

FOREIGN DIRECT INVESTMENT IN INDIA

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Paris

44833

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Foreword

India's outward-oriented policy reform started in 1991. Although trade and investment expansion in response to reform has been impressive, India's integration into the world economy is still modest compared to its considerable potential as a trading and investment partner. However, India has the potential to become a major player in the world economy.

Relations between the OECD and India have strengthened over recent years. India has been invited, since 1995, to participate in some workshops of OECD's Policy Dialogue with the Dynamic Non-Member Economies*. In January 1996, the Secretary General of the OECD visited India. Following this visit, the OECD Council agreed on a programme of dialogue and co-operation with India. The programme's objective is to support India's fuller and sustainable integration into the world economy, including the social and environmental dimension.

The programme includes :

- an annual India/OECD Symposium on Economic Policy. This will provide for an exchange of experiences in a broad policy area of common interest. The theme of the first symposium is "meeting the challenges of the global economy";
- co-operation on statistics and standards, including i.a. foreign direct investment statistics;
- participation by Indian tax officials in selected courses of the OECD Multilateral Tax Centres.

The programme of dialogue and co-operation with India is managed by the Liaison and Co-ordination Unit of the General Secretariat of OECD.

The present report provides a survey of trends and regulations concerning Foreign Direct Investment in India. It has been written by Ms. Kelly A. Johnson as a consultant for the OECD. It was presented at a Workshop on Foreign Direct Investment, held in Hong Kong on 26-27 March 1996, in the framework of OECD's Policy Dialogue with the Dynamic Non-Member Economies. The agenda of this workshop, to which India participated, included a discussion of India's experience in the liberalisation of Foreign Direct Investment policies.

The opinions in this report are those of the author.

* The Dynamic Non-Member Economies are Argentina, Brazil, Chile, Hong Kong, Korea, Malaysia, Chinese Taipei, Thailand and Singapore. China, India and representatives of the business and academic sectors of Indonesia participate in some workshops of this dialogue.

Introduction and summary

Foreign direct investment has played a relatively minor role in the development of the Indian economy since the country's independence in 1947. As part of the model of economic growth under centralised planning from 1951 until 1991, which was aimed at building up a self-reliant and self-sufficient economy, foreign investment policies were extremely restrictive. Inward flows of foreign capital were allowed to the extent that they were necessary to sustain the planners' inward-looking strategy of import substitution industrialisation (ISI). Acceptance of FDI hinged on requirements of technology transfers and were permitted in high-tech industries, industries that were experiencing large production gaps or industries that could expand India's exports. Foreign equity participation had a general ceiling of 40 per cent.

After years of isolation, India initiated a wide-ranging program of outward-oriented economic reforms on July 24, 1991. The new policy direction was built upon the realisation that economic and social advancement could be achieved only if India grew as part of the world economy. Sweeping changes toward liberalisation were made in policies of trade, industry, foreign investment, finance, taxation and the public sector. Short-term priorities of the new policy included the stabilisation of internal and external macroeconomic imbalances.

The role of the private sector (domestic and foreign activities) was increased as part of the reforms. The requirement of industrial licensing was abandoned, trade barriers were drastically reduced, the financial sector was partially liberalised, market-entry barriers were removed in many sectors of the economy and some disinvestment schemes were introduced in the public. A wide range of state monopolies and sectoral restrictions - in power, telecommunications, transport infrastructure, tourism, mining, petroleum, finance and banking - were relaxed during the post-liberalisation period. Most of the private investment increases were a result of the removal of permit requirements and other barriers to entry: the actual privatisation of public enterprises has played a minor role in attracting private investment.

In the area of FDI, the requirement that such investments be accompanied by technological transfers was abolished and the approval process was streamlined and liberalised. India's Reserve Bank was authorised to grant *automatic* approval for foreign investments up to an equity participation limit of 51 per cent in specific sectors, subject to certain conditions. Investments with foreign equity participation of up to 100 per cent were allowed in many sectors which are open to the private sector, yet they remain subject to prior government approval. It is no longer required that foreign investors have a local partner, even when the foreign investor wishes to hold less than the full equity of the company. The use of foreign trademarks and brand names is no longer prohibited and local content regulations have been withdrawn.

The Foreign Exchange Restrictions Act of 1973 was amended, placing all companies operating in India at par - regardless of the foreign equity participation level. Incentive programs do not discriminate between foreign and domestic firms: tax and non-tax concessions are available to all new investment, foreign or domestic, and industrial undertakings which are export-oriented. Foreign investors can freely access the Indian capital market to raise funds through equity shares, debentures, hybrids or loans from financial institutions. Tax rates for domestic and foreign firms operating in India are comparable. Profits may be freely expatriated except for in a few consumer goods industries where repatriation is subject to dividend balancing against export earnings

Notwithstanding the important progress that has been made liberalising the FDI regime, there are several areas where foreign investment is restricted and where monopolies and other market access barriers impede direct investment inflows. For example, foreign participation outside the narrow parameters of the

automatic approval process is determined on a case-by-case basis at the discretion of the Indian authorities. In addition to lacking clear ground-rules and transparency, this practice places foreign investors at a disadvantage *vis-à-vis* their Indian counterparts regarding the right of establishment. It also raises questions surrounding India's commitment to the more liberal FDI regime--namely whether the surge in FDI approvals is temporary or if the trend will continue.

Further, despite the broad range of FDI liberalisation measures implemented by the central government, sector-level policies and the institutional framework at the state level still contain elements of India's legacy of state intervention which act as barriers to foreign investment. Restrictions to foreign investment apply in several sectors, too. Companies in telecommunications services are restricted to foreign equity participation ceilings of 49 per cent. In banking, existing foreign banks may acquire up to 20 per cent of new private banks. The opening of ports, shipping, roads and railways sectors has been cautious and slow, with foreign participation at a minimum. The insurance sector has not joined in the reforms at all.

Most public enterprises suffer from low productivity, dismal financial performance and over-employment. In order to meet the challenges of rapid growth and international competitiveness, there is an urgent need to upgrade many public services, yet the government's ability to take on large investments is severely constrained. Given the state's large role in the Indian economy, its desire to heighten competition in sectors where the state dominates and the severe budget constraints of the grossly indebted and cash-strapped government, a privatisation program has been recommended by a special advisory committee. Yet, the government has not yet taken steps toward implementing a large-scale privatisation program. Privatisation would achieve enhanced competition, it would also reduce government expenditure and boost revenue. Privatisation would also widen the scope of investment opportunities. By pushing ahead with privatisation, the government faces the obstacle of rising political and social tension. This tension may threaten to undermine the success of the reforms and has already somewhat tainted India's reputation of credibility among international investors.

This report examines the role of foreign direct investment in the Indian economy, the country's current FDI policies and discusses economic and political factors that may influence investors' decisions. In the first part of the study, an analysis of FDI trends will be presented in order to shed light on the importance of such flows on the Indian economy. Foreign direct investment flows will be broken down into sectors and the impact of the 1991 liberalisation will be traced. While policies governing FDI appear to have been the most important determinant of FDI inflows in the case of India, the section will end with a look at economic and political factors that also have an impact on these inflows.

The second part of the report will focus on current FDI policies in India. The new industrial policy of 1991 was accompanied by a substantial liberalisation of the FDI regime. Changes and proposals affecting foreign investors which took place in 1991 and those which have been introduced since then shall be examined.

Part I. The role of foreign direct investment in India

A. Data and methodological issues

Traditionally, there have been two principal sources of data on India's international direct investment. Since 1948, the Reserve Bank of India (RBI) has been reporting official data on FDI inward stock and flows in its publication entitled *The Reserve Bank Bulletin*. Data on outflows of FDI have long been published in the Ministry of Commerce's annual report.

The Reserve Bank of India defines inward foreign direct investment flows as the actual inflow of long-term foreign capital into corporate, industrial and commercial enterprises in which foreigners have at least a 25 per cent stake. This includes direct investment equity capital flow, retained earnings and inter-company debt, defined as the change in indebtedness of branches to their principals abroad. The net inflow of FDI is then the sum of the above components minus the repatriation of firm capital. The Ministry of Commerce defines foreign direct investment outflows as investment contributions made by Indian firms to joint ventures abroad and wholly-owned subsidiaries. Up until the 1980s, wholly-owned subsidiaries were excluded from the Commerce Ministry's data. Investment contributions by Indian firms and joint-ventures abroad include capital in the form of equity, equipment exports, know-how, cash, bonus shares and loans. Neither of the two sources reports FDI flows in banking, insurance and government companies, sectors which have been generally closed to foreign investors. The Ministry of Commerce has not been reporting data on outward stock for some years now, which makes the search for recent figures extremely difficult.

There are several problems associated with collecting data on FDI in India. First, the above definitions differ from the guidelines of the International Monetary Fund and the OECD, which set a lower limit of foreign ownership of ordinary shares or voting power of an enterprise at 10 per cent.¹ Therefore, discrepancies arise when official Indian data on FDI inflows are compared to outflow figures from investor countries. Another problem with the RBI surveys on foreign investment statistics is that they are published intermittently. The RBI has put out seven such surveys from 1968 to 1994, which cover the period from 1961-92. Unfortunately, gaps appear in the data. Where such gaps in data on flows are present, estimations will be made by taking the difference between stock levels for two consecutive years.

Other agencies collect data on FDI in India; however, they are often inconsistent with the "official" statistics kept by the aforementioned government departments. Two sources have managed to provide easily accessible data on the number of government approvals on FDI and actual inflows which correspond with the official figures during the post-liberalisation period after 1991. The Secretariat for Industrial Approvals and the Indian Investment Centre now publish informative monthly newsletters comprised of such figures as well as news on developments in FDI policy and trends.

The number of FDI project approvals is another statistic provided by the Indian Government. These statistics are more widely cited than direct flows, perhaps due to the incomplete and unreliable manner in which actual flows are reported. Both approvals and actual flows will be examined in this study.

1 Until several years ago, the IMF reported data on FDI in India, but it was limited to investments in foreign-owned petroleum companies.

Data on FDI in India are reported by the government agencies in the local currency, rupees. The official rupee-denominated figures shall be provided, accompanied by a United States (current) dollar amount which is calculated by using the International Monetary Fund principal exchange rates in the *International Financial Statistics* for the relevant years. The yearly rate is formed as a period average. The rupee per US dollar rates used in this study are the following:

Table 1. Rupees per US dollar

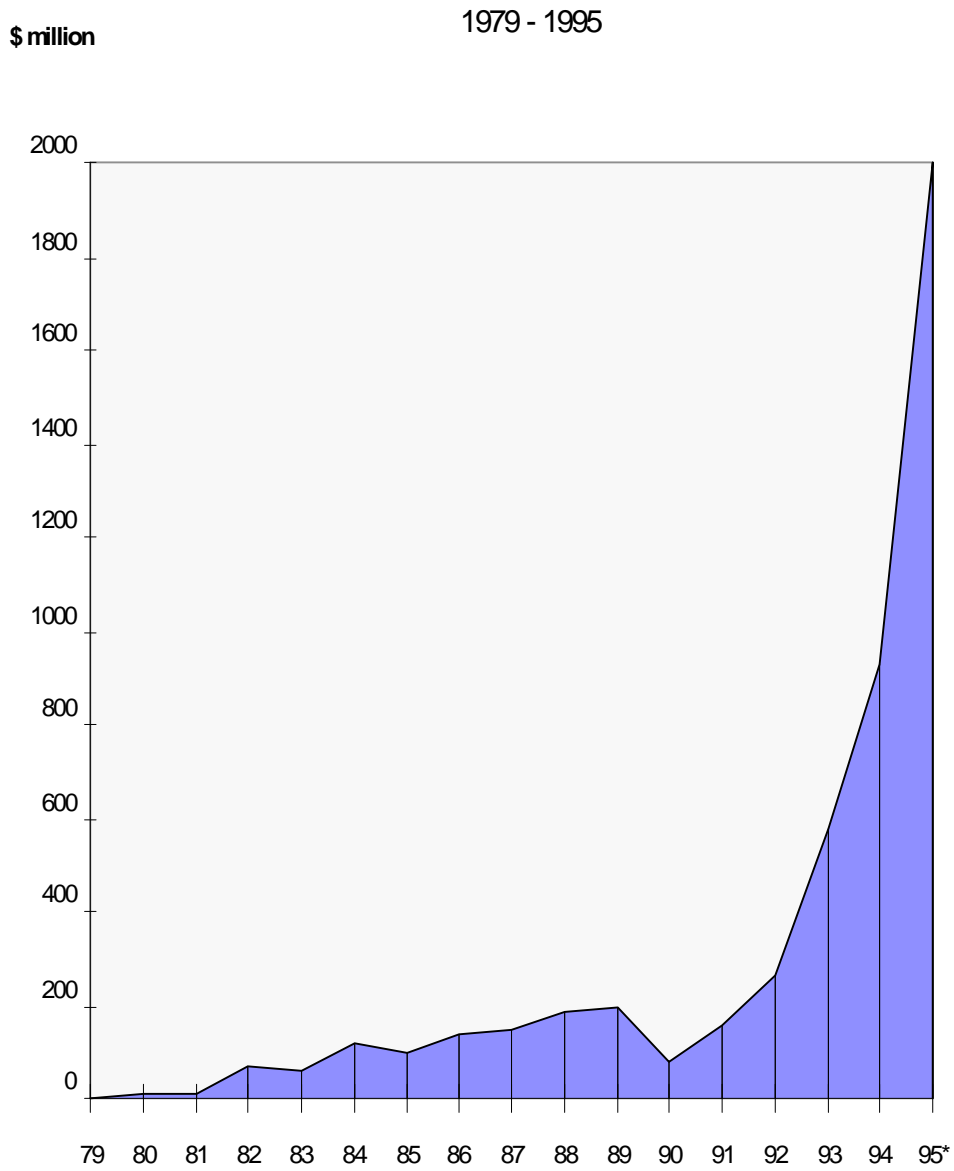
Year	Rupee/\$	Year	Rupee/\$
Prior to June 1966	4.76	1982	9.46
1966	6.36	1983	10.10
1967-1971	7.50	1984	11.63
1972	7.54	1985	12.37
1973	7.74	1986	12.61
1974	8.10	1987	12.96
1975	8.38	1988	13.92
1976	8.96	1989	16.23
1977	8.80	1990	17.50
1978	8.19	1991	22.74
1979	8.13	1992	25.92
1980	7.86	1993	30.49
1981	8.66	1994	31.50

B. FDI inflows, home countries and sectors

Similar to most developing countries, India has generally been a net recipient of FDI. Yet unlike a number of developing countries in Asia and Latin America, the level of FDI inflows have been lower in India. For example, in Asia during the period 1980-1985, FDI inflows totalled \$9.5 billion in Indonesia, \$3.87 billion in Thailand and \$1.28 billion in Malaysia, while they amounted to less than half a billion dollars in India. Between 1979 and 1993, China received \$60 billion in FDI, compared to only \$2 billion in India (Chart 1 and Table 2). It must be remembered, however, that RBI data on flows to India include foreign investments with equity participation of more than 25 per cent. Thus, by OECD standards, the actual amount of FDI flowing into India is probably larger than indicated by these RBI figures.

