Government Efficiency and Investments in India

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Investment Policies

Foreign investors always face risk. In emerging markets, this risk is amplified because business decisions seldom are made with a rigorous understanding of the regulatory environment. Currently, due diligence consists of standard evaluations of marketing opportunities, financial structuring, partnering opportunities, profit estimates, and the experience of other firms. What is missing is a systematic assessment of the regulatory environment. This omission increases the risk of failure.

In this article, we resolve that issue by presenting a new measure of government efficiency that measures the discretionary power of the government to support rules and regulations affecting business decisions. Effective governments live up to their economic promises, for example, by assuring that existing rules are followed as in the case of tax holidays. Governments, of course, have many priorities. Their first priority is to maintain security. Previous empirical work shows that, driven by political survival, governments place security ahead of business opportunity. Political actors recognize that business performance enhances stability and business failure leads to government change but immediate security concerns often overpower business preferences. Efficient governments find a way to maintain security and then enhance business opportunities. National level systematic assessments of government effectiveness are available, but only now have precise, cross temporal provincial or state level estimates been developed (Arbetman and Kugler, 1997). These state level assessments provide a key to foreign investment success.

Understanding governmental effectiveness is critical to any business decision in emerging societies. China attracts a substantial amount of Foreign Direct Investment, lured by high growth rates, low labor costs, a large domestic market, and a reasonable assurance that governmental commitments will be honored. On the other hand, India has attracted far less interest, despite an education and language advantage. One reason for this is the uncertainty generated by the wide variation in state level government efficiency.

Below we explore the interaction between political effectiveness and investment opportunities. Our findings indicate that investment opportunities in India have flowed to certain established areas based on government efficiency and a track record of success established by other firms. But, looking to the future, these areas no longer appear so

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1 Political effectiveness is not confined to business environments. Efficient governments wage war successfully (Kugler and Domke 1986), preserve government stability (Johnson 2007), increase economic performance and generate conditions that sustain steady economic growth (Feng, Kugler and Zak 2000); stabilize population growth while reducing fertility and infant mortality (Organski.et.al. 1997, Kugler and Swaminathan 2006, Swaminathan and Thomas 2007) and provide effective economic practices (Arbetman and Kugler, 1997).

2 Increasingly poor economic performance and reduced political effectiveness preceded the collapse of the USSR (Arbetman and Kugler, 1996).
attractive as unexploited regions and states pose new opportunities for significant returns at lower risk.

**Government Effectiveness**

To construct a consistent government efficiency indicator across time and space requires access to fiscal and economic data at the provincial or state level. This data is difficult to find as well as analyze; however, we have been able to overcome these obstacles for India, China and a number of other countries. Government effectiveness is assessed by the relative ability of provincial governments to extract transfers from the central authority, and augment those with their own extraction capabilities. Figure 1 shows the anticipated general distribution of government effectiveness given levels of economic performance.

**FIGURE 1 about here**

India is an emerging economy where affluent provinces coexist with very poor ones. Isolating the motivation behind substantial variations in government effectiveness across India can determine the success or failure for new business ventures.

**FIGURE 2 about here**

The specific distribution of government effectiveness across Indian states is presented in Figure 2. Figure 3 displays the structural conditions which influence governmental effectiveness, in particular the government response to instability and national security questions.

**FIGURE 3 about here**

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3 The relative efficiency of a provincial government is derived from the ratio of revenues a government extracts compared to the predicted levels it could attain based on economic endowment. The general equation is given by:

\[ Y_{it} = \alpha + \beta X_{it} + \nu_{it} \]

\( Y_{it} \) = Adjusted tax revenue for province \( i \) at time \( t \)
\( X_{it} \) = Vector variables that determine potential tax collection
\( \nu_{it} \) = White noise disturbance

Government Efficiency = Observed Government Revenue/Predicted Government Revenue
Political effectiveness in India varies widely. In general, the south and border areas have efficient governance. The reasons for this variance in efficiency fluctuate depending on the states involved. The specific differences offer a perspective on incentives for foreign investment.

Figure 3 shows that governments transfer resources to ensure security and stability before they support business interests. In the north border areas, government effectiveness results from the infusion of central government resources to buttress border security with Bangladesh, China and Pakistan. Not surprisingly, few foreign investors have ventured into this area. While the chances of a conflict with China and Pakistan are now remote, Kashmir is India’s largest domestic issue because a substantial portion of that state’s Muslim population supports independence, and a smaller subset seeks unification with Pakistan.4

FIGURE 4 about here

Figures 4 presents central government allocations dedicated to addressing the issue of poverty. Governments and particularly democratic governments allocate resources to reduce income inequality in hopes of increasing their popularity. India is no exception. Areas in the south receive very limited discretionary transfers but still attain the highest levels of government effectiveness. Reducing poverty is a laudable goal but seldom do these investments attract foreign investment. In fact, they probably discourage investment since they signal these states as having a less well educated work force. The central government transfers that focus on security enhance government efficiency but they do not create business opportunities.

