EMBRYONIC JOURNEY HURDLED BY JAGGED SPACE: A CASE STUDY OF TRANSPARENCY AND ITS IMPACT ON FOREIGN DIRECT INVESTMENT IN INDIA.

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Abstract

Foreign direct investment (FDI) has become a key part of national development strategies for many countries. They see such investments as strengthening domestic capital, productivity, and employment, all of which are crucial to jump-starting economic growth. While many highlight FDI's positive effects, others blame FDI for "crowding out" domestic investment and lowering certain regulatory standards. While FDI's impact depends on many conditions, well-developed and implemented policies can help maximize its gains. Transparency is another indispensable ingredient which warranties sustenance of high capital flows in an economy. Transparency, in order to be better scrutinized has to be analyzed from two perspectives.

First aspect is analyzing set of government policies that increase the risk and uncertainty faced by foreign investors. Uncertainty stems from the presence of bribery and corruption, unstable economic policies, weak and poorly enforced property rights, and inefficient government institutions. . High levels of non-transparency can greatly retard the amount of foreign investment that a country might otherwise expect. The second aspect of transparency that has been discussed is Transparency between sellers and buyers, that we call capital-market transparency; and transparency between managers and owners, that we call corporate-governance transparency.

Keywords: Foreign direct investment, Transparency, liberalization, corporate governance

INTRODUCTION

The Indian economic story can be explored from diverse perspectives with nearly all narrating breathless accounts of India's potential as an economic colossus. Indian economy has exponentially grown ever since it incorporated tenets of Globalization, free market and liberalization in its policies, making it fall in line with that of the global economy[1]. India having recognized FDI as an important driver for economic growth has gone to great lengths to clarify and simplify its investment procedures.[2] India with the second largest population and a conducive location on the world trade route has become the second largest Gross Domestic Product and has successfully acquired a flourishing market.[3] Despite its colossal success and future assurances of higher growth rates based on the prevailing factors, there are various predicaments which have evolved into complex problems. Lack of transparency in India is one such crisis which has jeopardized its prospects of expansion. Non-transparency is a set of government policies that increase the risk and uncertainty faced by foreign investors. This increase in risk and uncertainty stems from the presence of bribery and corruption, unstable economic policies, weak and poorly enforced property rights, and inefficient government institutions[4]. Non-transparent policies translate into lower levels of FDI and hence lower levels of welfare and efficiency in the host country's economy[5]. For India to spread out its wings and throttle its development in the globalized era, it is inevitable for it to imbibe transparency in its otherwise obscure FDI policies.

In this article, the authors have attempted to estimate the impact of lack of transparency on foreign direct investment in India. Following introductory sections, the article examines necessity for FDI in developing countries, as a process of infusing needed capital, and other constructive effects such as growth in employment opportunities, technology up gradation, boosting competition within the national market and lastly an opportunity for earning valuable foreign exchange[6]. Further, the need for a transparent polices and their embracement has been focused upon. Next, the existing types of transparency such as governmental, capital market and corporate governance have been analyzed in the Indian context. Finally, the article concludes with suggesting various reforms which need to be undertaken by the policy makers to consolidate the progression of advancement.

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[1] See generally Work, Tracy, Student Author, India Satisfies Its Jones For Arbitration: New Arbitration Law In India, 10 Transnat'l Law, 217, 220 (1997).

[2] Mark B. Baker, awakening the sleeping giant: India and foreign direct investment in the 21st century, 15 Ind. Int'l & Comp. L. Rev. 389, 391(2004)

[3] Ministry of External Affairs (India), Inv. & Trade Promotion Div., Brief for Promotion of Foreign Investment & Business, available at http://www.embindia.org/Articulos/Investbrief0804.htm (last visited oct. 25, 2007)

[4] Zdenek Drabek and Warren Payne, The Impact of Transparency on Foreign Direct Investment, world trade organization, Staff Working Paper ERAD-99-02, Revised November 2001, page 1.

