Chapter IV

THEORIES AND POLICY OF FDI IN INDIA

The existing theories Government policies of FDI will help us to clearly understand the role of FDI in economic process. Theories of FDI assert that the basis for such investment lies in the transaction cost of transferring technical and other knowledge, and market imperfections. The four FDI theories are briefly discussed below.

Hymer-Kindleberger Theory

According to the Hymer-Kindleberger theory (1969), the foreign owned firm would make an investment in the host country only if it possesses some compensating indigenous firms. This is however, not a sufficiency condition of FDI since the firms has the option of licensing the advantage (technology) to an indigenous producer or exporting the product to host country. Clearly certain other conditions have to be satisfied for FDI flows to arise. Three such conditions are:

(i) The advantage is internally transferable (it can be exploited by a subsidiary of the parent firm, without any additional cost to the parent firm or to the subsidiaries already exploiting it);

(ii) It is more profitable for the foreign owned firm to exploit the advantage itself than to license an indigenous producer
(because of imperfections in the market for knowledge, and heavy to heavy firm to firm transfer costs of the advantage); and

(iii) Exporting the product to the host country is not possible or unprofitable due to tariff or transport cost barriers.

**General Theory**

The general theory of Transnational Corporations (TNCs) traces their emergence to internationalization of markets (1991). The theory is based on the three simple postulates as given below:

(i) Firms maximize profits in a world of imperfect markets;

(ii) When markets in intermediate products are imperfect, there is an incentive to by-pass them by creating internal markets (within the firm); and

(iii) Internationalization of markets across national boundaries generates MNCs.

It is argued that the location strategy of a vertically integrated firm is determined mainly by the interplay of comparative advantage, barriers to trade and regional incentives to internalize. The firm will be multinational whenever these factors make it optimal to locate different stages of production in different countries.
This theory predicts that unless either transport costs are very low, returns to scale (at the plant level) are high, or the comparative advantage of one location is very significant, the international acquisition and exploitation of knowledge will normally involve international production through a world-wide network of basically similar plants. Thus, prior to Second World War, multi-nationality was a by-product of the internationalization of intermediate product markets in a multistage production process, and in post-war period it is a by-product of internationalization of markets in knowledge.

**Kojima Theory**

The **Kojima theory (1960-1970)** argues that Japanese type FDI would upgrade the industrial structures of both Japan and the host country, or play the role of initiator or tutor in the industrialization of less developed countries. Lots of Japanese small and medium firms in the host countries were expected to provide production and technological linkages with local firms. Thus, the theory presents the triple effect viz., investment, trade and industrial restructuring with mutual benefit. The triple effect can be seen in the textile industry typically, but not so much in the automobiles and electrical appliances industries, which contributed to upgrade local industry ‘to some extent’ but much lesser in the exports of these manufacturers.
Dunning’s Electric Theory

Dunning’s electric theory of international production (1988) explains both the ways in which overseas markets are served by enterprises of different nationalities and the industrial and geographical composition of such activities. According to this theory, a firm will make a direct investment in a foreign country if following three conditions are satisfied.

(i) It possesses same ownership advantage vis-à-vis firms of other nationalities in serving particular markets;

(ii) It is more beneficial for the firm to use the advantage itself than to sell or lease them to foreign firms; and

(iii) It is profitable to the enterprise to utilize these advantages in conjunction with at least some factor inputs outside the home country. The greater the ownership advantage of the enterprise, the more the incentive to exploit these themselves. The more the economies of production and marketing favour a foreign location, the greater is the inducement of FDI.

Location specific or country specific advantages have an important bearing on FDI. Such advantages of particular host countries make FDI in themselves preferable to not only other potential host countries, but also to domestic investment. An important determinant of FDI is the ability of the firm to generate
ownership advantages, which are best exploited by the firm in foreign rather than in domestic investment. This way, the electric theory is able to provide an explanation for differences in the industrial pattern of outward FDI of different industrialized countries. While the electric theory provides a good explanation of the decisions of firms to invest abroad, it seems that the theory does not cover the competitive FDI, induced by trade restrictions, when a country imposes restrictions on imports of a particular industrial product there is obviously inducement to multinational firms of the industry to invest in that country. If one or two firms invest, the other must also do so to counter competition and ensure their market share, even if the returns to investment are negligible, particularly for late entrants. Multinationals may also enter a market today even if it is not profitable to do so, because they foresee future growth and want to have the first entrant advantage.

The rich literature on FDI flows, causes and effects suggests that the applicable theories lend themselves to organization into three schools – the two traditional schools of development thinking are the dependency and the modernization school and the third is the integrative school. They are discussed here in detail.
The Dependency School

The dependency school, which flourished between 1960s and 1980s, seeks to achieve more equal wealth, income and power distributions through self-reliant and collective action of developing nations.

Dependency theories see the cause of underdevelopment primarily in exploitation by the industrialized nations. The dependency school’s major contribution to the FDI field is its focus on the development models. Two sets of theories within the dependency school have emerged to explain the causes of underdevelopment and dependency:

(i) the dependency sub-school; and

(ii) structuralist sub-school

i) The dependency sub-school

The dependency sub-school states that developing countries are exploited either through international trade which leads to deteriorating terms of trade or through multinational corporations (MNCs) transferring profits out of developing economies.

ii) The structuralist sub-school

The structuralist sub-school posits that international (industrialized) centers and domestic centers (national capital)
extract resources from the peripheries (namely the poor countries or local countryside). It does not criticize capitalism outright but rather points out that peripheries don’t gain from capitalism as much as the center does.

