Foreign Direct Investment in India: Opportunities, Challenges and Suggestions

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Abstract

India's approach towards foreign private investment was basically restrictive and selective before the changes in the industrial policy of 1991. Before 1991it was largely designed to acquire foreign technology for improving domestic production or augmenting exports, foreign equity participation was limited to 40 %.

But after the liberal policy was announced in 1991, which leads to a de-licensing of industry, competition rather than was encouraged protection as the desired environment. This policy has made the Indian market more attractive for both foreign and domestic investors.

Notwithstanding a regulated and mixed economy, India has a strong and growing private sector which is expected to receive a big boost due to liberalization and de-licensing of the industry. In support of industrial development programs, the Government of India is strengthening infrastructure facilities. India possesses vast reserves of minerals for a wide range of industrial products and offers a low-cost labor supply of skilled personnel.

Financial institutions and commercial banks provide loans for approved industrial products at concessional rates, tax law providing some incentives and tax holidays for investors. India has never defaulted in meeting its financial obligations and plans to maintain an excellent record despite the adverse trend in its debt service ratio in past.

Foreign investors should take advantage of the Government India's relaxed policy and its legal system which does not differentiate between a foreign firm and an Indian firm once the firm is incorporated in India. Like an Indian company the foreign company also does not require any approval or license, and the same procedure govern both Indian and the foreign firms alike. I believe that more liberal policies are anticipated under the new Prime Minister Dr. Man Mohan Singh, the out look for collaboration should improve further.

Economic Environment of India

India, the seventh largest country in the world in terms of area, is the largest democratic republic with a politically stable government. It is also the fourth largest economy in the world (ranking above France, Italy, the United Kingdom, and Russia) in terms of purchasing per parity (PPP). It is good for the Indian economy that it is growing with 8 % annual growth rate and making it third largest GDP in the entire continent and the second largest market of developing nations in the world.

Agriculture was the dominant source for Indian economy, but over the last two decades it has become a less dominant sector, but still it has a large role in Indian economy about holding 35 % of income. This is good sign for India because India has diversified the economy into a full range of manufactures, including consumer and heavy capital goods. Indian government has recently liberalized the Indian economy and has opened it for foreign investors.

India is richly endowed with minerals such as coal, iron, bauxite, manganese, chromites, limestone, dolomite, and barite which is the principal industrial raw material for iron and steel, cement, aluminum, etc. The country has subsequent reserves of natural gas, which is to be used as feedstock for the proposed gas based fertilizer plants, India's recoverable crude oil reserves are estimated at 530 million metric tons, equivalent to only 13 years of consumption at the present annual level of consumption rate.

India's transportation system includes a wide network of railways, the fourth largest in the world, and extensive roads. Mumbai is the largest port of the country handling over 25 % of total traffic. The country also has an extensive network of communication facilities and is linked to most countries through modern communication means.

Also new liberal industrial policy has made the Indian market more attractive for foreign investment. This new industrial investment policy was announced in 1991 and it has lead to the liberalization of the Indian economy and emphasis on de-licensing which reduces the unnecessary time wasted in bureaucratic and the red tape system. It is very important that Indian law does not differentiate between Indian and foreign company, if once the foreign company is incorporated in India. It has equal opportunities as compared with Indian firms, for example these foreign firms also do not require license like Indian firms in most of the sectors.

The country's major economic problems are unemployment, poverty, high cost of industrial products and large underutilization of industrial capacities, inadequate infrastructure. Although 90 % of the skilled personnel are employed but the unemployment is high in rural area where mostly people are uneducated and the main source of income is agriculture which is based on monsoon, lacking some proper irrigation systems. It increases the poverty level in India which puts burden on the Indian economy.

India's Attitude toward Foreign Direct Investment

The government of India (GOI) welcomes foreign investment largely as a vehicle for transfer of technology to reinforce domestic efforts to accelerate economic efforts to accelerate economic growth. Foreign investment is more rapidly permitted if accompanied by transfer of technology. However the government of India has relaxed this policy for investors for oil exporting developing countries who are allowed to invest up to 40 % in equity in new ventures such as cement, and petrochemicals, etc. Also the general policy is that non-resident of Indian origin can invest in industrial units without the transfer technology.

