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Foreign Direct Investment: A Significant Driver to India's Growth Story

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Abstract

Emerging markets are changing the way world works by developing into global powerhouses. They constitute the major growth opportunity in evolving the world economic order. This paper aims to examine specifically- how ***Foreign Direct Investment (FDI)*** *acts as an important driver of growth in India. The research is positioned on a tripod that investigates:-*

1) *What are the current and anticipated* ***protectionist*** *barriers to FDI in India?*
2) *Why* ***corporate transparency*** *is important for FDI in terms of* ***tax rate*** *and* ***corruption****?*
3) *How* ***economic policies*** *should have variations to accommodate the interest of foreign investors as well as creating equity among population?*

Therefore, an attempt is also made to propose a strategic plan to derive ***social welfare*** *from FDI initiatives to decipher the long term impact of FDI on economic development.*

This research will be based on secondary data with relevance to the current trends and reforms happening in Indian economy. The paper will also include a case to highlight how FDI has played a vital role in economic growth of and affected the growth due to transparency issues.

This study will lead to better analysis and understanding of the impact that FDI has on overall economic growth and how an ease of doing business environment can be created for foreign investors.

Keywords: FDI, Corporate transparency, Social welfare, Protectionism, Economic policy.

1. Introduction

Foreign Direct Investment (FDI) is a powerful instrument for growth and development. Its relevance is enhanced today by its role as the crucial engine of trade through global value chains; and by the critical need to increase investment flows to boost the global economy, create jobs and promote knowledge and productivity enhancements.

Capital formation is an important determinant of economic growth. While domestic investments add to the capital stock in an economy, FDI plays a complementary role in overall capital formation and in filling the gap between domestic savings and investment. At the **macro-level**, FDI is a **non-debt-creating source of additional external finances**. At the **micro-level**, FDI is expected to boost output, technology, skill levels, employment and linkages with other sectors and regions of the host economy.

All firms with foreign **equity participation of 10 per cent** and above have been considered to be **FDI-enabled firms** or "FDI firms". All other firms, with less than 10 per cent foreign equity, are referred to as "domestic firms". India enjoys a strong position as a global investment hub with the country registering high economic growth figures even during the peak of financial meltdown. As a result, overseas investors rested their confidence in the economy which eventually pushed foreign direct investments (FDI) in India. According to **Department of Industrial Policy and Promotion (DIPP),** the total FDI inflows soared by 24.5 per cent to US$ 44.9 billion during FY2015, as compared to US$ 36.0 billion in FY2014. FDI into India through the **Foreign Investment Promotion Board (FIPB)** route shot up by 26 per cent to US $ 31.9 billion in the year FY2015 as against US$ 25.3 billion in the previous year.

Developed economies consider FDI as an engine of market access in developing and less developed countries vis-à-vis for their own technological progress and in maintaining their own economic growth and development.

Developing nations looks at FDI as a source of filling the savings, foreign exchange reserves, revenue, trade deficit, management and technological gaps. FDI is considered as an instrument of **international economic integration** as it brings a package of assets including capital, technology, managerial skills and capacity and access to foreign markets.

This paper tries to investigate the protectionist barriers and other investments barriers for FDI coming in India. Steps that can be undertaken to boost the flow of FDI.

The three main determinants of FDI in a particular location are:

- market forces (including market size and growth, as determined by the national income of the recipient country),
- cost factors (such as labour cost and availability and the domestic inflation situation) and
- The investment climate (as determined by such considerations as the extent of foreign indebtedness and the state of the balance of payments).