The solution for underdevelopment (offered by dependency theorists) encompasses various strategies of closing developing countries to international investment and trade. However, today it’s widely accepted that FDI is indispensable for economic growth and development and thus dependency theory is no longer a state doctrine. Nonetheless, fears of domination through foreign capital continue to be expressed in complex regulations, rent seeking and lagging implementation of investment reforms.

**The Modernization School**

This school was developed before the dependency school, and it remains widely influential to the present day. Modernization theorists proclaim that there is a natural order through which countries ascend to what is seen as higher developmental stages. The theorists recommend that developing countries follow the footsteps of developed countries and overcome endogenous barriers to exogenously motivated development through industrialization, liberalization and opening up of economy. The ability to overcome
these barriers will depend how endowed the country is with production factors such as labour; capital and natural resources.

The modernization school views FDI as a prerequisite and catalyst for sustainable growth and development. For FDI to fulfill its crucial role, economies have to be freed from distorting state interventions and opened to trade and foreign investment.

The Integrative School

The integrative school attempts to transform categorical thinking on FDI by analysing it from the perspective of host countries as well as investors. It integrates those dependency and modernization concepts that are applicable to current FDI analysis.

An integrative FDI theory considers macro, micro and meso-economic variables that determine FDI. The macro-level envelops the entire economy, the micro-level denotes firms, and the meso-level represents institutions linking the two, for example government agencies issuing investment policy to enterprises.

What distinguishes integrative FDI theory from its predecessors is that it accords more importance than previous theories to the meso-level, the sphere where macro and micro-variable meet, and public and private sector interact. It is the arena
that public policies are established and implemented. Thus, the meso-level is pivotal to the successful implementation of public policies. It is at the meso-level where day-to-day challenges in FDI policy implementation occur and structural rigidities are revealed. Structural rigidities such as corruption that can be eradicated through measures such as appropriate training and pay for public servants. Despite its importance, the meso-level, has not received the attention it deserves, because theorists are not always aware of the daily challenges that developing countries encounter in implementing economic and investment reforms. At the same time the policy-makers often hesitate to speak out due to local sensibilities.

**Theories of Foreign Direct Investment**

Stands of the modern theory of TNCs can be traced back to the writings of Coase (1937) and more particularly, to the literature on barriers to entry of Bain, (1956). The essential core of the modern theory is the proposition that foreign entrants are disadvantaged relative to local firms because of their inherent unfamiliarity with local conditions. To offset this, it is posited that the entrants must have a ‘compensating’ advantage which is internationally transferable. Since in a perfectly competitive framework no foreign firms could exist, this compensating advantage must exist in a scenario of market imperfections. As Kindleberger noted (Kindelberger, 1969, pp.13-14). Kindleberger listed four possible
imperfections: in the goods market (product differentiation), in the factor market including access to patented knowledge, internal and external economies of scale and government intervention.

In another approach, Aliber (1971) views TNCs as a currency area, phenomena. Here the advantage accrues not to any firm but to all firms within a currency area. The basic idea is that investors value all the assets of a TNC in the currency of the home country. Given risk aversion, investors would demand a premium for bearing the exchange rate risk. Further, investors have a bias in the application of the currency premium. Consequently, source country firms are able to borrow at the lowest rates. Aliber’s theory explains broad trends in FDI: US expansion after the war followed by expansion of German and Japanese FDI in the ‘seventies’ and ‘eighties’. However, the assumption of investors myopia is untenable in a longer time horizon. Further, the theory fails to explain the industrial distribution of FDI and the phenomena of cross-FDI among the DCs in particular (Buckley and Casson, 1976; Dunning, 1971).

In another industrial organization approach, Knickerbocker (1973) viewed TNC investment as a defensive oligopolistic reaction. In an empirical study of US multinationals, he found a bunching of entry by firms into a market: the greater the seller concentration the quicker the entry of a leader into a market is followed by others.
Theoretical justification for the contention that some entry modes should consistently outperform others is based on previous entry mode research in the contingency tradition. The Eclectic Theory of international production (Dunning 1988) is used as a general point of departure for developing the argument that mode selection has an impact on subsidiary performance. Within this framework, ownership, location, and international direct investment choices. Ownership advantages are tangible and intangible assets in the focal firm’s possession that lead to a competitive advantage: proprietary products or technologies, specialized know-how about production, and marketing expertise. Rhizobium and D intensity, advertising intensity, international experience, product diversity and firm size are resource-based concepts that have been empirically linked to the choice of wholly-owned modes (Agarwal and Ramaswami 1992, Caves and Mehra 1986, Kogut and Singh 1986, Kogut and Zander 1993). The ability to innovate (meta-knowledge) may itself be a further, second-order form of knowledge (Buckley and Casson 1976), even more intangible and difficult to transfer, but no less important in many industries. These variables are operationalization of the assets possessed by a firm, or the necessary assets required to compete effectively in a given industry. They were used in these studies to explain the intensity with which companies seek unambiguous control, or alternatively, their propensity to seek local partners.
The most important idea in developing theories of FDI is that firms engaging international production are at a disadvantage compared to local firms. This is generally assumed to be so because of their unfamiliarity with local market conditions. The operation of a subsidiary in foreign market probably requires a greater commitment of time, attention and control compared to operating a subsidiary in the home market. Additional costs are incurred in terms, for example, of communication, administration and transportation. For FDI to be successful, multinationals must, therefore, possess certain advantages not available to existing or potential local competitors. The conditions required for multinational to compete successfully with local firms in host country environments is discussed by Hymer (1960). He observes that foreign firms must possess advantages over local firms to make such investment viable and, usually, the market for the sale of the product or service is imperfect. FDI is motivated by market imperfections which permit the multinational to exploit its monopolistic advantages in foreign markets.

