

sector enterprises implying that states with excessive administrative burdens suffer from relatively low fixed capital formation and small average firm size.

To begin the process of closing the gaps in economic performance across states, the relatively restrictive states need to improve their regulatory environment so as to become more competitive and productive. Econometric work on the relationship between product market regulation and labour productivity in OECD countries suggests that new and more efficient technologies would diffuse to the more restrictive states more quickly if they were to adopt the regulatory stance of the least restrictive states (Conway *et al.*, 2006). For the relatively more liberal states, the challenge is to further improve their business framework conditions towards those in the OECD area.

Policies to improve product market regulations

The key to improving product market performance in India is to focus on changing those policies that result in high levels of government interference in markets and restrict competition. Relative to recent history, the government has already moved substantially in this direction by liberalising some aspects of domestic product market regulation and allowing increased competition from foreign producers and investors in domestic markets. This section reviews progress in these areas and outlines where further improvements could be made.

Dealing with state-owned enterprises

As mentioned above, according to the OECD's PMR indicators, the extent of state control in product markets is relatively high in India reflecting the large size and scope of public sector enterprises (PSEs). 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 almost half of value added. This is high in comparison to OECD countries (OECD, 2005b).

At the state level the PMR indicators suggest that there is wide variation in the degree of state control, predominantly as a result of differences in the size and scope of the public enterprise sector, reflecting different starting points and commitments to privatisation (Figures 3.4 and 3.5). The state governments collectively control a much larger number of PSEs than the central government – just over 1 000 in 2003 in 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.

As well as being large in size, the public enterprise sector is extremely broad in scope with PSEs operating in a diverse range of sectors. As well as the network sectors, PSEs also operate in, and in some cases dominate, sectors that are inherently competitive (Figure 3.6, Panel A). Finance is the predominant sector in the government portfolio (Figure 3.6, Panel B). Within the industrial sector, PSEs have a strong presence in the production of coal and lignite, electricity, petroleum, metal industries and fertiliser. At the state level, investment in PSEs is often concentrated in the electricity sector, underlying the importance of ongoing regulatory reform in this sector (see Chapter 7).