LEVERAGING FOREIGN DIRECT INVESTMENT FOR ECONOMIC GROWTH IN INDIA

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Abstract: FDI has been the most attractive of the capital flows because of its lasting nature and because it is a vehicle of transformation of the domestic production process. Though a major development catalyst, it is highly complex and contentious and, not an unmixed blessing. Whether the benefits can outweigh the costs depends. Policies matter greatly for a country's ability to fully reap the benefits. The paper focuses on leveraging and not on consequences of FDI. A number of theories and available empirical literature suggest what motivates FDI.
The data on FDI inflow in India indicates that the country has witnessed an increase of 390 times in the post – reform period. This infusion of investment is an evidence of the attractiveness of India as a destination of foreign investment. There are several factors including its macroeconomic fundamentals, growing middle class and liberalized – investment friendly policy framework which makes India attractive. However the governance and institutional issues weigh against it. Thus for leveraging the FDI there is need to address the governance and institutional issues while maintaining the macro fundamentals and investment friendly policy regime. An effective publicity mechanism based on marketing of our strengths and all relevant information, including the privileges, pertaining to FDI may also help.

Keywords: FDI,Governance, Macro-Fundamentals, Policy-Framework.

In the schema of classification of capital flows based on duration, FDI has been the most attractive capital flows for emerging market economies because of its lasting nature and because it is considered a vehicle of transformation of the domestic production process. It adds to investible resources, provides access to advanced technologies, assists in gaining production know-how and promotes exports. China's dramatic growth has demonstrated the power of FDI as a development tool.
Though a major development catalyst, FDI is a highly complex and contentious issue and, not an unmixed blessing. There are possible negatives as well. Whether the benefits can outweigh the costs depends. Benefits do not accrue automatically. Policies matter greatly for developing country's ability to fully reap the benefits. The host country's authorities have a key role in creating the conditions that allow for the leverage of the positive effects or for the reduction of the negative effects of FDI on the host country.
The purpose of this paper is to focus on leveraging FDI and not on consequences of FDI. It may therefore be appropriate at the outset to have a quick look at the data on FDI inflow in India. The data indicates that the country has witnessed a surge in FDI in the post-reform period. FDI which was Rs174crores in1990-91 increased to Rs 154816 in2011-12 registering an increase of 890 times. The inflow touched its peak level at Rs 190700crores in2008-09. In US million dollars, FDI increased from97 million dollars to32957 million dollars during the same period registering an increase of 340times.The peak level being at41737 million dollars. This infusion of investment is an evidence of the attractiveness of India as a destination of foreign investment. This takes us to the question "What Makes India an Attractive Investment Destination". Before touching this question it may be appropriate to have a quick look at "What Causes or Motivates FDI".

FDI Inflow		
Period	**Rs. Crores**	**Million US Dallars**
1990 – 91	174	97
2011 – 12	154816	32957
2012 – 13	146582 (Prov.)	26953 (Prov.)
2008 – 09	190700 (Max.)	41737 (Max.)
Source: RBI Hand Book of Statistics on Indian Economy (2013)		

What Causes or Motivates FDI?

A number of theories have been propounded to answer this question.
Some theories try to explain outward FDI (Why MNCs choose to invest abroad), where as others try to explain inward FDI (A country's propensity and ability to attract FDI).
We may more appropriately refer to these theories as hypotheses as 'there is not one but a number of

competing theories with varying degrees of power to explain FDI'

Apart from number of hypotheses, a large number of empirical studies pertaining to determinants of FDI have been undertaken. As the literature on FDI is massive, there is no alternative here but to be selective. Based on the hypotheses and empirical literature an outline of some of the causes of FDI may be presented.

Differential Rates of Return: 'Capital flows from countries having lower rates of return to countries having higher rates of return'.

Portfolio Diversification: 'In an attempt to reduce risk investors seek to invest in different Countries'.

Market Size: 'Larger market size is expected to attract more FDI as it provides greater potential for demand and lower production costs through scale economies'. A good number of empirical studies find market size as a significant determinant of FDI.

Location: 'FDI exists because of location related difference in costs of production of factors of production such as labour, capital, power and raw material'. Labour unions and labour disputes have adverse effect on FDI.

Oligopolistic Reactions: 'In an oligopolistic environment, FDI by one firm triggers a similar action by other leading firms in the industry in an attempt to maintain their market share'.