This view is elaborated further by Kindleberger (1969), who suggests that a market imperfections offer multinationals compensating advantages of a magnitude that exceeds the disadvantages due to their lack of origins within a host environment, and it is the financial effects of this that underpin FDI. Again, FDI is
a direct outcome of imperfect markets. Market imperfections may arise in one or more of several areas – for example, product differentiation, marketing skills, proprietary technology, managerial skills, better access to capital, economies of scale and government imposed market distortions, to name but a few. Such advantages give multinational has secured internally transferable advantages. These enable it to overcome its lack of knowledge of local conditions in host environments and to compete with local firms successfully. Market imperfections, created by the existence of an oligopolistic advantage for the multinational, may become a driving force for FDI. Multinational firms are typically oligopolistic. Virtually all multinationals enjoy considerable market power. The market in which they operate is usually one of international oligopoly with shades of monopolistic competition. May be this is because of the sizeable set up costs involved in establishing an overseas plant. Only large firms may be willing to incur this entry cost. In a British study, Dunning (1985) identified oligopoly as a distinguishing feature of markets in which multinationals operate, confirming many other investigators findings.

Many of the insights into the role of market imperfections in impelling foreign direct investment derive from the work of Hymer (1960). In pursuing foreign direct investment, it would seem that an organization must possess a specific advantage to such an extent that
this outweighs its fear, in terms of language, culture, physical
distance and so on, of doing business in an environment where local
practices are different from the home market. The argument goes
that this advantage must be sufficient to offset the presumed
potential of competition from locally situated organization in order
for foreign investment to occur. Such specific advantages may reside
in barriers to entry. Caves (1982) makes the point that the most
powerful source of specific advantage is product differentiation
through, for example, a patented product or via production
technology or marketing investment in branding, styling, distribution
and/or service. But other sources are significant in creating
competitive advantage – for example, economies of scale, access to
capital and raw materials, integration backward or forwards, skills
such as managerial know-how, research and development and so on.

Market imperfections may be created in a number of ways.
1. Internal of external economies of scale often exist, possibly
due to privileged access to raw materials or to final markets,
possibly from the exploitation of firm-specific knowledge
assets, possibly from increases in physical production. The
oligopolies which may result do not react as would firms in
perfectly competitive markets. For example, Knickerbocker
(1973) has shown that oligopolistic competitors tend to follow
one another into individual foreign markets-behaviour which may not always be justified by pure profit potential.

2. Effective differentiation-not only to products and processes but also to marketing and organizational skills-may create substantial imperfections.

3. Government policies have an impact of fiscal and monetary matters, on trade barriers and so on. Multinationals are often able to borrow at lower rates than indigenous firms. Due to their stronger credit ratings, multinationals may often borrow funds in international markets at favourable rates when host government policies make domestic capital expensive or unavailable for indigenous firms. And multinationals are able to build efficient portfolios of FDI - thus reducing the risk involved in any one host’s intervention. This may not be available to more regional competitors.

Market imperfections enable firms to use the power of their specific advantage to close markets and obtains superior rents on their activities. To quote Hymer (1960), multinationals are propelled for monopolistic reasons ‘to separate markets and prevent competition between units’. Clearly, if markets were open and efficient, organizations would not be able to sustain monopolistic advantages and perhaps, the amount of FDI would be less. Essentially then, theories of international investment based on the
existence of market imperfections, suggest that foreign investment is undertaken by those firms that enjoy some monopolistic or oligopolistic advantage. This is because, under perfect market conditions, foreign firms would be non-competitive due to the cost of operating from a distance, both geographically and culturally. Presumably, the firm that invests abroad has some unique advantage, whether it be in terms of product differentiation, marketing or managerial skills, proprietary technology, favourable access to finance or other critical inputs. Oligopoly theory may also explain the phenomenon of defensive investment, which may occur in concentrated industries to prevent competitors from gaining or enlarging advantages that could then be exploited globally.

FOREIGN DIRECT INVESTMENT POLICY IN INDIA

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 globalize 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. 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.

