OCCASIONAL POLICY PAPER

FOREIGN DIRECT INVESTMENT REFORM

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The views expressed in the Policy Papers are those of the author(s) and do not necessarily reflect those of the Indian Council for Research on International Economic Relations.

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1 INTRODUCTION*

Foreign direct investment is the best means of transferring business knowledge from the developed countries. This consists not only of technology defined in the conventional sense of production processes for existing and new products, but also organisational, managerial, marketing, distribution, procurement and logistics knowledge & systems. Skills and technology diffuse from such foreign companies into the rest of the economy through movement of skilled personnel, through demands on input suppliers, through supplies of superior output to users and by imitation. FDI flows are preferred over other forms of external finance because they are non-debt creating, less volatile and their returns depend on the performance of the projects financed by the investors. FDI also facilitates international trade and transfer of knowledge, skills and technology. In a world of intensifying competition and accelerating technological change, this complimentary and catalytic role can be very valuable.

Foreign Direct Investment constituted 1 percent of India's Gross fixed capital formation in 1993, which went up to 3.2 percent in 2001. The Tenth Plan postulated a GDP growth rate of 8.0% during 2002-07. Given the ICOR and the level of domestic savings it left a savings gap of 2.8%, which required an increase in FDI from the pre-plan level of $ 2-3 billion to $7-8 billion during 2002-07. We are now almost half-way through the 10th Plan and it is quite clear that neither the FDI nor the growth targets of the tenth Plan are likely to be fulfilled. Yet another examination of FDI and related policies is therefore appropriate.

Section 2 analysis the global trends in FDI with a focus on developing countries. It compares the FDI flows into India, relative to that of other emerging economies. It concludes by presenting the sectoral distribution of FDI inflows into India. Section 3 reviews the growth strategy of the fast growing S. E Asian countries

* This paper is a revised, updated and extended version of one written in 2002-3. The 2002-3 paper benefited immensely from questions and issues raised by Mr. N K Singh. My thanks also for his inputs on marketing strategy and foreign investment law. Mr. V. Govindrajan contributed substantially to the section on procedures and institutional reforms and Mr. Prodipto Ghosh to the arguments for Sector Caps. My thanks to Dr Sharat Kumar and Mrs. A Srija for their assistance in writing the earlier version of this paper as Member-secretary of the Planning Commission Steering Group on Foreign Direct Investment. My thanks to Rashmi Banga for her contribution to the literature survey and to Gurnain Pasricha for research assistance for updating and extending the paper.

and places it in the context of the literature on FDI and productivity and FDI and Growth. Section 4 outlines the current FDI policy. Section 5 analyses the reasons for the relatively low FDI in India and section 6 makes recommendations on how to remove the distortions and disincentives to FDI. Section 7 concludes the paper.

2 FDI TRENDS

2.1 Global Trends

Global foreign direct investment (FDI) almost quadrupled between 1995 and 2000. FDI flows to Developing countries grew at a much slower rate over this period, doubling to $240.2 billion their share. Growth of FDI inflows into developing countries virtually halted in 1998 as a result of the Asian crisis. The share of developing countries in global flows reached a peak of 39.6% in 1996, declining rapidly thereafter to reach 18.9% of total flows in 2000. Though absolute FDI amounts have declined since 2000, the share of developing countries has increased to 23.8% in 2003.

Table 1: FDI Inflows by Host Regions

(Billions of US Dollars)

Country/ Region	1989-94 (annual average)	1991-96	1995	1996	1997	1998	1999	2000	2001	2002	2003
World	200.1	254.3	331.1	384.9	477.9	692.5	1075	1270.8	823.8	651.2	653.1
Developed Countries	137.1	154.6	203.5	219.7	271.4	483.2	829.8	1005.2	589.4	460.3	467
Developing Countries	59.6	91.5	113.3	152.5	187.4	188.4	222	240.2	209.4	162.1	155.7
(in %)	(29.8)	(36.0)	(34.2)	(39.6)	(39.2)	(27.2)	(20.7)	(18.9)	(25.4)	(24.9)	(23.8)
Argentina		4.3	5.6	7.0	9.2	7.3	24.0	11.7	3.2	1.0	-0.3
Brazil		3.6	5.6	10.8	19.0	28.9	28.6	32.8	22.5	16.6	9.1
China		25.5	35.8	40.2	44.2	43.8	40.3	40.8	46.8	52.7	57
Indonesia		3.0	4.3	6.2	4.7	-0.4	-2.7	-4.6	-3.3	-1.5	N.A.
India		6.1	2.2	2.5	3.6	2.6	2.2	2.3	3.4	3.4	3.4
Malayasia		5.4	5.8	7.3	6.3	2.7	3.9	3.8	0.6	3.2	N.A.
S. Korea		1.2	1.8	2.3	2.8	5.4	9.3	9.3	3.5	2.0	N.A.
Singapore		6.9	8.8	8.6	13.5	7.6	13.2	12.5	10.9	7.7	N.A.
Thailand		2.0	2.0	2.3	3.9	7.5	6.1	3.4	3.8	1.1	1.6
Taiwan		1.3	1.6	1.9	2.2	0.2	2.9	4.9	4.1	1.4	N.A.
Vietnam		1.2	2.3	1.8	2.6	1.7	1.5	1.3	1.3	1.2	1.3

Source: World Investment Reports, UNCTAD, various issues; and UNCTAD Press release, Jan 12, 2004

2.2 Share of Countries in Global FDI

India's share in FDI inflows among developing countries rose to 1.9% in 1997, but declined sharply to 1% in 1999 and 2000. It reached a peak of 2.1% in 2002 (**Table 1** and **Table 2**). In 2002 China with 32.5% had the highest share of developing country FDI followed by Brazil with 10.2% of developing country FDI. The gap between the shares of these two countries narrowed during the nineties with Brazil gradually catching up with China, but has again widened since. Though the share of Argentina, S. Korea, Singapore, Malaysia and Taiwan is much lower than that of China & Brazil it was till 2000 two to five times that of India. 2001 and 2002 saw a sharp drop in FDI inflows into these countries, with the result that in 2002, (of these countries) only Singapore had a higher share (4.7 per cent) of developing country FDI than India (2.1 percent). The increase in India's share from 1.6 percent in 2001 to 2.1 percent in 2002 is largely a result of the decline in FDI inflows to developing countries as a whole. The quantum of FDI inflows into India in the two years was more or less constant at $3.4 billion in 2001 and 2002. South Korea liberalised FDI policy in the late 1990's and the economy saw a stock adjustment and sharp temporary increase in FDI inflows during 1998 to 2000. Since 2001, the inflows have fallen to nearer their trend level and stood at US$ 2 billion in 2002. Because of the Asian crisis in 1997-98 and the effect of sanctions on investor sentiment India's share of developing country FDI fell at the end of the nineties (Though even at the peak of the crisis, Thailand and Malaysia were attracting more FDI than India.) There are indications of improvement after 2001.

India's measured FDI as a percentage of total GDP is quite low in comparison to other competing countries (**Table 3**). India, the 12th largest country in the world in terms of GDP at current exchange rates was able to attract FDI equal only to 0.7% of its GDP in 2002. In contrast, in the same year, FDI inflows into communist Vietnam were 3.4% of its GDP. Similarly Communist ruled China attracted FDI equal to 4.2% of its GDP. Even Malaysia, which has recently developed an image of being somewhat against the globalisation paradigm, received FDI equal to 3.5% of its GDP. Thailand, which has a relatively low FDI-GDP ratio among the major developing country recipients of FDI, had a ratio over four times that of India in 2001, though it fell to 0.9% in 2002.

Table 2: FDI Inflows into Developing Countries

(Share of developing country total, %)

Host Region /Economy	1989-94 (ann.avg)	1991-96	1995	1996	1997	1998	1999	2000	2001	2002
Developing Countries (in billion$)	59.6	91.5	113.3	152.5	187.4	188.4	222	240.2	209.4	162.1
Argentina	4.5	4.7	4.9	4.5	4.9	3.9	10.9	4.7	1.5	0.6
Brazil	2.5	4.0	4.9	6.9	10	15.1	14.1	13.9	10.7	10.2
China	23.5	27.8	31.6	26.4	23.6	23.2	18.2	17.0	22.3	32.5
Indonesia	2.5	3.3	3.8	4.1	2.5	-0.2	-1.2	-1.9	-1.6	-0.9
India	0.7	6.6	1.9	1.7	1.9	1.4	1.0	1.0	1.6	2.1
Malayasia	6.2	5.9	5.1	4.8	3.5	1.4	1.6	2.3	0.3	2.0
S. Korea	1.5	1.3	1.6	1.5	1.5	2.9	4.8	4.2	1.7	1.2
Singapore	8.1	7.5	7.8	6.8	6.9	3.3	3.2	2.7	5.2	4.7
Thailand	3.2	2.1	1.8	1.5	1.9	2.7	1.6	1.0	1.8	0.7
Taiwan	2.0	1.4	1.4	1.2	1.2	0.1	1.3	2.0	2.0	0.9
Vietnam	1.0	1.3	2.0	1.6	1.5	1.2	0.9	0.9	0.6	0.7

Source: World Investment Reports, UNCTAD, various issues

Table 3: Ratio of FDI inflows to Gross Domestic Product

(per cent per annum)

Developing Countries	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Argentina	2.0	2.5	3.1	2.4	8.5	4.1	1.2	0.4
Brazil	0.8	1.4	2.3	3.6	5.9	5.6	4.5	3.3
China	5.1	4.9	4.9	4.6	4.1	3.8	4.0	4.2
Indonesia	2.2	2.7	2.2	-0.4	-1.9	-3.0	-2.3	-1.0
India	0.6	0.7	0.9	0.6	0.5	0.5	0.7	0.7
Malayasia	6.8	7.2	6.5	3.8	4.4	4.2	0.7	3.5
S. Korea	0.4	0.4	0.6	1.7	2.6	2.0	0.8	0.4
Singapore	10.5	11.4	13.7	7.6	8.6	13.5	11.8	8.2
Thailand	1.2	1.3	2.4	4.6	3.0	2.7	3.3	0.9
Vietnam	11.5	10.9	10.0	8.5	6.9	4.1	4.0	3.4

Source: World Investment Report, 2001 & World Development Reports, various issues.

2.3 Comparability of Indian Data

India's FDI inflow estimates in the Balance of Payments given in **Table 1** and **Table 2** above do not include reinvested earnings (by foreign companies), inter-company debt transactions (subordinated debt) and overseas commercial borrowings by foreign direct investors in foreign invested firms as per the standard IMF definitions. Methodologically, reinvested earnings are required to be shown notionally as dividends paid out under investment income in current account and as inflow of FDI. The other capital, in turn, covers the borrowing and lending of funds – including debt securities and suppliers' credit –between direct investors (parent enterprises) and affiliate enterprises. From a technical point of view, it is well recognized that it is quite difficult to capture reinvested earnings through the reporting arrangements for foreign exchange transactions mainly because such transactions do not take place although those have to be imputed in the balance of payments statistics.

Direct investment, other capital transactions between direct investors and direct investment enterprises, however, pass through the banking channel. There exists, however, the problem of identifying and isolating mutual borrowing and lending of funds among direct investors and direct investment enterprises. In this context, the National Statistical Commission recommended conducting periodical surveys on dividends and profits arising out of foreign direct investment and portfolio investment separately. In pursuance of the recommendation, a survey was launched by the Reserve Bank to collect detailed information on FDI. The data on inward FDI has subsequently been revised to include the data on reinvested earnings and other capital. A new data series was released in June 2003 that has corrected FDI data from 2000-01 onwards. The revised estimates for India for 2000 and 2001 are given in **Table 4** (estimates for 2000 are available only for months included in the financial year 2000-01).

There is an additional problem of non-comparability when comparing the FDI flows of different countries with China, which also applies to China-India comparisons. According to Global Development Finance, 2002, round tripping amounts to nearly 50 per centof total FDI inflows into China in 1999 and 2000. This would reduce China's real FDI share to about 9 per cent of developing country

inflows and its adjusted FDI-GDP ratio to 1.8 per cent in 2000. Thus in 2000 the adjusted FDI-GDP ratio for China would be only double the adjusted FDI-GDP ratio for India[1].

Table 4: FDI Inflows, India

	Old Estimates		Revised Estimates		Ranking*	
Year	Bi. US $	%	Bi. US$	%	Old	New
2001	3.40	1.6	5.62	2.7	7	4
2002	3.45	2.1	5.48	2.6	4	4

Source: RBI Bulletins, various issues and Author's Calculations
Note: * refers to ranking amongst the chosen sample of developing countries, in **Table 2**. % refers to % of GDP.