Nevertheless, a relatively low level of FDI has persisted in India, which has been largely due to the highly regulated environment and the labyrinth of required procedures. In the case of India, the single most influential factor determining both the magnitude and pattern of FDI has been government policy. In accordance with the priorities of the country's inward-looking development strategy, restrictions were placed on equity participation and requirements were set for technology transfer and industrial licensing.

Chart 1. Foreign direct investment flows



Source: Reserve Bank of India

Table 2. **Foreign direct investment inflows, 1970 - 1994**
Rs million (\$ million, current)

Year	Inward flows	Year	Inward flows
1970	21.9 (\$2.9 mn)	1983	618 (\$61 mn)
1971	33.4 (\$4.5 mn)	1984	1130 (\$113 mn)
1972	46.4 (\$6.1 mn)	1985	1260 (\$101.6 mn)
1973	28.4 (\$3.7 mn)	1986	1770 (\$140.5 mn)
1974	48.7 (\$6 mn)	1987	1850 (\$142.7 mn)
1975	60 (\$7.2 mn)	1988	2570 (\$184.6 mn)
1976	-8.1 (-\$.9 mn)	1989	3167 (\$ 195 mn)
1977	-26.8 (-\$3.1 mn)	1990	1283 (\$ 73.3 mn)
1978	-17.8 (-\$2.2 mn)	1991	3514 (\$155 mn)
1979	23.7 (\$2.92 mn)	1992	6752 (\$260 mn)
1980	68.5 (\$8.7 mn)	1993	17589 (\$577 mn)
1981	109 (\$12.5 mn)	1994	29717 (\$929 mn)
1982	628 (\$66 mn)	1995*	67000 (\$2 bn)

Source: RBI, SIA, United Nations Committee on Transnational Corporations

* First four months at annual rate

Note: Flows during 1981-1985 are UNCTC estimations based on approvals and annual stock levels

In the wake of the foreign exchange crisis in the late 1950s, the government began to encourage foreign investment into the country. Consequently, the average annual number of FDI approvals jumped from 50 during the period between 1948 and 1958 to 297 during 1959-66 (Table 4). In terms of actual FDI stock in India, the value rose from Rs 3860 million (\$810 million) in 1955 to Rs 6120 million (\$1.3 billion) by March of 1965 (Table 3). However, since the government's policy favoured retaining control of firms in Indian hands, investment in foreign subsidiaries was discouraged. As a result, their share in total foreign direct investment fell from 62.9 per cent to 42.8 per cent between December 1955 and March 1965.² Out of the total of 537 foreign controlled rupee companies (FCRCs) examined by the Reserve Bank between 1964 and 1970, only 51 were wholly-owned and 176 were majority-owned by foreign nationals.³

By the late 1960s and early 1970s, the Indian government began to adopt more restrictive policies with regard to FDI. Particularly distortionary policies such as the Monopolies and Restrictive Trade Practices Act (MRTP) of 1969, the Indian Patent Act (IP) of 1970 and the Foreign Exchange Regulation Act (FERA) in 1973 had a strong deterrent effect on FDI flows. The MRTP Act scrutinised the proposal for capacity expansion by large firms and foreign collaboration approval was often tied to export commitments. The IP Act removed many monopolistic advantages of multinational corporations once protected under the old patent law and aimed to help domestic firms grow, particularly in the area of chemicals and pharmaceuticals. Under FERA, which finally came into effect in 1974, restrictions were imposed on the operations of foreign companies in India. Subsidiaries of foreign companies were given a certain amount of time to complete the 'Indianisation' process which was

2 Sharan, Vyuptakesh, "Foreign investments in India: trends, problems, and prospects", Foreign Trade Review, 27(1) April June 1992, 74-94.

3 Reserve Bank Bulletin, The Reserve Bank of India, New Delhi, 1974.

designed to reduce foreign equity participation in companies to less than 40 per cent. The FERA also prohibited the entry of foreign investors in the banking, commerce, finance, plantations, trading and construction industries.

These restrictive policies resulted in a downward trend of FDI flows in 1970s. The average annual inflow of FDI during this decade was only \$3 million. The average yearly number of foreign collaboration approvals dropped to 279. During the mid and later 1970s, due to the lag effect of the FERA, the total stock of FDI shrunk to Rs 8750 million (\$1.9 billion in 1990 dollars) in 1979 from Rs 9238 million (\$2.2 billion in 1990 dollars) in 1976, as firms withdrew capital from their Indian investments. Measured in constant US dollars, the FDI stock shrunk from \$5.2 billion in 1965 to \$1.9 billion in 1979. A Reserve Bank of India study on the impact of FERA showed that out of 179 sample companies, 52 per cent diluted their foreign shareholding to 40 per cent or less between 1973 and 1981.⁴ Those companies which were allowed to hold more than 40 per cent operated in “high priority” industries, which boosted exports and/or used sophisticated technology.

Table 3. **Foreign direct investment inward stock, 1948 - 1994**
Rs million, \$ current, \$ constant (1990)

Year	Inward stock	Year	Inward stock
1948	2559 (\$538 mn, 3 bn)	1980	9330 (\$1.2 bn, 1.89 bn)
1955	3860 (\$811 mn, 4.1 bn)	1981	10015 (\$1.3 bn, 1.86 bn)
1961	5284 (\$1.1 bn, 4.8 bn)	1982	10124 (\$1.1 bn, 1.5 bn)
1965	6120 (\$1.3 bn, 5.2 bn)	1983	10752 (\$1 bn, 1.3 bn)
1969	8046 (\$1.1 bn, 3.7 bn)	1984	11370 (\$956 mn, 1.19 bn)
1970	8068 (\$1.1 bn, 3.5 bn)	1985	13400 (\$1.1 bn, 1.3 bn)
1971	8102 (\$1.1 bn, 3.4 bn)	1986	15570 (\$1.2 bn, 1.4 bn)
1972	8177 (\$1.1 bn, 3.2 bn)	1987	17420 (\$1.3 bn, 1.47 bn)
1973	9022 (\$1.2 bn, 3.3 bn)	1988	19910 (\$1.4 bn, 1.53 bn)
1974	9130 (\$1.1 bn, 2.8 bn)	1989	22280 (\$1.3 bn, 1.35 bn)
1975	9178 (\$1.1 bn, 2.5 bn)	1990	27423 (\$1.5 bn, 1.5 bn)
1976	9238 (\$1 bn, 2.2 bn)	1991	29616 (\$1.2 bn, 1.15 bn)
1977	9202 (\$1.1 bn, 2.2 bn)	1992	33130 (\$1.3 bn, 1.21 bn)
1978	8760 (\$1.1 bn, 2 bn)	1993	39882 (\$1.3 bn, 1.19 bn)
1979	8750 (\$1.1 bn, 1.9 bn)	1994	57471 (\$1.8 bn, 1.6 bn)

Source: RBI and UNCTAD

4 UNCTC, Foreign Direct Investment and Technology Transfer in India, United Nations publication, 1992.

Table 4. Foreign collaboration approvals
1948 - 1995

<i>Year</i>	<i>Total number of cases approved</i>	<i>Cases involving foreign capital participation</i>	<i>Foreign investment involved (Rs mn/\$mn, current)</i>
1948-55	284	-	-
1956	82	-	-
1957	81	-	-
1958	103	-	-
1959	150	-	-
1960	380	-	-
1961	403	165	-
1962	298	124	-
1963	298	115	-
1964	403	123	-
1965	241	71	-
1966	202	49	-
1967	182	62	-
1968	131	30	-
1969	134	29	-
1970	183	32	25 (\$3 mn)
1971	245	46	58 (\$8 mn)
1972	257	37	62 (\$8 mn)
1973	265	34	28 (\$4 mn)
1974	359	55	67 (\$8 mn)
1975	271	40	32 (\$4 mn)
1976	277	39	73 (\$8 mn)
1977	267	27	40 (\$5 mn)
1978	307	44	94 (\$11 mn)
1979	267	32	57 (\$7 mn)
1980	526	73	89 (\$11 mn)
1981	389	57	109 (\$13 mn)
1982	592	113	628 (\$66 mn)
1983	673	129	619 (\$61 mn)
1984	752	151	1130 (\$99 mn)
1985	1,024	239	1258 (\$102 mn)
1986	957	240	1070 (\$85 mn)
1987	853	242	1077 (\$83 mn)
1988	926	282	2388 (\$172 mn)
1989	605	193	3167 (\$195 mn)
1990	666	194	1280 (\$69 mn)
1991	950	289	5350 (\$235 mn)
1992	1,520	692	38875 (\$1.5 bn)
1993	1,476	785	88600 (\$2.9 bn)
1994	1,854	1,062	141900 (\$4.5 bn)
1995			

Source: UNCTC

In the 1980s, FDI flows increased as policies were liberalised for two select groups. First, the policy for investors from Oil Exporting Developing Countries (OEDC) was liberalised in October 1980. Equity participation of up to 40 per cent without the requirement of technology transfer was permitted from these countries in core sector industries such as fertilisers, cement, petro-chemicals, export-oriented industries and even hotel and hospital projects.⁵ During this period, with the inflow of petro-dollars to the OEDC, investment by these countries to India grew in importance. In 1984-85, the value of FDI approvals from OEDCs amounted to 64 per cent of the total value of approvals. The government also actively promoted investment by non-resident Indians (NRI) during 1982-83 by allowing them to invest in certain schemes without the insistence of the transfer of technology. NRIs were also given tax and interest rate concessions.

During the mid-1980s the industrial policy was also relaxed, abolishing the requirement of licensing in several industries, and a system of 100 per cent export-oriented units was established along the lines of free trade zones. Accordingly, FDI inflows increased. The average annual number of approvals rose to 752 during 1981. The annual value of FDI approvals rose to Rs 909.4 million (\$82 million) during 1982-85 and to Rs 1925 million (\$138 million) during 1986-89. And the level of actual inward FDI stock grew from Rs 9330 million (\$1.19 billion) in 1980 to Rs 19910 million (\$1.43 billion) in 1988, as the average annual inflow of FDI during the decade climbed to over \$100 million. In constant terms, however, the stock of FDI continued its declining trend from the 1970s until 1984, reaching a low of \$1.19 billion before beginning a slow rebound.

Under the economic reform announced in July of 1991, Indian policy-makers expressed the importance of FDI in order to modernise the economy and establish global linkages. Along with the new policy pronouncements, came a substantial liberalisation of the FDI regime. Since the reforms, FDI into India has experienced a spectacular rise. From an initial level of \$155 million in 1990, inflows reached nearly \$1 billion in 1994 and are expected to reach \$2 billion in 1995.

In line with the new policy direction, the value of government approvals of FDI soared. The value of approvals rose from Rs 1280 million (\$73 million) in 1990 to Rs 5350 million (\$235 million) in 1991 and then they jumped seven-fold in 1992. In 1993, the second year of the post-liberalisation era, the total value of approvals more than doubled to Rs 88 billion (\$2.9 billion), shooting up again in 1994 to Rs 142 billion (\$4.6 billion). The total value of FDI proposals approved since the start of the reforms until January 1995 was worth Rs 279.1 billion (\$8.7 billion). This amount exceeds FDI projects approved during the last two decades combined.

Table 5. FDI Approvals by Route
(Rs million)

	1990	1991	1992	1993	1994
SIA	1.2	3.6	4.2	1.6	3.2
FIBP	na	0.3	26.9	80.4	133.4
RBI	na	1.4	7.8	6.6	5.3
TOTAL	1.2	5.3	38.9	88.6	141.9

Source: SIA

A closer look at approval rate statistics shows support for India's commitment to opening the economy to higher levels of foreign equity participation (Table 5). Less than eight per cent of the total value of

5 Kumar, Sanjeev, "Foreign direct investment in India," MDI Management Journal Volume 7, no.1 (January 1994).

FDI approved has taken place through the RBI automatic route, the channel designed to swiftly approve FDI proposals with foreign equity participation of up to 51 per cent in predetermined “high priority” industries, subject to certain conditions and foreign exchange balancing requirements for the repatriation of dividends and import of capital goods. The remaining 92 per cent has been cleared by the alternative approval route (FIPB and SIA), which clears proposals that do not meet the requirements of the automatic route. These data indicate that India’s new policy has more openly accepted foreign investments which involve levels of foreign equity participation greater than 51 per cent and that do not meet foreign exchange requirements. Unfortunately, the same may not be said of India’s openness to FDI in all sectors of the economy, as nearly 90 per cent of approvals during the post-liberalisation period have gone to the 35 “high priority” sectors (Annex 1).⁶

When compared to actual flows of FDI, a significant gap appears between the value approved in a given year and those which are realised. The gap exists primarily because there is a natural lag in investment project situations, which would spread the actual inflows over a longer period than one year. For example, many proposals have been cleared by the FIPB and SIA which include foreign equity participation of 51 per cent or more since 1991; however, due to the lag, only about 80 firms in India had foreign equity participation exceeding 40 per cent as recently as early 1993.⁷

Yet since the implementation of the new FDI policies, the ratio of actual to approved investments has fallen. During the period from August 1991 to January 1995, only 22.3 per cent of approved proposals were transformed into actual flows. Throughout the 1970s and 1980s, this ratio was significantly higher. The average annual ratio from 1970-1975 was nearly 88 per cent. In 1989, the ratio was 51 per cent, followed by 66 per cent in 1991, and then it fell to 17 per cent in 1992, 20 per cent in 1993 and 21 per cent in 1994.

One interpretation for the drop in the actual/approval ratio since the onset of the liberalisation is that the new investments are not easily absorbed by the institutional framework. Elements of India’s past development policies still remain in many sectors of the economy. These sectors have perhaps been open to private investment, yet sector-level policies and the regulatory framework are not fully capable of supporting a flood of private investment. According to government policy papers, foreign and domestic private investment continues to be affected by state level barriers:

“While fetters on industrial investment and production have been sharply reduced at the Central Government level, it is important to recognise that they are still pervasive in many States. The requirement for licenses, permits and inspections at the State and local levels continue to be onerous and extract a heavy toll in terms of efforts and resources from industrial units. Enterprises continue to face difficulties in procuring land, water, and electricity connections.”⁸

If the new FDI regime is not accompanied by changes at the sector and state levels, which support and complement private investment, the measures taken since the 1991 reform could reap far fewer benefits than anticipated. In the recent Economic Survey 1995-96, the government indicates that measures have already been initiated in industrial policy reform by various state governments in an effort to move FDI implementation along more smoothly.

