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FOREIGN DIRECT INVESTMENT IN INDIA: FACTS AND ISSUES

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AND
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FOREWORD

Trade and foreign direct investment policies have become the focus of liberalization efforts in recent times. Though not on the top of the agenda in India's development strategy until the early eighties, the government is now pursuing a pro-active policy to attract foreign direct investment. The industrial policy of 1991 and subsequent amendments provide a very liberalized policy framework to attract foreign direct investment (FDI) into the country. Many of the restrictions prevalent earlier by way of limitations on equity participation, areas of operation, etc., have been withdrawn.

The current foreign direct investment regime of India compares favourably with those of several Asian countries which have been quite successful in augmenting FDI inflows. Thus, the current FDI policy contains a wide variety of incentives to promote policy objectives. Among the many types of incentive schemes, industrial estates, special economic zones, bonded areas, export processing zones, and more recently technology parks have attracted considerable attention. In addition, a broad spectrum of financial incentives, particularly in the form of tax holidays, subsidized sites, other infrastructure facilitation and business services are offered by central and state authorities to encourage economic development. The 1990s have clearly seen a radical change in India's policy towards foreign investment which is now actively encouraged in all sectors.

However, despite such widespread liberalization, foreign investors remain concerned about the pace of implementation and wary about the irreversibility of the liberalization process. This has resulted in a "wait and watch" attitude on the part of some foreign investors, either because they are not absolutely sure of the future or because of the expectation of securing a better policy package in the succeeding period.

The current institutional system must, therefore, provide a mechanism for aggressive marketing of India as a location for

Foreign Direct Investment in India: Facts and Issues

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I

FDI IN INDIA : AN ASSESSMENT

THERE has been a growing recognition in India that any credible attempt towards economic reforms must involve upgradation of technology, scale of production and linkages to the increasingly integrated globalized production system chiefly through the participation of transnational corporations. Neglected in India's development strategy before 1991, the Government is now pursuing a pro-active policy to attract foreign direct investment. The industrial policy of 1991 provides a fairly liberalized policy framework to attract foreign direct investment into the country.

India has a number of advantages to offer to potential foreign investors. Among these are: political stability in a democratic polity, an economy characterized by steady growth and a single digit inflation rate, a vast domestic market, a large and growing pool of trained manpower, a strong entrepreneurial class, fairly well developed social and physical infrastructure, a vibrant financial system including a rapidly expanding capital market and a diversified industrial base. The fundamentals of the economy can be evaluated from the macroeconomic indicators corresponding to GDP, government deficit, inflation rate and trade deficit. GDP growth rate in the country increased from 1.3 per cent in 1991-92 to 5.3 per cent in 1994-95. Government deficit declined from 7.9 per cent of GDP in 1990-91 to 6.7 per cent in 1994-95. Inflation rate, which peaked at 17 per cent in August 1991, fell to 7 per cent in 1992-93 and 5.6 per cent in 1993-94. Simultaneously, trade deficit declined from \$9.4 billion in 1990-91 to approximately \$1 billion by 1994-95.

foreign direct investment. Further, it is also desirable to develop a mechanism which will have the private sector as an integral partner.

This monograph has been prepared as part of the Institute's unrelenting efforts towards disseminating knowledge on issues of topical interest. The paper is based largely on the findings of the Research Study conducted by the Institute during 1993-95 on "Policy Impediments to Trade and FDI in India" with financial support from the USAID.

We hope that readers will find the monograph insightful and illuminating.

Dr. P.L. SANJEEV REDDY
DIRECTOR GENERAL

New Delhi
January 1996

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Foreign direct investment (FDI) has gained importance globally as an instrument of international economic integration. Foreign direct investment policies along with trade policies have, in fact, become the focus of liberalization efforts in almost every country. Liberalized trade regime along with an open door foreign investment policy creates pressures to achieve higher levels of efficiency and flexibility at the firm level.

Extent of FDI in India

Liberalization of the FDI policy regime has resulted in a substantial expansion of FDI approvals and flows. The total number of foreign collaboration approvals went up from 950 in 1991 to 1,854 by 1994, registering an increase of over 95 per cent (Table 1). The 1995 year-end figure of total approvals, based on the annualized figures of the first five months, is likely to reach 2,196. Actual FDI inflows have also simultaneously gathered pace. The actual inflow of foreign direct investment increased more than eight times from Rs 3.5 billion in 1991 to Rs 29.7 billion by 1994. The first five months of 1995 have already registered Rs 28.6 billion worth of FDI inflows.

TABLE 1

FDI APPROVALS AND ACTUAL INFLOWS IN INDIA (1991-1995)

	1991	1992	1993	1994	1995*
1. Total number of foreign collaboration approvals	950	1,520	1,476	1,854	915
2. Total amount of foreign investment approved (Rs billion)	5.3	38.9	88.6	141.9	74.8
3. Actual inflow of foreign direct investment (Rs billion)	3.5	6.8	17.9	29.7	28.6

*Figures for 1995 relate to the period January-May 1995.