2.4 FDI in Privatisation

In recent years, privatisation and dis-investment of public enterprises has become an important channel for the flow of FDI into many emerging economies[2]. Brazil has been amongst the most successful countries in using privatisation to attract FDI. The annual FDI inflow into Brazil through the privatisation process during the nineties has ranged between 1.5% to 2% of GDP. Of the over US$90 billion of privatisation proceeds garnered during this period, nearly 35% was contributed by FDI. The sectors that were privatised include steel, petroleum, fertiliser, power, telecommunications, utilities, gas, banks, and ports. In other words, privatisation linked FDI has been primarily responsible for Brazil's quantum jump in FDI inflows. Similarly, a significant proportion of FDI in Argentina and Chile was through privatisation of state owned companies.

Privatisation-related FDI transactions have been a key determinant of FDI inflows in Central and Eastern European countries as well. Poland, for example, has been one of the most aggressive in attracting FDI through the privatisation route. Over 2000 firms have been privatised between 1990-2000 involving US$7 billion. In 2000, purchase of shares of Telekomunikacja Polska (Poland) by France Telecom alone

[1] Using the Pfefferman (2002) Methodology
[2] World Investment Report, 2000/2001, UNCTAD

accounted for inflow of US$4 billion. Similar FDI patterns are also seen in Czech Republic and Hungary.

China has also embarked on an aggressive corporatisation/privatisation programme. Between June 1999 to December 2001, China raised over US$23 billion, mainly through the IPO route. The major transactions include China Mobile, China Unicom, China Petroleum and Chemical Corporation, Petro China and China Telecom. In November 2000, China Mobile (HK) acquired 7 mobile networks in the mainland, with a deal value of US$33 billion. As the deal was partly financed by capital raised through new shares issued to its parent company in the British Virgin Islands, there were FDI inflows of US$23 billion into Hong Kong, China.

Given the slow start of dis-investment in India, there have been little or no foreign inflows into dis-investment till 2002-3. The small amount foreign inflows have primarily been in the form of GDRs. Over the past two years, the policy on 'strategic sale' has been clearly enunciated and implemented. This has begun to change the perception of potential FDI investors. Flows through this channel may be dependent on removal of sector specific barriers and public encouragement to FDI into privatisation. Even though this is a politically sensitive issue, from an economic viewpoint it would be reasonable to conclude that the disinvestment process has not resulted in additional foreign saving capital being injected into the country. This has not enabled India to secure one of the significant advantages of privatisation experienced in other countries.

2.5 Sector Distribution of India's FDI

Engineering, Services, Electronics and Electrical equipment and Computers were the main sectors receiving FDI in India in 2000-01 (Tables 3.5a and 3.5b). Domestic appliances, finance, food & diary products, which were important sectors attracting FDI in the early nineties, have now seen a downtrend in the latter half of the nineties. Services and computer have seen an increasing trend in the latter half of the nineties. The inflow of FDI into computers increased from 6 per cent in 1999-00 to 16 per cent in 2000-01. On the whole there have been significant changes in the pattern and composition of FDI inflows with few clear trends over the decade as whole.

Table 5 : Foreign Direct Investment: Industry-wise Inflows*

(US $ million)

Sector/ Industry	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-01	2001-02	2002-03 (P)
Chemical and allied product	47	72	141	127	304	257	376	120	137	67	53
Engineering	70	33	132	252	730	580	428	326	273	231	262
Domestic Applicances	16	2	108	1	15	60	_	_			
Finance	4	42	98	270	217	148	185	20	40	22	54
Services	2	20	93	100	15	321	369	116	226	1,128	509
Electronics and electrical equipment	33	57	56	130	154	645	228	172	213	659	95
Food and dairy product	28	44	61	85	238	112	18	121	75	49	35
Computers	8	8	10	52	59	139	106	99	306	368	297
Pharmaceuticals	3	50	10	55	48	34	28	54	62	69	44
Others	69	76	162	347	278	660	262	553	578	395	309
Total	480	403	872	1419	2058	2956	2000	1581	1,910	2,988	1,658

P Provisional.

Note: Data in this table exclude FDI inflows under the NRI direct investment route through the Reserve Bank and inflows due to acquisition of shares under Section 5 of FEMA, 1999.

Source: RBI Annual Reports

Table 6: Distribution of FDI by Sector

(As percentage of total)

Sector/ Industry	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-01	2001-02	2002-03 (P)
Chemical and allied product	9.8	17.9	16.2	8.9	14.8	8.7	18.8	7.6	7.2	2.2	3.2
Engineering	14.6	8.2	15.1	17.8	35.5	19.6	21.4	20.6	14.3	7.7	15.8
Domestic Appliances	3.3	0.5	12.4	0.1	0.7	2.0					
Finance	0.8	10.4	11.2	19.0	10.5	5.0	9.3	1.3	2.1	0.7	3.3
Services	0.4	5.0	10.7	7.0	0.7	10.9	18.5	7.3	11.8	37.8	30.7
Electronics and electrical equipment	6.9	14.1	6.4	9.2	7.5	21.8	11.4	10.9	11.2	22.1	5.7
Food and dairy product	5.8	10.9	7.0	6.0	11.6	3.8	0.9	7.7	3.9	1.6	2.1
Computers	1.7	2.0	1.1	3.7	2.9	4.7	5.3	6.3	16.0	12.3	17.9
Pharmaceuticals	0.6	12.4	1.1	3.9	2.3	1.2	1.4	3.4	3.2	2.3	2.7
Others	14.4	18.9	18.6	24.5	13.5	22.3	13.1	35.0	30.3	13.2	18.6

Source: RBI Annual Reports

3 THE IMPORTANCE OF FDI

3.1 The FDI-Export model of Growth

In the past 24 years India has been the eighth fastest growing economy in the World [Virmani(1999), Virmani(2004)]. In other words seven economies, all in Asia, have consistently had higher rates of GDP growth than India. All these (China, Singapore, S. Korea, Taiwan, Vietnam, Malaysia, Thailand) shared at least at the initial stages of their development a characteristic that of a "labour surplus" economy (Arthur Lewis). This indicates the potential for even faster growth of the 'labour surplus' Indian economy in the future.

At least five of these seven economies along with Indonesia and Hong Kong (which come in at number 9 and 10 after India) have since 1980 successfully adopted what one could call the 'FDI–Export-led model of growth'.[3] In economic terms this approach brings to a country two channels of fast catch-up growth. Foreign direct investment (FDI) is an instrument for bringing relevant information, appropriate technology, and critical knowledge into the country (see section 3.2 for literature review). The comparative advantage of the country in terms of relatively abundant labour (or in some cases educated or skilled labour) is then exploited through greater trade and manufactured exports.[4] Exports besides acting as a channel for information provide a benchmark and can help exploit economies of scale in new products (even for large poor economies).

The most successful practitioners of this approach deliberately adjusted their domestic policies (including labour policy), to maximise the inflow of export-oriented FDI (particularly in manufacturing) and obtain the full benefits in terms of industrial employment and wage growth.[5] Public utilities, such as electricity, were used as an instrument for providing subsidies to favoured sectors and/or hi-tech firms rather than

[3] This hypothesis was presented at the 4th Global Development Network (GDN) conference in Cairo in January 2003, Parallel Session II on the 'Global Economic Outlook.' Dunning, Kim and Lin (2001) talk about an investment development path and the trade development path and link the two through FDI.

[4] There is also parallel exploitation of natural resources in some cases, e.g. Indonesia and to a lesser extent Thailand.

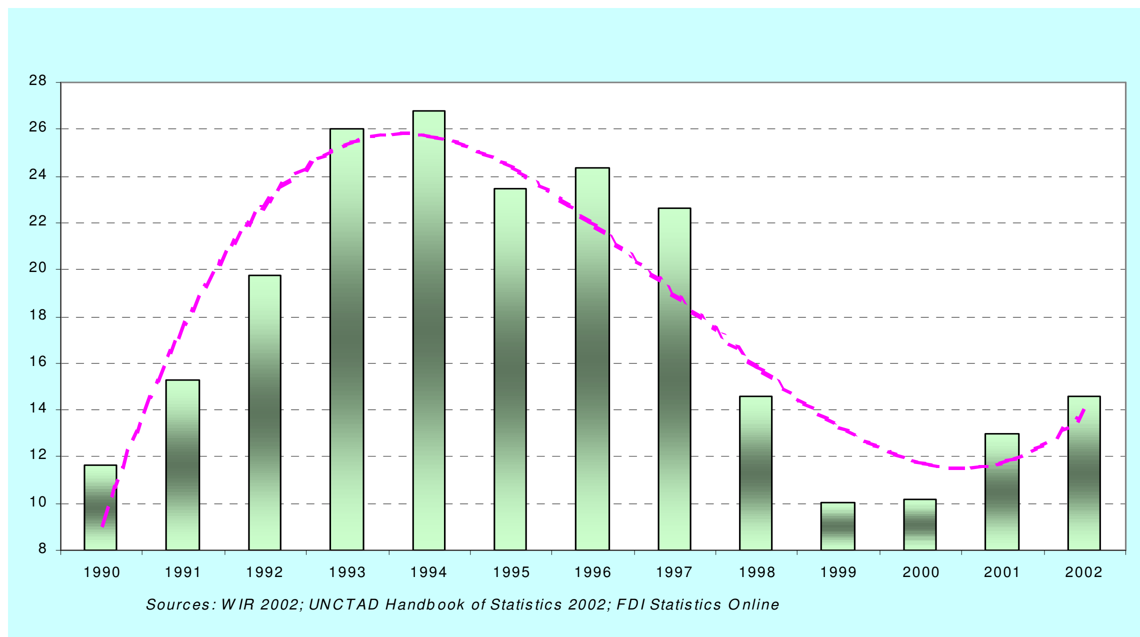
[5] Other longer-term policies included basic education needed for transforming agricultural labour into industrial labour and secondary education needed for moving from low- to middle-income levels.

as a channel for extracting rents from industry and commerce for the benefit of their bureaucratic-political masters, as in India.

The share of Asia in global FDI rose rapidly from 11.2% in 1990 to 15.8% in 1994 before collapsing in 1998 to reach a low of 8.9% in 2000 (Figure 1). It has recovered to over 13% subsequently, but is unlikely to revert to the earlier levels. Within Asia, the share of S. E. Asia (ASEAN) has been falling sharply while the shares of E. Asia and to a lesser extent S. Asia have risen.

Asia's share of world exports similarly rose from 12.9% in 1990 to a peak of 20.2% in 2000 and seems to have reached a plateau at 19% to 20 (Figure 2). These trends, along with other qualitative information suggest that the paths of China on the one hand and the Association of South East Asian Nations (ASEAN) and Taiwan, China on the other, are now diverging.

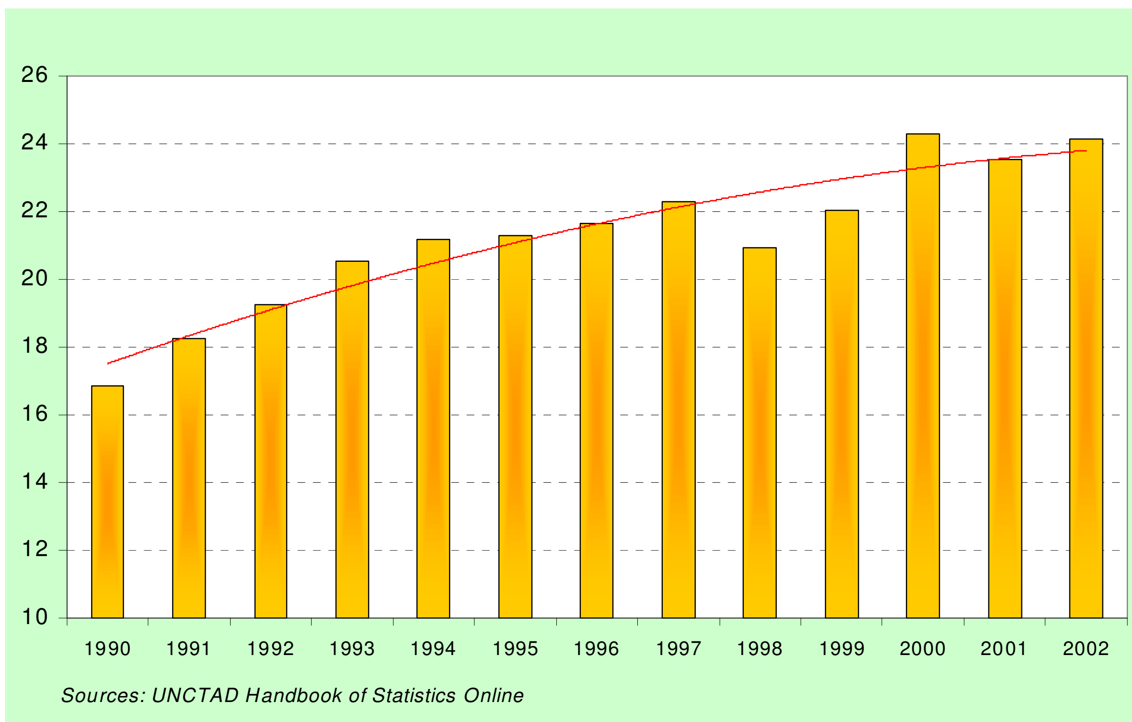
Figure 1: Asia's Share of World FDI (%)



The 'flying geese' model with Japan in the lead since 1985 has been under stress since the bursting of the Japanese asset bubble, even though the USA, and to a lesser extent the European Union, picked up the slack during the nineties. The rise of China as a preferred destination for FDI and export-oriented labour-intensive

manufacturing during the nineties ended in the Asian crisis of 1997–98. China has started to become a substitute location for the mass of manufacturing FDI earlier destined for ASEAN. This trend will strengthen over the current decade, with ASEAN attracting only niche FDI within the manufacturing sector (for instance SUV in Thailand).[6] Thus, the 'FDI–Export' model that has powered ASEAN growth during the past two decades will gradually cease to be relevant to ASEAN (except Vietnam), while it will continues to power the growth of China and possibly Vietnam.