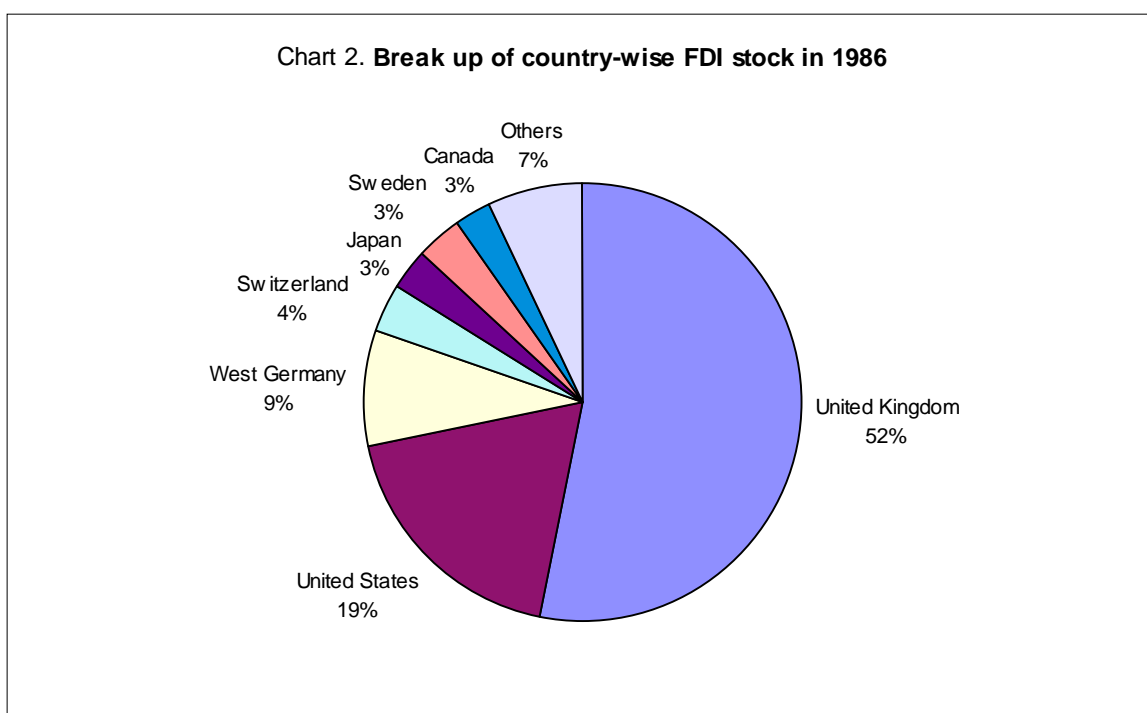
6 Secretariat for Industrial Approvals newsletters, various issues.

7 World Bank Country Study, “India: Recent Economic Developments and Prospects”, The World Bank, Washington DC, March 1995, page 42.

8 From the June 1993 World Bank Discussion Paper on institutional constraints on private investment.

Nearly 95 per cent of all FDI in India originates in OECD countries. Traditionally, the United Kingdom has been the most important country as a source of direct investment in India and holds the largest stock of FDI (Chart 2). In 1986-87, 52 per cent of all foreign controlled rupee companies (FCRC) were owned by British nationals. The USA owned 19 per cent and Germany 9 per cent of total FCRCs.

Foreign direct investments flows from 1983 to present show the growing importance of US companies as investors in India (Table 6). Since the late 1980s, the US has become the largest investor in India, a trend which has gained momentum throughout the economic reforms. From August 1991 to February 1995, 30 per cent of all approvals went to US firms, followed by UK companies with 7.7 per cent (Table 7).



Source: RBI

Table 6. Actual FDI flows from selected OECD countries*
US\$million

	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
US	19	-3	43	51	61	53	..	..	73	52	240
UK	32	62	38	30	70	25	59	75	..	-50	207
Japan	..	..	..	11	21	24	18	30	14	122	35
Germany	6	10	11	5	10	17	18	6	4	7	65
Sweden	1.4	0.72	2	3	1.3	0.14	2	0.67	0.27	2	5
Total	58.4	69.7	94	100	163	119	97	112	91.3	131	549

* These figures include FDI with equity participation lower than 25%.

Source: OECD

Table 7. Foreign Investment Approved By Country
Rs million

Country	1975-93	1993	1994
USA	52,135	34,619	34,881
NRI	16,256	10,433	4,909
Switzerland	11,931	4,268	483
Japan	10,299	2,574	4,009
United Kingdom	8,658	6,227	12,992
Oman	5,430	5,430	174
Germany	5,371	1,760	5,694
Netherlands	4,933	3,216	2070
UAE	4,335	4,049	512
Thailand	3,711	3,684	100
Italy	2,878	1,174	3,909
Mexico	2,509	2,390	0.1
France	2,234	1,291	897
Hong Kong	1,716	880	1,648
Ireland	1,657	1,656	64.1
Singapore	1,382	667	2,655
Mauritius	1,243	1,243	5,347
Australia	973	108	3,885
Denmark	921	391	533
Malaysia	849	85	252
South Korea	831	293	1,069
Sweden	755	6	116
Bahrain	657	0	48
China	626	617	273
Canada	403	273	420
Belgium	376	60	76
Taiwan	302	100	102
Austria	282	156	248
USSR(Former)	261	0	-
Finland	220	21	104
Norway	193	27	3.2
Spain	180	98	20
Philippines	164	144	41
Portugal	161	140	-
Russia	136	20	1,057
Saudi Arabia	116	109	-
Total	145,804	88,593	141,872

Source: Centre for Monitoring Indian Economy and SIA

Other changes in investor countries have transpired since the liberalisation. Countries with no investment interest in India during the 1980s, such as Oman and Thailand, appeared among the top ten on the list of investor approvals in 1993 (Table 7). Japanese investors have also become active in India since the reforms. This is clearly due to the liberalisation in India's FDI policy and India's joining the Multilateral Investment Guarantee Agency, but it also may have been encouraged by the Japanese government's initiative to promote investment in India by granting a \$1 billion credit line for export and investment insurance while easing the criteria for the latter.

Non-resident Indians have been one of the largest investor groups in the post-liberalisation era. Second only to the US, this group contributed 33 per cent of all actual inflows of FDI from 1991 to January 1995.

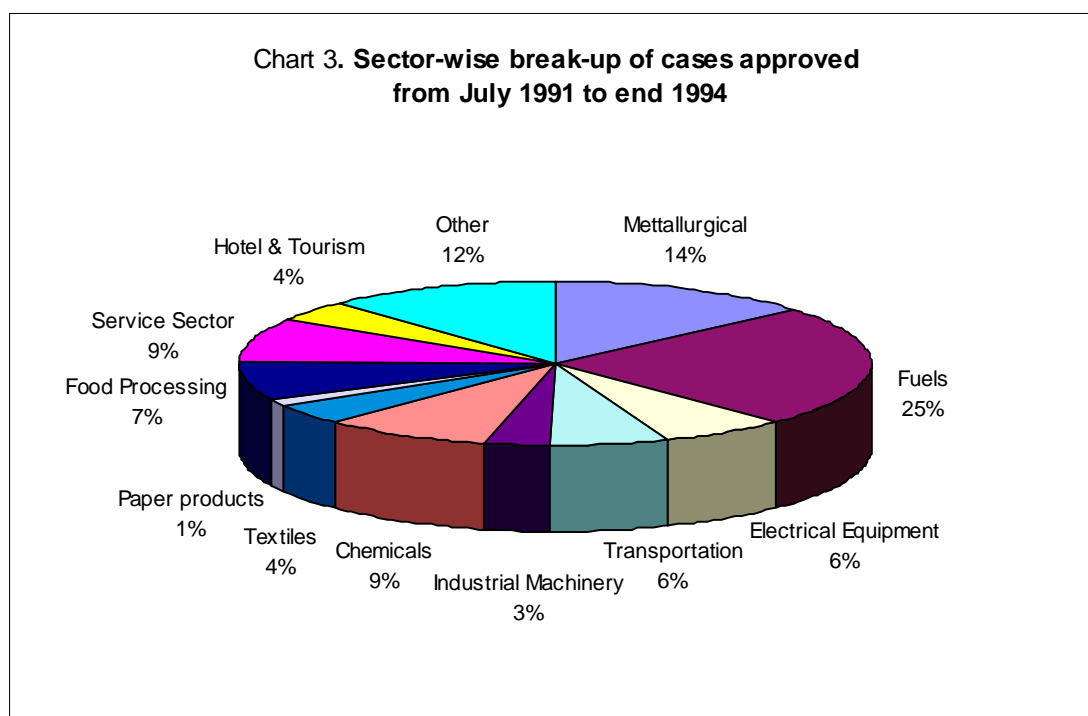
The sectoral distribution of FDI in India has evolved considerably since independence. This is largely a result of the Indian Government's efforts to channel foreign investment into specific sectors, namely manufacturing, by means of an elaborate licensing and approval system. Initially, most foreign investment took place in the primary sector. In 1948, 74.4 per cent of FDI was in tea and jute, with manufacturing accounting for roughly 25 per cent of FDI stock. The share of manufacturing increased to 40 per cent by 1964, 87 per cent by 1980, and 89 per cent by 1986 (Table 8). Even after the 1991 reform, FDI has continued to pour heavily in manufacturing, accounting for more than 90 per cent of all FDI.

Table 8. Sectoral Distribution of Foreign Direct Investment in India
Rs million, percentage

Year	Petroleum	Plantation	Manufacturing	Services
1974	1380 (15%)	1070 (12%)	6260 (68%)	400 (4%)
1980	370 (4%)	380 (4%)	8120 (87%)	380 (4%)
1986	20 (0.1%)	1380 (9%)	13350 (86%)	682 (5%)
1990	30 (0.1%)	2560 (10%)	22980 (85%)	-

Source: RBI

Within the manufacturing sector, FDI has been steered into heavy industries. Even though India has an enormous supply of low-wage, low-skill manpower which could be used to attract FDI into garment and light manufacturing, FDI has been concentrated in complex, technology-intensive industries. For instance, more than 65 per cent of total FDI was directed into the following five technology-intense sectors in 1989: chemical and allied products, electrical and mechanical equipment, metals and motor vehicles.

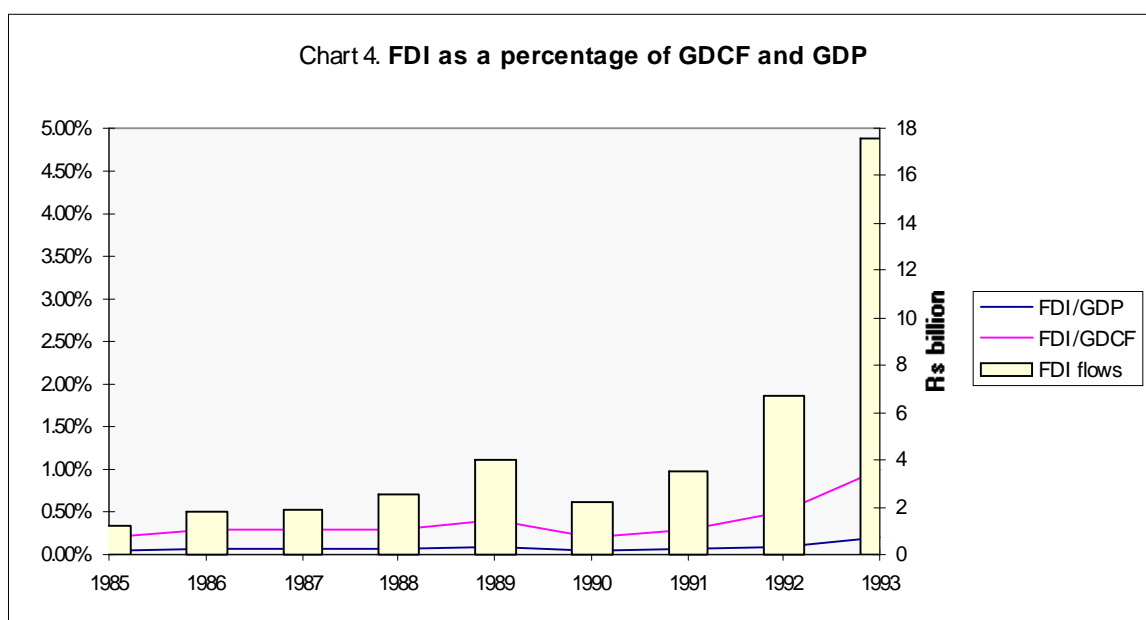


Source: RBI

Since the liberalisation, the break-up of shares does not show much evolution (Chart 3). A majority of approvals have been fuels and metallurgical industries, with a significant amount of FDI going to food processing, chemicals, electronics, telecommunications, transport, industrial machinery and hotel and tourism, all of which are “high priority” sectors. The lack of significant change in FDI patterns comes as little surprise in view of the above mentioned fact that roughly 87 per cent of government approvals, in terms of project value and number, have gone to the “high priority” sectors. Furthermore, the service sector, parts of which were included in the priority list of foreign investment, seems to be gaining momentum as its share in FDI, traditionally around five per cent, is expanding to around eight per cent.

In the post-liberalisation era, centralised industrial controls were cut drastically during the reform, leaving the states free to deal directly with investors. Out of the total amount of FDI received by India during the period between January 1, 1993 and January 30, 1995 (Rs 2.2 billion or \$70 million), the state of Maharashtra attracted nearly 25 per cent, with the state of West Bengal in second place with 14 per cent. Delhi received 12 per cent during this period and Gujarat, 7 per cent. In terms of FDI approvals made between August 1991 and May 1995, Maharashtra is scheduled to receive more than Rs 56 billion (\$1.8 billion), Delhi Rs 33 billion and Tamil Nadu and Gujarat just under Rs 25 billion (\$800 million) each.

Foreign direct investment has played a relatively minor role in the development of the Indian economy since the country's independence in 1947. As mentioned above, inward flows of foreign capital were allowed to the extent that they were necessary to sustain the planners' inward-looking strategy of ISI. As a result, India has not drawn significantly on FDI to help build its capital stock. Inward FDI represented only 0.1 per cent of gross domestic capital formation per annum during the period from 1980 to 1982, and 0.2 per cent in 1985 to 1987 (Chart 4). During the same periods, the average ratio of FDI flows to gross fixed capital formation in developing countries is estimated at 2.4 per cent and 2.7 per cent. Since the reforms, however, FDI share in GDCF has risen to 0.5 per cent in 1992 and 1 per cent in 1993.



Source: IMF International Financial Statistics and RBI

India's incoming direct investment comprises an extremely small part of its gross domestic product. The FDI/GDP ratio averaged 0.06 per cent during the period 1985 to 1991. However, since the liberalisation reforms, FDI share to GDP has grown significantly. It reached 0.1 per cent in 1992 and 0.2 per cent in 1993.