The Government of India’s policy towards foreign direct investment of ‘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.
Governments Policy towards FDI since Independence (1948-1979)

Soon after independence, India embarked on a strategy of import substituting industrialization in the framework of development planning with a focus on development of total capability in heavy industries including the machinery manufacturing sector. The scope of import substitution extended literally to almost everything that could be manufactured in the country (Bhagwati and Desai, 1970). The domestic industry was accorded considerable protection in the form of high tariffs and quantitative restrictions on imports. In order to channel country’s scarce investible resources (the savings rate was just over 10 per cent in 1950) according to plan priorities, an industrial approval (licensing) system was put into place in the country that regulated all industrial investments beyond a certain minimum. A number of key industries were earmarked for further development in the public sector either in view of their strategic nature or anticipated lack of initiative in the private sector because of large capital requirements. As a part of the development plans large investments were made in human resources creating activities such as expansion of education, especially the technical and engineering, facilities and creation of a scientific and technological infrastructure in the form of a network of national and regional laboratories in the country. The government also made investments in development of institutional infrastructure
for industrial development such as term lending and capital markets development. As the domestic base of ‘created’ assets, viz., technology, skills, entrepreneurship was quite limited, the attitude towards FDI was sought on mutually advantageous terms though the majority local ownership was preferred. Foreign investors were assured of no restrictions on the remittances of profits and dividends, fair compensation in the event of acquisition, and were promised a national treatment. The foreign exchange crisis of 1957-58 led to further liberalization in the government’s attitude towards FDI. In a bid to attract foreign investment to finance foreign exchange component of projects, a host of incentives and concessions were extended. The protection accorded to local manufacture acted as an important locational advantage encouraging market seeking FDI. A large number of foreign enterprises serving Indian market through exports started establishing manufacturing affiliates in the country. This (viz., late 1950s and early 1960s) was the period when western multinational enterprises started showing real interest in India.

Expect for the large oil companies and as well will see later on, the tea plantations, the policy towards FDI was quite pragmatic and flexible. This is clear from the statements made by Pt. Jawaharlal Nehru in the floor of Parliament (Ministry of Finance, 1969). Nehru, in particular, clearly recognised the role TNCs could play in India’s industrialization. In fact, except for FERA companies,
there has been no discrimination between Indian and foreign controlled companies from the point of view of laws and taxation. In 1965 and 1972 the FTZs were set up in Kandla, Gujarat and Santa Cruz, Bombay. Like in other Asian countries, a host of tax and other concessions were given to companies investing here for the export market. The concessions ranged from liberal depreciation allowances to complete tax exemptions. The main problem was that the policy towards FDI was being determined on a case by case basis. Except in the case of the oil companies, the view was that the 1956 IPR was unfavourable to FDI. However, as the foreign exchange crisis developed towards the late ‘fifties, some degree of pragmatism came in as TNCs began to be viewed as owners of technology and net foreign exchange earners through exports.

In 1969 a more precise police towards FDI was evolved. This consisted of setting out three groups of industries where (i) there would be FDI without technical collaboration, (ii) only technical collaboration, and (iii) no foreign participation. Second, the foreign exchange crisis precipitated FERA particularly article 29 which specified that any foreign owned firm with more than 40 per cent of equity held abroad had to apply to the Reserve Bank of India for approval in cases relating to expansion, mergers, purchase of share in other firms etc. FERA came into force in 1974 and all applications had been dealt with by 1979.
Investment made in machinery fabrication facilities, manpower development, scientific and technological infrastructure made in the previous period had led to development of certain ‘created’ assets in the country. For instance, certain capabilities for process and product adaptations had been built up in the country. A number of local design engineering and project management consultants had accumulated considerable expertise while acting as subcontractors for western prime consultants. A considerable plant fabrication capability had been built up in the country by late 1960s. The share of imported machinery and equipment as a proportion of gross domestic capital formation had gone down from 69 per cent in 1950 to under 25 per cent by 1968-69. However, locally available skills and capabilities were needing some sort of infant industry protection as these were not able to stand competition from more established industrialized country sources. Constraints on local supply of capital and entrepreneurship had begun to ease somewhat. On the other hand outflow on account of remittances of dividends, profits, royalties, and technical fees, etc., abroad on account of servicing of FDI and technology imports from the earlier period had grown sharply and had become a significant proportion of the foreign exchange account of the country.

All these factors together prompted the government to streamline the procedures for foreign collaboration approvals and
adopts a more restrictive attitude toward FDI. Restrictions were put on proposals of foreign direct investments unaccompanied by technology transfer and those seeking more than 40 per cent foreign ownership. The government listed industries in which FDI was not considered desirable in view of local capabilities. The permissible range of royalty payments and duration of technology transfer agreements with parent companies were also specified for different items. The guidelines evolved for foreign collaborations required exclusive use of Indian consultancy services wherever available. The renewals of foreign collaboration agreements were restricted. From 1973 onwards the further activities of foreign companies (along with those of local large industrial houses) where restricted to a select group of core of high priority industries. In the same year a new Foreign Exchange Regulation Act (FERA) came into force which required all foreign companies operating India to register under Indian corporate legislation with up to 40 per cent foreign equity. Exceptions from the general limit of 40 per cent were made only for companies operating in high priority or high technology sectors, tea plantations, or those producing predominantly for exports.

The government also issued the Industrial Policy of 1973. For one the policy specified the precise areas in which non-FERA companies could operate. It is clear that the idea was to restrict foreign firms to sectors producing basic intermediate and capital
goods. In particular, foreign firms were kept out of consumer goods. However, realizing the need for larger foreign involvement, the policy allowed for up to 49 per cent foreign equity in high technology, priority sectors which usually involved large investments. But here foreign participation was restricted to joint ventures with the government. In general, the government feeling was that the India private sector was ill-equipped to handle the large TNCs.

