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India's Foreign Investment Policy: Achievements & Inadequacies

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Contents

Introduction

India's conscious shift in the early 1990s from an inward-looking development strategy to a globalized market-based approach resulted in significant changes in its foreign investment policy. Till the 1990s, the policy was heavily restrictive with majority foreign equity permitted only in a handful export-oriented, high technology industries. Outward-oriented reforms radically changed such perceptions with foreign investment policy becoming progressively liberal following steady withdrawal of external capital controls and simplification of procedures.

Enabling policies have resulted in aggregate foreign investment into India increasing from US$103 million in 1990-91 to US$61.8 billion in 2007-2008.[1] India is variously identified as one of the most attractive long-term investment locations.[2] It can attract much larger foreign investments given its distinct virtues of large domestic market, rising disposable incomes, developed financial architecture and skilled human resources. But transforming the potential to actual will depend significantly upon further liberalization of its foreign investment policy.

This paper outlines salient aspects of India's foreign investment policy and traces the evolution of the same. It follows up with a critical evaluation of the policy from a political economy perspective. Structurally the paper is divided into three sections with the first and second dealing with features of the investment policy and its evolution and the third attempting to outline the unfinished policy agenda and the constraints on further liberalization from a political economy perspective.

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[1] Total of foreign direct investment and foreign portfolio investment. Estimates obtained from the *Handbook of Statistics on Indian Economy*, Reserve Bank of India (RBI), Table 159, p. 264. Available at: http://rbidocs.rbi.org.in/rdocs/Publications/PDFs/87541.pdf [Accessed on June 5, 2009].

[2] Observations from UNCTAD's *World Investment Report* (2007) and 'Foreign Direct Investment Confidence Index' of A.T. Kearney. See *Foreign Direct Investment in India: Policies and Procedures*, Government of India, p. 6; available at:

Operational Features

Foreign investment comprises foreign direct investment (FDI) and foreign portfolio investment (FPI). The two categories are conceptually distinct in several respects. FDI represents a long-term vision and strategic commitment of the investors to the recipient economy. In contrast, FPI is intrinsically short-term aiming to maximize risk-return payoffs from capital markets. While both FDI and FPI are reflected in capital structures of resident enterprises as equity held by non-resident entities, FDI is distinguished by the investor's desire to hold a controlling stake in the enterprise.[3] In this respect, foreign investment policies of host economies usually refer to FDI policies with operational procedures for portfolio investment being functionally inclusive aspects of such policies.

India's present policy framework for inward FDI was introduced by the Industrial Policy Statement of July 24, 1991. The framework has subsequently evolved and enlarged in line with reforms and structural developments in the economy. The present policy allows foreign investors to invest in resident entities through either the *automatic* route or the *government-administered* route. Most sectors and activities qualify for the automatic route. This route allows investors to bring in funds without obtaining prior permission from the Government, RBI, or any other regulatory agency. However, invested enterprises are required to inform RBI within 30 days of receipt of funds and also comply with documentation requirements within 30 days of issue of shares to foreign investors.[4]

Certain investment intentions do not qualify under automatic route and require prior permission from the government. There are also sectors/activities where despite being eligible for automatic route, foreign investment is subject to other caveats. A detailed

http://www.dipp.nic.in/manual/FDI_Manual_Latset.pdf [Accessed on June 2, 2009].

[3] Both IMF and OECD define FDI as investment for 'obtaining a lasting interest by resident entity of one economy in an enterprise that is resident in another economy.' The 'lasting interest' symbolizes a desire to exert significant influence in managerial control of the invested enterprise. The IMF's Balance of Payment Manual (1993, 5th edition) defines a 'direct investor as one owning 10% or more of an enterprise's capital.' See Duce, M. and Espana, B. (2003), 'Definitions of Foreign Direct Investment: A Methodological Note,' July 31; See also http://www.bis.org/publ/cgfs22bde3.pdf [Accessed on June 19, 2009]

[4] These apply to non-resident Indians (NRIs), Persons of Indian Origin (PIOs) and Overseas Corporate Bodies (OCBs) as well.

illustration of these sectors and associated conditions is at Appendix 1. Appendix 1 also indicates extant restrictions on degree of foreign investment permitted in various sectors. Though almost all of manufacturing is fully open to foreign investment, limitations on extent of foreign ownership (measured by proportion of equity capital belonging to non-resident entities) prevail in several services. Most of India's agriculture is closed to foreign investment, while it is prohibited in atomic energy, lottery business, gambling & betting and retail trading (except single-brand retailing).

The present policy permits foreign investors to collaborate with local partners as well as establish wholly owned subsidiaries (WOSs). Both joint ventures and WOSs can be incorporated as resident enterprises under the Indian Companies Act (1956). Foreign-owned enterprises can also be unincorporated entities such as liaison/project/branch offices. Commercial scopes of unincorporated entities, however, are narrower compared to their incorporated counterparts.[5]

India does not restrict repatriation of investments, dividends and profits. Non-resident investors can dispose equity shares without prior government permission. They are also allowed to purchase immovable property in India after acquiring permission for doing business as incorporated/unincorporated entities.[6] Such acquisition, however, needs to be brought to the notice of the RBI within 90 days. Furthermore, according to the Foreign Exchange Management Act (FEMA) of 2000, acquired property cannot be transferred without permission of RBI.[7]

Other than funding new ventures, foreign investors can acquire stakes in existing resident companies. Equity transfer from residents to non-residents in such instances of mergers and acquisitions (M&A) is usually permitted under the automatic route. However, if the M&As are in sectors and activities requiring prior government permission (Appendix 1) then transfer can proceed only after such permission.

The foreign investment policy offers some additional benefits to expatriate Indian investors (NRIs, PIOs and OCBs)[8] including permission to invest more than the prescribed foreign equity ceilings in specific sectors such as domestic scheduled passenger airlines, ground handling and cargo services where expatriates can invest up to 100 percent under the automatic route as opposed to non-

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[5] Liaison and project offices cannot carry out exclusive commercial activities except for facilitating export-import business, technical/financial collaborations and activities incidental to projects. Branch offices, besides acting as buying/selling agents of parent companies, can render consultancy services and research work. Source is as cited in 3 above, p. 24-25.