Currency Area: 'Firms belonging to a Country with stronger currency tend to invest in a Country having weak currency'.

Exchange rates are also important because:

(i) FDI are viewed as an alternative to export

(ii) Currency appreciations makes exports less competitive

Openness: Impact of openness or liberalised trade is somewhat ambiguous. First, FDI may be undertaken to circumvent trade barriers such as tariffs because FDI can be viewed as an alternative to trade. Economy with trade barriers is expected to attract more horizontal FDI which is undertaken for the purpose of horizontal expansion to produce the same or similar kinds of goods abroad (in the host country) as in the home country. More generally, horizontal FDI is undertaken to exploit more fully certain monopolistic or oligopolistic advantages, such as patents or differentiated products, particularly if expansion at home were to violate anti-trust laws. This means that open economies without much restriction on international trade should receive fewer FDI flows.

Second, increasing openness attracts vertical FDI flows in search of cheap intermediate and capital goods. Vertical FDI is undertaken for the purpose of exploiting raw materials (backward vertical FDI) or to be nearer to the consumers through the acquisition of distribution outlets (forward vertical FDI).

The ambiguity in impact of openness arises because horizontal FDI are attracted by trade barriers and vertical by openness.The net impact depends upon the relative strength of the two.

Political Stability: Lack of political stability discourages inflow of FDI. It is so because unexpected modifications of legal and fiscal frame work in the host country may change the economic outcome of a given investment in a drastic manner.

Example**:** A decision by the host government to impose restrictions on capital repatriation to the investor's home country will have an adverse effect on cash flows received by parent company.

Empirical results based on this factor are mixed but models encompassing economic and political factors perform better than those models that do not contain political variables.

Institutions and Governance: Institutional and Governance quality plays important role. First, good governance is associated with higher economic growth, which should attract more FDI inflows. Second, poor institutions that enable corruption tend to add to investment costs and reduce profits. Third, the high sunk cost of FDI that arises from poor institutions makes investors highly sensitive to uncertainty, including the political uncertainty that arises from poor institutions.

Regulatory framework is crucial. Restrictive and obsolete laws and regulations impede FDI. Red tape and poor implementation of laws creates further barriers. Good regulations and efficient processes matter and effective institutions help in fostering FDI.

Macroeconomic stability: Lower inflation rate and stable exchange rate are expected to attract greater FDI by mitigating uncertainty risk.

Macro Economic Sustainability: If government finances and external sector are considered sustainable, foreign investor feel assured of the safety of its investments. Fiscal sustainability is captured through GFD to GDP ratio and external sector sustainability is captured by CAD to GDP/ net IIP to GDP ratio.

Policy Framework: Policy regime is one of the key factors driving investment flows to a country. Apart from underlying macro fundamentals, ability of a nation to attract foreign investment essentially depends upon its policy regime - whether it promotes (by offering financial and tax incentives as well as market preferences) or restrains the foreign investment flows (by placing restrictions on the activities of MNCs). Typically the incentives offered by host governments to investing MNCs include the following:

i. Fiscal incentives – such as tax reductions, exemption from customs duties depreciation investment and reinvestment allowances.

iii. Market preferences – such as monopoly rights, protection from competition arising from imports, and preferential government contracts.

iv. Low cost infrastructure, fuel and energy.

v. A framework for clear, efficiently implemented stable policies with respect to FDI.

What Makes India an Attractive Investment Destination?: Let us first have a look at some of the statements which indicate the faith that worlds' reputed organizations/persons have in India.

"India is the world's third most attractive destination for foreign investment."-UNCTAD Report 2013.

ii. Financial incentives - such as subsidies, grants and loan guarantees.