Source : SIA, Ministry of Industry.

FDI Policy in India

The Government of India's policy towards foreign direct investment or "foreign collaboration" as it is most commonly referred to in official statements has evolved from cautious promotion in the late 1940s to a brief period of near "open door" in the 1950s, to a policy of rigorous selectivity in the late 1960s and 1970s and to a policy of increasing liberalization in the 1980s. These policy swings have reflected the socio-economic-cum-political objectives of the Government.

The current policy framework of FDI in India is as follows:

(a) FDI in 35 priority sectors are given automatic approval by the Reserve Bank of India, if the foreign equity participation is less than 51 per cent.

(b) All other proposals are considered by the Foreign Investment Promotion Board (FIPB), a high powered body located in the Prime Minister's office. The FIPB is especially empowered to "engage in purposive negotiations" and also considers proposals in totality, free from pre-determined parameters or procedures. No formal application forms are prescribed nor any fee is payable. The FIPB is working since July 1992.

(c) Since 23 September 1992, the Government has constituted an Empowered Committee to deal with FDI proposals recommended by the FIPB in which total investment is up to Rs 300 crore. Proposals involving total investment beyond Rs 300 crore are submitted to the Cabinet Committee on Foreign Investment.

(d) The condition of "dividend balancing", i.e. the obligation to earn equivalent amount of foreign exchange through exports as is spent on repatriation of dividends, has been dropped except in the case of 22 consumer goods.

(e) To provide access to capital market and to encourage modernization and technological upgradation in the small-scale industry sector, equity participation not exceeding 24

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(e) To provide access to capital market and to encourage modernization and technological upgradation in the small-scale industry sector, equity participation not exceeding 24 per cent of the total shareholding is allowed in the small-scale sector by other industrial undertakings, including foreign collaborators.

(f) The Reserve Bank of India accords Automatic Approval to all industries for foreign technology agreement within prescribed monetary/royalty limits, i.e., those involving a lumpsum payment up to Rs 10 million, 5 per cent royalty for domestic sales and 8 per cent for exports, subject to a total payment of 8 per cent on sales over a 10-year period from the date of agreement or seven years from the commencement of production.

The following two points are especially noteworthy in the new industrial policy that came into effect in 1991. First, the system for the acquisition of an industrial licence, which was required to initiate a business or expand existing facilities, was abolished. Governmental intervention, therefore, was limited and free competition was promoted. Second, a system was introduced allowing majority investment by foreign parties. Earlier, the Foreign Exchange Regulation Act (FERA) had placed many restrictions on companies with foreign equity participation of 40 per cent or more. Under the new economic reforms, however, the investment of foreign capital up to 51 per cent or less in 35 industries designated as high priority sectors of industries (including metals, electric and electronic equipment, transport equipment, industrial equipment, chemicals, pharmaceuticals, glass, cement, rubber, food processing, software, tourism, and trade) are automatically approved upon application to the Reserve Bank of India.

Another important step towards the liberalization of foreign firms' activities was the repealing of the phased domestic manufacturing programme in July 1991. This eliminated the requirement of a high local content imposed on foreign firms or joint venture firms. Moreover, the revision of the FERA in January 1993, which had limited the activities of foreign firms since 1973, also contributed to promoting overall liberalization. Under this revision, companies with more than 40 per cent of foreign capital are now permitted to engage in the establishment of branches, purchase of real estate, fund raising, acquisition of companies, and employment of expatriate advisers on an equal basis with domestic companies — all of which have facilitated new investment by foreign firms.

Sectoral Trends in FDI

Industrywise break-up of the FDI inflow during January 1991 to April 1995 indicates that the bulk of foreign investment has been in the priority sector. Fuels and metallurgical industries alone have accounted for more than 35 per cent of total approvals during this period. Chemicals (other than fertilizers), services, electrical equipment and telecommunications have taken up another 30 per cent of total approvals. Sectorwise FDI approvals in India during January 1991 to April 1995 are given in Table 2.

TABLE 2

SECTORWISE FDI APPROVALS DURING JANUARY 1991-APRIL 1995 IN INDIA

(Val: Rs million)

Sector	Value
Fuels	75,673.2
Metallurgical industries	40,250.0
Chemicals (other than fertilizers)	28,073.2
Services sector	26,091.1
Electrical equipment	22,131.1
Telecommunications	21,742.7
Food processing industries	20,445.5
Transportation industry	17,469.5
Hotel & tourism	17,170.9
Textiles	13,550.0
Industrial machinery	8,677.9
Paper, pulp & paper products	3,945.6
Drugs and pharmaceuticals	3,016.0
Agricultural machinery	1,613.5
Rubber goods	1,001.8
Others	28,870.4
Total	**329,722.4**

Source: SIA, Ministry of Industry.

Countrywise FDI Trends in India

Countrywise approvals show that five countries accounted for 44.26 per cent in 1994 and 58.55 per cent in 1995 (up to May). USA alone accounted for as much as 24.6 per cent of the FDI approved in 1994 and 35.59 per cent in 1995. The position from January 1991 to May 1995 is given in Table 3.

