CHAPTER 35

FOREIGN DIRECT INVESTMENT

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INTRODUCTION

Foreign direct investment (FDI) plays a major role in the economy. It is estimated that more than 40 per cent of output in the country's organised sector is attributed to FDI brought in by the multinational companies. FDI has been accumulating in the country over decades and has been complementing domestic investment in a big way. It has now spread over a vast range of industrial services and infrastructure segments. The need for FDI in the country has been emphasised in various industrial policies from time to time and specific measures have been enforced to attract investment particularly in areas of national importance. There is generally a great divergence of the motives for MNCs intending to make FDI and the motives with which a host country invites FDI. MNCs generally seek viable and profitable operations keeping in view their long-run overall corporate interests whereas the basic motives of the host country are to acquire latest technology, receive foreign exchange, generate competition, increase the rate of investment, reduce dependence on imports and boost the overall health of the economy. To what extent these expectations are realised, depends upon a host of factors relating to business environment and the way foreign investment is utilised.

THE CONCEPT OF FOREIGN DIRECT INVESTMENT

Foreign investment is called 'direct' if it provides actual control to the investor (usually a multinational company) in the invested-in enterprise. The investment is termed 'indirect' or 'portfolio' if the ownership or proprietary rights are not accompanied by actual control. The control over the enterprise doesn't merely involve the control of the invested capital; it is control in terms of actual power of management and effective decision-making in the major aspects of the working of the invested-in enterprise including finance, production, technology, marketing, staffing and further promotion.

With FDI, the invested-in enterprise becomes an affiliate of the investing parent company. With the establishment of the foreign affiliate, the parent company acquires a multinational status. The commonest way of establishing a foreign affiliate and gaining its control is through shareholding which would be in **cash** (foreign exchange) or **kind** (in the form of technical equipment, machinery or infrastructure) or a combination of both depending upon the laws and practices of the host country. In case of investment in kind, its cash equivalent is estimated at currently prevailing market price as per standard procedure and its value is included in FDI. When the affiliate is newly established, the FDI is called **greenfields investment**. Alternatively, an existing domestic enterprise can be acquired by a foreign firm and the cost of acquisition plus additional investment, if any, constitutes FDI. In this case FDI comes by way of **transfer of ownership** through substantial acquisition of shares.

Foreign investment laws in different countries provide different cut-off levels of foreign equity share at which foreign control is believed to be acquired. In most of the industrialised countries the effective control is believed to be acquired at 10 per cent foreign shareholding level. In India, RBI has adopted the cut-off level of 25 per cent and such companies are termed as foreign-controlled rupee companies. Foreign investment in equity shares which is less than the cut-

off level, is counted in the category of **foreign portfolio** investment though with the foreign investing firm may still be able to influence decisions in the invested-in enterprise.

CORPORATE FORMS OF FDI

As already pointed out above, generally MNCs are carriers of FDI which make investment keeping in view a large number of factors relating to the home-and host-country business environment as well as their own long-run mission and business interests. FDI acquires different corporate forms depending upon the foreign shareholding (**Table 35.1**). If the entire capital is owned or invested by the foreign company, then its affiliate is either a branch or a *fully-owned subsidiary. The difference between the two forms of organisation is that the former is incorporated under the laws of the home country and is subject to the regulation of both home and host countries; the latter is incorporated under and subject to the laws of the host country only.* The affiliate with majority foreign holding is predominantly controlled by the foreign parent. The extent of foreign control tends to weaken as the foreign equity share declines. *There are, however, a large number of exceptions to this general statement. Affiliates with critical inputs (like technology and foreign market information) from parent but with much lower foreign equity holding are also often observed to have dominant foreign control.*

Table 35.1: Corporate forms of foreign direct investment in India according to the extent of foreign shareholding

Extent of foreign shareholding	Corporate form of FDI
100%	Fully-owned subsidiary
>50% but <100%	Subsidiary or majority foreign owned
50%	Co-owned company
>25% but <50%	Minority foreign owned company

FDI AS A PACKAGE

FDI is not merely a singular flow of capital or foreign exchange. It is a composite package which has multi-dimensional gains for the recipient country. A full-blown FDI backage contains the following elements:

- Financial transfer in foreign exchange
- Production technology
- Management skills
- Physical resources like machinery, tools, equipments etc
- Institutional systems
- Information and databases
- Worldwide contacts
- Research and development

- Training resources
- Trade channels

FDI also comes packaged in institutional and organisational structures. ***It builds new organisations in which product and process-related abilities are developed*** (Bedi, 1985). ***Often, it is not possible to depackage FDI as separate markets for the individual components may not exist. For example, if a country wishes to have the technology of a particular foreign company, it may not be available in isolation. It might be available as a component of FDI as a whole.*** FDI may, therefore, be desired not only for **balance of payments** reasons, but also for its other components like export channels, information, access to R&D facilities or to obtain new products which were earlier imported. Motives for FDI are discussed later in the Chapter. Box 35.1 gives major constitutent element of an FDI package.

