

**Chasing the Dragon:
Accounting for the Under Performance of India by Comparison with China
In Attracting Foreign Direct Investment**

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Abstract

This paper compares and contrasts the performance of India and China in attracting foreign direct investment (FDI). Both economies are large emerging markets that had rather similar profiles in 1978. Today, China ranks number one as the world's preferred foreign investment destination. Closer examination of the FDI statistics suggests that India's performance has been significantly understated while China's performance continues to be overstated. However India still lags for a number of reasons. These include a high tariff regime, poor infrastructure (power, ports, roads and railways), a regulatory system that is too often not business-friendly, a policy of reservation of many potentially export-oriented sectors for small businesses and inflexible labour laws. The government's large budget deficit is preventing investment in necessary physical infrastructure yet India needs to increase the rate of private investment to enhance the economic growth rate and reduce poverty. The paper concludes that based on China's experience of promoting FDI, further economic devolution to state level is the best way forward. While this is likely to exacerbate inter-state income inequality in the short term, it does offer the possibility of redistribution in the longer term.

Chasing the Dragon: Accounting for the Under Performance of India By Comparison with China in Attracting Foreign Direct Investment¹

Introduction

Over the last two decades the policy stance of governments in emerging markets towards foreign direct investment (FDI) has changed dramatically. This has been brought about by the mounting evidence of the positive association of FDI with increased growth rates and in improvements in total factor productivity (TFP) {see, for example, de Mello, 1997& 1999 and Buckley et. al., 2002}. Notwithstanding calls for a nuanced assessment of the spillover benefits of FDI from some observers,² FDI is much sought after by governments seeking a catalysing boost to economic growth through technology transfers, employment generation, improved access to managerial expertise, global capital and product markets, marketing and distribution networks. Multinational enterprises (MNE) seeking a global rate of profit are generally unsentimental about where it is achieved. A concomitant of the global trend towards increasingly liberal trade and investment regimes and fierce competition to attract investors is the need for serious investment and leadership by governments and their agents at many levels, to create and maintain the necessary business-friendly policy environment.

This paper will examine why India and China that represent examples of very large emerging markets perform so markedly differently in attracting FDI despite the increase in the importance of global drivers behind FDI. Explanation will be sought in the way in which national and sub-national governments have gone about the task of promoting inward foreign direct investment. It will also consider how the governments of the two countries have faced the challenge of reconciling the many, often contradictory, interests of groups affected by economic liberalisation and foreign investment in the domestic economy.

Attracting FDI

Conventional analysis of the drivers behind FDI focuses on the distinction between horizontal market-seeking investment and vertical cost-minimising investment seeking a low cost production location (see Shatz and Venables, 2000; Lim, 2001). A large and growing market that permits economies of scale is particularly attractive to

¹ Fieldwork was carried out in November 2001, May 2002 and May 2003 in India and November 2002 in Western China. The author is grateful for the generous way in which people gave of their time to discuss the challenges of investment and export promotion in each country. It is hoped that those opinions are accurately reflected in this paper. However views expressed in this report are the responsibility of the author and do not imply endorsement by any Indian or Chinese authority, the Sichuan Academy of Social Sciences or UNIDO.

² For example, Rodrik (1999) argues that the effect of FDI on economic growth tends to be weak or even that much of the superior economic performance is driven by favourable domestic factors to which foreign investors respond.

market-seeking investment. Market servicing costs that favour foreign direct investment over exporting include the presence of import tariffs, non-tariff barriers, transport costs and local competition offering customer responsiveness.

The strategic logic behind production cost minimising through overseas location is based on segmenting the value chain and relocating those parts that can benefit from inexpensive inputs whether they are raw materials, intermediates or a lower unit-cost of labour. In general, since this type of overseas production rarely includes the entire value chain, but is part of a geographically distributed production network, it is invariably export-oriented. As the key drivers behind the investment are cost differentials between locations, there is sensitivity both to changes in technology and wage rates impacting on unit costs and to overhead costs and incentives associated with particular policy regimes. Although evidence is ambiguous as to whether fiscal incentives directly influence FDI because of the political risk attached, tangible benefits such as provision of cheap land and appropriate pre-start infrastructure are often considered to be necessary if not sufficient conditions for FDI of this type (Oman, 2000). A competitive fiscal regime is, at the very least, interpreted as reflecting a positive official attitude to the needs of business.

Recent work by Albuquerque et al (2003) suggests that global factors have increased in importance in explaining FDI flows. Using a large cross-country time-series data set, they model the significance of worldwide sources of risk that drive FDI across several countries. They conclude that in recent years, developing countries' exposure to global factors driving FDI has increased steadily and is now approaching that of developed countries.³ They identify capital market liberalisation and integration as the key driver. While Albuquerque et al (2003) argue global drivers are increasing in importance, domestic drivers (growth in local productivity, trade openness, financial depth, low government burden and macroeconomic stability) still account for a sizeable amount of inter-country variation in foreign direct investment.

The impact of FDI on growth is complex. First, growth occurs through capital accumulation and the introduction of newer technology, management systems and innovative products associated with FDI.⁴ Second, FDI improves the efficiency of locally-owned firms through contact and demonstration effects and exposure to increased competition. Third, FDI under the right economic conditions leads to technological progress through the introduction of new varieties of knowledge-based capital equipment. Fourth, the FDI 'package' proceeds through specific productivity-enhancing management development and skills training programmes. Fifth, just as local firms learn from contact with FDI so do governments, institutions and public service providers. MNEs bring certain expectations about the quality of the business environment and the cost of doing business in a particular location to the bargaining table with host governments. They are often in a stronger bargaining position than domestic firms from which to persuade the authorities to introduce the necessary reforms. Last, preconditions in recipient economies – a liberal and efficient business environment including infrastructure, quality of human capital stock and the

³ Albuquerque et al (2003) estimate the share of explained variance accounted for by their globalisation measure as 60 per cent for developing countries and 78 per cent for industrial countries.

⁴ The extent to which new products and technology are introduced is related to the motive behind FDI. Where there is only limited competition and the motive behind FDI is primarily market-seeking then the incentive for technology transfer is likely to be lower.

complementarity of existing firms – improve the conversion of FDI into higher levels of output.

Comparing the economic performance of India and China

China is a natural comparator for India for obvious geopolitical, economic and demographic reasons (Table 1). They both have populations in excess of one billion – China at 1.27 billion and India with 1.03 billion people in 2001. According to the World Bank (2003), on a purchasing power parity (PPP) basis, they are respectively the second and fourth largest economies in the world. In A T Kearney's September 2002 survey of the leaders of the world's 1000 largest corporations anticipated FDI intentions and preferences; China was ranked first, ahead of the USA for the first time, as the most attractive investment destination in the world. India was ranked fifteenth, down from seventh in 2001.

It is when changes in the participation of India and China in world trade are compared that one of the sharpest differences between the two countries is apparent. In 1978 external trade represented around 12 per cent of GDP for India and 10 per cent for China (Table 1). By 2001, India's merchandise trade amounted to 19.7 per cent of GDP and China's trade had expanded to 44 per cent of GDP reflecting China's emergence as one of the world's major trading powers. In 2000, China generated 4 per cent of world merchandise exports compared to 0.7 per cent from India (Table 3).⁵ In terms of merchandise trade, China ranked as the seventh largest exporter and eighth largest importer in the world in 2002.

A major difference in the composition of the output of each country is the relative importance of the contribution of the service sector, particularly computer software, in India. When trade in services is included, India's relative openness to trade improves significantly. Trade in goods and services amounted to 28.6 per cent of GDP in the case of India and 47.1 per cent of GDP in China. Even so, in 2001, China was a bigger exporter of commercial services ranking as the world's twelfth largest exporter while India was nineteenth.