Figure 2: Asia's Share of World Exports (%)



3.2 FDI and Technology

FDI provides a package of tangible and intangible wealth-creating assets to the developing countries due to the attributes embedded in it and the resources associated with it. These assets become available directly for use in productive activities in the

[6] Resource-related FDI is driven by different considerations and will continue to be attracted to resource rich countries. In fact this element of FDI is likely to increase with the increased demand for natural resources from China.

host countries and are amplified by externalities and spillovers that strengthen the resource base and production capabilities in developing economies. The mere presence of FDI in an industry is therefore expected to improve the average productivity and skill levels of the industry.

The direct link of FDI with output and productivity growth in a firm is through foreign affiliates. This increases knowledge of and access to technology. Such technology is exported through FDI to wholly owned foreign affiliates and joint ventures. Foreign firms maintain their competitive advantage by transferring their most recent technology to their affiliates, while selling or licensing only older technology to others. For developing countries, therefore, FDI may be the only way to gain access to latest or "relatively" later technology. Many empirical studies have found foreign firms to be associated with better technology and higher efficiency levels as compared to the domestic firms (e.g., Banga 2004, Goldar et al 2003, Canyon et al., 2002; Collins and Harris, 1999; Girma et al., 1999). Studies have also found that the presence of foreign firms in an industry raises productivity growth of the industry (Djankov and Hoekman 2000, Caves 1996, Blomstrom and Wolf 1994, Globerman 1979).

There is also an indirect contribution of FDI to the productivity growth, through positive technology and productivity spillovers from foreign firms. These occur via competitive pressures, learning by doing and diffusion of knowledge through demonstration effects, labor turnover or reverse engineering (Nadiri 1991, Blomstrom and Kokko 1998, Aitken and Harrison 1997, Tsou and Liu 1998). However, studies on productivity spillovers suggest that the exact nature of the impact of FDI depends on the firm-industry-host economy specific factors. These include the technological levels prevailing in the industry, the learning capabilities of the firms, the absorptive capacity of the host economy, the technology gap between foreign and domestic firms; the market share of the foreign firms etc. (Banga 2003a, Kathuria 2001, Aitken and Harrison 1997, Kokko et al., 1996). The spillovers from foreign firms have also been found to differ according to the source of FDI since foreign firms from different country-of-origin may come with different levels of technology and follow different output and investment strategies (Banga 2003b).

The role played by FDI in promoting exports from developing countries has also been extensively examined in many theoretical and empirical studies. For a

detailed survey see Jenkin 1991, Dunning 1993, Caves 1996, Kumar and Siddharthan 1997. Many studies have found that FDI has played an important role in rapid growth of manufactured exports of developing countries especially in Asian newly industrialising countries viz., Taiwan, Singapore, Hong Kong, Malaysia and other (Nayyar, 1983, Lall & Mohammed 1983, Willmore 1992, Haddad et al 1996,). In the case of India, even though FDI has not entered export-oriented sector, FDI has lead to export diversification, i.e., it has improved the export intensity of the non-traditional export sector (Banga 2003c). Export diversification occurs since ownership advantages of foreign firms (e.g., higher levels of technological skills, better marketing skills and international orientation) give them advantage over the domestic firms in terms of their capabilities to export. Apart from the direct impact on exports of the host countries studies have also found that FDI leads to export spillovers in the host country thereby increasing the export intensity of the domestic firms (Banga 2003d).

The role and nature of FDI has changed in response to the needs of the new technology and the WTO regime. During the 1970s and 1980s most FDI was targeted towards host country markets and for using the host country as an export platform to export to the home country. These were mainly in response to trade barriers, high effective protection rates and preferential tariffs. However, under the WTO regime, the roles of tariff, tax laws and non-tariff barriers has diminished drastically. Efficiency-seeking FDI, which establishes manufacturing units overseas with a view to export to third countries has expanded fast (Siddharthan 2001, Kumar 1998).

3.3 FDI and Growth

The relationship between FDI and growth has been surveyed by de Melo (1997, 1999). Bhagwati (1978) theorised that FDI would be more growth enhancing in countries that pursue export promotion (EP) strategy than in those pursuing import substituting (IS) development strategy. Balasubramanium et al (1996) show that FDI has a positive and significant effect on output in EP countries. Further the effect (elasticity) is higher than in IS countries. At a micro level, Lal and Streeten (1977) and Encarnation and Wells (1986) find that the net welfare gain associated with FDI projects is positively co-related with the degree of openness of the recipient country. Athokarola and Chand (2001) show that the productivity gains from FDI are greater

under a more open trade regime compared to a more closed one. They also find evidence of a negative effect of a stringent domestic tax regime on efficiency gains from international production.

4 CURRENT FDI POLICY

India has one of the most transparent and liberal FDI regimes among the emerging and developing economies. By FDI regime we mean those restrictions that apply to foreign nationals and entities but not to Indian nationals and Indian owned entities. The differential treatment is limited to a few entry rules, spelling out the proportion of equity that the foreign entrant can hold in an Indian (registered) company or business. There are a few banned sectors (like lotteries & gaming and legal services) and some sectors with limits on foreign equity proportion. The entry rules are clear and well defined and equity limits for foreign investment in selected sectors such as telecom quite explicit and well known.

Most of the manufacturing sectors have been for many years on the 100 per cent automatic route (Table 7). Foreign equity is limited only in production of defence equipment (26 per cent), oil marketing (74 per cent) and government owned petroleum refineries (26 per cent). Most of the mining sectors are similarly on the 100 per cent automatic route, with foreign equity limits only on atomic minerals (74 per cent), coal & lignite (74 per cent)[97] exploration for oil (51 per cent to 74 per cent) and diamonds and precious stones (74 per cent). 100 per cent equity is also allowed in non-crop agro-allied sectors and crop agriculture under controlled conditions (e.g. hot houses).

In the case of infrastructure services, there is a clear dichotomy. While highways and roads, ports, inland waterways and transport, and urban infrastructure and courier services are on the 100 per cent automatic route, telecom (49 per cent), airports (74 per cent), civil aviation (40 per cent) and oil and gas pipelines (51 per cent) have foreign equity limits[8]. India also has a clear policy of FDI in services. There is 100 per cent automatic entry into many services such as construction, townships/resorts, hotels, tourism, films, IT/ISP/ email/voice mail, business services

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[7] No limit for captive use.
[8] IT related investment has either 74 per cent limit or none (i.e. 100 per cent).

& consultancy, renting and leasing, Venture Capital Funds/Companies (VCFs/VCCs), medical/health, education, advertising and wholesale trade. The financial intermediation sector has sector caps with banking at 49 per cent and insurance at 26 per cent. So do a few other services like professional services (51per cent).

Subject to these foreign equity conditions a foreign company can set up a registered company in India and operate under the same laws, rules and regulations as any Indian owned company would. Unlike many countries including China, India extends National Treatment to foreign investors. There is absolutely no discrimination against foreign invested companies registered in India or in favour of domestic owned ones. There is however a minor restriction on those foreign entities who entered a particular sub-sector through a joint venture with an Indian partner. If they (i.e. the parent) want to set up another company in the same sector it must get a no-objection certificate from the joint-venture partner. This condition is explicit and transparent unlike many hidden conditions imposed by some other recipients of FDI. There are also a few prudential conditions on the sale of shares in unlisted companies and the above market price sale of shares in public companies.

Table 7: Sectors with Automatic clearance for 100% FDI

S No	Sector	Conditions/ Exceptions
I.	**Manufacturing**	Drugs (recombinant DNA, CL), Petroleum Refining PSUs, Telecom Eqpmt, Defence items, SSI
II.	**Minning & Quarying**	Diamonds and precious stones, Coal and Lignite, Atomic minerals
IV.	**Infrastructure Services**	
	Roads, Highways, Bridges	
	Ports, Harbours	
	MRTS in Metros	
	Electricity Generation, Transmission, Distribution	Atomic Reactor Power Plants
V.	**Financial Services**	
	NBFCs	Minimum investment by FI
VII.	**Other Services**	
	Film Industry	
	Advertising	
	Tourism, Hotels & Restaurants	

Source: Ministry of Commerce and Industry, Department of Industrial Policy and Promotion, Press notes (http://siadipp.nic.in/policy/changes.htm) and "Manual on Foreign Direct Investment in India – Policy and Procedures", Issue No. 1, 2003

5 CAUSES & REASONS FOR LOW FDI

In this section we highlight some of the weakness and constraints on achieving higher FDI inflows into India. Not all are relevant to every originating country or every destination sector. Some factors are more relevant for first time investors with no previous experience of investment in India. The review presents broad generalisations based on the perceptions of potential foreign investors and independent consultants who interact closely with them. Some of the factors mentioned, may be based on past experience that is no longer valid because of recent improvements. Our objective is to extract a kernel of truth from these perceptions so as to help improve our policy and procedures even further.

5.1 Image & Attitude

Though economic reforms welcoming foreign capital were introduced in the nineties it does not seem to be really evident in our overall attitude. There is a perception that foreign investors are looked at with suspicion. There is also a view that some unhappy episodes in the past have a multiplier effect by adversely affecting the business environment in India. Besides, the "Made in India" label is not conceived by the world as being synonymous with quality.

When a foreign investor considers making any new investment decision, it goes through four stages in the decision making process and action cycle, namely, **(a) screening, (b) planning, (c) implementing and (d) operating and expanding.** The biggest barrier is at the first, screening stages of the FDI decision & action cycle. Often India looses out at the screening stage itself. This is primarily because we do not get across effectively to the decision-making "board room" levels of corporate entities where a final decision is taken. Our promotional effort is quite often of general nature and not corporate specific. India is, moreover, a multi-cultural society and most of the multi-national companies (MNC) do not understand the diversity and the multi-plural nature of the society and the different stakeholders in this country. Though in several cases, the foreign investor is discouraged even before he seriously considers a project, 220 of the Fortune 500 companies have some presence in India and several surveys (JBIC, Japan Exim Bank, AT Kearney) show India as the most promising and profitable destination (**Table 8**).

Table 8: CEO Perceptions of India

	Positive	Neutral	Negative
CEO's Perception			
India as Investment destination	**67%**	7%	26%
India as FDI opportunity	**75%**		25%
Likelihood of Investment			
Existing Cos. in India	**61%**	11%	28%
New (no FDI in India)	**14%**	14%	71%

Source: AT Kearney (2001): FDI Confidence Audit: India

On the plus side (**Table 9**), India scores high on the market size and skilled labour fronts, which most respondents consider to be its main strengths vis-à-vis other emerging markets (even though most of the respondents considered China's market potential to be greater). Government incentives seem to matter only for the power and utilities sector and to a lesser extent for the consumer products firms, as determinants of investment interest.

