

India Risk: Perceptions and Reality

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One of the prime drivers of an international investment decision is the investor's perception of the country risk involved. Risk in the context of investment means in common parlance, the uncertainty of return. By its very nature 'Country Risk' is measured not in absolute terms but more in terms of a comparison between potential investment destinations.

'India Risk' denotes perception of the outside world about India – and such perception may be different from our domestic understanding of what we believe to be the reality!

Different political and economic systems of international markets impart varying degrees of risk and reward. Risks to international investment projects are mostly posed by political events. Violent political conflict can have profound negative effects on foreign direct investment. Unstable governments that cannot take strong decisions, corruption, inconsistent institutional reforms and shifts in public policy have a major adverse influence on investment environment.

Government policy can have an enormous impact on investment activities and investment value. By taxation, regulation, enforcement, litigation, publicity and even the threat of action, a government erects or lowers barriers, imposes or relaxes costs, dictates or ratifies standards, relieves or imposes risks of liability — and thereby — furthers or impedes the course of an investment initiative. This can affect the future cash flows of a project in that country in a variety of ways. Thus political developments affect the life and the terminal value of foreign investment.

The international perception of India's riskiness

A look at some snapshots of recent surveys reveals that political stability, bureaucratic hurdles and the legal environment are the key detriments in international perception about India.

Political instability

Based on their poll of a panel of expatriate business executives on their perceptions of the political and economic risk of the Asian countries, Hong Kong based Political and Economic Risk Consultancy has rated India 8.22 on a scale of zero to 10, with 10 the

worst possible grade. India is perceived as the 'most vulnerable country in Asia' in terms of external threat, while Australia, Hong Kong, Malaysia, China and Vietnam are perceived to be the least exposed. The factors considered are regional security, direct military threat, diplomatic relations with neighbours, fallout from political instability in neighbouring countries, and relations with major trading partners.

In fact, the very success of democracy itself spells a perceived risk in India. Consider the hindrances, the politically motivated protests and the Public Interest Litigations. Not all the political hurdles to privatisation have yet been crossed.

Apart from populism, there is an increasing sense of lawlessness that the political institutions seem not only incapable but also unwilling to contain. At a fundamental level, these political and democratic institutions have failed to provide a fair environment and efficient systemic protection to basic human rights when we look at the horrific events in Gujarat.

Significantly foreign investors may well see Gujarat not as an aberration but as a confirmation of fears that have helped keep foreign investment in India at relatively low levels.

Bureaucratic hurdles

The Political and Economic Risk Consultancy also highlighted how the human and regulatory dimensions of Asian bureaucracy posed major frustrations. Investors dislike systems with a multitude of rules, where decisions are open to interpretation by different authorities. Several Asian countries such as China, India, Indonesia and Vietnam fall into this category. Taiwan, Korea and Malaysia pose bureaucratic hurdles as well. India has been placed at the bottom of the pile.

A recent FDI audit by AT Kearney supports the same perception. Investors in particular from the power and utilities and the industrial products sectors cited bureaucratic hurdles at both the central and the provincial government levels in approvals as well as subsequent implementation. When considered together with other investment obstacles that have an impact on the regulatory environment - including slowdown of the reform process, excessive government involvement in the economy and corruption – the FDI confidence audit results suggest that India's regulatory environment is perceived to be the main obstacle for FDI in the country. The audit surmises: "In the long run, excessive bureaucracy could act as the greatest barrier... by undermining India's capability to materialise investor interest".

Significantly, the World Bank's World Business Environment Survey finds that in India managements spend as much as 16 per cent of their time for dealing with government officials.

Despite its ranking on the economic front having improved considerably from 33 in 2001 to 24, India has slipped down a rank to No. 42 out of the 49 countries surveyed in the annual World Competitiveness Report. Areas that have been identified as particularly in need of reform: curbing corruption, improving the effective implementation of government policies and infrastructure. In terms of government efficiency, India has slipped rather drastically from 37 in 1998 to 44 this year. India is in the bottom class in terms of assessment on public finance, the institutional framework, business legislation and education, all areas that involve government intervention. The lesson to be learnt is consistent: stable governments and better public policy would go a long way towards putting India on the world map as a viable investment destination.

Legal environment and judicial system

Responses in the AT Kearney FDI Audit reflect a perception of uncertainty due to protracted nature of legal disputes. Whilst our judicial process is considered to be somewhat slow, it is a matter of pride that the fairness of the judiciary is beyond reproach and any perception of national bias is absent.

Foreign investors have little or no control over regulatory and political events, which can adversely affect the commercial viability of their investments and future business plans in India. These may include political instability leading to delays in decision making; adverse changes or unpredictability on policy issues; bureaucratic inefficiency and corruption; disruption of normal business due to social and political unrest; or dilating judicial and dispute resolution processes.