Locational Determinants of FDI

Policy Framework for FDI	**Economic Determinants**	**Business Facilitation factors**
Core FDI policy regime • Rules regarding entry and operations • Standards of treatment of foreign enterprise • Policies of functioning	Market seeking FDI • Market size and per capita income • Market growth • Access to local and global markets • Country specific consumer • Preferences • Structure of markets	Investment Promotion Measures • Investment incentives • Hassel costs (corruption, administrative inefficiency) • Social amenities • After investment services

Trade Policy Regimes	Resource seeking FDI • Structure of markets • Raw material • Low cost unskilled labour • Skilled labour • Technology • Physical infrastructure	
Intellectual Property Protection Regime	Efficiency seeking FDI • Cost of resource and assets • Other input costs	
Economic stability of the country • Monetary policy • Fiscal policy		
Political and Social stability		
International Agreements on FDI • Bilateral Treaties • Regional integration framework • Multi investment framework		

When we discuss the attractiveness of India in terms of FDI, it is important to focus on the procedural, legal, tax and ease of doing business system that India can provide to its foreign investors. This paper also intends to make recommendations that can make the implementation of economic policies and FDI related policies more effective and achievable in the present scenario. FDI may also inhibit competition and thus hamper growth, especially if the host country government affords extra protection to foreign investors in the process of attracting their capital.

Nirupam Bajpai and Jeffrey D. Sachs47 (2006) in their paper **"Foreign Direct Investment in India: Issues and Problems",** attempted to identify the issues and problems associated with India's current FDI regimes, and more importantly the other associated factors responsible for India's unattractiveness as an investment location. The **conclusion** of the study is that a **restricted FDI regime, high import tariffs, exit barriers for firms, stringent labour laws, poor quality infrastructure, centralized decision making processes, and a very limited scale of export processing zones make India an unattractive investment location. Alhijazi, Tahya Z.D2 (1999) in his work, "Developing Countries and Foreign Direct Investment"** analysed the pros and cons of FDI for developing countries and other interested parties. This thesis scrutinizes the regulation of FDI as a means to balance the interests of the concerned parties, giving an assessment of the balance of interests in some existing and potential FDI regulations.

Corporate transparency in terms of **tax rate and corruption** are the most crucial elements while deciding the fate of FDI in India. By its nature, transparency cannot be easily quantified, nor can it be isolated from other policy aspects that impinge on foreign direct investment (FDI). Owing to the links between the regulatory structure of a country and the transparency of its policies, the focus needs to be both on the nature of the rules applying to foreign investment and on the extent of transparency in their implementation.

The social impact of larger FDI is dependent on India's policies and institutions. It is important for the government to ensure that equity among population is also focused upon so that it can bring long term economic and sustainable development in India in terms of Human Development Index. Alienating any section of the society from the prospective benefits of FDI can hamper the sustainable growth of the country. The paper tries to make a strategic plan to link FDI to social welfare.

2. Methodology

This research will be based on secondary data with relevance to the current trends and reforms happening in Indian economy. The paper will also include a case to highlight how FDI has played a vital role in boosting the economic growth of a country. It is based on secondary data because Foreign Direct Investments are based more on macro-economic factors.

The required data have been collected from various sources. Some of the sources are as follows:

- World Investment Reports
- Asian Development Bank's Report
- Bulletins of Reserve Bank of India
- Publications from Ministry of Commerce, Govt. of India
- Reports from Department of Industrial Policy and Promotion (DIPP)
- Websites of World Bank, IMF, WTO, RBI, UNCTAD, EXIM Bank, Make in India
- Reviews from the research already undertaken on issues related to FDI

3. Findings and Discussions

Nations' progress and prosperity is reflected by the pace of its sustained economic growth and development. Investment provides the base and pre-requisite for economic growth and development. Apart from a nation's foreign exchange reserves, exports, government's revenue, financial position, available supply of domestic savings, magnitude and quality of foreign investment is important for the country. Developing nations, in particular, consider FDI as the safest type of international capital flows out of all the available sources of external finance available to them. Apart from being a critical driver of economic growth, foreign direct investment (FDI) is a major source of **non-debt financial resource** for the economic development of India.