TABLE 3

COUNTRYWISE FDI APPROVALS DURING JANUARY 1991-MAY 1995 IN INDIA

(Val: Rs million)

Country	1991	1992	1993	1994	1995
1. USA	1,859	12,315	34,619	34,881	8,642
2. Germany	418	863	1,759	5,694	1,550
3. Belgium	16	237	60	77	1,433
4. Malaysia	2	744	85	252	1,390
5. Indonesia	0	19	4	0	1,200
6. UK	321	1,177	6,227	12,992	1,094
7. Switzerland	355	6,898	4,268	483	1,004
8. Singapore	14	602	667	2,655	584
9. Australia	26	776	296	3,885	440
10. South Africa	-	-	-	3	158
11. Netherlands	559	968	3,217	2,070	98
12. Mauritius	-	-	1,242	5,347	92
Total (incl. others)	**5,341**	**38,875**	**88,593**	**141,872**	**24,277**

Source: SIA, Ministry of Industry.

Importance of Different Channels of FDI Approval

It will be worthwhile to point out that during the post-policy period (August 1991-May 1995), the actual investment flows through the automatic route of the RBI in total FDI flows have been quite insignificant (6.48%). This is partly due to the fact that crucial areas like the electronics sector, services sector and the mineral products sector are left out of the automatic approval route. The restriction on foreign equity holding to 51 per cent also acts as a major hindering factor. The relative importance of different channels of entry of FDI flows into the country can be seen from Table 4.

TABLE 4

IMPORTANCE OF DIFFERENT CHANNELS OF FDI APPROVAL

	August 1991-July 1994	August 1994-May 1995	August 1991-May 1995
Total amount of foreign investment involved (Rs billion)			
(i) SIA	10.0	2.5	12.5
	(6.35)	(1.31)	(3.58)
(ii) RBI	16.9	5.7	22.6
	(10.73)	(2.99)	(6.48)
(iii) FIPB	130.7	182.5	313.2*
	(82.93)	(95.7)	(89.92)
Total	**157.6**	**190.7**	**348.3**

* Includes 24 proposals for Global Depository Receipts (GDR) involving investment of Rs 59.4 billion.

Note: Figures in brackets indicate percentage shares of total foreign direct investment approved.

Source: SIA, Ministry of Industry.

FDI in Relation to Total Foreign Capital Inflows

As a part of the liberalization process, foreign portfolio investment by Foreign Institutional Investors (FIIs) has also been allowed. In fact, FII investment has so far vastly outpaced FDI inflows. The share of FDI in total foreign inflows, at present, stands at 26.5 per cent of total inflows (Table 5). As portfolio investment is generally considered to be hot money, strategies must be designed to increase the share of FDI in total investment.

Global trends show that portfolio investment occupies a significant proportion of total capital inflows in countries which impose minimal capital controls. Thus, countries such as USA, Germany, etc., have recorded high levels of portfolio investment both in absolute terms as well as in relation to direct investment flows. For example, the ratio of foreign direct investment to portfolio investment in Germany in 1993 was only 0.007

(Table 6). The comparable figures for USA and UK during the same year were 0.19 and 0.23 respectively. Figures in Table 5 show that in India's case, the importance of portfolio investment has somewhat declined during 1994-95 as compared to 1993-94. While in 1993-94, portfolio investment was 2.69 times that of direct investment, this proportion declined to 1.23 during 1994-95. Table 6 shows that the position in case of Pakistan and Sri Lanka is almost similar to that of India. On the other hand, the ASEAN countries, in general, have not relied much on portfolio investment. Data published by the International Monetary Fund reveal negligible shares for portfolio investment in these countries.

TABLE 5

PROPORTION OF FDI IN TOTAL FOREIGN CAPITAL INFLOWS IN INDIA

($ billion)

	1991-92	1992-93	1993-94	1994-95
Foreign Direct Investment (FDI)	0.150	0.341	0.620	1.300
Portfolio Investment:				
(a) Foreign Investment Institutions (FIIs)	-	neg.	1.665	1.600
(b) Global Depository Receipts (GDRs) or Euro-Equities, Offshore Funds, etc.	-	0.086	1.810	2.000
(c) NRIs	0.008	0.005	0.015	-
Total	**0.158**	**0.433**	**4.110**	**4.900**
FDI as percentage share of total capital inflows	**100.0**	**78.8**	**15.1**	**26.5**

Source : *Reserve Bank of India Bulletins* (relevant years).