FIGURE 5 about here

Figure 5 indicates clearly that the northern and central states in India have very high fertility and low levels of education. This is the case despite substantial central government transfers. Low wages, the lack of human capital, and business infrastructure all handicap this area for potential investors, despite discretionary transfers by the central government that attempt to reduce poverty.

What is the record of foreign direct investment in India? Figures 6A and 6B reflect both the percentage of foreign direct investment by state as well as commitments foreshadowed by FDI contracts.

Figure 6A about here

Figure 6B about here

Foreign firms allocate the bulk of direct investment to the south and west of India with the exception of Kerala and the North-East border states. The former assumes an anti-

4 Swaminathan and Thomas (2003).
business posture while latter has experienced separatist violence. Foreign investments decline in the relatively poor northern states and those experiencing violence and instability. The number of contracts is even more telling. Heavy investment is now centered in the south with the exception of Maharashtra that has enjoyed extensive investment in the past.

The combination of these various Figures offers a proposition to test. States that are politically efficient, characterized by low fertility rates and high levels of human capital, should attract the largest portion of foreign investment. In Figures 7-10 we evaluate this contention.

FIGURE 7 about here

Figure 7 indicates that the greatest investment potential is among the rising states in the south particularly Tamil Nadu and Karnataka followed by Andhra Pradesh. These states enjoy high political capacity, low birth rates, high human capital and limit instability, in large part because they do not depend on central government handouts to generate efficient governments. Note that the efficient governments of northern states are excluded because their strength depends on subsidies that focus on poverty rather than business opportunities.

FIGURE 8 about here

Figure 8 highlights two states such as Punjab and Gujarat located in the north and west where foreign investment is expected to decline. Here, a combination of instability, rising costs and declining government effectiveness reduce the return on future investment. This is confirmed in part by the lower level of foreign contracts booked there. This is the expensive and entrenched region of India that has received investment for some time but the conflict there between industry and agriculture increases instability and the relatively weak governments are unlikely to provide incentives to new business ventures. We anticipate returns on investments already made there to fall in the future.

FIGURE 9 about here

Figure 9 highlights two areas of unusual opportunity: Kerala and West Bengal. These states have all the most promising characteristics but have failed to attract FDI. The reason is political preferences – both governments are effective, Kerala more so than West Bengal but they are less interested in business opportunities than economic redistribution. A change in political leadership could make these two states highly attractive to investors and therefore they should be monitored closely.

FIGURE 10 about here

Finally Figure 10 indicates the states at the bottom of the opportunity rung. These include the states of Assam, Bihar and Uttar Pradesh. Here investors would take very high risks because of instability, relative government inefficiency, and lack of development.
Conclusions

The measure of political effectiveness at the state level accurately isolates those variables important to foreign investment in India. Efficient governments aid investors, keep their promises, and maintain political stability. The essential preconditions for business success are present. There is not a simple direct relationship between effectiveness and investment because governments reallocate resources in response to security demands and political pressures. That said, factoring out these political variables allows business executives to view governmental effectiveness at the state level as an essential ingredient for success.

Investors in the north and border areas of India will take much higher risks than those in the efficient areas of the south. Investors that follow the traditional path and invest in well established states should find that their returns level off. New investors in the efficient southern states will enjoy long term benefits.

References


Figure 1: Government Efficiency and Economic Performance

![Graph showing government efficiency and economic performance](image)

Figure 2: State Government Efficiency

![Map of India showing state government efficiency](image)
Figure 3: Violence and Security

- Instability limits growth potential
- Government efficiency controls violence

Legend:
- Low
- High
Figure 4: Federal Transfers 2005

Federal allocations focused on security and poverty, NOT business opportunities.
Figure 5: Birth Rates and Government Efficiency

High birth rates and low education

Low birth rates and high education – opportunity for investment

Mature area – low birth rates and highest education – but NO immediate opportunities as long as restrictions are imposed.

Mature area – low birth rates and high education – immediate opportunities, but only when restrictions are not imposed.
Figure 6A: FDI by State

- Instability diminishes foreign investments
- High government efficiency attracts high foreign investments
- High government efficiency – investments restricted by policy
Successful attraction of FDI

Successful restriction of FDI

High potential for FDI based on government efficiency
Increasing government efficiency and positive growth rates indicates investment growth potential.

Stagnating economies and declining government efficiency limit investment potential.
Kerala leads West Bengal in government efficiency

Poor infrastructure and inefficient governments