CHAPTER IX

SUMMARY OF FINDINGS AND POLICY IMPLICATIONS

9.1 Introduction:

Most developing countries have low saving rates and hence investment rates. Foreign direct investment is viewed as a major stimulus to economic growth in developing countries due its ability to deal with two major obstacles, namely, shortages of financial resources and technology and skills, and has thus made it the centre of attention for policy-makers in developing countries. There has been a sea change in developing countries attitude towards FDI. As against a highly suspicious attitude of developing countries towards inward FDI in the past, most countries now regard FDI as beneficial for their development efforts. India, as part of the developing world, has not been immune to this change.

The late 1960's to the 1970's was the period when restrictive policies were introduced. In 1973, the Foreign Exchange Regulation Act (FERA), marked the beginning of restrictions on FDI. Upto 1980’s aid and loans from bilateral sources and multilateral agencies like IMF, ADB, IBRD were the main sources of funding for India. As a result, during the late 1980s India relied increasingly on borrowing from foreign sources. Increased borrowing from foreign sources in the late 1980s, which helped fuel economic growth, led to pressure on the balance of payments and led to crisis in 1990. The New Industrial Policy of 1991 marked the starting point of a new phase of FDI in India.

The reference period of the present study chosen is from 1980-81 to 2002-03. This particular period of 1980’s and 1990’s has been chosen because of unprecedented changes in the eighties and nineties. The 19 states chosen for the study have a combined population of 1050 million, accounting for approximately 95 per cent of India's population, and 3094032, square kilometers, accounting for 94 per cent of India's total land area. The present study has been undertaken to identify the main socio-economic and political variables that influence FDI flows into India and states in particular and
also study the impact of FDI on Indian economy. The study is based on published secondary data collected from various sources both international and national. International sources.

The specific objectives of the present study are as follows

1) To examine the Government of India’s policy towards FDI during Pre-Liberalisation and Post Liberalisation.

2) To examine the pattern, and trends of FDI Approvals and Inflows in India during the two policy periods.

3) To examine the state-wise trends in FDI and also measure the extent of inter-state disparities in attracting FDI among states.

4) To examine the various factors that determines FDI approvals across states for post liberalization and for India during two policy periods. Apart from the determinants of total FDI inflows, another objective of the study is to examine the determinants of sector specific FDI in India like manufacturing FDI and export-oriented type of FDI.

5) To examine the FDI determinants as manifested in FDI approvals and actual FDI inflows.

6) To examine the impact of FDI on various macroeconomic parameters of Indian economy like economic growth, domestic investment, Foreign Exchange reserves, Balance of payments, trade deficit, import cover of reserves, technological development and industrial development.

7) To examine whether FDI in manufacturing, high technology intensive sectors and services sector exerts different effects on India's growth and domestic investment during post liberalization.

8) To draw policy implications based on observations and findings of the study.

Hypothesis:

H1. There are large inter-state variations in attracting FDI.

H2 Differences in Industrial development, availability of infrastructure, development of science and technology, development of Information Technology, availability
of skilled human capital and technical manpower, good governance and market size explains the inter-state variations in attracting FDI during post liberalization.

H3. The impact of FDI on economic growth, domestic investment, industrial development, and technological development is positive.

9.2 Summary of Findings

1) The policy framework towards FDI in India in the decade of eighties, was partial liberalization with many regulations, whereas, the period from 1991 till date is characterized by transparency and openness and is intended to seek more foreign investment inflows in various sectors. During pre-liberalisation, foreign ownership exceeding 40 percent equity was granted only in exceptional cases. In the post liberalization period, FDI is given automatic approval upto 51 percent foreign equity in priority sectors, which cover most, manufacturing activities including software development. Automatic approval with 74 per cent equity is permitted in several areas includes mining services, basic metals and alloys industries, manufacturing medical and laboratory equipment and photography, electric generation and transmission, non-conventional energy generation and distribution and construction. For other industries the figure is 51%, such as metallurgical, boilers and steam generating plants, prime movers, electrical equipment, transportation, industrial machinery and equipment, agricultural machinery, drugs, printing machinery, food products, cotton textile, basic chemical products (except products of petroleum and coal); the manufacture of metal products and parts except machinery and equipment. Up to 100% FDI is allowed in respect of projects relating to electricity generation, transmission and distribution, other than atomic reactor power plants. There is no limit on the project cost and quantum of foreign direct investment. India has opened its telecom sector to foreign investors up to 100 percent holding in manufacturing of telecom equipment, internet services, and infrastructure providers (e-mail and voice mail), 74 percent in radio-paging services, and 49 percent in national long distance,
basic telephone, cellular mobile, and other value added services. FDI upto 100 percent is permitted in advertising sector and development of integrated township, commercial premises, hotels, resorts and regional level urban infrastructure facilities such as roads and bridges and mass rapid transit system, subject to the guidelines of Government of India; 26 percent in print media and Insurance.