Since there has not been a large amount of FDI present in India, FDI has not, in turn, generated a great deal of employment. In 1991, all foreign firms located in India's six export processing zones added 30,000 jobs to the economy.⁹ American firms provided approximately 150,000 jobs to India's in 1989. Yet according to proposals approved during the period from August 1991 to November 1994, FDI projects are expected to create over 3 million jobs in India. The Reserve Bank of India also estimates that nearly 600,000 jobs will be generated in the state of Maharashtra, over 400,000 in Gujarat, about 320,000 in Uttar Pradesh and nearly 300,000 each in Punjab and Madhya Pradesh.¹⁰

The liberalisation of FDI policies has also had an impact on technology transfer in India. Since the reforms began in the 1980s, the number of technology agreements, of which only 450 cases involved any financial participation (usually ranged between 15 and 30 per cent equity). However, between 1985 and 1988, the number of technology agreements rose to 3,760 with equity participation in 1,002 cases. This increase suggests that the liberalisation measures of the 1980s resulted in higher levels of foreign technology inflows. More recent figures on technology inflows are difficult to find. It would be interesting to examine the impact of the 1991 liberalisation on the inflows of foreign technology, as greater amounts of FDI are usually accompanied by higher levels of technology transfer.

C. FDI outflows

The outflow of FDI from India is, while small in comparison to most OECD countries, is quite substantial by other standards. These flows are comparable to some small OECD countries and to many large developing countries (Table 9). In fact, India has emerged as one of the leading sources of FDI from the developing world. In addition, during the period from 1970 to 1980, outward flows of FDI were slightly higher than inward FDI flows (Table 10).

The data in Table 10 includes Indian joint ventures abroad only, therefore the actual total amount of FDI outflows is underestimated. Almost no information was available on wholly-owned subsidiaries until recently when the Finance Ministry and the Reserve Bank began to approve them. Most 100% Indian-owned firms are in industrial countries and are predominantly in investment, trading, marketing, hotels, computer software, shipping and consultancy. By December 31, 1994, 300 wholly-owned Indian subsidiaries were approved in 40 countries. Of those in operation 16 were in the United Kingdom, 15 in the United States, 8 in Singapore, 4 in Switzerland, 4 in Hong Kong, 3 in Germany, 2 in Malaysia and 1 each in the United Arab Emirates, Zambia, Sri Lanka, Thailand, Nepal and Indonesia. The 300 account for Rs 11176 million (\$360 million).

9 "Transnational Corporations, Employment and the Workplace", World Investment Report: 1994, United Nations, Geneva, 1994.

10 Reserve Bank Bulletin, The Reserve Bank of India, New Delhi, December 1994.

Table 9. FDI Outflows from selected countries
(1975 - 80, annual averages, US\$ million)

Source country	Outward flow
Portugal	2.6
Chile	10.9
South Korea	15.1
Colombia	18.1
India	35.3
Denmark	52.3
Philippines	66.9
Austria	89.8
Brazil	188.0

Source: Indian Export Import Bank, UNCTAD

One of the first recorded Indian overseas ventures began in 1962, when a large Indian engineering firm, Jay Engineering Works, invested in Sri Lanka. In the 1970s, the rate of Indian expansion abroad grew quickly, with a peak occurring in 1976. In 1980, 117 joint ventures were in operation with a total Indian equity participation value of Rs 927 million (\$116 million).¹¹ By the end of December 1994, there were 524 active Indian joint ventures abroad, of which 177 were in production/operation and the remaining 347 were under various stages of implementation. The total value of Indian equity in joint ventures already in operation amounted to Rs 1790 million (\$56 million), while the value of equity of those under implementation rose to Rs 13989 million (\$444 million).

In the case of India, outward FDI takes primarily the following forms:¹² joint ventures, turnkey contracts in industry and infrastructure projects, and licensing and management agreements. Other forms, like franchising, production sharing, risk service and subcontracting arrangements are few in number. In general, Indian joint ventures abroad are market seeking. The outward stock of FDI has gone predominately to labour-intensive, mature industries of the secondary sector. Manufacturing accounts for 56 per cent of total outward FDI, with the remaining 44 per cent being in trading and the service sector. Within the manufacturing sector, textiles is the most important, followed by pulp and paper and engineering.

The destination of Indian investment abroad is concentrated in developing countries. Of the \$96 million in outward stock of FDI in 1985, one per cent went to developed countries, leaving 99 per cent destined for developing countries. The largest recipient countries were Senegal, Indonesia, Malaysia, and Thailand.¹³ Southeast Asia accounted for nearly one-half of the total stock of FDI in 1980, followed by Africa with 29 per cent, South Asia with ten per cent and the Middle East with five per cent.

11 Lall, S., *The New Multinational: The Spread of Third World Enterprises*, 1983.

12 Lall, S., "India: a major south-south investor" in *New forms of overseas investment by developing countries: the case of India, Korea and Brazil*, edited by Charles Oman, OECD: Paris, 1986.

13 *Transnational corporations from developing countries: impact on home countries*, UNCTC: New York, 1993, page 49.

Table 10. **FDI outflows**
Rs million, \$ current

Year	Stock	Outflows	Number of JVs
1965	13 (\$2.7 mn)	-	6
1966	26 (\$3.9 mn)	-	10
1967	33 (\$4.4 mn)	-	12
1968	40 (\$5.3 mn)	-	14
1969	53 (\$7 mn)	-	21
1970	81 (\$10.8 mn)	30.2 (\$4 mn)	24
1971	95 (\$12.7 mn)	6.2 (\$0.83 mn)	32
1972	114 (\$15.1 mn)	12.3 (\$1.6 mn)	37
1973	130 (\$16.8 mn)	12.8 (\$1.7 mn)	41
1974	219 (\$27 mn)	21.8 (\$2.7 mn)	62
1975	312 (\$37.2 mn)	23.9 (\$2.7 mn)	83
1976	361 (\$40.3 mn)	30.1 (\$3.4 mn)	96
1977	459 (\$52.2 mn)	34.3 (\$3.9 mn)	117
1978	698 (\$85.2 mn)	24.6 (\$3 mn)	145
1979	835 (\$103 mn)	17.3 (\$2.1 mn)	159
1980	974 (\$124 mn)	28.8 (\$3.7 mn)	189
1981	1 160 (\$134 mn)	13.7 (\$1.6 mn)	226
1982	1 191 (\$126 mn)	-	221
1983	1 227 (\$122 mn)	-	221
1984	-	-	-
1985	1 173 (\$96 mn)	350.6 (\$28.3 mn)	208
1986	1 348 (\$107 mn)	391.7 (\$32 mn)	-
1987	1 116 (\$86 mn)	386.4 (\$30 mn)	-
1988	1 136 (\$81 mn)	-	-
1989	-	-	193
1990	-	-	214
1991	-	-	-
1992	-	-	-
1993	-	-	-
1994	1 790 (\$57 mn)	-	524 *

* Note that of the 524 JVs, only 177 were in operation and 347 under various stages of implementation. The large gap between those active and those in operation is likely a result of the new, more liberal 1992 policy regulating outward FDI flows. The large difference between active JVs and those in operation also explains the low stock figure.

Source: Exim Bank, India Investment Centre and UNCTC

Despite the relatively high figures, the outflow of FDI from India has traditionally been tightly regulated. The Indian government views outward FDI first and foremost as a form of export promotion. Accordingly, it insists that the provision of Indian equity participation be mainly in kind (capital goods, and to a less extent know-how) rather than in cash. The primary reason is that India has historically found itself short of hard currency. Consequently, capital equipment accounts for two-thirds of total equity contribution, with know-how at 11 per cent. The government also requires that machinery and equipment exported to joint ventures be of Indian make. It was not until October 1992, that second hand and reconditioned machinery could be supplied by the Indian party towards its contribution to outward FDI.

One of the major “push” factors of outward FDI has been the restrictive environment of the Indian economy, resulting in slow domestic growth. The MRTP Act has limited the growth and diversification of Indian firms within the country, both in size and activity. Under the MRTP, a firm is subject to various expansion limitations according to criteria such as market share, size of assets and conglomerate connections.¹⁴ This has resulted in inefficient production and has also offered an incentive to invest abroad. Also, tight control on the availability of foreign exchange and high tariff barriers for imported input goods have had a stifling effect on firms. As a result, local enterprises have often opted to locate production directly in targeted markets. Moreover, the restrictive trade regimes of partner countries have also acted as an obstacle to Indian exports. Since many developing countries followed strategies of ISI, India sought to locate production within the walls of their protective markets. Finally, lower tax rates abroad make profit expectations abroad much higher than returns in India.

As part of the new reforms, a procedure for automatic approval of investments abroad, subject to certain conditions, was introduced for the first time in October of 1992. The new procedure approved proposals involving investments up to US\$ 2 million, of which cash remittance does not exceed US\$ 0.5 million. Following the reform, 107 cases were cleared in 1992, followed by 198 in 1993 and 230 in 1994.¹⁵ The approval of projects involving larger sums is granted by the Special Committee constituted under the revised guidelines by the RBI, the Ministry of External Affairs, the RBI, the Exim Bank and India Investment Centre, presided over by the Ministry of Commerce.

D. Economic and political factors affecting FDI

As elaborated above, the policies governing FDI have been the most important determinants of the magnitude and pattern of FDI in India. The liberalisation of these policies has brought forth a structural change in the trend of FDI inflows, as the magnitude of these flows has soared. Should additional reforms be made to the country’s huge private sector, the pattern of investment might change significantly. Already, steps to open the fuel and energy sectors and parts of the service sector have attracted substantial amounts of FDI into those areas.

Yet, FDI policy is only one of the concerns of the foreign investor. FDI policy sets the terms and conditions by which foreign investments take place, while other determinants of a more economic and political nature are also important in determining the breadth of FDI flows. It must be remembered that a firm’s decision to invest abroad is motivated by a higher expected profit rate or perhaps a higher expected future profitability if economic development or growth is foreseeable in the chosen country. Such expectations are formed according to the prevailing economic conditions or policies directed at growth and stability. What is most interesting about the case of India is that the liberalisation of FDI policies was accompanied by an overall economic liberalisation and stabilisation reform which has generated expectations of future economic growth and stability, hence, magnifying the impact of attracting FDI flows.

The object of this section is to examine economic and political factors which affect the FDI climate in India. Economic policy reforms coupled with the country’s plentiful economic endowments set the stage for a healthy investment climate. However, political and social tension, in part provoked by the economic reforms and more open policies towards foreign investment, pose a threat to India’s credibility among international investors for fear that FDI projects will be rejected at the local (state) level.

14 UNCTC, 1993.

15 Ministry of Commerce, Annual Report 1994-95, Government of India.

(i) *Economic elements*

India has traditionally had much to offer foreign investors. Her endowments of low-cost and highly skilled labour pools, natural resources, and large domestic market appeal to most types of foreign direct investors. Yet, as outlined at length above, the government's policies have not always supported the private sector and have made it difficult for FDI to enter the country. In addition to liberalising FDI policies, the government's move to adopt more liberal economic policies aimed at fostering macroeconomic stability, implementing structural reform and pursuing outward-oriented trade has resulted in drastically improving India's business climate. These policy changes have played a key role in raising growth expectations, reducing uncertainty and, thus, have acted as a magnet for FDI.

Under the previous ISI development strategy, India suffered from unsatisfactory economic performance and declining productivity. It adopted policies which tended to spoil the macroeconomic environment. The new industrial policy of 1991 included a short-term priority of stabilising the fiscal and external imbalances of the economy which had generated double-digit inflation and placed the country on the verge of defaulting on its external debt obligations. The economy's response to the stabilisation program has been generally positive.¹⁶

This section will highlight certain economic conditions which, in theory and practice, influence international investor decisions and act as determinants of FDI. Economic variables that reveal information about internal macroeconomic conditions of the economy, external conditions and microeconomic, country-specific characteristics will be presented. In addition to each description, India's position regarding each determinant will be used as a point of reference. First, internal macroeconomic conditions will be described.

- a) **Growth of GDP.** A high growth rate attracts FDI. It is also an indicator of further growth potential in the future. India has traditionally experienced a slow rate of growth at approximately 3-5 per cent per year. Since the reforms of 1991, the pace has quickened, especially annual growth of industrial production which averaged 8.4 per cent in 1994 and peaked at 13.4 per cent in April 1995. The export sector has boomed since the reforms. Exports were up 27 per cent year-on-year in the April-June quarter of 1995, after expanding 18 and 19 per cent in the two preceding years.
- b) **GDP per capita.** A high GDP per capita translates into a country's good economic health; therefore, a positive relationship is expected between GDP per capita and FDI. While GDP per capita is not strong on a national level in India, a huge domestic market consisting of between an estimated 100 and 300 million people are in a position to make sizeable outlays on durable and semi-durable goods.¹⁷ In view of the economy's healthy expansion, this market is expected to grow further over the years to become one of the world's largest consumer markets.
- c) **Inflation.** A high rate of inflation is an indication of internal economic tension and discord between the government and central bank. India has made attempts to stabilise price increases in the economy. It has, for example, halted all policies of fiscal deficit monetisation and, in order to control the inflationary impact of capital inflows, the RBI has increased the reserve requirements. After reaching 17 per cent in August 1991, the inflation rate remained less than 10 per cent during most of 1995.

16 See World Bank (1995) for an in-depth analysis of the economy's response to the reforms.

17 Business Perspectives in India, Government of India, Ministry of External Affairs, Economic Co-ordination Unit, New Delhi, 1994.

External macroeconomic conditions are viewed through the following two variables.

- d) **Level of indebtedness.** As there is a concern that a country heavily indebted may not be able to repay its loans or service its debts in the future, FDI could be discouraged. Even a balance of payments deficit in a country (especially a developing one) may deter foreign investors on the grounds of a potential danger to restrict the free flow of capital. Under such a scenario, it would become more difficult to transfer profits back into the investor's home country. Therefore, a negative relationship is expected between the inflows of FDI and the level of indebtedness and balance of payments deficits. India's cumulative domestic and foreign government debt over \$100 billion (roughly 66 per cent of GDP and 266 per cent of exports), and the country has never reneged on a debt payment. The debt service ration was 24.9 per cent in 1994 and is expected to decline to 23.7 per cent in 1995 and 23.6 per cent by 1996. Interest payments claim over half of the central government's fiscal revenues. Fiscal deficits are crowding out private investment and have pushed up the yield on government bonds to a record 14 per cent. Aware of the dangers that the relatively large fiscal deficits pose, the government is trying to limit them to less than 6 per cent of GDP. Nonetheless, the fiscal deficit problems persist and continue to pose a threat to macroeconomic instability, thereby diminishing India's ability to attract international investors. Balance-of-payments problems, however, are growing less significant in the post-policy era as India has been reducing its current account deficit since the reform, turning it into a surplus in 1995.
- e) **Exchange rate changes.** The under-valuation, overvaluation, devaluation or revaluation of a country's currency might not determine FDI flows, yet it could likely influence the timing of these flows. Froot and Stein (1991) show that a depreciation of a country's exchange rate can give foreigners a boost in their purchasing power. The idea is that exchange rate changes have an impact on international wealth and increased wealth facilitates the buying of assets especially in situations where the foreign firms are cash-constrained. Furthermore, economic conditions in a country improve as the level of certainty rises. Severe exchange rate volatility only increases uncertainty and, as a result, is hypothesised to deter FDI. The value of India's currency, the rupee, has declined considerably since the country's independence. The value of the rupee in dollar terms nearly halved from 1966 to 1981. From 1982 to 1994, the currency depreciated nearly 200 per cent. The rupee was devalued in 1991 as part of the economic reforms, and then again in late 1995.

