CHAPTER 1

INTRODUCTION

1.1 Introduction

Broadly, investment can be subdivided in to three as physical capital, financial capital and human capital. Physical capital creation occurs with the manufacturing of physical goods such as machines and equipments while financial capital is accumulated with the creation of equity capital. A country develops human capital gradually through the establishment of facilities for better health, education, research and development etc. While both physical capital and financial capital directly exert influence on the level of economic growth, the role of human capital is indirect. The accumulated financial capital ultimately gets channelized to the formation of physical capital. In the perception of economics, investment is the creation of physical capital. Investment can directly affect the direction of economic growth through the changes it can bring down to the level of production and consumption of goods and services in an economy. Thus, investment becomes inevitable for the sustainable sustenance of an economy. Investment in an open economy can either be domestic or foreign. For domestic investment to be accumulated in an economy, domestic saving needs to be properly generated and amassed. Domestic investment tends to reduce with a fall in the domestic savings. A reduction in the domestic investment ends up with reduced income, consumption and employment, which leads ultimately to a downtrend in economic growth. Here comes up the significance and need for foreign capital. In an open economy, foreign investment, specifically, direct foreign investment can be attracted to supplement the reduced level of domestic investment. Thus, Foreign Direct Investment (FDI) has been turned out to be a most prominent form of capital flow to developing economies in the backdrop of globalization. FDI is a unique form of capital preferred by policy makers on account of its stable nature and resistance to the host economy's external debt stock. Beyond the provision of capital, FDI generates spillover effects of technology and knowledge in the host economy which stimulates economic progress. After the liberalization and privatization measures introduced in the beginning of 1990s, FDI flows to India strengthened. Thus, by the next decade, among the emerging market economies, India became one of the leading destinations for foreign investment. Route wise, automatic route has turned out to be the most prominent route for FDI inflows to India by surpassing government route, which is in line with the policy reforms. Further, the sectoral composition of FDI inflows in India has also gone through profound transformation since 1990's. In the pre-liberalization period, multitude of FDI streamed towards the manufacturing sector and in the era of liberalization, foreign investors centered on India's service sector. On a worldwide basis itself, foreign investors had begun to center on service sector by the early 90s. After liberalization, the principal changes in the policy regime on FDI in India encompasses establishing the limits of foreign investment in high priority industries, liberalizing and streamlining the procedures and mechanisms, bringing in transparency in the decision making process, easing of bureaucratic controls, expanding the list of industries or activities eligible for automatic route of FDI, encouraging investments by Non-Resident Indians (NRIs) and Overseas Corporate Bodies (OCBs), etc. Thus, the advent of FDI to India surged up in the form of mergers and acquisitions, green-field and brown-field investments, joint ventures etc. Increase in the volume of FDI inflows to India due to the liberal policy measures also boosted up the competition among the state governments for fetching in more FDI to the respective states in recent years. Several states are focusing on attracting foreign investors to their regions by offering extensive incentives in the form of tax reduction, provision of land and public utilities at lower cost etc. As long as the state governments are in need of investment and investors require investment friendly locations, the output counts on the negotiating skills of individual states and also on the state's competence or necessity to collaborate with their counterparts to restrain competition. However, in the run to attract FDI inflows, only a few states could bring potentially positive outcome from FDI, even if several states incurred huge administrative and promotional costs. Nevertheless, the inter-state competition staged to captivate FDI inflows has prominent implications for broad inter-state variations in FDI inflows. Thus from April 2000 to March 2016, six regions such as Mumbai (Maharashtra, Daman and Diu and Dadra and Nagar Haveli), Delhi [National Capital Territory (NCT) of Delhi and some parts of Uttar Pradesh and Haryana], Bangalore (Karnataka), Chennai (Tamil Nadu and Puducherry), Ahmedabad (Gujarat) and Hyderabad (Andhra Pradesh) together received 74 per cent of FDI inflows while four regions such as Kanpur (Utharakhand and UttarPradesh), Bhubaneshwar (Odisha), Patna (Bihar and Jharkhand) and Guwahati (Assam, Arunachal Pradesh, Manipur, Meghalaya, Mizoram, Nagaland and Tripura) left with only 0.36 per cent. Thus, it is inevitable to study about this huge difference in the magnitude of FDI inflows across the regions of India in order to curb the further occurring of unbalanced regional development in the country and thereby to impede the probability of befalling tough consequences on the socio-economic-political stability of the country. The present study is an attempt in this direction.

