Impact of Foreign Direct Investment in India

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Abstract: Foreign direct investment (FDI) is the important catalysts for economic growth in developing countries. The association between Foreign Direct Investment (FDI) and economic growth is a subject of great interest in the field of international development. In the scenario of volatile flows of global capital, the stability of FDI emerges as an effective channel to faster growth in developing countries, particularly in relation to Least Developed Countries. After getting independence in 1947, the government of India envisioned a socialist approach to developing the countries economy - broadly based on the USSR system. The government decided to adopt an economic agenda that would follow five year plans. Each five year plan was focused on certain sectors of the economy that the government felt needed to be developed for the countries progress. The government followed an interventionist policy and dictated most of the norms of running a business by favoring certain sectors and ignoring others. Foreign direct investment (FDI) is a direct investment into production or business in a country by an individual or company of another country, either by buying a company in the target country or by expanding operations of an existing business in that country. Foreign direct investment is in contrast to portfolio investment which is a passive investment in the securities of another country such as stocks and bonds. This manuscript highlights various aspects affecting Indian Economy with respect to foreign direct investment.

Keywords: Foreign Direct Investment, Economic Growth, Impact on India

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I. Introduction

The gains from FDI inflows are unquestionable as it contributes to economic growth through an increase in productivity by providing new investment, better technologies and managerial skills to the host countries. The impact of FDI on economic growth depends on the degree of capacity of the host country to use FDI efficiently. Similarly, trade liberalization may facilitate economic growth through efficiency in production by utilizing the abundant factors of production more effectively and absorbing better technologies from advanced countries. On the one hand, it may harm the growth process through various forms of macroeconomic instability such as terms of trade deterioration and balance of payments crisis. Therefore, it is a challenge for developing countries to find out the appropriate direction of the role of FDI and trade liberalization in economic growth.

The basic shortcoming of conventional neo-classical growth models, as far as FDI is concerned, is that long-run growth can only be achieved by technological progress, which is considered to be exogenous factor. FDI would only affect output growth in the short run and, in the long run, under the conventional assumption of diminishing returns to capital inputs with a given technology, FDI would have no permanent impact on output growth. Within the new growth framework, FDI is treated as one of the factor inputs along with labor and capital and is expected to promote growth in the long run. Whether technological progress is best described as exogenous to the world as a system, the role of FDI in diffusing technology to developing countries? Consequently, a positive relationship between FDI and long run growth in a developing host country is expected.

It should be pointed out that the direction of causation may run either way. The FDI may be drawn to regions of faster growth or greater potential because their growth prospects have made it more attractive to foreign TNCs. De Mello (1997) envisions a case in which the size of the consumer market in a recipient economy is getting larger, as a result of faster growth leading to rapid increases in the potential purchasing power of consumers in a host country. Consequently, it is tenable that growth itself may be an important determinant of FDI in addition to those listed above.

Foreign Direct Investment (FDI) broadly encompasses any long-term investments by an entity that is not a resident of the host country. Typically, the investment is over a long duration of time and the idea is to make an initial investment and then subsequently keep investing to leverage the host country’s advantages which could be in the form of access to better (and cheaper) resources, access to a consumer market or access to talent specific to the host country - which results in the enhancement of efficiency. This long-term
relationship benefits both the investor as well as the host country. The investor benefits in getting higher returns for his investment than he would have gotten for the same investment in his country and the host country can benefit by the increased know how or technology transfer to its workers, increased pressure on its domestic industry to compete with the foreign entity thus making the industry improve as a whole or by having a demonstration effect on other entities thinking about investing in the host country.

II. Historical Economic Perspective

Until 1991, India was primarily a closed economy. The industrial environment in India was highly regulated and a license system - known as “licence raj” - was in place to ensure compliance with the government regulations and directives. Under the Industries Development and Regulations act (1951) starting and operating any industry required approval - in the form of a licence - from the government. Any change in production capacity or change in the product mix also called for obtaining government approval. This led to the development of increasingly complex and opaque procedures for obtaining a licence and led to a burgeoning bureaucracy. The licence system thus shifted lot of power and perverse incentives in the hands of file pushing bureaucrats (or “Babus”). This directly led to increased corruption as the procedure for obtaining a licence was vaguely defined and left open to individual interpretations. In addition, there was no monitoring system in place to ensure speedy disposal of licence applications. Also, the labor markets were highly regulated and the government did not allow the companies to lay off its workers. This meant that even in severe downturns the companies kept bleeding but could not rationalize its workforce. Eventually these companies - majority of them public sector companies - would become chronically sick and the government kept subsidizing them at huge costs to the taxpayer.