How successful was FERA? In actuality there were a lot of exemptions from FERA. For one, in the case of firms exporting more than 60 per cent of output, 74 per cent of equity could be held abroad. Second up to 51 per cent foreign equity was permissible if 60 per cent of the firms turnover was in core sector activities and it exported 10 per cent of production. The same level applied to firms exporting more than 40 per cent of their turnover. For a 100 per cent export oriented firm, 100 per cent foreign equity was permitted.

The period from 1970-80 can be then considered the most restrictive from the point of view of FDI mainly because implementation of FERA was the principal item on the agenda of policy makers. However, in terms of the general attitude towards FDI we can really think of the whole period from 1949 as one of cautious encouragement followed by strong reaction. The main
drawback of the system of control through FERA was that it failed to control the large TNCs for whom it was intended. At the same time it sent negative signals to prospective investors thus perpetuating the monopoly control of foreign and local capital. Like the Industrial Licensing system FERA was an instrument of control rather than an incentive.

1980s: Government’s Initiatives for Cautious Deregulation

Towards the end of the 1970s India’s failure to significantly step up the volume and proportion of her manufactured exports in the background of the second oil price shock began to worry the policy-makers. It led to the realization that international competitiveness of Indian goods had suffered from growing technological obsolescence and inferior product quality, limited range, and high cost which in turn were due to the highly protected local market. Another limiting factor for Indian manufactured exports lay is the fact that marketing channels in the industrialised countries were substantially dominated by MNCs. The government intended to deal with the situation by putting emphasis on the modernization of industry with liberalized imports of capital goods and technology, exposing the Indian industry to foreign competition by gradually liberalizing the trade regime, and assigning a greater role to MNCs in the promotion of manufactured exports. This strategy was reflected in the policy pronouncements that were made
in the 1980s. These covered liberalization of industrial licensing (approval) rules, a host of incentives, and exemption from foreign equity restrictions under FERA to 100 per cent export-oriented units. Four more Export processing Zones (EPZ) were set up in addition to the two existing ones, namely, those at Kandla (set up in 1965) and a Santacruz (set up in 1972) to attract MNEs to set up export-oriented units. The trade policies gradually liberalized the imports of raw materials and capital goods by gradually expanding the list of items on the Open General License (OGL). Between 1984-85 alone, 150 items and 200 types of capital goods were added to OGL list. Tariffs on imports of capital goods were also slashed. Imports of designs and drawings and capital goods were permitted under a liberalized Technical Development Fund Scheme.

The liberalization of industrial and trade policies was accompanied by an increasingly receptive attitude towards FDI and foreign licensing collaborations. Approval systems were streamlined. A degree of flexibility was introduced in the policy concerning foreign ownership, and exceptions from the general ceiling of 40 per cent on foreign equity were allowed on the merits of individual investment proposals. The rules and procedures concerning payments of royalties and lump sum technical fees were relaxed and withholding taxes were reduced. The approvals for opening liaison offices by foreign companies in India were liberalized. New
procedures were introduced enabling direct application by a foreign investor even before choosing an Indian partner. A ‘fast channel’ was set up in 1988 for expediting clearances of FDI proposals from major investing countries, viz., Japan, Germany, the US and the UK.

1990s: Full-scale Liberalization and Integration with World Economy

In June 1991, the Indian government initiated a programme of macro-economic stabilization and structural adjustment supported by the IMF and World Bank. As a part of this programme a New Industrial Policy (NIP) was announced on July 24, 1991 in the parliament which has started the process of full scale liberalization and intensified the process of integration of India with the global economy. The NIP and subsequent policy amendments have liberalized the industrial policy regime in the country, especially, as it applies to FDI beyond recognition. The industrial approval system in all industries has been abolished except for 18 strategic or environmentally sensitive industries. In 34 high priority industries FDI up to 51 per cent is approved automatically if certain norms are satisfied. FDI proposals do not necessarily have to be accompanied by technology transfer agreements. Trading companies engaged primarily in export activities are also allowed up to 51 per cent foreign equity. To attract MNEs in the energy sector, 100 per cent foreign equity was permitted in power generation. International
companies were allowed to explore non-associated natural gas and
develop gas fields including laying down pipelines and setting up
liquefied petroleum gas projects. A new package for 100 per cent
export-oriented projects and companies in export processing zones
was announced. A Foreign Investment Promotion Board (FIPB)
authorized to provide a single window clearance has been set up in
the prime minister’s office to invite and felicitate investments in
India by international companies. The existing companies are also
allowed to raise foreign equity levels to 51 per cent for proposed
expansion in priority industries. The use of foreign brand names for
goods manufactured by domestic industry which was restricted has
also been liberalized. India became a signatory to the Convention of
the Multilateral Investment Guarantee Agency (MIGA) for
protection of foreign investments. The Foreign Exchange Regulation
Act of 1973 has been amended and restrictions placed on foreign
companies by the FERA have been lifted. Companies with more than
40 per cent of foreign equity are now treated on par with fully Indian
owned companies. New sectors such as mining, banking,
telecommunications, highways construction and management have
been thrown open to private, including foreign owned, companies.
These relaxations and reforms of policies have been accompanied by
active courting of foreign investors at the highest level. The
international trade policy regime has been considerably liberalized
too with lower tariffs on most types of importables and sharp pruning of negative list for imports.