In 2015 India emerged as top FDI destination surpassing China and the US. In first half of the 2015 India attracted FDI of $31 billion compared to $28 billion and $27 billion of China and the US respectively. During 2014-15, India received most of its FDI from:

- Mauritius
- Singapore

- Netherlands
- Japan
- United States of America

3.1 Make in India

Make in India is a major new national programme of the Government of India designed to **facilitate investment, foster innovation, enhance skill development, protect intellectual property and build best in class manufacturing infrastructure in the country.** The primary objective of this initiative is to attract investments from across the globe and **strengthen India's manufacturing sector**. It is being led by **the Department of Industrial Policy and Promotion (DIPP), Ministry of Commerce and Industry,** Government of India. The Make in India programme is very important for the economic growth of India as it aims at utilizing the existing Indian talent base, creating additional employment opportunities and empowering secondary and tertiary sector. The programme also aims at improving India's rank on the **Ease of Doing Business Index** by eliminating the unnecessary laws and regulations, making bureaucratic processes easier, making the government more transparent, responsive and accountable.

The focus of Make in India is basically on **25 sectors**. These include: automobiles, aviation, chemicals, IT & BPM, pharmaceuticals, construction, defence manufacturing, electrical machinery, food processing, textiles and garments, ports, leather, media and entertainment, wellness, mining, tourism and hospitality, railways, automobile components, renewable energy, biotechnology, space, thermal power, roads and highways and electronics systems.

The initiative has been highlighted at key international events. The Make in India programme was the key message on ***Brand India*** **at the Annual Meeting of the World Economic Forum at Davos 2015.**

3.2 FDI as growth accelerator

While the quantity of FDI is important, equally important is the quality of FDI. The major factors that might provide growth impetus to the host economy include:

- the extent of localization of the output of the foreign firm's plant, its export orientation,
- the vintage of technology used,
- the research and development (R&D) best suited for the host economy,
- employment generation,
- inclusion of the poor and rural population in the resulting benefits, and
- Productivity enhancement.

3.3 What makes India attractive destination for FDI?

- Host countries with sizeable domestic markets, measured by GDP per capita and sustained growth of these markets, measured by growth rates of GDP, attract relatively large volumes of FDI
- Resource endowments of host countries including natural resources and human resources are a factor of importance in the investment decision process of foreign firms.
- Infrastructure facilities including transportation and communication net works are an important determinant of FDI.

- Macroeconomic stability, signified by stable exchange rates and low rates of inflation is a significant factor in attracting foreign investors.
- Political stability in the host countries is an important factor in the investment decision process of foreign firms.
- A stable and transparent policy framework towards FDI is attractive to potential investors.
- Foreign firms place a premium on a distortion free economic and business environment. An allied proposition here is that a distortion free foreign trade regime, which is neutral in terms of the incentives it provides for import substituting (IS) and export industries (EP), attracts relatively large volumes of FDI than either an IS or an EP regime.
- Fiscal and monetary incentives in the form of tax concessions do play a role in attracting FDI, but these are of little significance in the absence of a stable economic environment.
- Increased autonomy over decision-making and implementation of reforms to the state governments in India is yet another suggestion for attracting increased volumes of FDI.

3.4 Protectionist Barriers

A wide range of restrictions and mounting protectionist measures have a paralyzing effect on Foreign Direct Investment. All affect the free flow of goods, services and capital and is detrimental to both the potential investor and local economic growth. When faced by increasing tariff and non-tariff barriers (NTBs) businesses become more cautious about engaging in FDI because of **lack of legal certainty and predictability**. There is a large gap between business needs and reality in terms of investment. Companies make investment decisions based on how open the country in question is for investors. What acts as a barrier is important to be dealt with. They include:

- Plant and product approval procedure
- Regulatory approach
- Unpredictable tax regime
- Time and costs involved
- Distribution groups
- No incentives for investments
- Corruption
- Foreign exchange restrictions
- Requirements on repatriation of assets and operations

3.5 Incentives to attract FDI

Authorities naturally compete to attract FDI that creates job and revitalizes the local economy. In the longer run emerging market economies like India become over reliant on incentives to attract FDI and it can adversely affect their own development. Foreign Direct Investment incentives can take the following form:

- Low corporate tax rate
- Low individual tax rates
- Preferential tariffs
- Special economic zones (SEZs)
- Export processing zones (EPZs)
- Investment financial subsidies
- Relocation and repatriation
- Land subsidies
- Research and Development facilities