[6] Liaison offices cannot acquire immovable property.

[7] Refer Notification No. FEMA 21/2000-RB dated May 3, 2000.

[8] Companies or other entities owned directly or indirectly to the extent of at least 60 percent by NRIs.

expatriate investment ceiling of 49 percent.[9] Expatriate investors also enjoy more liberal facilities with respect to transfer of immovable property acquired in India.

Short-term portfolio investors, primarily foreign institutional investors (FIIs)[10], can invest in equity shares and convertible debentures of resident enterprises. They, however, need to register with the Securities and Exchange Board of India (SEBI) - India's capital market regulator. FIIs can split capital portfolios in 70:30 ratios between equity and debt. Though they can transact on notified stock exchanges without prior permission of RBI, individually, they cannot own more than 10 percent equity in paid-up capitals of Indian enterprises, while aggregate FII holding is capped at 24 percent. In this respect, the foreign investment policy shows a clear preference for longer-term FDI, which is allowed up to 100 percent in most areas, rather than short-term portfolio flows.

Small scale enterprises[11] can attract FDI up to 24 percent of their total capital. Higher levels of foreign equity require the enterprises to surrender their 'small' status. Small enterprises cannot remain 'small' even if 'non-small' domestic investors pick up more than 24 percent of their capitals. Foreign investors seeking more than 24 percent equity holding in enterprises manufacturing items reserved for small industries require prior government approval. Infusion of such equity also requires the small enterprise to obtain an industrial license for continuing to produce items reserved for small industries.

Investing in Special Economic Zones (SEZs) attracts a slew of incentives for foreign investors with such investments exempt from practically all taxes, including those on export profit, capital gains, dividend distribution as well as customs duties on imported goods and local excise. In addition, investments in specific segments of infrastructure such as roads, airports, seaports, inland waterways, sanitation and sewage systems, solid waste management, electricity generation, transmission & distribution and housing and hospital development are eligible for full income-tax exemptions. India has double tax avoidance agreement (DTAA) with 69 countries enabling foreign investors to choose their preferred taxation turfs.

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[9] Press Note 7 (2008), Department of Industrial Promotion and Policy (DIPP), Government of India. Available at: http://siadipp.nic.in/policy/changes.htm [Accessed on June 3, 2009].

[10] FIIs include asset management companies (AMCs), pension and mutual funds, investment trusts, endowment foundations, university funds, charitable trusts and societies. Further details on portfolio investment scheme are available at source cited in 3 above, p. 32-33.

[11] An enterprise whose investment in plant and machinery does not exceed Rs 10 million.

Gradual Evolution

India's approach to foreign investment during the 1950s and 1960s was cautiously pragmatic. It was ensured that ownership and enterprise control remained primarily with resident investors. Within such limitations, foreign investment was sought to be utilized in a manner beneficial for the economy.

The official position on foreign investment was articulated in a statement[12] made to the Constituent Assembly on April 6, 1949, by Jawaharlal Nehru. Foreign capital was recognized as an important supplement to domestic savings for facilitating national economic and technological progress. Foreign investors were allowed full freedom of repatriation with the assurance of compensation in the unforeseen event of nationalization.

Foreign investment proposals, however, were sanctioned only after careful scrutiny necessitated by India's fragile balance of payments (BOP) and scarce foreign exchange reserves. Authorities did not wish to aggravate BOP difficulties given the unconditional assurance of repatriation and foreign investment therefore was channelized mostly into 'essential' industries. The tight monitoring ensured that there was hardly much FDI in the economy (except in the oil sector) till the middle of the 1950s.

The situation changed from India's 2nd Five-Year Plan (1956-1961) that awarded high priority to rapid industrialization. The Industrial Policy Resolution (IPR) of 1956 emphasized on increasing technological capabilities of indigenous industry for producing high-quality capital, intermediate and consumer goods. The thrust on technological self-reliance increased the importance of FDI with the latter expected to be a key conduit for transfer of advanced technology. At the same time, while foreign exchange difficulties had earlier forced rationing of FDI, aggravation of the same difficulties increased its acceptance[13], as it was realized that foreign exchange resources were inadequate for importing large-scale machinery and equipment for domestic industry. Foreign investment began to be

[12] See IIC (1965), *India Welcomes Foreign Investment* by India Investment Centre (IIC), New Delhi; p. 7.
[13] Kidron, M. (1965), *Foreign Investments in India*, Oxford University Press (OUP), London.

encouraged with fiscal incentives[14] during the late 1950s and 1960s with foreign capital also allowed in industries reserved exclusively for the public sector.[15]

The 1970s kicked off an inward-looking phase that led to foreign investment getting heavily regulated. The scope of foreign investment was not only confined to industries requiring sophisticated technology, but was accompanied by a deliberate attempt to divert FDI from consumer goods to capital and intermediate goods.[16] Restricting FDI was a part of efforts aiming to extend state control in various sectors of the economy and was consistent with promulgation of restrictive legislations such as Monopolies and Restrictive Trade Practices (MRTP) Act (1969), the Patent Act (1970) and allied measures such as nationalization of banks, insurance companies and coal mines.

The Industrial Policy Resolution (IPR) of 1973 limited foreign participation to export-oriented industries that were strategically important for long term growth prospects of the country. The most restrictive controls were enforced through the Foreign Exchange Regulation Act (FERA) of 1973. FERA consciously discriminated between domestic and foreign investors making it mandatory for branches and subsidiaries of foreign firms to convert foreign equities to minority holdings.[17] There were, however, some exceptions such as predominantly export-oriented firms, or those producing items requiring sophisticated technology. But even these firms had to fulfill export obligations by exporting certain minimum parts of their annual turnovers. The Industrial Policy Resolution (IPR) of 1977 further indicated industries where no foreign collaboration (financial or technical) was considered necessary. Foreign companies, which had already diluted foreign ownership to 40 percent or less in line with the FERA, were assured treatment on par with their Indian counterparts. However, despite imposition of such sweeping controls, it is noteworthy that no restrictions were imposed on remittance of profits, royalties, dividends and repatriation of capital.