One draconian measure was the introduction of the Foreign Exchange Regulation act (FERA) of 1973 which curtailed foreign investment to 40% in Indian companies. This had a very adverse impact and companies such as Coca-Cola and IBM exited the country. The impact of this could be seen in the slow growth of the Indian economy as compared to its neighbors over a 30 year period. Table 1 shows a comparison between the Indian industrial development and that of some of the other developing countries in the region. From the data it is clear that India lagged behind other countries in its growth rates over a sustained period of time and this led to increased poverty. Surprisingly, there were some very strange reasons given for this lag in economic performance. The excuses went to such ridiculous extents as to the development of a “Hindu rate of return” theory which stated that the “Hindu rate of return” was lower than that of the western nations and thus a comparison of India’s economic return with that of western nations was inappropriate.

The government also adopted a policy of import substitution and the idea was to help the domestic industry improve in a safe environment until the local industries could compete internationally. This was implemented by levying extremely high tariffs or completely banning imported goods. Table 2 in the appendix shows the nominal tariff rates in effect in 1985. Due to the government’s protection most of the industries failed to catch up with the technological innovations taking place around the world. As they were shielded from imports due to extremely high import tariffs the industries had no incentive to improve their operations. This led to a vicious circular logic where the tariffs were not reduced since domestic companies could not compete and the high tariffs prevented industries from innovating. Corruption and opacity of the system added to the difficulties and the situation became extremely complex.

Historical Aspects Of Fdi In India

Starting with the market reforms initiated in 1991, India gradually opened up its economy to FDI in a wide range of sectors. The “licence-raj” system was dismantled in almost all the industries. The infrastructure sector which was in dire need of capital welcomed foreign equity. FDI was especially encouraged in ports, highways, oil and gas industries, power generation and telecommunication. Consumer goods and service sector which was once completely off-limits for foreign equity was also gradually opened up. The reserve bank of India set up an automatic approval system which allowed investments in slabs of 50, 51 or 74% depending on the priority of the industry, as defined by the government. The foreign investment limits were slowly raised and some sectors saw the limits raised to 100%.

The reforms thus led to a gradual increase in FDI in India. Table 3 shows the FDI flow to India after the structural reforms began in 1991. As can be seen from the table, FDI increased from a non-existent value in the start to about $4 billion a year. It should be noted that till 2000, the figure of FDI reported actually understimates the amount of FDI according to IMF definition. This is because the Indian government had its own definition of FDI and did not include heads like reinvested earnings, proceeds of foreign listings and foreign subordinated loans to domestic subsidiaries. But, the government recognized this problem and after a study undertaken in 2003, the standard definition of FDI as suggested by the IMF was adopted by the Indian government.

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Current Scenario

More and more multi-national corporations have come to realize that India is the place to be. India is the world’s second largest economy (in terms of population) with a total population of just over one billion, forth largest in the world in terms of GDP13 ($3.3 trillion) and ranked twelfth in the world in terms of Gross National Income14 ($570 billion). It is potentially a very fast growing market and all the multi-national corporations realize the fact that to take advantage of this ever growing economy they need to present in the country.

It has been more than a decade since the reforms first began and today in the 21st Century, India has come a long way from the early days of licence raj and Babus. India has been able to make its mark in the world standing as a lucrative country for FDI by becoming more and more competitive on the world standard.

According to the A. T. Kearney’s report on the FDI Confidence Index15 in October 2004, India was ranked third just behind China and the United States as the choice country for foreign investment up from its previous rankings of sixth in 2003 and fifteenth in 2002.

Just looking at pure numbers the amount of FDI in the last couple of years have gone up from $2.3 billion in the year 2000 to $3.4 billion in 2001 and 2002 and eventually $4.3 billion in the year 200316 and still growing.

All this growth has been achieved through a number so factors amongst which the main factors are proactive government policy and regulations and favorable economic conditions. One example would be the favorable conditions such as highly educated but comparatively cheap labor force for outsourcing to India, services such as customer service call centres and research and development facilities, which paved the way for so many future incidences of investment. Other examples include the adoption of numerous Double Taxation Avoidance Agreements with other countries, creation of numerous Export Processing Zones and Special Economic Zones, liberalization of trade policies, relaxation in import tariffs in almost all areas and on all products, increased simplification of the whole investment process by placing more and more sectors on the automatic approval route with only limited sectors requiring licensing, provision of easy availability of information on policies and procedures of FDI and most of all creation of independent institutions and authorities to assist in the prompt and smooth flow of FDI into the country.