One of the most obvious differences in the trade regimes of the two countries is the tariff regime. The average Most Favoured Nation (MFN) tariff rate in China has fallen from well over 50 per cent in the early 1980s to 15.3 per cent in 2001 (Tseng and Zebregs, 2002). India's standard applied MFN tariff averaged 32.3 per cent in 2001/2002 and is amongst the highest in the world (WTO, 2002, p.31).⁶ In addition, there is a Special Additional Duty (SAD) which is estimated to raise the unweighted average customs duty on all goods to 35 per cent in 2002/03 (World Bank, 2003, p. 53). The government's stated aim is to reduce the simple average applied MFN tariff rate to ASEAN country levels of less than 15 per cent (WTO, 2002, p.5).⁷ However this poses a major problem for the government because of its heavy reliance on

⁵ Indian industrial products amounted to 0.55 per cent of world exports in 2002/3 up from 0.5 per cent in 1990/91 (World Bank, 2003).

⁶ The average collected tariff rate was 21 per cent in 2000/01 down from 31 per cent in 1996/7. The collected tariff rate does not bear any direct relationship with the "marginal" tariff rate, which may even deter all imports under a particular category. It does include various exemptions. As a consequence collected rates do not reliably capture the distorting effects of the overall tariff structure.

⁷ China has already announced that its import duties are expected to average 9 per cent by 2005.

customs tariffs for tax revenue – 30 per cent of net tax revenue was derived from import tariffs in 2001/2002. By contrast, the Chinese central government only raised around 7.4 per cent of its revenue from import duties in the period 1995-98 (IMF, 2002). The potential benefits for India of liberalising trade in manufactures are clear. Wood and Calandrino (2000) estimate using China as a benchmark that were India to reduce its existing barriers to trade, especially to exports, to Chinese levels it could double its per capita income and increase exports five fold within two decades.

Tariff reform would be a lot easier to implement in India were it not for the size and continuing deterioration of the fiscal deficit. The Central Government's deficit has risen from 4.2 per cent of GDP in 1995/96 to 5.7 per cent of GDP in 2001/2002, while the overall public sector deficit (which includes the deficits of the Centre, of States, central public sector enterprises and the oil pool account) was 10.6 per cent of GDP in 2001/2002. The overall revenue deficit was estimated at 6.9 per cent of GDP in 2002/03 (World Bank, 2003, p.16). This is larger than the crisis level of 1991 and is projected to go higher still in 2003/04. Partly this is because agriculture and the services sector, which make up more than three-quarters of Indian GDP go virtually untaxed unlike in China.

FDI flows

One of the major drivers behind China's trade expansion has been foreign direct investment (FDI) so that by 2000, China's stock of FDI as a percentage of GDP amounted to 32.3 per cent compared to India's stock equivalent to 4.1 per cent of GDP, (UNCTAD, 2001).⁸ Even if allowance is made for some inflation of Chinese FDI statistics, and some estimates suggest the figures may be inflated by as much as 30-50 per cent by "round tripping", there can no doubt about the significance of foreign direct investment for Chinese economic performance (Table 2 and Figure 1).⁹ According to Tseng and Zebregs (2002), FDI flows to China have raised annual GDP growth by nearly 3 percentage points per year during the 1990s. In 1992, foreign affiliates contributed 6 per cent of total industrial output, 20 per cent of exports and 6 per cent of tax revenues. By 2001, they were generating some 23 per cent of total industrial value added, 48 per cent of China's total exports and 18 per cent of tax revenues (MOFTEC, 2001). Significantly, reinvested earnings constituted nearly one third of total FDI inflows in 2000-2001.

India's FDI statistics, prepared by the Reserve Bank of India (RBI), until July 2003 only recorded flows in the form of foreign investors' direct equity investments.¹⁰ There has thus been significant downward bias in Indian FDI statistics. An

⁸ If flows of FDI are considered the gap between China and India narrows. According to UNCTAD, FDI as a percentage of gross fixed capital formation was 2.4 per cent for India and 11.3 per cent for China in 1999. It should be noted that FDI flow statistics are much more prone to volatility than stock statistics.

⁹ Wei (2000) estimates that China's FDI stock figures should be reduced by 60 per cent and flows by 50 per cent, to take account of the Hong Kong effect and "round tripping".

¹⁰ Until July 2003, the RBI did not follow the standard IMF definition and excluded reinvested earnings, royalty payments, inter-company debt transactions and commercial borrowing by foreign direct investors. For example, BG plc announced in 2002 investments of £500 million in the oil and gas sector using loan financing but this investment would not have appeared in the Reserve Bank of India's FDI statistics. The equity capital of unincorporated entities such as foreign bank branches were also excluded.

International Finance Corporation (IFC) estimate suggests that India's actual FDI inflow in 2001 was between US\$5 billion and US\$8 billion.¹¹ The Planning Commission Report (August 2002, p.16-17) argues that if allowance is made for round tripping of FDI in China and under-estimation in India, then China's FDI inflow/GDP ratio at 1.8 per cent is *only* double the adjusted FDI inflow/GDP ratio for India. The provisional estimates released by the RBI in July 2003 indicate that FDI flows to India stood at about 1.3 per cent of GDP in 2001/202 declining to 0.9 per cent in 2002/03 compared with 4 per cent of GDP to China (World Bank 2003, p 49). When disparities in the per capita GDP of China and India are factored in the volume gap widens much further.¹²

Overall then, India's performance in attracting FDI is still modest in aggregate. Aspects of the business environment continue to discourage FDI flows on a scale commensurate with the size of the Indian economy despite all the liberalisation efforts since 1991. Perhaps it is India's misfortune to reach the mid-point of reforming national business legal and regulatory infrastructure at the end of a period of rapid world economic growth. Many observers believe that there is still much that needs to be done. Acharya (2001) cites the anti-export bias of foreign trade policies, the rigidity of labour laws, the policy of reservations for the small-scale industry sector, the weakness of infrastructure (especially power, ports, roads and railways) and slow and cumbersome administrative procedures (especially customs and excise) as factors contributing to a sluggish industrial economy. Wei (2000) estimates that if India reduced its level of bureaucracy and corruption to Singaporean levels, it could expect FDI 348 per cent higher than present levels (and in China, if the authorities could do likewise, FDI would be 218 per cent higher than current levels). Clearly if Wei's estimates are reasonably accurate, China also has some way to go in improving its business environment to Singaporean standards.

Sources of FDI

Table 3 reports sources of FDI flows to India and China in 1999. The information has to be interpreted with a degree of caution. Firstly, country of origin is as declared to the authorities in each country yet much of the investment goes through a process of 'two-stage round-tripping' making it very difficult for the authorities to collect meaningful country of origin statistics. Investment, which can originate anywhere in the world (Europe, Japan, US, etc. including India and China), may first go through a registered company in an offshore tax haven such as the British Virgin Islands or the Cayman Islands. It then passes through a subsidiary registered in Mauritius (for India) or Hong Kong (for China) or direct into the country concerned. For example, Mehta (1999) reports that Enron's Dabhol Power Company in Maharashtra was controlled through six different companies registered in various offshore locations. Indeed, UNCTAD (2001, p.25) estimates that as much as 40 per cent of total FDI inflows into Hong Kong in 1998 was 'Hong Kong-tax haven routing' and the British Virgin Islands became the fourth largest source of FDI in China during 1999-2000. Meanwhile, Hong Kong's FDI in the mainland has apparently been decreasing since 1998.

¹¹ Estimate attributed to Guy Pfeffermann, Chief Economist of the IFC, in the Planning Commission FDI Report (2002), p.16.

¹² India's GDP per capita was \$467 and China's was \$855 in 2000, (Tseng and Zebregs, 2002).

A second source of difficulty in making comparisons is that the Reserve Bank of India only publishes statistics relating to country of origin of FDI by RBI approvals. The conversion rate of RBI approvals to actual investment varies from year to year but appears to be rising. In 2000 it was just under fifty per cent compared to a 1991-99 average of around one-third, although this may be a function of a slowdown in the number of applications to the RBI for approval of new projects (Nagaraj, 2003)¹³. In China, the Ministry of Foreign Trade and Economic Co-operation (MOFTEC) compiles FDI statistics. MOFTEC statistics inevitably exaggerate the significance of Hong Kong as the ultimate source of foreign investment because of the much greater significance of 'round tripping' of domestic capital and what Zhan, (2001) describes as 'transit FDI' from elsewhere through Hong Kong.