The year 1991 marked a key transition in India's foreign investment policy. The transformation was induced by the government's decision to encourage stable non-debt creating long-

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[14] These included concessional rates of dividend tax for foreign investors and lowering of taxes on technical service fees and income from royalties.

[15] Phillips Petroleum of USA had a minority stake in Cochin Refinery Ltd. – a public sector undertaking. The International Telephone and Telegraphs Corporation of the US also collaborated with the Government in a similar manner for manufacturing telephone equipment. See IIC (1965), p. 9.

[16] Martinussen, J. (1998), *Transnational Corporations in a Developing Country: The Indian Experience*, New Delhi, Sage.

[17] Section 29 of FERA dealt with branches of foreign companies in India and Indian joint stock companies having foreign participation. The FERA stipulated: 1. Branches of foreign companies were to convert to Indian companies with minimum 60% equity participation. 2. Subsidiaries of foreign companies were to reduce foreign equity to 40% or less.

term capital flows as a major source of funds for supplementing domestic savings. This was a significant departure from the overt reliance on debt-creating flows during the 1970s and 1980s. Such reliance was instrumental in creating structural imbalances in the economy that manifested in a serious balance of payments crisis in 1991. The crisis precipitated a paradigmatic shift in the policy perspective on future development of the country resulting in reforms aiming to move away from a rigidly controlled, inward-looking, state-dominated economic framework to a decontrolled, outward-oriented and market-friendly system. The positive outlook towards FDI was a key part of this shift.

The foreign investment policy for a reforming Indian economy was articulated in the new industrial policy announced on July 24, 1991. The latter differed significantly different from its predecessors in its emphasis on private entrepreneurship. Entry barriers to private participation in different industries were sought to be removed by reducing the scope of industrial licensing, restricting the public sector to areas of vital national importance, and withdrawing several prohibitions under the MRTP Act of 1969, which constrained expansion of industrial investment.

The industrial policy allowed foreign investment in thirty five high-priority industries while removing several procedural controls on inflow of FDI.[18] The policy introduced the 'automatic' route for FDI. Sectors opened to FDI included almost the entire gamut of machineries (e.g. rubber, printing, electrical, industrial and agricultural), processed food, oil extraction, cement, metallurgical industries, chemical, ceramics, paper, fibres, pharmaceuticals, fertilizers, automobiles & auto components, electrical equipment, hotels & tourism and software.[19] The thrust was clearly on attracting foreign capital and technology in large segments of manufacturing with FDI in services remaining restricted to tourism and software.

Easy entry of foreign capital in notified industries was accompanied by some limiting restrictions. Foreign ownership was capped at a maximum of 51 percent of enterprise capital. Automatic approval was contingent upon the proposed foreign equity covering the foreign exchange requirement for imported capital goods.

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[18] 'Statement on Industrial Policy', July 24, 1991, paragraph 1.25 as reproduced in *Handbook of Industrial Policy and Statistics* (2006-2007), Office of Economic Adviser, Ministry of Commerce and Industry, Government of India; p. 6; available at: http://eaindustry.nic.in/2008_handout.htm [Accessed on June 2, 2009].

[19] Press Note No. 10 (1992 series), DIPP, Government of India; pp. 60-81; Available at: http://siadipp.nic.in/policy/changes.htm [Accessed on June 2, 2009].

Furthermore, companies receiving automatic approval for FDI up to 51 percent were required to 'balance' their dividend payments by export earnings over a period of seven years.[20]

Entry of foreign investment was streamlined in two distinct channels. Apart from the automatic route, an empowered Board was set up for negotiating with investors and approving investments in select areas. This board –the Foreign Investment Promotion Board (FIPB) – administers the government channel of foreign investments.[21] Subsequent developments in FDI policy have focused on altering the scale and scope of foreign investment between these two routes.

Since 1991, FDI policies and procedures have been progressively relaxed at different points in time. A major policy revamp occurred in February 2000. The automatic route was significantly expanded to make FDI in all items/activities eligible for the route except a well-defined 'negative list'. The latter included industries requiring licenses under the Industries (Development and Regulation) Act of 1951 and in terms of locational policy requirements of the Industrial Policy of 1991, proposals involving FDI higher than 24 percent of equity in small-scale enterprises, instances where foreign collaborator had previous venture/tie-up in India, cases relating to acquisition of shares in resident Indian companies in favor of foreign/NRI/OCB investors and all proposals falling outside notified sectoral policy/caps relating to the automatic route, or in sectors where FDI was not permitted. The 'negative list' proposals were to be examined by FIPB.

Liberalization of FDI policies has been a part of reforms aiming to remove controls on industrial output. A key reform in this regard has been *reduction of the scope of the public sector*. India's industrialization during the first four decades of its planned development was led by the public sector. Public enterprises dominated the basic and heavy segments of manufacturing (e.g. steel, cement and coal). While consumer goods and intermediates had sizeable presence of small and medium private enterprises, key services (e.g. electricity, telecommunication, road transport, aviation, shipping, banking, insurance) were monopolized by state agencies. Effective entry of foreign investors in the Indian economy was inconceivable till the scope of the public sector was reduced and private enterprise allowed to fill up the vacuum. The Industrial Policy of 1991 limited public sector monopoly to only eight activities while

[20] Source is as cited in 18 above; pp. 15-16.

[21] The FIPB is located in the Department of Economic Affairs, Ministry of Finance. The Board includes Secretaries of the Department of Economic Affairs, Department of Industrial Policy & Promotion, Department of Commerce, Department of Economic Relations, Ministry of External Affairs and Ministry of Overseas Affairs. The Board is chaired by the Secretary, Department of Economic Affairs. Source is as in 3 above; p. 55.

freeing up the rest.[22] Subsequently state monopoly has been cramped to only sectors of strategic importance such as atomic energy. Private initiative and foreign investment has been allowed in most of the erstwhile domain of the public sector including 'sensitive' segments such as defense, insurance, petroleum & natural gas.