Some of the key highlights of the current procedures and policies of Investing in India are as follows17:

a) FDI of up to 100% is allowed in numerous sectors and activities which include most manufacturing activities, non-banking financial services, software development, hospital, private oil refineries, electricity generation (non-atomic) / transmission / distribution, roads & highways, ports & harbors, hotel & tourism, research and development etc. Only a have been limited to industrial licensing and a couple being total prohibited e.g. atomic energy, railway transport18 etc. Other places where 100% FDI is permitted are for setting up Special Economic Zone (SEZ) Units and 100% Export Oriented Units (EOU).

b) There are multiple forms of entry for a corporation depending on its needs and requirements which include entry through setting up Joint Ventures, Wholly Owned Subsidiaries, Liaison / Representative Office, Project Office or Branch Office.

c) Liberal foreign exchange regulations, under the rule of the Central Bank, namely the Reserve Bank of India e.g. all foreign investment and dividends declared thereon is freely repatriable unless otherwise specified under a particular scheme and through an authorized dealer.

d) Favorable policies for Foreign Institutional Investors (FIIs) looking to just invest and trade in as well as out of the Stock Exchange under the Portfolio Investment Scheme (PSI). They have the option of investing in both equity and debt instruments, the only catch being that the investment has to be split in the ratio of 70:30, and also the other option of declaring themselves purely interested in debt instruments and then becoming a 100% debt FII.

e) A mature and favorable taxation system with low customs and excise duties and low corporate taxes. It caters for numerous tax holidays or rebates depending upon the sector of investment and geographical location e.g. there is a tax holiday of 10 years for foreign investment in infrastructure projects, various projects taken up in certain backward areas in the North Eastern States and Sikkim, units located oriented etc. Moreover India has already entered into a Double Taxation Avoidance Agreement (DTAA) with 65 other countries, under which the income generated in India will be taxed in India and then would not be re-taxed in the home country of the investor, only the difference in the tax rate between the home country and India would be payable.

f) Keeping in mind the growing concern over intellectual property rights, India has been prompt to enact numerous rules and regulations e.g. The Patents Act, The Trademarks Act, The Geographical Indicators of Goods Act and The Designs Act.

g) To assist in providing a prompt and smooth investment process the Indian
Government has set up numerous independent institutions e.g. The establishment of Foreign Investment Implementation Authority (FIIA) to assist in the prompt implementation of FDI approvals, the formation of the Foreign Investment Promotion Board (FIPB) to assess various FDI proposals and to cater to the grievances and complaints of potential and current investors the appointment of a Business Ombudsperson and Grievances Officer-Cum-Joint Secretary in the Ministry of Commerce and Industry.

h) Also, to ensure adequate and up-to-date information on current policies and procedures is available at all time to investors various points of call have been set up which can be easily accessed e.g. the Secretariat for Industrial Assistance (SIA) has been set up for this particular purpose. Other means are through the internet on various websites (e.g. http://dipp.nic.in), online chats, bulletin board services, frequent publications and monthly newsletters.

i) Focusing in on more recent events in India and specifically in the Banking and Insurance Sector, in previous years the FDI limit in private sector banks was raised to 74% from the existing 49% and the insurance sector to be hiked from 26% to 49%. However, there was a caveat of only having 10% voting rights irrespective of the shareholding, which was seen as a major constraint. In 2005, a new regulation namely the Banking Regulation (Amendment) Bill 2005 has been proposed which will give private investors voting rights which will be in line with their current shareholding. Once this regulation is given the nod, it is likely to increase foreign investment significantly.

India compared with China

Since India and China are perceived to be the two most attractive locations for FDI in the future apart from the United States, it would be good to just compare some key statistics of the two countries.

<table>
<thead>
<tr>
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<th>India</th>
<th>China</th>
</tr>
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<tbody>
<tr>
<td>Population (2005 est.)</td>
<td>1 billion</td>
<td>1.3 billion</td>
</tr>
<tr>
<td>Labor force (2004 est.)</td>
<td>482.2 million</td>
<td>760.8 million</td>
</tr>
<tr>
<td>Population growth rate (2005 est.)</td>
<td>1.4%</td>
<td>0.58%</td>
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<tr>
<td>Infant Mortality (per 1,000 live births)</td>
<td>56.29 deaths</td>
<td>24.18 deaths</td>
</tr>
<tr>
<td>Population below poverty line (2001/2 est.)</td>
<td>25%</td>
<td>10%</td>
</tr>
<tr>
<td>GDP ($, 2004 est.)</td>
<td>3.319 trillion</td>
<td>7.262 trillion</td>
</tr>
<tr>
<td>GDP - real growth rate (2004 est.)</td>
<td>6.2%</td>
<td>9.1%</td>
</tr>
<tr>
<td>Foreign Direct Investment ($, 2003)</td>
<td>4.269 billion</td>
<td>53.505 billion</td>
</tr>
<tr>
<td>No. of projects (Jan-Sep 2004)</td>
<td>986</td>
<td>2,520</td>
</tr>
<tr>
<td>Top 3 FDI destination sectors</td>
<td>IT &amp; software</td>
<td>Chemicals &amp; industrial goods</td>
</tr>
<tr>
<td>Top 3 business functions</td>
<td>Research &amp; development</td>
<td>Manufacturing</td>
</tr>
<tr>
<td>Top 3 source countries</td>
<td>US, UK, Germany</td>
<td>Japan, US, Germany</td>
</tr>
</tbody>
</table>