According to the Department of Industrial Policy and Promotion, India is now ushering the second generation reforms aimed at further and faster integration of Indian economy with the global economy. India has been rapidly changing from a restrictive regime to liberal one, and FDI is encouraged in almost all the economic activities under the automatic route.

With the new investment policy after 1991 the government of India does not insist on investing in the industrial sector. Also reforms in the1991 investment policy have abolished state owned monopoly from domestic economy now it is free, liberal and open for private investors. For example, ten years ago the telecommunication industry was state owned fully monopolistic market constituted with a lot of bottlenecks, but with new liberal policy it is growing with 20 a % rate and leading telecom companies are expected to invest about $20 billion with in five years.

As the restrictions on foreign investments were reduced, there is a sudden increase in foreign investment. The value of foreign direct investment increased significantly since the last decade. In 1997, it was $15.8 billion as compared to $.3 billion in 1991. After the 1991, the foreign investment followed a steep upward curve and grew 23 % annually and 44 % from 1991 to 2001 (World Bank Development Indicators).

Investment Laws

Industrial investment in India is regulated through the Industries Development and Regulation Act of 1951. However, the major legislation affecting the inflow of foreign investment is the Foreign Exchange Regulation Act (FERA) of 1973. This law is aimed to broaden the ownership base of foreign controlled companies in India. FERA provides approval of foreign equity of up to 51 %. The exceptional case exists where significant contribution has been made and foreign holdings are high up to even 100 %. Additionally 60 % foreign of equity can be retained if the combination of a company's exports and its participation in the core sector adds up to 75 % of sales.

"The government of India issues from time to time lists of industries indicating, where foreign investment may be permitted. No doubt, a broad technology base has been made in the country, yet a need to update the production technology may arise due to constant technological changes in the developing countries." According to India Business law Guide.

The Laws in Actual Practices

The Indian legal regime governing foreign investment clearly gives the Indian government power to accelerate, to slow, or even to halt foreign investment. Under its present overall economic policies the government is interpreting the investment laws liberally and positively with a view to facilitating foreign investment. Criteria for high technology content and for export commitment have been loosened in order to allow a larger percentage of approvals for proposed joint ventures. In India, as is the case for joint ventures for export in terms of their feasibility and foreign exchange earning potential. As one of senior official put it, the initial assumption is that private entrepreneurs, both Indian and foreign, know what they are doing.

Often foreign investment projects are discouraged from investing in India because of the 40 % foreign equity rule since, in making overseas investment, they insist on management control guaranteed by holding 51 percent or more of a foreign exchange subsidiary equity. While the 40 % rule can be a drawback in terms of aggregate return on capital, for several reasons it need not to be barrier to management control. First, the local equity portion often widely held. In fact, stock offerings for ventures where there are well-known and respected foreign partners are usually over subscribed. Second Indian company law permits management to be firmly in the hands of a minority partner. In general, foreign equity holders should not go below 26 % since at that level or above, the owner of that minority share of the corporation holds an automatic veto over any management decision proposed by other shareholders.

Procedures of Foreign Direct Investment in India

Foreign collaborations in India take various forms, according to reports from The Department of Industrial Policy and Promotion (GOI), foreign direct investment is freely allowed in all sectors including the service sector. The department says that foreign investment can be brought through the automatic route under powers delegated to The Reserve Bank of India (RBI), and for the remaining activities through Government approvals along with recommendations by Government Investment Promotion Board (FIPB). Foreign investments for trading can be approved through the automatic route up to 51 % foreign equity and beyond this by the government approval along with FIPB recommendation.

These reports further talk that a foreign company may establish presence in India in number of ways, the foreign companies may open a branch office or they may have a project office or a liaison office or setting up an Indian company. For the formation of an Indian company these are the options:

(1) Foreign company setting up a 100 % wholly owned Indian subsidiary.

(2) Foreign company setting up 51 % subsidiary with 49 % held by an Indian partner.

(3) Foreign company investing in a joint venture.

(4) Foreign companies have a Greenfield venture.

Most of the Multinational companies enter as either a joint venture or as a Greenfield venture. Technology and industry type is the main criteria to decide which channel to opt. In my research I found that companies entered with joint venture cater more to local markets and companies entered with Greenfield project cater overseas markets.

Most of the firms investing in India are from the USA and from Western Europe, together accounting for the 78 % of the firms in this sample. Multinationals from Germany with 11 % and from the United Kingdom with 9 % are the leading European investors.

Although Indian industry is enjoying liberalization, Indian market has higher requirements for the number of permits and longer median number of days to start a firm. As compared with china, a foreign company requires 10 permits in India where as only 6 permits are required in China to start a business. India also needs to make its bankruptcy policies compatible with global standards because those are outdated making Indian industry ineffective and inefficient.

Also there is a major gap in Indian industry in that it has a fragmented structure with a dominance of small scale. As a challenge for foreign investment I see there are very few clear examples of industry leadership, and the fragmentation of supply base also creates barriers in achieving true integration between the various links in the supply chain. This lack control and consistent or reliable performance.

Despite the current efforts to simplify and speed procedures, India's mechanism for foreign investment remains slow and complex. In brief, the approval process involves consideration of the proposal by several agencies including the administrative ministry concerned with the type of investment proposed (Heavy Industry, Electronics, Agriculture, Food, etc.), the FIPB, and the commerce ministry for review of export –oriented undertakings and capital goods imports.

Rules on Acquisitions, Takeovers and Reinvestment

Proposed acquisitions of any Indian undertaking, wholly or in part, by foreign firms or by individuals resident outside of India must be approved by The Reserve Bank of India. There are not takeovers in the sense of unfriendly purchase of firms through proxy battles or the like.

There is no discrimination between foreign and Indian investors. Investment is treated alike by the GOI under the same set of laws, rules, and regulations. Normally, India's policies do not permit nationalization of foreign investments. Evidence of this policy occurred when major banks were nationalized and foreign banks were left in 1969 and 1980. Other than this the government provides for rapid equitable compensation without any discriminatory treatment between foreign and Indian investments.

Remittances of dividedness, royalties, technical fees, etc, are freely allowed. Similarly, capital can be repatriated at any time, together with appreciation, after tax payment. India has never defaulted even during the most serious foreign exchange crisis. With respect to dividends, there are essentially no limits but there are differences in procedure. Dividends can be remitted directly through foreign exchange dealers.

If dividends exceed certain amounts or if they are to be remitted by firms with over 40 percent foreign equity, The Reserve Bank of India's is required. Royalties are calculated on the basis of ex-factory selling price, net of excise taxes, and costs of certain purchasing or imported components. Recently, the government has liberalized this standard and has approved several collaborations with royalties at 8 percent for 10 to 15 years.

Taxation and Incentives for Foreign Investors

Income in India is taxed in accordance with income the Income Tax Act of 1961, and the corporate tax rate for the foreign companies is 40 % and with various deductions and exemptions available. Indian tax law provides incentives for industrial growth which well-managed companies use routinely to their advantage. The private firms making new investments or which steadily expand their plant and production can be virtually exempt from tax. Several Indo-U.S. joint ventures already operating in India have paid no taxes.

The government has published detailed showing that a hypothetical new, widely held, high priority industry could have a taxable income of zero in the first years and no more than 23 % in the ninth year. Again continuous expansion guarantees continuing low taxation. However The Finance Act of 1983 has restricted the use of tax incentives so-that companies pay minimum tax on at-least 30 percent of their income. The most successful companies engage expert counsel on the tax planning.

The tax law does not discriminate against companies with foreign participation; rates are lowest for widely held companies. There are separate rates on dividends and other remittances to the foreign companies. The major tax incentive for the foreign companies include new investment and for expansions include additional depreciation, investment allowance (25-30 % of cost of new plant and equipment), partial tax holiday for new industrial undertakings (25 % of net earnings for 8 years), with additional tax concessions for those in backward areas (20 % of profits for 10 years) and no tax for free trade zone projects (5 years). The investment allowance and accelerated depreciation combined can total 125 % deduction on costs of plant and machinery for specified periods. There are substantial tax incentives on scientific research and development as well as for exploration and development of oil and gas.

In addition there are special incentives for foreign non-resident tax payers (individuals and foreign companies), including concessional rates of 25 % on dividends and 4 %on royalties and technical fees. Foreign technicians employed by joint ventures can receive the equivalent of total tax holiday for up to 4 years, including educational and travel allowances. There are additional concessions with respect to interest paid on foreign loans.

Foreign Investment Performance Requirements

According to the book Investment Climate in Foreign Countries by U.S. Department of Commerce International Trade Administration, previously designed, India links approval of foreign investment proposals to criteria which promote transfer of technology and/or increase production for export, to implement this policy the government has established the following specific performance requirements concerning import substitution and local content:

- Investing firms must procure from local sources where domestic production capacity exists and must, if possible, shift to domestic procurement when new capacity is created. Annually announced changes in import policy specify the kinds of raw materials, components and production machinery which may be imported. However, firms exporting 100 % of their output are exempt from local-content requirements and are allowed duty free imports.

Imports performances are given to investments predominately for export production with a minimum export requirement of 60 % of total output.
In addition, there are following requirements not related to trade:

- Local hiring of employees; employment of Indian nationals to extent possible is one of the general appraisal criteria in evaluating a foreign investment.

- Technology transfer/R&D; foreign investors are expected to transfer technology are expected to transfer technology and to carry out research and development in India. To promote this, a tax deduction equal to 125 % (or 133 % in certain cases) of R&D expenditures is permitted.

Finance, Credit and Banking

Indian business and industry has available a full range of finance and credit institutions. There are 12 recognized stock exchanges, the largest being in Mumbai and Delhi which offer organized markets for shares, debentures and other securities.

The government of India, as well as each state government, has established numerous institutions to provide short and long term financing for industrial undertaking on both concessional and commercial bases. The key organization is the industrial development bank of India which finances all types of industrial undertakings through direct assistances, various soft loans and seed schemes, technical development loans, refinancing and special programs for exports to Indian overseas projects. Other institutions include the industrial finance corporation, industrial credit bank of India. In addition, each of the Indian states has industrial development and financial institutions.

Foreign investors will do well to work with such institutions not only for the competitive financing they provide but for their ability to guide a project through government regulations.

Although the government owns over 90 % of the domestic banking system, its services and functioning are essentially the same as if the systems were private. Foreign, including many American, banks operate full-service facilities in major centers. The Reserve Bank of India sets credit policies, which in recent years have been restrictive to combat inflation. However, most observers believe that for worthy investors, there is no real credit shortage.

Foreign Trade Zones

Investment in the country’s free trade zones at Kandla (Gujarat) and Santa Cruz (Mumbai) for electronics is open to foreigners, Indians, and non resident Indian origin. Units of these zones can be 100 % foreign-owned or joint ventures with majority foreign equity holding. Investment in trading and business at Kandla port is also permitted. Incentives to promote units in these zones also are permitted. Incentives to promote units in these zones include duty free imports of capital goods, raw materials, components, etc, export incentives allowed on raw materials and components, and excise tax exemption on manufactured products.

Units in these zones enjoy complete tax exemption for a period of 5 years. In addition, simplified procedures along with single point clearance are available to reduce bureaucratic delays. Also in order to promote exports and also to meet the demands of the various state government fold additional zones, four new zones are being established in Indian states, Utter Pradesh, Tamil Nadu, West Bengal, and Kerala.

Labor

India has an adequate skilled labor force and ranks third in the world's largest pool of technically trained people. This is a big advantage for investors because they can get the skilled man power with lower salary scales. Wage payment is regulated by the Payment of Wages Act, 1936, which is amended from time to time.

Industrial relations are governed by the Industrial Disputes (ID) Act of 1947, also amended from time to time. Recent changes in the ID Act provide a 90 day notice by an employer intending to close down the business. This Act also curbs unfair labor practices by employers or workers in trade unions through the imposition of fines and imprisonment.

Infrastructure

The Indian status of infrastructure is not satisfactory, which is a negative side for both domestic and foreign investment, as the role of infrastructure in any century's economy is very vital and it provides the base a solid base to the economy. The infrastructure includes Power Supply, Telecommunication Network, and Transport System.

Transportation is the area where India's infrastructure does not meet with the competitiveness of its neighbors. For example the total number of containers handled at the Indian ports is lower than that of Shangi. Good transportation works like veins in our body. Another important area in Indian transportation is that higher costs of shipping, transportation costs associated with shipping a container of textiles to the United States costs over 20 % more in India compared to Thailand and 35 % more than China. In my research paper I see that this is a very important area where Indian government should invest money and make sure that Indian Transportation standards are met with the standards of at least its competitors.

Another big factor under infrastructure is lack the of power supply for business industry as well as for domestic use. India short falls in meeting the power demand estimated 11 % for regular and 18 % during the peak energy demand. Through my research I have found that this is very common in India and that small or mid-size firms have their own power generator which is much less common in economies such as China, Thailand, and Korea. 69 % of Indian firms have their own power generators, compared to 30 % in China. The lack of energy increases the costs of doing business in India because firms need to have their own back for that which is an expensive option, and this increases the costs of production, therefore it, becomes difficult for an Indian firm to compete globally.

The primary reason for the lack in the power supply in India is because of state ownership of energy supply and its distribution, which lacks some control problems and leads to inefficiency. My suggestion to deal with the power problem is to privatize the power sector. I am glad to see that the Government of India has taken steps toward this direction and some big cities like New Delhi has a privatized power industry which I hope will provide better business.

Telecommunication is the area in Indian infrastructure, where business managers do not have complains like in some other areas. In this sector India's performance is comparable to China and its competitors, yet Indian telecommunication network is behind the Western countries, but good news is that this industry is growing with a rate of 20 % per year and about $20 billion is expected to be invested in next five years.

Political Stability

Indian is parliamentary democratic country and is known as the world's biggest democracy. Since the political independence from the Great Britain there has been no serious revolutionary movement in India and there is also no possibility of collapsing any state. Therefore sovereign risk in India is zero. However, there has been some political instability occurred in 1995-96 when with in a year India had to face two parliamentary elections but after that period it has been stable. It is good for India that political instability during 1995-96 did not change India's economic course. Economic liberalization, which is what foreign investors are interested has been accepted by all the political parties in India, therefore it is safe in India to invest no matter which party in authority.

As far as the threats of terrorism are concerned there is no terrorist outfit strong enough, which can disturb the state. Through my research it would take strong imagination to think about any terrorist attack on India. However, there is some dispute over Kashmir (north Indian state) between India and Pakistan but Indian foreign policy believe to solve this issue through bi-lateral channel and also because of international presser I don't think that there would be any possibility of war between these two countries.

Capital out Flow Policy

Owing largely to balance of payments difficulties, capital out flows are generally not allowed because of a substantial diversification of its industrial base, the main thrust is on export of capital goods and technology in joint ventures. Now one may think how to get money out of India? Historically, it is not a problem to repatriate investments and profits from India. The Overseas Private Investment Corporation (OPIC), a U.S. government backed insurer of foreign commercial dealings, is good news for Indian business is that OPIC has never had to pay any claim due to India's failure to provide the foreign exchange. I see that it is a good sign for foreign investors and it would not be hard for them to take their money back. Dividends, Capital gains, Royalties, and Fees can be repatriated easily with the permission of the Reserve Bank of India.

In case of exit, the Indian market investor can repatriate his share after discharging taxes and other obligations. The investor can disinvest his share either to an Indian partner; to another company, or to the public. Even during the so-called worst period no foreign company left India with out proper and due compensation. Companies have problems doing in other countries business but that is due to some inexperience and cultural ignorance.

Rupee is the Indian currency, and rupee is easily convertible for current account. This means that repatriation of foreign exchange at the existing market rate has become easier. According to my research, exports can retain 25 %of total receipts in foreign currency accounts to meet requirements such as travel, and advertising expenses. The bottom line is that system has advantages of completely bypassing bureaucratic controls and freeing investors from delaying and inefficiencies.

Trade Barriers

Trade barriers are generally defined as government laws, regulations, policies, or practices that either protect domestic products from foreign competition or artificially stimulate exports of particular domestic products. Low trade barriers are important for global business and this leads to greater opportunities of investing in other countries, especially when there is a trend of investing in the developing countries with ample of business opportunities. It was surprising to know when I found that in my research that India's economy is one the most closed in the world and India's tariff remains highest in the world, although in the last thirteen years India has taken noteworthy steps to open its economy but still it is second in terms of high tariff zones in the world.

The other important issue I have found in my research which is challenging for investors is that the Indian government publishes tariff and import taxes rates, but they are not transparent. There is no single official publication that include all necessary information, definitely this provides a negative environment and hampers the foreign investment. Although the FDI is increasing in India but it is still lower than that of limiting foreign equity ownership and its poor infrastructure. Therefore I suggest that the Government of India should have more transparency about import tax rates and all other information which is necessary for the investors. Also I suggest that the Government of India should more privatize the Indian market so-that there will be more opportunities for both domestic and foreign investors. So far I see that manufacturing and service industry is mostly privatized but there is big opportunity especially in the insurance sector. So if the Government of India opens this sector for private investors I strongly believe that there will be a lot of foreign as well as domestic investors would like to invest.

Despite these trade barriers India also has some macro-level disadvantages. For one it has a global disadvantage that is due to its geographic location. Unlike its competitors, such as Mexico (for the U.S.), Turkey (for the EU), and China (for Japan and U.S. west coast),. India is distant from all the major market and non efficient shipping network adds some extra barriers in global investment.

Another disadvantage I see with Indian economy is that it also lacks any serious trade pact membership, and therefore it does not receive preferential access to the major markets. For example NAFTA is for Mexico, Canada, and U.S. and the European Union has its own common trade for the member countries. In my research I see that the lack of trade treaties it is challenging to attract the foreign investors because the current situation does not provide a conducive and a lucrative environment for the foreign investment. In my suggestion I would like to see that the Government of India should have more trade pacts with other countries not only with developed countries but also with some developing countries such as China and Brazil.

Despite these disadvantages and some geographic hurdles, the Indian market has a lot of opportunities because of its macro economic and large growing local market, low cost labor force, critically educated and technically skilled workers, and abundant resources of raw materials. I think these are some major advantages for India and it should attract foreign investment. For example, the development of exports of software and banking services, among with the emergence of a competitive automotive sector driven largely by the reforms initiated in the early 1990s.

Conclusion

There is no doubt that from the last decade Indian economy is reaping the benefits of liberalization and foreign investment, which has helped a lot to improve Indian GDP as well as to reduce unemployment, and poverty level in India, with a growing rate of 8 percent per year Indian economy has provided a lot of job opportunities and has made Indian economy more lucrative for both domestic and foreign investors.

Despite all this liberalization and boom in Indian economy, still there are some bottlenecks which need to be removed for more exploitation of globalization. In my research I have found that it is still difficult for especially for foreign investors to enter into Indian market. In my opinion it is very important that entry and exit procedures are complemented by smoothly workings market. The excessive regulations of industrial relations are often pointed as one reason, why India is not doing well. Therefore I would like to suggest that the new Government should make entry and exit decisions easier for investors.

My second suggestion is about improving the infrastructure and institutional environment in India. Investors feel that this environment is not optimistic and therefore they are reluctant to invest in India, also there are inadequate controls and procedures in this area such as still investors have to suffer sometimes from some bureaucratic and red tape problems. For example couple of leading Indian software companies such as Tata Consulting services and Satyam Computer services has established their research centers in China because these companies face less problems in terms of delays, and some bureaucratic problems. In my suggestion to avoid this problem the government of India should have more educated workers and good system to speed up approval procedures for new businesses.

Another suggestion I would like to recommend is that India should have more trade pacts like its competitors have, more trade pacts would provide a better environment and opportunities to investors and also this will provide Indian market more attractive. I have already mentioned that there is also lack of transparency in tax laws and the list of sectors which are open for investment. My recommendation would be to have more transparent rules and regulation especially for the foreign investors.

India has higher shipping and higher industrial material costs which make it difficult to compete with other countries such as China, Korea, and Taiwan where shipping and industrial material is not too high. The government of India should make sure that India has lower shipping costs. To achieve this it should spend more resources to build a good infrastructure which would provide a strong basis for both domestic and global business.

Instead of some bottlenecks in Indian system India is a favorable place for foreign investors; both India and China are two main places where mostly big companies want to invest, giving challenges to the United States which was the number one place for investors before 1998. Now China ranks first as the most favorable place for foreign investment and India has raised from 6th to 3rd the most attractive destination for global business and the United States of America holding the second rank.

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