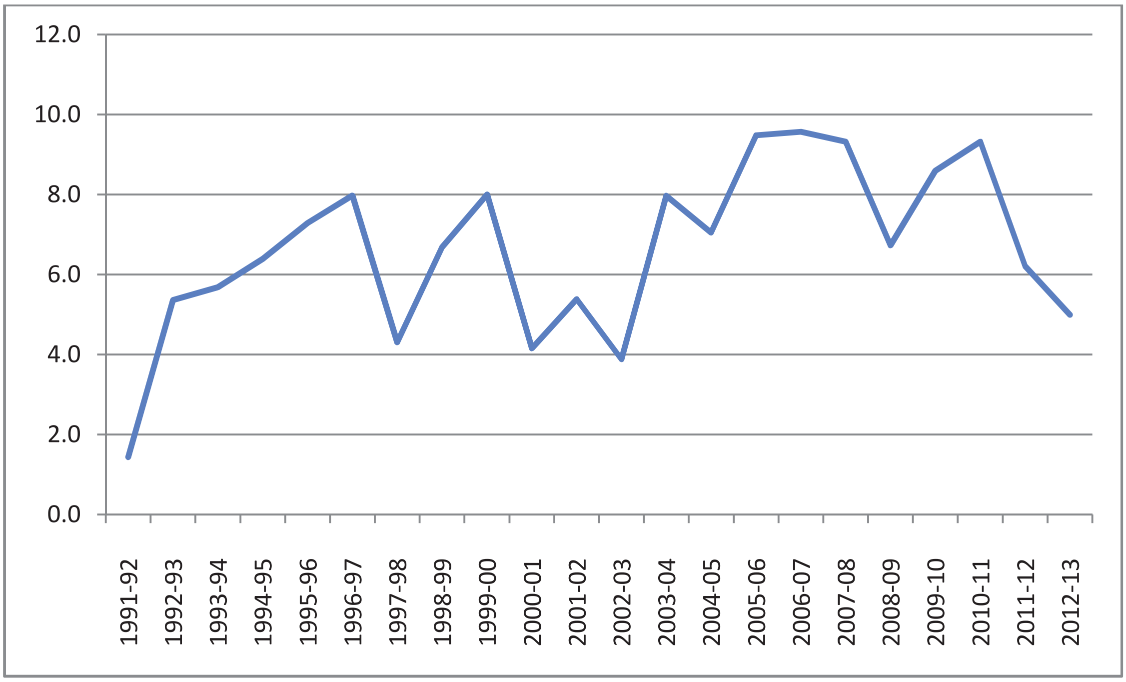
"FDI flows likely to remain subdued but India may see rise"- UNCTAD Report 2013.

"India is sure to become world's biggest economy by the year 2025". - IMF

"India is not simply emerging: India has already emerged." - Barack Obama.

"The level of macro-economic growth that is occurring in India compared to other parts of the world is a positive factor for the rating."- Standard & Poor's.

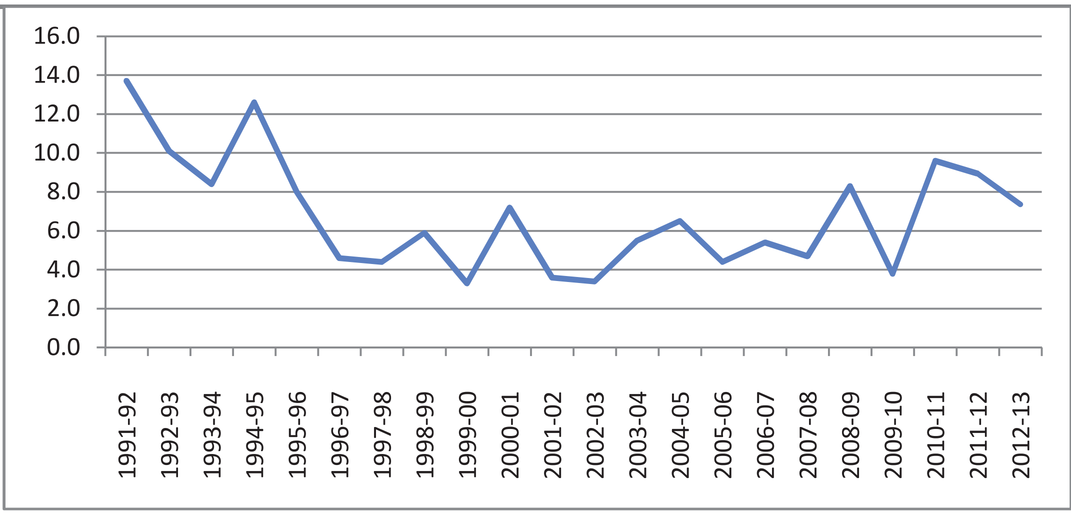
There are several reasons for this faith:

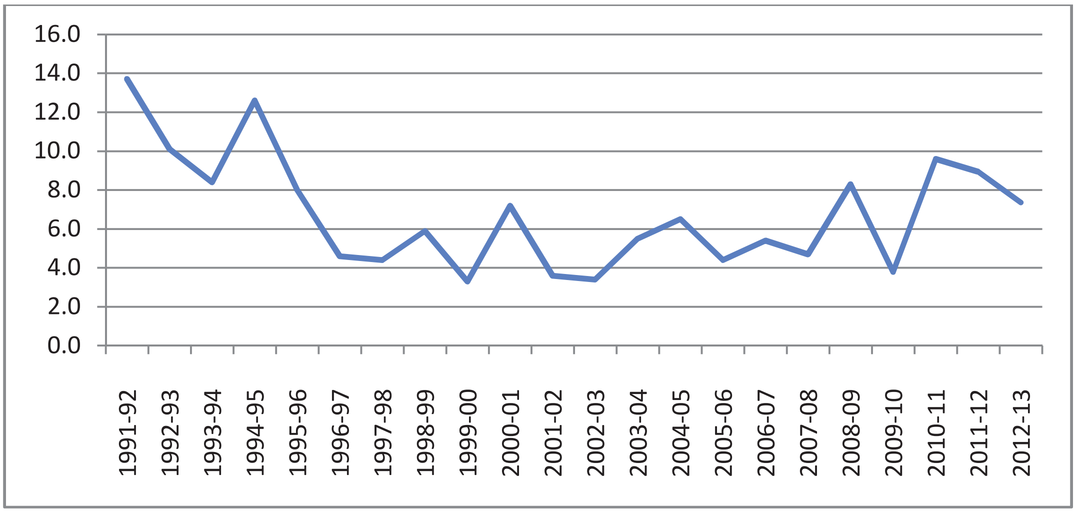


Trend in Growth Rate

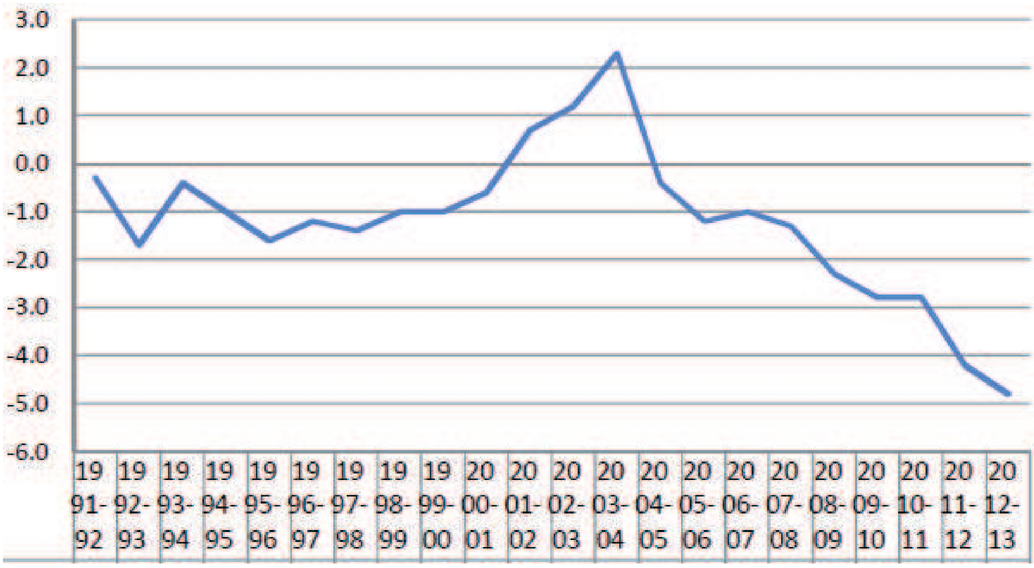
The high economic growth makes India an attractive destination for foreign capital as compared to its peers. The low annual GDP growth rate, which stagnated at less than 4% from 1950s to 1980s, has increased to above 8% average GDP growth from 2004-2009, making it one of the fastest growing emerging economies in the world . Economists expect GDP growth to reach 10% in the next 3 to 4 years on the back of higher domestic consumption and export growth. India is set to grow at a staggering pace at least for next couple of decade. India has emerged as the fourth largest economy in the world on a purchasing power parity basis and is expected to become world's biggest economy by the year 2025.

