THE MAGAZINE OF THE WORLD ECONOMIC FORUM

JANUARY/FEBRUARY 1997

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## IT at the top

Why business leaders need to take charge of change

JANUARY/FEBRUARY 1997

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**World Link Publications Limited**
Nestor House
Playhouse Yard
London EC4V 5EX
United Kingdom
Telephone (editorial)
+44 171 779 8314
Telephone (advertising)
+44 171 779 8726
Fax +44 171 779 8727
Subscription enquiries
David Willment
Telephone +44 171 779 8610
Fax +44 171 779 8617
Operations manager
Kellie Mason
Telephone +44 171 779 8615

**Publisher**
David Derrick
Telephone +44 171 779 8726
**Deputy publisher**
Julia Oxenbridge
Telephone +44 171 779 8723
**Publishing assistant**
Sara Iturrioz
Telephone +44 171 779 8923
**Advertising manager, Europe and Africa**
Andrew Cover
Telephone +44 171 779 8761
**Advertising manager, Spain and Latin America**
Stella Kenway
Telephone +44 171 779 8301

BILL BUTCHER

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**Tel + 44 171 779 8724**
**Fax +44 171 779 8727**
**email 100437.766@compuserve.com**

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**Advertising representation**
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John Wilson
International Media
Representatives
Telephone +61 2 954 5732
Fax +61 2 954 5753
**Bolivia**
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Walter Zuletta
Telephone +591 2 430 722
**Central Europe and CIS**
Martin Born
Telephone +41 22 786 9660
Fax +41 22 786 4960
**France**
Bernard Pingree
Infopac SA
Telephone +33 1 46 43 00 66
Fax +33 1 4643 0134
**Germany**
Franz Schrecklinger
Top Media
Werbegesellschaft mbH
Telephone +49 69 72 60 46
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**Hong Kong**
Colin Low
International Media &
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Telephone +852 2815 1889
Mobile telephone
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**India**
Jyoti Verma
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Response
Telephone +91 22 262 0085
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Telephone +65 287 7880
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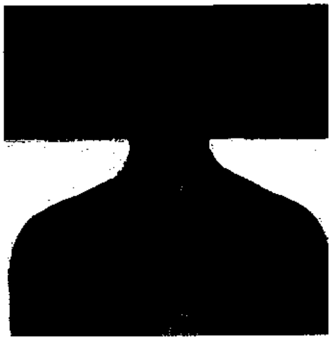
**Switzerland**
Guy van Thuyne
Van Thuyne & Cie SA
Telephone +41 21 729 5594
Fax +41 21 729 4732
**Turkey**
Mine Hekimoglu
Telephone +90 216 337 5507
Fax +90 216 337 5507

**ISSN 1016-359X**

GARY BATES



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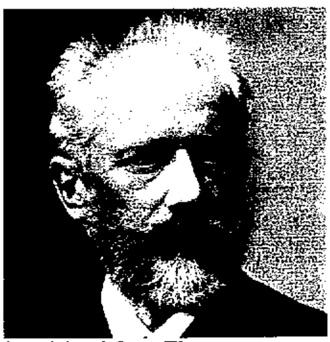

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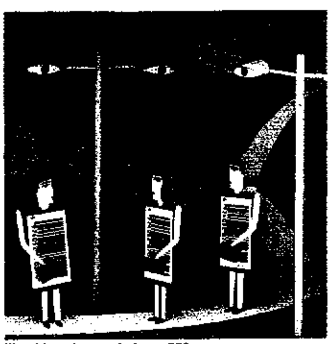

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# Separate supplement



Cover illustration by Zafar and Barbara Baran

Events at the state level are looming larger in national politics. This is good news for the durability of reform

# Coalition for business

*By Rob Jenkins, lecturer in politics, Birkbeck College, University of London*

About the worst way to convince anyone that India's economic reforms are "irreversible" is to say so volubly, repeatedly and with a just a hint of irritability. Yet this is precisely what prime minister HD Deve Gowda did in a recent speech to an international business conference in New Delhi.