Table 9: FDI Drivers in India

FDI Drivers By Importance	**Respondents by Sector**							
	All sectors	Telecom & Hi-Tech	Power & Utilities	Industrial products	Consumer products	Construction Engineering	Financial Services	Aero-space
Market Size	33%	**	***		***	***	***	
Labour Skills	26%	***	***	***	**	***		***
Wages	18%	*	**	**	**	**		
Incentives	13%		***		**			
Infrastructure (opportunities)	13%	*	***				**	

Source: AT Kearney (2001): FDI Confidence Audit: India

Notes: *** = most important, **= 2nd most important, * = 3rd most important

China with its mono cultural communist hierarchy is viewed as 'more business oriented,' its decision-making is faster and has more FDI friendly policies (ATK 2001). Despite a very similar historical mistrust of foreigners and foreign investment arising from colonial experience, modern (post-1980) China differs fundamentally from India. Its official attitude to FDI, reflected from the highest level of government

(PM, President) to the lowest level of government bureaucracy (provinces) is one of welcoming FDI with open arms. They recognise well the mutual benefit arising from FDI. FDI comes because such investors want profit just like domestic investors. Modern foreign investors are not monopolists backed by a colonial ruler like the "East India Company." They are competitive market participants in an economy regulated by an independent democratic government of India.

5.2 Domestic Policy Issues

Most of the problems for investors arise because of domestic policy, rules and procedures and not the FDI policy per se or its rules and procedures. The FDI policy, which has a lot of positive features, has been summarised above. In this section we highlight the domestic policy related difficulties that are commonly the focus of adverse comment by investors and intermediaries.

The domestic policy framework affects all investment, whether the investor is Indian or foreign. To an extent foreign companies or investors that have set up an Indian company or Joint Venture have become indigenised and thus can operate more or less competitively with other Indian company. They adjust themselves to the milieu. This is not, however, true of foreign direct investors who are coming into India for the first time. To them the hurdles look impassable and the complexity too much for their appetite.

Among the policy problems that have been identified as acting as additional hurdles for FDI are outdated laws, controls, regulatory systems and Government monopolies. The outdated Food Price Order (FPO) and Prevention of Food Adulteration Act are a major hurdle for FDI in food processing. The latter makes even a technical or minor violation subject to criminal liability. As the Prime Minister's Task force had recommended some years ago, we need to formulate a single integrated Food Act (including weights & measures). This should also make provision for a modern Food Regulatory system with a single integrated regulator. The Essential Commodities Act adds to the difficulty of entering the food processing industry by making the procurement, storage and transport of agricultural produce subject to the vagaries of implementation (including the threat of arrest). The central

government has recently taken steps to reduce the ambit of this act and eliminate controls on movement and storage of food grain. Initial steps have been taken in the direction of putting this act into suspended state to be revived only by GOI notification to be applied only in well-specified emergency conditions like drought, floods and other natural disasters for a specific area and duration. Other simplification measures announced are as follows. (a) An amendment of the Milk and Milk products Control Order to remove restrictions on milk processing capacity. (b) De-canalisation of the export of agricultural commodities and phasing out of remaining export controls. (c) Expansion of futures and forward trading to cover all agricultural commodities. (d) An amendment to the Agriculture Produce Marketing Acts to enable farmers to sell directly to potential processors.

Similarly labour laws discourage the entry of green field FDI because of the fear that it would not be possible to dismiss un-productive (non-) workers or to down size if and when there is a downturn in business. Labour laws, rules and procedures have led to a deterioration in the work culture and the comparative advantage that is even beginning to be recognised by responsible Trade Unions. Pursuant to the announcement in the 2001-02 budget that labour laws would be reformed, a Group of Ministers was set up to work out the modalities. The Labour Commission has in the meanwhile also submitted its report. The Group of Ministers will suggest specific changes in the laws for the approval of the Cabinet. SSI reservations further limit the possibility of entering labour intensive sectors for export. De-reservation of readymade garments during the year 2000 and de-reservation of fourteen other items related to leather goods, shoes and toys during 2001 is a welcome development. About 10 per cent of the items on the list of items reserved for the small-scale sector have been freed over the past few years. These two policy constraints are particularly relevant for *export oriented, labour-intensive FDI*. More flexible labour laws that improve work culture and enhance productivity and SSI de-reservations will help attract employment generating FDI inflows of the kind seen in South East Asia in the seventies and eighties and in China since the nineties.

The Urban Land Ceiling Acts and Rent Control Acts in States are a serious constraint on the entire real estate sector. This is another sector that has attracted large amounts of FDI in many countries including China. Like the labour-intensive industrial sectors it can also generate a large volume of productive employment.

These Acts need to be repealed if a construction boom is to be initiated that would reverse the decline in overall investment, attract FDI, generate employment and make rental accommodation available to the poor. The Centre has already repealed the Urban Land Ceiling Act but each State has to issue a notification to repeal the Act in that State. Rent Control is a State subject and each State would have to reform its Rent control Act. The Central government has set up an Urban Reform Facility to provide funds to States that repeal the State Land Ceiling Act, reform the Rent Control Act and carry out other urban reforms.

Weak credibility of regulatory systems and multiple and conflicting roles of agencies and government has an adverse impact on new FDI investors, which is greater than on domestic investors. All monopolists have a strong self-interest in preventing new entrants who can put competitive pressure. In the past, government monopoly in infrastructure sectors has slowed down policy reform. FDI was discouraged by the fear that pressure exerted by government monopolies through their parent departments would bias the regulatory system against new private competitors. As regulatory systems and procedures move up the learning curve, initial problems stemming from lack of regulatory knowledge/experience in sectors such as Telecom have been gradually overcome. Similarly, in the past, strategy and implementation problems connected with dis-investment created great uncertainty and increased policy/ regulatory risk, resulting in a lack of interest of FDI investors in bidding for these companies. With a much clearer strategy and effective implementation over the past year and a half, there should be better inflow on this account.

According to some consultants, in the banking sector, controls on activity dampen FDI inflows. It is alleged that persistent fears of impending "fiscal crisis" is another constraint, and that a well articulated strategy for medium term fiscal consolidations would address these concerns. The absence of product patents in the chemicals sector has reduced inflows into the drugs and pharmaceuticals sector.

Though the foreign trade & tariff regime for Special Export zone (SEZ) approximates a genuine free trade zone, the other elements of the policy framework and procedures remain virtually the same as in the Domestic Tariff area. The SEZs are therefore nowhere near on par with the Export Zones of China with respect to Labour Intensive production.

5.3 Procedures

According to Boston Consulting Group, investors find it frustrating to navigate through the tangles of bureaucratic controls and procedures. McKinsey (2001) found that "The time taken for application/bidding/approval of FDI projects was too long. Multiple approvals, excessive time taken (2-3yrs) e.g. food processing and long lead times of up to 6 months for licenses for duty free exports," and concluded that this lead to "loss of investors' confidence despite promises of a considerable market size."

In a survey of senior executives from the 'Global 1000' firms, AT Kearney & Co. identified bureaucracy and overall regulatory environment in India as the top most concern of foreign investors (**Table 10** below). 41% of the respondents considered a positive regulatory environment as a driver of global FDI and 39% responded that the regulatory environment in India was such as to be a deterrent to investment. This sentiment was most pronounced in the CEOs from Telecom and Hi-tech firms, all of whom cited India's bureaucracy as a major hurdle for investment here. 25% of respondents from this sector also perceived corruption as a major obstacle in India, as compared to other emerging markets, whereas all other respondents ranked India in the medium-low corruption category. For construction and engineering firms, India's poor infrastructure was as important a dampener as its bureaucracy.

As shown by a CII study, of the three stages of a project, namely general approval (e.g. FDI, investment licence for items subject to licence), clearance (project specific approvals e.g. environmental clearance for specific location and product) and implementation, the second was the most oppressive[9]. Three-fourth of the respondents in the survey indicated that (post-approval) *clearances connected with investment* were the most affected by India's red tape. According to a CII study, *a typical power project requires 43 Central Government clearances and 57 State Government level (including the local administration) clearances*. Similarly, the number of clearances for a typical mining project are 37 at the Central Government level and 47 at the State Government level. Though the number of approvals/clearances may not always be much lower in the OECD countries such as the USA and Japan the regulatory process

is transparent with clear documentation requirements and decision rules based largely on self-certification, and generally implemented through the legal profession.

Table 10 : Deterrents for FDI in India

Deterrents for Investment	**Respondents by Sector**					
	All Sectors	Telecom & Hi Tech	Power & Utilities	Industrial products	Consumer products	Construction Engineering
Bureaucracy	39%	40%	42%	100%	>50%	40%
			C & S	C & S	S>C	S>C
Reform Slowdown	28%		30%			
Poor Infrastructure	17%					40%
Cultural Barriers	11%					
Govt. involvement in Economy	8%					
Poverty/ Income disparity	8%					
Corruption		25%				

Source: AT Kearney (2001): FDI Confidence Audit: India
Note: C = Bureaucratic obstacles at the Central level were faced/are a problem
S = Bureaucratic obstacles at State/local level are a problem.

The respondents of the ATK survey also indicated that the divide between central and regional governments in the treatment of foreign investors could undermine the FDI promotion efforts of the Central Government. The FICCI study similarly cites centre-state duality as creating difficulties at both the approval and project implementation stages. Thus, matters relating to environment clearances etc. come under the purview of the Centre. These studies find that the bureaucracy in general is quite unhelpful in extending infra-structural facilities to any project that is being set up. This leads to time and cost overruns. At an operational level, multiple returns have to be filed every month.

One effect of these bureaucratic delays is the low levels of realisation of FDI inflows vis-à-vis the proposals cleared. Although the realisation rate has improved to 45% in 2000-01 compared to 21% in 1997, it remains a serious problem. The precise reason for the low levels of realisation is *the post approval procedures,* which have played havoc with project implementation.

[9] The definitions of approval and clearance are not standardised. Our usage is consistent with CII's while AT Kearney's appears to be the opposite/ inverse.

5.3.1 FIPB and FIIA

The delays mentioned by foreign investors are not at the stage of FDI approval per se i.e. at the entry point whether through RBI automatic route or FIPB approval.[14] The FIPB considers application on the basis of notified guidelines and disposes them within a 6-8 week timeframe, as has been laid down by the Cabinet. The entire process of FIPB applications, starting from their registration through to listing on FIPB agenda and their final disposal and despatch on official communication is placed on the web site, which adds to the transparency of decision-making and enhances investor confidence. Similarly, the underlying advisory support in the form of online chat facility and dedicated email facility for existing and prospective investors has created an investor friendly image. A FICCI Study on, "Impediments to Investment" (January 2002) has acknowledged that the Central level FIPB clearances have been successfully streamlined. The FIPB approval system has also been rated as world class by independent surveys conducted by CII and JICA.

The FIIA framework was also strengthened by adoption of a six-point strategy. This includes close interaction with companies at both operational and board room level, follow up with administrative ministries, State Governments and other concerned agencies and sector specific approach in resolving investment related problems. The major implementation problems are encountered at the state level, as project implementation takes place at the state level. FICCI in its study on "Impediments to Investment" has observed that *the Regional meetings for foreign investors under the FIIA chaired by the Industry Secretary are now turning out to be problem-solving platforms.*

5.4 Quality of Infrastructure

Poor infrastructure affects the productivity of the economy as a whole and hence its GDP/per capita GDP[10]. It also reduces the comparative advantage of industries that are more intensive in the use of such infrastructure. In the context of FDI, poor infrastructure has a greater effect on export production than on production for the domestic market. FDI directed at the domestic market suffers the same

[10] In a market-determined exchange rate, this is reflected in an exchange rate that is more depreciated than it would be if infrastructure was efficient.

handicap and additional costs as domestic manufacturers that are competing for the domestic market. Inadequate and poor quality roads, railroads and ports, however raise export costs vis-a-vis global competitors having better quality and lower cost infrastructure[11]. As a foreign direct investor planning to set up an export base in developing/emerging economies has the option of choosing between India and other locations with better infrastructure, India is handicapped in attracting export oriented FDI. Poor infrastructure is found to be the most important constraint for *construction and engineering* industries.

"Law, rules, regulations relating to infrastructure are sometimes missing or unclear e.g. LNG and the power sector is beset with multiple problems such as State monopoly, bankruptcy and weak regulators" (McKinsey, 2001). The electricity act (2003) is an important first step is solving these problems.

5.5 State Obstacles

Decentralisation from Centre to States creates more problems than it solves (for some sectors). Globally the Services sector received 43% of total investment in emerging markets in 1997 (ATK). As this is a State subject in India, the Sates have to take the lead in simplifying and modernising the policy and rules relating to this sector.

