

# FOREIGN INVESTMENT AND ISSUES OF CORPORATE GOVERNANCE IN INDIA

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*Profits earned by hook or crook cannot be the sole criterion for judging the success of a business. The success of liberalization requires the steady development of a new corporate ethic.*

Prime Minister Vajpayee in his 15<sup>th</sup> August 2001 address.

## 1. Introduction

Foreign Investment can be defined as the acquisition by governments, institutions or individuals in one country of assets in another. Foreign investment covers both direct investment and portfolio investment and includes public authorities, private firms and individuals. For a country in which savings are insufficient relative to the potential demand for investment, foreign capital can be a fruitful means of stimulating rapid growth. In addition, direct investment may be a means of financing a balance of payments deficit. Direct investment often involves the setting up of subsidiary companies for the domestic production of goods which previously were imported from the parent company. (Bannock et al, 1998).

External capital flows to developing countries have undergone fundamental changes during the past three decades. More recently rapid liberalization of financial markets and privatization of economic activity in developing countries have influenced them. The private sector has become the principal borrower in international capital markets and recipient of other private financial flows. Direct investment is often referred to as foreign direct investment (FDI). FDI inflows have increased in importance during the 1990s, becoming the single most important component of total capital flows to developing countries. FDI not only adds to external financial resources for development but is also more stable than other types of flows. FDI is typically based on a longer-term view of the market, the growth potential and the structural characteristics of recipient countries. FDI is generally preferred by the host country to portfolio management. FDI and the policies concerning it have a preponderant role as the engine of growth because of the diffusion of technology. FDI can contribute to technological upgrading in two ways: if it embodies a higher level of technology than domestic investment, it makes a direct contribution by raising the overall technological level of the host country; and it can also make an indirect contribution through positive externalities which benefit local enterprises.

In recent years competition among governments to attract FDI has heated up. The main reason for this is the large number of developing and emerging market economies that have moved during the 1980s and 1990s from relatively closed state-led growth strategies and dirigiste policy regimes to more open and market friendly policy regimes, and have moved in the process to seek actively to attract FDI. For example, China alone has moved from a policy of virtually excluding FDI, until 1979, to successfully attracting an annual FDI inflow of over \$40 billion by the mid-1990s—and in doing so has caused developing and emerging countries throughout Asia, and beyond, to worry about intensifying competition, with China and with each other, to attract FDI. The crisis that emerged in Asia in 1997 has tended, if anything, only to heighten those worries. [Oman, 2000].

There are two types of competition among countries to attract FDI. These are rules-based forms of competition and the incentives-based forms of competition.

Rules-based forms of competition are a broader and more heterogeneous group of government actions and include: changes in the rules on workers' rights; protection of the environment; signing of regional-integration treaties with neighbouring countries; greater protection of intellectual property rights; strengthening the rule of law & improved judicial systems; the establishment of "export-processing zone's or special economic zones" with distinct legislation from the rest of the country; the privatisation of state-owned enterprises; market deregulation; and the liberalisation of trade and investment policies.

Incentives-based forms of competition refer to fiscal and financial incentives. Common *fiscal incentives* include: a reduction in the base income tax rate a particular category of investors must pay; tax holidays; exemptions from import duties or duty drawbacks; accelerated depreciation allowances; investment and re-investment allowances; specific deductions from gross earnings for income-tax purposes; and deductions from social security contributions.

The most important financial incentives are grants; subsidised loans and loan guarantees. These incentives are frequently targeted for specific purposes, such as grants for labour training, wage subsidies, donations of land and/or site facilities, rebates on the cost of electricity and water, and loan guarantees for international lines of credit. Other incentives include government provision or subsidisation of "dedicated" infrastructure such as railroads, roads, industrial sites, sewage treatment facilities and the like built specifically for the investment project.

Decisions to invest abroad usually have two sets of components. One depends upon firm/industry-specific factor and the other on the host-country factors. The former are largely responsible for the decision to undertake the investment and the latter influence the destination of the investment. Firms invest outside their home country for one of three reasons: to exploit a natural resource available in the host country, to get access to the host country's protected market, or to maintain international competitiveness in the face of rising cost of labour and other non-tradeables in the home country. These three types of investments can be referred as natural-resource seeking, market-seeking and export-oriented FDI. Natural resource-seeking FDI, which consists of investment in areas such as mining, oil and gas extraction, etc., is probably the earliest

type of foreign investment. Natural endowment is the primary determinant of such investments. (Chakwin and Hamid, 1997)

Market-seeking FDI has changed significantly in recent years. Since World War II it had been largely confined to the manufacturing sector, but due to the recent trends in most developing countries towards greater openness of the economy and privatisation of infrastructure, sectors such as power, telecommunications and financial services are attracting increasing amounts of foreign investment. Also because of the import-substitution industrialisation policies formerly followed by most developing countries, until recently FDI in the manufacturing sector generally served to leapfrog tariff barriers, with very little, or even negative, value added in the host country. However, import liberalisation and the electronics revolution, and the consequent development of machinery and process which make smaller production runs possible without incurring significant cost penalties, have given rise to a more efficient FDI in industries catering primarily to the host country's market. (Chakwin and Hamid, 1997)

Export-oriented FDI is of relatively recent origin. The "product life cycle" theory of FDI, which postulates that as economic growth leads to higher wages in a country, labour-intensive industries will relocate to countries at a lower level of economic development, is most applicable to export-oriented FDI. However, the mere availability of cheap labour is insufficient to attract such investments. Factors such as location, infrastructure endowment and the policy environment are equally important. Export-oriented FDI is believed to be a major factor in developing Asia's economic success, and, thus it is the type of investment that developing countries most want. (Chakwin and Hamid, 1997)

The factors that affect the host country's decisions for attracting investment are political and macroeconomic stability, availability of infrastructure, natural resource endowment, economic policies relating to industry, trade and finance, wage costs, the investment incentive regime and the institutional framework such as the legal system, labour laws, etc. Investment flows are also influenced by factors like size (for example, China and India will attract substantial FDI just because they have a huge potential domestic market) and location (e.g. East and Southeast Asia have profited from their regional location because firms in Japan and the NIEs have found it easy to move their light, labour-intensive production to Malaysia, Thailand, Indonesia and the coastal provinces of China). (Chakwin and Hamid, 1997)

Investors, when selecting the site for a major investment project, tend to attach importance to the following factors:

- Political and macroeconomic stability;
- Market access and long-term growth potential;
- The availability of appropriately skilled workers and of necessary infrastructure;
- Fiscal incentives; and
- Financial incentives.

## **2. Corporate Governance**

Corporate governance refers to the procedures and rules, explicit and implicit, that provide the incentive framework for companies to attract financial and human capital, perform efficiently and avoid corruption (World Bank, 1999). They have evolved over

time and are still evolving in response to corporate failures and systemic crisis. Consequently, there are likely to be different models of corporate governance around the globe. Among the developed world, the main ones have been seen to be those of the English speaking countries, with dispersed controls, and the German and Japanese models, which reflect a more concentrated ownership structure. India's corporate governance system is a hybrid of the arms-length market-based systems of UK and USA and the insider-dominated-bank-based systems of Germany and France (Sarkar and Sarkar, 1999). In Australia the failures in 2001 of the insurance giant HIH, of the third largest Telco, One-Tel, and of the second largest airline, Ansett, has led to concerns about the lack of due diligence during takeovers and the inadequacy of protection of workers dues and of customers. It has led to workers' entitlements being put at the top of the queue of creditors. It is also clear in the context of such collapses that though the existence of a market for takeovers has been seen as improving corporate governance (World Bank, 1999), in practice HIH's takeover of FAI and Air New Zealand's takeover of Ansett, without adequate due diligence, contributed to poor corporate governance outcomes. In India, unlike the other English speaking countries, the market for takeovers is weak and inadequately developed.