TABLE 6

DIRECT AND PORTFOLIO INVESTMENT IN SELECTED COUNTRIES (1986-1993)

Country	1986	1987	1988	1989	1990	1991	1992	1993
				(US$ billion)				
USA								
DI	35.64	58.22	57.27	67.73	47.92	26.00	9.89	21.37
PI	85.79	66.92	73.85	95.7	1.23	57.54	71.55	111.49
DI/PI	0.42	0.87	0.78	0.71	0.026	0.45	0.14	0.19
				(US$ million)				
UK								
DI	8,570	15,696	21,414	30,553	32,436	16,158	16,738	13,241
PI	17,732	36,128	29,300	27,454	14,453	31,317	33,446	57,232
DI/PI	0.48	0.43	0.73	1.11	2.24	0.52	0.50	0.23
Germany								
DI	0.74	1.47	0.87	10.78	9.16	7.93	5.35	1.04
PI	33.31	11.6	-2.36	22.15	11.42	39.22	90.82	157.4
DI/PI	0.02	0.13	neg	0.49	0.80	0.20	0.06	0.007
Australia								
DI	3,484	3,920	8,013	7,770	6,884	4,772	5,299	2,708
PI	3,035	5,273	7,496	2,756	838	7,030	neg	2,680
DI/PI	1.15	0.74	1.07	2.82	8.20	0.68	neg	0.74
Thailand								
DI	163	263	352	1,105	1,775	2,444	2,014	2,116
PI	895	-29	346	530	1,486	-38	-81	750
DI/PI	0.18	neg	1.02	2.08	1.19	neg	neg	2.82
Pakistan								
DI	105	129	186	210	244	257	335	346
PI	83	131	126	16	87	92	370	292
DI/PI	1.27	0.98	1.48	13.13	2.80	2.79	0.91	1.18
Sri Lanka								
DI	29.7	59.5	45.7	19.7	43.4	48.4	122.6	194.5
PI	-	-	-	-	-	32.1	25.7	67.2
DI/PI	-	-	-	-	-	1.51	4.77	2.89

Notes : (a) DI stands for Foreign Direct Investment

(b) PI stands for Portfolio Investment

(c) DI/PI stands for the ratio of Foreign Direct Investment to Portfolio Investment

Source : IMF, *Balance of Payments Statistics*, 1994.

Focus Areas for Attracting Higher FDI Flows

Although India has done well in terms of attracting foreign direct investment, the potential has not been fully exploited. Greater attention to the following factors is required to improve the locational attraction of India for foreign investors.

Stability

Despite the series of steps taken by the Government to attract FDI, foreign investors remain concerned about the pace of implementation of the reform measures and wary about the irreversibility of the liberalization process. Stability is the most important element in the corporate appraisal of a country's FDI policy, as FDI involves a long-term commitment. Unless the corporate body is sure that the present policy will continue for some time, it is not in a position to take a decision. Unfortunately, the record with respect to stability is rather poor. Policy relating to foreign investment in the power sector is a classic case where policies and procedures have been in a state of flux for a long time. So is the case of the telecommunications sector. This has resulted in a "wait and watch" attitude on the part of some foreign investors, either because they are not absolutely sure of the future or because of the expectation of securing a better policy package in the succeeding period. Recent developments, including a fairly large number of FDI proposals by the FIPB, may have further dampening impact.

Transparency

It has been observed that while the FIPB system provides a great degree of flexibility, there is scope for introducing further transparency in the system. Lack of transparency leads to unnecessary delays in the approval and the execution of the projects.

Simplification in the Approval System

Currently, there are several agencies which are involved in FDI approval system. Though the domain of each agency is more or less defined, the very fact that there is more than one agency for granting approvals causes confusion in the minds of prospective investors. Multiplicity of routes of approval creates confusion which could be simplified and reduced to only Automatic Approval (AA) and FIPB routes. Ideally, the FIPB route should confine itself to special and mega projects while other proposals should be channelized through AA route. It may be desirable to raise the ceiling of 51 per cent on equity holding for projects under the AA route, because the current restriction does not appear to serve any useful purpose.

Importance of a Negative List

There is need to consider a change-over from the positive list approach to a negative list approach for expanding the areas for FDI. It has been seen in many countries that laying down clearly the areas where foreign investment is not permitted adds to the transparency in the Policy.

Systemic Issues

At the systemic level, bureaucracy is still perceived to be a major area of concern. The unchanged mindset and an antiquated legal-cum-procedural system generate enormous delays. Progress is slow with approvals for land acquisition and environmental issues may delay start-ups substantially. There are essentially three solutions, all are to be sought simultaneously. First, extensive and intensive orientation programmes are to be organized, especially for lower and middle level functionaries. Second, since the work load is bound to get reduced in organizations whose regulatory powers are being taken away, large scale redeployment of staff has to be done. This is necessary because so long as the officials are there, they will try not to lose their powers in some ways or other. Third, a major revision of the Central/State level laws and regulations will have to be undertaken.

Centre-State Interface

There is virtually no cooperation between the States and the Central Government in terms of FDI approvals and subsequent follow-ups. Once the approval for FDI is given by the Central

Government to the foreign investor, he has to approach the State level agencies for project implementation. These relate to approvals for acquisition of land, clearances for water, power connections, sales tax number, etc. Some laws, e.g. the Urban Land Ceilings Act, the Industrial Disputes Act, the Sick Industries Companies Act (SICA), the Packaging Control Regulations Order and the Lube and Grease Control Order have also been identified as major hurdles for implementation of larger FDI projects. Lack of cooperation between the Centre and the States has also affected the marketing of reforms in the domestic market.