Plagued by the widespread belief that his precarious 13-party United Front coalition is incapable of providing the coherence necessary for the next wave of reforms, Deve Gowda's frustration is understandable. Much of the scepticism he faces comes from comparisons with other emerging markets, most notably China, which have moved much more quickly to reduce trade barriers, clear foreign investment proposals and privatise state-owned corporations. And quite a large part of it comes from an appreciation of the sheer scale of domestic political resistance to change. But these are old complaints, as much an indictment of the previous Congress government as of Deve Gowda's.

To the sceptics, the most troubling aspect of the current political climate is the composition of Deve Gowda's coalition. It is not the participation of communists in the cabinet that most irks them. Most people know that India's communists are pragmatic: that's how they got into government. The main ground on which sceptics question the government's potential is its reliance upon an array of regional parties. The assumption is that state capitals are breeding grounds of parochialism, unsuited to launching India further into the global business arena. According to this logic, economic policy management will suffer as the voices of India's hinterland gain control over government. In the eyes of many Indian and foreign observers, enlightened national policy-making without a united national ruling party is unimaginable.

They are wrong. The regionalisation of Indian politics will certainly complicate some investors' decisions. But its most prominent impact so far has been to make economic reform politically sustainable. This was as true during PV Narasimha Rao's premiership as it has been in Deve Gowda's.

During Rao's five-year rule, economic liberalisation shifted a good deal of control over economic policy-making from the central government to the states. Little of this was deliberate. The abolition of the industrial licensing system, for instance, meant that decisions on where to locate a new factory were made by investors, rather than bureaucrats in New Delhi. It wasn't long before both Indian and foreign entrepreneurs were shopping around India's states for the best locations, taking into account state-government tax concessions, the quality of the labour force and the state of labour relations, and the attitudes of civil servants.

### State governments become key

Fierce competition for inward investment forced state governments to be disciplined in exercising their new-found influence, but they had at last become something more than rubber stamps for centrally planned industrial investment decisions. Without their help in getting water, power, land and other amenities, new ventures could not move forward. Suddenly state governments were the key to getting projects off the ground.

One of the most important political implications of this situation was to defuse resistance to reform. Regionalisation, in other words, has been one of the hidden secrets of reform's political durability. Because the impact of economic reform varied from region to region, interest groups that might have united to fight against liberalisation fragmented along regional lines. This has reduced their political potency. In just one example, small-scale industrialists bound up in negotiations with state governments have found it difficult to press their case effectively in New Delhi, resulting in the loss of a significant number of privileges. And this was a sector once considered sacrosanct.

A similar dynamic has been at work in relation to labour issues. While the most radical reforms to labour legislation have not yet come to pass, there has been a considerable accumulation of minor reforms, many of which have taken place quietly, and mostly at the state level. By using their considerable political resources, state-level politicians have also been instrumental in brokering agreements between local trade unions and managements.

Local politics assists such transactions, rooted as it is in a shared political culture and common system of political rewards. The tendency for intervention at the regional level has undercut whatever latent worker solidarity might have existed at the national level. The Rao government steadfastly refused to risk a direct confrontation with labour, and the strategy paid off, if only because of the political skills of its initially unwilling accomplices at state level. The effect of national neglect and state power has been to chip away at the strength of organised labour, helping to undermine the capacity of important sections of the trade union movement to resist what may prove to be far more radical policy change in the future.

During Rao's tenure, the federal system also gave many parties with local, but little national representation, the experience of operating as reforming governments in their own right. Much of this was forced on them by reductions in financial transfers from central government, which found it convenient to cut its fiscal deficit by starving state governments of resources.