Industrial licenses were widely perceived as critical entry barriers for private enterprise. It was evident that mere opening up of the economy to foreign investment was unlikely to see such investment materializing unless entry barriers were removed. Thus while limiting the public sector increased potential for competition, *withdrawal of licenses* facilitated competition. The Industrial Policy of 1991 confined mandatory licensing to 18 manufacturing industries. These included minerals and natural resource-based products, chemicals, alcoholic beverages, tobacco and consumer durables.[23] Licensing continued even in some high-priority industries made eligible for FDI up to 51 percent through automatic route (e.g. pharmaceuticals and automobiles). These were, however, freed soon after. While automobiles were de-licensed in April 1993, most bulk drugs and formulations were freed from licensing in 1994.[24] The measures have yielded dividends with leading global automobile assemblers (e.g. Benz, Honda, Hyundai, Toyota) setting up production facilities in India and the pharmaceutical & biotechnology industries witnessing entry of major global players such as GlaxoSmithKline, Eli Lily, Monsanto and Wockhardt.

Progressive de-licensing has resulted in licensing now being confined to five activities: alcoholic beverages, electronic aerospace and defense equipment, cigarettes & tobacco, industrial explosives and hazardous chemicals.[25] FDI is permitted in these industries, though proposals for manufacture of cigarettes and defense equipment require clearance from the FIPB, while the remaining is eligible for the automatic route.

The industrial policy of 1991 justified entry of foreign investment by citing the intrinsic virtues of FDI such as advanced technology, proven managerial expertise and modern marketing

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[22] These areas were arms & ammunition, atomic energy, coal and lignite, mineral oils, mining of iron and manganese, mining of copper, lead, zinc and tin, minerals specified in the Schedule to Atomic Energy and railway transport.

[23] Coal & lignite, petroleum, alcoholic drinks, animal fats & oils, sugar, cigarettes & tobacco, asbestos, plywood and other wood-based products, raw hides & skins & leather, tanned and dressed fur skins, motor cars, paper and newsprint, electronic aerospace and defense equipment, industrial explosives, hazardous chemicals, drugs & pharmaceuticals, Entertainment electronics (e.g. television, tape recorders), white goods (refrigerators, washing machines, microwave ovens, air conditioners etc). See Annex II, Press Note No. 9 (1991 series), DIPP, Government of India, available at: http://siadipp.nic.in/policy/changes.htm [Accessed on June 3, 2009].

[24] Press Note No. 5 (1996) series, DIPP, Government of India; Source as in 23 above.

[25] Source is as cited in 3 above, p. 14.

techniques.[26] New export possibilities were also underlined as one of the likely spin-offs from such investment. It was therefore natural that FDI be initially allowed only in sectors where advanced technology and other attributes could make a significant difference to industrial capacities and competitiveness, both in domestic and overseas markets. More industries have been subsequently opened to FDI. Almost the entire sweep of manufacturing ranging from basic and capital goods to intermediates and consumer durables are now open to foreign investment. But the across-the-board opening up in manufacturing has not been accompanied by similar moves in services and agriculture.

Over time India's foreign investment policy has steadily enlarged the scope of foreign ownership in resident enterprises. The 1991 policy made a rather cautious beginning in this respect, which was fully in sync with the calibrated approach characterizing India's economic reforms. With FDI ceiling frozen at 51 percent, foreign investors, while aspiring to become majority stakeholders, had to still have local partners and could not establish WOSs. Foreign equity remained capped at 51 percent for quite a few years and it was only in January 1997 that nine industries were allowed to increase FDI to 74 percent[27] under the automatic route. The bulk of the expanded list comprised services including mining, electricity generation and transmission, non-conventional energy generation and distribution, construction, land transport, water transport, storage and warehousing. Only two industries – basic metals & alloys and other manufacturing industries – were manufacturing.

In a significant move, 100 percent foreign ownership under automatic route was allowed in electricity generation, transmission, and distribution in June 1998. However, the projects were capped at a maximum of Rs 15 billion (approximately US$300 million @1USD=Rs 50). Within less than a year in January 1999, projects for construction and maintenance of roads, highways, vehicular bridges, toll roads, vehicular tunnels, ports and harbours were permitted 100 percent FDI under automatic route subject to same limitations on size.[28] Permission of full foreign ownership underlined the urgency of inviting funds in India's infrastructure. Since then, almost all manufacturing activities and several services have been allowed to access 100 percent FDI under automatic route.

The gradual *ease of entry* enabled to foreign investors through the automatic route marks another key reform in India's foreign investment policy. The automatic route is a simpler route than the government-administered (FIPB) process. Since the latter involves

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[26] Source is as cited in 18 above, p. 11.
[27] Press Note No. 2 (1997 series), DIPP, Government of India; Source is as cited in 23 above.
[28] Press Note No. 1 (1999 series), DIPP, Government of India. Source is as cited in 23 above.

acquiring prior permission before the investor can bring in funds, there are more procedures involved entailing greater transaction costs. For almost a decade, however, the scope of the automatic route remained relatively restricted. It is interesting to note that though bulk drugs figured in Annexure III of the industrial policy of 1991, which specified industries eligible for FDI under automatic route, investment proposals in drugs continued to be guided by restrictive provisions of the Drug Policy of 1986. It was only in October 1994 that FDI in bulk drugs, intermediates and formulations were granted automatic approval.[29] The coverage of the automatic route remained restricted till January 1997, when thirteen new industries were permitted FDI up to 51 percent under automatic route.[30] Ease of entry for foreign investors were greatly expanded in February 2000[31] with FDI in all industries channelized to the automatic route barring activities attracting provisions of the 'Negative List' mentioned earlier.