Globally the service sector received 43 per cent of total investment in emerging markets in 1997 (ATK 2001). As this is a State subject, the States have to take the lead in simplifying and modernising the policy and rules relating to this sector.

At the local level (sub-state) issues pertaining to land acquisition, land use change, power connection, building plan approval are sources of project implementation delay. The State level issues were considered by the Govindarajan committee which gave its recommendations on how they can be alleviated. It is not clear what action has been taken on these recommendations.

[11] These costs have been quantified by the CII - World Bank study (year?) of Investment environment in India and its comparison with similar World Bank studies on China and other countries.

5.6 Tax distortions

Taxes levied on transportation of goods from state to state impact the economic environment for export production as they impose both cost and time delays. Differential sale and excise taxes (States & Centre) on small and large companies are found by Mckinsey to be a deterrent to FDI in sectors such as Textiles.

Taxes levied on transportation of goods from State to State (such as octroi and entry tax) adversely impact the economic environment for export production. Such taxes impose both cost and time delays on movement of inputs used in production of export products as well as in transport of the latter to the ports. Differential sale and excise taxes (States and Centre) on small and large companies are found to be a deterrent to FDI in sectors such as textiles (McKinsey 2001). Investments that could raise the productivity and quality of textiles and thus make them competitive in global markets remain unprofitable because they cannot overcome the tax advantage given to small producers in the domestic market.

6 RECOMMENDATIONS

6.1 REGULATORY REFORMS

The proposed regulatory reforms are stand-alone reforms and therefore *neither* mutually exclusive *nor* sequential in nature.

6.1.1 State Laws on Infrastructure

Infrastructure Investment and Exports can be key drivers of productivity change and economic growth. Both domestic private and foreign direct investment can play an important role in these areas, but FDI can potentially play a more than proportionate role because of the special features of these sectors. Critical Infrastructure investment is capital intensive and the easier access of foreign investors to capital resources and global expertise can expedite investment if the policy framework and regulatory structures are appropriate. Similarly the knowledge, experience and connectivity of Foreign companies to global markets gives them an advantage in accessing export markets for manufactured goods.

We therefore recommend that the States consider enacting a special Investment Law covering infrastructure investment. This law would apply to both

domestic and foreign investment. The Andhra Pradesh Infrastructure Act provides a useful template on which other States' laws could be based[12].

This law would cover issues connected to investment in and production of infrastructure services. The objective of this law would be to integrate to the extent feasible, the many State laws, rules and regulations applicable to these critical sectors. It could thus potentially cover environmental clearances, industrial relations, worker health and safety etc. It could also specify special labour laws, rules and procedures for investment in infrastructure and production/supply of infrastructure services. It would have simplified rules and regulations and would specify and enforce time limits on all relevant clearances. A statutory body should be defined and set up under the Act, whose primary objective would be to increase and speed up private investment in these sectors. This body could also have some members from the private sector.

6.1.2 Foreign Investment Law

At present, the entire FDI policy and procedures, as notified by the Government from time to time, are duly incorporated under FEMA regulations. FEMA also covers all issues related to foreign exchange management such as issue/valuation/transfer of shares, divestment of original investment, foreign technology collaboration payments, repatriation of profits, acquisition and disposal of immovable property etc. by foreigners.

Brazil is in a similar position to us in that it does not have a separate Foreign Investment law. Malaysia's Industrial Co-ordination Act (1975) has foreign investment and technology transfer policy as an integral element. This act is supplemented by the Malaysian Industrial Development Authority Act (MIDA), which provides an institutional and legal framework for a single point facilitation of FDI into Malaysia. China, Vietnam and S Korea have separate laws dealing with Foreign Investment. Communist China's (1979) and Vietnam's (1987) acts signalled an "open door" policy with guarantee of legal protection for foreign investment. Korea's post Asian crisis legislation lays emphasis on promotion of FDI. It's Foreign Investment Promotion Act (1998), has a provision for the **Office of Investment Ombudsman** to redress grievances and solve problems of foreign investors.

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[12] The experience of the Gujarat government in attracting private investment/FDI in ports and other infrastructure could also be drawn upon.

There are differing views on whether India needs a separate foreign investment law. The activity of encouraging FDI is a promotional one and not a regulatory one.

6.2 INSTITUTIONAL CHANGES

6.2.1 Industry Department

Within the government, the Department of Industrial Policy and Promotion (DIPP) is responsible for foreign investment, with the Secretary (DIPP) chairing the Foreign Investment Promotion Board (FIPB), the nodal agency for FDI. The Foreign Investment Implementation Authority (FIIA), designed to assist foreign direct investors with respect to post –approval operational problems is also serviced by the Secretariat for Investment (SIA) in the DIPP. There is a need to increase the effectiveness of FIPB and FIIA in removing procedural bottlenecks and reducing bureaucratic red tape.

The FIPB could be empowered to give initial Central government level approvals, such as company incorporation, DGFT registration, central and excise registration, income tax registration etc. The objective would be to speed up the process of getting regulatory and administrative approvals, so that it can be more effective in promoting FDI. A composite form containing such entry-level central approvals should be devised, with a time bound referral system to speed up company incorporation, DGFT registration, central and excise registration, income tax registration etc. within the FIPB clearance system.

The Transaction of Business rules should be modified to empower the Foreign Investment Implementation Authority (FIIA) so as to enable it fix the time frame for investment related approvals both at the State and Central levels. In regard to Central level approvals, FIIA would be empowered to obtain the approval of CCFI directly in the event of administrative ministries failing to respond conclusively within the prescribed time limit.

With greater automaticity in foreign direct investment, fewer and fewer cases require FIPB approval and its regulatory functions are getting reduced. The emphasis henceforth would be increasingly upon the promotional aspects. An exercise using PERT/CPM chart techniques could be carried out to identify clearance process

bottlenecks. This should cover both the Centre and States. After mapping the delays, procedures for reducing delays were also worked out by the Govindarajan Committee.

6.2.2 Non-governmental Facilitation Services

Some Industry associations such as CII are already taking steps to help foreign direct investors in dealing with unfamiliar Indian procedures. This effort needs to be supported and expanded. A Non-governmental Society or Council should be set up by Industry associations with the help and encouragement of the government (DIPP), for assisting first time foreign (FDI) investors. This organisation would operate on a non-profit basis and supply information, approval and clearance services to Foreign (FDI) investors. These could range from giving advice & information to a comprehensive service that obtains all clearances and approvals for the FDI investor. For instance, first time FDI investors also find it difficult to find genuine and sincere Joint venture Partners. This society would facilitate the search for joint venture partners. This society could have representatives from Central government ministries, State governments, Industry associations, Multinational & other companies.

6.3 RAISING FDI SECTORAL CAPS

Given the imperative of attracting FDI for increasing India's GDP growth rate, there should be a presumption in favour of permitting FDI. Accordingly, entry barriers to FDI (i.e. over and above those applying to private investment generally) in any industry must be explicitly justified. The arguments that are used for imposition of caps and bans are analysed to see which may be justified.

6.3.1 National Security

As a general proposition all governments prefer vital defence industries to be controlled by their own resident nationals. There are however two dimensions of this issue that need to be considered in the Indian context. One is the boundary of the defence industry. There is absolutely no need to put equity restrictions on the production of civilian goods used by the defence forces. More importantly we need to distinguish between pure defence/security equipment such as weapons platforms and dual use equipment and parts that are also used in the production of civilian goods. A narrow boundary would imply that such dual use goods are treated as civilian and

freed from FDI equity limits, while a broad boundary would imply the opposite. In any case FDI equity limits should in general be much more liberal for dual use items than for pure defence equipment.

The second dimension that is important in determining FDI equity limits is the domestic production versus import decision. Most discussion of FDI limits is carried out on the presumption that the item will be produced in India no matter what and the only choice is the level of FDI equity or management control. The reality is that considerable defence equipment is imported from privately owned companies. In this situation the choice is much more likely to be between FDI with high level of foreign equity & management control and continued imports. The former would in most cases be much more preferable than the latter. Thus import substitution in defence industry should be allowed with much greater level of foreign equity.

The third dimension relates to bans imposed by developed countries on the import of defence & dual use goods and strategic technology. If unlimited equity share and tax benefits can help attract such technology into India, then the nation can benefit in the long run by achieving greater domestic control and self sufficiency.

6.3.2 Culture and Media

We should have no objection in principle to publications on culture, society and entertainment being published and sold in India as long as this is not at the expense of Indian culture, social norms and practices. One touchstone for deciding on foreign equity could be a criterion of true cultural globalisation. In other words globalisation of culture must be a two way street, with the rest of the world having the same access to Indian culture as we do to theirs. Globalisation of media cannot merely mean that all the existing cultural (e.g. soap operas) and nationalistic (e.g. war news) content created in democratic USA, UK and other English speaking countries is merely transferred to India. Globalisation must also mean that the cultural and nationalistic content created by one-sixth of the humanity living in democratic India is also in due course brought to a global audience. Our experience with the opening of TV media demonstrates the strength of Indian culture in that most foreign companies have been forced by the market to increase content based on Indian cultural and entertainment traditions and reduce transplanted foreign culture sensitive programs.

Some element of restriction can also be applied to foreign entrants in the field of current affairs and news programs. Reporting of international affairs is strongly influenced by nationality, as demonstrated by reporting of the war in Afghanistan and related issues of Pakistani involvement in terrorism in the South Asian region. Editorial control (policy & content) must vest with Indian nationals. The business managers and those who control commercial decision can, however, be foreigners. Over time a more liberal policy that focuses on controlling dominance in terms of share of the market for news and current affairs is desirable. Thus FDI equity limits in terms of individual companies in this field could eventually be replaced by limits on the aggregate market share (25 per cent-49 per cent) that can accrue to foreign controlled news/current affair companies taken together.

6.3.3 Natural Monopolies

Natural monopolies arise in the case of some non-tradable infrastructure sectors. These sectors or natural monopoly segments need to be regulated by independent regulators whether they are government or private, domestic or foreign owned. Efficient and effective regulation requires professional skills and knowledge. Independent and autonomous regulatory systems must be built so that the public benefits rather than the owners and/or managers of such 'natural monopolies.' It can be argued that when such expertise does not exist in the regulatory system it may be better for monopoly profits to accrue to resident nationals than to foreigners. Though this argument has some validity in the short term it is a defeatist approach in the long term. Domestic monopolists are more likely to succeed in distorting the regulatory process in their favour ('regulatory capture') than foreign monopolists, because of their more intimate knowledge of and association with domestic political processes. Any such restrictions must therefore be temporary with continuous efforts made to improve regulatory structures and skills. We have adopted different approaches in various sectors. The power generation sector was opened early to 100 per cent foreign equity, followed thereafter by roads and ports. In telecom, where the natural monopoly elements have virtually been eliminated by technological developments, the 49 per cent foreign equity limit has remained unchanged. Though foreigners can hold another 49% in a company that controls 51% of the Telecom company. The initial reasons for caution do not appear to be valid any more and the time has come

for a more liberal approach. It is even more difficult to find significant 'natural monopoly' elements in civil aviation so that this argument cannot be used for justifying foreign equity or ownership restrictions in this sector.

6.3.4 Monopoly Power

In tradable goods, competition arises not just from domestic production but also from imports. A limited number of domestic producers need not denote monopoly power[13]. Modern competition law emphasises the 'abuse of monopoly power' rather than focussing on the number of producers in a narrowly defined sub-sector. FDI can in fact enhance domestic competition if a global player sets up a green field project, thus expanding the number of domestic producer of the good. There can, however, be a genuine concern if a foreign producer with very high global share tries to acquire an existing domestic producer from among a few remaining domestic producers. This potential problem can and should be dealt with under the proposed competition law and does not require a cap on foreign equity holding.

6.3.5 Natural Resources

The ownership of natural resources such as the electromagnetic spectrum and sites for dams & harbours vests in the people and their government. The resource rent is defined as the difference between market price and the efficient costs of exploitation of the particular resource at a particular time and place. The resource rent depends on scarcity of the resource and its quality. Resource rent tax systems and auctioning procedures have been designed to extract the highest proportion of such resource rent to the government. If these are effective there is no reason to discriminate between FDI and domestic investment in production or use of such resources and consequently to put FDI limits on the former[14].

The situation is somewhat different with respect to internationally created sovereign rights such as those created by IATA for international civil aviation. These artificially created rents accrue to the government and would be enhanced if they are fully exploited. Rent accrual would be enhanced if Air India was privatised without

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[13] This generally arises from high capital requirements for reaching minimum efficient scale or high marketing costs in building brand recognition.

limits on foreign equity. However these rights vest in the sovereign and can only be assigned to 'National carriers' and majority ownership must remain with Indian nationals if these rights are to remain valid. Thus in this case foreign equity limits in Air India are justified as long as the IATA agreement is not modified and the old rules continue to remain.