[5] *See id.*

[6] See Resolution on International Investment for Economic Development, Mar. 4, 1955, GATT B.I.S.D. (3d Supp.) at 49-50 (1955) ; see also Edward M. Graham, Direct Investment and the Future Agenda of the World Trade Organization, in The World Trading System: Challenges Ahead , page 206.

Transparency and the Need to Embrace It

A comprehensible definition of transparency put forward by Chayes and Chayes defines transparency as the availability and accessibility of knowledge and information about: (1) the meaning of norms, rules, and procedures established by the treaty and practice of the regime, and (2) the policies and activities of parties to the treaty and of any central organs of the regime as to matters relevant to treaty compliance and regime efficacy[7]. After understanding the definitional aspect of transparency, the next pertinent question remains regarding the need for its embracement by national regimes. M.Camdessus, the former managing director of IMF once rightly termed transparency as the 'golden rule' of the new financial market.[8] The importance of Transparency can be highlighted by the fact that it has managed to seek global attention and carve a niche for itself in GATT as well.[9] Firstly, it abbreviates the process of cross border mergers and acquisitions. The technicalities so involved in the form of requisite approvals from commissions and organizations become unproblematic if the information regarding them is circulated in a crystal clear, open and unambiguous manner to the investors. Secondly, due to lack of transparency the additional capital so invested in the host country considerably decreases. Otherwise, investors would have to waste their capital on corruption, bribery and their repugnant forms of non-transparency[10]. Thirdly, protection of property rights runs parallel to foreign direct investment as it encourages investors to pursue new investment and research.[11] So one can reckon that it enhances an investor's knowledge of the behaviors and operations of institutions in a target economy; helps reduce uncertainty about future changes in policies and administrative practices in the business environment; contributes data and perspectives on how best an investment project can be initiated and managed; and it contributes to the creation of country image and affect investor perception[12]. Further, it would not be abstruse to deduce that companies like to invest in places on the basis of fundamentals in the host nation which would palpably include economic rate and GDP[13].Thus, rightful information diffusion encourages open and organized trade leading to higher prospects of development within a nation.

One can also understand it through the 'game theory' in which the 'perfect information' means decisions of the investors based on full knowledge of the facts whereas 'imperfect information' means that the decisions of the investors are based on superfluous

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[7]Carl-Sebastian Zoellner, Transparency: An Analysis of an Evolving Fundamental Principle in International Economic Law, 27 Mich. J. Int'l L. 579, 580 (2006)

[8] Stated in his speech at the 24th Annual Conference of the International Organization of Securities Commission in Lisbon, on May 25, 1999

[9] General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, T.I.A.S. 1700, 55 U.N.T.S. 194

[10] Zdenek Drabek and Warren Payne, see supra note 4, at page 7

[11] Rapp, Richard and Rozek Richard, Benefits and Costs of Intellectual Property Protection in Developing Economies. National Economic Research Associates, Working Paper 3, June 1990.

[12] Abraham A. Azubuike , Accessibility of Government Information as a Determinant of Inward Foreign Direct Investment in Africa, ECA Library, United Nations Economic Commission for Africa, Addis Ababa, Ethiopia, page 9.

[13] Hoekman, Bernard and Saggi, K., Multilateral Disciplines for Investment-Related Policies, Rome : Institute of International Affairs, (1999)

knowledge.[14] Lack of transparent information dissemination to the interested foreign investors in an economy gives rise to situations of fear and chaos. The arguments in the favor of transparency can be analytically expressed in form of following equation:-

$$\mathbf{FDI = f(T, Y, r, i, ER, TR, C)}$$[15]

Where, T = transparency; Y = economic growth; r = interest rate; i = inflation; ER = exchange rate changes; TR = openness of trade regime; C = country dummy

Practices like investment in "black" markets, such as illegal logging, unsustainable natural resource exploitation and government revenue victimizes the legitimate foreign investor[16].In addition, due to no clear mechanism of information dissemination adopted by the government the investor assumes that the host country has no mechanism to deal with the conventional shocks of the economy[17]. Corruption distorts flow of foreign investment and involves illegitimate payments which are never made otherwise public even though corruption may be sometimes widespread. The institutions established in every economy are of crucial importance as they are enforcement agencies which have the implied duty to enforce government policies. However, if their functioning is flawed with lack of transparency or corruption then they make the nation susceptible to downfall simulating termites which eat away the massive wooden structures.