NON-TRADITIONAL FORMS OF DIRECT CONTROL

Though foreign equity holding is the traditional and most popular form of acquiring control over the invested-in enterprise, it is not the only form of direct control. Direct control can also be acquired through a number of other arrangements which may involve much less or even equityless investment. Most of these arrangements are non-traditional and have evolved over a period of time. They have different degrees, kinds and durations of control. The major organisational arrangements are the following:

- Licensing
- Franchising
- Joint ventures
- Technical collaborations
- Buyback arrangement and counter-trading
- Management contracts
- Sub-contracting arrangements
- Strategic alliances and cartelisation
- Market sharing arrangements
- Assembly operations
- Turnkey operations
- Mergers and acquisitions

The list is not exhaustive. MNCs often devise innovative and more sophisticated arrangements to gain control over other enterprises to strengthen themselves or reduce competition. Most of these, as compared to foreign equity holding, are weaker forms of direct control though in certain cases like a management contract, control can be more dominating then through equity. However, investment or fund commitment under these arrangements is difficult to determine or even quantify.

INTERNATIONAL DEFINITION OF FDI

The definition of FDI, as adopted by most of the countries of the world, including developed countries, includes equity capital, reinvested earnings and 'other capital' which includes inter-company debt transactions covering borrowing and lending to funds, debt securities and **trade credits** between related entities. This definition is adopted and prescribed by the ***International Monitory Fund (IMF)***. According to the ***IMF Assessment Standards***, 'reinvested earnings are the direct investors' shares (in proportion of equity held) of the undistributed earnings of a direct investment enterprise. Reinvested earnings are recorded, with an offsetting capital transaction, as income.

BOX 35.1

Full Range of the Constituents of FDI The definition of FDI as adopted by the IMF and practised internationally contains some elements which theoretically belong to portfolio category but within an intra-affiliate system of an MNC are instrumental in acquiring or furthering direct control. Some countries adopt even more liberal definitions. A full-blown definition of FDI contains the following elements in additional to the traditional controlling foreign equity:

a. Reinvested earnings of the foreign collaborator;
b. Inter-company debt transactions covering borrowing and lending of funds, debt securities and trade credits between related entities;
c. Proceeds of American Depository Recripts (ADRs) and Global Depository Receipts (GDRs)
d. Earnings of indirectly held FDI enterprises;
e. Short-and-long term loans;
f. Financial leasing;
g. Non-cash assets in lien of cash equity; and
h. Foreign venture capital investment.

FDI INFLOW IN INDIA: TRENDS AND PATTERN

QUANTITATIVE TRENDS

As already pointed out, the government has been encouraging FDI through various policy measures and incentives. The inflow has been the result of a large number of factors which are discussed later. FDI comes in the country from a number of sources and the inflow has taken place at varying rates. **Table 35.2** presents the picture since 1991. The Table points to the following trends:

- Except for the year 1995 and 1996, India's share in the total FDI inflow in less developed countries has been less than 1 per cent. During 1992-1999, the share value traces an inverted bell path (Ç) rising from 0.5 to 1.9 during 1992-1995, and falling to 1.0 over 1995-1999.
- Actual FDI inflow has been much less than the FDI approved by the government. Actual FDI as percent of FDI approved (called ***FDI Realisation Rate***) has been very low during 1991-96 and has picked up later. During 1991-2000, the realisation rate has been 39 per cent.

- *Approved* FDI also traces an inverted bell shape (Ç) whereas FDI inflow traces a general rising trend.
- Actual FDI as a proportion of total private investment (represented by gross domestic *capital formation* in the private sector) has been low. It rose consistently during 1991-97, dropped significantly in 1998 and has been slowly rising thereafter.
- FDI as a proportion of total foreign investment has been widely fluctuating. The fluctuation has been largely due to the volatility of foreign portfolio investment.

Table 35.2: Trend of FDI Inflow in India, 1991-2002

Year	India's share (%) in developing countries	FDI Approved (Rs' 000 cr)	Actual FDI inflow[1] (Rs' 000 cr.)	Actual FDI as % of gross private capital formation	FDI as % of total foreign investment[2]
1991	-	0.5	0.4	Neg	97.0
1992	0.5	3.9	0.7	Neg	56.4
1993	0.7	8.9	1.8	1.5	14.1
1994	0.9	14.2	3.3	2.5	25.6
1995	1.9	32.1	6.8	3.4	43.8
1996	1.7	36.1	10.4	4.8	46.0
1997	2.0	54.9	16.4	7.0	66.0
1998	1.5	30.8	13.3	5.1	10 2.5[3]
1999	1.0	28.4	16.9	5.7	41.6
2000	–	37.0	19.3	6.1	45.9

Notes: [1] Rounded Values

[2] Total foreign investment includes both foreign direct and portfolio investment

[3] Figure exceeds 100 as foreign portfolio investment is negative for the year

Source: Calculated from *Govt of India, Ministry of Finance, Economic Survey, various years.*

Keeping in view the country's share in the total FDI inflow of developing countries and the share of India's FDI in its total private investment, the FDI inflow in the country has been quite weak. This is in spite of the fact that India has a large domestic market and an open-door policy towards FDI. There are a number of deterrents and disincentives for FDI which are dealt with later in the Chapter.

