market information; and
- human resources development.

These issues can be solved by:

- liberalising existing labour legislation;
- enacting a flexible exit policy;
- 'rightsizing';
- reforming trade unions;
- continuously retraining the workforce and updating skills;
- encouraging worker participation in management; and
- good corporate governance.

One of the major issues surrounding labour reform in India is the abolition of certain laws. Various countries, including Britain, New Zealand and the US, have liberalised their labour legislation. Unfortunately, in India, protecting

employee rights under labour laws has created a highly restrictive environment, which has, in fact, slowed down the growth of employment. But although the existing laws are detrimental to economic growth, the government is reluctant to change them.

Now everyone is involved in the labour reform process, from the government to industry, trade unions, industry associations, economists, sociologists, constitutional experts, intellectuals, institutes of management and social sciences, and the media. A holistic and multi-disciplinary approach should be adopted to solve the problems relating to labour reforms.

SIMPLIFICATION OF EXCISE LAWS

A large proportion of the revenue received by the Indian government is derived from excise duty – a tax on the manufacture of goods that is levied at the point of manufacture. The structure of excises levied at the central level has been simplified considerably over the past ten years. The number and level of rates have been reduced, and the current central rate stands at 16%. Credit/offset (referred to as CENVAT) is, in general, given for input tax.

While most goods are taxed at the main rate of 16%, higher rates exist (from 24% to 40%). Although the non-16% rates only apply to a few types of goods, the administration of multiple rates is not amenable to financial control methods (based on a self-removal procedure) that have primarily replaced physical controls.

It is therefore recommended that a two-rate structure of 16% together with a higher rate should be introduced. An increasing number of items are to be converged to fall under the 16% rate to minimise classification problems. This would be economically desirable and administratively simple. The rates would have to be adjusted for inclusion of services in the CENVAT.

REFORM OF CUSTOMS DUTIES TO ENCOURAGE FREE IMPORTS AND EXPORTS

One important challenge for the Indian government is to reduce customs tariffs to international levels. The basic tariff rate will therefore be reduced from 25% to 20%. This will reduce the need for exemptions.

The customs tariff rules run to 1,150 pages, of which 406 pages describe 121 exemptions, some of which have conditions and lists. This is further compounded by separate exemptions notifications under the Additional Duty, Special Duty, and the Special Additional Duty.

All this is set to change. The Indian government is committed to enforcing a transparent and efficient customs tariff structure that will enable sustained growth in imports and exports.

CONCLUSION

The process that began in 1990 and caught momentum in 2000 will develop rapidly in the coming years. The Indian economic and legal environment will be on a par with developed countries such as the UK and the US. The government is keen to support Indian industry and forge solid partnerships with the international business community.

The key word is reform, and the objective is parity with international business practices.

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