Governmental Transparency

Today transparency has become a subject of debates concerning the democratic legitimacy of the changing international legal order, particularly with respect to new obligations that arguably require the partial transfer of sovereignty and previously national competences to international regimes[18]. Clearly due to the non transparency, the amount and quality of investment needed in India is still under utilized. Reflecting such slackness, it is no surprise that the gap between actual FDI and approved FDI in India is incessantly increasing[19] giving a food for thought to the authors. In this section the emphasis is given on the governmental transparency in India by analyzing the infrastructure, labor, taxation laws and other areas of excessive regulation.

1) Infrastructure and labor laws: - The extremely stringent labor laws have made the thought of investment in India difficult. Foreign investors have also consistently expressed their concerns regarding lack of infrastructural support in particular, electricity and transport. The cheap availability of Indian labor is often overshadowed by their lack of formal training and delays in meeting deadlines. Despite the fact that there is a large

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[14] James D. Morrow, Game Theory for Political Scientists, page 217. (1999)
[15] Zdenek Drabek and Warren Payne , supra note 4, page 13.
[16] Dan Kingsley, Substance needed to woo investors, Indonesia Outlook 2006 – Economic, September 30, 2006 available at http://www.thejakartapost.com/Outlook2006/eco07b.asp (last visited July. 20, 2007)
[17] Abraham A. Azubuike , supra note 12, page 10.
[18] Carl-Sebastian Zoellner, Transparency: An Analysis of an Evolving Fundamental Principle in International Economic Law, 27 Mich. J. Int'l L. 579, 580 (2006)
[19] See Kishor Sharma, Econ. Growth Ctr., Yale Univ., Export Growth in India: Has FDI Played a Role? Page 4, available at http://www.econ.yale.edu/growth_pdf/cdp816.pdf (last visited Apr. 25, 2007)

population of highly skilled workers, many Indian workers do little more than what is specifically assigned. Many companies have experienced delays due to Indian workers not understanding what they were expected to do or not completing contingencies associated with the project.[20] India has rigid labor laws that make it almost impossible to fire an employee or hire contract labor. That is one reason India attracts roughly a tenth as much foreign direct investment as China.[21] Due to excessive overheads on labor and infrastructure laws, India might not continue to attract investment as it is losing its charm of providing cheap labor in the world market and thus bamboozling the potential investors to inexpensive nations like China.

2) Taxation laws: - India in the recent years has made noteworthy amendments in its taxation laws so as to woo foreign investors. One area that still requires some attention is that of double taxation In When a double taxation treaty exists between two nations, the corporate tax applicable to the foreign company is pre-decided as per terms of the treaty and at times can be the lower rate prevailing in either of the two countries

3) Maze of avenues and excessive regulation: - Amongst all forms of non-transparency in India, remarkable mention is required regarding ways in which the avenues are opened to foreign investors in India. They are essentially three ways a multi-national enterprise can enter Indian market. Firstly, through establishment of a new branch or subsidiary, (2) an investor can acquire the controlling share of an existing firm; or (3) an investor can participate in a joint venture.[22]There are onerous regulations which a newly established company has to comply with. For instance, it has to comply with Companies Act, Income Tax Act, Industrial Policy of 1991, FERA and regulations of RBI along with their compulsory registration with the ROC (Registrar of Companies)[23]. If they are not deterred by the excessive regulations so offered to them, then their hopes regarding establishment of liaison office or branch office often hurdled.