Though corporate governance issues have been seen historically to be the province of lawyers, economists have begun to make important contributions in this area. Lawyers writing in this area tend to focus on the fiduciary duties of the directors and the need to have independent directors, who will represent the interests of minority shareholders (see for instance, Srivastava, 2000, who focuses on this aspect) without linking it to the role of the capital markets, whereas economists see good corporate governance as a means of improving the efficiency of the capital markets, so that sustainable economic growth can occur in this era of increasingly global capital markets (*The Economist*, Survey Article "Asian Business: In Praise of Rules" 7<sup>th</sup> April 2001, pp.1-18). Essentially, there is increasing recognition in Asian countries that good corporate governance, by improving the availability of information to investors, improves the allocation of funds through the capital markets, both at the global level as well as within a country.

Corporate governance has become a very important international issue mainly due to the increasing volume of FDI. It is one of the main issues facing those who deal with the international political economy and business studies. One can classify the following three dominant forms of corporate governance in the world: the German, the Japanese and the Anglo-American models. A comparison of these three 'models' reveals what can be called a permutation of priorities towards the "three Ps", people, products and profits:

Japan	Germany	Anglo-American
People	Products	Profits
Products	People	Products
Profits	Profits	People

The implications of these differences in priorities are quite profound and can be depicted in tabular form as follows:

<b>Japan</b> →People have priority→Emphasis on market share→CEO is a 'generalist'
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**Germany**→Products have priority→Emphasis on technology & engineering→CEO is an engineer

**Anglo-American**→Profits have priority→Emphasis on share-holder value→CEO is an MBA or an accountant.

Source: Lehmann, (1997).

Corresponding to these corporate governance models one can notice the following three government industry models to see the impact of government-industry relationships on corporate governance. These models can be summarised as shown in the following table:

Model	Countries	Salient features
Government as Referee	USA, UK, Hong Kong, Australia, New Zealand	<ul style="list-style-type: none"> <li>• Government totally impartial with respect to the market;</li> <li>• Government stands on the sidelines;</li> <li>• Government intrudes if or when abuses need to be prevented or perpetrators of illegal acts have to be punished;</li> <li>• Government's emphasis on fairness and unregulated market forces;</li> <li>• Minimise regulations;</li> <li>• Open transparent, accountable forms of corporate governance;</li> <li>• Auditors and lawyers have an important role to play;</li> <li>• Corruption tends to be low.</li> </ul>
Government as Manager	France, Italy, Spain, China, Vietnam, Singapore, Indonesia, Malaysia, Thailand, India	<ul style="list-style-type: none"> <li>• Govt. neither recognises nor respects the market and does not trust it;</li> <li>• Economic nationalism &amp; protectionism;</li> <li>• Govt. intervention and control;</li> <li>• Promotion of national corporate champions;</li> <li>• Corporate governance is opaque, secretive and closed, with little public accountability;</li> <li>• Bureaucracy is powerful.</li> </ul>
Government as coach	Germany, Austria, Switzerland, Norway, Netherlands, Sweden, Finland, Denmark, Korea, Japan, Taipei, Chinese, Malaysia, Thailand, Indonesia	<ul style="list-style-type: none"> <li>• Sidelines partiality;</li> <li>• Administrative guidance Support system, subsidies etc.;</li> <li>• Organised competition;</li> <li>• Semi-transparent/ semi-opaque corporate governance with limited public accountability;</li> <li>• Considerable scope for corruption.</li> </ul>

Source: Lehmann, (1997).

Though new agendas, as discussed earlier, related to workers' entitlements and customer protection, have emerged, the current focus of corporate governance issues in most English speaking industrial countries, such as Australia, is the protection of individual and minority shareholders. This aspect has assumed even greater focus in the context of the collapse in Australia in 2001 of HIH, the insurance giant and One-Tel, the third largest telco. These failures have raised questions about the approaches taken by the regulatory agencies, such as the Australian Prudential Regulation Authority and Australian Securities and Investment Commission, and about the capacity of such agencies to monitor the behaviour of the CEOs of such corporations. In the case of One-Tel, both the Packer and Murdoch families were represented on its boards as minority shareholders, but the combination of the abilities of the top management to hide information and the sudden deterioration in demand conditions, meant that there was little the individual and minority shareholders could do to protect themselves. Though there is likely to be some corrective action, in the aftermath of these collapses, minority and individual shareholders tend to often lose out, because of inadequacies of information and because of the herd-like behaviour, driven by 'irrational exuberance' of such investors, which tends to push up the prices to giddy heights (e.g. the share price of One-Tel in 2000 rose to giddy heights enabling its two CEOs to claim millions of dollars in bonuses), from which they are likely to collapse, creating major losses for investors. When this happens investors tend to, for a period, keep away from the capital markets. If this can happen in societies, where rules-based governance systems, with relatively well managed and well funded regulators are in place, one can imagine how much more difficult it is for most Asian countries, which have traditionally had relations-based and insider-dominated governance systems in place and/or which are much more resource constrained to monitor the behaviour of their corporates.

Nevertheless, all countries are being forced towards rules-based governance systems, requiring greater transparency of information to the markets and greater protection of minority shareholders, and improvements in corporate governance systems in general. This is partly because of the pressures from the IMF on Asian countries, in the context of and aftermath of the Asian crisis, to improve their corporate and state governance. It is also because of increasing recognition that as the capital markets are liberalized, funds at the international level tend to flow to jurisdictions with a more developed rules-based corporate governance system, where small investors and minority shareholders are more likely to be protected and away from the relations-based governance systems, which are likely to fleece small investors, *ceteris paribus*. This is reflected in the fact that at around \$280 billion of capital inflows in 2000, USA is by far the major recipient of global funds (Source: USA Bureau of Economic Analysis, International Investment Data). Even though recorded data shows that China, with its relations-based governance system, is a major recipient of Foreign Direct Investment (Government of India. *Economic Survey 2000-01*, Table 6.9, p.119, reproduced as Table 1 below), yet on a net basis China is an exporter of finance capital probably to the tune of \$20b per annum. In fact a large part of what is recorded as FDI flows into China are China's funds coming to Hong Kong and then being reinvested by Hong Kong based China transnationals into the mainland, i.e., they are recycled Chinese funds, but recorded as Hong Kong investment in China. Even some of what are recorded as US investments in China are likely to be recycled China funds. This is because, until recently, capitalists

could not join the Communist Party and therefore legally no member of the Communist Party could invest in China, hence this recycling. In addition, since most of such investment involves equipment and technology investment, it tends to reflect inflated prices of such inward bound investment. This is because it raises the equity holding of such investment in joint ventures with local governments, increasing control in the process, even as it enables the company to increase its after tax profits, through investment allowances and accelerated depreciation offered by China to FDI. In addition to such recycling, funds coming from China to Hong Kong, and there were around \$65 billion in 2000-01 of these, end up in other countries, mostly in the USA. This development is in the face of stringent capital controls operating in China.

Despite the severe opaqueness of corporate governance system in China (see *The Economist*, 7<sup>th</sup> April, 2001, p.4, Transparency bar-chart, which ranks China as the worst of 10 Asian countries on the transparency grading, which argues that corruption, market-rigging and accounting fraud seem common in China; (Lin, 2000), explains that 'actual governance practices of corporatised Chinese firms are characterized by excessive power of CEOs', insider control and collusion, lack of safeguards for minority shareholders and weak transparency'), there are large FDI flows from Taiwan, Japan and USA with each contributing roughly on average around \$4 billion per annum in the post-1992 period. In fact, in the early years of post-reform period in India, even as FDI and foreign investment flows increased substantially from a very low base, recorded FDI in China also increased sharply from US\$4.4 billion to around US\$40 billion by the mid-nineties and stabilized at this level, i.e., officially it remains at 15 to 20 times the levels achieved by India. Even, when the FDI flows to China are discounted by 'recycled funds' or round-tripping and it is probable that most of the FDI recorded as originating from Hong Kong and some from USA represents such re-cycling, China at an actual investment of around US\$18 billion (see below) in the second-half of the nineties still receives more than six times the FDI that India receives. What are the reasons for this?