Looking at Table 3, it is clear that Hong Kong plays a very important role in the financing of FDI in China. Whether this is as a transit centre for FDI or as an independent centre for mobilising finance capital is much less clear-cut. Mauritius plays a more limited role in relation to FDI into India functioning essentially as a tax haven. This is because India's capital market is much more developed than that of China and India's foreign investment regime provides 'national treatment' to all investors. There are corporate income tax advantages established in 1982 for Mauritius-registered companies operating in India but these are not dependent on specific policy instruments of the Indian government. A second feature is the importance of European Union FDI for India and the Asian Pacific Rim countries for China. Japan and Korea are also becoming increasingly important for India. Both India and China receive significant volumes of FDI from the USA. However as noted above it is difficult to establish whether country of origin statistics merely reflect the changing tax advantages of offshore registration. As China extends its policy of "national treatment" of FDI as part of the WTO accession agreement it is expected that round tripping of domestic capital will have all but disappeared by 2005. This, of course, does not mean that foreign investors will stop seeking to minimise their global corporate tax rate through judicious use of tax havens.

Sectoral distribution

When the sectoral distribution of FDI is examined, major differences between the two countries are apparent. Between 1991 and 2000, a quarter of approved FDI in India was for power generation, 18.5 per cent for mobile phone companies, and electrical equipment - mainly software - attracted 10 per cent by value. Manufacturing attracted 12 per cent of FDI approvals and, within that total, labour intensive textiles received only 1.4 per cent of approvals. In China, the majority of FDI went into the manufacturing sector – 60 per cent of total contracted FDI – while real estate attracted 24 per cent. Within the manufacturing sector, according to Tseng and Zebregs (2002), half was directed towards labour-intensive manufacture (textiles and clothing, food processing, furniture).

What is striking about the statistics is the impact of government investment regimes on FDI sectoral flows. India opened up the power and telecommunications sector in the 1990s to FDI while China has only recently begun taking tentative steps to allow

¹³ As Nagaraj (2003) observes, 'Apparently, even the concerned official agency does not seem to know - let alone monitor - how actual inflows are translated in capital formation, transfer of assets or change in managerial control' (p. 1702).

FDI in these sectors. By contrast, India maintained a policy of reserving real estate development and the textile industry up until 2000, before introducing a gradual process of liberalisation. The retail sector remains closed to FDI in India, while China began permitting international retail investment after 1992.

Sectoral trends suggest that China's policy of opening up the manufacturing sector virtually without reservation has been effective in attracting FDI to the sector to take advantage of the low unit cost of labour, while proceeding cautiously with liberalising the service sector (telecommunications, power, retail and distribution and financial services). This cautiousness as exemplified by the policy of only granting licences to foreign investors in restricted sectors in designated cities, has been tempered by a willingness to ignore infractions of the FDI regulations by powerful municipalities when it has been thought politically expedient to do so.¹⁴

In India, the private sector is much more developed and politically active than in China. Liberalisation of FDI equity caps has tended to proceed first in central government-controlled infrastructure sectors where the authorities are manifestly unable to finance the requisite investment (power, telecommunications, transportation infrastructure and large-scale urban development). The policy of reserving industrial sub-sectors for small-scale industries (SSI) particularly textiles, garments and leather is taking a long time to roll back because of political opposition and the threat to the livelihoods of millions of small producers.¹⁵ Unel's (2003) analysis reveals that the productivity of Indian manufacturing after the 1991 reforms increased sharply in the chemical, metal, machinery and transport sectors, while productivity in all the traditional sectors remained static or declined. He suggests that it is no accident that the sectors experiencing significant productivity growth have also been subject to competition from imports and FDI.

The list of SSI reservations contained over 800 items in 1991 and still contained 674 in 2003, although as a concession to large-scale exporters, a license can be obtained for manufacturing SSI-reserved products provided all output is exported. Perhaps the most crippling element of SSI policy is the cap on investment by SSI firms at Rs. 10 million for 610 reserved categories and Rs. 50 million for 64 reserved items.¹⁶ This has stunted the natural growth path of successful domestic SSI sector firms and deterred expansion of domestic operations and venturing into exports. Of course, many Indian entrepreneurs have built up their operations by artificially sub-dividing business units to fit under the capital cap but this inevitably adds to business costs. It also inhibits subcontracting and joint venturing relationships with foreign partners because of the limit it puts on scale efficiencies in the SSI sectors.

Indian retailing remains totally protected from FDI apart from very limited franchising, because of fears of the political consequences of retail consolidation. As the Planning Commission Report on Foreign Direct Investment (August, 2002)

¹⁴ For example, in 1992, China agreed to allow FDI in retailing in 14 designated cities but by the late 1990s city authorities were openly flouting the regulations in a dash to attract FDI to the sector (Au-Yeung and Henley, 2003).

¹⁵ For example, it is estimated that there are 12 million handloom weavers working in the State of Andhra Pradesh whose livelihoods would be put at risk if the weaving sector were fully opened to investment in integrated textile mills and a non-discriminatory tax regime for domestic and foreign investment.

¹⁶ US\$1 = Rs. 47.3 as at May 2003.

observed; ‘The retail sector in India is dispersed, widespread, labour intensive and disorganised. In the light of this it is not thought desirable to lift the ban on FDI in retail trade’ (p.46).

By contrast with their Indian counterparts, local government officials in China are incentivised by the central government to expand the penetration of FDI at provincial and city level and across selected sectors. The incentive comes in two main forms. First, provincial and city governments are under considerable competitive pressure from the central government and their peers to produce FDI statistics that demonstrate they are expanding inward foreign investment year on year. For example, local government officials have been known to court potential investors by offering to lobby central government for a licence on their behalf. Foreign-owned banks and insurance companies are currently only granted full licenses to operate in a small number of major coastal cities. Yet behind the scenes, provincial governors and city mayors elsewhere are campaigning hard to gain licences for foreign financial institutions in anticipation of greater liberalisation that is part of China’s WTO accession timetable.

Second, foreign invested enterprises (FIEs) are an important source of local tax revenue. Local government officials derive their authority directly from central government but have delegated powers to enact laws “according to concrete local conditions and actual needs”. Because central government has increasingly devolved spending responsibilities to local governments, while reducing their share of central government revenues, they have had to raise business taxes to meet the shortfall¹⁷.

Local officials have been forcing private Chinese businesses, since the beginning of the introduction of economic reforms after 1978, to make ad hoc contributions to local infrastructure and social development. Officials expect FIEs to behave in a similar way (Blackman, 2000). Local Chinese bureaucrats have both administrative and legislative power so local taxes are subject to negotiation within the “spirit of applicable law and the Constitution” and many of the regulations are intentionally vague. As a result local taxes are not imposed on all enterprises at a standard, centrally set rate but are administered on an informal quota system. This lack of transparency can give rise to corruption and complaints from investors. However the fierce competition for FDI at municipality level seems to keep the worst excesses under control. For example, the mayor of Chengdu, the provincial capital of Sichuan in western China, has a monthly meeting with all foreign investors in the city. Before the meeting officials from city hall routinely telephone investors to ask if they have any complaints to make about the business environment.