The total outstanding foreign investment in the country declined by three per cent over the past year. This was mainly due to gradual withdrawal of foreign companies from power and other infrastructure projects. Lacunae such as the lack of independent regulators or even dispute settlement mechanisms in existing legal framework have constrained commercialisation of infrastructure. Two highly visible cases of governance failure have been in the electricity and financial sectors, resulting in an adverse climate for reforms.

While our legal system and an independent and fair judiciary has for long been one of our hallmarks, systemic delays in judicial process for dispute resolutions have led to some not

unexpected results. Absent means of expeditious legal remedies to enforce rights behavioral modes and culture develop where there is no respect for law as the retribution is too late and in the context too little. A market economy requires a cultural infrastructure of norms – mere laws alone are not adequate. An efficient justice delivery system can provide powerful impetus to creating an environment of business behavior, which respects legal obligations.

Public interest litigation, sequential legal proceedings, injunction orders against implementation of projects, CBI enquiries - lead to a frustrating experience – strong enough to drive away many investors who can use their money and time more productively elsewhere.

While the Hon'ble Supreme Court has in a long series of judgments, commencing in 1995 (Mahadeo Versus Pune Municipal Corporation) and until recently – December 2001 (Balco Case), has made several observations on the ill effects of delays caused by injunction orders and limitation on judicial review of economic policy decisions, the examples of Cogentrix, Narmada Dam and several other projects in legal quagmire still haunt the investors.

The clear pronouncements made by the Hon'ble Supreme Court in such matters, do not appear to have percolated down to the other levels of judiciary. Post the Balco Judgement over a dozen PILs were filed in various High Courts – 8 against ITDC privatisation. There PILs were not dismissed in limini but notices were issued. Eventually, the Hon'ble Supreme Court in April 2002 transferred to itself all the PILs against ITDC divestment so that there could be dealt with once for all.

Risk mitigation

Foreign investors view India as a very attractive destination in terms of the huge opportunities that this market (product as well as factor market) offers. But, they will hold back till their key fears are addressed in the areas of political instability, bureaucratic inefficiency and ambiguity in regulations are mitigated and there is a clear movement towards greater reliance on market mechanisms for resource allocation.

The most desirable duty that the government can perform is to put in place policies that reduce risks, increase returns and ensure safety of investments. The government can improve private investors' ability to forecast and plan for his investments and thus reduce perceived riskiness of projects by making relevant public information available. By

encouraging competition, there can be a reduction in political pressure on governments to intervene in markets. In instances where monopolies may still be unavoidable, government can reduce risk by establishing laws and regulations that protect property rights and by enforcing them in a fair and consistent manner.

There is a need to establish expert regulatory agencies that have a significant degree of independence from the rest of the government and are thus somewhat insulated from popular pressure to keep prices below costs. Moreover, strengthening the judicial system to ensure timely and efficient resolution of disputes must be achieved by introducing procedural changes expedite litigations, appointing special Judges to deal with infrastructure related disputes, sensitising the judiciary to the economic and social costs of delays in infrastructure projects. In particular, there is a clear need for designing and writing better contracts, bringing clearer and transparent rules, besides the critical but oft-neglected need to avoid internal contradictions in policy and laws.

(Accompanying Box)

Private infrastructure projects particularly sensitive to actions or the lack of actions on the part of public authorities in their host country

- The monopoly characteristics of many infrastructure activities expose their operations to easy influence of public supervision through a strong role of Governments and regulators in regulation of entry, prices as well as quality of services.
- Infrastructure services (power, water, transport, and telecom) are both widely consumed and deemed essential. This increases political sensitivity to the prices charged, as pressure from consumers to keep prices low makes it difficult to cover costs. It is natural to expect broad popular protest when prices rise or services deteriorate. Their facilities may become obvious targets for expressions of other kinds of discontent as well.
- In many cases government-owned companies may be key suppliers to, or purchasers from, private infrastructure firms. Private infrastructure projects are particularly prone to receive public criticism and public intervention.
- Infrastructure projects involve typically large investments that require long gestation periods to bring the projects to revenue stream and thereafter very long payback periods. The sheer time scale introduces risk of uncertainty and exposure to changes in circumstances, laws and policy.
- Infrastructure projects are also characterised by high leverage ratios. Financing of these projects is different from the traditional method of financing based on the balance sheet support. These projects are often financed through Special Purpose Vehicles (SPVs) and are structured on a limited/non-recourse basis. Once investors are committed to projects, they can pull out only by taking a huge loss. Investors and lenders are typically unwilling to make investments without adequate and often complex contractual protection. While negotiation of such contracts is tedious and costly, enforceability of these contracts although essential, is tough. Investors are faced with the possibility of changing contractual agreements or failure by the government to implement such agreements because of political considerations.
- Arbitration and settlement of disputes tend to be very time consuming and add to project cost. Infrastructure projects are highly capital-intensive projects and the costs of delay in resolution of disputes could be extremely high.