### **The case of China**

China is evolving from a command economy to a market economy. The pace and sequencing of economic liberalisation has made the transition successful so far. Agricultural reforms started the process in the late 1970s and the reform process continued with the establishment of four special economic zones (SEZs: Shenzhen, Zhuhai, Xiamen and Shantou) in 1980. The areas were chosen in the provinces of Guangdong and Fujian because of their proximity to Hong Kong, Chinese Taipei and Macao. All enterprises, i.e. both foreign-funded and domestic, in SEZs were taxed at a concessional rate of 15 per cent and allowed to import building materials, office and production equipment, vehicles, etc. free of import duties. In addition, imports of inputs for production of exports were permitted free of import duties and licensing restrictions. (Chakwin and Hamid, 1997).

Foreign investment has played an important role in China's growth. FDI has been the main source of more efficient production and management techniques from abroad, as well as a more extensive knowledge base. It allowed direct contact to be established between Chinese and foreign entrepreneurs through joint ventures or cooperation agreements. The presence of foreign enterprises in China has contributed to the

development of local entrepreneurship. Foreign investment flows introduced competition into the Chinese economy and encouraged local enterprises to allocate available resources more efficiently, which in turn favoured productivity. Foreign investment has served as a vehicle for advanced foreign technology and managerial know-how. (Démurger, 2000)

In an excellent study Jesus Estanislao (1997) provides information on various aspects of policy towards foreign investment, and how that policy may have changed in recent years, in China and in six main ASEAN countries. China's open-door policy is in fact recognition of the need for foreign capital and technology. Foreign investments are promoted to generate foreign exchange. Generally, China promotes labour-intensive and high technology industries. Agriculture, energy-development, electronics and manufactures are the areas, which have been promoted by China.

Foreign investment in China can take place in the form of equity joint ventures, contractual joint ventures and wholly owned foreign enterprise. In wholly owned enterprises, the following conditions apply: it must utilise advanced technology and equipment; develop new products or improve existing ones, and must export more than 50% of output. The restricted areas for foreign investment in China are public utilities, transport, real estate, trust and investment leasing.

China's open door policy began in isolated areas or special economic zones (SEZ) with considerable autonomy for attracting foreign investments. The SEZs are designed to encourage foreign capital and technology by offering various incentives such as duty-free import, lower taxes and administrative autonomy in order to boost the development of China. In the SEZs foreign banks are generally allowed entry and this is also extended to insurance and securities firms. Limited foreign ownership is allowed in civil aviation industry including airport facilities. Joint ventures are allowed in energy and infrastructure projects. (Estanislao, 1997)

China's tariff regime is characterised by a relatively high average tariff and a large number of tariff bands with wide dispersions. In 1993, the average unweighted tariff stood at approximately 40%. Rates tend to be lowest for raw materials and higher for finished consumer goods. The structure of tariffs gives rise to very high rates of effective protection for some finished goods. Since the APEC Bogor Meeting in 1994, China has reduced the regulatory tariff on some products. In 1996, China promised to slash substantially the tariff on 4994 tariff lines. The average tariff rate was planned to be cut from an average 35.9% to 23%. (Estanislao, 1997)

Several levers of state control over Chinese foreign trade activity remain in place. These include export and import licensing; restrictions on foreign exchange retention and use; commodity inspection; customs regulation and protective duties; and state pricing of traded goods, especially imports. Although the scope of state planning has been reduced, substantial portions of imports remain regulated by licensing and other forms of control. Import licensing has been used for a variety of purposes including implementing the state plan, protecting certain sectors, and containing overall imports for BOP purposes. In 1993, 53 product categories representing 30% of total imports were subject to licensing. State control is also exercised over the pricing of imports. State price controls are used to promote exports and restrict imports. Beginning 30 June 1995, China removed quota, licensing and other non-tariff measures from 367 tariff lines. In 1996, China planned to eliminate the quota, licensing and other import control measures on about another 170

tariff lines, accounting for over 30% of the commodities subject to import quota and licensing requirement. (Estanislao, 1997)

China's government consumption is considered very high due to the fact that the state owns most of the economy. In addition, difficulties between central and provincial governments in their fiscal relations result in an increasing proportion of government revenue (and spending) controlled at the provincial level. Public expenditure averaged 19.9% of GDP between 1989-94, slightly up from 18% during 1986-90. Mostly on education and social services, construction and defense. Debt-service ratio is around 10% between 1994-95. Employing over 100 million people, more than 100000 state-owned firms have been touched little by economic reform. Including dependants, about 304 million people owe their livelihood to state firms. Local governments control about 80% of state-owned firms. Chinese authorities report that 40% of state-owned firms lost money in 1994, though this is an improvement over 60% in 1993. Returns on investment in SOEs dropped steadily from 11.9% in 1985 to about 1.9% in 1993. Unpaid debts of these firms rose 74% in 1994, roughly equivalent to about 84% of GDP and 30% of industrial output. Bailing out SOEs accounted for about 60% of budget deficit. (Estanislao, 1997)

Official policy decrees that state-owned firms will remain backbone of country's economy, with privatisation limited to smaller firms and joint stock options. Reforms of state-owned enterprises includes mergers, take-overs and reorganisations, and improved enterprise management. Key aspect of China's public enterprise reform has been the delegation of managerial responsibility. Further reforms of SOEs expected to increase their independence from the state and make them fully responsible for their production, investment and employment decisions. Government has pledged to keep only 1000 of the most important companies and let the other large and medium-sized state-owned enterprises find their own way, but it has often bailed out losers for fear of creating massive unemployment. (Estanislao, 1997)

State companies receive preferential treatment from government, like tax breaks. Government absorbs most debt of state-owned enterprises. They have preferential access to subsidised credit and foreign exchange as well as lower priced production inputs. Policy of subsidising urban consumers, farmers and loss-making state-owned enterprise is gradually being phased out. (Estanislao, 1997)

Law is vaguely written and inconsistently interpreted, while enforcement is lax. All too often, politics interferes with both interpretation and enforcement of the law. The increase in commercial disputes has been attributed to an imperfect legal system and ineffective government supervision. Many enterprises lack knowledge of international and domestic rules and regulations. Process of legal reform is currently being undertaken to make system more professional and independent. (Estanislao, 1997)

The Chinese government restricts the mobility of Chinese workers and keeps a lid on the wage differences among various enterprises. The restrictions also maintain the state's prerogative to be the final arbiter in labour management decisions. In the mid-1980s, the Chinese government carried out wage and employment reforms that resulted in the first significant decentralisation of state sector wage and employment decisions in almost 30 years. State industrial enterprises adopted a wage system that linked the size of their wage bill to an index of performance, and they were given the power to determine their own internal wage structure. As a result of these reforms, the wage payment scale

used in state industrial enterprises no longer corresponds with that used in government administrative units. (Estanislao, 1997)

In reality, labour unions are politically subordinate to the Party and government. Union effectiveness, as far as official policy is concerned, takes the form of unions helping the government achieve economic growth and modernisation, as well as protecting workers' welfare, providing education facilities, and so on. Unions are expected to cooperate with management. Their role centres on "labour productivity, worker morale and welfare rather than the interpretation of national policy". (Estanislao, 1997)

Enterprise unions are politically subordinate to the Party and government. Under the 1982 constitution, workers do not have the right to strike. All unions are under the leadership of the national trade union federation, which is controlled by the Communist Party at both the provincial and the national level. (Estanislao, 1997)

The Chinese Communist Party (CPP) is the centre of political power and authority in the country. Paralleling the government, the party assumes the responsibility for political education, ideological guidance, and discipline, supervision of state enterprises. The post-Deng Xiaoping scene remains uncertain. (Estanislao, 1997)

China ranked among the top three most corrupt countries in Asia. The entire system lacks transparency, leaving the door open for influence peddling and backroom deals. The problem is especially serious in the booming coastal cities in the South. (Estanislao, 1997)

The government cracks down on dissent and limits the formation and activities of groups and individuals. However, rapid economic growth, especially in the coastal provinces, have given rise to commercial and other entities that operate freely from the central government. The military, especially after the Tiananmen incident in 1989, remains an important and crucial supporter of the Party.