Source: CIA World Fact Book 2005

On comparing the key attributes between China and India, China comes out more favorable in terms of market size and growth potential, access to export markets, higher government incentives, financial/economic/political/social stability, quality of life and infrastructure availability whereas India comes out on top with respect to providing a highly educated workforce, management talent, rule of law, transparency, fewer cultural barriers and a relatively strong regulatory environment. Based on these different attributes investors perceive China and India as two different markets for potential investment. India is identified as the upcoming business process and IT services provider and there are more investments in sectors and activities such as IT & software, business services and research & development. China is recognized as the fastest growing consumer market and the world’s leading.
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Recent Challenges

As explained above, India is definitely a lucrative place for FDI, but there are certainly some challenges and areas for improvement still present. Until, these areas are honed to perfection, India will not become the number one place for FDI. Some of the key areas are listed below:

a) Political risk: Amongst the top items is the political instability of the country. On one hand the fact that India is the world’s largest democracy does add a sense of pride and security, but the hard reality is that there is insurmountable instability present. Just the fact that the past two governments have been based on coalitions between a few parties is reason enough to be skeptical. Moreover, each new government has certain policies which are different from the ruling government and if there is frequent change in government, this will lead to changes in policy and increased uncertainty. Just take the example of the last elections in 2004, where by a sudden change of event the Indian National Congress was able to come into power by forming a coalition government, by soliciting the vast majority of the poor people of the country, surprising the incumbent government which was relying heavily on a fast growing economy, increased privatization and a thriving middle class.

b) Bureaucracy: Another very important factor that affects India’s competitiveness on the world standing is the Bureaucracy. Particularly in the FDI process the Indian Government has already invested a lot of time and effort but there is still a lot of room for improvement in the identification, approval and implementation process e.g. creating more centres for assistance, more user friendly processes, effective use of technology, being as clear as possible leaving no room for interpretation, assisting in identifying new areas for investment etc.

c) Security risk: Another important factor that needs to be handled with care and worked upon is the ever present security risk. This risk includes the geopolitical risk with Pakistan and the ongoing dispute over the Kashmir issue, which on numerous occasions has brought these two countries armed with nuclear weapons to the brink of war. The other security risks would include incidences of domestic terrorism, not only in the Kashmir valley but also in Assam, Manipur and Nagaland, where numerous separatists group operate. 11 WMRC Country Report: India (Country Analysis and Forecast)-10 May 2005, World Markets Research Centre

d) Cost advantage: One of the attractions of India is the lower cost advantage as compared to most western economies. The Indian Government would have to work on creating an atmosphere where this advantage can be maintained else it might result in India not seem as attractive. One of the key drivers would be to try and control inflation because if there is increased level of inflation then there would be increased costs and reduced returns. Other factors which would act in similar respects would be increased tax incentives and reduced tariffs.

e) Intellectual Property  (IP) Rights & Piracy: With the increased instances of Piracy around the world and the extreme importance placed by Investors on maintaining their IP rights, this is definitely an area which needs improvement in India. India has begun instilling intellectual property rules and regulations into the country but there is still a long road ahead. The main area for improvement in this respect is the enforcement, which is the most crucial part but the weakest at present in the country. The enforcement of IP rights included the increased crackdown in the market pirated and knock-downed good.

f) Privatization and deregulation: Increased privatization of various sectors would definitely enhance the attractiveness of India as an FDI destination. India has already taken steps to privatize areas such as electricity, telecommunication etc. and increase the foreign holding capacity in sectors such as banking and insurance which is a first step.