In India, there is sensitivity to political opposition from large-scale domestic business interests. This is hardly surprising given the high concentration of ownership in the private sector. Bardhan (1998) estimates that in 1996, the top 50 Indian business houses controlled 44 per cent of private sector assets. The great majority of the most valuable companies are family businesses. For example, Harriss (2002) reports that in Chennai, of the 31 companies represented in the list of the top 500 Indian companies

¹⁷ Blackman (2000) reports that in the early 1980s expenditure by local governments was about equal to that of central government. By 2000, local government was spending at more than twice the central government rate and yet its share of central government revenue had fallen from 67 per cent to 50 per cent.

only five are not family businesses, while seven belong to a single family group. Up until 1991 and the beginning of liberalisation, big business houses rarely faced much competition in the highly protected industrial economy, did not need to be customer-oriented and invested little in product development. Joint ventures with foreign companies could be used to reap monopoly profits in the domestic market. Since 1991, many of the big family-controlled business groups are in crisis as a result of growing competitive pressure from MNEs. Harris reports sharp declines in capitalisation of the big family groups relative to MNEs operating in India.¹⁸

Big business groups are well represented at the highest level by trade associations such as the Confederation of Indian Industries (CII) and the Federation of Indian Chambers of Commerce and Industry (FICCI). Many industrial groups have extensive connections with the political elite, some dating back to support for the independence movement. As Encarnation (1989) observed in his pre-economic liberalisation study of Indian business houses, many maintained what he styles 'industrial embassies' in Delhi to co-ordinate lobbying efforts. Domestic small-scale business interests impact more directly through political parties at State level. The BJP, the leading party in the ruling coalition, is well known for its small business connections in many northern states. The democratic political process has continued to constrain the authorities' capacity to develop policies to capitalise on India's comparative advantage in labour-intensive manufacturing and repeal totemic policies dating back to pledges rooted in the struggle for independence (Anand, 1999)

The power of China's industrial oligarchs is of more recent vintage than in India. It was recently recognised by the election of the chief executive (CEO) of the Haier Group, Zhang Ruimin, to become an alternate member of the Chinese Communist Party Central Committee in 2002. Most Chinese CEOs direct diversified conglomerates with many business units: some units may be joint ventures with foreign partners, some may be partially privatised (up to a maximum free float of 35 per cent of equity), while other units may be entirely state or municipal government-owned. Overall ownership control of these often extremely complex conglomerates remains vested in the state or a local government authority. Thus representation of Chinese domestic industrial interests in the political system is exercised, if at all, directly through the state apparatus. Where protection and support is provided, it is dispensed through that apparatus, typically through favourable treatment in the allocation of state resources such as land or access to credit from state-owned banks or a light touch by the regulatory authorities. This process is usually opaque which is difficult for foreign investors to challenge and the outcome has only a tenuous connection with considerations of economic efficiency.

Geographical Distribution of FDI

The geographical distribution of FDI in China is notoriously skewed towards the coastal provinces and Shanghai and Beijing municipalities. According to the OECD (2000), the coastal provinces plus Beijing accounting for 64 per cent of GDP, attracted nearly 88 per cent of total FDI inflows between 1983 and 1998, while the

¹⁸ Khanna and Palepu (2000) suggest that the performance of Indian business groups initially declines with group diversification and subsequently increases once group diversification exceeds a certain level. Affiliates of the most diversified business groups outperform unaffiliated firms.

central provinces attracted 9 per cent (21 per cent of GDP) and Western China received only 3 per cent of FDI inflows (15 percent of GDP).

The central government's policy since the early 1980s has been to selectively channel investment into infrastructure in support of inward FDI promotion, initially in the coastal region, while at the same time experimenting with new policy instruments in a limited number of locations before adopting them more widely. The first step was taken in 1980 to establish four Special Economic Zones along the coast, which offered potential foreign investors significant tax holidays, low tax rates and flexible administrative arrangements. In 1984, 14 coastal cities were declared open foreign investment areas. Since then the central government has gradually devolved power to allow provincial governments and municipalities to establish a wide variety of different 'special' investment zones across the country to attract FDI. China now has 49 national zones, complemented by hundreds of export processing zones, development zones, industrial parks and science and technology zones at municipality level (UNCTAD, 2002). After 1996, the central government began to relax restrictions on access to the domestic market and started to implement a policy of "national treatment" for FDI that will be completed by 2005 as part of the WTO accession agreement. A concomitant of this policy of introducing "national treatment" for FDI is the phasing out of tax concessions.

The outstanding success of this strategy in the coastal region and resulting disparities in quality of infrastructure and distribution of FDI from east to west is also reflected in widely differing levels of economic development. The Ninth Five-Year Plan (1996-2000) committed the government to introduce measures to redress regional economic imbalances. The Western Regional Development Programme launched in 1997 explicitly recognised that the remarkable development of eastern China in the 1990s now permitted the central government to redistribute resources from the east to develop the west through heavy investment in human capital and physical infrastructure. The policy initiative to develop Western China was again reiterated in the Tenth Five-Year Plan (2001-5).

Work by Buckley et al. (2002) confirms that the significance of the growth effect of both domestic and foreign investment increases from the western region of China to the coastal region. Furthermore the relative growth impact of FDI rises from west to east. In the less developed western region of China, domestic investment is of primary importance, while in the coastal provinces it is the interaction of domestic and foreign investment that produces growth-promoting effects. They conclude that FDI favours growth in the economically stronger provinces of China and those endowed with superior infrastructure. The contribution of domestic investment to growth is important at all levels of provincial development. Dayal-Gulati et al. (2000) are less sanguine about the role of domestic investment pointing out that the loan-deposit ratio by province has a negative impact on growth. They interpret this relationship as reflecting state-owned banks being required to lend to inefficient state-owned enterprises. By comparison with coastal provinces, central and western provinces have a disproportionate share of state-owned enterprises in their economies as a result of state industry dispersal policies adopted in the 1960s and as a consequence of the overwhelming concentration of FDI in coastal provinces.

Graham and Wada (2001) suggest a more finely nuanced view of foreign investment patterns in the coastal region. They distinguish between non-Japanese Asian-controlled FDI (owned by the ethnic Chinese diaspora from countries around the South China Sea)¹⁹ that is primarily concentrated in labour-intensive, export-oriented activities and FDI from Europe, Japan and North America which tends to be concentrated in more capital-intensive activities targeted at the domestic market. They conclude that while total factor productivity has accelerated in the coastal region relative to other regions, if China is to optimise the potential benefits from FDI it is necessary to differentiate between the policy regime for export-processing FDI and import-substituting FDI. In so far as export-oriented FDI in China is routinely tested in the global marketplace for competitiveness the policy regime may generally be assumed to be satisfactory. The more problematic policy regime is that operating in the import substitution sectors which is famously opaque and unequal in its treatment of investors once they have established themselves in China. This topic will be returned to below.

Unfortunately there is no comprehensive record of Indian FDI stocks or flows at state level so that it is not possible to carry out conventional statistical and econometric analysis of determinants.²⁰ However RBI statistics do provide information on the declared location of approved FDI by state. As in China distribution of FDI in India is also skewed. Some 45 per cent of approved new FDI investment by value between August 1991 and May 2002 was destined for four southern states of Maharashtra (17.4 per cent), Tamil Nadu (8.3 per cent), Karnataka (7.7 per cent), and Andhra Pradesh (4.7 per cent) and Gujarat on the west coast (6.6 per cent). Delhi attracted a further 12.2 per cent of approved FDI. Only 16 per cent went to the remaining states.²¹

Ahluwalia (2001) presents data to demonstrate rising regional inequality in India as measured by an increase in the inter-state Gini-coefficient from 1986-7 to 1997-98. The main driver behind differences in growth rate at state level is private investment, which has a strong and significant positive correlation with growth. Public investment and plan investment had no discernible impact on growth. The high growth states identified by Ahluwalia are, unsurprisingly, the states that have been most successful in attracting FDI (with the exception of West Bengal, which paradoxically has experienced agriculture driven growth and private industrial capital flight).

Unlike in China there is no central government policy in India to direct infrastructure investment in favour of particular states or regions in order to promote inward FDI, though at central government level there is a general budgetary redistribution mechanism that operates between the wealthier and poorer states. Since the economic liberalisation programme began in 1991, the power to attract FDI has been devolved to states. This has been taken up with varying degrees of energy and success.

¹⁹ Jonathan Story claims 80 per cent of the stock of FDI in China is held by ethnic Chinese from the diaspora (Story, J () *China: the Race to Market*,)

²⁰ Some might argue that the lack of visibility of FDI in state-level economic statistics reflects a deep-rooted ambivalence. However there is a general absence of reliable data at state level covering both domestic private and foreign investment. The Centre for Monitoring the Indian Economy (CMIE) does maintain a capex database but that has a number of weaknesses (see Ahluwalia, 2001, pp. 11-12.).