2) The changing patterns of approvals and inflows reflect the growing investor confidence in the country. The share of FDI in GDP formed a very small share, an average of (0.06 percentage) share during 1980’s and an average of (0.65 percent share) during 1990’s. The percentage share of FDI in Gross Fixed Capital Formation was 0.30 in 1980’s and increased to 2.29 percentage during 1990’s. Further there has been diversification of sources of FDI. Until 1990, European countries have been the major sources of FDI in India. They accounted for nearly two third of total stock in 1990. However, their share has declined during 1990’s. Among the European countries, the decline was significant for U.K, from 49 percent in 1980’s to 7 percent in 1990’s. During post liberalization period, countries like Mauritius, South Korea and Singapore, Malaysia and Thailand from Asia have come into FDI picture of India.

3) The declining importance of manufacturing with the opening up of infrastructure and services including telecommunications to FDI is a remarkable shift from 1980’s. During 1990’s FDI has been directed into infrastructural sectors like Energy (Fuels, power and refinery) and Telecommunications. Considering the economic growth targets, significant power generation capacities need to be added. The Planning Commission has estimated that around 47,000 MW of new power generation facilities will have to be set up over the next 5 years. Given the high capital-intensive nature of this sector and the large incremental capacity addition requirements, the need for financial resources is immense. So FDI in power is encouraged. Energy sector received 26 percent of FDI approvals and Telecommunications 19.69 percent and these two sectors alone accounts for nearly half of total share in FDI approvals.
While one third of the approvals are being directed towards the power and telecommunications sector alone, only one-fourth of total approvals were directed towards major exporting sectors like textiles, chemicals & pharmaceuticals, leather goods, transport, metallurgical industries and food processing industries. The idea is that once infrastructure is developed, attracting FDI in to export-oriented industries will become demand driven based on the competitiveness of the individual industries. The multiplier effect of telecom investment on GDP is likely to be higher because of both the direct and indirect effect that this investment has on production. Further Information technology is seen as a capability-enhancing activity. Although Infrastructure FDI is the riskiest one for the investor it is also the most promising for the country receiving it. With increased globalization and without reliable power, telephone, and transport networks—and now information technology networks—a country cannot hope to increase its industrial production and economic growth. Without foreign involvement, it is highly unlikely the country can ever build the infrastructure it needs and still take care of other important objectives, such as education and health. Recent evidence seems to indicate that, although telecommunications and airlines have attracted FDI flows (e.g. to India and Pakistan), other more basic infrastructure such as road building remains unattractive, reflecting both the low returns and high risks of such investments. India’s automatic approval of equity up to 51% is a unique process, which goes a long way in making Indian Policy on FDI transparent. The software industry has emerged as one of the fastest growing sectors in the economy and obviously this is the sector to receive highest share of FDI inflows. Transportation Industry, Telecommunications, Fuels (Power & Oil Refinery, Service Sector, Chemicals (Other than Fertilizers), Food Processing Industries have been the other major sectors to receive FDI inflows during post liberalization.

4) The New Economic Policy has prompted the governments at the state level to initiate measures to attract FDI. The performance of the selected 19 states, however, has not
been uniform during the post reform period. FDI is biased towards the more developed states. Maharashtra has topped the list in attracting FDI approvals worth Rs. 507121.41 million, which works out to 17.44 percent share of the total FDI approved during Post Liberalisation period. Other states to attract FDI approvals are Delhi, Karnataka, Tamil Nadu, Gujarat and Andhra pradesh. Among the states, Karnataka records the highest growth rate in attracting FDI approvals to the extent of 49.63 percent per annum during post liberalization period. Tamil Nadu records a growth rate of 34.45 percent. Maharashtra records a growth rate of 33.38. Punjab and Rajasthan record a low growth rate of 6.16 and 2.98 percent respectively. Bihar too records a low growth rate, although it is positive. The states to experience negative growth in FDI approvals are Orissa, with a high negative growth rate of 31.20 percent, Himachal Pradesh (-4.07), Jammu and Kashmir (-0.88) and Madhya Pradesh (-7.49) percent per annum. Due to varying growth rates of population, the growth rates of Per capita FDI Approvals need no coincide with that of amount of FDI approvals. In terms of per capita FDI approvals, Karnataka again occupies the first place, with highest growth rate of 47.55 percent, followed by Tamil Nadu (33.24 percent); Andhra Pradesh (31.39 percent); Maharashtra (31.0 percent) and Delhi (22.38 percent). The states to experience negative growth rate in per capita FDI approvals during the said period are Bihar (-13.67 percent); Himachal Pradesh (-10.42 percent); Jammu and Kashmir (-2.14 percent); Orissa (-30.86 percent) and Punjab (-5.45 percent). Five major states, viz. Gujarat, Maharashtra, Tamil Nadu, Andhra Pradesh and Karnataka, that together account for less than one-third of our population, accounted for almost two-third of the FDI proposals over the last 13 years. These states have maintained consistent performance throughout the time period examined here. Uttar Pradesh, Bihar, West Bengal, Madhya Pradesh, Rajasthan, Orissa and Assam together accounting for 55 percent of the population received less than 25 percent of FDI approvals. Geographically, the Western region captures 32.9 percent of FDI approvals and Southern regions 30.26 percent; Northern region 21.3 percent, without any significant catching up in Eastern and Central
Region. Widening disparity in terms of Co-efficient of variation among states is observed during the said period, which is a disturbing trend.