Table 35.3 gives inflow of FDI in terms of US dollars as well as its composition in terms of the routes of inflow. The routes are discussed in the later sections of the Chapter. SIA/FIPB continues to be the most widely used route. In fact, there are few investment proposals which fit

within the standard norms of the RBI's automatic route. FDI through acquisition of shares has picked up since 1997-98 and at present it is as important as RBI's automatic route (also see **Cbapter 20**). FDI through NRIs has remained weak throughout the post reform period 1991-2001, except for the period 1995-97. Since 1995-96, FDI inflow has remained within the range $ 2-4 billion.

Table 35.3: Channel-wise Inflow of FDI (in US dollars) in India in post-reform years

($ million)

Year	FDI inflow through				Total FDI inflow
	SIA/FIPB	RBI	NRI	Share acquisition	
1991-92	66	–	63	–	129
92-93	222	42	51	–	315
93-94	280	89	217	–	586
94-95	701	171	442	–	1314
95-96	1249	169	715	11	2144
96-97	1922	135	639	125	2821
97-98	2754	202	241	360	3557
98-99	1821	179	62	400	2462
99-00	1410	171	84	490	2155
2000-01	1456	454	67	362	2339
2001-02	2221	767	35	881	3904

Source: RBI

FDI PERFORMANCE INDEX

United Nations Conference on Trade and Development (UNCTAD) periodically brings out the *World Investment Report* which, among other things, ranks different countries on the basis of FDI Performance Index. The Index is constructed on the basis of a set of FDI benchmark tools and measures which assess FDI-related performance of a country by standardising the inflows to the size of its economy. **The FDI Performance Index (FDIPI)** ***is defined as the ratio of a country's share in global FDI flows to its share in GDP.*** Thus,

$FDIPI = FDI_a/FDI_g$

GDP_a/GDP_g

Where, FDIa = FDI in counry 'a'

FDIg = FDI at the global level

GDPa = GDP of country 'a'

GDPg = world GDP

A low value of the index implies that the country receives less FDI than what is expected from its size relative to the world economy.

In the World Investment Report 2002, India's rank on the basis of the index stood at 119th position which was lower than China, Pakistan and even Sri Lanka. The value of Index for India was 0.2 compared to 0.4 for Sri Lanka, 1.2 for China, 5.9 for Hong Kong and 13.8 (highest score) for Luxemburg.

SOURCE PATTERN

Almost entire FDI in the country comes from advanced countries, notably USA, UK, Japan, South Korea, Germany, Netherlands, Australia and France (**Table 35.4**). These countries account for the largest number and value of the FDI proposals approved by the government. As already pointed out, the realisation rate of the approved investment has been low for almost all the source countries. However, these countries continue to be the principal sources of FDI even on *realised* FDI basis.

Table 35.4 Source pattern of FDI in India, 1991-2000 (top 10 source countries).

Source country	FDI approvals (total) (Rs.' 000 cr)
USA	57.0
Mauritius	33.7
UK	22.3
Japan	11.3
South Korea	9.8
Germany	9.0
Netherlands	8.8
Australia	6.8
France	6.5
Malaysia	6.0

Source: Secretariat of Industrial Approvals, Ministry of Industry, Govt. of India.

It is interesting to note that Mauritius is the second largest source country for FDI in India. In fact, a number of developed countries including the USA are finding it more convenient to route investment to India through Mauritius. A number of developed countries are sending FDI both directly as well as through Mauritius. The following are the main reasons for using Mauritius as the base:

- *Double taxation treaty* between India and Mauritius provides a tax shield to fore:gn investors.
- Mauritius is a **popular tax heaven** which provides tax advantage to foreign investors
- The *investment environment* in the country is liberal and disclosure requirements are comparatively less.
- It is *easier for the foreign investors to dispose off investment* in case they decide to quit.
- The country has *highly reformed administrative system* offering advantages to foreign investors in dealing with government agencies.
- Offshore companies incorporated in Mauritius after June 30, 1998 are subject to income tax at 15 per cent. The **Mauritius Income Tax (Foreign Tax Credit) Regulation 1996** permits such firms to claim **credit for actual foreign taxes paid.** If such proof of tax payment is not available, a deemed tax credit of 90 per cent of Mauritius tax payable is available. This reduces tax liability to only 1.5 per cent.

Due to these advantages, MNCs prefer to set up affiliates first in Mauritius and then invest in India (as well as in other countries) through these affiliates.

INDUSTRIAL AND GEOGRAPHICAL DISTRIBUTION

In response to profitability conditions, FDI policy of the government and the overall business environment, FDI over the years has permeated to almost all major sectors of the economy. However, the levels of FDI and its sectoral rates of growth widely diverge. The preference of foreign investors can be seen from the sectoral classification of FDI amounts approved by the government. The major recipient industrial segments since 1991 have been the following:

- Fuels
- Telecommunications
- Chemicals (except fertilizers)
- Transportation
- Electric equipments
- Metallurgical industry
- Glass
- Food processing industry
- Textiles
- Industrial machinery
- Paper and pulp
- Fermentation industries
- Sugar

More recently, the bulk of FDI is flowing into computer hardware and software, engineering industries, services, electronics and dairy products. Industrial distribution of FDI greatly depends upon the cost, demand and competitive conditions prevailing in the different industry segments. Availability of technical skills and infrastructure are also important influences on FDI in a particular segment. More factors are discussed in subsequent sections.