The scopes of the Negative List and intervention by FIPB have narrowed over time. Much of the contraction has come from increases in FDI limits for automatic route as well as wider structural facilitations. A key step in this respect has been simplification of rules relating to foreign investment in instances where the investor had a previous tie-up with a local partner. Foreign investors with previous tie-ups were required to justify why the new venture will not be injurious to the existing collaboration.[32] The current rules specify the onus of justification on both the foreign investor as well as the local partner. All proposals of this nature now qualify under the automatic route unless the proposed venture is exactly in the 'same' field.[33]

The FIPB is also no longer required to decide on proposals pertaining to transfer and acquisition of resident shares by non-residents with the process now being delegated to the automatic route.[34] Indeed, except for segments where FDI has equity caps (Appendix 1) and the narrowly defined premise of new ventures in

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[29] Press Note No. 4 (1994 series), DIPP, Government of India. Source is as cited in 23 above.
[30] Same as in 27 above.
[31] Press Note No. 2 (2000 series), DIPP, Government of India. Source is as cited in 23 above.
[32] Press Note no. 18 (1998 series); DIPP, Government of India. Source is as cited in 23 above.
[33] Press note no. 1 (2005 series); DIPP, Government of India. Source is as mentioned in 19 above.
[34] Press note No. 4 (2006 series); DIPP, Government of India. Source is as mentioned in 23 above. However, FIPB's approval is required for transfer of shares in sectors where FDI is not permitted up to 100% under automatic route (Appendix 1). For all these industries, FIPB approval is required in instances where an Indian company is being incorporated with foreign funds and such a company is either owned/controlled by non-resident entities, or where ownership/control of Indian companies resting with resident Indian entities is being transferred to non-resident entities on account of merger, amalgamation or acquisition. Press Note No. 3 (2009 series), DIPP, Government of India. Source again is as in 23 above.

fields where investors have existing collaborations, the FIPB's role is confined to cases where investment proposals involve more than 24 percent equity in small enterprises.

The Unfinished Agenda

India's present foreign investment policy facilitates easy entry of foreign capital in most areas subject to specific limits on extent of foreign ownership. Entry options have not only become procedurally simpler, but prospects for higher yields from investment have also become brighter with withdrawal of restrictive provisions such as balancing dividend payouts by exports.

In hindsight, the balance of payments crisis in 1991 left little option for India other than adopting an accommodating policy towards foreign investment. The crisis was largely a result of the economy's heavy reliance on high-cost external debt for financing balance of payments deficits. While hefty inflows of concessional assistance covered these deficits during the 1950s, 1960s, and 1970s, non-concessional loans on market terms were the main sources of finance during the 1980s leading to sharp increase in debt-service obligations.[35] The imperative for the economy was to urgently reduce reliance on debt flows in favour of stable, non-debt capital like FDI.

The importance of foreign investment in revitalizing the economy also fitted well with the spirit of market-oriented economic restructuring initiated from early 1990s. A liberal foreign investment policy was consistent with simultaneous measures aiming for greater integration with the world economy: removal of import restrictions, introduction of a market-based exchange rate management system, convertibility of the Indian Rupee in the current account of the balance of payments, phased withdrawal of restrictions on capital account transactions and replacement of FERA (1973) by the Foreign Exchange Management Act (FEMA) of 2000.[36]

Though FDI inflows have responded positively to policy changes by increasing from US$ 97 million in 1990-1991 to US$ 32.4 billion in 2007-2008, they might have been much more had foreign investment not been regulated in some key areas. Activities promising high returns on investment yet being of a strategic nature

[35] Jalan, B. (1992), "Introduction", in Jalan, B. (ed.), *The Indian Economy: Problems and Prospects*, New Delhi, Viking.

[36] FEMA (2000) has replaced FERA (1973) from June 1, 2000. Under FEMA (2000), there are no restrictions on current account transactions involving foreign exchange. Capital account transactions (e.g. investment by non-resident entities in India and investment by Indian entities abroad) continue to be regulated by the RBI. FEMA indicates a move away from a regulatory arrangement in the Indian foreign exchange market to a management mechanism.

(e.g. telecommunications, defense production, broadcasting, print media and satellite operations) have limitations on foreign ownership and require government sanctions. Such concerns, however, should not apply to agriculture. Nonetheless foreign investment can only be in a few value-additive agricultural activities like aquaculture, floriculture, pisciculture, horticulture, development of seeds, animal husbandry and cultivation of vegetables and mushrooms. While these are eligible for 100 percent FDI under automatic route, investment in tea plantations is regulated by the FIPB and is subject to the restrictive condition of divestment of equity in favour of local partners (Appendix 1).

Closed policies for FDI in agriculture can partly be explained on account of the latter figuring primarily in administrative domains of states. Article 246 in the Seventh Schedule of the Indian Constitution divides responsibilities between the central government (Union List), state governments (State List) and jointly between centre and states (Concurrent List). This vests agriculture, water, and land with states[37] enabling state governments to frame their own policies in these subjects. On the other hand, external trade & commerce and industries rest with the central government. The Constitutional separation of responsibilities implies that framing an overarching foreign investment policy in agriculture requires close coordination between individual states, as well as between the centre and states. Such coordination is difficult to achieve in a large and complex federal administrative set-up like India's. In addition, foreign investment in key agricultural activities such as procurement is not possible unless individual states reform their marketing and procurement policies.

The fate of foreign investment in India's agriculture will depend upon political management of domestic sensitivities. Several segments of India's agriculture remain protected from imports. This inward-looking attitude seems to have influenced the outlook towards foreign investment as well. Potential welfare gains (or losses) associated with greater market access to imports in a sector providing livelihood to around two-third of the country's population (despite contributing only 17 percent of national output) is debatable. Nonetheless, resistance to market access and antipathy to foreign investment has overlooked the positive difference which such investment can make to agricultural productivity and infrastructure. But given the political sensitivity associated with impacts of economic policies on farming livelihoods, a circumspect approach to foreign goods and capital looks set to prevail in the foreseeable future.