Since the adoption of open-door policies, China has become more receptive to foreign business. However, some segments of the society remain suspicious. The government remains opposed to certain foreign cultural influences and strictly regulates the flow of information.

Such inflows are bound to take place in a rapidly growing economy with an expanding internal market, driven by high investment rates despite relatively high risks. Moreover, some of these risks are reduced through the operation of export-processing zones and special economic zones, where internal laws and rules are minimized and capital utilization is increased because of the absence of unions and work practices limiting such utilisation and in the case of Taiwan they are reduced through language and links in a relations-based system. The point that we are making is that contrary to popular and academic opinion ( e.g. Chunlai, 1997, argues that China was the second largest recipient of global FDI. In this paper it is apparent that Hong Kong accounts for 62.1% of total accumulated FDI in China) China, with estimated actual FDI receipts of around \$18 billion (45% of recorded given 'round-tripping' and inflation of equipment and technology figures in the data), in the context of its well developed export-processing and special economic zones and rapidly expanding internal market, is not an extraordinarily large recipient of FDI.

Nevertheless, even after downwards adjustments for recycling of Chinese funds, China receives at least six times the FDI that India does. In the post-1991 period, which is

seen as India's reform period, China on an unadjusted basis received around 25 times the FDI that India did (see Table 1). This is despite India having based itself on the British rules-based system of corporate governance. At first sight, it does show India in a fairly poor light. But the post-reform period shows an increase in India's share of inward bound developing countries' FDI and a decline in China's share. China's share after hitting a high of 34.9% in 1993, declined continuously to 19.4% in 1999, while India's share increased from 0.5% in 1992 to 2% in 1997, suffering subsequently because of the reasons discussed elsewhere in the paper.

**Table 1**  
**FDI by Host Region (US\$ million)**

Country	1992	1993	1994	1995	1996	1997	1998	1999*
<b>China (recorded)</b>	11156	27515	33787	35849	40180	44236	43751	40400
<b>China adjusted</b>	5020	12382	15204	16132	18081	19906	19688	18180
<b>India</b>	233	550	973	2144	2426	3577	2635	2168
<b>Indonesia</b>	1777	2004	2109	4346	6194	4677	-356	-3270
<b>South Korea</b>	727	588	991	1357	2308	3088	5215	10340
<b>Malaysia</b>	5183	5006	4581	5816	7296	6513	2700	3532
<b>Philippines</b>	228	1238	1591	1459	1520	1249	1752	737
<b>Thailand</b>	2114	1805	1343	2000	2405	3732	7449	6078
<b>All Developing Countries (including China)</b>	51108	78813	104920	111884	145030	178789	179481	207619
<b>Share of India in Developing countries (%)</b>	<b>0.5</b>	<b>0.7</b>	<b>0.9</b>	<b>1.9</b>	<b>1.7</b>	<b>2.0</b>	<b>1.5</b>	<b>1.0</b>
<b>Share of China in Developing countries</b>		<b>34.9</b>	<b>32.2</b>	<b>32</b>	<b>27.7</b>	<b>24.7</b>	<b>24.3</b>	<b>19.4</b>

\* estimates

**Source:** Government of India *Economic Survey 2000-2001*, p.119, Table 6.9, which states its source as *World Investment Report*, United Nations, 2000

It should be obvious that expectations of risk-adjusted rates of return are likely to drive FDI. A faster growing economy raises expectations of such returns, increasing capital inflows, which in turn promote higher growth, expectations of higher returns and for a period through a virtuous circle, such a process may be continued. China's reforms, coupled with its high saving and investment ratios of around 40 percent of GDP, with an incremental capital:output ratio (ICOR) of 4, should make possible a rate of growth of 10 percent, even during periods of extensive development. Against this, with a saving/investment ratio of 24 percent (22 per cent in 2000) and an ICOR of 4, India's rate

of economic growth comes to around 6 percent. China's GDP growth rate has been adjusted, by some prominent economists in the field not necessarily unsympathetic to China, to an average of 8.5% (Garnaut and Huang (eds.), 2001, p. 13), from an average of 10.7% in the nineties, shown in World Bank Development Report 2000/2001, page 294, Table 11. This tends to raise China's ICOR to 4.7, pointing to the possibility that India's investment is being used more efficiently than China.

Though FDI's role, as discussed earlier, can be important in driving growth in developing countries, in practice this is only in conjunction with local investment. Where it promotes technology transfer, including of better management practices, it can help. In addition, increased competition by foreign investors can improve the performance of local companies. But, countries such as Japan and South Korea have had historically high rates of growth, without FDI and resource rich developing countries with high rates of FDI, such as Papua New Guinea, because of the absence of positive spillovers through stimulation of local investment, have failed to provide improvements in growth rates and living standards. There are also problems of transfer pricing and inflation of their investment quantum, which subsidiaries of large foreign companies may engage in; thus reducing the benefits to the recipients. Moreover, the major positive impact of improvements in corporate governance is likely to come from the enhanced ability of domestic small savers to channel their savings to the better performing corporates and to penalize the poor performing ones.

Against this though, because of the short-term nature of flows, foreign institutional investors (FIIs) have had a bad name in the context of the 1997-98 Asian crisis, in practice FIIs can provide a monitoring role in a system, where the capacity of the other monitors, such as independent directors, minority shareholders, domestic institutional investors and regulatory agencies is weak. Such monitoring role of FIIs can improve corporate governance and firms' performance.

Essentially, if risk can be reduced through improvements in corporate governance, then foreign and local investment may increase, creating a virtuous circle.

### **Developments in Corporate Governance in India**

The development of the Indian corporate sector can be divided into three distinct phases. In the first phase, which lasted from the beginning of independence of the late 1960s, the corporate sector was dominated by 20 family groups who had their beginnings as traders in the pre-independence era and who took a pioneering interest in the industrialisation of the country in the post-independence era. These family groups developed strong political connections and took full advantage of the licensing system to control a large portion of the industrial activity. Each group controlled several corporations, each with different groups of shareholders and significant public shareholdings. In quite a few of these, family groups held less than ten per cent of the shares, but retained control. Notwithstanding the diverse shareholdings pattern, companies were managed by the same family group with all senior management positions being occupied by the family. (Vaghul, 1997)

During the second phase of development from the early 1970s to the mid 1980s, which can be called the socialist phase, these traditional family groups came under intense pressure. During this period a Monopolies Commission was established and

restrictions were imposed on the expansion of the family groups, ostensibly with a view to broadening the entrepreneurial base in the country. This phase saw the emergence of a new breed of entrepreneurs who quickly seized the advantage and competed effectively with the traditional family groups. The pattern of growth, however, remained unchanged except that the new groups were gradually supplanting the old. The pattern of corporate governance by the new industrial groups was in no way different from that of the traditional groups. The second phase also saw the emergence of the financial institutions as shareholders in large companies. Access to credit from the financial institutions was based on an important conditionality of converting loans into equity, and this gradually gave the financial institutions a commanding presence in the corporate sector. As the financial institutions were under the control of the government, theoretically the government controlled a large part of India's private corporate sector. (Vaghul, 1997)