Although the time period is too short for any analytical study some inferences can be drawn. For one, reduction of bureaucratic procedures is not enough to attract FDI. This is evidenced by the fact that foreign investors have not been making use of the automatic approval route for FDI. The difference in the automatic and the non-automatic route lies in the industries covered and the extent of foreign ownership permissible. It is clear that if foreign control is the principal requirement of foreign investors, then 51 per cent ownership is adequate even in closely held companies. What is probably the greater deterrent to foreign investors is that the list of industries where automatic approval is permissible excludes consumer goods. It is thus clear that a major motivating factor behind FDI is the size of the domestic market. The Economic Survey for 1993/94 notes that 80 per cent of approvals have been in the priority sectors. These include power equipment and similar infrastructural facilities where the domestic demand is expected to show phenomenal growth. Second, it is also clear that export markets are not a major attraction despite the low costs of the Indian operations. Finally, the flows of FDI in the form of portfolio capital are still dominant. Since portfolio capital flows are short-term, speculative flows and may not lead to an increase in productive
capacity, and hence cannot be of as much benefit to India as FDI flows in the form of long-term equity.

As is clear from the above, the policy towards FDI is still restrictive although the restriction on the level of foreign equity is likely to be done away with. However, this may not be enough as it is clear that a major attraction for FDI is the domestic market. Second, the obsession with export oriented FDI continues as also restrictions on large volume of FDI in the form of equity. Given that foreign exchange is no longer a constrain it is unclear why this obsession continues. Presumably, import substituting FDI can save as much foreign exchange as export oriented FDI; Hence, the continued restrictions on FDI catering to the domestic consumer goods market are difficult to understand. Finally, the restrictions on high levels of FDI (the FIPS route) have also been carried over from the past. This was precisely the problem in the past: such a policy allowed foreign investors a mode of involvement in the Indian economy in which they had little at stake.

**FDI Policy and Prospects**

The cumulative approval of FDI since 1991 adds up to approximately US $ 46 billion (excluding GDRs) and the total inflows up to December, 1998 are nearly US $ 13.30 billion (excluding GDRS) giving a success rate of around 29%. To bridge
the Investment Saving gap (of 3 to 4 per cent) in order to achieve a sustained growth of 6 to 7 per cent, FDI of the order of US $ 10 billion or more per annum is required. It is in this light that FDI is invited as a measure to supplement domestic efforts, especially because assistance from multi-lateral and bilateral sources is either stagnant or declining in comparison to private capital flows. Even in the private capital flows, the short-term foreign capital flows are prone to quick reversal in terms of investors’ perception on how the domestic economy is shaping. FDI, which is a long-term investment is, therefore, of crucial importance. FDI is the most desirable form of external funding not only for the long-term additional capital it brings in, but also for the technology up gradation and modern production and management practices that accompany it.

Recent policy initiative taken by the Government are as follows:

- Requirement of prior/final approval by RBI for binging in foreign investment/allotment of shares against proposals duly approved has been dispensed with. New companies will only have to file the required documents with the RBI regional office within 30 days of issue of shares;
- The Reserve Bank of India has delegated powers to its regional offices for granting Automatic Approval in respect of Foreign Collaboration;
• Foreign Equity up to 100 per cent in the power sector for electric generation, transmission and distribution has been made eligible for automatic approval (barring atomic-reactor plants) provided foreign equity does not exceed Rs.1500 crore;

• In case of shortfall in NRI contributions in private sector banks, multilateral financial institutions would be allowed to contribute foreign equity to the extent of the shortfall in NRI contributions within the overall limit of 40 per cent;

• Select infrastructure projects of Rs.100 crore and above are taken up for detailed monitoring to remove bottlenecks and expedite implementation; and

  Two additional activities, namely, “Credit Card Business” and “Money Changing Business” have been included in approved Non Banking Financial activities for FDI and minimum capitalization norms have been dispensed with, in respect of non-fund based Non Banking Financial activities.

The measures introduced by the Government to liberalize provisions relating to FDI have been consolidated and further expanded into new areas. The Government is committed to promote increased inflow of FDI and its intended benefits such as better and high technology, modernization, increased opportunity of exports and providing products and services of international standards to Indian consumers.
To achieve these objectives, it is the Government’s continuing endeavour not only to provide greater transparency in the policy and procedures but also to enable a more dynamic and investor friendly policy framework. With this end in view high priority sectors with 50/51/74/100% foreign equity are already under Automatic Approval Route. To provide greater transparency to the approval process, the Government has issued a set of guidelines for the consideration of proposals by the Foreign Investment Promotion Board (IFPB) so as to make prospective investors aware of the issues, which are considered by the FIPB while deciding proposals.

Some of the initiatives taken by the Secretariat for Industrial Assistance (SIA) are

- In line with the economic reform policy inter alia aimed at deregulation and decontrol of industry, three more industries have been delicensed, namely: (i) coal and Lignite, (ii) Petroleum (other than crude) and its distillation products, and (iii) Sugar Industry. With this the list of industries requiring compulsory licensing has been reduced to 6 on the basis of environmental, strategic and safety considerations;
- The Ministry has taken up a consultative exercise with Administrative Ministries concerned for bringing in further clarity in the sectoral policies concerning FDI. Foreign Equity up to 100 per cent in Power Sector for electric generation,
transmission and distribution as also roads & highways, ports & harbours, and vehicular tunnels and bridges has been made eligible for automatic approval provided foreign equity does not exceed Rs.1500 crore;

- Requirement of prior approval by RBI for bing in FDI/NRI/OCB investment and issue of shares to foreign investors after FIPB/Government approval has been done away with. New companies will have to file the required documents with the concerned regional office of the RBI within 30 days of issue of shares. However, they are also required to intimate RBI of receipt of inward remittances within 30 days.