1.2 Statement of the Problem

India started to receive enhanced inflow of FDI since the outset of economic reforms in the beginning of 90s. The considerably raising volume of FDI to India has also been accompanied by substantial regional dissimilitude. The attendant regional disparity in FDI inflows to India resulted in the denial of benefits of liberalization to a number of poor states. In India, foreign investors typically stream their resources to economically advanced states; thus such regions including Mumbai, Chennai etc retained a principal share of FDI. As a whole, the six Indian regions with advanced economic conditions, *viz*., Mumbai, Delhi, Bangalore, Chennai, Ahmadabad and Hyderabad together accounted for over ***74 per cent*** of FDI equity flows to India during April 2000 to March 2016 which reflects the distinct signs of FDI concentration at the regional level. At the time of liberalizing FDI regime in India in 90s, Policy makers envisioned to ensure the equitable distribution of FDI inflows to India that the entire part of India would avail the benefits from FDI impartially; those benefits include stable capital inflows, spillover from technological and marketing capabilities of foreign investors, crowding in domestic investment etc. Nevertheless, even now when it turns out nearly three decades after liberalization, majority of the poor regions in India struggle behind the advanced ones with the negligible portion of FDI they received. De facto, the volume or quantity of FDI received by particular regions is regarded as a parameter of economic development achieved by them without being considered the quality of FDI. Hence, hereafter onwards, it is essential to ensure that the rising FDI flows do not lead to a further increase in regional inequality. In view of this, the study examines the major determinants which play a role in distributing varied magnitude of FDI across the regions of India; the role played by FDI at the regional level in India has also been identified.

1.3 Significance of the Study

India has been witnessing elevated inflows of FDI since 1990s; from the time onwards, countless studies have been emerged evaluating the pros and cons of FDI inflows to the economy. Nevertheless, even if the fact of subsistence of wide regional concentration in the inflow of FDI to India with only six or seven regions attracting unreasonably large portion is crystal clear, only very few analytical studies on the inter-state or inter-province differences in FDI inflows have occurred so far. Beyond barely identifying the interregional determinants and role of FDI inflows, the studies subsisting have not taken note of the multifarious impacts that may cause due to the magnitudinal variations in the FDI inflows across the regions in India. Thus, the significance of the present study is in analyzing the determinants and role of FDI inflows in the regions in India, on the basis of the magnitude of FDI received by each of them and the concept has not yet been covered by any of the subsisting studies.

1.4 Objectives of the Study

The objectives of the study are as follows:

1. To evaluate the trend and pattern of FDI inflows to India during the post reform period.
2. To evaluate the FDI policy framework of India.
3. To evaluate the trend and pattern and also to identify the determinants and role of FDI in Regions with High Inflow of FDI (RHIF) in India.

4. To evaluate the trend and to identify the determinants of FDI in Regions with Low Inflow of FDI (RLIF) in India.

1.5 Scope of the Study

This study covers the dynamics of inter-regional distribution of FDI inflows in India. The trend and pattern of FDI flows to India in the post liberalized regime has been evaluated. A review of the post independent policy framework on FDI in India has also been carried out. The trend and pattern, the role and determinants of FDI inflows in regions with high FDI inflows and the trend and determinants of FDI inflows in regions with low volume of FDI have also been examined.

1.6 Hypotheses of the Study

- Inflow of FDI in India is being rightly directed during the post reform period.
- The inflow of FDI is judiciously distributed across regions and sectors.
- Policy framework of FDI is apt with regard to the economic conditions of India.
- Inflow of FDI is being rightly directed and judiciously distributed in Regions with High Inflow of FDI (RHIF).
- The FDI in RHIF is explainable by domestic savings, domestic investment, size of host economy and deficit financing.
- FDI, along with domestic savings and industrial output contribute towards the size of the economy in RHIF.
- Inflow of FDI is being rightly directed in Regions with Low Inflow of FDI (RLIF).
- The FDI inflows in RLIF is explainable by financial intermediation, manufacturing output and capital expenditure of government.

1.7 Methodology

1.7.1 Frame

This study is based on descriptive research design. It principally assesses the region specific role and determinants of FDI inflows in India. The survey of literature signifies the wide-regional disparity existing in the distribution of FDI inflows with in developing countries and in India. The trend and pattern of the distribution of FDI inflows in India has been evaluated. The post independent policy regime on FDI in India has also been evaluated. Afterwards, it has been attempted to understand the magnitude-specific dynamics in the FDI inflows to India by examining the determinants and role of FDI inflows in regions with high volume of FDI and determinants of FDI inflows in regions with low volume of FDI.

1.7.2 Type of Data

The study is explanatory in nature and based on secondary data. However, a preliminary assessment of the foreign firms in Kerala has been done by meeting some of the officials at Infopark at Kochi. Discussions have been conducted with the managing director of Kochi Smart City Project and officials at the RBI's Kochi regional office.

Both time series and panel data have been used for analysis.