In addition to sound macroeconomic conditions which reduce uncertainty and promote stability and expectations for growth, FDI may be attracted by an interaction of different host country characteristics and advantages. It is important to keep in mind that "attractive characteristics" may often be a function of the type of direct investment in which the foreign firm engages. The range of India's characteristics is wide and varied and is expected to attract many different types of FDI (market seeking, export-oriented, resource seeking, cost cutting, labour seeking). Such characteristics include the following:

- f) **Cheap Labour.** A comparative advantage of most developing countries, the supply of relatively less expensive labour attracts FDI. India is widely known for its low-cost labour force and it is expected that this characteristic draws FDI.
- g) **Skilled Workers.** For FDI to be worthwhile, all the benefits accrued by a lower cost of labour should not be lost due to an exceedingly low workforce productivity rate. Hence, a somewhat skilled labour force is desired. Compared to other developing country's, India has one of the largest highly trained and educated pools of labour. The percentage of school-aged persons enrolled in

secondary school was 44 per cent during 1987-91, compared to an average of 40 per cent in South Asia. This characteristic is expected to give India an extra advantage in attracting FDI flows.

- h) **Market Size.** Several studies have suggested that a larger economy provides many opportunities: exploiting economies of scale, a likelihood of technological advances, a relatively high degree of skilled labour and a plenitude of capital to compliment FDI flows.¹⁸ Traditionally the large size of India's market has attracted FDI. This trend is expected to continue as the economic reforms make the Indian economy grow larger.
- i) **Rate of Domestic Capital Formation.** Countries which invest a high proportion of their income in capital equipment tend to attract foreign investors seeking to acquire existing firms. Gross domestic capital formation in India is high, at 25 per cent of GDP. The level of domestic investment grew nearly 20 per cent in 1992, after experiencing an annual growth rate of less than five per cent during the period of 1965 to 1991.
- j) **Availability of Certain Resources.** Countries that are endowed with natural resources may attract FDI that seeks to exploit these endowments. India possesses a wide variety of natural resources such as iron ore, coal and bauxite. Now that the mining industry is gradually being opened to foreign investment, this determinant is becoming even more important than it was before the reforms.
- k) **Adequate Infrastructure.** In order for an economy to expand and gain efficiency, a reliable network of transportation, electricity connections, water supply and telecommunication is necessary. The government recognises that India's deficient infrastructure is not capable of supporting great economic expansion, yet by the same token the government is not in a position to take on infrastructure investments. It has, therefore, opened the sector to foreign and domestic private investment. Plans to upgrade this sector envisage achieving the provision of basic services within 15-20 years time.
- l) **Degree of Openness of the Economy.** Theoretically, both a relatively open or closed market can explain the attraction of FDI flows. The hypothesis which assigns a negative relationship between the openness of the market and FDI stresses that the higher the tariffs, the greater the incentive for a foreign producer to produce locally to gain or maintain his/her market share. The more the market diverges from its competitive paradigm, the higher the profits are likely to be. Towards the other extreme, FDI may be attracted to a healthy, dynamic economy in which the competitive forces shape efficient production.

In the case of India, FDI has traditionally been attracted to the large, protected domestic market preserved by India's inward-looking policy of ISI. By implementing outward-oriented trade and investment policies which place fewer biases on international trade and transnational corporation activities, India now hopes to integrate its economy into the world market. A similar strategy has allowed the newly industrialised economies of Asia to benefit by using their comparative advantages to raise the competitiveness of their countries' exports, generating strong economic performance and high growth rates. Foreign direct investment in these economies has soared as a result of their open trade and investment regimes, two areas which are inherently complementary. It is therefore postulated that a more liberal trade regime will attract FDI in India for two reasons: the economic growth that is associated with trade liberalisation and the nature of today's FDI

18 World Investment Report: Transnational Corporations as Engines of Growth, UNCTC, New York, 1992.

which, due to the globalisation of the international economy, is attracted to economies with more liberal trade regimes.

A commitment to freer trade in a globalised world economy will attract FDI flows simply because of the nature of integrated international production methods associated with today's global economy. In an era of globalised production where fierce competition drives producers in search of cost advantages to remain competitive, lower trade barriers facilitate the movement of imported capital goods, intermediate inputs and finished product exports for transnational corporations which export to the world market. The lowering of barriers undoubtedly influences the willingness of foreign investors to engage in long-term investments.¹⁹ An example of such investment behaviour on a regional basis is demonstrated by the enormous capital flows to Mexico in the early 1990s stimulated by the initiation of negotiations for the North American Free Trade Agreement, which was eventually signed in 1993. A commitment to freer trade increases the attractiveness of some developing countries, for example, as low-cost locations for labour-intensive products. Further, as the trend toward freer trade continues, especially within a multilateral context, the surrounding market expands and producers are provided with the opportunity to exploit economies of scale in addition to benefiting from the low-cost advantages of operating in a developing country. Such trends and related outcomes complement globalised methods of production.

Perhaps more important for India is the relationship between trade and growth. A credible, lasting trade liberalisation policy will bring about anticipated economic growth effects. These expectations of future growth come about because trade liberalisation widens the market and allows for specialisation based on comparative advantage: it enables a country to raise the efficiency with which factors of production are employed and the rewards that these factors are paid. As resource allocation becomes more efficient, productivity increases and the investment climate improves. As the level of productivity and investment increases, the capital-labour ratio rises and so will per capita output. The relationship between trade and economic growth is a dependent one, and international trade is now generally accepted as an engine of growth.

A study by Reynolds²⁰, evidence indicates that significant "turning points" in developing countries' economic growth, such as sustained increases in per capita income, often occur as a result of important policy changes in these countries. Relevant changes that ameliorate the business climate include the adoption of policies which promote macroeconomic stability, policies of structural reform and outward-oriented trade policies. Each of these changes are currently being implemented in India as part of the new economic policy package announced in July of 1991. As long as the new policies, which promote economic stability and growth, are not reversed and proceed in a direction which supports the private sector, India will remain an attractive destination for foreign capital.

(ii) Political elements

Foreign direct investment is a sensitive subject in India. Memories of the English East India Company and centuries of colonialisation led the Indian planners to accord the highest importance and priority to self-reliance within the shortest period. Yet a crucial part of the new industrial policy of 1991 was the government's decision to open the economy to foreign investment. The turn-around in attitudes regarding FDI, however, has not been universal. Lack of trust *vis-à-vis* foreign investors and political unrest linked to the dismantling of the

19 International Capital Markets: Developments, Prospects, and Policy Issues, IMF, 1994.

20 Reynolds, L. "The Spread of Economic Growth to the Third World: 1950-1980," *Journal of Economic Literature* 21, September. pages 941-80.

public sector threatens investment projects even after they are approved by the central government. As a result, international attention has been drawn to question the credibility of the liberalisation reforms.

The emergence of nationalism is becoming apparent across India, despite the general success of the 1991 reforms. The Congress Party, leader of the 1991 liberalisation reform, has been voted out of power in several states, including the state of Maharashtra (where Bombay is located) which attracts the largest amount of FDI. The Congress Party's majority may be threatened in the 1996 general election. The Hindu-nationalist BJP, which is generally for the liberalisation of the economy, says that it is nevertheless against foreign domination and foreign investment in consumer goods. Its slogan is 'India needs computer chips, not potato chips'.

This unstable political climate may begin to threaten to foreign investors' confidence, as examples of outbreaks against foreign firms are growing in number. For instance, foreign companies have recently been told that they will have to wait until after next year's elections before entering India's insurance industry. Also, several consumer-goods firms, including US Kellogg, have been denied permission to take full control of their Indian joint ventures. A joint venture between Singapore Airlines and the Tata group is being opposed by the aviation ministry. An anti-foreign party has threatened to destroy Kentucky Fried Chicken (US) outlets in the state of Bangalore on grounds that the restaurants instil unhealthy eating habits on unsuspecting Indians. The political and social tension culminated in the cancellation of what was to be the largest foreign investment project ever approved by the Indian government, the Enron power project.

The newly elected coalition in Maharashtra, dominated by the BJP and the ideologically similar Shiv Sena, cancelled a \$2.8 billion project by the American energy concern Enron Corporation. The Indian government had approved the project under a fast-track policy designed to actively encourage foreign investment into its inadequate power sector. Maharashtra's previous administration had firmly committed the state to go ahead on the project. The fast-track system was set up to quickly pass FDI projects, which in the case of the power sector automatically allows foreign participation of up to 100 per cent. The project was scrapped on grounds of alleged charges of bribery. The nation's largest industrial state also criticises the fast-track approval process, because it takes place behind closed doors and is not subject to well-defined guidelines or a system of competitive bidding. As a result of the suspicions of corruption, three other government-approved power projects have come under question and another American company has slowed its negotiations.

Whether or not the state's new ministers' charges of bribery are true, their criticisms of the awarding process to foreign investors are well-founded because of the lack of transparency. Since the negotiations take place behind closed doors and the decision process is not based on competitive bidding, it easily becomes subject to corruption accusations. In view of the problems which have arisen regarding the automatic approval system, Indian authorities are considering changing the procedure to one which is less controversial. It is not clear whether the system will become more liberal; however, it will most likely be based on a more well-structured set of rules and may involve competitive bidding.

In the face of rising uncertainty surrounding the political instability, the Indian government contends that there is a political consensus behind their reforms and stressed their irreversibility. According to the government, no matter what the rhetoric, nearly all political parties have embraced the reforms. Evidence of this may be demonstrated by the policies followed by governments by various political parties at state levels. Moreover, the government points out the sharp rise in FDI during 1995 as an endorsement of the belief in the irreversibility of the reform policy among foreign investors in this election year.

While investment capital inflows have soared since the new industrial policy was announced, it must be said, however, that there are other important prerequisites for stimulating inflow of foreign equity investment if India is to maintain these increases and attain a level somewhat closer to that of other Asian economies. These include, *inter alia*, economic and political stability, a properly functioning law and order system, adequate

availability of infrastructure and rates of taxation largely in line with international levels. A major obstacle to FDI is political and social instability. Political sensitivity to the presence of foreign investors is inevitably the source of investor concern and will take away from India's ability to attract investment. On the other hand, economic elements indicate an improving investment climate. The supply of low-cost, skilled labour and technicians is plentiful and sound institutional framework of law is in place. The macroeconomic environment is generally healthy and is improving. However, the government will need to continue to strive to augment the availability of infrastructure and reduce the fiscal deficits.

Part II. Policies affecting FDI

A. Introduction

During India's earlier quest for self-reliance and industrial development through ISI, foreign trade and FDI were assigned a limited role. The government invited foreign investment when and where it was needed to increase the local level of technology and satisfy foreign exchange requirements. As mentioned above, the Indian economy received two dosages of FDI liberalisation, a mild one in the 1980s and a strong one in the 1990s. The mild one was quite limited in scope and had only a minor impact on the FDI climate. The strong dosage introduced in 1991 by the Congress party, encompassed large, sweeping steps toward a non-discriminatory liberalisation of FDI policies. Since then, the trend towards liberalisation has continued.

The latest set of FDI liberalisation policies in India includes a reduction of market-distortions and the establishment of standards of equal treatment and protection for foreign affiliates. Foreign equity participation of up to 100 per cent is now allowed in many sectors which are open to private enterprise, yet it remains subject to certain conditions (listed below) and government approval. It is no longer required that foreign investors have a local partner, even when the foreign investor wishes to hold less than the full equity of the company. The use of foreign trademarks and brand names is no longer prohibited and local content regulations have been withdrawn. Incentive programs do not discriminate between foreign and domestic firms: tax and non-tax concessions are available to all new investment, foreign or domestic, and industrial undertakings which are export-oriented.

Despite the foreign collaborations approval requirement, which persists as a barrier to non-resident investors as compared with resident investors on the issue of the right to establishment, foreign-owned firms are generally treated at par with domestic firms once they are up and operating in India. Foreign investors can freely access the Indian capital market to raise funds through equity shares, debentures, hybrids or loans from financial institutions. Tax rates for domestic and foreign firms operating in India are comparable. Profits may be freely expatriated except for in a few consumer goods industries where repatriation is subject to dividend balancing against export earnings (Annex 2).

No separate law exists in India that deals exclusively with FDI. The government interprets policy provisions in a discretionary manner in order to control FDI in the economy according to its current objectives. A complete understanding of policies governing FDI necessitates a comprehensive examination of various policies and laws. Therefore, the next section's contents include a broad spectrum of laws and regulations which affect FDI in India.

B. Industrial Policy and FDI

The overall industrial policy of India is laid out in the Industrial Policy Resolution of 1956 and the Statement on Industrial Policy of 1991. The basic objectives of the country's industrial development strategy has included increased production and higher productivity, diversification and modernisation of the industrial sector, promotion of small-scale and export-oriented industries, prevention of concentration of economic power, removal of regional imbalances and poverty, higher employment generation and self-reliant growth. In accordance with achieving these objectives, the state designed a vast network of licensing procedures governed by the Industries (Development & Regulation) Act of 1951 to control the allocation of scarce industrial inputs, and the growth, concentration and composition of industrial capacity. Foreign direct investment was carefully

integrated into this system of industrial licensing and industrialisation strategy, where it served as a vehicle for the transfer of technology and generator of foreign exchange.

As mentioned previously, the system of government approvals was liberalised over the 1980s in many areas of industrial activity. The process was finally concluded in the Statement on Industrial Policy of 1991, which abolished nearly all industrial licensing (see Annex 3 for exceptions).²¹ Applications for the remaining industrial licenses are submitted to the Secretariat of Industrial Approvals.

The starting point of the new approach to industrial development lies in the present government's recognition that economic and social advancement can be achieved "if India grows as part of the world economy and not in isolation".²² Consequently, the new, more liberal policy focuses on facilitating and encouraging foreign investment and technology transfers, and making the public sector more dynamic by opening it to private investment as a means for integrating the Indian economy into the global trading network.

Prior to the reform, FDI acceptance hinged on requirements of technology transfers and the approval process was long and ridden with bureaucratic "red tape". Investments were permitted in high-tech industries, industries that were experiencing large production gaps or industries that could expand India's exports. Foreign equity participation had a general ceiling of 40 per cent and often an upper limit of 15-30 per cent, yet if the required foreign technology was highly sophisticated or the project was export-oriented or to be established in a free trade zone, a larger foreign equity participation was permitted.

The new policy abolished the requirement that FDI be accompanied by technology transfers and the approval process was streamlined. Foreign equity participation of up to 100 per cent is now permitted, subject to government approval, in many sectors with the exception of those reserved for the public sector. While no approval is now necessary for foreign investors to own up to 24 per cent equity in any private or public Indian firm and 20 per cent in new private banks²³, the government has set up two routes for foreign investors to obtain approval for FDI projects involving an equity participation of 25 per cent or more.