²¹ 26.8 per cent of approved FDI is not allocated to particular states in official statistics though it seems reasonable to assume a similar geographical distribution to that for FDI where location is declared. (http://iic.nic.in/iic2_c03.htm)

In 1997, the World Bank could write enthusiastically about the complementarity of state-level development spending in support of attracting private capital investment. By 2003, the situation had deteriorated significantly. Revenue deficits have averaged more than 6 per cent of GDP over the last six years reflecting falling revenues and rising expenditures on interest payment, subsidies, civil services salaries and pensions. This has inevitably crowded out development spending. High real interest rates necessary to sustain the funding of rising government debt have also constrained private investment. Indian banks in 2003 had one of the highest ratios of government debt to deposits in the world (World Bank, 2003, p. v).

In this situation, state governments find they have very limited capacity to fund the quality of physical infrastructure necessary to attract large volumes of FDI even though there is evidence of strong positive complementarities between public investment in infrastructure and private investment. For example, Oman (2000) cites a study by Venkatsen of the correlation between the incentives offered by states and their ability to attract FDI, which concludes that the major determinant of investors' decisions in India is the availability of good quality infrastructure. A state's provision of incentives can "play a significant role in attracting private investment if, and only if, the state has a certain level of infrastructure available to support investors' activities"(p.46).

Despite the fact that India was a pioneer in creating one of the world's first export processing zones at Kandla in 1965, EPZs have never had much impact on India's export performance. Tariff exemption schemes have tended to be excessively complex and encourage a 'licence raj' mentality at the operational level. The Central Government introduced a policy promoting fifteen Agricultural Export Zones (AEZs) and the enhancement of Special Economic Zones (SEZs) in April 2000.

Unlike the previous EPZ policy and reflecting the current reality of acute shortage of development funds, the private sector is expected to play the lead development role in the zones. The Central Government has promised to provide some incentives for State Governments to promote exports.

The Planning Commission Report (2002, pp. 49-52) puts considerable emphasis on the merits of the new SEZs as a policy instrument for bypassing necessary but politically difficult reforms required to secure the success of labour intensive export-oriented production. The Report emphasises the need to market Indian SEZs in order to attract export-oriented FDI. At State level there is some scepticism as to the speed with which SEZs and AEZs will build up significant new exports. Nevertheless many States have ambitious plans to promote new zones. For example, Andhra Pradesh's Chief Minister has already taken a road show around major financial centres in Europe, the Gulf States and the US promoting a range of industrial and financial park formats and zones. It remains to be seen whether the volume of mobile investment capital available in the world will find India more attractive than China.

Work by Lall et al. (2003), on the economic geography of industry location in India, concludes that the local presence of a mix of industries at district level is the only economic geography variable that has a significant, consistent and substantial positive effect for firms. This factor is significant for all sizes and sectors of manufacturing industry. The implication of this finding for India is clear. With the very modest public investment in industrial infrastructure that is possible given the size of current

budgetary deficits, industrial growth will continue to occur where a diverse manufacturing base has already become established, and where all kinds of private investment – foreign and domestic – is growing vigorously. This in turn is likely to have a positive impact on state-level capacity to invest in infrastructure, both because of the positive impact of growth on state revenues, and because various forms of private-public funding partnerships to develop infrastructure are likely to become more feasible. Nevertheless, any improvements in infrastructure investment are likely to be modest in comparison with, for example, even ‘remote’ western Chinese provinces such as Sichuan, which in 2001 alone invested US\$ 20 billion in infrastructure. Sichuan’s GDP is ranked tenth in China.

Business climates compared

An investor entering a new market faces a variety of uncertainties in carrying out a project appraisal. The costs of inputs such as labour, capital and land should be relatively easy to calculate but the total cost of doing business also includes transaction costs, many of which are hidden and intangible. They depend on institutions. Good institutions, from an investor’s perspective, should minimise the hidden, human-made costs of doing business. High transaction costs deter domestic as well as foreign-owned private investment.

For example, an International Finance Corporation survey of major obstacles to doing business in East Asia in 1999-2000, revealed that in practice domestic investors were more deterred by tax rates and regulations, and policy instability than wholly foreign-owned enterprises. The one constraint that deterred foreign firms more than domestic firms was the poor quality of infrastructure (Pfeffermann, 2001). Foreign investors presumably believed they could, on average, better leverage their superior resources and bargaining power with host governments in dealing with the regulatory environment than local firms. Nevertheless domestic and foreign investors were both significantly deterred by adverse tax and regulatory regimes and policy instability.

One of the paradoxes of India’s FDI policy regime is that few restrictions apply to foreign-owned enterprises and not to Indian-owned entities yet the perception remains that business activity is over regulated and foreign investors are viewed with some suspicion (Planning Commission, 2002, pp.21-3). Apart from equity limits on a relatively small number of sectors, India extends National Treatment to foreign investors and so there is no specific statute to regulate foreign direct investment (WTO, 2002, p.22). However, it is a common complaint effectively orchestrated by organisations such as the Confederation of Indian Industries (CII) that one of the major barriers to investment in India, domestic or foreign, is excessive regulation of entry and exit. In surveys carried out by the World Bank Group, of a sample of firms in India and China (2002a and b)²², it was found that it takes 10 permits compared to 6 in China, and 90 days in India relative to 30 days in China, to start up a new business (see Table 5). When it came to a foreign-invested power plant in India, the survey (2002a) reports that it took 43 clearances at the central government level and

²² Both the India and China studies are based on surveys of firms located in state or provincial capitals, ten in Indian states and five in Chinese provinces. There is no distinction made between foreign and domestic firms in the Indian sample.

57 at the state level.²³ LaFarge apparently required 75 permissions to take over an existing cement business.

Widespread criticism of the Indian licensing system for business start-ups has sparked off reform in many states where the introduction of the so-called single window system of investment approval has been adopted and seems to be working well. For example both Tamil Nadu and Andhra Pradesh have adopted such a scheme and actively proclaim the involvement of the Chief Minister in monitoring the progress of large projects (more than Rs. 25 crores²⁴). The Chief Secretary is responsible for tracking even quite modest new investment proposals (up to Rs. 25 crores). The state government of Orissa is committed to introducing a single window system in its new Industrial Policy (paragraph 5 and 6).

Certainly there seems to be widespread competition for mobile investment at state level. Both Tamil Nadu and Andhra Pradesh offer an impressive array of inducements from tax breaks to a variety of industrial parks providing guaranteed power and water supplies and telecommunications connectivity. In the case of Andhra Pradesh, a dedicated administrator is assigned responsibility for managing the ‘inspector raj’ for particular industrial parks. Orissa has boldly proclaimed that it wishes to promote a system of self-certification and that it is instituting a training programme for civil servants in collaboration with Industry Associations to bring about ‘attitudinal changes’.²⁵ These provisions have important symbolic as well as substantive benefits particularly for domestic investors.

Once the deal has been done and the investor attempts to open for business in India, the ‘inspector raj’ is liable to move into action. While this may be a minor irritant for a large international company with good political connections, the management time that has to be devoted to dealing with an endless stream of inspectors can be a significant cost burden for smaller companies. The World Bank surveys estimate that in India it takes on average 16 per cent of senior manager’s time to deal with government officials compared with 9.9 per cent of management time in China. Foreign investors do not seem to find this as burdensome as domestic investors because they rely on their local joint venture partners to deal with these intrusions or, in the case of a wholly-foreign owned subsidiary, a specially selected local manager to liaise with officials. Nevertheless interview data suggest that foreign investors are also annoyed by visits from too many inspectors from different government department making surprise inspections and sometimes pulling up management on frivolous grounds. In its worst form, it is often little more than blatant ‘rent collecting’.

The World Bank studies of the investment climate in China and India (2002a & b), come to rather different conclusions about the significance of the efficiency of government for business development. In India, the Bank concludes that excessive regulation imposes a severe handicap on business development in what it styles as poor-climate states. In China, the Bank concludes that inter-city differences in

²³ A more charitable interpretation of the licensing requirements for power plants might be that the authorities are trying hard to avoid the mistakes made over the Enron investment in the Dhabol power plant in Maharashtra which had a damaging impact on India’s reputation as an FDI destination.