- Tax Holidays

3.6 Corporate Transparency

A history of corruption and political turmoil has given way to higher standards of corporate governance in today's globalized world. Though still far from perfect, the improved transparency and oversight has made important information available to investors and reduced uncertainty. By aligning themselves with international business standards and requirements, India can attract more foreign capital and better integrate them into the global marketplace. It includes sorting out-

- the problems in taxation,
- repairing the critically damaged banking sector and ensuring ease of doing business by facilitating enabling factors (land, water, electricity, necessary clearances etc) to begin a business in India.

Survey Results of Corruption by KPMG

- 90% of respondents believe that corruption prevents investors making long term investment
- 99% believe corruption attracts weaker, more inefficient firms affecting project execution negatively
- 68% respondents believe that India can achieve **9% growth rate** if corruption is controlled

Studies indicate that business environments often remain non-transparent even after governments have moved to enact clearer policies, simply because those measures are not actually implemented. However, except in cases where the host government maintains an outright prohibition on market access by foreign firms, the implementation of relevant legislation is likely to be more important in shaping investors' perceptions than is the actual legislation itself. There are wide variations in inflows even for countries with the same institutional governance rating – as one would expect given the multiplicity of factors behind the investment decision – but overall the relationship between the quality of institutional governance and the level of inflows is clear and positive. Thus, countries where the rule of law prevails and is enforceable, the judicial system is efficient, corruption is low and ownership is less concentrated, receive more investment.

CASE

Russia arguably provides one of the clearest examples of a **divergence between regulation and implementation.** A recent **OECD survey** of the investment environment in Russia found that the otherwise adequate rules-based legal and regulatory environment was consistently being undermined by failures in implementation and enforcement. There is no unified economic space, **no "level playing field" for businesses in Russia**, because of the multitude of administrative barriers and obstacles encountered by investors, particularly at regional level, often in contravention of federal legislation and regulation. As specific examples of unpredictable hurdles to be surmounted by investors at federal level could be mentioned sudden withdrawal of frequencies from telecommunication companies, or sudden unavailability of previously posted railway freight tariffs which served as a basis for feasibility calculations. At the regional level, examples abound in the form of unforeseen licensing or permission requirements, license fees in excess of what is legally required, tax payments that are negotiable rather than statutory, "voluntary" contributions to extra-budgetary funds, etc. In addition, the general burden of licensing and other policy-induced start-up difficulties at regional level is so onerous that firms specializing in helping new businesses to manage this process are becoming a new growth industry.

These **manifest problems with transparency** are almost certainly one of the main reasons why Russia, despite having a large domestic market, abundant raw materials, an educated workforce and geographical proximity to Europe, **does not rank even in the world's top 30 destinations for FDI**. Significantly, both foreign and domestic investment is low in Russia, suggesting that local investors are as discouraged by the lack of transparency as are foreign ones.

3.7 Recent policy measures

- Government eases FDI norms in 15 major sectors.
- Townships, shopping complexes & business centres – all allow up to 100% FDI under the auto route. Conditions on minimum capitalisation & floor area restrictions have now been removed for the construction development sector.
- India's defence sector now allows consolidated FDI up to 49% under the automatic route. FDI beyond 49% will now be considered by the Foreign Investment Promotion Board. Govt approval route will be required only when FDI results in a change of ownership pattern.
- Private sector banks now allow consolidated FDI up to 74%.
- Manufacturers can now sell their products through wholesale and/or retail, including through e-commerce without Government Approval.
- FDI cap increased in insurance & sub-activities from 26% to 49%
- FDI up to 49% has been permitted in the Pension Sector.
- Construction, operation and maintenance of specified activities of Railway sector opened to 100% foreign direct investment under automatic route.
- FDI policy on Construction Development sector has been liberalised by relaxing the norms pertaining to minimum area, minimum capitalisation and repatriation of funds or exit from the project. To encourage investment in affordable housing, projects committing 30 percent of the total project cost for low cost affordable housing have been exempted from minimum area and capitalisation norms.
- Investment by NRIs under Schedule 4 of FEMA (Transfer or Issue of Security by Persons Resident outside India) Regulations will be deemed to be domestic investment at par with the investment made by residents.
- Composite caps on foreign investments introduced to bring uniformity and simplicity is brought across the sectors in FDI policy.
- 100% FDI allowed in White Label ATM Operations.