Thanks, however, to a close nexus that developed between the political system and the family groups, both new and old, the commanding presence of the financial institutions was used more to the advantage of the family groups, rather than to their detriment. Some malpractices in corporate governance were either condoned or connived at. It was common practice for the groups to obscure corporate accounts or divert funds for making political contributions to the detriment of the small investors. There was hardly any transparency. It was common for family members to start independent trading companies which would act as agents for procurement of raw materials or sales of the finished product and divert funds through an unfair transfer-price mechanism. Promotion to senior management positions was not based on merit but closeness to the family. Family disputes leading to separation invariably resulted in a division of the company, much to the detriment of individual shareholders. Manipulation of prices in the stock market was not unusual and the small investors enjoyed little protection. Financial institutions not only turned a blind eye to such practices, but a cardinal principle of their policy was to support the family group's management of the companies. (Vaghul, 1997)

There were of course several notable exceptions to this otherwise widespread phenomenon. There were industrial groups, which functioned on professional lines with much greater transparency and ethical standards, but they were few and far in between. More importantly, there were not many large public corporations with a complete separation between ownership and management. (Vaghul, 1997)

The third phase in the development of the Indian corporate sector began in 1991 with the liberalisation and the globalisation of the Indian economy. With competition replacing the old protected environment, the corporate scene in India is undergoing a sea change. Indian corporations are seriously engaged in re-evaluating their strategy. Under the former regimented system, diversification of the industrial base was dependent on the availability of industrial licenses. When that system withered, the corporations began applying their minds seriously to the concept of core competence. Businesses are being divested, new businesses acquired and efforts being made to scale up operations to international size. This process also raises important issues of corporate governance, including a much greater degree of professionalism of the management. Nonetheless, there are no immediate signs of a clear demarcation emerging between ownership and the management. (Vaghul, 1997)

The New Industrial Policy was initiated in July 1991 and a gradual process of economic reform covering investment deregulation, promotion of the private sector and

trade liberalisation, has continued since then. The sectors in which only public investment was formerly permitted which have been opened to private investment include: mining, coal, hydrocarbons, power, air transport, ports, roads, telecommunications and banking. In addition, automobiles and textile production are no longer subject to licensing, the ready-to-wear garment industry, previously reserved for the small-scale sector, has been opened to large enterprises, and automatic approval of foreign majority ownership is allowed in a number of industries, while for the rest the approval process has been liberalised. As a result, the Foreign Investment Promotion Board's rejection rate fell from between 40 to 50 per cent prior to 1991 to under 10 per cent in 1993, while about 30 per cent of approvals were through the automatic route. (Chakwin and Hamid, 1997)

The telecommunications sector has been opened up for the private provision of basic services, as well as value added services, and concessions for a number of regions in the country have been awarded to private operators, mostly joint ventures. The government is promoting foreign investment in the power sector by providing sovereign guarantees, a guaranteed rate of return on equity, and a five-year tax exemption for power projects in backward areas. Several power projects involving multinational corporations and joint ventures sponsored by non-resident Indians are underway or planned. It seems probable that most of the additional investment in power generation will come from the private sector. (Chakwin and Hamid, 1997)

Trade reforms since 1991 have considerably eased import licensing requirements and, as a result, the proportion of the manufacturing sector protected by import restrictions has been reduced from 90 per cent to 50 per cent. Import tariffs have also been gradually lowered, with the maximum tariff rate being reduced to 50 per cent from 400 per cent in the pre-reform period. As a result, the trade-weighted average tariff has declined to 27 per cent from 87 per cent in 1990. The rupee has been made convertible on the trade account and the real effective exchange rate has depreciated by 30 per cent since 1990, making exports much more attractive than before. However, India remains a relatively protected market and, as a result, there is a need for the government to screen and restrict investment aimed at the domestic market, which unfortunately neutralises India's most important attraction for FDI. The government has provided a number of concessions to export-oriented FDI, but labour market rigidities, relatively high wages in the organised sector, and inadequate and poor quality infrastructure have prevented any significant inflows into the export sector. (Chakwin and Hamid, 1997)

Although moving cautiously with its market liberalisation, India is committed to the process, and the reforms have begun to generate increasing FDI flows. FDI has more or less doubled every year since 1992 to an estimated \$1.3 billion in 1995. However, investment is largely concentrated in infrastructure, particularly power and telecommunications; and petroleum refining, petrochemicals and automobiles in the manufacturing sector. (Chakwin and Hamid, 1997)

Infrastructure, particularly power, hydrocarbons and telecommunications are likely to be area of concentration for FDI in India. Private sector participation in these areas has been given the highest priority by the government. Power generation and distribution are open to private sector investment, but a lack of a comprehensive policy, and decisions on issues such as tariffs, subsidies and payment of dues by state authorities, are inhibiting investment despite widespread interest. Incentives for oil and gas exploration, along with the move towards privatisation, should make the hydrocarbon

sector extremely attractive to foreign investors. Guidelines, regulations and modalities for private investment in telecommunications, ports railways and roads are being developed. Most major TNCs in telecommunications have shown great interest in investing in India, and a number of projects are already underway in this sector. While these areas should absorb the bulk of the FDI in India in the next decade, there is considerable potential for FDI in the tourism sector, such as hotels, resorts, etc., but this sector is still virtually closed to foreign investment. However, this could change because growth in tourism has the potential of providing India with large foreign exchange earnings, and balance of payments considerations may be an inducement to opening the sector to FDI. (Chakwin and Hamid, 1997)

Corporate governance did not receive much attention in the initial phase of the post-1991 reform period. This may be, because there had been steady improvements in laws relating to rules-based governance, given that India had inherited a rules-based system from Britain at independence. For instance, the quality of financial and non-financial disclosures, mandated by law, are stronger in India than most developing countries and a number of developed European countries (World Bank, 2000, pp. 93-95). But there were a number of developments with regard to the financial sector, which led to increased competitiveness and improved corporate behaviour. India, in the post-reform period has allowed the entry of private mutual funds and private banks (Government of India *Economic Survey 2000-2001*, p.59). 10 new private banks were licensed in the post-1993 period, while the minimum risk-weighted capital adequacy ratio was lifted for scheduled commercial banks from 8% to 9% from 1<sup>st</sup> April 2000 and for new private banks it has been set at 10% from 1<sup>st</sup> January 2001. The entry of new private banks and foreign institutional investors has forced the government-owned financial institutions to lift their game or lose market share, while the lift in the capital adequacy ratio is aimed at reducing systemic risk. Non-performing assets of both private and public sector banks declined until 2000 in the post-reform period. (*Ibid.*p.62)

In addition, the Companies (Amendment) Act, which had been lying on the backburner for a number of years, was finally passed in 2000. The salient features of the Act are provided in the Box below. The act, among other things, introduces arms-length auditors, provides for improved protection of small investors, improves the transparency of Initial Public Offerings (IPOs) and requires a clear statement on Directors' responsibilities in the reports of Boards of companies.

#### Salient features of the Companies (Amendment) Act, 2000

- All provisions concerning issue and transfer of securities and non-payment of dividends in case of listed public companies and those planning to list shall be administered by SEBI
- The share capital of shareholder limited company shall be of two kinds only: i) equity share capital with voting rights and (ii) preference share capital
- Dematerialised form will be compulsory for listed companies making Initial Public offering (IPO) of any security for a sum of Rs. ten crore or more.
- Specific provisions for appointment of Debenture Trustees and creation of debenture redemption reserve has been made.
- Voting through postal ballot for important items has been prescribed
- The Report of Board of Directors should include a statement on Directors' responsibilities
- A holder of security with voting rights in a company is not eligible for appointment as its auditor
- A public company having a paid-up capital of Rs. 5 crore or more and one thousand or more small shareholders may appoint at least one director elected by small shareholders on its Board
- Confirmation by the Regional Director is compulsory for changing a Company's Registered Office from the jurisdiction of one Registrar of Companies to that of another
- Provisions have been made to ensure the protection of small investors; a small depositor is defined as one who has deposited in a financial year a sum not exceeding Rs.20,000 in a company, and includes successors, nominees and legal representatives.

**Source:** Government of India *Economic Survey 2000-2001*, p.72, Box 4.2

Nevertheless, there are a number of areas, which need strengthening.