²⁴ Rs. 25 crores is approximately US\$5 million.

²⁵ Paragraph 29 of the Industrial Policy (2001).

business performance do not hinge strongly on measures of government efficiency. Of course, there are severe methodological problems involved in making comparisons between surveys conducted in different countries, not least because of differences in samples and subjective expectations of government performance in different business environments. Overall, the Bank estimates that a tenth of the differences in total factor productivity between the Indian firms, grouped by the subjective rating of the investment climate of the state in which they were located, reflected the greater regulatory burden between good and poor investment climate states. Unsurprisingly the poor investment climate states (Uttar Pradesh, West Bengal and Kerala) have attracted relatively little FDI. In the China sample, a change in the share of foreign ownership in each city surveyed was estimated to have had a major impact on total factor productivity, sales growth and employment growth. Any business environment effect was thus moderated through the proportion of FDI relative to domestic investment. In the Indian sample, the density of FDI was simply too small to register a significant effect on TFP.

Joint ventures, disinvestment and bankruptcy

A contentious policy issue in India is the liberalisation of merger and acquisition (M & A) activity and, by implication, removal of exit barriers for foreign investors. The Planning Commission Report (2002, pp. 35-46) makes some very important recommendations in this regard by proposing the removal of most of the remaining sectoral equity caps on foreign investment and the deletion of almost all exit barriers.²⁶ One of the characteristics of contemporary corporate strategy is the constant search for new high margin business opportunities that fit with an enterprise's core competencies and its global positioning. This means that MNEs are constantly taking on new activities and shedding old ones. India's market for corporate control has recently risen sharply so that in the period 1999-2000 around half of all FDI inflows have been in the form of mergers or acquisitions (UNCTAD, 2001).

Many MNEs have been taking advantage of the relaxation of sectoral equity caps to buy out minority Indian shareholders in order to exit from the local stock market. The increasing competitive pressures on large Indian business houses have encouraged several to quit joint ventures. There are a few examples of the reverse process. For example, Toyota sold 10 per cent of its equity to Kirloskar, raising its Indian joint venture partner's share to 11 per cent in 2003. More usually the high capital requirements have ensured foreign partners have typically held most of the equity in vehicle manufacturing ventures. Similar arrangements either continue to favour the foreign party or have been abandoned. Famously, TVS, a south Indian scooter maker, broke off with its partner, Suzuki, after rows over sharing of technology to go it alone. Unsurprisingly, increased M&A activity has raised concerns about competition in consumer goods markets (Nagaraj, 2003, Chalapati Rao, et al., 1999).

Investors need to be able to enter or exit new or existing undertakings with a minimum of transaction costs. Nowhere is this more important than with respect to joint ventures where the foreign partner normally uses a joint venture as a way of testing the market. Equity caps have undoubtedly distorted and sometimes deterred

²⁶ The only significant barrier not included in the list recommended for deletion is the prohibition on local borrowing by foreign investors to fund purchases of shares (Table 5.3.7b).

market-testing investments in some sectors in India. At a certain point, one partner is likely to want to exit the venture yet it apparently takes on average nine years for the foreign partner to exit from India with the agreed sale proceeds.²⁷ Clearly this puts the foreign partner at a disadvantage in negotiating with the local partner over the sale price. Of course, liberalisation of the capital repatriation processes introduces an element of volatility but this also creates opportunities for domestic enterprises with lower cost profiles than MNEs to acquire new assets often at a discount on a willing-seller-willing-buyer basis. The Planning Commission's recommendations to remove equity caps and exit barriers are important because they increase the range of strategic options available to foreign investors appraising the Indian economy. The global market for mobile foreign capital is predicted to become even more competitive in the future and it is crucial that these barriers are removed.

An essential part of an efficient market economy is contract enforcement. Indian debt recovery and bankruptcy proceedings are notoriously drawn out. The CII asserts that it is 'normal' for proceeding to take more than two years so that enforcement of debt recovery schemes can be exceedingly protracted – up to 12 years. The consequence is a system that favours Indian companies that are able to use their 'connections' to achieve results outside the courts and discriminates against foreign-owned companies that have to rely on the official court system.

In China there is no open market for corporate control since virtually all foreign-invested joint ventures are with state-owned enterprises and equity sales are by private treaty. In 1999, half of FDI by total contracted value was in the form of joint ventures (OECD, 2000). There are no wholly foreign-owned firms yet listed on the Shanghai or Shenzhen domestic stock markets. Very few state-owned enterprises go bankrupt. This is because there is no effective bankruptcy law and Chinese state-owned banks are reluctant to foreclose on SOEs for fear of having to publicly acknowledge the write down of assets. Too often it has proved easier to continue lending in the hope that the situation will improve with the result that non-performing loans have built up to officially 23 per cent of commercial bank assets. State-owned manufacturing firms have been able to continue to expand production regardless of declining profit margins. The People's Bank of China (the central bank) reported at the end of 2002, '86 per cent of (Chinese) manufactured goods are over-supplied, yet factories run at full tilt as prices are slashed.' *Financial Times* (February 5, 2003, p. 15)

The very rapid build up of FDI in the Chinese car industry is occurring within a framework of 50-50 joint ventures and illustrates some of the dynamics behind over-production bubbles. Within this government-determined framework, each of China's top four (state-owned) carmakers has ties with at least two global players.²⁸ Such is the attractiveness of margins in the Chinese car market, foreign carmakers are willing to tolerate these very unusual arrangements. By 2006, China's capacity will have risen to at least 4.5m passenger cars according to AT Kearney implying more than a trebling of current domestic demand. There are apparently few complaints about the lack of an efficient market for corporate control in China while domestic markets are growing rapidly; either because MNEs are arrogant enough to believe that it does not

²⁷ One respondent alleged that nine years was an improvement on 18 years that used to be the average exit time.

²⁸ In India, foreign carmakers only have minority Indian private joint venture partners or are wholly foreign-owned.

matter or they have extraordinary faith in the WTO accession process. China's lax intellectual property regime may also cause problems for MNEs unable to control the leakage of IP to their joint venture partners.

Infrastructure constraints

The critical importance of efficient physical infrastructure was recognised early on in the 1980s in the process of establishing special economic zones (SEZs) in the coastal region of China for foreign, export-oriented investors. By contrast in India, the share of infrastructure in fixed capital formation has declined sharply for nearly one and a half decades (Nagaraj, 2003, p.1709).

Foreign investors evaluate projects in terms of the comparative impact of costs associated with operating in different locations. Prices used are those available in the different alternative locations being evaluated. Input supply chains and distribution channels are likely to involve more cross-border transactions than for local firms. MNEs, on average, use more capital intensive and technologically advanced production techniques than domestic producers implying greater sensitivity to production down time, whether caused indirectly by supply chain disruption or directly by infrastructure failures such as power cuts.

a) Transport

The poor quality of much of India's transport infrastructure is widely recognised. Steps are being taken to develop a four-lane 'quadrilateral' national road network linking Delhi, Kolkata, Chennai and Mumbai by 2003. However, the ubiquitous 10-ton axle-load lorry is symptomatic of the under-developed state of Indian roads and the dead weight of paperwork associated with sales tax which is charged ex-factory, per lorry load. India has a total of only 3000 km of four-lane highways compared to China, which has built 25,000 km of four to six lane, access-controlled expressways in the last ten years.

India's rail system also faces severe capacity constraints with an average rail speed of only 24 km per hours (World Bank, 2003). The longstanding practice of cross subsidising from freight to passengers causes inflated freight tariffs and shunting of goods traffic into sidings while passenger trains pass by. Indian railways carries a mere 5 per cent of freight as a percentage of traffic units compared to China where freight represents 79 per cent of traffic units. As the World Bank (2003, p. 62) trenchantly observes: 'Indian railways continues to be a patient who resists any bitter medicines despite plenty of prescriptions available.'