- The Reserve Bank of India has delegated powers to its Regional offices for granting Automatic Approval in respect of Foreign Technical Collaboration (FTC);

- As per new procedure, the applications for setting up Export Oriented Units in Export Processing Zones are to be submitted to the Development Commissioner of Export processing Zones directly for approval. However, induction of foreign equity would require Foreign Investment Promotion Board/Government approval and applications for foreign equity are to be routed through SIA.

- The facility available to EOU/EPZ units in regard to automatic approval for payment of lump sum fee and royalty for foreign
technical collaboration have now been made at par with the general facility available to non-EOU/EPZ units i.e., lump sum fee up to US $ two million and royalty payments up to 8% on exports and 5% on sales/DTA sales over a period of 5 years from the date of commercial production;

- Development commissioners have been delegated with powers to permit disposal of obsolete capital goods (used for less than five years) on payment of applicable duties, up to maximum limit of Rs. 10 lakh in each financial year for an EOU/EPZ unit; to permit import of office equipment not exceeding 20 per cent of the total capital goods value, subject to EXIM policy up to a maximum limit of Rs.25 lakh; and to permit merger of two or more EOU/EPZ units, provided the unit falls within the jurisdiction of the same Development Commissioner and the same Commissioner of Central Excise and Customs;

- Procedure for filling of Industrial Entrepreneur’s Memorandum (IEM) in composite form has also been streamlined. Amendments/Modifications allowed to the Entrepreneurs with reference to the status/ regulations/ notifications issued by the Central/State Governments from time to time;
Two additional activities namely “Credit Card Business” and “Money Changing Business” have been included in the approved activities FDI;

Minimum Capitalization Norm has been dispensed with in respect of non-fund based NBFC activities;

Foreign Direct Investment up to 40 per cent by multilateral financial institutions allowed in the case of Private Sector Banks, within the overall limit of 40 per cent of FDI, including NRI Investment;

Proposals for manufacture of cigarettes with FDI up to 100 per cent are now allowed. Such approvals shall be subject to the provisions relating to compulsory licensing under the Industries (Development and Regulation) Act, 1951;

For Foreign Collaboration and Industrial License, a revised composite form has been prescribed;

To encourage investment by Non Resident Indians (NRIs)/OCBs can now invest in a listed company up to 5 per cent of its equity (up from 1 per cent); the aggregate investment limit for all NRI/OCB investment is to be increased from 5 per cent to 10 per cent;

As announced by the Hon’ble Prime Minister the FIPB is making all efforts to give a firm ‘Yes’ or ‘No’ to FDI proposals within a stipulated time frame;
A Project Monitoring Unit has been set up within the Department to monitor and facilitate smooth implementation of large FDI projects having foreign equity of Rs.100 crore and above; and

Foreign financial/technical collaborators with past/existing joint ventures to seek Foreign Investment Promotion Board/Government approval in case of setting up new joint ventures in the same or allied activities.

**Major Initiatives to Attract FDI**

In pursuance of Government’s commitment to further facilitate Indian industry to engage unhindered in various activities, Government has permitted, except for a negative list, access to the automatic route for Foreign Direct Investment. The automatic route means simply that foreign investors need to inform the Reserve Bank of Indian within 30 days of bringing in their investment, and again within 30 days of issuing any shares. The negative list includes the following.

All proposals that require an industrial license because the activity is licensable under the Industries (Development and Regulation) Act, 1951, cases where foreign investment is more than 24% in the equity capital of units manufacturing items reserved for small scale industries, and all activities that require an industrial
license in terms of the locational policy notified by Government under the Industrial Policy of 1991.

All proposals in which the foreign collaborator has a previous venture/tie-up in India;

All proposals relating to acquisition of shares in an existing Indian company in favour of a foreign/Non-Resident Indian (NRI)/Overseas Corporate Body (OCB) investor; and All proposals falling outside notified sectoral policy/caps or under sectors in which FDI is not permitted and/or whenever any investor chooses to make an application to the Foreign Investment Promotion Board and not to avail of the automatic route.

Non-Banking Financial Companies may hold foreign equity upto 100 per cent if these are holding companies. However, their subsidiaries, which are operating companies, may hold only up to 75 per cent foreign equity. To facilitate the setting up and operation of such subsidiaries, Government has further allowed holding companies with a minimum capital of US $ 50 million, to set up 100 per cent downstream subsidiaries to undertake specific Non-Banking Financial activities with minimum capital of US $ 5 million. Such a subsidiary, however, would be required to disinvest its equity of the minimum extent of 25% through a public offering only, within a period of 3 years.
In the process of liberalization of FDI policy, Government has further announced the following policy changes:

100 per cent FDI permitted for B to B e-commerce;

Condition of Dividend Balancing on 22 consumer items removed forthwith;

Removal of cap of foreign investment in the Power sector; and

100 per cent FDI permitted in oil-refining.