There is misleading reporting of intra-group transactions, which may be rectified by making consolidation of corporate groups' financial statements mandatory. This can be done by changes in the Accounting Standard on consolidated financial statements, The Institute of Chartered Accountants of India should be able to affect this change (*Draft Report of the Kumar Mangalam Committee on Corporate Governance*).

There is only limited oversight of most listed Indian companies. This is because their boards are dominated by management (executive directors) or 'gray outsiders' (defined to include family members of executive directors, attorneys who represent the company, investment or commercial bankers who have close financial relationship with the company, long term consultants, or directors who have substantial business dealings with the company). At the same time, the Companies Act allows one person to hold up to 20 directorships, which is too many, if effective oversight is desired. Even if this is amended, given the fact that insiders are likely to have more information than outsiders, the directors representing minority shareholders are often helpless to protect the latter. There is also the problem in India of the inadequacies of Securities and Exchange Board of India or SEBI, as a regulator (Comment, "Sebi's sad report card", *The Economic Times*, 22<sup>st</sup> Aug 2001). SEBI's list of uncompleted investigations continues to rise, while the maximum penalty of Rs 5 lakhs is too low to deter market manipulations by insiders. The former reflect the inadequacies of staff at SEBI, the latter the inadequacies of law. The former needs to be strengthened through the addition of more competent and motivated staff, while the latter requires amendments to the law to raise penalties, which would act as deterrence to such market manipulators.

Unlike the German lead banks, which have played an effective monitoring role, as major debt and equity holders, the Indian banks and financial institutions have failed to play such a role for a number of reasons. Probably the principal reason is that the major

banks and mutual funds are under the control of the government. They are buffeted by contradictory pulls by the various ministries and therefore have difficulty in focusing on commercial accountability. The government involvement also raises the moral hazard problem with the financial institutions exposing themselves to risky lending and activities, because they know that they will be bailed out by the government, if they run into difficulties [for instance UTI's Cyberspace investment and the excessive exposure of its US-64 to the info tech stocks; it should also be noted that US-64 does not come under the ambit of SEBI; though after it is converted to a net-added value scheme by November 2000, US-64 and other UTI schemes are expected to come under SEBI's ambit (*The Times Of India*, UTI moots umbrella firm for its schemes" 28<sup>th</sup> Aug 2001)]. It is also likely that the banks lack qualified staff to monitor the activities of the corporations to which they are major lenders. They rely for information, in any case on the management, and seem to be captive of it, because they tend to support its decisions. Unless, there are incentives in terms of bonus payments for effective monitoring by the financial institutions' representatives on the boards of companies, as well as penalties for poor monitoring, this state of affairs will not change.

The most serious concern is with India's bankruptcy and liquidation laws and procedures. These are inadequate, time consuming and contribute to poor governance by management. Bankruptcy reorganization of large industrial organizations is governed by the Sick Industrial Companies (Special Provisions) Act, 1985 and the process is supervised by the Board for Industrial and Financial Reconstruction (BIFR). The latter tends to support the rights of existing management and of old shareholders over fully secured creditors. Liquidation poses even more serious problems. This is because most liquidation cases take between one to two decades to complete, resulting in a system that works against the interests of workers and secured creditors. Since management fears neither attachment nor bankruptcy, it leads to companies funding highly risky investments, which has several adverse consequences. It raises the cost of credit, it debases the disciplining role of debt and it increasingly risks the health of the financial sector. Under planned legislation BIFR will be replaced by National Company Law Tribunal, which will oversee revival, amalgamation and winding up of sick companies. The new legislation will also end the open-ended nature of BIFR proceedings by requiring winding up operations to be completed within 24 months. The legislation also requires the criterion for defining sickness to be made tighter, thus making it more likely for the failing company to be revived than in the past. The proposed legislation has run into opposition, because it requires the payment of a levy of 0.005% rising to 1% on companies' turnover (*The Hindu*, "End of the BIFR era", 22<sup>nd</sup> August 2001. But given that it will provide a revolving fund for failing companies and it is in the interest of the corporate sector to have a healthy corporate sector, it should not be seen as an attempt to fleece the healthy to support the poorly managed.

It is apparent from the above that though new laws, especially if they facilitate speedier resolutions and protect workers and secured creditors, will help, the major problems relate to delays in enforcing existing laws and securing outcomes, as in the case of SEBI and BIFR within a reasonable time frame. In addition, with 28 million cases pending and mounting arrears, it can take up to 20 years before a decision is obtained and enforced. With large number of state and central statutes, often with conflicting definitions and language, which require legal interpretation and delays because of

procedural and multiple appeals against the lower courts, India's business and legal environment is seen to be one of the most difficult. The Indian environment is made worse by the high degree of corruption. In a survey of local businessmen, 83% reported paying bribes in transactions ranging from customs, excise, taxes and licenses, to infrastructure connections and government contracts (World Bank, 2000, p.45-46). Though 91% of the respondents said they paid less than 10% of the contract value, 2% said that they paid more than 25% of the contract value. Moreover, India's relative position on businesses' perception of corruption appears to have deteriorated. Transparency International's earlier surveys ranked India as somewhat less corrupt than China and the 1995 Global Competitiveness Report ranked India somewhat higher than China. Since then China has improved its position relative to India. In 2001, out of 49 countries China was ranked 33 and India 41 on the World Competitiveness Scoreboard (IMD, *The World Competitiveness Yearbook*, April 2001, Lausanne). The level of corruption declined in India for the first five years of the reform process, as the 'license raj' was steadily dismantled and the economy on the trade side was liberalized. Foreign investment flows (FDI +Portfolio investment) increased sharply in 1993-94 to more than US\$4 billion and peaked in 1996-97 at US\$6.133 (Govt. of India, *Economic Survey 2000-2001*, Table 6.8, p.118, reproduced as Table 2 below). Since then the momentum appears to have gone out of the Indian economy. Both FDI and FII have been adversely affected, partly by sanctions imposed by the USA in the aftermath of Pokhran II, but also by controversies relating to FDI.

**Table 2**  
**Foreign Investment flows by Different Categories (US\$ millions)**

		1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	April-Dec 1999 <sup>^</sup>	April-Dec 2000 <sup>^</sup>
<b>A.</b>	<b>Direct Investment</b>	<b>315</b>	<b>586</b>	<b>1314</b>	<b>2144</b>	<b>2821</b>	<b>3557</b>	<b>2462</b>	<b>2155</b>	<b>1489</b>	<b>1916</b>
a.	RBI automatic route	42	89	171	169	135	202	179	171	127	330
b.	SIA/FIPB route	222	280	701	1249	1922	2754	1821	1410	987	1262
c.	NRI	51	217	442	715	639	241	62	84	71	51
d.	Acquisition of shares ~	---	---	---	11	125	380	400	490	304	273
<b>B.</b>	<b>Portfolio Investment</b>	<b>244</b>	<b>3567</b>	<b>3824</b>	<b>2748</b>	<b>3312</b>	<b>1828</b>	<b>-61</b>	<b>3026</b>	<b>1916</b>	<b>296</b>
a.	FII's #	1	1665	1503	2009	1926	979	-390	2135	1187	-476
b.	Euro Equities & ADRs/GDRs*	240	1520	2082	683	1366	645	270	768	619	696
c.	Offshore funds & others	3	382	239	56	20	204	59	123	110	76
<b>C.</b>	<b>Total (A+B)</b>	<b>559</b>	<b>4153</b>	<b>5138</b>	<b>4892</b>	<b>6133</b>	<b>5385</b>	<b>2401</b>	<b>5181</b>	<b>3405</b>	<b>2212</b>

<sup>^</sup> Provisional

~ Relates to acquisition of shares of Indian companies by non-residents under Section 29 of FERA

# Represents fresh inflows/outflows of funds by Foreign Institutional Investors

\* Figures include ADRs/GDRs amounts raised abroad by the Indian corporates.