The first route is administered by India's Reserve Bank, which grants *automatic* approval within 15 days for investments up to an equity participation limit of 51 per cent in 35 "high priority" manufacturing sectors and up to 50 per cent in the mining sector. This route also allows existing companies in designated high-priority industries to increase automatically their foreign equity interest up to 51 per cent. As part of this fast-track approval process, foreign equity must cover the foreign exchange requirement for the import of capital goods, which should be new and not second hand. The policy also requires that foreign investors earn the foreign exchange for the purpose of repatriation of dividends. These foreign exchange requirements, considered stringent when compared to other Asian countries, are designed to help India stabilise the economy by easing its balance-of-payments problems.

21 Industrial licensing is required for all companies, domestic and foreign alike, in specified industries.

22 As stated in the Statement on Industrial Policy of 1991.

23 Note that in order for foreign investment in India to be categorised as foreign direct investment, the foreign-owned equity participation must be at least 25 per cent. India classifies investments below the 25 per cent mark as portfolio investment, for which no prior approval is required. However, such investors must obtain a permit, valid for five years, from the Securities and Exchange Board of India which regulates securities markets. Acquisition of shares by non-residents through purchases on a stock exchange is allowed to a limited extent, i.e., only by non-resident Indians, offshore mutual funds and foreign financial institutions.

In setting up the automatic approval route, the Indian government set out to actively promote foreign investment in heavy manufacturing sectors, which the government views as crucial for the transfer of technology and export promotion. The ceiling of foreign equity participation at 51 per cent was designed to encourage foreign investors by allowing them to take a majority stake and “have a say” in the working of a company. Despite the vagueness of the list of 35 high priority sectors and its narrow range, roughly 87 per cent of FDI projects approved involve operations in one of these sectors. However, it must be remembered that only eight per cent of all approvals are made by the RBI, with the remaining amount approved by the second route.

The second route is administered by the Foreign Investment Promotion Board (FIPB)²⁴ of the Office of the Prime Minister and the Secretariat for Industrial Approvals (SIA), which review applications for investment projects that remain outside of the parameters for automatic approval. These include proposals involving foreign equity participation of more than 51 per cent (up to 100 per cent), or dealing with activities other than those in the list of 35 industries, or which fall short of the foreign exchange requirements. This procedure also applies to existing companies which wish to increase foreign equity above 51 per cent as part of an expansion program. Free from predetermined parameters, FIPB approval is based on the investment proposed, the technology to be introduced, the export potential or the import substitution factors, the foreign exchange balance sheet and potential employment generation. The approval process takes roughly four to six weeks to complete. The FIPB claims that very few proposals are rejected and a large number of approvals have involved foreign equity participation of 100 per cent.

As indicated above, the FIPB and SIA are indeed responsible for a majority of FDI approvals since the 1991 reforms. Notwithstanding this track record, the FIPB and SIA approval processes have provoked criticism from international investors. Since there are *no* prescribed ground rules for investments which lie outside the automatic approval criteria, approval becomes subject to negotiations and is ultimately at the government's discretion. This lack of transparency generates uncertainty surrounding India's conviction to a more open investment policy and places foreign firms at a disadvantage *vis-à-vis* their domestic competitors. Given the circumstances, it is not clear if the surge in FDI will be temporary or if the trend is to continue. If the Indian authorities are committed to a more liberal FDI regime, they should work toward institutionalising a more clear set of rules and transparent approval system for FDI projects which do not qualify for automatic approval.

Foreign investors may start operations as a company incorporated in India or as a branch operation. They may also set up a new company as a joint venture with an Indian partner or on their own. Approvals for branch, liaison and project offices, primarily meant for promoting business interests of the parent company or for international trading are given by the RBI. Most foreign investors in India set up projects through a private or public limited company. Incorporation in India takes approximately four to six weeks after submitting documents of the company's constitution and articles of association to the Registrar of Companies (ROC). Foreign subsidiaries, incorporated outside of India while conducting business in India, must comply with certain rules under the Companies Act of 1956. These companies must also register themselves with the ROC in New Delhi within 30 of establishment in India.

The policy on foreign technology agreements was also liberalised as part of the economic reforms. The Reserve Bank of India has been authorised to grant automatic approval for foreign technology agreements in all industries which meet the following conditions: lump-sum payment of no more than Rs 10 million; royalties of no more than five per cent on domestic sales and eight per cent on exports; and total payments that do not go

24 The FIPB is headed by the Principal Secretary to the Prime Minister and has as its members, the Finance Secretary, the Commerce Secretary and the Secretary for Industrial Development. Secretaries of the other Ministries concerned with specific investment proposals are also invited as appropriate. No special application form is needed for applying to FIPB.

over an eight per cent ceiling of total sales over a period of ten years from the date of agreement or over a seven year period from the date of commencement of commercial production.

C. Foreign exchange controls

The Foreign Exchange Regulation Act of 1973, which is the statute governing foreign exchange control in India, was also amended as part of the reform. Prior to the amendment, "FERA companies", despite being locally incorporated and partly owned by Indian shareholders, were subject to special restrictions regarding bank accounts, loans, foreign exchange trading and remittance of dividends and profits. In a January 1993 amendment, virtually all differences between foreign and domestic private investors were eliminated. The government removed restrictions on domestic borrowing²⁵, trading acquisitions and transfers of immovable property, inter-corporate borrowing, acceptance of fixed deposits, appointments as agents of technical management advisors, use of foreign trademarks and brand names and the establishment of branch offices for foreign companies. With these changes, FERA companies are now treated at par with Indian companies and they are able to invest in any sector open to domestic companies.

Foreign capital invested in India can be repatriated along with any capital appreciated profits and dividends, after the payment of taxes due on them. No permission from the RBI is necessary and authorised dealers have the power to remit dividends. In 22 consumer industries (Annex 2), repatriation of dividends is subject to the requirement of dividend balancing against export earnings for a period of seven years. RBI approval is required for the repatriation of sale proceeds of assets held in India. Also, repatriation in foreign exchange is allowed subject to tax payment and requires the RBI's approval.

As part of the amendment, the Government of India announced that the Reserve Bank would expeditiously approve disinvestment proposals from the foreign investors, subject to certain guidelines. One requirement is that the sale of foreign shares must be done on the stock exchanges through a registered merchant banker or a stock broker for listed shares at market prices. In the case of unlisted shares, the sale price is required to be approved by the RBI, prior to disinvestment. The RBI will also give permission to foreign investors who wish to transfer their shareholding on a private basis to another non-resident or resident.

As a result of amendments to FERA, many transnational corporations have increased their equity to over 51 per cent. Many companies like Coca Cola and IBM, which divested in the 1970s have returned to India to take advantages of new opportunities.

The 1993 FERA amendment also eased restrictions on Indian companies establishing joint ventures abroad. Thirty-day automatic approval is now available to Indians who wish to invest abroad, provided the value of the investment by the Indian party does not exceed \$2 million and, in case the direct investment consists solely of cash subscription, the cash subscription does not exceed \$500,000. Indian companies continue to be taxed according to their world income levels, but the amendment grants credits to residents for foreign tax paid on foreign income.

Foreign exchange controls have also been substantially relaxed. Effective from August 20, 1994, the Indian rupee became convertible on the current account, in accordance with Article VIII of the International Monetary Fund. However, other controls on the capital account remain. Foreign currency is not allowed to be held locally by residents. The only exceptions are exporters and receivers of foreign inward remittances. As of

25 Foreign investors are permitted to raise a substantial portion of the project cost in India through debt and equity instruments and can freely access the capital market. Private placement with institutional investors is also possible. Indian companies also have the option of raising funds from international capital markets.

March 1, 1994, exporters and other recipients are permitted to retain up to 25 per cent in foreign currency accounts with banks in India. For foreign investors, the rupee is already convertible on the capital account and no restrictions exist regarding assets held by non-residents.

D. Trade policy

A core element of the NIP has been a commitment to a progressive dismantling of the inefficiencies and distortions in India's trade regime, which has traditionally been plagued with extremely high customs duties. Accordingly, trade liberalisation has been conducted on two levels: to reduce the height and dispersion of tariffs and to phase out quantitative restrictions.

In line with these objectives, import controls through licenses have been virtually abolished and import duties have been drastically reduced. The maximum duty was lowered from 400 per cent in 1990-91 to 50 per cent at present, as announced in the Union Budget of 1995-96. In this budget, the finance minister also proposed lowering the peak rate of customs duty to 25 per cent within the machinery and capital goods sector, which is critical for the growth of industry. Capital goods imports were subject to tariff rates of about 100 per cent prior to July 1991.²⁶

The government has rationalised the tariff structure for major groups of goods²⁷ by bringing tariff rates on outputs below those on inputs and has eliminated about 350 of the 500 exemptions. Further rationalisation is expected and the government intends to bring tariff levels down over the next few years to levels comparable with other developing countries. The tariff schedule, recommended by the Tax Reform Committee, is expected to be reached by 1996 and includes the following: 40-50 per cent maximum tariff rate for consumer goods, 30 per cent for intermediates, 20 per cent for capital goods, and a 5-10 per cent minimum tariff.²⁸ The reduction of import taxes compensated by a general value-added tax.

As a member of the new World Trade Organisation (WTO), India must undergo a complete tariffication of non-tariff barriers to trade. In accordance with this and as part of India's own trade liberalisation initiative, the finance minister announced in the 1995-96 Union Budget that all import restrictions would be "tariffied", that is, non-tariff barriers would be abolished and equivalent-sized tariffs would be erected in their place. These changes follow a number of modifications that were made on March 30, 1994 to the Exim (export import) Policy 1992-97. Modifications included slashing the "negative" list of imports and substantially relaxing conditions for importing second-hand capital goods.

The WTO also obliges members to adopt measures agreed to under the Uruguay Round which affect FDI both directly and indirectly. The "Agreement on Trade-Related Investment Measures" (TRIMS) clarifies and provides a procedure that should ensure more effective compliance with GATT Article III on national treatment and Article XI on the prohibition of quantitative restrictions. Such restrictions include local content requirements, restrictions on enterprise imports, and trade balancing. India and other developing countries have five years to eliminate such requirements.

26 Note that India is not bound internationally to these tariff ceilings. At the WTO, India has set maximum levels as high as 300 per cent, with an average agricultural maximum of 100 per cent. Industrial goods are typically lower, at 65 per cent.

27 In particular capital goods, metals and metal products, and petrochemicals.

28 World Bank, 1995.

The General Agreement on Trade in Services (GATS), also agreed as part of the Uruguay round, affects FDI more directly. This agreement contains (i) transparency requirements, (ii) provisions on market access, and (iii) national treatment of trade in services. The first set of provisions includes matters such as the prompt publication of all laws and regulations affecting trade in services; the availability of an impartial and objective review mechanism and appropriate remedies for administrative decisions affecting trade in services; and the adoption of harmonised, international criteria to ensure that measures related to technical standards and qualification requirements do not act as unnecessary barriers to trade in services. The second two provisions concern the specific commitments contained in the concession schedules of the member states. Market access commitments comprise matters which aim to eliminate restrictions on the number or value of services supplied, the type of legal entities or joint ventures through which services are provided and limitations on the participation of foreign capital. National treatment commitments ensure that foreign service suppliers are treated no less favourably than domestic suppliers.

E. Intellectual property rights

The protection of intellectual property rights (IPR) is an important part of the legal environment which affects FDI. The issue of IPR in India has been raised by foreign investor groups. A recent study on IPR conducted by the International Finance Corporation concluded that India has one of the weakest IPR regimes, according to foreign investors. It is argued that India, which is not a signatory of the Paris Convention, has weak patent protection since it allows only process patents for up to 7 years in certain fields and does not permit product patents in food, pharmaceutical products and chemicals. At the same time, the Indian Patent Act of 1970 states that 14 years of protection is provided except in food and pharmaceuticals, where 7 year patent protection is recognised.

The government has made an attempt to improve the level of protection of intellectual property. It has become a signatory to the Agreement for the establishment of the WTO, including the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPs), which lays down minimum standards of protection that must become the national law of each member country. The accord provides for a ten year transition period for the introduction of product patents on drugs, chemicals and food products.

India enforces other types of intellectual property rights by offering protection of copyrights, trademarks and industrial design. India's copyright law, governed by the Indian Copyright Act (ICA) of 1957, incorporates all substantive obligations of the Berne Convention for the Protection of Literary and Artistic Works, to which India is a party. In 1994, the ICA was amended in order to bring it in line with the new developments in satellite broadcasting, computer software and digital technology. Indian copyright law is now on par with most OECD country standards. During the Uruguay Round negotiations, India fought for high copyright standards in order to provide greater protection to its vibrant film and software industries.

The Trademarks and Merchandise Act of 1958 offers full protection to trademarks in India. While service marks have not been included in this act, they have been protected in the country's courts, and the government has introduced a bill to provide protection for them. The Designs Act of 1911 permits the legal owner of an industrial design to take action against third parties who use the design without prior consent. Protection is offered under this act for five years, with renewals for two additional periods of five years each.

F. Treaty arrangements with other countries

To attract greater amounts of foreign investment and guarantee protection and repatriability, the Government of India became a signatory to the Multilateral Investment Guarantee Agency (MIGA) on 13 April

1992. This allows investors to take an insurance cover against risks of currency transfer, expropriation, war, civil disturbance and a breach of contract by the host government. Membership helps establish credibility among investors and a higher rating among global banking and financial capital markets. It also serves as a mandate for providing promotional and advisory services to assist in making India a more attractive environment for foreign investment. India is also a party to the New York Convention on the Recognition and Enforcement of Foreign Arbitration Awards of June 10, 1958.

With respect to bilateral treaties, India is party to treaties with Germany, Italy, Denmark, the Netherlands and the United Kingdom for the promotion and protection of FDI and has expressed willingness to sign similar treaties with other countries. Similar agreements with France and South Korea have been finalised and India is in the advanced stages of negotiations with Australia, Sweden, Switzerland, and Canada for the promotion and protection of FDI. India is also party with nearly all countries with which foreign investments are exchanged for the avoidance of double taxation. These countries include: Algeria, Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Egypt, Ethiopia, Finland, France, Germany, Greece, Hungary, Indonesia, Italy, Japan, Kenya, Kuwait, Libya, Malaysia, Mauritius, Nepal, New Zealand, Norway, Oman, Philippines, Poland, Singapore, Slovakia, Sri Lanka, Sweden, Switzerland, Syria, Tanzania, Tunisia, Thailand, the United Arab Emirates, the United Kingdom, the United States, countries of the former USSR, and Zambia.

G. Investment incentives

India has no special set of tax and non-tax incentives specially designed to attract foreign investors. All companies operating in India are eligible for available incentives, irrespective of the extent to which foreigners own their stock. The federal government has discontinued all regional incentives and resources have been shifted to the development of infrastructure in specific areas. Yet state governments offer various incentives for attracting industry to certain locations. These include land on concessional terms, water and power at reduced rates, concessions in the levy of sales tax and other state taxes and various small cash subsidies.