Service reforms have progressed far slowly than those in manufacturing. Public services in India were state monopolies for decades. Even now, rail transport, electricity generation, airports &

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[37] Seventh Schedule (Article 246) of the Constitution of India, available at: http://indiacode.nic.in/coiweb/fullact1.asp?tfnm=00%20511 [Accessed on June 4, 2009].

seaports, banking and insurance have overarching state presence. Opening up most services to foreign investment had to be preceded by domestic reforms enabling private entry and competition. Such reforms took considerable time in sectors like electricity and telecommunication due to efforts requiring establishment of independent regulators for creating appropriate incentive structures for private investment. With the exception of telecommunications, regulatory frameworks for most public services are still trying to come to terms with the complex challenges arising from nascent growth of competition in historically controlled territories.

Decisions relating to removal of industrial licenses and entry of foreign investment in manufacturing could be taken relatively easily since both figured under the operational purview of the DIPP in the Ministry of Industry. However, foreign investment decisions in services entailed extensive consultations between DIPP and individual ministries in charge of specific services adding to delays in arriving at decisions. Though the DIPP notifies policies on foreign investment in services, investment guidelines are usually accompanied by specifications issued by nodal ministries. FDI in power and airports, for example, despite being allowed up to 100 percent under automatic route is subject to provisions of the Electricity Act of 2003 and departmental regulations of the Ministry of Civil Aviation respectively.

Slow progress in domestic reforms in competition and regulation has resulted in FDI remaining restrictive in several services. These include domestic passenger airlines, FM radio and cable network services, publishing of newspapers and retail trading (except single brand)[38]. However, in services such as telecommunication and the internet, mining, road transport, electricity and non-passenger aviation services, FDI policies are more liberal (Appendix 1). Energy, road transport and mining were among the earliest to be opened up to foreign investment on account of pressing investment needs for augmenting capacities. Within financial services, liberal policies for non-banking services are accompanied by relatively restrictive regulations in insurance and banking.

India's foreign investment regime has experienced a gradual pace of liberalization in line with the caution and calibration characterizing India's economic reforms. The latter have never been overly aggressive. Measures to decontrol and introduce competition have usually been accompanied by conditions aiming to temper the initial intensity of such competition. The earliest efforts to invite foreign capital in July 1991 were accompanied by the dividend balancing condition. The condition of foreign equity covering foreign exchange requirements for import of capital goods – applicable to automatic approvals for 51 percent FDI in high-priority industries – was withdrawn much later. Similar moves in the later years pertain to

[38] NRIs can invest up to 100 percent in scheduled domestic passenger airlines.

limitation on project sizes in electricity and road transport despite allowing 100 percent FDI and minimum capitalization norms for non-banking financial companies (NBFCs). The caveats reflect caution arising from concerns over maintaining stable levels of foreign exchange reserves as well as avoiding marginalization of domestic producers in different segments.

Calibrated policy moves have been aimed at assuaging political opposition as well. Introduction of economic reforms generated intense debates in an economy accustomed to decades of controls and planned development. Controls had produced pressure lobbies enjoying political patronage and influence. Opposition to reforms were spearheaded by these segments, which included domestic producers benefitting from high import tariffs and entry barriers like industrial licensing. Indeed, early moves to open up manufacturing to FDI evoked a chorus of protests from many of India's leading industrialists – popularly christened the 'Bombay Club' – demanding a 'level playing field' between domestic and foreign investors.[39]

In the years that followed, there were attempts to exploit the emotive 'imperial' aspect of foreign investment by highlighting its allegedly adverse effects on indigenous producers and industries. Agitations against foreign investment with pronounced nationalistic hues and arguing for discrimination between domestic and foreign investors were led by organisations like the Swadeshi Jagaran Manch (SJM). The SJM was born in the early 1990s in response to India's efforts to globalize and is dedicated to fighting economic 'imperialism' for protecting indigenous industries. On the other hand, the Left parties (e.g. Communist Party of India (CPI) and the Communist Party of India (Marxist) (CPI-M) have been equally hostile to foreign investment. Their opposition stems from antipathy to private investment per se and is an extension of the 'infant industry' argument defending import-substitution and protectionist policies.

Political opposition to FDI has had a symbiotic association with interest groups with each trying to support the other on common grounds. In telecom and finance, stakeholders earning rents from monopolistic 'virtues' could hardly be expected to support competition, private entry and foreign investment. These specifically include employee federations affiliated to mainstream political parties and representing interests of India's over-protected organized sector workers.[40] Such groups are still active and resistant explaining why

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[39] See a) Boquerat, G. (2003), 'Swadeshi in the Throes of Liberalization,' *in* Landy, F. and Chaudhuri, B.(eds.), *Examining the Spatial Dimension: Globalization and Local Development in India*, New Delhi, Manohar Publications and b) Thakore, D (1998), 'Congress More Likely to Sustain Liberalization', *Business Commentary*, February 26, available at: http://www.rediff.com/money/1998/feb/26dilip.htm [Accessed on June 17, 2009].

[40] India's labor market is characterized by dualism where stringent labour laws on 'exit' in the formal organized sector co-exist with minimum regulations protecting

India's insurance sector which allowed maximum foreign ownership of 26 percent way back in October 2000 has not experienced any further increase in scope of such ownership after almost nine years and two different governments.

The role of politically motivated pressure lobbies in restricting FDI is best understood from the virulent opposition to foreign entry in retail trade. A modern, efficient and technologically advanced organized retail industry has never been welcomed by India's huge unorganized retail trade. Such opposition has enjoyed covert political support given the significance of the 13 million strong small unorganized retailers as a political constituency. In this respect the run-up to the latest Parliamentary elections held during April-May 2009 witnessed an interesting political consensus. Despite being at opposite extremes of the ideological spectrum, election manifestos of the right-wing Bharatiya Janata Party (BJP) and the Left parties were common in resisting foreign entry in retail.[41] The rather paradoxical similarity in agendas was clearly on account of both viewing unorganized retail as a 'core' constituency and advocating protectionist policies for safeguarding economic interests of small retailers.