**Source:** Government of India *Economic Survey 2000-2001*, p.118, Table 6.8, which states RBI as the source.

The lack of clear acceptance by the incoming governments of contractual obligations entered into by the previous governments of a different political persuasion has not helped to generate confidence of foreign investors. The opportunity for rent seeking corruption has also increased with the entry of new international players. Major projects, such as Enron's (US power company) Dabhol Power Company; Sterilite's (UK based overseas' Indian company) takeover of 51% stake in BALCO, and Singapore Airlines' takeover of Air India consequently become political footballs and instead of the bureaucrats and politicians focusing on the issue of cost, price and financing to obtain the best deal for India, the outcomes become a victim of corruption.

It is apparent that the tariff allowed to Enron was excessively high. The question to ask is why was such a contract entered into? The Dabhol saga, with its so far lack of resolution, has contributed to a slowing down of foreign investment flows into India, even as other foreign companies withdraw from the power infrastructure. The Dabhol Power problem will impact on the financial sector adversely, because a number of Indian

domestic financial institutions have provided loans to the project. Interest payments for these loans are said to dry up by September 2001 and Enron will not be able to service either the interest or the principal since the first phase has been shut down due to Enron's differences with Maharashtra State Electricity Board. Indian domestic financial institutions (including IDBI, ICICI and SBI), given a total exposure of Rs.6000 crore in the Dabhol project are looking to resolve the problem out of court, as is Enron, which wants to find a buyer for its share of investment amounting to \$1.1 billion (Baiju Kalesh, "FIs planning out-of-court settlement in Enron project", *The Times of India*, 28<sup>th</sup> August 2001). The Enron investment also suggests that not all FDI are beneficial to recipient countries.

The earlier more attractive offer, in the mid-nineties, by Singapore Airlines to takeover in partnership with Tatas the ailing Air India was rejected. The current state of bidding is unclear, with Tatas interested, but without a partner. Against this, it should be observed that Air-India's profitability has improved in year 2000/2001 and there is no reason, why effective management could not improve results under a corporatised, government-owned enterprise. Similarly, Sterilite's takeover of 51% of BALCO created strike and disruptions, often promoted by the State Government. But the Sterilite case demonstrated the capacity of the Indian political and legal systems to resolve the problem and Sterilite has committed itself to expand BALCO's capacity and output by 50%.

The above reflects the capacity of the Indian legal and political systems to resolve the corporate disputes and governance issues, both on a short-term and long-term basis. It is not surprising therefore that despite the above hiccups, India ranks a high 7<sup>th</sup> as an investment destination in a survey of 1000 top companies conducted by AT Kearney. (PTI, "India 7<sup>th</sup> on FDI confidence list, says A. T. Kearney", *The Hindustan Times*, New Delhi, 24<sup>th</sup> of August, 2001).

The government business enterprises, because of (1) the multiplicity of objectives and therefore lack of commercial focus, (2) their inability to improve technology due to union opposition and budgetary constraints and (3) political interference, forcing management to look over their shoulder for approval of political bosses, even where they have been corporatised, perform poorly. Of the 210 enterprises run by the central government in early 2001, half were loss making (Kevin Rafferty, "India, Shourie lays down the law", *Euromoney*, June 2001, p.26). The poor performance of UTI or Unit Trust of India's US-64 scheme is a case in point. This is the only mutual fund scheme in India, which is not bound by the industry standards administered by the Securities and Exchange Board of India, the regulatory agency, despite having to be bailed out in 1998 after a similar crisis then.

Though Table 7.8, p.135 of *Economic Survey* (see Table 3 below) shows improvements in pre-tax profit both in absolute terms as well as in relation to capital employed, most of these improvements occurred in the first five years of reforms to 1995-96.

**Table 3**  
**Profitability of Central Public Sector Undertakings**

	91-92	92-93	93-94	94-95	95-96	96-97	97-98	98-99
Number of Units	237	239	240	241	239	238	236	237
Paid-up capital	457.0	519.4	559.7	582.9	595.9	624.3	721.2	770.7
Net worth	603.3	705.3	795.3	899.5	991.8	1138.9	1350.6	1480.2
Capital employed	1179.9	1401.1	1598.4	1624.5	1739.6	2311.8	2536.6	2737.0
Gross profit	136.7	159.6	185.6	226.3	275.9	309.1	372.1	397.7
Pre-tax profits	40.0	50.8	66.6	97.7	136.2	153.8	193.5	197.3
Profit after tax (PAT)	23.6	32.7	45.5	71.9	95.7	101.9	137.2	132.3
Gross margin to capital employed (%)	18.8	18.0	17.3	20.6	23.1	19.2	20.9	20.7
Gross profit to capital employed (%)	11.6	11.4	11.6	13.9	15.9	13.4	14.7	14.5
Pre-tax profit to capital employed (%)	3.4	3.6	4.2	6.0	7.8	6.7	7.6	7.2
PAT to net worth (%)	3.9	4.6	5.7	8.0	9.6	8.8	10.2	8.9

**Source:** Govt. of India, *Economic Survey 2000-2001*, p.135, Table 7.8

The ratio of pre-tax profit to capital employed has stabilized since then. Moreover, bulk of the profits are generated by a few government monopolies. Comparisons of Air India with Singapore may be odious, but they reflect fundamental problems of corporate governance in GBEs in India. On the positive side, the opening up of the market to private sector participants has meant that, where GBEs are not performing well, they are losing market share to the private sector. UTI's share of domestic mutual funds is declining rapidly in the aftermath of the Cyberspace fiasco and the poor performance of US-64. At the same time the poor performance of GBEs is adding to the problems of fiscal consolidation, and in the process increasing pressures for privatization of Air India and other GBEs.

In addition the entry of FII is adding to improved monitoring of Indian corporates, thus leading to flows of funds to better managed corporates with more transparent accounting and reporting systems (Khanna and Palepu, 1999).

In recent times however, a new factor has emerged which is triggering off a crisis in corporate governance. Thanks to liberalisation, the Indian economy is today moving at a much faster pace than at any time in the past. In particular, the Indian corporate sector is experiencing a growth rate of more than 12 per cent, and several segments of the industry are registering growth rates of well over 30 per cent. The economic reform has unleashed a very strong demand for quality products and Indian industry is responding to this challenge with a great deal of enthusiasm. Even though the degree of inefficiency still leaves Indian industry internationally uncompetitive, international competition has not yet become significant notwithstanding the opening of the Indian economy. Indian industry has been taking advantage of the time lag to increase productive efficiency and

achieve international competitiveness. There is a mood of optimism in the air. (Vaghul, 1997)

However, the accelerated growth has led to a major problem for the corporate sector. In the past, most expansion plans were financed comfortably by the financial institutions and banks on terms which could be considered quite liberal. Access to the capital market was also fairly easy as the financial institutions controlled much of the capital market's activities. As the industrial groups continued to enjoy a cozy relationship with the financial system, funding of expansion hardly presented any difficulty. (Vaghul, 1997)

With the acceleration of the process of development, however, a severe liquidity squeeze has gripped the economy and it has become imperative for the corporations to seek more and more cross-border funding. Several leading corporations are now entering the international capital market for debt as well as equity. Thus foreign investment institutions now hold a significant proportion of the equity in Indian corporations. As the Indian corporations are gradually globalising their funding, a transformation is taking place in corporate governance because of the requirements of the international capital market. Certain immediate changes are visible, such as greater transparency in accounts, appointment of professional managers, greater sensitivity to shareholder's interest and a closer attention to profits. (Vaghul, 1997)

## **Conclusion**

The subject of corporate governance constitutes a very rich field for research. There is a great deal of work which needs to be done. This is all the more true for some of the societies in Asia where the subject is very new.