6.3.6 Transition Costs

An important reason for encouraging FDI is the productivity gains that can accrue. But the flip side of this coin is the short-term transition costs that it imposes on existing less productive competitors. For instant FDI in food retailing (entry of food department store chain) would lead to more efficient supply chain management systems that can reduce the large gap between the price received by farmers and that paid by consumers[15]. It would thus benefit both farmers and consumers besides creating profitable avenues for FDI. But in the short term, traders and intermediaries in direct competition with these new entrants could suffer a loss in income if the economy is not growing. Over time the productivity gains would generate much more income and employment opportunities, even for these intermediaries, by stimulating agricultural growth and consumer demand. Similar opportunity and difficulties arise in the case of FDI in the organised retail sector (general department stores)[16]. In both cases, if the economy is growing, the food and retail sectors would be growing and there may be little or no short run income losses. The more efficient producer would merely capture a larger share of the increase in demand.

The classical economic solution to the transition problem (if it exists) is to compensate the losers through direct budgetary assistance. The political economy, however, makes this somewhat difficult. A gradual approach has therefore to be adopted. This can consist either of first allowing a low level of foreign equity and then raising it gradually over time or of controlling/rationing the number of entrants

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[14] The national pool of human genes as well as non – human genes is a sovereign resource that can in principle have resource rents. The potential resource rents inherent in this resource needs to be estimated and accounted for in the national policy on bio-resources and their use.

[15] This was shown by a Mckinsey study (year?) on food processing/retailing in several countries including India.

[16] A recent Mckinsey study (year?) shows that the growth of productivity in the retail sector was second most important source of outstanding productivity growth in the US in the nineties.

so that they initially supply only a small proportion of the market (say the incremental demand)[17].

6.3.7 Recommendations

Many of the remaining entry conditions had greater justification at the time that they were imposed. With a much stronger and more competitive economy many of these can be removed. This will eliminate minor irritants that are sometimes blown out of proportion by interested parties to the detriment of the national interest. The recommendations on the existing entry barriers to FDI are summarised in Table 11.

[17] A roll out plan to develop domestic supply chain and train Indians in all respects of supply chain management could be used to rank potential entrants.

Table 11: Proposed Changes in Sectoral Limits on FDI

S No	Sector	Equity Limits		Entry Route		Condition Change
		Existing	Proposed	Existing	Proposed	Or strengthening
I.	**Manufacturing**					
I.2	Drugs (recombinant DNA, CL..)	74%	100%	FIPB	Automatic	GM regulations
I.3	Petroleum Refining-PSUs	26%	100%	FIPB	Automatic	PSU/govt decides
I.5	Telecom Equipment	49%	100%	Automatic	Automatic	
		100%		FIPB	Automatic	
I.6	Defence items	26%	49%	FIPB	No change	Security
I.7	SSI	24%	100%	Automatic	Automatic	
II.	**Minning & Quarying**					
II.2	Diamond, precious stones	74%	100%	Automatic	Automatic	Resource rent tax
II.4.1	Coal & Lignite					
II.4.1.1	PSU	49%	100%	FIPB	Automatic	PSU/govt decides
II.4.1.2	Non- PSUs	50%	100%	FIPB	Automatic	
II.4.1.3	Power user	100%	100%	FIPB	Automatic	
II.4.1.4	Other user	74%	100%	FIPB	Automatic	
II.4.2	Coal Processing	50%		Automatic	Automatic	
		100%		FIPB	Automatic	
II.5	Atomic Minerals	74%	100%	FIPB	No change	Security
IV.	**Infrastructure Services**					
IV.1	Airports	74%	100%	Automatic	Automatic	
		100%		FIPB	Automatic	
IV.1.1	Domestic Airlines	40%	49%	FIPB	Automatic	Incl foreign airlines
IV.2	Telecom					
IV.2.1	Basic & Mobile	49%	100%	FIPB	No change	Security
IV.2.2	Total Bandwidth	74%	100%	FIPB	Automatic	
IV.2.3	ISP with gateways	74%	100%	FIPB	Automatic	
IV.2.4	ISP without Gateways	49-100%	100%	FIPB	Automatic	
IV.2.5	Email, Voice mail	49-100%	100%	FIPB	Automatic	
IV.2.6	Radio Paging	74%	100%	FIPB	Automatic	
IV.2.7	End to End Bandwidth	74%	100%	FIPB	Automatic	
IV.2.8	IP providing Dark Fibre	49-100%	100%	FIPB	Automatic	
IV.2.9	Satellites	74%		FIPB		
IV.3	Pipeline:Oil & Gas	100%		FIPB	Automatic	
IV.4	Integrated Townships(all)	100%	Same	FIPB	Automatic	100acre->25 acre

Note: Security = Appropriate security clearance must be done prior to approval and regular monitoring thereafter. Licence would have provision for revocation if security conditions of license are violated. Reciprocity = The approval would apply only if the country of origin allows Indian FDI under similar conditions.

Table 13 (Contd): Proposed Changes in Sectoral Limits on FDI

S No	Sector	Equity Limits		Entry Route		Condition Change
		Existing	Proposed	Existing	Proposed	Or strengthening
V.	**Financial Services**					
V.1	Banking (private)	49%	100%	Automatic	Same	
V.2	Insurance	26%	49%	Automatic	Same	100% rural & agri
V.3	Investing Co.(infr/service)	49%	100%	FIPB	Automatic	
V.4	Venture Capital Fund / Co.	100%	Same	FIPB	Automatic	
VI.	**Knowledge services**					
VI.1	Information Tech	49%	100%	Automatic	Same	
VI.2	Broadcasting					Reciprocity;
VI.2.1	TV Software	100%	100%	FIPB	Automatic	No sub-limits
VI.2.2	Uplinking, HUB etc.	49%	100%	FIPB	Automatic	
VI.2.3	Cable network	49%	100%	FIPB	Automatic	
VI.2.4	DTH	20%	100%	FIPB	Automatic	
VI.2.5	Terrestrial Broadcast FM	20% FII	100%		Automatic	
VI.2.6	Satellite Broadcasting	49%	100%		Automatic	
VI.3	Print Media:					
VI.3.1	Science/professional journals	100%		FIPB	Automatic	Include educational magazines
VI.3.2	Newspapers, Periodicals	26%	49%	FIPB	FIPB	
VI.4	Education Services	100%	Same	FIPB	Automatic	
VII.	**Other Services**					
VII.1	Advertising	74%	100%	Automatic	Same	
VII.2	Trading (export, Cash & Carry Wholesale.)	51%	100%	Automatic		Allow all wholesale
		100%		FIPB	Automatic	
VII.3	Courier service	100%	Same	FIPB	Automatic	
VIII	**Agro Allied, Non-crop**	100%	100%	FIPB	Same	Clarify permissible items
	Plantations (Tea)	100%	No Change	FIPB,	Automatic	
	Currently Banned Sector					
	Agriculture (including Plantations except Tea)	0%	49%		FIPB	Domestic regulations apply to all
	Real estate:					
	Commercial Complex	0%	100%		FIPB	
	Retail Trade	0%	49%		FIPB	Indian supply chain
	Lotteries & Gaming	0%	Same		NA	

Source: Ministry of Commerce and Industry, Department of Industrial Policy and Promotion, Press notes http://siadipp.nic.in/policy/changes.htm

6.3.7.1 Manufacturing

The foreign equity limits on production of drugs using recombinant DNA technology or specific cell/tissue targeted formulations was recently raised from 74 per cent to 100 per cent. It, however, remains on the FIPB route. As all such processes are regulated by the biotechnology regulator (for both domestic and foreign investors) FIPB merely acts a redundant layer. We recommend a shift of this item to the automatic route. Though 100 percent FDI is allowed in private petroleum refineries, FDI in public sector refineries is restricted to 26 per cent. The public sector refineries are under the control of government appointed boards. Government as owner has the right to decide how much if any of its shares it wants to sell to a domestic or foreign investor. Further, as long as these refineries remain in the public sector government either has management control (50.1 per cent) or the right to veto any fundamental changes (25.1 per cent equity)[18]. It can therefore either control or directly supervise any FDI investor. When it has sold its last 25 per cent share the company becomes a private company and 100 per cent FDI is already allowed in this case. There is therefore no need for any equity limit and this should be raised to 100 per cent and put on the automatic route.

With a virtual monopoly of oil marketing currently in the public sector, with several Indian private players on the verge of entering this sector entry of foreign players will enhance competition. The power of Indians to block special resolutions serves no useful purpose and the FDI limit of 74 per cent can be raised to 100 per cent (automatic). The petroleum regulatory bill will in any case allow the regulator to give directions to all oil companies in the event of war and natural disaster. With these three changes the entire manufacturing sector, except defence, will be on the 100 per cent automatic route. Indian companies are currently prohibited to have more than 24 per cent equity in small-scale units (SSI)[19]. The same limits are applicable to foreign direct investors (i.e. this is not strictly an FDI policy issue). These limits reduce the ability of SSI to raise equity capital. In a situation in which every expert and every shade of political opinions supports a greater flow of funds to the SSIs, the equity limits are illogical. If a small-scale enterprise wants to expand by offering equity to

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[18] It can even have management control with 25 percent share.
[19] Higher equity proportion is permitted if 50 percent of output is exported.

FDI investors or domestic companies, it should be free to do so. This will not only ease the financing constraint but promote backward and forward linkages with medium-large (domestic and foreign) industry. Such synergy is essential for healthy growth of both sectors and for enhancing industrial efficiency and competitive strength. We therefore recommend raising the equity limit to 49 per cent and placed on automatic route[20].

6.3.7.2 Mining

There is currently an equity cap of 74 percent on exploration for diamonds and precious stones. As the rights to mine any mineral vests with the government, no individual or company, domestic or foreign can extract any mineral from the ground with out the explicit permission of the government. The government specifies various terms and conditions in these contracts (including resource rent or royalty) and the process is therefore fully under the control of the government. Nothing is gained from restricting foreign equity and the limit should be raised to 100 per cent.

For similar reasons the current restrictions on equity (74 per cent) in coal and lignite mining for non-power use should be removed and 100 per cent equity automatically allowed in coal mining. It may also be noted that restrictions under the Coal Nationalisation Act apply to both foreign and domestic investors. Foreign investment in coal washeries, which is a processing activity, should also be put on the automatic route. Foreign equity in petroleum exploration is automatically allowed up to 50 per cent but higher limits of 51 per cent, 60 per cent and 100 per cent are allowed through the FIPB route for incorporated joint ventures, unincorporated joint ventures and small fields given through the competitive bidding route. The economics of natural resources demonstrates clearly that the larger the number of companies interested in a particular field, the higher the share of rent appropriated by the government. If even one or two companies drop out of the race because of lower equity ceilings, the country looses and the explorer benefits. We therefore recommend that 100 per cent foreign equity on the automatic route be allowed for all petroleum exploration. As in any other exploration/mining contract the government is a contracting party and has direct say in the terms and conditions of the exploration.

In the case of atomic minerals, 74 per cent foreign equity is allowed through FIPB and even 100 per cen can be permitted if the Atomic Energy Commission approves. The entire FIPB process focuses on the national security and proliferation issues that are fully covered by the Atomic Minerals Act. Anybody wishing to mine atomic minerals has to get permission under this Act and follow the rules and precautions laid down by the AEC. There is therefore no need for an extra layer of approvals and FDI approval can be automatic 100 per cent. If these suggestions are accepted all mining will be on the 100 per cent automatic route.