The success of the Congress-led coalition at the elections is unlikely to change the prospects of foreign capital in retail since political opposition continues to remain significant within the legislature. A Parliament Committee has recently opined that foreign retail firms are likely to inflict significant welfare losses by creating large-scale unemployment through predatory pricing policies.[42] Though this has not stopped Wal-Mart from commencing India operations,[43] any precipitate move to encourage further foreign entry in retail appears remote at this juncture. This is in spite of the latest

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employee interests in the unorganized sector. See Kumar, Palit and Singh (2007), 'Sustainability of Economic Growth in India', Working Paper No. 25, Centre for International Governance Innovation (CIGI), May, available at: http://www.cigionline.org/sites/default/files/Paper%2025_India.pdf [Accessed on June 21, 2009].

[41] 'Party manifestos seek to axe FDI in retail', *Business Line*, April 21, 2009, available at: http://www.thehindubusinessline.com/2009/04/21/stories/2009042151381500.htm [Accessed on June 16, 2009].

[42] 'House Panel Applies Brakes on FDI in retail', *The Times of India*, June 9, 2009, available at: http://timesofindia.indiatimes.com/articleshow/msid-4632751,prtpage-1.cms [Accessed on June 16, 2009].

[43] Wal-Mart and Bharti Group opened their first cash and carry store in the city of Amritsar in Punjab on May 30, 2009. Story available at: http://www.bloomberg.com/apps/news?pid=20601205&sid=a5IJnEEOESTo [Accessed on June 21, 2009].

pre-budget Economic Survey of the Ministry of Finance making a strong pitch for FDI in multi-format retail, particularly in distribution of food items.[44]

Influential groups also continue to block entry of foreign capital in broadcasting, print media and aviation. In these areas, as well as in education, legal and accountancy services, which till now have almost entirely inward-looking foreign investment policies, complexities involved in multilateral trade negotiations have also, influenced investment policies. Restrictions on foreign entry in these sectors have been partly due to India's unwillingness to offer deeper commitments in services negotiations on account of lukewarm responses to its own demands for enhanced market access elsewhere. Reluctance to offer deeper market access commitments, however, has often been influenced by domestic protectionist pressures.

Fortunately, India's foreign investment policy has progressed in spite of political opposition and lobbyist pressures. This is primarily due to favorable dispositions of key decision-makers towards foreign investment. In more recent times, however, political resistance is turning out to be more successful in blocking reforms than in the past. This could be due to the complex nature of the turfs where foreign capital still has limited access. Agriculture, education, retail, media etc are sectors where policy consensus between centres and states – a difficult mission to accomplish in the first place – needs to be followed by effective coordination between central and state agencies. Reforms in many of these segments entail involvement of state legislatures as well. Matters are not helped by management compulsions of coalition politics, where minority partners hold considerable sway and can stall decisions on reforms and foreign investment.

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[44] *Economic Survey* 2008-2009; Box 2.6; p. 32, available at: http://www.indiabudget.nic.in/es2008-09/chapt2009/chap24.pdf [Accessed on July 2, 2009].

Conclusion

While India has an overall market-friendly and liberal policy towards foreign investment, foreign capital still does not enjoy equally porous access in all parts of the economy. Fairly unhindered access to manufacturing is accompanied by conspicuous lack of access in certain services and agriculture. India's future foreign investment policy faces the critical challenge of increasing access of foreign capital to these segments for enhancing inward FDI.

The existing pattern of inward FDI into India does point to the possibility of substantive increase in investment following further liberalization. FDI inflows in India have been concentrating mostly in services. Financial and non-financial services, computer software, telecommunications, housing and construction have been the top drawers of FDI during April 2000 – March 2009.[45] The services-orientation of inward FDI vindicates arguments for greater liberalization of foreign investment policies in services. Despite being relatively more restricted than manufacturing, India's services are drawing significant FDI due to undisputed virtues of large domestic market and skilled human resources. Manufacturing is unable to do so in spite of more liberal entry rules primarily on account of persistence of high transaction costs arising from poor infrastructure, inflexible labor policies in the formal sector and opaque land markets.

Structural changes within the economy also point to a larger role of foreign investment in some sectors. Insurance is a key area in this respect. Rising life expectancy and greater healthcare costs have increased demand for a variety of life and non-life, equity market-linked insurance products. Global insurance majors with a diverse product portfolio can make a major difference in this regard.[46] India's aviation industry, particularly the low-cost segment, can benefit from foreign funds and managerial expertise at a time when it is struggling to recover from financial difficulties. India's agriculture, on the other hand, is in dire need of investments for enhancing productivity and

[45] *Fact Sheet on Foreign Investment*; May 28, 2009; DIPP, Government of India; p. 2, available at: http://www.dipp.nic.in/fdi_statistics/india_FDI_March2009.pdf [Accessed on June 5, 2009].

[46] The *Economic Survey* 2008-2009 argues for 100 percent foreign equity in special insurance companies providing all insurance products to rural residents and in agriculture-related activities. Otherwise, it favors increasing FDI cap to 49 percent in insurance. Source is as in 45 earlier.

improving infrastructure, particularly in storage, conservation and transmission of farm produce. Foreign investment again can play a critically important role in augmenting capacities.

India has been able to provide an enabling environment to foreign investors in several respects. Deep reforms in capital markets aided by an efficient regulatory architecture have facilitated portfolio investments. Transfer and acquisition of shares are taking place according to investor-friendly guidelines. Foreign exchange regulations have been aligned to global standards courtesy FEMA. But these facilitations need to be matched by a more open foreign investment policy for increasing FDI inflows to a level higher than their current share of only 3 percent of India's GDP. A more open policy calls for committed political consensus on foreign investment. Such an accord has proved elusive so far. However, given that India's reforms have been irreversible notwithstanding political discord, hopes of further reforms in foreign investment are not entirely far-fetched.