5) The sectoral distribution of FDI approvals among states suggests that the States are keen on improving the power availability in their respective states. The various state Governments too have recognized its limitations in being a provider of infrastructure services, as FDI has been primarily targeted towards infrastructural development, with almost one third of the approvals being directed towards the power and telecommunications sector alone. A primary reason for the poor performance of the power sector is that until the 1990's power generation and distribution were a monopoly of government owned enterprises under State Electricity Boards (SEBs). Recent efforts at attracting private investment as a solution include the opening up of generation and distribution to private capital and the unbundling of SEB's into independent commercial agencies specializing in generation, transmission or distribution only. But the translation of approvals into inflows is equally important for the states to realize the true benefits of FDI.

6) The empirical findings of determinants of FDI flows is done at two different levels: across states and country level. Factors increasing the attractiveness of a particular region for FDI depends on various factors like industrial development of region, availability of infrastructure, availability of skilled human capital, availability of technical manpower, market size, R&D institutions, good governance and Information Technology development. Foreign investors prefer economies with a well-developed network of roads, power supply, telephones, and Internet access. Poor infrastructures increases the cost of doing business and reduces the rate of return on investment. At the national level, apart from market size, it is openness, infrastructure (in particular good roads), skilled human capital, technical manpower, Research and Development expenditures, public investment (good governance) macroeconomic stability and export orientation. Going a step further, separate empirical analysis for determinants of manufacturing sector FDI and export-oriented
FDI is conducted. The empirical results of the study demonstrate that, along with openness, good infrastructure, public investment in development of basic facilities (infrastructure, education, health etc), and technological development (Research and development expenditure in industry) exercise an extremely significant role in undertaking FDI in manufacturing sector. The empirical findings for the determinants of export-oriented type of FDI for India suggest that along with openness, EPZ’s, good infrastructure, good governance (development expenditure) too play an important role.

7) Granger causality Test shows that FDI causes economic growth. Neo Classical Growth function is used to estimate growth equation. The impact of FDI on economic growth is positive and more statistically significant during post liberalisation. Further, the impact of the other type of foreign capital (external assistance) turns less significant than FDI throughout the analysis, thus giving a clear message of the disadvantages associated with this type of foreign capital. The impact of FDI on investment, industrial development, foreign exchange reserves and import cover of reserves is positive. The impact of FDI on External borrowings, external debt, BOP and trade deficit is as expected negative. However, the impact of FDI on BOP is not significant although it is negative. Our empirical findings support the finding that the impact of FDI on domestic R&D expenditure which was significantly negative during pre-reforms has turned positive during post liberalization. R&D expenditure of the industrial (both public and private) sector of an economy provides a measure of the international competitiveness of the local firms. However, the impact of FDI on GFCF is not very significant although it is positive in India. The effect of lagged values of FDI inflows on GFCF is carried out to see whether FDI crowds-in or crowds-out domestic investment. With two period FDI lags, the contribution of FDI to GFCF in India improves slightly, though not very significant. The contribution of FDI to industrial growth is positive and significant during both periods. The contribution of FDI to domestic capital formation which
was negative during pre-liberalisation, turns positive and significant during post liberalization. Further, the impact of FDI on manufactured exports is not found to be statistically significant but significant for high technology exports. All these findings support liberal policies towards FDI. The empirical findings also point out that FDI is more beneficial than external commercial borrowings, which gives rise to debt problem.

