Conventional wisdom

- **Literature on law and finance:**
  - Stronger legal protection of investors is associated with more efficient institutions and better financial and economic outcomes (La Porta, Lopez-de-Silanes, Shleifer, and Vishny - LLSV - 1997, 98, 99, 00)

- **Literature on finance and growth:**
  - The development of financial system (stock market and intermediation sector) contributes to overall economic growth (McKinnon 73, King & Levine 93, Levine 97, Levine & Zervos 98)
  - Evidence at industry- and firm-levels (Rajan and Zingales 98)

- **Literature on law, finance, and growth:**
  - Country level evidence: Levine (99)
  - Evidence at industry level (Beck and Levine 02) and firm level (Demirgüç-Kunt & Maksimovic 98)
Is the conventional wisdom correct?

Alternative views
- Great reversals (Rajan and Zingales 2003a)
- Political economy factors (Rajan and Zingales (2003b), Acemoglu and Johnson (2005))

China as a counter-example to existing law, finance and growth literature:
- One of the largest and fastest growing economies despite its poor legal and financial systems and a corrupt and autocratic government; 
- Alternative and informal financing and governance mechanisms have substituted for formal channels and mechanisms (Allen, Qian and Qian - AQQ - 2005)

Why do we study India?
- English common-law legal origin; democracy for over half a century
- Second most populous country (1.1 billion at the end of 2004)
- One of the highest growth rates (7% per annum during 1990-2002)
- 2nd largest emerging markets, 4th largest economy in the world in PPP terms

Overview of India: Economy, Law and Institutions

Large and diverse country with rich history

Aggregate economy:
- Composition of GDP: 52% services, 26% in manufacturing, and 22% in agriculture
- Labor force: 2/3rd employed in agriculture; large fraction in the “unorganized sector”

Difference between protection of investors in law as opposed to protection in practice:
- Perfect score (4/4) on the Creditor Rights index (LLSV 1998); downgraded to 2/4 in Djankov, McLiesh and Shleifer (2005)
- Highest score (5/6) in a sample of over 100 countries for the Anti-Director Rights index in Djankov, La Porta, Lopez-de-Silanes and Shleifer (DLLS, 2005)
- Corruption (government and legal system): Ranked 90/145 on Corruption Perception Index (by Transparency International) in 2004
India: Financial System

- Banking sector: One of the best in Asia and among emerging countries
  - In terms of overhead cost, concentration, NPLs, ROE and ROA;
  - Stringent standards in lending (firms complain insufficient bank financing)
- Equity markets: Booming stock markets
  - Top 2 Indian exchanges combined ranked 14th (market cap) among stock exchanges around the world in 2004

![Return on Stock Indexes around the World](chart)

<table>
<thead>
<tr>
<th>Year</th>
<th>BSE-India</th>
<th>SSE-China</th>
<th>S&amp;P 500</th>
<th>FTSE-London</th>
<th>Nikkei-Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002-03</td>
<td>276.50</td>
<td>19.22</td>
<td>144.74</td>
<td>1.77</td>
<td>3,442</td>
</tr>
<tr>
<td>2001-02</td>
<td>265.68</td>
<td>18.56</td>
<td>139.88</td>
<td>1.74</td>
<td>3,312</td>
</tr>
<tr>
<td>2000-01</td>
<td>248.86</td>
<td>17.85</td>
<td>132.21</td>
<td>1.68</td>
<td>3,212</td>
</tr>
<tr>
<td>1999-00</td>
<td>223.54</td>
<td>17.16</td>
<td>123.76</td>
<td>2.05</td>
<td>3,080</td>
</tr>
<tr>
<td>1998-99</td>
<td>222.72</td>
<td>16.72</td>
<td>124.48</td>
<td>1.63</td>
<td>2,944</td>
</tr>
<tr>
<td>1997-98</td>
<td>210.40</td>
<td>16.00</td>
<td>116.02</td>
<td>1.54</td>
<td>2,803</td>
</tr>
<tr>
<td>1996-97</td>
<td>194.04</td>
<td>15.26</td>
<td>108.42</td>
<td>1.48</td>
<td>2,658</td>
</tr>
<tr>
<td>1995-96</td>
<td>169.13</td>
<td>14.66</td>
<td>95.19</td>
<td>1.30</td>
<td>2,571</td>
</tr>
<tr>
<td>1994-95</td>
<td>140.84</td>
<td>13.94</td>
<td>77.04</td>
<td>1.13</td>
<td>2,447</td>
</tr>
<tr>
<td>1993-94</td>
<td>126.56</td>
<td>13.41</td>
<td>68.29</td>
<td>1.12</td>
<td>2,388</td>
</tr>
<tr>
<td>1992-93</td>
<td>156.26</td>
<td>12.98</td>
<td>57.23</td>
<td>1.09</td>
<td>2,082</td>
</tr>
<tr>
<td>1991-92</td>
<td>96.19</td>
<td>12.53</td>
<td>49.96</td>
<td>0.78</td>
<td>1,948</td>
</tr>
</tbody>
</table>