Appendix 1

India's Foreign Investment Policy:
Sector-Specific Guidelines and Conditions

Foreign Investment	Industry	Condition
None	Atomic Energy	
	Gambling & betting	
	Lottery business	
	Retail trading (except single brand)	
	Activities/sectors closed to private investment	
Foreign equity up to a maximum of 26%	***Broadcasting services***	
	FM radio	Equity limit is FDI & FII combined. Requires FIPB approval and is subject to guidelines of Ministry of Information and Broadcasting
	Up-linking of news and current affairs TV channels	Equity limit is FDI & FII combined. Requires FIPB approval
	Print services – Publishing newspapers and periodicals on current affairs	Requires FIPB approval
	Defense industries	Requires FIPB approval
	Insurance	Equity limit is FDI & FII combined.
Foreign equity up to a maximum of 49%	Broadcasting services	
	Hardware facilities	Equity limit is FDI & FII combined. Requires FIPB approval and is subject to guidelines of Ministry of Information and Broadcasting
	Cable network	-Same as above-
	Direct-to-Home (DTH)	-Same as above. FDI limited to 20%

	Aviation services – Domestic passenger airline[47]	Automatic route. No direct/indirect participation of foreign carriers.
	Financial services	
	Asset Reconstruction Companies (ARCs)	No FII investment. Requires FIPB approval
	Credit Information Companies (CICs)	Equity limit is FDI & FII combined. FII limit capped at 24% in listed CICs. Investment subject to CIC (Regulation) Act, 2005.
	Stock Exchanges	Equity limit is FDI & FII combined. FDI and FII limits capped at 26% and 23% respectively.
	Commodity Exchanges	Equity limit is FDI & FII combined. FDI and FII limit capped at 26% and 23% respectively. FII purchases limited to secondary markets with no foreign investor/entity holding more than 5% equity.
	Refining services – petroleum and natural gas public sector enterprises	Subject to guidelines of the Ministry of Petroleum and no dilution of equity in public enterprises
Foreign equity up to a maximum of 51%	***Distribution services*** – single brand retailing	Covers products branded at manufacturing point. Products should belong to a single brand and sold under that brand globally. Requires FIPB approval.
Foreign equity up to a maximum of 74%	***Telecommunication services***	
	Basic & Cellular	Foreign equity between 49%-74% with up to 49% under automatic route and FIPB approval thereafter.

[47] NRIs allowed to invest up to 100%.

	Internet service providers (ISPs) with gateways, radio paging & end-to-end bandwidth.	-Same as above-
	Satellite establishment & operation	Requires FIPB approval.
	Financial services – private banks	Equity limit is FDI & FII combined. Under automatic route.
	Aviation services – non-scheduled, cargo & chartered airlines, ground handling services[48]	Under automatic route. Direct/ indirect participation of foreign airlines only in cargo services. Subject to guidelines of civil aviation ministry. Ground handling subject to security clearance.
Foreign equity up to 100% with conditions	***Aviation services*** – airport development	Up to 74% under automatic route and FIPB approval thereafter.
	Mining services – Coal and lignite for captive consumption	Under automatic route subject to provisions of Coal Mines Nationalization Act (1973)
	Distribution services	
	Trading of items sourced from small scale industries	Requires FIPB approval.
	Test marketing of items with approval for manufacture	Requires FIPB approval. Test marketing approval should be available for minimum two years. Investment in manufacturing should commence simultaneously with marketing.
	Courier services – Carrying packages, parcels and items not covered under the Indian Post Office Act (1898).	Requires FIPB approval. Activities exclude distribution of letters[49].
	Financial services – Non-banking financial activities like merchant banking, underwriting portfolio management, investment	Under automatic route subject to minimum capitalization norms : a.Fund- based activities: US$0.5

[48] As in 25 above.
[49] Responsibility of states under the Constitution.

	advice, financial consultancy, stock broking, asset management, venture capital, custodial operations, factoring, credit rating, leasing and finance, housing finance, foreign exchange broking, credit card, money changing, micro credit and rural credit.	million upfront for FDI up to 51% equity; US$5 million upfront for FDI between 51%-74%; US$50 million (US$7.5 million upfront and the balance over 24 months) for FDI between 75%-100%. b.Non-fund based activities: US$0.5 million c.100% operating subsidiaries can be established if 25% equity is divested to Indian entities over a period of time. However, this is exempted if US$50 million is brought in. Applies for joint venture companies with 75% or less than 75% foreign equity. Capital for minimum capitalization shall comprise ordinary shares. Investment process must comply with RBI guidelines.
	Construction *development services* – housing, commercial premises, resorts, education institutions, recreational facilities, city infrastructure, townships[50]	Under automatic route; subject to: a.Minimum capitalization of US$10 million for WOSs and US$5 million for joint ventures with funds to be brought in within six months of commencement of business. b.Minimum area of 10 hectares for serviced housing plots and built-up area of 50,000 sq m for construction development project and any of the above in case of combination of projects.

[50] FDI is not permitted in real estate business.

		Original investment cannot be repatriated before 3 years from minimum capitalization. However investor may exit early by FIPB approval[51].
	Telecommunication services – a) ISPs without gateways, b) Infrastructure provider of dark fibre, right of way, duct space and c) electronic mail & voice mail	Automatic route up to 49%. FIPB approval beyond 49%. Companies must divest 26% equity in favour of Indian public if they are listed in other parts of the world. Also subject to licensing and security requirements.
	Energy services – power trading	Under automatic route subject to provisions of Electricity Act (2003).
	Manufacture of cigars & cigarettes	Requires FIPB approval and industrial license.
	Alcohol distillation and brewing	Requires FIPB approval and industrial license.
	Tea industry, including plantations[52]	Requires FIPB approval subject to divestment of 26% equity in favour of Indian entities within five years.

Source: compiled from a) *Foreign Direct Investment in India: Policies and Procedures*, Government of India, available at: `http://www.dipp.nic.in/manual/FDI_Manual_Latset.pdf` [Accessed on June 2, 2009] and b) Press Note 7 (2008,) dated June 16, issued by DIPP, Government of India, available at: `http://siadipp.nic.in/policy/changes.htm` [Accessed on June 3, 2009].

[51] Exempted for NRIs and investments in Special Economic Zones (SEZs).
[52] FDI is not permitted in any other activity in agriculture or plantation.

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