Despite cutbacks, many politicians heading non-Congress state governments during 1991-96 came to realise that economic reform did not necessarily spell the end of their capacity to engage in illicit forms of "political fundraising". They were able, for instance, to profit from less-than-transparent privatisations of public-sector firms under their control and to manipulate the process of acquiring land for new industrial projects. Having been thrust into the role of reluctant reformers, leaders of a number of non-Congress state governments began to see political advantages. Their embrace of reform at state level undermined the heated anti-reform rhetoric emanating from some MPs in the national parliament. This further reduced the political pressures facing reformers in the central government and thus the chances that reform would suffer a reverse.

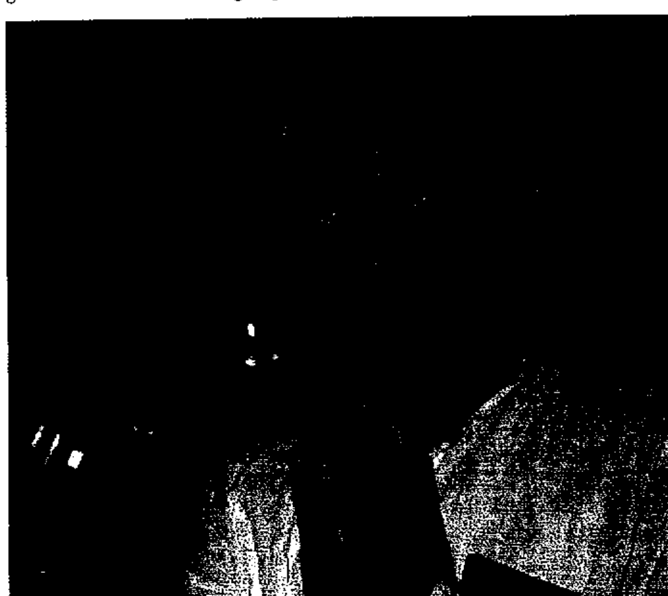
Indeed, to the extent that some states' economies did better in the process of reform while others found themselves worse off, the potential for provincial politicians to coordinate opposition to reform was undermined. Federalism helped to fragment the political class much as it did organised interest groups. By the time of the first general election of the post-reform period in May 1996, it was clear that no party was particularly interested in reversing the direction of policy. The centre-left coalition that ultimately displaced Congress is headed by a regional leader who developed a pragmatic approach to liberalisation as the chief minister of the southern state of Karnataka. He has continued this strategy as prime minister, egged on by ministers representing the many regional parties of which his coalition is composed.

**Increased activity traced to roots**

Far from bringing a provincial mindset to New Delhi, Deve Gowda's United Front government injected new life into a flagging reform process. In little more than three months, for instance, the newly constituted Foreign Investment Promotion Board (IPB) approved foreign investment proposals worth more than $5.5 billion. A good deal of the increased activity on this and other fronts can be traced to the coalition's regional roots. Ministers sitting on the IPB and other key decision-making bodies hail from regional parties and are politically answerable to party bosses in state capitals. Industry minister Murasoli Maran, for instance, belongs to the Dravida Munetra Kazagham (DMK), which rules in the southern state of Tamil Nadu. The DMK's leader, Tamil Nadu chief minister N Karunanidhi, wants to see new industrial projects sprout in his state. The decision of Ford, in a venture with its Indian partner Mahindra, to produce Fiestas at a greenfield plant in Tamil Nadu rather than at a site it had been studying in Maharashtra was considered a major coup when it was announced by Karunanidhi's predecessor as chief minister in January 1996.

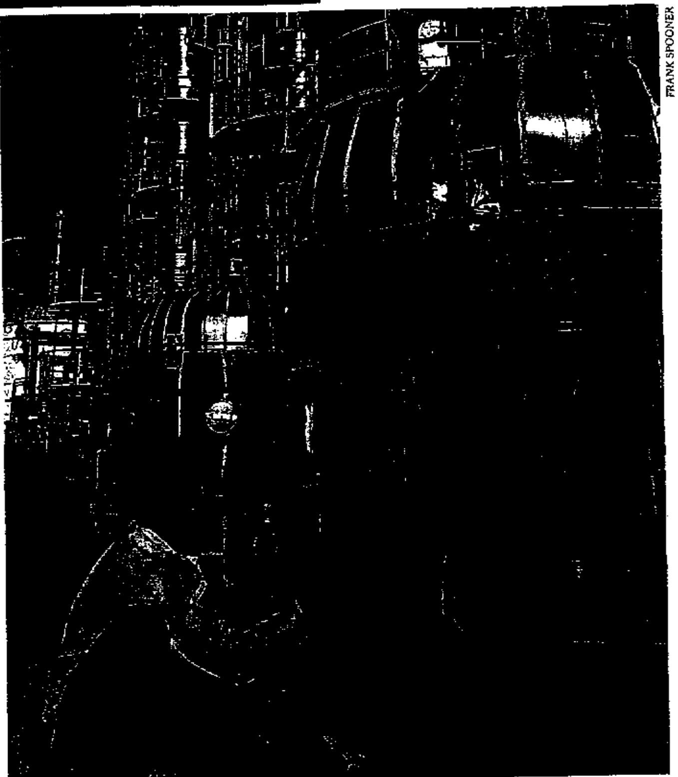
The key point is that Maran answers to Karunanidhi, just as government ministers from the Telugu Desam Party, another United Front component, answer to Andhra Pradesh chief minister Chandrababu Naidu – also a pragmatic provincial politician keen to attract private investment. New Delhi is largely dancing to the tune of state governments. This is a big departure from the past 25 years or more. Under Rao, for instance, Congress chief ministers could lobby their party chief and his ministerial colleagues in New Delhi for action on pressing foreign business projects. But the centralised Congress would respond in its own time, if at all. Congress chief ministers, in almost all cases, owed their jobs to the prime minister and kept them at his pleasure. They were in no position to lobby effectively for investment approvals, more autonomy over policy making or reforms to other economic regulations. The new dispensation has changed all of that, at least for the time being. Chief ministers from United Front parties are calling many of the shots and can threaten to bring down the government if they do not get their way. Rather than asking for the brakes to be put on restructuring, they are demanding action.

And the central government is responding. While not completely ceding economic control to the states, ▶



AJIT KUMAR/AP

**Prime minister Deve Gowda's United Front government has revived a flagging reform process**



FRANK SPOONER

Hazira petrochemical plant in Surat Gujarat state: authority over economic policy is devolving to state governments

◀ Deve Gowda, as a former chief minister, understands the problems of state governments. He announced in September that the government was considering allowing state governments to authorise power projects up to a value of Rs10 billion ($280 million), and thus no longer suffer the delays involved in getting central government approval.

In late October, Deve Gowda's government fulfilled a long-standing desire of state governments by initiating a process to give them greater control over granting mining concessions. As a first step the new guidelines allow states to grant prospecting licences that cover much larger areas, but more is promised. The government also plans to introduce a bill to amend the Urban Land (Ceiling and Regulation) Act of 1976, which restricts what state governments can do with vacant urban land needed for redevelopment.

All these reforms not only have implications for how state governments might make the most of a liberalised economic environment, but also have the potential to assist state-level politicians in building up new sinecures to replace those, like public works patronage, that liberalisation has eroded. A central government inclined to support such activities is building a larger and deeper consensus in favour of reform.

New powers for the states would not mean a thing if regional leaders were not motivated to throw their weight behind market-oriented reform. A cynical view is that the numerous scams that tainted Indian politics during the Rao years have convinced many state politicians that liberalisation, once seen as the greatest threat to their political livelihoods, provides no shortage of methods for "political fundraising".

### Messy hybrid emerges

In fact, the potential for economic reform to become too closely associated with corruption could provoke a political backlash and spell its demise. In the meantime, what has emerged is a messy hybrid, brimming with contradictions.

Much of what state-level reformers have achieved also lacks the sort of sex-appeal that grabs headlines. This tends to obscure the extent to which the liberalising tendency has become politically rooted. It is when mundane micro-reforms begin to affect the lives of diverse constituencies that the cumulative weight of liberalisation becomes irreversible. Complex sales-tax reform in Rajasthan, for instance, has simplified administration, reduced evasion and increased state revenues. Similarly, the deliberately unheralded commercialisation of public-sector companies in Maharashtra (termed "backdoor privatisation") and the reorganisation of West Bengal's State Electricity Board are the type of nuts-and-bolts reforms that any economic liberalisation programme needs if it is to be sustainable.

As for foreign investment, the attitudes of state-level politicians continue to change. Ford's Tamil Nadu project is again illustrative. After repeatedly criticising his predecessor for her handling of the Ford Mahindra negotiations, Karunanidhi went out of his way to honour the deal after becoming chief minister. Unlike the Shiv Sena-BJP government in Maharashtra, which cancelled the Enron power project agreed by its Congress predecessor only to reinstate it later, Karunanidhi was aware that populist actions can deter potential investors. The terms of the foreign investment debate have shifted from "whether" to "how?".

This is even true of states not considered likely to benefit from private investment. Orissa, in the east, is a case in point. It is one of India's least industrialised states. Mineral wealth, including 1.7 million tons of the world's 23 billion tons of bauxite reserves, has attracted a range of domestic and international players. It is not yet clear how much of almost $20 billion in investment proposals will actually materialise, but even if only a relatively small fraction do, Orissa will be transformed from a backwater into a major industrial player. Orissa chief minister JB Patnaik credits the reduction of central government control over investment decisions as the key factor that has enabled even the hope of economic renewal. And this is a man who represents the Congress party, which ran central government for all but five years since independence.

Yet, as more authority over economic policy-making devolves upon state governments, the central government has felt it necessary to step up its efforts to woo large domestic businesses. It was widely seen as a matter of political urgency. To convince industrialists that the United Front's approach to economic reform was not biased against domestic business groups, finance minister P Chidambaram took steps that, in effect, benefitted the largest and most powerful segments of Indian industry at the expense of smaller players.

These included support for a new code for corporate takeovers and greater opportunities to borrow on international debt markets. Industrialists are being told that the United Front government wants to build up Indian multinational corporations.

Cultivating businessmen is all well and good, but if the government is to continue easing foreign investment restrictions and deregulating trade, it ▶

◀ will have to face a lot of flack from domestic business interests. Again, the current coalition's roots in regional politics can act as a spur rather than a brake on new reforms because of its capacity to overcome daunting obstacles.

In early November, a leading industrialist personally told the prime minister that business was united in its opposition to the government's decision to allow majority equity holdings by foreign investors in a range of new industries – that is, beyond those that had been previously justified on the grounds that foreign technology and capital were desperately required. The prime minister was said to be unfazed by this display.

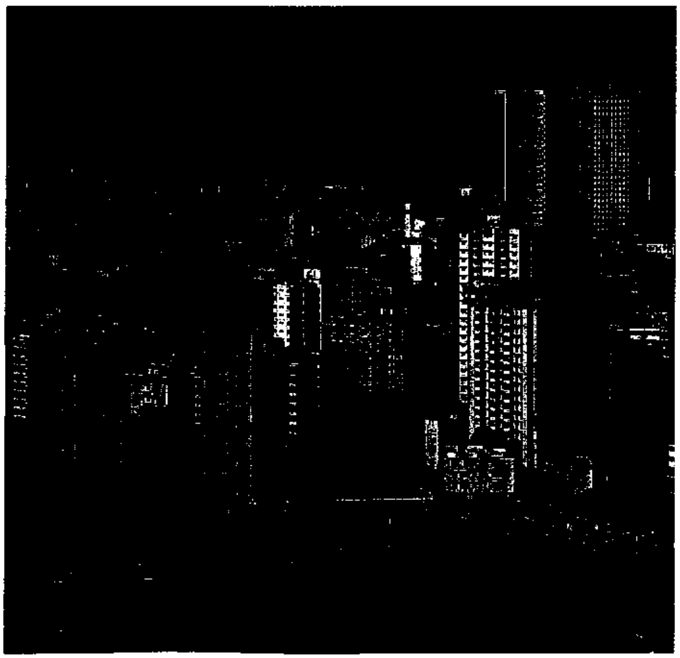
**Neglect of regional political alliances**