![State and Non-state Sectors: A Comparison 1990-2003 (Table 4)](chart)

<table>
<thead>
<tr>
<th>Year</th>
<th>Non-State Sector GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002-03</td>
<td>10.83</td>
</tr>
<tr>
<td>2001-02</td>
<td>276.50</td>
</tr>
<tr>
<td>2000-01</td>
<td>265.68</td>
</tr>
<tr>
<td>1999-00</td>
<td>248.86</td>
</tr>
<tr>
<td>1998-99</td>
<td>223.54</td>
</tr>
<tr>
<td>1997-98</td>
<td>222.72</td>
</tr>
<tr>
<td>1996-97</td>
<td>210.40</td>
</tr>
<tr>
<td>1995-96</td>
<td>194.04</td>
</tr>
<tr>
<td>1994-95</td>
<td>169.13</td>
</tr>
<tr>
<td>1993-94</td>
<td>140.84</td>
</tr>
<tr>
<td>1992-93</td>
<td>126.56</td>
</tr>
<tr>
<td>1991-92</td>
<td>96.19</td>
</tr>
</tbody>
</table>

State and Non-state Sectors: A Comparison 1990-2003 (Table 4)
Sources of Funds (Table 5-A)

<table>
<thead>
<tr>
<th>Sources of Funds</th>
<th>All Firms</th>
<th>State Sector</th>
<th>Non – state sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal Sources</td>
<td>36.3</td>
<td>42.0</td>
<td>33.1</td>
</tr>
<tr>
<td>Capital markets</td>
<td>17.8</td>
<td>12.6</td>
<td>20.9</td>
</tr>
<tr>
<td>Of which</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td>13.3</td>
<td>8.5</td>
<td>16.1</td>
</tr>
<tr>
<td>Debt</td>
<td>4.5</td>
<td>4.1</td>
<td>4.8</td>
</tr>
<tr>
<td>Banks/Financial Institutions</td>
<td>15.9</td>
<td>11.5</td>
<td>19.0</td>
</tr>
<tr>
<td>Group Companies/Promoters/Directors</td>
<td>0.9</td>
<td>1.2</td>
<td>0.6</td>
</tr>
<tr>
<td>Others (including current liabilities &amp; provisions)</td>
<td>29.1</td>
<td>32.7</td>
<td>26.3</td>
</tr>
</tbody>
</table>

Listed Firms

- For listed firms: Empirical tests based on sample of 800+ firms
  - Ownership: Concentrated among founder’s family or controlling shareholder;
  - Dividend and valuations: Lower than those of firms from countries with similar investor protection by the law;
  - India’s listed firms behave more like firms from countries with poor investor protection
    - Given the poor level of actual investor protection in India, the analysis is consistent with the spirit of LLSV’s predictions
Survey of the SSI Sector

Respondents: Owners or top executives;

Characteristics of sample firms:
- 76 SSIs (Small Scale Industry) in and around the South Indian city of Hyderabad;
- Less than one year to 38 years; close to uniform distribution;
- Sample firms span several industries including engineering, chemicals, packaging and software

Financing at Start-up Phase (Fig. 3A)
Survey Evidence on Financing Channels

- **Importance of internal funds:**
  - 61% of the respondents reinvested over 75% of net income in the first year in which they made reinvestments;
  - Only 13% made dividend payments in the past 5 years

- **Bank Credit:**
  - 19% had no bank/FI credit, only 16% dealt with two banks/FIs;
  - 88% had borrowed from one or more state-owned banks; 20% from specialized public sector institutions; 15% from private FIs, none from foreign banks;
  - Median monitoring frequency: “once-a-quarter”

Survey Evidence on Governance

- **Corporate control:**
  - The median non-owner ‘CEO’s had “little discretion” in business decisions;

- **Entry barriers:** Over 90% of the firms needed a license to start business;
  - 45% found obtaining it difficult; in half of these cases the government officials were the problem;

- **Government corruption:**
  - 85% thought others paid bribes to solve the problem, 23% thought they used friends of govt. officials;
Concerns for Default (Fig. 4)

Mean score (on a scale of 1-3)

- Loss of reputation
- Loss of personal assets
- Court sentence / jail
- Personal safety

Enforcement

Enforcement of contracts and resolving disputes:
- Resolving disputes: 64% would turn to “mutual friends or business partners” for mediation while 18% each would “go to court” and “settle out-of-court”;
- To ensure payment/repayment: 41% relied on screening, 35% would go to court with possible renegotiation, 24% would seize the defaulters’ personal assets;
- 42% had faced non-payment situations in the last 3 years, half of them did nothing about it and continued the business relationships
Summary

- India has been successful in terms of growth despite
  - Formal laws and institutions being of limited importance in practice
  - Financing depending mostly on internal and alternative sources and not very much on banks and stock markets
  - Corruption

Future Work

- Comparing China and India:
  - Differences in law and institutions;
  - Differences in formal financial systems: Banks and markets;
  - Comparisons of alternative/informal mechanisms.

- Large countries versus small countries

- How do alternative mechanisms work and complement standard mechanisms?

- What exactly is the role of the law and courts in commerce?