It is interesting to note that in a number of industrial segments, a significant proportion of FDI is proposed through fully-owned or 100 per cent subsidiaries. According to SIA data, during 1991-2000, 12.5 per cent (i.e. 2,334) of the total FDI proposals approved were in respect of 100 per cent subsidiaries and these proposals accounted for 34.2 per cent (or Rs 82,907 crore) of the

total FDI approved during the period. The major industry segments in which 100 per cent subsidiaries were approved with the above FDI include computer software industry, power projects, electric equipment, electronics, telecommunications, industrial machinery, textiles, food products, metallurgical industry, passenger cars, chemicals food products, hotels and restaurants and paper & pulp.

The state-wise distribution of FDI is highly skewed (**Table 35.5**). Maharashtra, Delhi, Tamil Nadu, Karnataka, Gujarat and Andhra Pradesh claim the lion's share. ***The states of Punjab and Haryana which have a high level of per capita income relative to other states are poor recipients of FDI. The share of these states in total FDI approved during 1991-2002 was only 0.7 per cent and 1.3 per cent respectively.***

Table 35.5: State-wise distribution of FDI approved during August 1991- May 2002

State	FDI approvals (Rs'000 cr.)	Per cent distribution
Maharashtra	48.7	17.4
Delhi	33.7	12.0
Tamil Nadu	23.2	8.3
Karnataka	21.6	7.7
Gujarat	18.5	6.6
Andhra Pradesh	13.1	4.7
M P	9.2	3.3
West Bengal	8.8	3.1
Orissa	8.2	2.9
Others	95.5	34.0
Total	280.4	100.0

Source: Prepared from SIA data

FDI in a particular state greatly depends upon its industrialisation level, availability of infrastructure, linkage with other industries and administrative efficiency of its government. Political environment, cultural factors, labour conditions and incentives offered by the state government also play a significant role.

CHANNELS AND CLEARANCE MECHANISMS FOR FDI

As already pointed out, FDI inflow can take place either as a ***greenfield*** (or fresh) investment leading to the creation of a new producing unit or through change of ownership in an existing enterprise. The change of ownership can take place through acquisition of shares of Indian

companies by non-residents under Section V of the **Foreign Exchange Management Act (FEMA), 1999.** Such acquisition has been included as a part of FDI since 1996. FDI can flow from foreign multinationals both in the public and private sectors, and non-resident Indians (NRIs) for which a separate category exists. As pointed out in **Chapter 20**, the main state agencies involved in the clearance of FDI through foreign collaborations are the following:

- Foreign Investment Promotion Board (FIPB)
- Foreign Investment Promotion Council (FIPC)
- Foreign Investment Implementation Agency (FIIA)
- Investment Promotion and Infrastructure Development Cell (IPID)
- Secretariat for Industrial Approvals (SIA)
- Reserve Bank of India (RBI)
- Business Ombudsperson

Under the present policy, there exist two major routes for clearance of FDI proposals in the country viz., the RBI route and the FIPB/ SIA route.

THE RBI ROUTE

Under this route, the foreign investor is required to first inform the RBI within 30 days of making the investment. Under the present (2002) policy, the following categories of investment can access this route:

- Proposals in the IT sector.
- All manufacturing activities in **Special Economic Zones** (except arms and ammunition, atomic substances, narcotics and hazardous chemicals, alcoholic drinks and cigarettes).
- Collaborations involving **royalty** payment upto two per cent on exports and one per cent on domestic sales in return for use of **trademark** or brand name of the foreign collaborator without **technology transfer**.
- Collaborations involving **royalty** upto eight per cent of exports and five per cent on domestic sales by wholly-owned subsidiaries to foreign parent companies without any restriction on the duration of the royalty payment.
- Investment by foreign **venture capital** companies subject to SEBI guidelines and sectoral limits on FDI.
- Foreign collaborations (with maximum foreign equity of 26 per cent) in the insurance sector, subject to permission to operate by **Insurance Regulatory and Development Authority** (IRDA).

RBI's automatic route is also available to foreign **technical collaboration** proposals from Indian companies (without foreign investment) involving a lump-sum payment of **technical know-** how fee upto Rs two million and/ or royalty upto eight per cent on exports and five per cent on domestic sales over a period of seven years from the date of commencement of production

or 10 years from the date of agreement. Foreign equity upto 100 per cent is allowed in most of the sectors which fall under the purview of the RBI route.

The Negative List under the Automatic Route

The RBI's automatic route is not available to certain categories of investments. These investments are contained in the 'negative list' of the RBI route. Some of these restrictions flow from the provisions of the industrial policy in force. Major foreign investment categories in the negative list are the following:

- All FDI proposals which require an industrial licence under **Industries (Development and Regulation) Act,** 1951
- Proposals which provide for more than 24 per cent foreign equity in enterprises manufacturing items reserved for the small-scale sector;
- Proposals in respect of an industrial activity which requires a licence in terms of the locational policy notified by government under the Industrial Policy, 1991;
- All proposals in which foreign firm already has a collaboration in the country;
- FDI by way of acquisition of shares in an existing Indian company by an NRI or a foreign corporate body;
- FDI proposals which are outside the notified sectoral policies or FDI limits or the areas in which FDI is not permitted;
- FDI proposals in which the foreign investor chooses the SIA/FIPB route rather than the RBI's automatic route;

SIA/FIPB Route

All proposals of foreign collaboration which are not allowed through the RBI's automatic route have to pass through the **Secretariat for Industrial Approvals (SIA)** and **Foreign Investment Promotion Board (FIPB)** for approval by the government. Such cases are decided on the basis of individual merit of each proposal in addition to certain basic criteria and guidelines common for all proposals. **Technical collaboration** proposals that have to pass through any of the above two routes must involve any of the following:

- Payment of technical knowhow fees; or
- Payment of drawing and designs; or
- Payment for engineering services; or
- Payment of royalty.