g) Infrastructure: It definitely is an added bonus to the investor if there is adequate infrastructure present in the country. In India there is substantial lack of robust infrastructure around the country, e.g. proper roads, highways, adequate supply of clean water, uninterruptible supply of electricity etc. But there is a flipside to this lack of Infrastructure. Quoting the prime minister Dr. Manmohan Singh on a recent speech at the NYSE23,

Fdi And Economic Growth

The gains from FDI inflows are unquestionable because it contributes to economic growth through an increase in productivity by providing new investment, better technologies and managerial skills to the host countries. However, the effect of FDI on domestic investment is an issue of concern because there is a
possibility of displacement of domestic capital due to competition from foreign investors with their superior technologies and skills. Thus, the ultimate impact of FDI on economic growth depends on the degree of capacity of the host country to use FDI as efficiently as possible. Similarly, trade liberalisation may facilitate economic growth through efficiency in production by utilising the abundant factors of production more effectively and absorbing better technologies from advanced countries on the one hand, it may harm the growth process on the other through various forms of macroeconomic instability such as terms of trade deterioration and balance of payments crisis. Thus, it is a challenge for developing countries to find out the appropriate direction of the role of FDI and trade liberalisation in economic growth.

As part of developing countries, South Asian economies were also concerned with issues pertaining to foreign private capital inflows and trade liberalisation initially. However, they later moved to liberalise their trade and investment policies to include various investment incentives, particularly, for foreign investors. Along with these, South Asian countries have maintained high and steady economic growth, single-digit inflation rate; they have a growing domestic market, a large number of low-paid workers with growing number of skilled personnel and a more favorable investment climate. As a consequence, South Asia, as a group, has been successful in attracting a significant amount of FDI and raising its volume of trade (export plus import) as percentage of GDP during the last two decades. The question which naturally arises here is whether the increase in growth is brought about by FDI inflows. Therefore, it is important to explore the impact of FDI on the growth process, quantitatively, in South Asian economies for a better understanding about the linkages among FDI and economic growth.

Foreign Direct Investment (FDI) is often seen as an important catalyst for economic growth in developing countries. Development economists have long argued that countries pursuing outward-oriented development strategies are more likely to achieve higher rates of economic growth than those that are internally focused. A number of studies have examined the relationship between inward foreign direct investment (FDI) and economic growth in the developing host countries. A generally accepted conclusion is that FDI has played a significant role in promoting economic growth in host countries because FDI represents “the transmission to the host country of a package of capital, managerial skills, and technical skills” (Dattaray 2003). A significant finding of previous studies is that the economic and technological conditions of a recipient economy manipulate the extent to which FDI contributes to growth.

### FDI Statistics / Fact Sheet in India

<table>
<thead>
<tr>
<th>SHARE OF TOP INVESTING COUNTRIES FDI EQUITY INFLOWS (Financial years):</th>
<th>Amount Inflows in Rupees (US$ in million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>MAURITIUS</td>
</tr>
<tr>
<td>2.</td>
<td>SINGAPORE</td>
</tr>
<tr>
<td>4.</td>
<td>JAPAN</td>
</tr>
<tr>
<td>5.</td>
<td>U.S.A.</td>
</tr>
<tr>
<td>6.</td>
<td>NETHERLANDS</td>
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<tr>
<td>7.</td>
<td>CYPRUS</td>
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<tr>
<td>8.</td>
<td>GERMANY</td>
</tr>
<tr>
<td>9.</td>
<td>FRANCE</td>
</tr>
<tr>
<td>10.</td>
<td>SWITZERLAND</td>
</tr>
</tbody>
</table>

TOTAL FDI INFLOWS FROM ALL COUNTRIES: 121,069 (22,482) 147,518 (24,299) 35,663 (5,309) 1,079,093 (223,011)

[Source - Reserve Bank of India]
III. Conclusions

The main objective of this work is to analyse the relationship between FDI and economic impact in India. Foreign investment was introduced in 1991 under Foreign Exchange Management Act (FEMA), driven by then finance minister Manmohan Singh. As Singh subsequently became the prime minister, this has been one of his top political problems, even in the current times. India disallowed overseas corporate bodies (OCB) to invest in India. India imposes cap on equity holding by foreign investors in various sectors, current FDI in aviation and insurance sectors is limited to a maximum of 49%. Starting from a baseline of less than $1 billion in 1990, a 2012 UNCTAD survey projected India as the second most important FDI destination (after China) for transnational corporations during 2010-2012. As per the data, the sectors that attracted higher inflows were services, telecommunication, construction activities and computer software and hardware. Mauritius, Singapore, US and UK were among the leading sources of FDI. Based on UNCTAD data FDI flows were $10.4 billion, a drop of 43% from the first half of the last year.

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