1.7.3 Sampling

In India, 17 Regions receive FDI inflows (DIPP, 2016). They are Mumbai [*Rank **1*** (29 per cent – Rs 4157.53 billion)], Delhi [*Rank **2*** (22 per cent – Rs 3323.12 billion)], Chennai [*Rank **3*** (7 per cent – Rs 1185.47 billion)], Bangalore [*Rank **4*** (7 per cent – Rs 1089.12 billion)], Ahmedabad [*Rank **5*** (5 per cent – Rs 684.64 billion)], Hyderabad [*Rank **6*** (4 per cent – Rs 595.56 billion)], Kolkata [*Rank 7* (1 per cent – Rs 208.47 billion

)], Chandigarh [*Rank* ***8*** (0.5 per cent – Rs 65.38 billion)], Jaipur [*Rank* ***9*** (0.5 per cent – Rs 71.26 billion)], Kochi [*Rank* ***10*** (0.5 per cent – Rs 67.39 billion)], Bhopal [*Rank* ***11(***0.5 per cent – Rs 66.14 billion)], Panaji [*Rank* ***12*** (0.3 per cent – Rs 39.84 billion)], Kanpur [*Rank* ***13*** (0.2 per cent – Rs 29.68 billion)], Bhubaneshwar [*Rank* ***14*** (0.1 per cent – Rs 19.97 billion)], Guwahati [*Rank* ***15*** (0.03 per cent – Rs 4.47 billion)], Patna [*Rank* ***16*** (0.03 per cent – Rs 5.39 billion)] and Jammu and Kashmir [*Rank* ***17*** (0 per cent – Rs 0.37 billion)](as on the Quarterly Fact Sheet on FDI, Department of Industrial Policy and Promotion (DIPP), March 2016).

From these regions, two forms of categorization have been made by the researcher. The first category is Regions with High Inflows of FDI (RHIF). RHIF includes the top six ranked regions such as Mumbai, Delhi, Chennai, Bangalore, Ahmedabad and Hyderabad which received a total of 74 per cent of FDI from April 2000 to March 2016.

The second category is Regions with Low Inflows of FDI (RLIF). RLIF encompasses four regions with lowest ranks such as Kanpur, Bhuwaneswar, Guwahati and Patna with the exclusion of Jammu and Kashmir since the percentage component of FDI received by Jammu is zero. RLIF received only a negligible portion of 0.36 per cent of FDI from April 2000 to March 2016.

1.7.4 Sources of Data

Data has been collected from the following sources:

- Reserve Bank of India (RBI) - RBI Bulletins, Hand book of Statistics on Indian States and Hand book of Statistics on Indian Economy.
- Department of Industrial Policy and Promotion (DIPP) - Quarterly Fact Sheets on FDI and FDI Newsletters.

- ❖ Websites of 'Make in India' initiative and 'Invest India' (National Investment Promotion and Facilitation Agency).
- ❖ Websites of Central Statistical Organization (CSO), National Institution for Transforming India (NITI) Aayog and archived website of erstwhile Planning Commission of India.
- ❖ Economic review reports of various state governments.
- ❖ World Investment Reports (WIRs) of United Nations Conference on Trade and Development (UNCTAD) and online data centre of UNCTAD.
- ❖ Websites of World Bank and International Monetary Fund (IMF).

1.7.5 Tools Used for Analysis

Essentially, percentage analysis, analysis with Compound Annual Growth Rate (CAGR) and Average Annual Growth Rate (AAGR), basic economic ratio analysis and correlation analysis have been performed. Principally, the following tools have been used.

1. Auto Regressive Integrated Moving Average (ARIMA) for forecasting the monthly FDI inflows to India with time series data.
2. Pooled OLS Regression for panel data analysis
3. Random-effects [Generalized Least Squares (GLS)] regression, also for panel data analysis.

1.7.6 Period

Period has been selected for study largely on the basis of the availability of data. Only limited sources are providing data on FDI in India and internationally. In India, Department of Industrial Policy and Promotion [(DIPP), *the DIPP was established in 1995 under the Ministry of Commerce and Industry as a nodal agency for design and* *facilitation of industrial, FDI, trade and commerce policies*], and RBI are the only government institutions which provide reliable data on FDI inflows. DIPP's quarterly fact sheets on FDI are the major source for getting monthly and yearly inflows of FDI to India. However, DIPP provides yearly data of FDI inflows to India only from the year 2000-01 onwards. Monthly data of FDI inflows to India is available only from April 2005 in the fact sheets of DIPP. For the accomplishment of the present study, the researcher needed data of region-wise annual FDI inflows to India. However, the data required is available in the quarterly fact sheets of DIPP only from 2006-07 onwards. In this context, the researcher selected different periods from different sources for fulfilling each objective.

1. For accomplishing the first objective- to evaluate the trend and pattern of FDI inflows to India- the period taken is April 2005 to January 2019 (monthly data).
2. To evaluate the FDI policy of India, post independent period has been considered.
3. For achieving the third and fourth objectives, period from 2007-08 to 2015-16 (yearly data) has been considered.

1.8 Scheme of the Report

The research report has been subdivided in to seven chapters. After the first chapter of introduction, second chapter carries out an analysis of the empirical literature on FDI inflows. The third chapter is focusing on FDI policy in India. The fourth chapter expounds the trend and pattern of FDI inflows to India. Chapter five deals with FDI inflows in Regions with High Inflow of FDI (RHIF). Chapter six discusses the FDI inflows to Regions with Low Inflow of FDI (RLIF). Chapter seven discusses the major findings, policy implications and conclusion.