Automatic Route is available to proposals in the Information Technology sector, even when the applicant company has a previous joint venture or technology transfer agreement in the same field. Automatic Route of FDI upto 100 per cent is allowed in all manufacturing activities in Special Economic Zones (SEZs), except for the following activities: Arms and ammunition, explosives and allied items of defence equipment, defence aircraft and warships; Atomic substances; Narcotics and psychotropic substances and hazardous chemicals; Distillation and brewing of alcoholic drinks; and Cigarettes/cigars and manufactured tobacco substitutes.

FDI upto 100 is allowed with some conditions for the following activities in Telecom sector:
ISPs not providing gateways (both for satellite and submarine cables);

Infrastructure Providers providing dark fiber (IP Category I);

Electronic Mail; and

Voice Mail

Payment of royalty upto 20 on exports and 1 per cent on domestic sales is allowed under automatic route on use of trademarks and brand name of the foreign collaborator without technology transfer.

Payment of royalty upto 8 per cent on exports and 5 per cent on domestic sales by wholly owned subsidiaries to off-shore parent companies is allowed under the automatic route without any restriction on the duration of royalty payments.

Off-shore Venture Capital Funds/Companies are allowed to invest in domestic venture capital undertakings as well as other companies through the automatic route, subject only to SEBI regulations and sector specific caps on FDI.

Existing companies with FDI are eligible for automatic route to undertake additional activities covered under automatic route.
FDI upto 26 per cent is eligible under the automatic route in the Insurance sector, as prescribed in the Insurance Act 1999, subject to their obtaining licence from Insurance Regulator and Development authority.

Capital Flows and FDI

The new institutional framework will promote free flow of capital and foreign investment, both direct as well as portfolio. Capital rich nations will seek out investment destinations generating higher returns. This trend will be reinforced by rising income levels and the again of the OECD population, which will swell the size of pension, insurance and mutual funds, resulting in a continuous increase in international capital flows in search of secure and attractive returns. At the same time, large manufacturing companies will increasingly move from national to global production strategies, resulting in further shifting of production and direct investment in countries or regions in which markets exist or in which production costs are lowest (Vision 2020).

The enlargement of the international capital market will open up increasing opportunities for India to attract foreign direct and institutional investment. Foreign direct investment (FDI) expanded globally from $ 59 billion in 1991 to $ 1,270 billion in 2000, but with an increasing proportion of these flows moving between
developed nations. During this period, FDI flows to India increased six fold to $2.3 billion, which represents less than 0.12 per cent of global FDI. The amount of capital globally available will continue to grow, but improvements in infrastructure and elimination of bureaucratic barriers will be major determinants of India’s success in attracting a greater share of FDI flows. The size and prosperity of China’s non-resident population has been a vital link for the channeling of technology, investment and business back to the mainland. A similar mobilization of India’s expatriate population could have momentous impact on the inflow of FDI in 2020. Likewise, multinational investments in India should be encouraged, especially in technology intensive sectors where they can supplement and strengthen India’s technological capabilities (Vision 2020).

**Indian’s Trade and FDI policies**

India’s economic policy after independence was one of national self-sufficiency that stressed the importance of government regulation of the economy and planned industrialization. Its economic policy was considered as inward looking and highly interventionist. The salient features of the policy included import protection, complex industrial licensing requirements and substantial public ownership of industries, especially heavy industries, among other (Topalova 2004). India’s trade policy was characterized by high tariffs and pervasive import restrictions. These restrictive
policies continued till the 1970s. However, amidst growing dissatisfaction over its results, there was a gradual shift in the focus of India’s development strategy towards export-led growth during the 1980s. Seeing the experience of many east Asian countries in achieving high growth and poverty reduction and encouragement of the private sector, several liberalization measures were adopted during the 1980s and 1990s. Industrial licensing was eased and import restrictions were brought down. The 1991 liberalisation included major structural reforms including trade and foreign investment liberalisation. Telising the importance of FDI through MNEs in improving productivity, exports and overall economic growth, a number of policy decisions were undertaken to attract more FDI. This has resulted in increased inflow of FDI. The FDI inflow has increased from a mere $ 97 million in 1990-91 to $ 34,362 million in 2007-08 (RBI 2009).

Along with the foreign investment policies, there was tremendous reduction in tariffs and non-tariffs barriers and also in the protection to Indian industries (Ahluwalia 2002). The consistent trade reform polices ushered in through various export-import policy plans helped India to increase its share in world exports from 0.5 per cent in the half of the 1990s to 0.7 per cent in 2000-01, and to 1 per cent in 2005-06. This share in world exports remained the same at 1 per cent till 2007-08. The ratio of total exports to the gross domestic
product (GDP) rose from 5.8 per cent in 1990-91 to 12.2 per cent in 2004-05, and grew further to 14 per cent 2006-07 (GOI 2008). Merchandise exports from India increased rapidly from $ 18,145 million in 1990-91 to $ 162,983.90 million in 2007-08, with almost 70 per cent of the export contribution coming from the manufacturing sector (GOI 2009).

Having presented the Theories and Policy of Foreign Direct Investment in India, the next two chapter deals with data analysis on Foreign Direct Investment inflows into India.