Delays and inefficiencies in many Indian ports, in particular, the slowness and corruption of customs handling are infamous. The World Bank – CII (2002a) survey estimates that it takes on average 11 days to clear imports through customs in India compared eight days in China (Table 5). The introduction of computerisation in customs administration is reported to be improving delays but firms' representatives still complain that the tariff and exemption system is overly complex and subject to interpretation on the spot. Given that tariff 'spikes' (rates exceeding 15 per cent) amount to 93.9 per cent of tariff lines it is hardly surprising that firms try hard to negotiate favourable treatment (WTO, 2002, p. 30). The standard publication of

customs tariffs contains 1,150 pages and around 400 pages relate to exemptions. The lack of transparency is obvious.²⁹ The Chinese tariff system is now very much simpler than in India because tariff rates are on average less than half those prevailing in India with many fewer sharp spikes to 'negotiate' over.

b) Power

A reliable power source is a critical concern for most enterprises. India's burgeoning information technology and business processes outsourcing (BPO) sectors are no less dependent on reliable power for driving computer hardware and air-conditioning than more conventional manufacturing processes. Yet the India-wide shortfall in meeting electricity demand is conservatively estimated as 11 per cent for regular and 18 per cent for peak energy demand according to the CII.³⁰ 69 per cent of firms responding to the CII/World Bank (2002a) survey reported that they had their own standby power generator, a very considerable additional capital cost. In China, 16 per cent of firms reported owning a standby generator. Not only is the power supply unreliable and of poor quality in India, the industrial tariff for a high-tension supply is 8-9 cents/kWh compared with 3-4 cents in China.³¹ Generation capacity is being expanded rapidly in China.

When the Indian power sector was first opened up to private investors there was considerable interest in building power plants, but seven years on, it has become clear to all that distribution is the binding constraint rather than generating capacity. The failures of State Electricity Boards (SEBs) to collect bills and prevent power theft are notorious. Some SEBs lose as much as 40 per cent of output in distribution and whole industries depend on stolen power. For example, McKinsey (2001) describes in detail how the Indian mini-mill steel sector survives and flourishes on stolen electricity.³² The scale of illegal taps in India is simply incomprehensible to Chinese state electricity company officials.

The plethora of under-funded but subsidised consumers pushes up the cost of electricity to commercial users. For example, farmers currently get free electricity in Tamil Nadu yet it cannot be rational for textile factories, many small scale, to be expected to pay more for power than similar textile factories in the USA.³³ Under the Central Government's reform programme - the Accelerated Power Development Programme, the State has signed a 'memorandum of understanding' agreeing to ensure the metering of every connection and improve technical losses. The Central Government is providing funding for reform but the State has to file its new tariff proposals, including its scheme for phasing out subsidies, with the regulator. Some industry representatives expressed scepticism about whether the State Government had the political will to remove subsidies especially from farmers.

²⁹ Apparently, the general notification for exemptions will go up from 378 entries in 2001/2002 to 415 in 2002/2003 {Ministry of Finance [Central Board of Excise and Customs] (2002b), Notification No. 21/2002 – Customs}.

³⁰ The World Bank (2003) reports an estimate for the power shortfall in 2001/02 at 7.5 per cent and 13 per cent for peak demand.

³¹ Typical industrial rates in Europe are in the range 6-7 cents/kWh.

³² With modern electricity metering and IT technology it is relatively cheap to identify the majority of illegal power theft. The real problem is the scale of the problem and the political will to act.

³³ How many firms actually pay the official tariff is currently only a matter of speculation.

In Orissa, the distribution system has been privatised as part of a wider power sector reform programme costing \$740 million using over 20 different teams of consultants mostly from overseas and funded substantially through the World Bank, the ADB and the Department for International Development, UK. The new owners are apparently still finding it very challenging to drive down the illegal 'tap' and are reported to be making very little profit, not least because the biggest debtor of the distribution company is the state government.

Using the private sector to finance investment in infrastructure and utilities allows the level of investment to be determined by political constraints on price increases to customers rather than the government's cash constraints (Helm, 2001). No officials dispute the need for a credible tariff enforcement mechanism to be in place, for it to be seen to apply to all and to provide a fair rate of return to power producers and distributors. Ironically, the constraint on implementation is a shortage of finance, expertise, and the political commitment and continuity to drive the reform process. Reform is also necessary to provide incentives for the development of a properly functioning national electricity grid with power trading across state boundaries and to create opportunities for earning income for states with comparative advantage in power generation such as Orissa and West Bengal. Regulators need to define terms of access, and to enforce a level playing field for all users of the electricity network. The newly passed Electricity Act 2003 is supposed to facilitate these urgently needed reforms. However implementation ultimately depends on action at state level reinforced by central government enforcement of hard budgetary constraints on state-level utilities.

c) Telecommunications

Liberalisation of Indian telecommunications is beginning to yield benefits for users. Industry representatives do not complain about the quality of telecommunications as much as they do about power and water supplies. The spectacular growth rate of the Indian IT and software sector and its expanding economic significance has had a major beneficial impact on the telecommunication sector more generally by focusing the authorities' attention on the sector. The software industry association, NASSCOM, continues to campaign for improved telecommunications infrastructure and lower tariffs.³⁴

The reform process initiated in the early 1990s has resulted in local fixed line services being provided by two state-owned enterprises, BSNL and MTNL, with additional private operators in seven service areas. Long-distance services are still dominated by the privatised VSNL but with two other private companies also licensed to provide long-distance services and a letter of intent issued to a fourth, the situation is changing. The number of fixed lines has jumped dramatically from 14.54 million in 1996/7 to 35.51 million by January 2002 or 41.44 million if cellular services are included, a teledensity of four per cent. Tariffs are continuing to fall sharply under competitive pressure. For example, New Delhi had eight different mobile phone operators by November 2002. Indeed, some commentators argue that there is now too much competition in some cities. This compares with a fixed line density of more than 14 per cent in China and 11 mobile subscribers per hundred people.

³⁴ National Association of Software and Service Companies (2001), p.8

Labour flexibility

Another area of radical difference between India and China is in employment relationships. India has one of the most formally protected labour markets in the world yet this protected enclave coexists alongside an unregulated labour market that is vastly larger. The organised industry and services sector accounts for 27 million jobs (just 7 million in manufacturing) while the total Indian labour force is about 406 million. Any registered firm, that is one employing more than 100 people, is required to seek permission from the state government to retrench its workforce under Section 5B of the Labour Code. The Budget Speech of March 2002 promised that this piece of legislation would be changed to raise the level to 300 but implementation depends on legislation and political will in the coalition Union government.

The radical difference in the attitude of the Indian and Chinese governments on this matter is reflected in the recently published investors guide for special economic zones in India. It states ‘ the labour laws of the land will apply to all units inside the Zone. However, the respective State Governments may declare units within the SEZ as public utilities and may delegate powers of the Labour Commissioner to the Development Commissioner of the SEZ’ (Ministry of Commerce and Industry, 2002, p.15). In China, the right to hire and fire has been enshrined in SEZ regulations since 1982. Moreover, in India there are strict regulations stipulating that contract labour is only allowed work of a temporary nature. By contrast, the World Bank survey (2002b), estimates that in Guangzhou firms employ more than 20 per cent of the labour force as non-permanent workers. Of course many Indian employers find ways round the regulations through outsourcing and less formal means but the current system undoubtedly reduces flexibility and deters FDI concerned about reputational risk attached to adopting local survival techniques.³⁵

Why India needs foreign direct investment

From the analysis above it might seem that India could never catch up with China and indeed some might ask why should India want to catch up with China. Unfortunately for India, China poses a direct threat to much of India’s manufactures export markets. Estimates (Ianchovichina and Walmsley, 2003) suggest that WTO accession benefits in the form of trade liberalisation for Chinese goods will make China an even more formidable competitor in areas such as apparel and textiles where India might otherwise expect to make progress from its own, albeit slower, liberalisation programme.