India's macroeconomic performance compares fairly well with select EMEs (Indonesia, Thailand, Brazil, Arzentina, Chile and Mexico) which received higher FDI inflows than India particularly during the last decade. Whereas GDP growth rate wise India's performance was better, the pattern of current account balance as percent of GDP was in tune with the select EMEs, except Argentina. Inflation in India was generally higher than other select EMEs except Argentina.





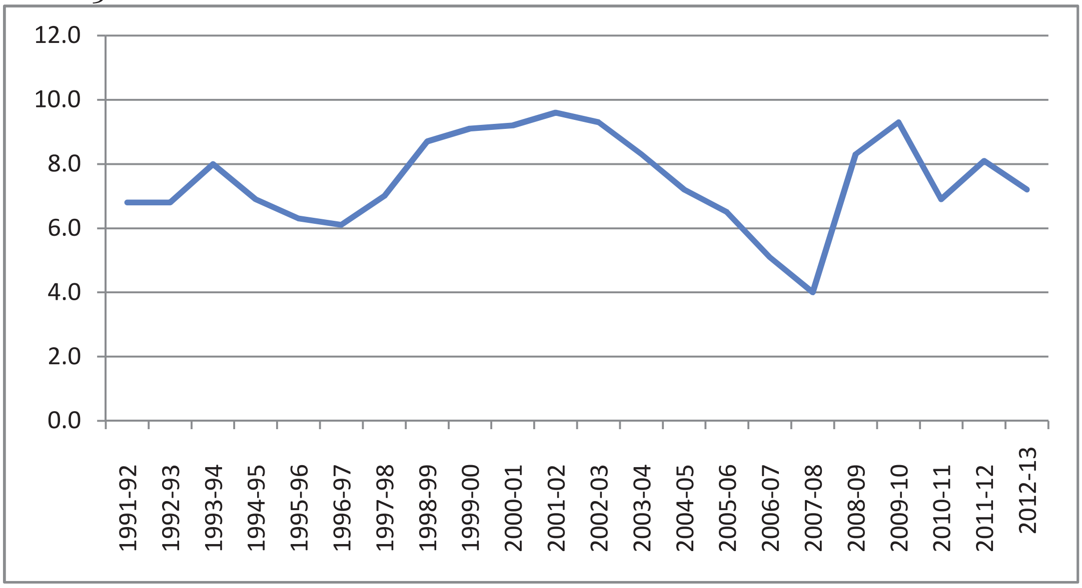
Trend in Inflation Rate



Trend in CAD/GDP Percentage

1995-96 onwards, the WPI based inflation rate has remained in single digit fluctuating in between 3.3% to 9.6%.

Barring the years 2011-12 and 2012-13 when the Current Account Deficit as percent of GDP crossed 4% and created concerns, it has remained below the accepted limit of 3%. In the recently concluded Quarter it has recovered to touch 3%.



Trend in FD/GDP Percentage
(Centre States Combined)

Fiscal Deficit has of course been a matter of concern. The combined centre state FD/GDP ratio has varied in between 4 to 9.6%.The policy target centre's FD/GDP ratio has varied in between 2.54% and 6.76% ranging above the accepted figure of 3% in most of the years. Government has however unveiled a fiscal consolidation roadmap last year to bring FDP/GDP ratio to the accepted level of 3% by the year 2016-17.

India's growing middle class is an investment-magnet. Large population of poor is shifting to middle class adding to the purchasing power and demand for goods and services of the middle class. On the other side, per capita income in India is increasing giving further boost to consumer spending. Household Final Consumption Expenditure (HFCE) is a measure of consumer spending in a country -- amount spent by residents of a country to buy goods or services. In a country having high consumer spending is regarded as good investment destination. Among the top 15 largest consumer markets of the world, India ranks at number 11. There is a forecast that by year 2025 India will be the fifth largest economy in terms of consumer spending. With consumer spending in India rising to such higher levels in next decade, it obviously becomes an attractive investment destination.

The quality of business environment in the country has improved manifolds in the recent years. We saw India's resilience during global financial meltdown in year 2008-09. Indian is also known for its low cost competitive workforce and natural resource deposits. It also enjoys great advantage over other developing countries due to fact that business is mainly done in English language. India has 16% of world's population having majority of young. More than 50% of the population is in the age group of 22 to 60 years. In next 10 years country is going to be still younger. This is one very positive aspect of India's growth story. If this young generation can be educated, India in next 10 years will be unmatchable. India is seeing a massive growth in education system. The literacy rate is more than 70% and is on rise.