Environmental Clearance

The issue of environmental clearances needs further analysis. As the environmental standards prescribed in many developed countries for many technologies are rigorous and stringent, there appears to be low risks in granting automatic approval to such technologies either by the Central Government or State Governments.

Tariffs & Customs Administration

India's trade regime with high tariff rates and complicated customs administration has not only affected foreign trade but also inflows of foreign investment. Though over the last four years, the customs duties have been brought down, the average tariff level is still quite high. The average collection rate, which is a better indicator of the protection level as it takes into account various tax exemptions, was 47 per cent in 1990-91, 44 per cent in 1991-92, 37 per cent in 1992-93 and approximately 30 per cent in 1993-94. This rate is even now too high and introduces both an anti-export bias as well as perpetuates an unacceptable level of inefficiency in the domestic production system. While it is true that the government is heavily dependent upon import duties for revenue realization, this should not be a problem if the base of imports increases due to both rise in GDP and lowered tariffs. For example, if the customs duties are reduced by one-third on an average, revenue neutrality will be maintained if value of imports increases by the same proportion. Most econometric studies on India's imports suggest an import elasticity value between 1 and 1.5. Since there are reasons to believe that these values are under-estimates, it can be argued that there is hardly any possibility of any revenue loss due to customs duty reduction if the licensing and foreign exchange control regime concerning imports are also concurrently liberalized.

Besides, there are problems at the ports. The most commonly mentioned problems are extensive delays of three weeks or more in the ports, plus the hassle and corruption in dealing with Indian customs.

Corporate Tax Rates

India's corporate tax rates are also perceived to be higher than the corresponding rates in some other Asian countries. There is some empirical evidence to show a negative correlation between tax rates and FDI flows. Though it is extremely difficult to calculate effective tax rates and make a cross-country comparison, the nominal tax rates can be easily benchmarked. Since at the time of initial locational choice, investors will be influenced *prima facie* by data which are easily available and comparable, it is obvious that the Indian corporate tax structure needs to be suitably modified to make it more transparent and bring down the differential between the nominal and effective tax rates.

Rupee Convertibility

Issues regarding convertibility are often referred to in the context of FDI flows. It is argued that the convertibility of the rupee will provide necessary psychological support to the foreign investor regarding the safety of his capital in terms of complete freedom to remit not only his earnings in the form of dividends, royalties and management fees, but also his capital. Besides, it is believed that convertibility also helps the foreign investor to plan his global investments without the apprehensions of delays and sometimes refusal of or reduction in the volume of repatriation. However, studies show that though foreign investors would welcome such a move, lack of capital account convertibility has not acted as a deterrent to foreign investment into India due to the long-term market commitment of the investors. The overall investment climate is held to be a more significant determinant of FDI.

IPR Issue

Although the protection of intellectual property rights is not found to be one of the main determinants of FDI in several studies in several countries, it is certain that stronger protection is likely to boost the flow of FDI to some industries, such as pharmaceuticals, agro-chemicals and micro-electronics. Intellectual property protection is also crucial for new products. A study by International Finance Corporation on "Intellectual Property Protection — Foreign Direct Investment and Technology Transfer" came to the conclusion that IPR regime affects investment flows except in high technology sectors where the impact is greater on technology flows. The study also concluded that India is perceived to have one of the weakest IPR regimes by foreign investors.

Protection of FDI & Related Issues

Although India has become a member of Multilateral Investment Guarantee Agency (MIGA), it has so far not concluded bilateral agreements for settlement of investment disputes with the important FDI supplying countries. The issue of amending the present Indian Arbitration Act 1940 has to be sorted out to provide an internationally acceptable legal framework for settlement of commercial disputes expeditiously and effectively. At the same time, it is also necessary to have more and more Avoidance of Double Taxation Agreements, as studies show that these have a positive effect on FDI inflows.

Financial Sector Reforms

The need for financial sector reforms has also been highlighted, especially by Japanese investors. The specific requests included liberalization of banking activities, development and stabilization of the call market and removal of loan obligations to priority sector.

It is well known that not much progress has been made in this sector, though the need for it is recognized by all, including the Government.

Labour Laws

Lack of an exit policy continues to worry foreign investor as there is no flexibility in the labour market. The existing laws place high degree of control so far as the closure of an industrial unit is concerned.

Marketing of India as FDI Location

Since India for all practical purposes followed a fairly restrictive FDI policy for more than two decades, it can be presumed that both the quantity and quality of information on "doing business in India" were at a sub-optimal level at the beginning of the reforms process. As a logical corollary, it follows that unless there is concerted national effort to publicize the Policy changes and the long-term potential of India as a market, the anticipated fallouts of the new Policy would be far below expectations. Many investors feel that India is still fairly unknown as a FDI location. To bridge this gap, it is necessary to take steps for promoting India as an attractive investment destination. In the past, official and semi-official delegations went to various countries while private sector firms had gone for road shows for their GDR/Euro issues, but still a lot more needs to be done. In other words, a plan is to be developed for effective marketing of India. The first element of this plan is to provide information on tap to any potential investor. Audio-visual packages must be developed which should be continuously updated. If need be, the services of private foreign agencies may be utilized.