India’s economic growth rate over the past decade has been quite respectable with real GDP growth averaging around 6 per cent. However, according to Acharya (2001, p.5) the average GDP growth rate over the last four years 1997/8 to 2000/01 has dropped to 5.4 per cent, and no improvement in 2001/2002. With a population growth rate of 1.8 per cent per annum, Indian employment growth has lagged behind population growth since 1993. While social indicators have improved over the last

³⁵ One MNE interviewed stated that the Labour Department’s inspectors were the most resented. The company decided that the easiest way to achieve the desired level of labour force flexibility was to put the labour inspector on the MNE’s payroll.

decade, poverty is estimated to increase unless real GDP growth rises above 7-8 per cent.

The Approach Paper to the Tenth Five Year Plan (2002-07) examines the feasibility of doubling per capita income over the next ten years assuming population growth continues its decline to 1.6 per cent per annum over the period. The Planning Commission estimates this requires a GDP growth rate of around 8.7 per cent over the period and propose an indicative target of 8 per cent for 2002-07. Assuming an incremental capital output ratio (ICOR) of 4 achieved over the previous decade, to achieve an average annual GDP growth rate of 8 per cent requires the investment rate to average 32 per cent of GDP. The McKinsey Report (2001) approaches this estimation slightly differently. It estimates that India's ICOR is 30 per cent more extravagant of resources than that of China and therefore for India to grow at the same rate as China – around 10 per cent per annum – requires an investment rate of about 35 per cent of GDP. India's actual gross investment ratio fell to 23.3 per cent in 1999/2000 from a peak level of 26.8 per cent in 1995/96 (Acharya, 2001, p.31). As the Planning Commission's FDI Report (2002, p.67) trenchantly observes 'quite obviously, this calls for sourcing foreign savings to bridge the (domestic savings) gap'. All analysts seem to agree India needs to increase its investment rate, while at the same time improving the efficiency with which it uses its scarce capital investment if it is to double per capita income over the next ten years.

Previously, the authorities might have relied on the state for investment but today the Central Government and State Governments together are running an unsustainable budget deficit. A more promising route would be to accelerate the privatisation programme that has so far raised around almost \$3 billion from the sale of 33 public sector companies over the last two years. However the programme has recently run into political opposition and, as the Planning Commission Report (2002, p.18) observes, privatisation in India has not attracted significant foreign investment interest. The stop put on plans to privatise India's two state-owned oil companies is certainly not encouraging foreign investor interest.

What is apparent is the importance of the threat from the budgetary and fiscal crisis confronting Central and State Governments and of finding a way out that sustains investment and economic growth. The consequent requirement for political leadership in driving the reform process is widely recognised. The current budgetary crisis is focusing minds on the need for reform.

The role of democracy and political continuity

A topic of much interest is the impact of India's political system on economic policy formation and, in particular, the consequences of the 'revivalist revolution' (Cohen, 2001). According to Cohen, the stresses of rapid and uneven economic growth spur on the Hindu revivalist movement yet the BJP, as the political party representing those interests, has to work in coalitions to maintain its hold on power. In short, it has to temper its policies. More generally, the rise of caste-based politics means increased pressure to reserve public sector jobs for "scheduled castes" and entrenched resistance to public sector reforms from the beneficiaries.

By devolving responsibility for economic reform to state level, the Central Government encourages local accommodation between caste politics and the realities of economic development led primarily by the private sector. At state level, the tension between the demands of the public sector and those of the private sector are much clearer. Cohen predicts that States will 'continue to grow in power, especially in the economic sphere, but they will not displace the centre' (Cohen, 2001, p. 125). The hoped for increase in economic growth rates is likely to continue to exacerbate regional inequality. China's experience is certainly not encouraging in this respect but rapid growth does allow the centre's revenues to expand sufficiently to permit significant redistributive policies to be implemented.

The promotion of deregulation and rolling back the 'inspector Raj' is more likely to be perceived as worthwhile at state level as States compete with each other to attract domestic and foreign investment. It will also encourage choice of policy instruments and infrastructure investment that better match local needs. Otherwise there is a danger of States pursuing a 'beggar my neighbour' policy spurred on by Central Government initiatives that cannot discriminate efficiently between States for political reasons. For example, it cannot be sensible for all States to set up biotechnology and software parks. In short there is a need for focus on core strengths and sources of comparative advantage at State level. Policy intervention should not in principle discriminate between domestic and foreign direct investment if States wish to appear genuinely welcoming and even handed in the treatment of FDI.³⁶

Is the regulatory burden worse in India than in China?

World Bank data would suggest that the regulatory burden is higher in India than in China when measured in terms of the time managers spent dealing with government officials. Perhaps more important than comparisons with China is the fact that managers in Indian companies, regardless of whether they are domestic or foreign-owned, believe there is excessive regulation of business activity. Reforming the 'inspector Raj' is all about devolving power through self-certification and the changing social status of civil servants and businessmen. There is a learning curve for both parties in the new business environment. It is vital that senior political and civil service leaders maintain the momentum for reform. It also means politicians must restrain themselves from tinkering with policy and civil service appointments once they have been made. There is an evident requirement to train all civil servants who interact with private business to appreciate the role and the needs of the private sector and that of foreign investors in particular.

The new regulatory infrastructure

Since 1991, the Indian government's role has gradually begun to shift from that of owner of key producer monopolies and micro-regulator of the private sector through a complex licensing system, to a largely unfamiliar role of strategic regulator of industries and the structure and performance of markets. While privatisation and disposal of unproductive public sector units has been much slower than envisaged in

³⁶ While India is a founding member of the WTO and grants at least Most Favoured Nation (MFN) treatment to all its trading partners, it does not consider a general framework on investments to be necessary.

1991, the reform process appears to be accelerating. The current fiscal crisis seems to be persuading more and more politicians that there is no alternative.³⁷ It is in the privatisation and deregulation of infrastructure and utilities that the government faces some of the greatest regulatory challenges. Expectations are very high. There is almost universal recognition of the crucial complementary role efficient infrastructure and utilities play in the development of a globally competitive Indian economy, and the inadequacies of current arrangements.

Unfortunately markets for utilities and infrastructure access do not spontaneously develop; they require the state to actively keep markets open and encourage competition. As Dieter Helm (2001) observes ‘Competition is not the aim of business. Market power and monopoly are more typical objectives’. This means that the Indian authorities both at the Centre and at State level need to invent a new version of the ‘inspector Raj’ charged with responsibility for creating competition and regulating the structure of utility markets and access to infrastructure. British experience suggests that governments find it very hard to avoid drift towards detailed interference in the conduct of regulated utilities over time. Even with the establishment of independent and well-funded technical regulators, the British government has found it difficult to resist intervention in response to political demands and, of course, the costs of regulation have increased with each intervention. With political risk of regulatory intervention have come increases in the cost of capital available to utility companies and infrastructure projects.

In a liberalised economic environment effective competition policy is critical. It is going to take time to build up this expertise in India, particularly with respect to utility regulation. This would seem to be an area where there are clear economies of scale for Central Government to provide advice on institutional development, and to organise appropriate training. Without proactive investment in institutional and technical staff development at Central and State level to support the new ‘regulatory Raj’, there would seem to be a real danger of the liberalisation programme running into increasingly costly administrative and political interference.

China is as much a novice in this area of policy making as India. The growth of independent regulatory institutions is a new phenomenon in an economy more used to regulation by negotiation with government and party officials. However in China, rapid economic growth and increasing complexity drive the need for regulation. Sustaining high levels of FDI is accepted as a central policy objective in order to ensure continuing economic growth. The political leadership has maintained its commitment to encouraging FDI since four Special Economic Zones were announced in 1982. Perhaps the key element of this policy has been devolution of economic decision-making to provincial and municipality level. India’s constitution needs a thorough overhaul in this regard in order to disentangle the multiple jurisdictions for economic and industrial policy both at the Union Government and State Government level. There are Chief Ministers and senior civil servants that are committed to promoting FDI in their States. They need the freedom to do so.

³⁷ Arun Shourie, the disinvestment minister, has managed to dispose of 33 public sector companies in the last two years.

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