4) Corruption and related issues: - Further, due to non availability of speedy information, the investors often overestimates market size and profitability assumptions[24].The business environment in India is corrupt and uninformed that additional costs in the form of bribery, corruption and additional payments to custom officials eat away the substantial shares of profit. For instance, HFCL did not pay license fee for basic service networks because it thought of India to be highly corrupt[25]. Unfortunately, even N.K. Singh committee so formed for the tenth plan by Indian government to improve FDI inflows failed to throw light on the dark road of non-transparency our nation has been walking

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[20] Mark B. Baker ,Awakening the Sleeping Giant : "India and Foreign Direct Investment in the 21st Century" , 15 Ind. Int'l & Comp. L. Rev. 389 , 394 (2004)

[21] *See id.*

[22] James D. Nolan, A Comparative Analysis of the Laotian Law on Foreign Investment, the World Bank Guidelines on the Treatment of Foreign Direct Investment, and Normative Rules of International Law on Foreign Direct Investment, 15 Ariz. J. Int'l & Comp. L. 659, 663 (1998)

[23] Secretary for Industrial Assistance, Indian Ministry of Commerce and Industry, Entry Strategies for Foreign Investors, at http://siadipp.nic.in/policy/entry.htm (last visited July 25, 2007)

[24] R Nagaraj, Foreign Direct Investment in India in the 1990s Trends and Issues, available at http://www.igidr.ac.in/~nag/Personal/FDI%20into%20India%20in%20the%201990s.pdf

[25] See The Price of Corruption, India Today, Sept. 30, 1996, page 4.

since ages. Further, India is blind towards the cause of producers who are not all that efficient as they are fortified by government facilities hence leaving very little scope for any incentives for their betterment[26]. One can easily deduce from the above that India has left so many loopholes in its procedures regarding FDI that it is now perplexed and trapped in its own maze of policies and laws. Corruption, bribery, market manipulation are deep rooted in the economy and require immediate attention of the government. The Enron case and Harshad Mehta stock market scam that was uncovered in April 1992, which involved a large number of banks, and resulted in the stock market nose-diving are lessons enough to tutor the government about the need for a transparent regime.

Capital-Market Transparency and Corporate Governance

This section focuses upon the second aspect of transparency that is transparency between sellers and buyers, that we call capital-market transparency; and transparency between managers and owners, that we call corporate-governance transparency. Poor transparency and lack of good corporate governance norms have been accorded as the explanation behind the Asian economic Crisis of 1997. Corporate governance can also be defined as a concept that embodies ethical and pragmatic business practices to enhance the long-term value of the company.[27] Corporate governance can also be described as *an economic, legal and institutional environment* that allows companies diversify, grow, restructure and exit, and do everything necessary to maximise long term shareholder value.[28] Foreign investors and creditors are more comfortable in dealing with economic entities that adopt transparent and globally acceptable accounting and governance standards.[29]Special emphasis should be given by government and RBI to bring about significant changes in the corporate governance mechanism adopted by banks and other financial intermediaries. The problems of corporate governance in India; including the dominance of majority shareholders, fraudulent activities with respect to corporate funds, and other control issues; occur largely because Indian law does not mandate the independence of directors, officers, and accountants.[30]

Effective corporate governance systems promote the development of strong financial systems irrespective of whether they are largely bank-based or market-based which, in turn, have an unmistakably positive effect on economic growth and poverty reduction[31] Good corporate governance can remove mistrust between different stakeholders, reduce legal costs and improve social and labour relationships and external economies like

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[26]Mark B. Baker , supra note 23.

[27] See ENCYCLOGOV.COM, What is Corporate Governance?, http://www.encycogov.com/WhatIsGorpGov.asp (last visited oct. 24, 2007).

[28] Desirable corporate governance-A code, Confederation of Indian Industry, (1998) available at http://www.ciionline.com

[29] Raghbendra Jha, Recent Trends in FDI Flows and Prospects for India, available at http://ssrn.com/abstract=431927 (last visited Aug.. 24, 2007).

[30]Sarita Mohanty, Sarbanes Oxley: can one model fit all?, 12 New Eng. J. Int'l & Comp. L. 231, 261 (2006)

[31] Claessens, S. Corporate Governance and Development, Global Corporate Governance Forum, World Bank, Washington D.C. (2003)

environmental protection[32]. India has a detailed statutory framework of corporate governance has been defined primarily by the Companies Act and has shown significant progress with regards to development of norms and guidelines to improve corporate governance. However the persistent threat is posed by the proper implementation of those rules at the ground level.

