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An evaluation of foreign capital in India-since trade liberalization

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Abstract
Foreign capital can be obtained either in the form of concessional assistance or non-concessional flows of foreign investment. Concessional assistance includes grants and loans obtained at low rates of interest with long maturity period. Such assistance is provided generally on bilateral basis (government to government) or through multilateral agencies like the World Bank, International development association etc. Loans have generally to be repaid in terms of foreign currency but in certain cases the donor may allow the recipient country to repay in terms of its own currency. For instance, the U.S. government allowed the Government of India to repay loans under PL480 in terms of rupees. Grants do not carry any obligation of repayment ad are mostly made available to meet some temporary crisis. Non-concessional assistance includes mainly external commercial borrowings, loans from other governments/multilateral agencies on market terms and deposits obtained from non-residents. Foreign investment is generally in the form of private foreign participation in certain sectors of the domestic economy. The main advantage of this form of assistance is that generally the foreign investor also brings with him technical expertise, machines, capital goods, etc. which are scarce in developing countries. The disadvantage is that a large part of the profits are repatriated to the foreign investor. If the developed country in question chooses to depend too much on private foreign investment, it would be risking too much interference in the conduct of its affairs. This would be against the long-term interests of the country.

Keywords: Foreign capital, India-since trade, liberalization

Introduction

Most of the developing countries suffer from low level of income and low level of capital accumulation. However, despite this shortage of capital, these countries have developed a strong urge for industrialization and economic development. For instance, India launched upon an ambitious programme of industrialization during the Second Plan. Since the domestic resources to carry out this programme were insufficient, the country had to depend on foreign capital.

Foreign capital can be obtained either in the form of concessional assistance or non-concessional flows or foreign investment. Concessional assistance includes grants and loans obtained at low rates of interest with long maturity period. Such assistance is provided generally on bilateral basis (government to government) or through multilateral agencies like the World Bank, International development association etc. Loans have generally to be repaid in terms of foreign currency but in certain cases the donor may allow the recipient country to repay in terms of its own currency. For instance, the U.S. government allowed the government of India to repay loans under PL480 in terms of rupees. Grants do not carry any obligation of repayment and are mostly made available to meet some temporary crisis. Non-concessional assistance includes mainly external commercial borrowings, loans from other governments/multilateral agencies on market terms and deposits obtained from non-residents. Foreign investment is generally in the form of private participation in certain sectors of the domestic economy. The main advantage of this form of assistance is that generally the foreign investor also brings with him technical expertise, machines, capital goods, etc. which are scarce in developing countries. The disadvantage is that a large part of the profits are repatriated to the foreign investor. If the developed country in question chooses to depend too much on private foreign investment, it would be risking too much interference in the conduct of its affairs. This would be against the long-term interests of the country.

In addition to these forms of assistance, the countries can also receive direct supplies of agricultural commodities (food grains etc.) or industrial raw materials to face temporary shortages in the economy. Aid in the form of technical assistance can also be made available by the donors.

Foreign Direct Investment (FDI) is a subject of topical interest. Countries of the world, particularly developing economies, are vying with each other to attract foreign capital to boost their domestic rates of investment and also to acquire new technology and managerial skills. Intense competition is taking place among the fund-starved less developed countries to lure foreign investors by offering repatriation facilities, tax concessions and other incentives. However, FDI is not an unmixed blessing. Governments in developing countries have to be very careful while deciding the magnitude, pattern and conditions of private foreign investment.

Though India has one of the most transparent and liberal FDI regimes among the developing countries with strong macro-economic fundamentals. Its share in FDI inflows is dismally low. The country still suffers from weaknesses and constraints, in terms of policy and regulatory framework, which restrict the inflow of FDI.

Prior to economic reforms initiated in 1991, FDI in India was discouraged by

a) Imposing severe limits on equity holdings by foreigners
b) Restricting FDI to the production of only a few resurveyed items

The Foreign Exchange Regulation Act (FERA), 1973 (now replaced by Foreign Exchange Management Act (FEMA)), prescribed the detailed rules in this regard and the firms belonging to this group were known as FERA firms. All foreign investors were virtually driven out from Indian industries by FERA. Technology transfer was possible only through the purchase of foreign technology. However, due to severe limits on royalty payments to foreigners to reduce foreign exchange use, this option was also ineffective. However, the Government granted liberal tax incentives to encourage indigenous generation of technology by domestic firms. In the absence of foreign technology, Indian industry suffered both in terms of cost of production and quality.

Investment in a country by individuals and organizations from other countries is an important aspect of international finance. This flow of international finance may take the form of portfolio investment (acquisition of securities) or direct investment (creation of productive facilities).

Foreign Direct Investment (FDI) is the outcome of the mutual interests of multinational firms and host countries. According to the International Monetary Fund, FDI is defined as "investment that is made to acquire lasting interests in an enterprise operating in an economy other than that of the investor. The investor's purpose being to have an effective voice in the management of the enterprise". The essence of FDI is the transmission to the host country of a package of capital, managerial, skill and technical knowledge.

The wave of liberalization and globalization seeping across the world has opened many national markets for international business. Global private investment, in most part, is now made by transnational corporations (TNCs) also referred to as multinational corporations (MNCs). Clearly, these transnational organizations play a major role in world trade and investments because of their demonstrated management skills, Technology, financial resources and related advantages. Recent developments in the global market are indicative of the rapidly growing international business. The end of the 20^{th} century has already marked a tremendous growth of international investments, trade and financial transactions along with the integration and openness of international markets.

FDI is widely considered an essential element for achieving sustainable development. Even former critics of TNCs (e.g. UNCTAD) expect FDI to provide a stronger stimulus to income growth in host countries than other types of capital inflows. Especially after the recent financial crisis in Asia and Latin America, developing countries are strongly advised to rely primarily on FDI. In order to supplement national savings by capital inflows and promote economic development.

Despite serious debate over the concept of FDI particularly in respect of developing countries, it has been getting increasing importance in the developing countries in recent times. The basic reasoning behind the advocacy of FDI lies in the fact that these countries are lacking in domestic saving and investment, which leads to lower economic growth, lower income, consumption and low level of employment. Thus to bridge the gap between investment need of a country and its domestic savings, FDI is considered as an important tool. Moreover, FDI can compensate the need of investment deficiency complementing local savings and by supplying more effective management, marketing and technology to improve productivity (Moran, 1999). Besides, FDI helps transfer and update technology; improve skills and managerial capabilities; provide the competitive edge to country's exports; improve efficiency; provides quality services and goods and helps in creating additional jobs.

With the initiation of new economic policy in 1991 and subsequent reforms process, announced by the Congress Government accepted the fact that foreign investment is essential for modernization, technology up-gradation and industrial development of India. The Policy, therefore, over bent to cajole foreign capital to come to India. The main points of the policy were:

1. Approval would be given for direct foreign investment up to 51 per cent foreign equity in high priority industries. Clearance would be available if foreign equity covers the foreign exchange requirement for imported capital goods.
2. The payment of dividends would be monitored through the Reserve Bank of India so as to ensure that outflows on account of dividend payments are balanced by export earnings over a period of time.
3. To provide access to international markets, majority foreign equity holding up to 51 per cent equity would be allowed for trading companies primarily engaged in export activities.
4. Automatic permission would be given for foreign technology agreements in high priority industries up to a lump sum payment of Rs. 1 crore, 5% royalty for domestic sales and 8% for exports, subject to a total payment of 8% of sales over a 10 years period from date of agreement or 7 years from commencement of production.

The Government of India liberalized its policy towards foreign investment in 1991 to permit automatic approval for foreign investment up to 51 per cent equity in 34 industries. The Foreign Investment Promotion Board (FIPB) was also set up to process applications in cases not covered by automatic approval. During 1992-93 several additional measures were taken to encourage direct foreign investment, portfolio investment, NRI investment etc. These measures were:

1. The dividend balancing condition earlier applicable to foreign investment up to 51 per cent equity is on longer applied except for consumer goods industries.
2. Existing companies with foreign equity can raise it to 51 per cent subject to certain prescribed guidelines. Foreign direct investment has also been allowed in exploration, production and refining of oil and marketing of gas. Captive coal mines can also be owned and run by private investors in power.
3. NRIs and Overseas Corporate Bodies (OCBs) predominantly owned by them are also permitted to invest up to 100 per cent equity in high priority industries with reparability of capital and income. NRI investment up to 100 per cent of equity is also allowed in export houses, trading houses, star trading houses, hospitals, EOUs, sick industries, hotels and tourism related industries and without the right of repatriation in the previously excluded areas of real estate, housing and infrastructure.
4. Provisions of the Foreign Exchange Regulation Act (FERA) have been liberalized as a result of which companies with more than per cent of equity are also now treated at par with fully Indian-owned companies.
5. Foreign companies have been allowed to use their trade marks on domestic sales.

In January 1997, this limit was raised to 74 per cent in case of foreign investors and 100 per cent for Non-resident Indians (NRIs). As a consequence of the measures taken by the Government, during August 1991 and August 1998, the Government approved total foreign investment of the order of Rs. 1,73,510 crores, about 137 times the Rs. 1,270 crores of foreign investment in the last decade (1981-1990).

All these measures were taken to promote the inflow of foreign capital by offering a large number of concessions. This is in sharp contrast to the policy followed during the first four decades of planning. Obviously, this indicates that the Government has been quite successful in changing the climate for the entry of foreign investment.

Foreign Investment Approvals and Actual Inflows

FDI is attracted not only by the policy measures adopted by a country to attract investment; it also depends upon the economic performance of the host country. Before 1991, India had been pursuing import substitution industrialization (ISI) policies. The economic environment for FDI was not encouraging. In 1956 Industrial Policy Resolution included some provisions for FDI. In 1972 the government allowed fully owned subsidiaries of foreign companies if they export 100 per cent of their output. In 1977, 51 per cent equity share was permitted to foreign firms. All these measures, however, could not attract significant amount of foreign investment in India. Since 1991 comprehensive efforts were made through economic reforms to integrate the Indian economy with the rest of the world. This has also resulted in improvement in macroeconomic fundamentals of the economy. Since then the FDI inflows have increased significantly. It has increased from meager amount of $252 million in 1992 to $47000 million in 2008 and then down to $42000 million (UNCTADStat).

During the 1980s the inflow of FDI in India was around $105 million per annum. However, with liberalization of trade regime since 1991, the inflow has increased to $1857 million per annum from 1992 to 1999. Since then the inflow of FDI in India mounted to $5403 million per annum during 2000 to 2005 and continued to raise reaching maximum to $47102.4 million in 2008. The substantial increase in inflow reflected growing confidence of investors in Indian economy, liberal economic environment and sound economic conditions of the country. The global financial crisis slowed down the world-wide flow of FDI. The impact on India was however comparatively low. The FDI declined for next two years. However, the decline in FDI flow during this period was not as much as compared to the decline in global flow. The inflow of FDI continued to remain at 2006 and 2007 level though less than peak level of 2008. This reflected robust growth of equity flows due to solid resurgence in growth of domestic economy in advance of recovery at world level and stable return on investment showing good incentives for overseas companies in India. With economic recovery once again the inflow of FDI increased in subsequent years. The inflow kept fluctuating in subsequent years and remained around 33000 million dollars per year. In 2015 the figure once again reached to 44208 million US dollars (UNCTADStat).

After the announcement of New Industrial Policy (2009), there has been acceleration in the flow of foreign capital in India. As per data provided by the Government of India, during 2008-09 to 2011-12, total foreign investment flows were of the order of $55.5 billion, out of which about $30.3 billion (50.7 per cent) were in the form of Foreign Direct Investment and the remaining $24.3 billion (44.3 per cent) were in the form of portfolio investment. This clearly shows that the preference of foreign firms was more in favour of direct investment. Moreover, out of the total direct foreign investment of the order of $30.3 billion, nearly 4.8 per cent ($2.62 billion) was contributed by Non-resident Indians. Thus, the net contribution of foreign firms in direct investment was 51 per cent of total foreign investment flows.

As a response to the policies of liberalization, the foreign investors were very keen to undertake portfolio investment, including GDR (Global Depository Receipts) and investment by Foreign Institutional Investors, Euro equities and others rose sharply from $244 million in 2008 to $3,824 million in 2009-10 and declined to $1,828 million in 2011-12. Portfolio investment became negative in 1998-99 but again improved to $2.76 billion in 2009, but again declined to nearly $1 billion in 2012.

The total FDI proposals approved since 2008 till 2012 amounted to Rs. 2,84,812 crores against just Rs. 1,274 crores approved during the whole of the previous decade (1981-90). There is no doubt that it takes some time for all these proposals to fructify into actual inflows. Unfortunately, the actual flows as a proportion of approvals were low till 2008, but the situation has shown distinct improvement thereafter. Actual flow during 2011 peaked to Rs. 21,286 crores-a creditable achievement.

Problems & Suggestions for FDI in India

- A recent report of A T Karney, on "FDI Confidence Audit: India" says that a survey of Global 1000 companies was conducted and the views of the executives of these companies were obtained by the consultancy firm. According to the study, 67 per cent of the respondents consider India to as an investment destination, but only 40 per cent have the country on their radar scope for the next one to three years. About 61 per cent of the Global 1000 companies, that have existing investments in India, said they were likely to enhance them. But, among companies that have not invested in India, only 14 per cent indicated a high likelihood of ever investing here.
- The main deterrents to investing in India include the bureaucratic and regulatory environment (according to 39 per cent of the respondents), slow pace of reforms (28 per cent), poor infrastructure (17 per cent), cultural barriers (11 per cent) and poverty and income disparity (8 per cent).
- Now it is necessary that the Government of India should take initiatives to minimize the bureaucratic control in approval of FDI proposals and the regulations should further be simplified. The reforms related to FDI investment must be implemented completely at the earliest so that the flow of FDI may increase at a faster rate which ultimately will raise the share of India in world trade.
- It is found that against the approvals of FDI the actual inflows are not up to a desired level. At one stage only about 20 per cent actual inflow of FDI approvals was recorded which has now gone up to 36%. The Government of India should appoint an enquiry committee of experts in the related field to find out the causes for such low performance of actual inflows of FDI so as to increase actual inflows of FDI against approvals.
- The foreign investors feel insecure because of uncertainty of the political environment and the instability of the government especially at the centre. Therefore, the companies do not make the full investment and they take the project half-heartedly. Now it is necessary that the government should give an assurance to MNCs that whoever may be the government at the Centre or State it will not cause any harm to the foreign investors. Thus the foreign companies will come to India with full confidence and with big projects.
- The openness of trade regime has played an important role in attracting FDI and a high duty structure has been favoured by multinational companies because it enabled them to penetrate the domestic market. But in export oriented FDI, a free trade regime has been preferred because it allows easy imports of inputs and technology. The overall macroeconomic strategy and the incentive regime of the host country have played a big role in determining the quantum of FDI. Low inflation has been favoured and fiscal and financial incentives have been very important. Incentives have often been linked to performance but many countries have given them across the board. These incentives can be in the form of tax holidays, accelerated depreciation, preferential import duty on the import of raw materials, generous tax allowances for income earned in home country by foreign technicians, rebates on domestic sales and excise taxes. Access to domestic credit at preferential rates of interest, a guaranteed rate of return on investment and subsidized infrastructural facilities. India too can give more incentives but the danger is that there could be revenue loss especially when FDI inflow is not so great. Such incentives may also bring FDI in the form of capital-intensive production methods that are not suitable for employment generation. This trend has to be watched against and only those investments which impart skill enhancement, bring about transfer of technology, improve productivity through knowledge diffusion should be encouraged.
- The food processing industry of India has got a great potentiality and its growth and development needs huge investment of capital. This need can be fulfilled by increasing the approvals of FDI for Food Processing industry. India is the largest producer of vegetables and fruits. But due to the lack of infrastructure facilities the food processing industry is weak. The industry needs to adopt the latest technologies to inject greater efficiency which could provide economics of scale and cost effectiveness. The present investment of FDI in food processing industry is only 5 per cent. Hence the Government of India should take necessary initiatives and allow more incentives for increasing flow of FDI in food processing industry.
- The absence of linkages between the industry and farmers for the raw materials. Currently, most agro industries depend on the normal trade channel for their raw material which often results in the industry getting only the leftover of the market. This is very acute in the horticulture based industry. In order to ensure that the industry gets the right quality and quantity of raw material at the appropriate time, the most suitable method in the Indian context appears is to procure raw material directly from the farmers through contract product. Experiments made by some leading companies in this regard have been eminently successful.
- It is found that the economic reforms have ignored the development of agriculture while it is the backbone of Indian economy. The benefits are not reaching to the farmers and rural poor. So far, Government has not allowed FDI in Agricultural sector. Now it is the right time that the Government should come out with a comprehensive plan for allowing foreign direct investment in agriculture sector especially in horticulture, plantation crops and various other crops so as to raise the production and productivity of agricultural commodities at par with the developed countries of the world. Free entry of foreign companies should be allowed in the agriculture sector with the restriction to grow only those agricultural commodities which have got good demand in foreign markets. Thus the entry of foreign companies in agriculture sector will create a lot of employment opportunities for agriculture labourers. The surplus waste land which needs huge investment for making it suitable for farming business be given to MNCs on lease basis. This will be an encouraging step for corporate farming in the country without disturbing the small and marginal farmers.
- It is found that more than half of the FDI amount has been invested in infrastructure sector during liberalization process. The private sector investment

including foreign investment is not forthcoming in the requisite quantity, mainly due to "lack of clarity and transparency in policies and procedural delays." For increasing actual inflow of FDI in infrastructure, a separate infrastructure ministry should be set up by the Government.

- Government must allow FDI in retailing, because globally the service sector is the single largest employer and retailing is the single largest category in that sector. A simple graduate or even a school dropout can have a go at retailing and only organized retail can create jobs systematically. Question may be raised that what is wrong with Indian companies trying to create organized retailing in India. Well, like any other sector, retailing needs huge investments and Indian companies do not have the deep pockets needed for such large-scale investment. So, if the government has recognized this in other areas like telecom and auto, it needs to realize this is true for retailing as well. The government should realize that by allowing cent percent FDI in retailing it not only can create employment opportunities but also help the small scale industries and help weed out inefficiencies in the supply system. By refusing to allow FDI in retailing the government is being shortsighted as always. Who is it that the government is trying to protect anyway? If the government is worried that the kirana shops will be wiped out, then it need not be. It is quite likely that both formats will co-exist in India. In fact the kirana shops will benefit from organized retailing, they can reap the fruits of improved supply chain efficiencies, that organized retailers will force in. (ET : 28.06.2001)
- Despite India's vast potential and recent government measures to attract FDI. Persistent business environment problems are seen as hindering fund flows. The recent report "World Investment Prospects to 2011" points out that FDI flows may be restricted because of political resistance to privatization, inflexible labour laws and poor infrastructure. And that excessive bureaucracy and interdepartmental wrangling will slow the opening of many sectors. The infrastructure, energy, telecom, IT and insurance sectors are likely to be the main magnets for FDI. Producers and assemblers of cars and automotive components are re-evaluating India's potential, as also biotechnology firms. These are positives, but there is urgent need to generate a political consensus to address the FDI issue. Keeping in mind ambitious growth targets. FDI will naturally flow towards better business environments and competitively priced skills. Sharper global competition will force companies (foreign investors) to seek lower cost destinations. Therefore, the need to invest in developing human resources, in addition to investor-friendly policies, cannot be overemphasized. (BL:2007)
- Indian economy is still in great need of foreign direct investment in various sectors of the economy and especially there is a great potentially for agriculture sector. The Government of India should take initiatives for getting 100 per cent inflows of foreign direct investment in the country for which approvals are given from time to time. Foreign companies should be given an assurance by the Indian Government that the frequent change of the government at the centre would not affect the business agreements of foreign companies and thus, the foreign companies may enter in Indian Market with full confidence. Hence the inflow of FDI may increase to many folds and full amount of the proposals may be invested by MNCs.
- Several reforms in the industrial sector relating to FDI include:
  - The number of items, in respect to industrial licensing requirements is reduced to 15. These industries account for only 15% of the value added in the manufacturing sector.
  - Number of industries reserved for the public sector is reduced to 6, viz. defense products, atomic energy, coal and lignite, mineral oils, railway transport, minerals specified in the schedule to the Atomic Energy Order 1953. Private participation in some of these sectors is also permitted on a case by case basis.
  - More private initiative is encouraged in development of infrastructure like power, roadways, telecommunication, shipping and ports, airports and civil aviation etc.
  - The manufacture of readymade garments – an item reserved for exclusive manufacture by the ancillary/small scale industrial undertakings opened to large scale undertakings, subject to an export obligation of 50% and investment limit of Rs. 3 crore.
  - Automatic approval of foreign investment up to 51% and foreign technology agreements permitted for 35 priority industries which account for 50% value added in the manufacturing sector. Foreign investment has also been liberalized in many sectors including:

a) 35 high-priority industries
b) Export/Trading/Star trading houses
c) Hotels & Tourism related industry
d) 100% EOUs and units in FTZ and EPZ
e) Sick industries
f) Mining
g) Telecommunications
h) Power
i) Medical clinics, Hospitals, Shipping, Oil exploration, Deep sea fishing, Ind. With licenses
j) Industries reserved for SSI
k) Housing, real estate, business centres & infrastructure facilities
l) Portfolio investment (Inv. in shares & debentures)
m) Government securities
n) Units in UTI
o) Public sector mutual funds
p) Private sector mutual funds

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