(i) taxation

At 16-17 per cent of GDP, Indian tax levels are above international levels.²⁹ Nearly 95 per cent of total tax revenue is concentrated in five areas: customs, excises, sales taxes and taxes on corporate and personal income. Such high taxes will tend to discourage private investment, including FDI.

In an effort to make the tax system less distortionary, the 1994-95 Budget took steps to implement certain Tax Committee recommendations and bring the excise system closer to a value-added tax scheme. First, the modified value-added tax (MODVAT), introduced in 1986, was expanded to include petroleum products, textiles, capital goods and special services.³⁰ Second, the budget called for the reduction of the total number of *ad valorem* MODVAT rates by half and reduced the number of special notification exemptions by roughly half. An excise duty has been introduced for the first time to cover certain services such as telecommunications, brokerage and non-life insurance. In the 1995-96 Union Budget, the finance minister announced transforming the MODVAT into a general VAT. Under the plan, it is foreseen that the reduction of import tariffs and other taxes

29 World Bank, 1995.

30 Special services include telephone services, the net premium charged by insurance companies on non-life policies, and the brokerage commissions charged by stock brokers. However, the Tax Reforms Committee's recommendation to also tax life insurance premiums and advertising services have not been implemented.

will be compensated by the erection of a less distortionary general VAT. It is also expected that States will harmonise their sales tax rates and convert them into VAT rates.

Further, in the 1995-96 Union Budget, the finance minister proposed lowering the rate of direct and indirect taxes to levels comparable with other parts of Asia. Regarding corporate income taxes, the budget has reduced the rate applicable to domestic firms to 40 per cent plus a 15 per cent surcharge for those with taxable income exceeding Rs 75,000. Foreign-owned companies are subject to a 55 per cent tax rate. The finance minister also proposed income tax exemptions on income by way of dividends and long-term capital gains of venture capital funds or investments made by equity stakes. Regarding personal income tax, the budget has withdrawn the 12 per cent surcharge on non-corporate income.

(ii) tax and non-tax incentives

The Indian government is trying to encourage investment in certain sectors of the economy deemed important for economic development. Several tax and non-tax incentives are offered for setting up new industrial undertakings and for encouraging exports. Manufacturing, software development, shipping and hotels are covered by general industry incentives. A 30 per cent reduction of company profits in computing their taxable income during the first ten years is granted to new industrial undertakings in these "high priority" sectors. This incentive is also available to new approved hotels set up by Indian companies and ships operated by Indian companies.

Certain industries, such as jute textiles, are given credits in the form of soft loans. Others, such as tea plantations, are eligible for subsidies for projects such as labour housing and replantations.

In the Union Budget of 1995-96, the finance minister announced a five-year tax holiday from April 1, 1995 for enterprises which build, maintain and operate infrastructure facilities. This includes investments in the following sectors: highways, bridges, airports, ports, rapid mass transportation systems.

The Government of India is also actively encouraging private investment in the power sector. The import duty on equipment needed for power projects has been reduced to 20 per cent, a total five-year tax holiday is granted to private sector companies engaged in power generation and distribution and at least a 16 per cent rate of return on equity in the currency of subscribed capital is guaranteed. The return on equity greater than 68.5 per cent Plant Load Factor may be higher. The government has also agreed to grant counter-guarantees to certain projects for the payment obligations of State Electricity Boards, for power purchased. With regards to foreign investors, an equity participation of 100 per cent is permitted on a fast-track basis, and the condition of dividend balancing by export earnings does not apply to these investments.

Tax incentives have long been available for export-oriented industries. Income tax exemption of 100 per cent is available for export-oriented industries. Firms may deduct 100 per cent of their profits from exports in computing taxable income where the proceeds from the sale are received in foreign exchange. Export earnings are tax-free and imports for use in the manufacture of export items are duty free for firms in these industries.

Similar tax concessions are available for new units in specified free-trade zones, export-processing zones³¹ and for those set up as 100 per cent export-oriented units (EOUs). The free-trade zones in India are (a) Santa Cruz Electronics Export Processing Zone; (b) Falta Export Processing Zone; (c) Cochin Export Processing Zone; (d) New Okhla Industrial Development Area (Noida) Export Processing Zone; (e) Kandla Free Trade

31 Used in the Indian context, the two terms, "export processing zones" and "free trade zones", are synonymous.

Zone; (f) Madras Export Processing Zone; and (g) Visakhapatnam Export Processing Zone. A 100 per cent equity participation is automatically allowed to foreigners in these zones.

Incentives, available to domestic and foreign companies alike, given within these zones include the following:

1. Exemption from customs duty on industrial inputs;
2. No import licenses required;
3. Excise duties are not levied on goods manufactured in the free zones;
4. Exemption from payment of corporate income tax for any five consecutive years during the first eight years of operation. Export earnings continue to be exempt from tax even after the tax holiday is over.

Foreign investments which introduce new technology, technical know-how and new research and development are also encouraged. Research and development costs and interest are fully deductible items.

H. Public sector reforms, monopolies and the role of the state

State-owned enterprises were established as an important part of India's development strategy in the early days of the country's independence, since the small private sector was thought incapable of promoting quick industrial growth. The role of the public sector was to be active in areas either where the private sector was unable to venture due to large capital requirements or where social welfare objectives were very different from private ones.

Today, India's public enterprises hold 55 per cent of the economy's capital stock and generate 25 per cent its non-agricultural GDP. In 1990, the public sector accounted for 36 per cent of the country's total employment. The public sector has a large presence in steel, minerals, coal, hydrocarbons, power generation and distribution, petroleum, natural gas and services such as railways, telecommunication and hotels. Public enterprises dominate ports, air transport, storage, banking, insurance and manufacturing industries including capital goods, pharmaceuticals and fertilisers.

The 1991 industrial policy stresses the importance of public sector reform. The government recognises that many public enterprises suffer from serious problems such as low growth in productivity, poor management, lack of technological advancement, and low rates of return on the capital invested. As part of the sector's reform, the central government announced a three-pronged strategy to improve public enterprises' finances. The plan³² consists of: (i) eliminating public enterprises' protection, such as entry barriers, severe import restrictions and preferential access to budget and bank resources; (ii) restructuring potentially viable public enterprises, liquidating the others, and establishing a safety net program to cushion the social cost of this process; and (iii) giving public enterprises more autonomy and the mandate to become profit-oriented concerns. Large scale disinvestment was not part of the strategy, except for relatively small blocks of shares sold to the public and mutual funds to mobilise fiscal resources. The total amount of disinvestment of the selected public sector enterprises up until March 1994 was Rs 49500 million (\$1.6 million).

The Monopolistic and Restrictive Trade Practices (MRTP) Act was also amended in 1991 to focus on trade-related matters, rather than on the prevention of concentration of economic power. For instance, an entire

34 This is taken from the World Bank Country Study, 1995, which goes into a great deal of detail in describing the failures and successes of the plan.

section dealing with restriction on expansion, establishment and take-over has been abolished. In addition, the sections on restrictions on the acquisition of certain shares, transfer of shares and the power of the central government to direct companies not to give effect to the transfers have been deleted.

The Rangarajan Committee, an advisory committee established to study the public sector and make policy suggestions, has recommended stepping up private investment in the public sector. The group suggests disinvesting up to 49 per cent of equity in areas still reserved for the public sector (listed below) and over 74 per cent in other areas.

However, a definitive decision has not been formally taken and progress opening the public sector has been limited. Public sector enterprises continue to be over-staffed and their rationalisation or privatisation cannot proceed effectively without greater labour market flexibility. Present labour regulations make it extremely difficult to lay off workers. The National Renewal Fund was set up in February 1992 to help workers in the public sector who are displaced by the sector reforms. Schemes have been proposed to assist in employee retraining, job search, and counselling. Yet labour reforms have not moved ahead, limiting until now the ability for the public sector to disinvest and privatise.

I. Security issues

Foreign investors are allowed to make applications to invest in all areas of the private sector. It follows that the private sector is permitted to operate in all areas except those of strategic concern. As part of the new industrial policy, the number of industrial sectors reserved exclusively for public sector investment has been reduced from seventeen to six:

1. Arms, ammunition and allied items of defence equipment, defence aircraft and warships;
2. Atomic energy;
3. Coal and Lignite;
4. Mineral oils;
5. Mining of minerals specified in the Schedule to the Atomic Energy (Control of Production and Use) Order, 1953;
6. Railway transport.

J. Sectoral issues

Over the last four years the government has taken many measures aimed at dismantling the previous system of controls. With an objective of accelerating the growth of private investment, the government has even lifted the ban on foreign participation in several sectors which had been until now reserved for the public sector. The object of opening these sectors to private investment, including foreign investment, is to increase efficiency, competition and, in many cases, upgrade areas where the public sector has not succeeded in providing adequate services. Yet measures to reduce public sector presence have been cautious and slow. Efforts have been made to open infrastructure, mining, oil, banking and insurance.

In the area of infrastructure, investment of Rs 538 billion (\$17 billion) is needed in the next few years. As the government's ability to take on investment in infrastructure is constrained, it has been necessary to induce private sector participation. Therefore the government has begun to reduce the state's presence in the power, telecommunications, railway, the roads and highway, air transport, and ports and shipping sectors. The extent to which foreign investment is permitted is evaluated on a case-by-case basis and the maximum foreign equity participation varies.

The acquisition of real estate has acted as a barrier to some foreign investment projects. According to existing Indian legislation on acquiring land, a company incorporated in India can buy land from the state governments in designated industrial areas and parks. Land may be purchased from private parties, yet state approval is necessary. Land destined for agricultural use can be converted into industrial land on application to local authorities and subject to state-level conditions. What complicates matters is that guidelines vary from state to state. Apparently there are no problems associated with foreigners leasing land. Non-resident Indians are on equal footing with Indian residents and have permission to acquire real estate without prior approval.

(i) telecommunications

The National Telecom Policy of 1994 has recognised that the provision of telecommunication services of world-class quality is needed to ensure the success of the new economic policy set out by the government. Accordingly, the guidelines of the policy aim to provide an environment which promotes private investment in order to expand and modernise this sector. In the country's efforts to provide universal access to basic telecommunication services by 1997, up to 49 per cent foreign equity is permitted in basic, cellular and paging services. The IFC has commented that Compared to this sector in other countries, . Licenses are granted through the Department of Telecommunications and are valid for five years.

In the 10-month period ending January 1995, the Department of Telecommunications added approximately 915,000 connections, nearly 34 per cent more than it did in the same period the previous year. But the waiting list for new phones still runs to over 2.5 million people, and only sometime later this year will the first pagers and cellular phones become operational in the country's main cities.

(ii) power

India has among the lowest rates of consumption of electricity in the world - 270 kilowatt hours per capital a year, against 570 in China. The gap between demand and supply is large, and growing. According to one official estimate, the country will require a massive 142,000 megawatts of additional generating capacity by the year 2007, providing significant scope for new investment. In the medium term, India needs to increase the present level of generating capacity, 73,000 megawatts, by at least 30,000 megawatts.³³

Aware of the greatly underdeveloped state of the power sector, the Indian government opened the sector in June 1992 to domestic and foreign private investors, incentives for which have been mentioned above. Foreign investors are permitted an equity participation of up to 100 per cent. The new policy framework opens investment in the following areas:

- thermal (coal/gas), hydro and wind/solar energy projects of any size are permitted;
- private sector companies may operate either as licensees distributing power in a licensed area from their own generation or from purchased power or as generating companies generating power to supply the grid.

(iii) roads and railways

The highway sector in India carries 60 per cent of freight and 85 per cent of passenger traffic.³⁴ Growth of traffic on Indian roads has been phenomenal during the past 50 years, while the expansion of roads and highways has been at a much slower pace. It is estimated that approximately 10,000 km need to be built in India.

33 Business India, page 32.

34 Indian Investment Centre Newsletter, Government of India, December 25, 1994.

In view of this, the government has decided to invite private sector participation in development and maintenance of national highways in order to raise capital investment in the sector, as funding from budgetary sources alone is not sufficient to meet the needs of highway infrastructure. Under the “Build, Operate and Transfer” (BOT) scheme, private investors in projects recover funds by the collection of tolls for a specified period. This scheme covers expressways, bypasses, tunnels and major bridges.

In order to attract foreign investors, the government openly permits certain elements which in other sectors are usually discouraged. For example, the government will allow the repatriation of profits, appointment of foreign experts, technicians and a simple procedure for importing construction equipment. In addition, certain fiscal incentives are offered by way of tax holiday for five years after completion of the project. In 1994-95, the government invited proposals from the private sector, including foreign firms, for 17 projects worth Rs 8500 million (\$274 million), yet no progress has thus far been made. Barriers at the sector and local level, such as the procurement of land, have slowed investment in this sector.

Legal framework for private sector participation is now in place following the recent amendment of the National Highways Act 1956, whereby it is legally permissible for the government to enter into an agreement with a private company for the development and maintenance of national highways. This enabling legislation provides that the government can grant concession to a person for construction and operating a facility. A competitive process will be followed in the selection of the entrepreneur and award of concession contracts, based on feasibility studies.

There is also an overwhelming case for the modernisation and expansion of the railways. Indian Railways runs an extensive network of more than 62,000 km and employs about 1.6 million people. In the first three quarters of fiscal 1994-95, it carried 264.7 million tonnes of revenue-earning cargo, 2.5 per cent more than in the year earlier. However, users have preferred to use less energy efficient road transport because of greater convenience and better service.

However, only a few steps have been taken to attract private sector investment. The railways have introduced reforms in their marketing and commercial policies and have simplified rules and procedures in key areas. Also, private sector participation is allowed through “own your own wagon” schemes. Foreign participation has been small.

(iv) air transport, ports and shipping

In the air transport sector, private airlines have been allowed to compete in the domestic market with the two dominant public sector airlines, Indian Airlines and Air India, since 1992. Yet until the Air Corporation Act of 1953 was repealed in March 1994, the Indian airlines enjoyed monopolistic power, confining the private airlines under the status of air taxis which meant, for example, that they were not allowed to publish time schedules. The enactment of the Air Corporation Act of 1994 has enabled private air taxi companies to operate freely in the domestic market. There are presently seven air taxi operators complying with the criteria prescribed within Air Craft Rules have been granted scheduled airline status and 12 non-scheduled air taxi operators in the private sector. They offer about 40 percent of the total domestic market capacity. Areas like the development and maintenance of airport infrastructure and handling of materials at major airports have also been opened to the private sector.

In ports and shipping, private sector investments and operations are being increasingly encouraged. As part of the government's plan to upgrade infrastructure to keep up with the expansion of the economy, areas in the port sector open to private investment include the following:

- establishment of container terminals;
- setting up of warehousing and storage facilities;
- operation and maintenance of various cargo handling facilities;
- provision of pilotage and craning services;
- leasing of port equipment;
- dredging;
- maintenance and other services.

Private investors may participate in the port sector by leasing equipment, managing port/service contracts and privatisation. They may also set up private ports nearby coast-based industries, engage in ship repair and organise transport within ports.

The shipping policy has been liberalised and technical barriers lowered to encourage private investment. As is the case with all foreign investment, prior government approval is required.

(v) oil and gas

In the oil and gas industry, including the exploration and development of existing fuels, production, refining and marketing, has undergone reform as part of the government's attempts to make the public sector companies globally competitive. The government has allowed imports and distribution of certain petroleum products such as domestic kerosene, LPG by the private sector at market prices to stimulate new investments and promote operational efficiency.

The Oil and Natural Gas Commission (ONGC), the public monopoly which previously dominated the sector, has been transformed into a limited corporation and 20 per cent of its equity has been disinvested. Private domestic and foreign companies are now allowed to invest in oil exploration and production in joint ventures with ONGC and also in the refining of petroleum products. The domestic market in lubricants has also been opened to foreign collaborators.

(vi) mining

In March 1993, the government unveiled a new National Mineral Policy to open the mining sector to the private sector. Foreign equity participation up to 50 per cent would be allowed, with equity participation levels above this level to be allowed on a case-by-case basis.

In order to invite private investment in the coal sector, the Coal Mines (Nationalisation) Act of 1973 was amended in June 1993. The amendment allows the operation of captive coal mines by companies engaged in the production of iron, steel, power generation and washing of coal in the private sector. Import tariffs have also been reduced for coking coal to 35 per cent (from 85 per cent).

In the hydrocarbon sector efforts have also been made to attract private investors; but results have been modest.

(vii) finance and banking

The banking system is being gradually opened as part of the financial sector reforms under the new industrial policy. The reform seeks to achieve four objectives:³⁵ (i) to correct and improve the macroeconomic policy setting within which banks operate, by rationalising interest rates, redesigning direct credit programs and reducing the level of resource pre-emptions; (ii) to improve the financial situation and competitive condition of banks by recapitalising them, restructuring weaker ones and allowing freer entry of new banks and other financial intermediaries; (iii) to build financial institutions and infrastructure regarding supervision, audit, technology and legal framework; and (iv) to improve the level of managerial competence and quality of human capital.

In pursuance of these objectives, sectoral reforms have moved ahead swiftly. For example, banks have been allowed to set their own interest rates on loans of more than circa \$6,400. Further, in January of 1993, the RBI announced guidelines for the entry of new, private commercial banks. Nine new banks (three foreign ones) have been authorised to set up operations and existing foreign banks have been permitted to acquire 20 per cent of equity in new private banks.

The government has also taken steps toward reducing its ownership in public banks. Public sector banks were authorised to sell shares to the public up to 49 per cent of their equity to strengthen their capital base. New private sector banks have been authorised to operate. At present, there are only 46 private banks in India, of which 23 are foreign. India has recently permitted foreign and non-resident Indian investors to hold equity in financial services. A maximum of 24 per cent of shares of companies in hire purchase, leasing, trading and other financial services is allowed to be issued to overseas investors. The RBI sees the introduction of foreign banks as a technological solution to banking problems and a way to attain higher levels of productivity.

However, the RBI continues to support the continuation of stringent conditions for the entry of the private sector in to banking. These requirements are heavy initial minimum capital, insistence on the applicability of priority sector lending stipulations and opening of at least 25 per cent of branches in semi-urban rural areas. The RBI claims to maintain such conditions in order to avoid the shortcomings such as unfair pre-emption of credit, monopolisation of economic power, cross-holding with industrial groups, etc., which beset the private sector banks prior to nationalisation.

(viii) insurance

The Indian government first announced that it would consider opening the insurance industry, currently a public sector monopoly, in its Union Budget of 1994-95. After reviewing the findings and recommendations of a report conducted by the Committee on Reforms in the Insurance Sector (CRIS), which underscored the need for progressive deregulation of the insurance sector to make it stronger and more competitive, the finance minister announced the intention of the government to evolve a broad national consensus about the future direction and content of reform in this sector.

As part of the government endeavour to reform the insurance sector, the main recommendations made by the CRIS were considered in a series of discussions held with the management of the Life Insurance Corp of India (LIC) and General Insurance Corp of India (GIC) and its four subsidiary companies; the representatives of the trade unions of the insurance industry; and representatives of consumer interest groups, the Chamber of Commerce and Industry, economists and opinion makers.

35 RBI, December 1994, page 1585.

The government has said that it will take into consideration the different views expressed at these meetings while making its final decision on the recommendations of the CRIS. However, as a first step towards the introduction of reforms in the insurance sector, the government announced during the Budget Speech of Finance Minister for the year 1995-96 that it was proposed to establish an Independent Regulatory Authority for the insurance industry, for which the necessary legislation will be introduced shortly.

In pursuance to the above decision, an interim regulatory authority was constituted on January 23, 1996 as a precursor to the proposed statutory authority with which this would be ultimately merged on which it will be converted into when the latter is constituted. The main function of the interim regulatory authority will be to exercise the existing powers of the Controller of Insurance (COI) and assisting the government to bring out a suitable legislation for the proposed statutory Insurance Regulatory Authority.

Conclusion

Foreign direct investment has not traditionally contributed significantly to the Indian economy. Yet under the new, more liberal foreign investment regime, FDI is expected to assume a much larger role in spurring economic growth and integrating India into the world economy.

India has made great strides in liberalising its FDI policies and the economy, and the trend toward liberalisation is steadily continuing. Liberalisation of FDI policies began slowly in the mid-1980s and a fundamental change came in 1991 when a new approval process was established, the ceiling on foreign equity participation was increased and sectors open to foreign investment were expanded. The new policy, and other changes which have occurred since 1991, have placed foreign companies operating in India at par with domestic ones. Exceptional to most OECD countries, India grants genuine national treatment to foreign investors; for example, it does not allow carve-outs or exception from national/state procurement, subsidies or fiscal concessions for establishment of industries in industrial backward districts on the basis of domestic or foreign equity. Also, many restrictions, such as local content ones, have been abolished, however, several requirements, such as foreign exchange ones, still exist. Today, FDI policies in India are comparable to those in other Asian countries.

Despite all of this progress, India still has a long way to go before its FDI policies in other areas resemble those of OECD countries. First, the current prior authorisation procedure allows automatic approvals in a fairly limited area of the economy - in 35 high priority manufacturing sectors, hotel and tourism industry and mining. It places a ceiling on foreign equity participation at 51 per cent (50 per cent in mining) and is subject to other restrictive requirements. India's strategy here is clearly biased toward promoting investment in sectors of the economy which have the greatest propensity to transfer technology and promote exports, while making it more difficult to invest in other, non-priority sectors.

Second, the route through which most FDI projects in India pass, the FIPB and SIA route, is *not* conducted in a manner which ensures that India's policies and attitudes toward FDI will not be reversed. This route is particularly worrisome due to the absence of ground rules and lack of transparency which gives the government total discretion in FDI approval. Nothing in this route's approval framework obliges the Indian government to continue approving FDI projects at the rate and volume that it currently does. Further, the current system does not put foreign investors on equal footing with domestic ones in the right to establishment. However, one must concede that this application of National Treatment is fairly advanced notion which is not commonplace among East Asia, nor is it among OECD countries.

If India is indeed committed to a more liberal FDI regime, it should act soon to build on the momentum of the reforms by institutionalising the process of approvals in a more transparent way which will lock in lasting rules and provide foreign investors with certainty and policy stability.

India should also move forward on reforms in the public sector and institutional reforms at the sector and state levels to attract FDI. Foreign participation is limited in many sectors of the economy because of a large state presence, not because of national security reasons. Reducing the state's presence in the steel, transport, telecommunications, banking and insurance sectors and opening these activities to foreign investors would increase competition and productivity and ease the burden of the government deficit, while upgrading capacity and services. The present government has expressed the desire to move forward with these public sector reforms, yet has had to slow the pace because of political and social opposition. Nonetheless, before further attempts can

be made toward liberalising the public sector, labour reforms must move forward in a manner which would facilitate the shedding of redundant workers.

The government also recognises that by adjusting sector level policies and institutional framework at the state and local levels to the new, more market-friendly central government policies, private and foreign investment implementation would be greatly facilitated. So far, the redirecting of such policies has largely been left up to the individual states and significant progress is yet to be made.

The Indian government has made substantial progress in liberalising the FDI regime, facilitating investor participation in the domestic economy. Policies to further open Indian economy to FDI will reinforce broader efforts to integrate India more fully into the global economy. FDI should begin to play a more active role in aiding India achieve its goals of greater economic growth and prosperity and closer integration with the world economy.

Annex 1
High priority industry list

1. Metallurgical industries
 - (i) ferro alloys
 - (ii) casting and forging
 - (iii) non-ferrous metals and their alloys
 - (iv) sponge iron and pelletisation
 - (v) large diameter steel welded pipes of over 300 mm diameter and stainless steel pipes
 - (vi) pig iron
2. Boilers and steam generating plants
3. Prime movers (other than electrical generators)
 - (i) industrial turbines
 - (ii) internal combustion engines
 - (iii) alternate energy systems like solar wind, etc., and equipment therefor
 - (iv) gas/hydro/steam turbines up to 60 MW
4. Electrical equipment
 - (i) equipment for transmission and distribution of electricity including heating equipment
 - (ii) electrical motors
 - (iii) electrical furnaces, industrial furnaces and induction heating equipment
 - (iv) X-ray equipment
 - (v) electronic equipment, components including subscribers and telecommunication equipment
 - (vi) component wires for manufacture of lead-in wires
 - (vii) hydro/steam gas generators/generating sets up to 60 MW
 - (viii) generating sets and pumping sets based on internal combustion engines
 - (ix) jelly-filled telecommunication cables
 - (x) optic fibre
 - (xi) energy efficient lamps and
 - (xii) midget carbon electrodes
5. Transportation
 - (i) mechanised sailing vessels up to 10,000 DWT including fishing trawlers
 - (ii) ship ancillaries
 - (iii)
 - (a) commercial vehicles, public transport vehicles including automotive commercial three wheeler jeep type vehicles, industrial locomotives
 - (b) automotive two wheelers and three wheelers
 - (c) automotive components/spares and ancillaries
 - (iv) shock absorbers for railway equipment and
 - (v) brake system for railway stock and locomotives
6. Industrial machinery and equipment
7. Agricultural machinery
 - (i) tractors
 - (ii) self-propelled harvester combines
 - (iii) rice transplanters

8. Earth moving machinery
9. Industrial instruments
10. Scientific and electro-medical instruments and laboratory equipment
11. Nitrogenous and phosphoric fertilisers
12. Chemicals (other than fertilisers)
 - (i) heavy organic chemicals including petrochemicals
 - (ii) heavy inorganic chemicals
 - (iii) organic fine chemicals
 - (iv) synthetic resins and plastics
 - (v) man made fibres
 - (vi) synthetic rubber
 - (vii) industrial explosives
 - (viii) technical grade insecticides, fungicides, weed killers, etc.
 - (ix) synthetic detergents
 - (x) miscellaneous chemicals for industrial use
 - (a) catalysts and catalyst supports
 - (b) photographic chemicals
 - (c) rubber chemicals
 - (d) polyols
 - (e) isocyanates, urethanes, etc.
 - (f) specialised chemicals for enhanced oil recovery
 - (g) heating fluids
 - (h) coal tar distillation and products therefrom
 - (i) tonnage plants for the manufacture of industrial gases
 - (j) high altitude breathing oxygen/medical oxygen
 - (k) nitrous oxide
 - (l) refrigerated gases like liquid nitrogen, carbon dioxide, etc., in large volumes
 - (m) argon and other rare gases
 - (n) alkali/acid resisting cement compound
 - (o) leather chemicals and auxiliaries
13. Drugs and pharmaceuticals (according to the drug policy)
14. Paper and pulp including paper products and industrial laminates
15. Plate glass
 - (i) glass shells for television tubes
 - (ii) float glass and plate glass
 - (iii) HT insulators
 - (iv) glass fibres of all types
16. Industrial rubber and plastic products
 - (i) automobile tires and tubes
 - (ii) rubberised heavy duty industrial belting of all types
 - (iii) rubberised conveyor belting
 - (iv) rubber reinforced and lined fire fighting hose pipes

- (v) high pressure braided hoses
- (vi) engineering and industrial plastic products

17. Ceramics
18. Cement products
19. High technology reproduction and multiplication equipment
20. Carbon and carbon products
 - (i) graphite electrodes and anodes
 - (ii) impervious graphite blocks and sheets
21. Pre-tensioned high pressure concrete pipes
22. Rubber machinery
23. Printing machinery
24. Industrial synthetic diamonds
25. Biological products
 - (i) photosynthesis improvers
 - (ii) genetically modified free living symbiotic nitrogen fixer
 - (iii) pheromones
 - (iv) bio-insecticides
26. Welding electrodes other than those for welding mild steel
27. Extraction and upgrading of minor oils
28. Pre-fabricated building materials
29. Soya products
30. Soya protein isolates
31. Certified hybrid and synthetic seeds and certified seedlings developed through plant tissue culture
32. Food processing industries other than milk food, malted foods, and flour
33. Packaging items for food processing industries
34. Hotels and tourism-related industries
35. Electronics software

Annex 2
Consumer Goods Industries where Dividend Balancing is Required

1. Manufacture of food and food products
2. Manufacture of dairy products
3. Grain mill products
4. Manufacture of bakery products
5. Manufacture and refining of sugar (vacuum pan sugar factories).
6. Production of common salt
7. Manufacture of hydrogenated oil (vanaspati)
8. Tea processing
9. Coffee
10. Manufacture of beverages, tobacco and tobacco products
11. Distilling, rectifying and blending of spirits, wine industries, malt liquors and malt, production of country liquors and toddy.
12. Soft drinks and carbonated water industry
13. Manufacture of cigars, cigarettes, cheroot and cigarette tobacco
14. Manufacture of wood and wood products, furniture and fixtures
15. Manufacture of leather and fur products.
16. Tanning, curing, finishing, embossing and japanning of leather
17. Manufacture of footwear (excluding repair) except vulcanised or moulded rubber or plastic footwear
18. Manufacture of footwear made primarily of vulcanised or moulded products
Prophylactics (rubber contraceptive)
19. Motor cars
20. Entertainment electronics (VCRs, colour TVs, CD players, tape recorders)
21. White goods (domestic refrigerators, domestic dishwashing machines, programmable domestic washing machines, microwave ovens, air conditioners)

Annex 3
Compulsory industrial licensing is still required in 15 industries for reasons of strategic concern, social reasons, and environmental concern.

1. Coal and Lignite
2. Petroleum (other than crude) and its distillation products
3. Distillation and brewing of alcoholic drinks
4. Sugar
5. Animal fats and oils
6. Cigars and cigarettes of tobacco and manufactured tobacco substitutes
7. Asbestos and asbestos-based products
8. Plywood, decorative veneers, and other wood based products
9. Tanned or dressed fur skins
10. Chamois leather
11. Paper and newsprint except bagasse-based units
12. Electronic aerospace and defence equipment
13. Industrial explosives
14. Hazardous chemicals
15. Drugs and pharmaceuticals (according to Drug Policy)
16. Entertainment electronics (VCRs, colour TVs, CD players, tape recorders)