The official release said refining of foreign investment norms in construction is to facilitate the construction of **50 million houses for poor**. It added that opening up of the manufacturing sector for wholesale, retail and e-commerce is aimed at motivating industries to Make in India and sell it to the customers here instead of importing from other countries.

3.8 Macroeconomic analysis and growth

Beyond the macroeconomic stimulus from actual investment, FDI influences growth by raising total factor productivity and efficiency of resource use in recipient economy. This works through three channels:

- Linkages between FDI and free trade flows
- The spillovers
- The host country business sector and direct impact on structural factors in host economy

FDIs allow companies to avoid governmental pressure on local production and cope with protectionist measures by circumventing trade barriers. The move into local markets also ensures that companies are closer to their consumer market, especially if companies set up locally-based (national) sales offices.

Weak financial intermediation hits domestic enterprises much harder than it hits multinational corporations (MNCs). It may lead to scarcity of financial resources for host country business sector to seize the opportunity arising from foreign presence.

The ability of FDI to contribute to developing export capabilities depends on the economic policy and condition. Export processing zones may be an important tool for integration with world trade but they come with a cost.

Reserve Bank of India Governor Mr. Raghuram Rajan's growth supportive move needs to be reciprocated by the government. Mr. Rajan had cautioned that the government too needs to do its part. **"...Monetary policy has to be accommodative to the extent possible, given its inflation goals, while recognizing that continuing policy implementation, structural reforms and corporate actions leading to higher productivity will be the primary impetus for sustainable growth,"** Rajan said.

3.9 FDI and Social welfare

More than 40 percent live on little more than $1.00 per day and more than 25 percent live below the national poverty line. The government should pay close attention and take the necessary steps to reduce inequalities so everyone can enjoy economic growth evenly, especially people living in rural area. The government should promote the manufacturing sector for future economic growth, in order to reduce dependency on the service industry, and divert future investments to the rural areas of India to decrease urbanization and increase employment in small towns and villages.

A **diversifying strategy** like this would compel the government to invest more money in **rural infrastructure** and other basic public services, such as electricity, sanitation and clean drinking water, to support manufacturing facilities as well as people living in that vicinity. People living in rural areas are now aware of India's economic progress and it is important to include the people who were left behind and ignored for twenty some years. The social impact of larger FDI is dependent on India's policies and institutions. The flexibility of the labor market would determine the employment opportunities. The extents to which the lower income groups can take advantage of the growth policies determine the growth-poverty relationship.

The production in the fields of physical and social infrastructure determines the regional developments. The Indian industries are predominantly labor based but there are also many capital based companies. Capital intensive set up is an expensive proposition but India can look forward to more professional and sophisticated number of workers and employees at all levels. Human capital in terms of quantity was never a big problem in India due to its huge population added emphasis must be laid on the quality and efficiency in work. Even the civil society can work with the government and help in reducing bureaucratic hassles and interferences.

To get the complete picture of growth, it is essential to make sure that the rural section has equal amount of development as the urbanized ones. FDI helps to focus in this area thus, **fostering social equality** and at the same time a **balanced economic growth.**

4. Conclusion

Today represents new era of economic globalization with rising single global market, the political foundation of global economy is still fragmented. It is still based more on nation state-centred international politics than on "world government".

FDI is an integral part of an open and effective international economic system and catalyst to development. National policies and the international investment architecture matter for attracting FDI to a larger number of emerging economies and for reaping full benefits of FDI for economic growth. **Incomplete utilization of FDI benefits** is due to incoherent institutional policies and regulatory conditions, unavailability of skilled labour and infrastructure.