A serious and intense debate has emerged in India and various issues relating to corporate governance following the liberalisation of the economy and its globalisation. The issue is of great relevance to foreign investors in Indian companies and for foreign corporations seeking to establish projects in India or strategic alliances with India. (Vaghul, 1997)

Until the mid 1980s, the Indian economy looked inwards and functioned behind a protective wall of high tariffs and quantitative restrictions on imports. Self-reliance was the catch phrase and this was supposed to be achieved through the public sector, which was intended to run the commanding heights of the economy. This approach was combined with a strict regimentation of the private corporate sector. Restrictions were placed on growth and almost all industrial activity was subjected to licensing by the government. The financial sector was brought under government control and the capital markets, though theoretically free, were also closely controlled by the government. (Vaghul, 1997)

In the mid-1980s a beginning was made towards a reform process. However, this was short-lived for a variety of reasons and the economy went back into a shell, resulting in a deep financial crisis in 1991. (Vaghul, 1997)

The new economic reform, triggered by this crisis, brought about a significant turnaround of the economy. Tariffs were lowered, all import restrictions were removed, the licensing system was abolished and a large part of the economy and markets were freed from government control. The government still retained the public sector, not so

much out of any ideological considerations, but because of the problems arising from a redundant labour force. (Vaghul, 1997)

The position of India has been somewhat marginal in international business discussions. Quite apart from the sheer size of its population, India has Asia's second largest middle class after Japan. But since 1991, India's economic policies have become more oriented towards globalisation, liberalisation and privatisation. Certainly there is a great deal more foreign interest in India, e.g. the recent entry of German, Korea, Japanese and USA's car manufacturers. In certain respects corporate governance in India should be more familiar and transparent to the West than that of East Asian countries. Nevertheless, India has been and remains a comparative outsider in international economic and business affairs and consequently has featured less in the strategic horizons of Western and East Asian corporations, though this is likely to change a lot in the next decade.

### Promoting FDI and Export Oriented Industries

	China	India
Contact Agency	<ul style="list-style-type: none"> <li>Ministry of Foreign Economic Relations and Trade (MOFERT)</li> </ul>	<ul style="list-style-type: none"> <li>Foreign Investment Promotion Board (FIPB)</li> </ul>
Tax Holiday/ Concessions	<ul style="list-style-type: none"> <li>2 years plus 50% reduction for 3 years.</li> <li>Reduced income tax rate of 15% in SEZ, ETDZ.</li> <li>Local income tax reduced to 10% for activities in SEZ. For export oriented production a 50% reduction in income tax each exported &gt;70% of output</li> <li>For technology enterprises a 50% reduction in income tax for a three year period.</li> <li>Duty free imports of inputs for export industries.</li> <li>Duty free import of investment goods in SEZs.</li> </ul>	<ul style="list-style-type: none"> <li>5 years for export oriented unit and infrastructure project companies.</li> <li>Reduced income tax for economic development areas.</li> <li>Refund of income taxes paid on export earnings.</li> <li>Eight years, 30% tax exemption for 100% export firms.</li> <li>Tariff reduction to 15% on import of capital goods used in export production.</li> <li>Access to tax free capital goods for 100% export firms.</li> <li>Duty drawback scheme which allows direct and indirect exporters access to raw materials and intermediate goods free of import duties.</li> </ul>
Profits Repatriation	<ul style="list-style-type: none"> <li>Foreign exchange retention for exporters.</li> </ul>	<ul style="list-style-type: none"> <li>Foreign exchange retention for exporters.</li> </ul>
Guanrantees/ Protection/ Legal system	<ul style="list-style-type: none"> <li>Unclear legal procedures.</li> <li>Political authority and enforcement of regulations not fully tested.</li> <li>Intellectual/ design and patent protection lack formal legal guarantees.</li> </ul>	<ul style="list-style-type: none"> <li>Internationally recognized legal system provides investor protection for contract, land rights, dispute arbitration, etc.</li> </ul>
Promotional activities	<ul style="list-style-type: none"> <li>Special economic zones (SEZ) / open coastal areas, etc.</li> <li>Economic and technological development zones (ETDZ) in 14 coastal cities-old urban districts.</li> </ul>	<ul style="list-style-type: none"> <li>Export processing.</li> <li>Zones</li> <li>Automatic approval of foreign ownership to 51% of equity in 34 priority areas.</li> <li>Fast approval for investments entailing 100% foreign ownership of firms committed to 100% exports.</li> </ul>

Foreign Ownership	• Can be up to 100% in non-restricted areas.	• Can be up to 100% but very restricted.
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Source: Chakwin and Hamid (1997).

The close relationship between financial institutions and the Indian corporate sector is undergoing a change. Public financial institutions are now going to the capital market to meet their capital needs and in the process they are acquiring a large body or vigilant individual shareholders. Foreign institutional investors are also acquiring a significant stake in the Indian financial system. The financial sector is now realising the need for much greater accountability to its own shareholders and this, more than anything else, is bringing a change in the attitude of the financial institutions towards recalcitrant borrowers. (Vaghul, 1997)

One of the significant features of the economic reform is the change that is taking place in the government-corporate relationship. The government has so far played the role of manager in the corporate sector. While in the East Asian models this role has become transformed into that of a “coach”, for a variety of reasons, this is unlikely to occur in India. On the other hand, there is greater likelihood of India moving towards the Anglo-American model, with the government emerging as a “referee”. In large measure, this would be close to the pattern of the political and bureaucratic system that emerged during the last four decades. To what extent this will inhibit India from emulating the East Asian pattern of growth remains to be seen. (Vaghul, 1997)

India has some unique advantages, besides its size, which could help attract FDI to the manufacturing sector. These include: (i) English is a working language, which can involve considerable saving of time and money for foreign investors since neither written or oral instructions, have to be translated, technical materials can be easily adapted and used, and managers from the parent company can quickly begin to work locally; (ii) The legal system, although slow, is well established with a tradition for fairness; (iii) There is a strong engineering base, and although machinery and equipment may be obsolete, the basic engineering infrastructure to adapt and use new technologies already exists; and (iv) There is a large reservoir of educated, skilled human resources, and since labour laws and unions do not extend to professionals, salaries of engineers, managers and technical staff are relatively low. (Chakwin and Hamid, 1997)

India has a well developed corporate regulatory and governance system in place. This is being steadily upgraded and improved. It also has well developed checks and balances in place to prevent multinationals from obtaining excessive advantages through FDIs. The entry of private banking and private mutual funds and FII's has increased competition, as well as monitoring of the corporate sector. They have also forced government owned financial institutions to lift their performance or lose market share.

A country of 1000 million people today, India's annual production of cars is around one million units. When purchasing power really improves, there will be immense business opportunities in India. This is also true of the power sector, and it is going to be true of roads, ports airports and other infrastructure. (Vaghul, 1997)

India is going to provide great economic opportunities for the rest of the world. Beyond the year 2000, when the developed economies are likely to experience a growth plateau, the stimulus for growth in the world economy is going to come only from certain regions. India and China are the two large countries which will offer part of this stimulus.

Thus we really have to take these countries very seriously. During the next five to 10 years India will be transformed into a country that is quite different. (Vaghul, 1997)

In India, the savings rate is around 24 per cent, but even if this seems to be quite thrifty from the point of view of the rest of the world, from the point of view of India's own development needs, it is rather modest and insufficient for the country's investment requirements. With such a level of savings, India is lucky to enjoy growth of 6 per cent. For growth of 9 to 10 per cent, however, outside investment is a necessity. India's reforms therefore will be dictated by requirements for cross-border investment, which is critical for economic development. (Vaghul, 1997)

There are two specific areas, where progress has not occurred. These are in the areas of liquidation and bankruptcy and in the delays in the resolution of outstanding cases with SEBI and the courts.

Against this improved capital adequacy standards and prudential supervision has led to reduced systemic risk within the financial sector.

The sanctions imposed by the USA in the aftermath of Pokhran II have also been lifted recently.

On balance India is well placed to attract foreign investment in the next decade.

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