6.3.7.3 Infrastructure

Foreign equity in airports is already allowed up to 100 per cent but anything between 75 per cent and 100 per cent has to go through the FIPB route. Even 100 per cent foreign equity should be made automatic as no specific purpose is served by FIPB scrutiny in this heavily regulated sector. Oil and gas pipelines have a "natural monopoly" element but this is quite weak because oil and gas can and are routinely transported by rail and road in direct competition with pipelines. This contrasts with other capital-intensive sectors such as power transmission where there is currently no other competitive alternative. As in the case of transmission a well-designed, optimally used gas/ oil pipeline system can reduce capital costs and improve economic efficiency/ competitiveness. With 100 per cent foreign equity allowed in power transmission (and other pipelines), the arguments against allowing the same in oil and gas pipelines are weak. These pipelines are regulated by the government and will come under the purview of an independent regulator in due course. We therefore recommend 100 per cent foreign equity under the automatic route. The telecom sector foreign equity cap of 49 per cent may have reduced FDI inflows even though foreign investors can own another 49 per cent in a company that hold the remaining 51 per cent equity. Even in existing joint ventures between domestic and foreign companies, management can vest either with the domestic or foreign partner or both. Any change in management control is in general subject to the 'Takeover Rules and Regulations,' and these have been evolving over time to account for different possibilities. This process will continue. Security aspects of foreign investment in telecom are taken care

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[20] Higher limits can also be permitted through FIPB route in case of committed exports.

of through a security clearance procedure and these can and should apply whatever the level of foreign equity. If necessary they can be modified and/ or strengthened. The time has therefore come, in our view to revise the foreign equity cap on basic and mobile services upwards to 74 per cent. Along with this, equity caps on radio paging, end-to-end bandwidth and internet gateways can be raised from 74 per cent to 100 per cent. These three along with voice mail, e-mail and ISP can be put on automatic route (subject to security clearance).

The entry of private airlines into the domestic aviation sector initially helped improve the quality of even Indian Airlines. The quality and competitiveness of domestic civil aviation can be improved on a sustainable basis by the entry of foreign airlines. The current ban on foreign airline participation in joint ventures is not possible to justify on rational economic grounds. The foreign equity cap on civil aviation should be raised to 49 per cent (from 40 per cent) and foreign airlines allowed to invest within this cap. The 49 per cent limit represents below majority holding unlike 40 per cent, which has no link to any other limit or rule.

The experience of opening of terrestrial TV has demonstrated that private domestic and foreign entry is beneficial for citizens in terms of both information access and consumer choice. Direct to Home (DTH) broadcasting competes with terrestrial TV transmissions and is a competitive service with high capital costs and risks. Given the current 20 per cent foreign equity limit (KU band) foreign companies have little or no interest in entering this sector. This limit should be raised to 49 per cent (KU band etc.) so that foreign companies with the capital, technical competence and risk appetite can enter the country.

6.3.7.4 Services

There is scope for greater FDI inflow in the insurance sector if the cap of 26 per cent foreign equity is raised. The experience of opening up of this sector to FDI has set at rest the fears that were expressed earlier regarding the effect of such opening. The public insurance monopolies have responded to private entry by trying to increase their efficiency and effectiveness. This process would be enhanced and sustained by more effective competition. The regulatory system is in place and the Insurance Regulatory Authority (IRDA) is functioning effectively. In my view the

foreign equity cap can be raised immediately to 49% per cent and to 100% within a few years.

With a large and mature banking system about 80 per cent of whose assets are in the public sector, the entire private sector is a relatively small player. Despite this the private sector has introduced new products and processes into banking and forced the public sector banks to compete in these areas. This process would be accelerated and enhanced if the FDI limits for private banks are raised from 49 per cent to 100 per cent, as few new foreign players have entered so far. With RBI recognised as one of the most competent regulators in the country, both domestic and foreign entrants can be effectively regulated. Given effective regulation, the entry of large foreign banks will enhance competition in the private banking and eliminate any temporary monopolies that may have arisen with innovation.

The minimum investment norms for FDI investment in Non-Bank Financial Companies no longer serve a useful purpose (as all NBFCs have to satisfy regulatory norms) and should be deleted. Similarly the equity limits on investing companies (for infrastructure and social sectors) should be raised to 100 per cent (from 49 per cent) and put on the automatic route. 100 per cent foreign equity is already allowed in courier services and this can be transferred to the automatic route. Consideration should also be given to bringing these services under the TRAI or the new regulator to be set up under the convergence bill.

There is currently a 74 per cent cap on foreign equity even though this is on the automatic route. Advertising is a creative process critically dependent on the creative human resources working in the company. Advertising requires a knowledge and understanding of culture that nationals always have a natural advantage. Similarly the relative salary levels that need to be paid to Indian nationals are significantly lower than nationals from richer countries. Because of both cultural understanding and salary differentials the creative and other professional workers critical to advertising are bound to be largely Indian. There is no need to insist on 26 per cent Indian equity. We therefore recommend that 100 per cent FDI be permitted in the advertising sector.

The real estate and housing sector has a globally demonstrated potential for attracting FDI. Though 100 per cent foreign equity is automatically allowed in the development of urban infrastructure and townships, only NRI/OCBs have the same

facility as far as real estate and housing is concerned. Opening up of the real estate and housing sector to FDI investors can attract significant amount of FDI. Automatic 100 per cent equity could be allowed in industrial, commercial and residential complexes (covering one acre or more), while below this size and in the case of individual properties FDI could come through the FIPB route.

100 per cent FDI has recently been approved in tea plantations so that the considerable capital requirements of this sector can be met. In the absence of risk capital, the quality of output from these plantations has been deteriorating. Liberalization of FDI is similarly warranted in other plantations so that greater amount of risk capital is available for raising the productivity and output quality. We recommend a lower equity limit of 49 per cent (initially) for two reasons. There was 100 per cent foreign equity in many tea plantations at and after Independence right till the forced dis-investment in the seventies. Other (non-tea) plantations are generally smaller with a much larger proportion owned by small farmers. A gradual approach that allows these owners to bring in foreign equity while retaining majority ownership is therefore preferable.

In many countries across the world the real estate sector has been a leading sector in promoting overall growth. This has been true of emerging markets such as those in E & S E Asia. A substantial part of China's FDI has been in this sector. The most visible sign that S E Asian countries were moving ahead of us in the eighties were the transformation of the skyline & roads of their capital cities. We have to remove the plethora of controls on our real estate and housing sector if we are to initiate a similar boom.

There is currently a somewhat complicated regime for FDI in non-retail trading. Automatic 100 per cent FDI is allowed in bulk handling, storage and transport of food and 51 per cent in export trading. 100 per cent equity is also allowed through the FIPB route in SSI products, hi-tech products, e-commerce (with 26 per cent dis-investment in 5 years), cash and carry wholesaling and warehousing. At least as far as these permitted areas of trading are concerned the regime should be simplified by allowing 100 per cent foreign equity through the automatic route with clearly spelt out conditions (if any). The retail sector in India is dispersed, widespread, labour-intensive and dis-organised. In the light of this a phased approach should be adopted in permitting FDI in retail trade. FDI up to 26% could be allowed initially

and raised to 49% within 5 years. Once the system has adjusted to the new competition the limits should be removed completely (i.e. 100% automatic). In the case of agricultural goods and food department stores, equity limits (above 26%) could be allowed subject to the introduction of supply chain management skills, systems and procedures into the food chain.

We also recommends that the exit barriers identified in **Table 12** be removed.

Table 12: Exit Barriers to be Considered for Deletion

1	Sale of shares by foreigner to another foreigner (FIPB-sectoral caps)	Remove
2	Sale from non-resident to resident (RBI permission)	Remove
3	Share SWAP permission-separate permission for share sale	Remove
4	Premium on publicly listed share price cannot exceed 25%	Remove
5	Share sale price (unlisted companies): Min (Book value, PE multiple method)'	Remove
6	Borrowing not allowed to purchase shares	No change

6.4 Marketing India

The problem at the screening stage needs to be seriously addressed *through improving the image of India, marketing India and conveying a positive approach towards FDI to foreign investors.* According to BCG, unhappy encounters would have to be replaced by success stories.

6.4.1 Attitude to FDI

An attitudinal and mind set change towards FDI is necessary. This may be conceptually simple but practically difficult to change; changing foreign perception of India and making India an attractive destination for FDI is a daunting challenge. The only method that is known to have worked in other countries is a clear and unambiguous message from the top leadership of the government conveying its importance to all organs of government. An alternative could be a well-designed publicity campaign bringing out the advantages that various countries have reaped from FDI.

6.4.2 India's Image

6.4.2.1 Advantages/Positives

Surveys have identified several advantages offered by India to FDI investment. These "Business Sweet Spots," need to be capitalised on (BCG). Among the advantages clearly perceived by existing and potential FDI investors are, higher skills, competitive wages and market size (ATK 2001). With respect to market size, it is however, necessary to be realistic given the low average per capita income. In the case of luxury products the market potential lies in the future and we should not oversell this advantage.

Studies have also shown that foreign invested companies in India have higher returns than in any other region. This is perhaps one of the reasons that a very high proportion of existing FDI want to carry out further investment in India (FICCI). Knowledge and experience of operating in India reduces the perceived risk making the return-risk trade off highly attractive. The success stories of Multi National Companies operating in India need to be documented and made known to potential investors. Officials of these Multi National Companies should also be involved in helping market India to other potential investors.

Other advantages include government incentives and opportunities in infrastructure development. This information needs to be made widely known to potential infrastructure investors. India's tax regime for exporters and export production has been one of the most transparently favourable for at least a decade(this has however, changed during the last few years). Yet few potential investors are aware of the tax regime, because we have not publicised it appropriately, for instance by comparing it with the taxes in favoured FDI destinations.

6.4.2.2 Inconveniences/Negatives

There are also many actual and perceived disadvantages facing FDI in India that must be addressed on in any marketing effort. In one survey 54 per cent of the respondents said that India's structural inconveniences do not exceed that of other

emerging markets (ATK 2001). Yet these disadvantages are cited in the media much more often with respect to India than with respect to other countries[21].

FDI investors perceive a high degree of uncertainty in India. This includes political and administrative uncertainty, legal delays and bureaucratic delays. This translates into a higher risk perception than is perhaps warranted. To the extent that actual risk differs from the perceived risk, the best antidote is better and more authentic information. Thus for instance research institutions should publish objective measures of risk such as the variance of returns. Comparative studies on risk-return trade-off should also be helpful. Available studies and success stories should be publicised.

6.4.3 Revamping Publicity

The government must take steps to provide more and better information about policy, regulations, procedures etc., as relevant to each sector. This could be done through a web site designed with the specific objective of facilitating foreign and domestic investment but designed keeping in mind the special difficulties perceived by potential foreign direct investors relatively unfamiliar with India.

A strong publicity mechanism needs to be put in place, which can project success stories in various sectors. The administrative ministries have an important role to play in this regard. While it is most important to remove real constraints to investment, it is equally important to remove coloured perceptions that prospective investors may have about India as an investment destination. For example, on the issue of policy uncertainty, which is often cited as a negative feature of India, it has to be emphasised that there has been only one incident of major policy reversal since 1991. The recent spurt in FDI inflows also requires to be projected prominently as an indicator of growing investor confidence. Similarly, some of the sector initiatives taken by the Government such as the National Mineral policy, the Biotech Park scheme, power sector reforms and dis-investment need to be publicised more effectively. India has one of the most liberal and transparent FDI regimes as noted by several informed observers. This fact needs to be publicised.

[21] If the Pfefferman/IFC study is valid, investors are finally beginning to see through the veil created by media.

6.4.4 Marketing Strategy

The Foreign Investment Promotion Council (FIPC) should be transformed into the primary arm of the government for promoting FDI in India, with the Department of Industrial Policy and Promotion (DIPP) continuing to act as its secretariat[22]. The Chairman of the FIPC could be a person of national and international credibility. The membership of FIPC should include a finance person, an economist, a legal expert, and the secretary (IPP) as an ex-officio member. There should also be provision for two part-time members from the industry. The organisation should target specific corporations and interact with the CEO and boards of these companies for enticing them to take investment decisions in favour of India. Besides the authority should also constitute half a dozen special groups headed by Ministers or Minister level functionaries who could be earmarked a set of companies with whom they have to establish contact.

The existing approach to providing information and generic promotion of FDI to India needs to be complemented by a sector and firm specific marketing strategy. We should make a short list of potential investors and develop a customised sales pitch for each of them. Based on this a business focused discussion should be held with the real decision-makers. For such an approach to be effective we must understand the fundamental and specific needs of each of the targeted investors. Only then can we help them work out concrete investment proposals. At the problem solving stage the right ministries, concerned State governments and other relevant institutions must be available around the table to find solutions and make quick decisions. A start can be made by collecting and analysing information on the activities and foreign investments of the 500 largest trans-national companies. The analysis would identify the sectors of interest to each of these 500 companies. This could be followed by the setting up of sector specific high-level special groups and the apportioning of the 500 companies among them according to their likely sector of interest in India. This would include sectors like electronics and computers, machinery and equipment (including electrical), chemicals and cosmetics, motor vehicles and parts, food and beverages and services (utilities, telecom, media,

[22] An alternative would be to transform this into a registered society so that there can be more equal public- private partnership in marketing and facilitation of services.

publishing, retailing, trading) and other manufacturing (paper, packaging, rubber/tyres, steel, construction materials). Marketing expertise should be drawn upon by the special groups in devising a strategy for contacting and persuading each of these companies to make large investments in India.