8) Going a step further, an econometric analysis is carried out to see whether or not the sectoral composition of FDI matters while contributing to the economic growth in India during post liberalisation. The empirical findings show that it is FDI mainly in manufacturing sector and high technology intensive sectors that contributes more to growth and capital formation. The impact of manufacturing sector FDI on manufacturing sector growth and investment is positive. Similarly the impact of Service sector FDI on service sector growth of Indian economy and investment is positive. FDI flows in manufacturing sector may have a larger impact in the economy through a broad range of potential linkage-intensive activities. Conventionally defined, services sector includes wide range of different activities such as finance, infrastructure (such as electricity, water, and telecommunications), wholesale and retail, real estate as well as tourism. FDI to the sector is mostly to serve to the domestic market hence potential forward linkages for the sector are quite strong, while backward linkages may vary by industry.

9.3 Policy recommendations:

While FDI can be engines of growth, it is the government that lays tracks and provide the signals which as part of entire system determine both the speed with which the engines can travel and the direction in which they do so. (WIR, 1996). The policy recommendations that follows from the study are as follows.

1) While the central government has greatly improved the environment for FDI, state governments have more to do. Of course, it will be impossible to substantially improve whole country’s attractiveness for FDI. For backward states especially, the strategy to
maximize growth through regional development must dominate. State governments can now take more initiatives for economic development than ever before. The policy message is that in order to promote economic development and improve local investment climate commitment of the respective state governments to economic and social development is a must. The degree of reform mindedness of the respective states matters a lot in the Indian context. Huge fiscal imbalances are not conducive to growth. States with weak investment climates tend to become concentrations of poverty. So it is essential to strengthen the investment climate (both private and foreign) throughout the country, rather than just in the wealthier states. Improvement in basic infrastructural facilities like power, roads, communications, internet, is a pre-condition to attract private investment. Public intervention is essential for higher levels of investment in socio-economic services and development of infrastructure in backward states. Public investment measures in various developmental activities by both central and state governments can facilitate both domestic and foreign investment in less developed regions.

The Chinese government has launched ‘Great Western Development Strategy’ as a part of the Tenth five Year Plan (2001-2005) in order to steer state investment, outside expertise and private capital into the parts of China most in need but less likely to attract investment on its own. The target is the neglected Western region during the last two decades. In India, the target should be the Central and Eastern Region to arrest regional disparities. Madhya Pradesh, which is rich in natural resources can attract FDI in a big way. Large investments in Orissa to mining and power can lift up Orissa’s growth rate. Assam needs large investment in infrastructure and higher and technical education. Bihar is a classic example of abundant natural resources, large surplus population but acute deficiency of capital. The absence of law and order hardly helps to attract investment and technical skills to Bihar. The main reason for the failure of Kerala and West Bengal is their local political economy rather than some structural factors such as lack of infrastructural facilities or skilled labour.
2) Policy framework is necessary but not sufficient condition to attract FDI inflows. Opening up is only a partial answer. A strong signal to the investment community that the economy is open for business can attract FDI into areas of existing comparative advantage. But if attractive locational assets are limited, there will be little FDI inflows. Any FDI strategy has to suit the conditions of a country at a particular time and evolve as its needs change and its competitive position in the world alters. Further, to ensure that FDI is sustained and enters new activities requires policy intervention both to target investors and raise the quality of local factors. Some policy implications that flows from the empirical findings of the study are as follows:

a) The empirical analysis indicates that the availability of quality human capital and skilled technical manpower is an important factor for FDI inflows. The availability of local skills has clearly gained importance in the age of globalisation. Koji Miyamoto, (2003) points out that high value-added FDI require high level of human resources. This strengthens the case for human capital formation. Skilled human capital and technical manpower is essential to absorb the advanced technologies and management skills made available by FDI inflows. The productive use of capital and technology for economic growth requires vocational and technical skills in workforce. A principal task that follows from these findings is that the governments at all levels improve the quality of human resources by investing in education and training. In addition to general education, vocational training affects the absorptive capacity for more advanced technical knowledge. Thus the acquisition of technological capabilities from FDI depends on training possibilities for local personnel, including those needed to adapt such technology to local needs. On the other hand, FDI too contributes to HRD since MNCs themselves can be active providers of education and training, bringing new skills, information and technology. Singapore, Ireland and Costa Rica started their industrial development with a large fraction of unskilled workers and low FDI. Recognising the importance of FDI in economic growth, these countries made rapid HRD, and have
continuously increased the supply and quality of education. They have all initially started attracting low value-added MNCs, and have gradually succeeded in attracting high value-added MNCs in the past one or two decades. The establishment of effective IPAs (Investment promotion Agencies) with strong authorities to coordinate human resource development was a key starting point. All IPAs in the three countries had good links with industries and MNCs, which helped identify the skill needs of the economy. This was crucial in devising effective educational policies and establishing government funded skills development institutions. An important striking trend in India is the growing share of FDI in services sector like financial services, information technology, telecommunication and others, which require strong business support linkages and global connectivity. This calls for a highly skilled workforce that could handle business administration and management as well as computing and information and technology. This calls for devising HRD policies that are highly flexible, reflecting fast changes in the skill demands of the economy.