The capacity of the government to resist this kind of pressure stems largely from the fact that the traditionally dominant business houses have in the past relied on a close relationship with the Congress Party, which operated a top-down form of federalism. These business houses neglected to build political alliances at the regional level, precisely the level from which power is flowing in today's bottom-up political environment. The business links of the parties ruling in most states are with smaller, but more outwardly oriented regional business groups. Their backers do not in general share the aversion to foreign investment voiced by the traditionally dominant north Indian business houses.

Deve Gowda and his ministers, because they hail from the provinces, are not as beholden to traditional big business as the leaders of the two main national parties. They can take tougher decisions, and have done. Big business houses are running scared not because Deve Gowda and his cabinet are abandoning liberalisation, but because they are pursuing it more zealously.

Family-run business houses are, above all, concerned about loss of management control. In the good old days, large family-run businesses were able to retain control while owning only a tiny proportion of the total share capital. This was because the huge government financial institutions that owned significant percentages on the public's behalf were controlled by friendly politicians who allowed them a relatively free hand. Now that these financial institutions are under pressure to reform themselves – and some are doing so very effectively – they are dumping shares on to the market, much to the chagrin of family managements.

Some of these families have resorted to questionable practices to retain their stakes when new funds are sought from the market. Even the blue-chip Tata Group has faced controversy over the methods used to raise funds to consolidate its holdings. Many less upright corporate players have engaged in far more flagrant tactics. While threatening to come down hard on any proved malpractices, the finance minister has simultaneously dangled the carrot of supporting a financial instrument known as the non-voting share, allowing firms to go to the public for the share capital needed to modernise plant and machinery, but without sacrificing their grip over management.



A view of Bombay: the large family-run concerns worry about losing management control under reforms

MARK HENLEY/IMPACT

Despite the advantages of running a government with strong roots in the regions, where politicians are eager for reform, Deve Gowda has plenty of political problems. Many of these stem from the need to retain Congress party support without alienating too many members of his own coalition. But perhaps just as many are by-products of a political strategy in which the central government issues vague assurances to various interests, while state governments do the dirty work.

A particular sore point has been the government's abuse of the so-called National Renewal Fund, which was set up to finance retraining schemes for retrenched workers. In reality, it has been used almost exclusively to fund "voluntary retirement schemes", some of which have been less "voluntary" than others. Another example is the continued support for management lockouts by a number of state governments. Union leaders argue that while they have fulfilled their part of the bargain by toning down labour stridency, "management militancy" has been on the rise, abetted by state governments.

In response, a number of national trades unions have initiated moves to merge. Since inter-union rivalry has in the past been a major impediment to organised labour's capacity to resist government reform, the prospect of unification has filled liberalisers with anxiety and has the potential to create new difficulties for foreign investors.

Yet the regionalisation of politics may serve to counteract this trend as well. Though rival trades unions at the national level are coming closer together, their state-level components are beginning to drift farther away from their parent organisations. Tackling such thorny issues at the state level, as one labour activist put it, is analogous to the police taking their suspects to different interrogation rooms and working them over in isolation. There is a certain political expediency to such *de facto* decentralisation, especially if it helps to prevent labour militancy from engulfing national politics. Ironically, the advent of a coalition of regional parties in New Delhi has led not to an invasion of the centre by the forces of parochialism, but to an increased ability of local arenas to absorb some of the political backlash that inevitably accompanies economic reform. This is perhaps the most convincing reason to believe that, despite latent political opposition to economic reform, it is effectively "irreversible". ■