The industry and trade associations like the FICCI, ASSOCHAM, CII, FIEO and PHD Chambers of Commerce, too, can play a greater role in helping foreign prospective investors. One of the major problems faced by foreign investors is identification of the right Indian partner for joint ventures, etc. Although these associations provide help in such matters, a more systematized national approach by delineating responsibilities for each body needs to be developed with the combined support of these apex associations. There is a need to compile and publish periodically the latest information with regard to the opportunities available in various States and the policy package of incentives offered by these State Governments to foreign investors. Since the Indian High Commissions and Embassies are the first links that can be established by any foreign investor in respect of India, their role in attracting FDI is critical.

Beyond the FDI Policy Regime

It is necessary to appreciate that the FDI policy *per se* is only one of the concerns of the foreign investor. The FDI policy determines the ease of accessing the domestic market and the terms and conditions of entry. But the other policy regime and the operating environment determine the project viability, the progress of project implementation and successful business operations. An investor, therefore, cannot concern himself with only what the new Industrial Policy provides but he must evaluate the entire spectrum of rules, regulations and operating conditions once he is in. Consequently, issues like law and order conditions, labour policy, etc., become as important as the FDI policy itself.

FDI-Export Linkage

Further, no purpose will be served by attempting a linkage between FDI and export promotion through the policy framework. It is quite clear that some firms, in fact the majority, are contemplating coming to India to take advantage of the burgeoning domestic market. Whether a firm will use its foreign investment to service a domestic market or its global operations is a part of its strategic decisions and it is better left to them. It is definitely possible to influence this decision-making by appropriately redefining the policy and building in an incentive package for its export-orientation, but that would need a fairly drastic restructuring of the present policy framework. This seems to be uncalled for due to two reasons. First, given the importance currently being accorded to FDI proposals for infrastructure development, the export-orientation of the policy will be *ab initio* infructuous. Second, any incentive-based policy suffers from the deficiency that it can be ineffective if other contending countries change their policy package and, therefore, a certain amount of competitive bargaining creeps in the system.

Besides, the magnitude of export-oriented FDI attracted by a country is determined more by structural advantages than by incentives offered. Kumar (1994) in an empirical study analyzing the inter-country pattern of export-oriented FDI made by United States MNEs found the extent of export-oriented FDI investment attracted by a country to be determined by wage levels, industrial capability and infrastructure of EPZs. The Government policy towards FDI (e.g., incentives and performance obligations) or the overall international orientation of the economy did not affect it significantly.

Role of States

This brings the State-level policies and procedures firmly in the picture. In the Indian polity, the States provide the location, the infrastructure and the operating environs. They also extend, increasingly these days, a host of incentives to attract investment, irrespective of their origin. State Governments and their agencies are responsible for the numerous clearances, approvals and operating procedures. It has been found that to set up a power sector project, 42 statutory clearances and approvals are required from various Central and State agencies. No nodal agency will be able to sort out such massive regulatory requirements, because no agency will like to delegate its powers to another agency. Therefore, the legal regime also needs to be simplified.

Like infrastructure, general law and order situation in some States has been identified as an important factor for promoting FDI. Many States have lost out in the race for FDI because of bad law and order situation leading to lack of investor friendly environment. It is this whole package of laws, systems and procedures and not the FDI policy alone, which is considered by any farsighted investor. And this is where India seems to lose out to other competing countries. According to a recent country risk rating prepared by London-based EIU, India is ranked as the 11th most risky country in the world. In another survey conducted by Roper Starch Worldwide on behalf of the Washington and New Delhi based Indo-US Joint Business Council, it was found that China and the ASEAN countries were the most preferred destinations for FDI. In the last few months, however, China appears to be losing its charm to foreign investors, especially due to the tightening of its FDI policy.

II

GLOBAL FDI FLOWS AND DEVELOPING COUNTRIES

Greater attention to FDI policies is required by all developing countries as global trends show that FDI so far has played a relatively minor role in the aggregate capital flows to developing countries. This has been particularly so after the onset of the debt crisis in the early 1980s. Experience shows that in the event of a debt crisis, leading to a decline in commercial lending to some countries, FDI also simultaneously gets adversely affected. The ASEAN countries, owing to their large growth potential, on the other hand, have attracted a large volume of FDI, though there have been large inter-country variations in the FDI-GDP ratios within the ASEAN. Private, including foreign, investment now accounts for over two-thirds of total investment in Indonesia, compared with about 50 per cent in the early 1980s, and is estimated to account for about three quarters of Indonesia's overall economic growth since 1983. However, despite these trends, FDI is still concentrated in developed countries. Table 7 shows this position.