Investment friendly policies and progressive reform process further contribute towards India being an appropriate choice for investors. The government of India has put in place a liberal and transparent FDI policy. In the post liberalization era, a number of initiatives have been taken to attract FDI in several sectors. This includes opening of many new sectors to FDI, raising FDI equity caps in sectors already opened and procedural simplification.

Foreign direct investment is allowed in almost all sectors barring a few sensitive areas such as defense. Further, FDI up to 100% is allowed in most of the sectors and activities under the automatic route, except a few, where approval from the Foreign Investment Promotion Board (FIPB) is required. FDI under the automatic route does not require any prior approval either by the Government or the Reserve Bank. The investors are only required to notify the concerned regional office of the RBI within 30 days of receipt of inward remittances. Under the approval route, the proposals are considered in a time-bound and transparent manner by the FIPB. India's foreign trade policy has been formulated with a view to invite and encourage FDI in India. The process of regulation and approval has been substantially liberalized. The Reserve Bank of India has prescribed the administrative and compliance aspects of FDI. Today, the FDI policy in India is widely reckoned to be among the most liberal in the emerging economies.

As against above advantages, India's high fiscal deficit and the time taken to get permits weighs against it. Foreign investors look at many factors including labour laws, the legal system, corporate governance, ability to attain permits and so on.

In the recent past, many economists, policymakers, academicians and corporate researchers have raised concerns over India's regulatory policies in terms of procedural delays, complex rules and regulations related to land acquisition, legal requirements and environmental obligations. In this context, a look at some of the statements and observations made in various reports may be of worth.

"As an investment destination, India compares favourably on growth. But one area where it compares unfavourably is the time it takes to obtain approvals, and the lengthy process for resolving disputes through the legal system. It is cumbersome for getting permissions to start business as compared to some of its neighbouring countries" (Standard & Poor's).

''Last year also saw the most additions to investor-state dispute settlement cases. Fifty-eight new cases were added in 2012 taking the total known disputes to 514, prompting many countries to debate the advantages and disadvantages of the system" (UNCTAD Report2013).

"Procedural delays are bothering nearly all of the respondents with almost 93 percent of the respondents indicating this issue to be "quite to very serious". The time consuming systems and procedures to be complied with, the bureaucratic layers to be dealt with and the multiple bodies from which clearances are to be obtained- all add up substantially to the transaction cost involved and take up a lot of management time thus making it an issue of serious concern for the investors" (FDI Survey by FICCI, December 2010).

"Infrastructure projects in India carry significant risks associated with meeting government regulation, environment norms and legal requirements; inadequate user charges; and execution and construction risks" (CRISIL Report, January 2011).

"Identification of environment clearances, land acquisition and rehabilitations are the key issues that delayed large investment projects in the steel industry" (Kotak Institutional Equities Research, October, 2010).

Findings of a RBI Study, examining FDI trends in 10 select EMEs over a 7 year period (2003-04 to 2009-10), suggest that apart from macro fundamentals and investment friendly policy regime, institutional factors such as time taken to meet various procedural requirements, certainty of policies, effective implementation of policies make significant impact on FDI inflows. The study also found that given the macro fundamentals and the policy regime, FDI flows to India should have been higher by about 35% than that was actually received. The shortfall was attributed to institutional factors that dampened the investors' sentiments despite strength of economic fundamentals.

The RBI Study captures Institutional framework and governance by constructing a Government Effectiveness Index known as Kaufmann Index. It captures "perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies". Score is assigned on the scale of -2.5 to 2.5. Higher score means Government procedures are more efficient.

The World Bank has been bringing out an annual report 'Doing Business' since 2003. The *Doing Business Project* provides objective measures of business regulations and their enforcement across 189 economies of the world. Economies are ranked on their ease of doing business, from 1 – 189. A high ranking on the ease of doing business index means the regulatory environment is more conducive to the starting and operation of a local firm. This index averages the country's percentile rankings on 10 topics (sub indices), made up of a variety of indicators, giving equal weight to each topic.