The Road to Organic Growth

Such is the condition in India that a very serious restructuring of laws regarding transparency is exigent for it to prosper and maintaining high growth rates. Some of the reforms which require immediate attention have been discussed. Firstly, Insider trading (trading on a particular information without disclosing it to the general public[33]), is a blotch over Indian investment .It works as a bonus for the insider. Due to absence of a level playing field, the confidence in market is completely lost. So as to curb the same, it is imperative for the government to ameliorate the SEBI laws including Securities and Exchange Board of India (Insider Trading) Regulations, 1992[34], which prohibit insider trading. The punishment for this kind of crime should be made more stringent having a deterrent effect on the culprits. The governmental bodies practicing control over the market should be made more active and given more authority. For instance, MRTP Commission which curtails companies from unfair trade practicing,[35] Reserve Bank of India which restricts the ambit of banks in the market[36] and the Company Law Board's[37] supremacy should be made crystal clear to the investors.

So as to prevent market manipulations like the securities scam of 1992 and the Enron fiasco, SEBI supervision[38] should be made more rigorous. It must set certain fixed standards and legalizing broker's ambit. India should take tougher measures so as to exterminate corruption and bribery from the grassroots level through austere policies and laws restricting them. Hence, the need for making Prevention of Corruption Act of 1947 and Indian Penal Code of 1860 ascetic is crystal clear. The number of intermediaries involved in the process of establishing an industry in India must be condensed[39] and the information regarding them should be disseminated in a comprehensive manner to the interested investors. This way the avenues open for corruption at the hands of local officials would diminish substantially.

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[32] Rajesh Chakrabarti, Corporate Governance in India – Evolution and Challenges, available at http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN023826.pdf (last visited oct. 24, 2007).

[33] See Twentieth Century Fund, The Security Markets 14 (1935).

[34] § 30 of the Securities and Exchange Board of India Act, 1992, Securities and Exchange Board of India, Bombay, 19 Nov. 1992.

[35] Securities and Exchange Board of India, Investor Grievances, Rights, and Remedies 3 (1991)

[36] R.B. Sethi, Banking Regulation Act, 1949, page 16 (1981)

[37] Robert C. Rosen, The Myth of Self-Regulation or the Dangers of Securities Without Administration: The Indian Experience, 2 J. Comp. Corp. L. & Sec. Reg. 270-71 (1979)

[38] Securities and Exchange Board of India (Stock Brokers [sic] and Sub-Brokers) Regulations, 1992, under § 30 of the Securities and Exchange Board of India Act, 1992, Securities and Exchange Board of India, New Delhi, 23 Oct. 1992, at Reg. 7, sched. II(c)

[39] Toral Patel, Corruption Practices in India: No Payoff, 20 Loy. L.A. Int'l & Comp. L.J. 389, 390 (1998)

A country like India which has suffered a continuous history of scams, scandals and a series of instances of corruption needs to employ public relations programs[40] so as to improve its reputation in the world market. Protection of property rights can be increased by adopting legislations for the same which should not only abide by domestic norms but international standards as well[41]. Provisions for regulatory transparency, institutional efficiency, simplification of administrative procedures, discard ambiguous legislations to bring certainty, augment the responsibility of public sectors so as to increase accountability of the government[42]. While FIPB (Foreign Investment Promotion Board) makes certain reforms for the enhancement of FDI, it should also ensure that the facets of transparency, rightful information dissemination, no corruption or bribery are well attended because they form the fundamentals of any economy in the world. Hence, it is not abstruse to conclude that for blissful FDI to enter into India it really needs to make huge efforts in reforming the existing institutions and bringing them at par with that of developed countries in terms of transparency and efficiency.

[40] See Saralyn M. C. Ang , Promoting Foreign Direct Investment in Developing Countries , Organization for Economic Cooperation and Development, 13 Int'l Tax & Bus. Law. 85 , 88 (1993)
[41] Zdenek Drabek and Warren Payne , The Impact of Transparency on Foreign Direct Investment , Staff Working Paper ERAD-99-02 , Revised November 2001, page 5.
[42] Dan Kingsley, supra note 17.