Studies on Determinants of FDI Flows

In a world of intense competition among countries for FDI, liberalization of policies and incentives are important but not sufficient for attracting FDI. Active promotion is required on a continuous basis.

A key problem for governments in designing FDI policy lies in how the policy package and its context will be perceived by the TNCs. If the perception is that the macro system is highly regulatory and restrictive in nature, the FDI-specific promotional features may be ignored — even if these are highly attractive. Further, if the system is highly regulatory *de jure*, but in practice these regulations are waived or are easily circumvented, even then the TNCs may view the system as highly restrictive.

TABLE 7

GLOBAL FOREIGN DIRECT INVESTMENT FLOWS (1981-1993)

(US$ billion)

	1981-85	1986-90	1990	1991	1992	1993
World	48	168	232	192	171	195
Industrialized countries	47	163	222	185	162	181
Developing countries	1	6	10	7	9	14
Former USSR and Eastern Europe	0.004	0.02	0.04	0.01	0.03	n.a.

Notes : (1) "Industrialized countries" include the members of the OECD, Israel and South Africa.

(2) Figures for 1981-85 and 1986-90 are averages for years covered. Figures for 1993 are early reports.

(3) "Developing countries" exclude Hong Kong.

Source : UNCTAD, *World Investment Report 1994*, Geneva.

Determinants of FDI have, in fact, been studied from different perspectives, both cross-sectorally and cross-nationally. The studies reveal that besides government policies, several other economic and political variables determine FDI flows. The major factor explaining FDI flows is found to be the "economic environment" prevailing in a particular country, which is inclusive of cost conditions, market size, levels of human capital and infrastructural development and broad macroeconomic conditions. Empirical studies published by UNCTAD on the effect of market growth in manufacturing industries have generally been inconclusive. According to a study published by UNCTAD (Pearce, 1991), direct investment seems to be positively related to the level of market size and its underlying growth, but does not seem to react systematically to short-term changes in rates of market growth. Once a market attains a size that permits local production to realize effectively economies of scale, the level of FDI in that market is likely to be closely related to its size. Regulations in areas such as remittances, price controls and foreign investment do not seem as influential on investment decisions as economic factors.

Most of the current literature on the effectiveness of FDI policies, however, focuses on the issue of incentives without necessarily distinguishing between the differential impact of the various types of incentives or addressing the question of how incentives may be nullified by disincentives and performance requirements. The literature, in general, questions the value of incentives in attracting investment. Some observers feel that incentives may tip the balance in investor's choice between country locations, although in an empirical test of FDI flows to several developing countries, fiscal incentives were not found to be a statistically significant discriminant variable. Some experts hold the view that incentives are effective in affecting a project's location within a country. Despite the almost near unanimous view among the economists that fiscal/financial incentives are not the major FDI determinants, many governments continue to offer such packages.

Studies show that there is a time lag of minimum one year between the announcement of a policy change and changes in investment flows in developing countries. Among tax incentives, tax holiday has been the most popular, though its impact by way of attracting foreign direct investment is not beyond doubt. While studies on the experiences of developed countries show its strong influence in promoting investment, studies in the ASEAN countries reveal its minimal influence on a project's internal rate of return. Yet, barring Indonesia, many East Asian countries continue to offer tax holidays to foreign investors.

It is generally observed that for investment that is oriented towards the local market, prospective investors do not "shop around" but rather look at the viability of the country's market. In particular, the degree of tariff/non-tariff protection an investor may enjoy is often a crucial determinant and is of greater concern than tax holidays. If the market is heavily protected as most developing country markets are, significant potential for profits will exist. If the market is poor or highly competitive, tax holidays will not be seen as a significant incentive as the profit potential will be low. Market protection may, therefore, draw investors. In fact, historically, bulk of the FDI has been of tariff-jumping type. Incentives, on their own, have had very limited impact on the locational decision-making.

Foreign Direct Investment in Services

Foreign investment of transnational service companies (TSCs), in particular, is expected to be positively related to the rate of market growth in host countries. Firms in different service industries, however, may pursue different strategies in their international expansions in developed and developing countries.

Analysis of the sectoral and industrial composition of outward FDI by developed countries reveals a shift in the sectoral pattern of global FDI from the primary and secondary sectors to the tertiary sector. During the 1980s, FDI in services grew dynamically and outpaced investments in the primary and secondary sectors. Indeed, the rapid increase of FDI flows during the 1980s was accompanied by a transformation in the structural composition of these flows in favour of the services sector. By the end of the 1980s, FDI in services accounted for 55-60 per cent of total FDI flows, and close to half of the world's FDI stock. The history of FDI in the services sector in the south and south-east Asian region reflects the divergent stages of the development and industrialization process of the concerned nation-states.

III

FDI POLICIES IN COMPETING COUNTRIES

Analysis of FDI policies in some countries can provide some useful insights. Among the countries in Asia, in fact in the world,

China has emerged as the winner in attracting FDI. Though recent studies which critically analyzed the FDI flows to China discount the absolute figures by about a quarter due to the so-called "round-tripping", the flows are still substantial partly due to the large contribution of overseas Chinese. At the systemic level, it is found that China's success in attracting large volumes of FDI has been largely on account of the highly decentralized system of administration which gives most of the decision-making powers to local authorities.

At the policy level, there is a striking difference between the policies followed by China and India. Differences also exist with respect to the policies of south and south-east Asian countries. The first difference refers to the minimum level of FDI. Thailand, for example, does not permit FDI below 5 million baht and has no ceiling on foreign ownership of equity. China, too, insists that the foreign participant holds at least 25 per cent of the equity capital. Singapore encourages FDI exceeding one billion dollars. The Indian policy, on the other hand, is restrictive limiting the maximum foreign equity participation generally to 51 per cent, though FIPB has been given discretionary powers to permit 100 per cent equity ownership in some cases. Another fairly common feature in the FDI policies of other countries is to give liberal tax concessions to foreign enterprises. In some countries, the waiver of equity restrictions or tax concessions are linked to export performance and other important domestic policy parameters such as employment, local content and location. Tax policies in ASEAN countries can be summarized in the following manner: (1) all countries provide exemption of import duties and taxes on capital equipment imported by promoted enterprises; (2) Malaysia and Singapore provide additional deductions for certain types of capital expenditure; (3) accelerated depreciation is provided in Malaysia and Singapore to promoted firms; and (4) all countries, except Indonesia grant income-tax holidays linked to the time period of foreign investment. China, too, grants preferential tax treatment to enterprises set up in Special Economic Zones and specified coastal cities. Enterprises that qualify as export-oriented or technologically advanced also avail of a 50 per cent reduction in the income-tax rate. A crucial characteristic missing in the Indian policy is the absence of tax exemption on imported materials and equipment. Some tax reduction, though, is possible in the case of power projects, coal mining and petroleum refining projects.

The Indian FDI policy, nevertheless, scores over the policies of other competing countries in the matter of employment of foreign personnel. Whilst restrictions on their employment do not exist in India, they are prevalent in most countries in the ASEAN group as well as in China. In Malaysia and Indonesia, expatriate employment even for technical and managerial positions requires justification in terms of non-availability of local skills. Singapore relaxes restrictions on employment of foreign personnel only under condition of foreign investors providing manpower training at all levels in the enterprise to supplement and complement government efforts.

IV

CONCLUSIONS

While foreign direct investment to developing countries, including India, has grown rapidly in recent years, shifts in its distribution suggest that significant competition exists among potential host countries. Even assuming that FDI is not an example of a strict zero sum game, aggregate FDI flows are not infinitely expandable. TNCs frequently make choices among potential host countries when deciding where to locate their foreign production facilities. In that regard, the prospects for increase in FDI to India in the future may be affected by favourable changes in policies governing trade and FDI in the other host countries. India still needs to introduce substantial reforms in its trade policy to boost FDI. The negative list of imports, especially in the consumer goods sector, can be pruned considerably. The average rate of tariffs is quite high when compared to other countries. Many countries such as Indonesia and China permit duty-free import of capital goods required by foreign enterprises.

To attract more investment from foreign companies in the future, it will be important to focus on small and medium sized business and selected services sector. The investment made up to now has mostly been by large global corporations and front-line companies. India will have to encourage investment from small and medium businesses as well in future. Attracting small and medium enterprises, however, will require a greater and better targeted marketing effort. The reason for seeking investment from the services sector is that there is a large number of companies in the USA and other countries with superior capabilities in the fields of medicine, medical services, the environment, leisure, software, design and business services. Investment in these sectors would add vitality to domestic businesses and the domestic market. Further, investment in the services sector could be expected to have a ripple effect on the manufacturing industries.

Further, though India has a large number of free trade zones and 100% export-oriented units providing similar benefits, their functioning is hampered by location-specific or infrastructural problems. These schemes require greater attention of the policy-makers in India.

In terms of the policy areas, simplification of the entry routes, raising of equity ceiling, introduction of a negative list, simplification of the operating systems & procedures, IPR legislation and a comprehensive dispute settlement system are critical. The most important point is India should be viewed as a country that is adhering to its policy of reforms. Foreign investors should get the signal that FDI is still welcome to India, that their investment will be safe, that they will be allowed to operate their businesses and not be subject to political/public/NGO pressures. In FDI flows, perceptions are more important than reality. That should dictate the future strategy for FDI promotional efforts. This means that foreign entrepreneurs will believe that they will be participating in an economy where all the infrastructural facilities are expanding continuously to meet the requirements of a growing economy and where the State is determined to fill up the gaps in private investment in order to maintain and sustain industrial growth. Unless India and its policies are marketed vigorously, the anticipated fallouts from policy liberalization will remain sub-optimal. One way to create a better image of India as a business location will be to introduce stability in the system. Incremental policy changes as is being done in the case of the power and telecom sectors can cause total confusion regarding the sincerity and stability of any policy regime.

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