Doing Business encompasses two types of indicators: indicators relating to the strength of legal institutions relevant to business regulation and indicators relating to the complexity and cost of regulatory processes. Those in the first group focus on the legal and regulatory framework for getting credit, protecting investors, enforcing contracts and resolving insolvency. Those in the second focus on the cost and efficiency of regulatory processes for starting a business, dealing with construction permits, getting electricity, registering property, paying taxes and trading across borders. Economies that rank high on the ease of doing business tend to combine efficient regulatory processes with strong legal institutions that protect property and investor rights.

India's position vis- a- vis other countries of the world according to overall ease of doing business index and its ten sub-indices is displayed in various tables.

Doing Business 2013 – World Bank Ease of Doing Business			
Country	Ranking	Country	Ranking
India	134	Nepal	108
Sri Lanka	82	USA	4
China	91	Singapore	1
Pakistan	107	Australia	10
Bangladesh	129	Hong Kong	2

Even after over two decades of economic liberalization, it is still difficult to do business in India. Comparison with other countries highlights the problems in India. India's ranking according to Ease of doing business is 134. The more striking fact is that we rank below our all neighbouring countries including Bangladesh and Nepal. Sri Lanka ranks much higher (82).

Rankings According to Ten Topics (Sub-indices) of 'Ease of Doing Business'

Ease of Doing Business Rank	Starting a Business	Dealing with Construction Permits	Getting Electricity	Registering Property	Getting Credit	Protecting Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Resolving Insolvency
134	179	182	111	92	28	34	158	132	186	121

India ranks very low with respect to most of the sub indices. The rankings are as low as 179 in case of 'Starting a Business', 182 in case of 'Dealing with Construction Permits' and 186 in case of Enforcing Contracts. The Country ranks much higher in case of 'Getting Credit' (28) and 'Protecting Investors (34).

Starting a Business			
Country	Rank	Procedures	Time(days)
India	179	12	27
Sri Lanka	33	5	7
China	151	13	33
Singapore	4	3	3
Australia	2	2	2

It is not easy to start a business. Start ups require 12 procedures which take 27 days while in Sri Lanka there are only five procedures takings just five days. The best environment is in Australia – just two procedures taking two days.

Enforcing Contracts			
Country	Rank	Procedures	Time(days)
India	186	46	1420
Sri Lanka	133	40	1318
China	19	37	406
Singapore	12	21	150
Australia	15	28	395

Enforcement of contract is not strict. It has 46 procedures as compared to 37 in China and 21 in Singapore. The time taken is 1420 days against 406 in China and 150 in Singapore.

Resolving Insolvency			
Country	Rank	Procedure s	Years
India	121	-------	4.3
Sri Lanka	51	------	1.7
China	19	------	1.7
Singapore	2	--------	0.8
Australia	15	-------	1.0

Time taken in Resolving Insolvency is much more as compared to other countries as shown in the table.

In the 'Ease of Doing Business' context it is worthwhile to mention about two positive developments. First, there is much headway in the process of obtaining approvals which has been substantially facilitated and liberalized. For almost a decade since 1991, FDI inflows as a proportion of FDI approvals ranged between 20 and 50 per cent. Obviously the impediments to implementation of FDI approvals resided in obstructionist bureaucracies and political establishments.

In an effort to bridge the gap between FDI approvals and actual inflows, the government set up the Foreign Investment Implementation Authority (FIIA) in 1999, designed to function as a fast track facilitation device to help foreign investors clear bureaucratic hurdles at the central and state levels. Further, FDI under the automatic route does not require any prior approval either by the Government or the Reserve Bank. Consequently, FDI inflows have substantially exceeded approvals and proportions have ranged between 134 to 350 %.

Second, in its publication 'Doing Business in 2013', the World Bank highlights that "India has implemented strict time limit at municipality for processing building permit"

Besides improvement in institutional and governance related issues, a strong publicity mechanism to market our strengths and provide more and better information about policy, regulations, procedures, etc. as relevant to each sector may be of help in promoting FDI. Apart from advertisements, a website may be designed with the specific objective of facilitating foreign and domestic investment keeping in mind the difficulties perceived by potential foreign direct investors relatively unfamiliar with India.

To conclude, for leveraging the FDI there is need to address the governance and institutional issues while maintaining the macro fundamentals and investment friendly policy regime. An effective publicity mechanism based on marketing of our strengths and all relevant information, including the privileges, pertaining to FDI may also help.

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