6.5 Policy for Special Economic Zones

China's success in attracting export related FDI and its success in labour intensive exports contrasts sharply with that of India. Many of the policy reforms that are politically difficult in India were equally difficult in China. China however was able to introduce these reforms on an experimental basis in their Special Export Zones and then use the demonstrated success of these reforms to make them deeper and wider. This is an example worth emulating.

6.5.1 State SEZ Law(s)

We would recommend that States consider enactment of a Special Economic Zone (SEZ) law that would apply to all SEZs in the State. The Maharashtra SEZ law can be used as a basis or a possible model for this purpose. The law should cover State level industrial, labour, environmental, infrastructure and administrative issues, with a view to simplifying and promoting investment and production in the SEZs.

6.5.2 SEZ Infrastructure Policy

Though it will take a decade or more to improve infrastructure services across the country, infrastructure availability and quality can be brought to global standards in the Special Economic Zones (SEZs) within a couple of years. The effect of a weak highway and railway system can be minimised by locating SEZs in the coastal regions as was done by China and many other countries in S. E. Asia. Among the measures needed for accelerated development of Infrastructure in and exports from SEZs are;

a. Power generation and distribution for the SEZ needs to be isolated from the crumbling SEBs to the extent possible. As size limitations make electricity generation for the SEZ (alone) non-optimal, the private electricity generator for the SEZ should be allowed to sell excess power to parties outside the SEZ subject to transparent wheeling charges and cross tax-subsidy arrangement.
b. There should be free entry and exit of Telecom service providers into the SEZ without any service or USO charges, subject only to the condition that the

spectrum would be auctioned if and only if it ceases to be a "free good" within the SEZ. Inter-connectivity with other countries (ILD) should be free and unrestricted (subject only to the condition that this cannot be used as a conduit for provision of unregulated telecom services into the DTA). Automatic 100 per cent FDI should be allowed.

c. Private parties would also be free to set up a private airport or port to service the SEZs with automatic 100% FDI. If an unused harbour is not available nearby, the requisite number of berths in the closest port should be made available to private parties for the purpose of servicing the SEZ. These parties (or another developer) should be given the authority to set up toll highway connecting the port to the SEZ.
d. A law should be passed by the State governments under which 100% privately owned townships can be set and run by private developers as private municipalities. Private SEZs should be designated as private municipalities under this law and road, electricity transmission & other linkages provided by State/Central govt.

6.5.3 SEZ Administrative Structure

A number of other legal and bureaucratic changes can also be introduced much more quickly in the SEZs than is possible in the country in general. The applicable laws, rules, regulations and procedures in the SEZs should be made as attractive as in China's coastal regions & other competing destinations. In fact we should experiment with an even bolder model of a market economy with no controls and restrictions complemented by a modern regulatory system based on trust that punishes violators quickly and effectively like the traffic light approach[23]. This requires,

a. Elimination of all price controls & distribution controls (e.g. on Power, Rent),
b. Removal of all investment restrictions (e.g. SSI reservation, foreign equity limits & bans, public sector reservation) for production and supply within the zone or for export. This would include removal of State & local restrictions (eg. Urban land ceiling, retail trade, real estate).

[23] For some regulations, self certification may be adequate while for others outside (private) certification (eg. by an accredited professional or certification agency) may be required.

c. Removal of all capital account restrictions/controls/prior permissions for businesses operating within the SEZ (reporting requirements and regulations relating to inflow of Foreign exchange debt etc. into DTZ would remain).
d. International standard financial regulations for financial institutions operating within the zone with our unique Indian "controls" eliminated. Thus the FDI limits on Banking, Insurance, NBFCs would not apply, directed credit & SLR would be eliminated and CRR brought down to internationally comparable levels.
e. Customs, Excise & Service tax laws to be modified so that all transactions within the SEZ are exempt and transaction of DTA with the SEZ can be treated as if with a foreign country. Normal excise (& customs) rules would no longer apply for transactions within the SEZs. Customs and Additional duty (equal to CENVAT/Excise) would apply to all sales to DTA. SAD should not apply as state sales and other taxes would apply. State sales tax law should also be modified, so that within the SEZ only sales to resident consumers (not producers/traders) are taxed. No excise/CST/ST/Octroi would be charged for sales from DTA to SEZs.
f. SEZs should be exempt from MAT and dividend tax. All export related profits should be exempt from corporate income tax for a specified period.
g. A new labour law incorporating a work ethic. Abolition of Contract Labour restrictions. Freedom for multiple and night shift for workers of both sexes. Designation of Development Commissioner as Labour Commissioner.
h. An integrated unified industrial regulator (i.e. only one inspector for all continuing industrial regulations including pollution, labour safety).
i. Designation of the Development Commissioner as the Commissioner under all the relevant laws (industrial, environmental etc.) within the SEZ.
j. A modernised judicial sub-structure for SEZs that deals with cases in a time bound manner.

Though some of these have been introduced others changes have proved painfully difficult to get approved from the responsible departments.

6.5.4 Marketing of SEZs

A special marketing effort is needed for export oriented FDI. For instance, Taiwanese and other exporters in East and S.E. Asia can be targeted for this purpose. Our missions in OECD and other FDI source countries should be fully briefed on the comparative advantages of SEZs in India and distribute the required literature.

6.6 SECTOR POLICY REFORM

Domestic policies and regulations determine the environment for private investment. This environment affects both domestic investors and FDI. Simplification and modernisation of laws, rules and regulations, elimination of controls and bans, introduction of a modern professional regulatory systems and other policy reforms will result in greater gross domestic investment. These measures will also increase the flow of FDI. A few of the policy issues that can have a relatively larger affect on FDI vis-à-vis indigenous investment are discussed below.

6.6.1 Dis-investment

Across the world dis-investment has acted as a magnet for FDI. Though foreign companies are allowed to bid for government strategic share sale, there is some apprehension about doing so. If a clear signal is given that foreign companies are not only allowed but encouraged to bid in dis-investment auctions, this could attract a significant amount of FDI. This in turn means that additional outside capital and investment will flow into industry from outside the system rather than existing private investment moving from one industry or sector to another. FDI flow into privatisation is more likely to be complimentary, while strategic purchase by domestic investors may have some element of substitution. The strategic sale route had about two years ago crystallised into a transparent, time-bound, non-discretionary process, FDI investors had developed confidence in the mechanism. Since then the situation has deteriorated with first elements within the ruling party and subsequently its allies turning against it. The earlier recommendations of a well-programmed "Road Show" for large value high profile dis-investment to target FDI should be encouraged may not be feasible at this point in time.

6.6.2 Power

Private investment in the power sector, both domestic and FDI, depends on power sector reform. Policy and regulatory reform, relating to user charges, reduction of theft and private entry into distribution are a pre-requisite for increased private investment. Without such reforms FDI and domestic investment in the power sector will remain a trickle. The Electricity Act (2003) lays down a framework for private entry into and competition in this sector. Remaining lacuna in the bill, such as with regard to the appointment and terms under which the regulatory authority would function need to be corrected through an amendment to the act.

Privatisation of the existing generating capacity along with open access to the transmission-distribution system subject to explicit cross-tax subsidy and the setting up of a competitive market could also attract substantial FDI and private domestic investment. Complete decontrol of new investment in power generation and distribution in rural areas can also be experimented with to free entrepreneurs from the vice like grip of legacy systems. Besides stand-alone systems this may also require open access to the existing rural electricity distribution system.

6.6.3 Urban Infrastructure & Real Estate

It is estimated that removing land market barriers can contribute an additional 1% to India's GDP growth rate.[2] There is an urgent need to ensure compulsory registration of land deeds and also to computerise such records so as to create a database of such records. The Andhra Pradesh experience is a good example to begin with where registration of sale of land/property is achieved within a month. Conversion of rural land to urban use at market prices within the master plan of the city, should be completely de-controlled and left to the market. The Centre has repealed the Urban Land Ceiling act, but only a half a dozen States have notified its repeal. Other should also do so.

The Rent Control Act is probably the single most important cause for the existence of metropolitan slums, as building rental housing for low and middle income groups amounts to gifting ones assets. States should repeal the Rent control act for all new tenancies and phase it out for existing tenancies. Our urban and municipal laws and regulations date back to half a century if not more. There is a need to thoroughly review and modernise them in the light of the latest developments in

urban infrastructure, transport, pollution control etc. A system of deemed approvals for all planning permissions by registered architects operating on a self-regulatory basis, much like chartered accountants, would enormously speed up the entire process and ensure far larger quantum of housing stock are supplied every year, at more reasonable prices than is the case thus far.

Urban taxes such as property tax, stamp duty on sale of land and buildings and entertainment tax need to be rationalised. Creation of Real Estate Mutual Funds/Real Estate Investment Trusts should be permitted. Development of the secondary mortgage market and securitisation of loan assets will increase the liquidity position of the housing finance companies and make available funds at low cost. Foreclosure laws to be passed- this will enable financiers to repossess properties without having to seek recourse from courts.

An urban reforms facility has been set up by the Central government to provide an incentive to States to carry out these reforms, which fall largely under their purview.

6.6.4 De-control & De-licensing

De-control of the Petroleum (oil, gas etc.), Coal and small industry sectors needs to be completed to stimulate efficiency and productivity improvement and investment. Though the Administered Price Mechanism (APM) for oil and its refinery products has been formally discontinued, the proposed Petroleum Regulation law has many clauses that could be misused by a future administration to re-impose controls through the back-door. These clauses need to be removed or modified to dispel such apprehensions. A number of items with export potential have recently been removed from the list of SSI reserved items and the investment limit raised for items where the technology requires greater investment to attain Minimum efficient scale (MES). Over 600 items however remain on the list. SSI reservation should be phased out over the next year or two. Limits on equity holding by companies in SSI units should be removed so that those units who require equity for growth are not constrained by the weak access of small units to the capital market. Factor markets (management, labour) liberalisation also needs to proceed forward.

6.7 Tax Rules and Rates

6.7.1 Corporate *Tax*

Many countries, such as Malaysia, Thailand and China have had at various times tax rates that favour foreign direct investment over domestic direct investment. Our tax laws treat all companies incorporated in India equally, irrespective of the proportion of foreign equity holding (national treatment). Tax rates have however often been higher in the case of Indian branches of foreign incorporated companies (eg. foreign airlines and banks operating in India through such branches). These rates should be equalised. There is also a clear case for making tax laws and rules as simple and internationally comparable for FDI. Lower rates for FDI in selected high technology sectors can be considered as they can act as a signalling device.

Both domestic and foreign investment would also be encouraged by a reduction in the corporate tax rate (35%) to the highest marginal rate on personal income (30%).

6.7.2 Tariff Rates

The Virmani Committee [Revenue Department (2001)] recommended the reduction of peak rates to 10% and Virmani (2002) has outlined a schedule of tariff reductions to a uniform rate of 5% by the end of the decade. This would align India's import tariff rates with those of ASEAN, a move whose importance has increased with the signing of the framework agreement for an India-ASEAN FTA. As shown in Virmani et al (2004) the Indian manufacturing sector has responded magnificently to the reduction in peak duties from 150% in 1991 to 20% in 2004. This study has also shown the linkage between tariff reductions and exports and higher domestic productivity and demonstrated how manufacturing exports and production will benefit from further reductions in import tariffs.

Given the recent surplus on the current account, the upward (appreciation) pressure on the rupee and the continued increase in service exports it is necessary to accelerate the reduction in non-agricultural tariff rates to 5%. We should target 2006-7 or 2007-8 as the year in which a uniform 5% duty is imposed on all non-agricultural products. This will give a tremendous boost to export oriented FDI and manufactured exports.

7 CONCLUSION

India's domestic entrepreneurs and companies are fairly strong and competent compared to those in many other emerging economies including China. China has however, successfully overcome the domestic weakness created by 30 years of communist economics by laying out the red carpet for FDI in general and export oriented FDI in particular. There is absolutely no other way in which China could have grown at over 9% per annum for 24 years. India in contrast has been stuck at a growth rate of 5.8% per annum over the same 24-year period. Though we do not need FDI to maintain this rate of growth for the next few decades, FDI can play a critical role in helping us to break out of this growth band to a higher one. Further a sustained growth rate of over 7.5% will be near impossible without a much greater inflow of FDI. The recommendations made in the previous section can help bring about a quantum change in both domestic and foreign (FDI) investment and lead to a sustainable and sustained increase in the growth rate.

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