The World Bank had recently improved India's ranking by 12 places (to 130th rank from 142nd rank last year) in the 2016 Study of Ease of Doing Business. Besides, many global institutions have projected India as the leading destination for FDI in the World. IMF has branded India as the brightest spot in the global economy whereas the World Bank has retained the growth forecast for India at 7.5% for FY16.

5. Recommendations

Manufacturing is a brick and mortar investment. **It is permanent** and stays in the country for a very long time. Huge investments are needed to set this industry. It provides employment potential to semi skilled and skilled labour. On the other hand the service sector requires fewer but highly skilled workers. Both are needed in India.

5.1 Make in India

Make in India is not an excuse for **protectionism**. To ensure its success the government must resist pressures from domestic industries that want to reap undue advantage from protectionist policies at the cost of consumers and other industry players.

- It could also enforce property rights and rule of law more effectively so as to reinforce the confidence of investors.

Case

China's FDI saga has been a textbook replay of what institutional economics would call **"adaptive efficiency" on the part of its political regime**. The country made courageous but careful choices in difficult circumstances, signalling radical departure from the belief system it has been accustomed to for decades. China seems to have **discovered its own reform model with "Chinese Characteristics".** A western observer calls it the "Beijing Consensus". India is currently fumbling to validate a different kind of model – call it the "India Consensus"- for demarcating country in a globally interdependent world.

5.2 Corporate Transparency

In cases where the host government maintains an outright prohibition on market access by foreign firms, the implementation of relevant legislation is likely to be more important in shaping investors' perceptions than is the actual legislation itself. National treatment, for instance, may be enshrined in legislation in many countries, but if foreign firms are effectively discouraged through discretionary decisions of the relevant national authorities, they will perceive such arbitrariness as being just as restrictive as an outright prohibition on foreign investment. Thus, countries where the rule of law prevails and is enforceable, the judicial system is efficient, corruption is low and ownership is less concentrated, receive more investment.

- Focus should be on removing existing political and administrative barriers that **impede** local innovation and entrepreneurship
- Removal of red tape and bureaucratic barriers to enable faster clearances.
- Foreign firms place a premium on a distortion free economic and business environment. An allied proposition here is that a distortion free foreign trade regime, which is neutral in terms of the incentives it provides for import substituting (IS) and export industries (EP), attracts relatively large volumes of FDI.

5.3 Taxation

- It is important to reduce tax burden of enterprises in order to induce them to invest in specific project and sector

- **Tax incentives** are exceptions to general tax regime. Targeted tax incentives should be designed to attain increased investment in intended field.
- There should be coordination between the centre and the state government regarding total package of tax benefits that investors finally receive due to incentives.

5.4 Macroeconomic policy and Social Welfare

The most important question is whether FDI brings equity along with growth effects? FDI might enter a labour-abundant country with capital-intensive technologies; however, if the labour laws are not flexible, this would have a relatively small impact on employment generation. On the other hand, the entry of FDI in labour-intensive firms would have a positive impact on equity and poverty reduction if the FDI-enabled firms choose to locate close to suburban/rural areas.

Government should **promote medium term fiscal discipline, efficient and socially just tax systems and prudent public sector debt management.** The production in the fields of physical and social infrastructure determines the **regional developments**. To get the complete picture of growth, it is essential to make sure that the rural section has equal amount of development as the urbanized ones. FDI helps to focus in this area thus, fostering social equality and at the same time a balanced economic growth. Government should ensure the **equitable distribution of FDI inflows among states**. The central government must give more freedom to states, so that they can attract FDI inflows at their own level. The government should also provide additional incentives to foreign investors to invest in states where the level of FDI inflows is quite low.

6. Road ahead

All the above will happen, if the planned structural changes to the Indian economy are concurrently made and country's bureaucratic structure is made investor friendly. The recent changes in India's patent rules and regulation are steps in the right direction.

India has to become investor friendly. It is need of the hour. **Opportunism in politics, which endangers the welfare of the people, is to be thoroughly discouraged.**

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