Technical collaborations involving payments purely for the use of brand names or **trademarks** are generally not viewed favourably. Payments for such items may 'however' be combined with any of the above four categories. All investment proposals providing for foreign equity share in excess of what is provided under the **Industrial Policy 1991** (as amended from time to time) has to pass through this route for government approval. The proposal, in order to be effective, has to meet the approval of FIPB or **Cabinet Committee on Foreign Investment** (CCFI).

FIPB is under the overall monitoring and control of the union industry minister. The composition of the Board is as follows:

- Industry Secretary (Chairman)
- Finance Secretary (Member)
- Commerce Secretary (Member)
- Secretary – Economic Relations (Ministry of External Affairs) (Member)
- Secretary (Deptt of Revenue) (Member)
- Secretary (Deptt of Small Scale Industries) (Member)

Thus, the Board has representation from all the concerned ministries. FIPB is empowered to consider proposals of investment upto Rs 6 billion (Rs 600 cr.) and can accept or reject such proposals on the basis of certain pre-laid criteria. If an application is recommended, it is forwarded to the Industry Minister for approval. While taking a decision on FDI proposals, it applies the following main criteria.

- The amount of foreign investment involved in the proposal;
- Employment potential;
- New technology proposed to be inducted;
- Export potential or commitment; and
- Overall contribution to economic growth of the country.

If the FIPB recommendation is approved by the Industry Minister, the approval is conveyed to the foreign company via **Secretariat of Industrial Assistance (SIA)**. Upon receipt of approval, the foreign company makes investment in the manner or the corporate form, as proposed and approved, in the Indian company (new or old) and receives equivalent equity shares. It is ***obligatory for the Indian company receiving foreign investment to inform the RBI about the receipt of investment from and issue of shares to the foreign investor as post-investment intimation.***

FDI proposals with foreign investment exceeding Rs 6 billion have to be forwarded by the FIPB to the **Cabinet Committee on Foreign Investment** which makes recommendations on the basis of specified criteria to the Industry Minister. FDI proposals involving foreign investment in public sector or sensitive areas are forwarded to **Cabinet Committee on Economic Affairs** which sends its recommendations to the Industry Minister. The subsequent procedure is the same as in the case of FIPB. The approval mechanism for FDI through alternative channels is exhibited in **Box 35.2**. The government has, over the time, considerably improved the working of FIPB mechanism.

There has been some attempt at standardising the criteria for approval. In 1999, **Foreign Investment Implementation Authority (FIIA)** was set up, independent of the FIPB, to act as a single point interface between foreign investors and government agencies. ***FIIA has been assigned the role of providing proactive one-step service to foreign investors to assist in obtaining approvals from various government departments and agencies and to sort-out various coordinational***

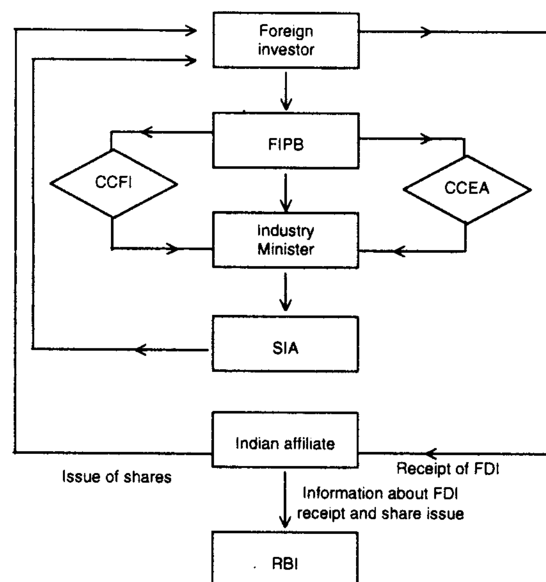
problems. However, there are still a number of inadequacies in this approval mechanism. Some of the commonly held criticism points are the following:

- Opaqueness in the guidelines and criteria for approval;
- Bureaucratic red-tapism and insensitivity of the government towards timeliness of investment;
- Long processing time;
- Involvement of a number of ministries and many a time application of contradictory criteria of different ministry representatives in evaluation of FDI proposals;
- Political considerations; and
- Lack of objectivity in clearing FDI proposals.

In the FIPB route, inter-ministerial conflicts are not uncommon. This speaks of the lack of coherence in the overall FDI policy and leads to protracted delays. In 1999, for example, FDI proposals received from Rothmans and British Gas were favoured by the Industry Ministry but disapproved by the Ministry of Finance. Similarly FDI proposal for Tata Airlines was favoured by the Industry Ministry but rejected by the Civil Aviation Ministry. This points to the need for greater inter-ministerial understanding of the FDI policy and its priorities.

BOX 35.2

The approval mechanism for FDI through FIPB/SIA route



Source: Joshi, Kishore and Deanne D'Souza (1999), 'Wanted: An India Brand Manager for FDI, *The Economic Times*, 26 February.

PREDOMINANCE OF THE FIPB ROUTE

In spite of the automatic and single window clearance, FIPB route continues to be the predominant route for FDI inflows. During 1991-2002, more than 90 per cent FDI wascleared through the

FIPB route, RBI and SIA claiming only a small share. This shows that in spite of substantial liberalisation of the policy towards FDI, government continues to prefer case-by-case decision of FDI proposals. As a matter of fact, automatic and single window routes are meant for FDI propφsals that are intended for specified sectors of government preference and where FDI is proposed on standard terms and conditions.

It is an equally important fact that FDI proposals do not come on standard terms and conditions. These terms and conditions often widely deviate from the ones that are contained in the various provisions of the FDI policy. As such proposals do not fit neatly into the standard FDI policy norms, these have to be processed individually on a case-by-case basis. There have also been cases where foreign investors, in spite of being eligible for the automatic RBI route, deliberately chose to apply through FIPB channel as the central government clearance reduces obstacles at the level of the state government. Agencies of the state government, particularly at the local level (like municipalities), are often observed to view with suspicion the automatic clearances and tend to apply their own norms more rigorously while granting clearances relating to land acquisition, water supply, power supply, wastage disposal etc. There are also compulsive reasons. A proposal once approved through FIPB has to pass through the same channel if re-submitted after revision or alteration.

The major pressure on the FIPB route in one of the reasons for longer delays or dilution of the quality of examination of the proposals. There is a strong need to widen the FIPB channel by including more and liberal alternative criteria for clearance of FDI proposals. Alternatively, more routes may be opened according to the specific sectors or operational norms for foreign investment.

DRIVERS OF FDI

Before commenting upon the existing FDI policy or suggesting measures to improve the inflow of FDI in the country, it is essential to understand what drives FDI in the country. FDI inflow in the country is the resultant of a multitude of domestic and international determinants, motives, inducements and deterrents at various levels ranging from the firms specific factors to the global business environment. Further, FDI flows are closely linked to other economic variables like **exchange rates, inflation**, interest rates and economic growth rate. The inflow is also affected by less measurable factors like market competition, business risk and uncertainty, political stability, range of business laws, **corporate governance** standards and quality of public administration. A schematic classification of such factors of determinants of FDI inflow is provided in the following sections.

FIRM-LEVEL MOTIVES AND FACTORS

External factors which affect the inflow of FDI in India, like in any other country, pertain at various levels ranging from those relating to the foreign investing companies, business environment in the foreign countries and global market and business conditions. The main firm-level motives and factors are the following:

Oligopolistic Reactions

A firm may plan to invest abroad in response to a similar move by a close rival in an **oligopolistic market situation.** Such a move may be considered essential to maintain competitive position in the market.

Market Dominance

A foreign firm may be motivated to invest abroad if it visualises that by doing so it will be able to establish a dominant position in the foreign market through its superior technology, better access to low-cost global finance and raw materials, worldwide marketing contacts, strong management resources or unique ***competitive advantages*** enjoyed by it.

Economies of Scale

A firm may have strong inducement to invest abroad for reasons of **scale economies.** Economies may accrue not only through larger scale of production but also from **horizontal and vertical or backward and forward industrial integration.** The scale economies can provide a better edge not only in the host country but also in the home country.

Maximising Gains on Monopolised Knowledge

A number of firms, over time, tend to develop strong advantages like technology, managerial expertise, business connections, marketing or customer understanding. In order to capitalise on this knowledge, a firm may seek new locations for operation. The knowledge of technology resulting from industrial research and development is often one of the leading factors behind FDI.

Internal Growth and Organisational Maturity

FDI by a firm may be straightway attributed to sustained internal growth so that international investment is the next logical stage of the firms' expansion. Organisational experience and maturity permit or facilitate the firms' decision to go international. In the absence of the **internalisation,** the firms' growth might be circumscribed.

The Internalisation Motive

A number of firms often confront **market failure** for their marketable knowhow, managerial skills, vital raw materials or even market knowledge. ***When open market doesn't exist for their resources which are often unique, firms are compelled to seek returns on these resources by internalising and utilising them through FDI by setting up affiliates abroad. This is particularly evidenced in knowledge-intensive industries.***

Resource-Seeking

Firms may enter foreign markets through FDI seeking cheaper factor (like labour or capital) or material resources: This reduces production costs which can make the firms competitive in third (foreign) markets. Cheaper resources could be the result of low wage-price profile of the economy, idle or unutilised resources or state subsidies. Resource-seeking FDI is most common in less developed countries.

Market-Seeking

This is a powerful motive that explains FDI in large developing countries like China, India, Mexico and Brazil. Large populations, particularly in the middle-class segment, provide a good attraction to FDI. Market seeking motive is greatly reinforced by the dominance motive for FDI.

MACRO-ECONOMIC DETERMINANTS

At the macro-economic level, the overall business environment, macro-polices and the growth performance of both host and home countries play a key role in stimulating direct investment flows. Within the overall stance of macro-policy, the policy specifically relating to FDI is important. For the home or originating country, FDI is a capital outflow adversely affecting its **balance of payments** (BOP) but in the long run, it might bring in interest and **dividend** repayment, improving **balance of payments**. FDI further impacts international trade, technology and financial markets in various ways and the direction of impact can be known through empirical research. For the host country, FDI inflow instantaneously improves BOP but causes outflow through interest, dividend and **royalty** payment repatriation. Thus, in addition to the internal firm-specific factors, macro-economic determinants have the environmental or enveloping influence on FDI. ***Firm-level motives generally do not work well in the absence of an enabling macro-economic environment.***

Trade Barriers

Trade and non-trade barriers erected by importing countries for revenue or **protection** purposes limit the efforts of firms to have presence abroad through exporting. To escape or bypass such barriers (like custom duties, **quotas, state trading**, subsidies, administrative or procedure controls, **orderly marketing arrangements**, credit restrictions and foreign exchange controls), foreign firms may enter the foreign market through FDI and market their products.

Comparative Advantage

Depending upon the nature of factor endowments and the quality of factor resources (including technology), different countries enjoy comparative advantage in different industrial segments. These segments offer production opportunities at lower costs and higher quality. Such advantages attract FDI and foreign firms as they promise a competitive edge.

Currency Premium

Countries with depreciating or weak currencies often attract export-oriented foreign firms. Depreciating host country currency reduces the dollar equivalent of contractual FDI and increases local currency equivalent of receipts in foreign exchange via exporting. Depreciating currency, however, also reduces the foreign currency equivalent of repatriable dividend and interest payments working in opposite direction. But, if the foreign firm intends to build itself through reinvested or **retained earnings**, this deterrent may lose its significance.

Business Environment in Host and Home Countries

A consistent and positive business environment in the host country, which is the resultant of a

large number of factors, offers a good inducement to FDI. The same environment in the home country, however, works in the opposite direction as the firms would like to focus on the markets of their own countries. ***Unstable business conditions or saturated markets in the home country often drives out FDI and discourages inward FDI.***

Market Forces and Globalisation of the Host Country

Freedom to private enterprise, competitive conditions and least interference of the state offer a good package of incentives for FDI. The extent of globalisation of the economy greatly matters. ***Foreign firms prefer globalised foreign locations as these provide scope for world-wide sourcing for key inputs and international marketing for the products.*** Decision to invest abroad greatly depends upon the perception and attitude of the top management regarding business environment, macro-economic policies and growth performance of the host-and home countries. In addition, decisions are also affected by the overall corporate strategy, business priorities and attitude towards risk and competition in the foreign markets.

FDI APPEAL OF THE INDIAN ECONOMY

It is often commented that India has a huge potential for FDI though current inflows are weak in relation to a number of emerging market economies. The economy provides a number of inducements and deterrents to FDI and the current inflows are the net result of these opposite factors. In fact the FDI appeal of the economy is greatly discounted by the deterrents which are pointed out towards the end of the Chapter. Some of the major appeals of the economy which point to the magnificent FDI potential of the economy are the following:

- Large size of the economy, particularly the large and growing middle class.
- Open door policy towards FDI.
- Rich resource base.
- Diversified industrial sector.
- Cheap and abundant availability of technical manpower at various levels of skills.
- Stable political system.
- Emerging trends towards deregulation, privatisation and globalisation.
- Large network of banking institutions.
- Liberal policy towards technology and capital goods imports.
- Gradual reduction in barriers to trade.
- High level of compliance towards the policies of multilateral economic institutions like WTO, IMF and World Bank.
- Comfortable size of **foreign exchange reserves** and **current account convertibility**.
- Price stability.
- Declining structure of interest rates in tune with global trends.

- Good international economic and political relations.
- Strong advertising media.
- Large base of existing MNCs in a number of industrial segments.

These characteristics point to good potential for FDI in the country. A number of good points of the economy are, however, not suitably projected to prospective foreign investors.

PRESENT POLICY TOWARDS FDI

Since the beginning of the process of economic reforms the policy towards FDI has been gradually liberalised. The liberalisation measures include opening up of more sectors to foreign investment, relaxation of restrictive conditions and clauses, simplification of procedures and permission for higher level of foreign equity. The present policy views FDI as a means to:

- Supplement domestic investment;
- raise the level of economic development;
- provide greater choice of products to consumers;
- ceate opportunities for technological upgradation;
- provide access to world class technology, managerial resources and corporate practices;
- cptimally utilise human and material resources;
- make Indian industry globally competitive;
- provide forward and backward industrial linkages ; and
- gain access to world-class goods and services.

The major aspects and characteristics of the policy are the following.

- Automatic route to FDI has been opened for proposals that belong to specified areas and on standard terms and conditions as laid down in the policy. Under this route, the foreign investor has only to inform the RBI within 30 days of bringing the FDI and again within 30 days of issue of shares. The route has been discussed earlier in the Chapter.
- Non-banking financial companies (NBFCs) can hold 100 per cent foreign equity if these are **holding companies**. For other fund-based NBFCs, permitted foreign equity share is linked to the amount of foreign investment as shown in **Table 35.6**. Similar provisions exists for non-fund based NBFCs.

Table 35.6: Relation between FDI size and permitted foreign equity share in fund-based NBFCs

Amount of FDI ($ million)	Foreign equity share permitted (%)
0.5 (upfront)	£51
5.0 (upfront)	>51 but £75
50.0 ($7.5 m upfront, balance in 24 months)	>75 but £100

Source: pared from *Govt of India, (2003), India 2003: A Reference Annual* (New Delhi: Govt of India) p. 529

- In addition to selected categories of NBFCs, 100 per cent foreign equity is allowed in the following segments.
  - B to B e-commerce
  - Oil refining
  - Advertising
  - *Special Economic Zones* (all types of manufacturing except a small negative list) Films
  - Selected activities in the telecom sector
  - Airports
  - Courier services
  - Integrated townships including housing, commercial complexes, hotels, ports, resorts and regional level urban infrastructure
  - Mass rapid transport systems
  - Hotels and tourism
  - Drugs and pharmaceuticals.
- FDI upto 49 per cent from all sources is permitted in private banking sector on the automatic route.
- **Dividend balancing requirements** (**DBRs**) have been lifted from FDI in a number of consumer items.
- Automatic route has been made available to FDI in the IT sector even if the foreign investor already has a **joint venture** or **technology transfer** agreement in the same field.
- FDI upto 26 per cent is allowed under automatic insurance sector subject to licensing provisions.
- NRI investments in **foreign exchange** have been made fully repatriable.
- International financial institutions (like ***ADB***, ***IFC***, etc.) have been allowed to invest in Indian companies through automatic route subject to SEBI/RBI guidelines and sectoral limits on FDI.

There is no doubt that the policy of the government is getting progressively liberalised. However, in addition to the specific FDI policy provisions, what is more fundamentally required is the overall good environment for foreign investment in the country. In the absence or deficiency of an overall healthyenvironment liberalisation of the FDIpolicy may not prove effective. It is a fact that inspite of the liberal measures, both FDI realisation rate and the qualitative inflows of FDI as already pointed out are weak.

DETERRENTS TO FDI

Weak FDI inflow in the face of a liberal policy can be explained in terms of a number of obstacles which act as deterrents to foreign investment in the country. ***The deterrents are composed of a set of obstructive factors which greatly offset the inducement effect of the FDI policy. Most of***

these deterrents are endemic and persistent. Some of the leading deterrents are the following:

- Bureaucratic and procedural complexities;
- infrastructural bottlenecks;
- high rate of direct and indirects taxation;
- highly rigid and protective labour laws;
- high import tariff and other import restrictions;
- poor standards of governance;
- weak intellectual property regime;
- high level of corruption; and
- lack of focus and transparency in macro-economic policies.

Most of the impediments are built into the economic, political and social system of the country and are subject to slow improvement. In order to increase the inflow of FDI, strong administrative and institutional reforms are required to break the barriers.

Key Terms

Foreign direct investment (FDI)
Foreign portfolio investment (FPI)
Licensing
Joint venture
Franchising
Technical collaboration
Buyback
Management contract
Sub-contracting
Strategic alliance
Cartel
Turnkey project
Merger
Acquisition
Trade credit
American Depository Receipts (ADDRs)
Global Depository Receipts (GDRs)
Capital formation
Special Economic Zone (SEZ)
Royalty
Trademark
Technology transfer
Venture capital
Technical know how
Exchange rate
Inflation
Corporate governance
Economies of scale
Internalisation
Horizontal integration
Vertical integration
Forward integration
Backward integration
Balance of payments (BOP)
Quotas
State trading
Orderly marketing arrangements (OMOs)
Retained earnings
Privatisation
Globalisation
Foreign exchange reserves
Current account convertibility
Holding company
Dividend balancing requirements (DBRs)
Intellectual property

Supplementary Reading

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Long Questions

1. Discuss the environment for foreign direct investment in the country. Why is the inflow of FDI weak in spite of a welcoming FDI policy?
2. Account for the main factors behind low FDI realisation rate. Suggest measures to increase the inflow of FDI in the country.
3. Discuss the FDI appeal of the Indian economy. How can the FDI potential of the country be realised?
4. Discuss the benefits and costs of FDI. What is the clearance mechanism for FDI in the country? Suggest methods to improve the mechanism.

Short Questions

1. What is the meaning of 'direct' in foreign direct investment (FDI)? How is FDI different from foreign portfolio investment?
2. Explain FDI as a 'package'. What are the components of the package?
3. What are the different corporate forms of FDI? What are foreign-controlled rupee companies?
4. Give three striking features of the trend of FDI inflow in India in the post-reform years.
5. What is FDI Performance Index?
6. 'Mauritius is a small country but is among the top three source countries for FDI in India', Explain.
7. Explain the nature of SIA/FIPB and RBI as the routes and clearance mechanism for FDI in India.
8. Give five main deterrents to FDI in the country.
9. Explain the major weak areas of FDI policy of the country.

Practical Assignments

1. Hold a group discussion on: *'How to Make India an FDI-Friendly Destination*'?
2. Hold a brain-storming session to trace the links between foreign trade and foreign direct investment.
3. Hold a panel discussion on 'How to attract FDI in the small scale sector'.
4. Conduct a field project involving a survey of recently established enterprises with FDI with a view to find out the main difficulties faced in the process of getting foreign investment cleared by the government.