In order for this to happen, industry involvement in HRD policymaking, with industry-driven training schemes becomes a key. More government effort is needed to improve education and related skills in backward states.

b) If FDI is to be utilized for sustaining growth process of a country, it is essential to create local technological capabilities. The success of an industry in a globalize scenario hinges on its capacity to effectively cope with technical change. The best policy package for India is to support Research and Development activities of local firms to increase their absorptive capacities. Research and Development activities can be promoted by subsidies, or tax incentives. The absorptive capacity would be accumulated to increase capability of local firms to innovate new products or technologies as Japan and the newly industrialized countries did.

c) Policies that support the linkages should be encouraged. Such policies relate to developing local entrepreneurship. These include a reduction of administrative barriers on new business, providing training in business skills to employees in small and
medium size enterprises. The potential spillover benefits are realized only if local firms have the ability and motivation to invest in absorbing foreign technologies and skills. To motivate subsidization of foreign investment, it is therefore necessary, at the same time, to support learning and investment in local firms as well. The contribution of FDI to domestic capital formation is enhanced by the local capabilities. Many studies have found that the extent of effectiveness of FDI linkages depends upon local conditions. In Singapore and Taiwan, a two way relation is found as the growth of foreign production stimulates local entrepreneurship, while the growing availability of local suppliers attracts more FDI. The entry of FDI shouldn’t weaken the competitive position of existing firms. Further research is needed to evaluate the linkages effect on domestic economy. A strong base of local capabilities and facilities only can attract higher quality and technologically more advanced FDI, with greater local linkages and spillovers.

d) A central concern for a developing country like India is to increase exports. Economies such as Hong Kong, China and Singapore have grown with open policies towards FDI as well as emphasis on exports. The developing countries that attracted export-oriented FDI offered attractive fiscal incentives, export-oriented production facilities like EPZ’s and infrastructure and skilled technicians and manpower. The empirical findings for the determinants of export-oriented type of FDI for India also suggest that along with EPZ’s, good infrastructure, and good governance too plays an important role. Such FDI can create jobs and raise standard of living, transfer new skills and expertise to local human resources, boost non traditional exports and export sector, increase Foreign Exchange earnings, and create backward and forward links to increase the output and raise the standard of local enterprise that supply goods and services to the zone investors. Since EPZs offer a package of services simultaneously, it is essential to set up more EPZ’s throughout the country and improve the other factors that are essential to attract export-oriented FDI. FDI policies in India should aim at increasing the competitiveness of existing exports and
at also provide incentives to both domestic and foreign firms to export and explore new areas of comparative advantage. Many examples of the success in exports through EPZ may be cited. In Malaysia, electronics exporters have attracted FDI to deepen backward linkages. They have upgrades their technological activity and enlarged their product range. The success comes through policies for upgrading skills and attracting the right kind of investor. Much of Singapore’s success is due to careful targeting of industries such as electronics, which accounts for over half of exports. In turn this was feasible only because of government intervention in skills, infrastructure and support institutions. Following the Chinese model, India recently took steps to establish special economic zones. Thus export linked FDI can be boosted tremendously if facilities in Special Export Zones are improved. In China, the vast majority of manufactured exports are from the special economic zones. In Malaysia, as much as 75% of all manufactured exports were produced in such zones. Over 95% of Mauritius’ manufactured exports are produced in EPZs. This calls for Developing high quality infrastructure such as SEZs/EPZs and specialized zones such as science or technology parks that draw on high skilled employees. The Special Economic Zones should be developed as the most competitive destination for export related FDI in the world, by simplifying applicable laws, rules and administrative procedures and reducing red tape.

e) A strategic FDI policy entails government intervention to target FDI in areas where the country has dynamic comparative advantage. India has comparative advantages in IT and related services, Chemicals and chemical products, Services, Rubber, Electrical machinery and apparatus, consumer goods, transportation industry, machinery and machine tools etc. These are the sectors that would not only benefit in the short run (potentially increasing employment and tax revenues), but also would benefit the economy in the long run, through increased training opportunities and technology spillovers.
References:
