# CHAPTER III

# FOREIGN DIRECT INVESTMENT (FDI) POLICY OF INDIA

## 3.1 Introduction

The survey of literature showed that the few studies conducted on the magnitudinal wise disparity in FDI inflows across India have not taken in to account the varied trend and pattern existing. These studies focused on interregional variation in the FDI inflows to India by viewing the entire regions collectively. The same set of determinants and role of FDI inflows were identified for the entire regions. Though it was apparent that the trend and pattern of FDI inflow is quite different in these regions, no attempt has yet been carried out to classify these regions on any basis. One of the reasons for adopting such weak research methods may be the ambiguity prevailing with regard to the concept, theory and policy on FDI. The present chapter, thus, intends to overview the concept of FDI and theoretical literature on it. FDI policy framework of India is evaluated.

## 3.2 Concept of Foreign Capital

Capital flows from outside the territory of a country can be classified into many types on the basis of several attributes. However, foreign capital is bifurcated into official flows and private flows by OECD and World Bank.

Official flows, i.e. Official Development Finance (ODF) include a) official grants b) concessional loans from either bilateral or multilateral sources c) non-concessional loans from either bilateral or multilateral sources.

Various forms of private external finance include FDI, project lending, Foreign Portfolio Investment (FPI), close-end equity funds, private non-guaranteed debt etc. However, this study focuses only on FDI and a brief review of FDI which encompasses its definition, classification, determinants etc. have been given in the following section.

### 3.2.1 Concept of FDI

FDI and FPI are two prominent modes of external finance. Under FDI, residents of one country (the source country) acquire ownership of assets for the purpose of controlling the production, distribution and other activities of a firm in another country (the host country). The terminology of FDI has been defined differently by various national and international organizations.

The World Trade Organization (WTO) defines FDI as follows: "FDI occurs when an investor based in one country (the home country) acquires an asset in another country (the host country) with the intent to manage the asset". This *dimension of management* as stated in the definition distinguishes FDI from the Foreign Portfolio Investment (FPI).

The International Monetary Fund's (IMF) Balance of Payments Manual, fifth edition (BPM5) defines FDI as a category of international investment that reflects the objective of a resident in one economy (the direct investor) obtaining a lasting interest in an enterprise resident in another economy (the direct investment enterprise). The lasting interest implies the existence of a long-term relationship between the direct investor and the direct investment enterprise, and a significant degree of influence by the investor on the management of the enterprise. A direct investment relationship is established when the direct investor has acquired ten percent or more of the ordinary shares or voting power of an enterprise abroad.

The United Nation's Conference on Trade and Development's (UNCTAD) World Investment Report (WIR, 2007) defines FDI as "an investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise, affiliate enterprise or foreign affiliate)".

According to the detailed benchmark definition of FDI: Fourth Edition [Paris, Organization for Economic Co-operation and Development (OECD), 2008], Direct investment is a category of cross-border investment made by a resident in one economy (the direct investor) with the objective of establishing a lasting interest in an enterprise (the direct investment enterprise) that is resident in an economy other than that of the direct investor. The motivation of the direct investor is a strategic long-term relationship with the direct investment enterprise to ensure a significant degree of influence by the direct investor in the management of the direct investment enterprise. The "lasting interest" is evidenced when the direct investor owns at least ten percent of the voting power of the direct investment enterprise.

Thus, the element of 'control' and 'controlling interest' can be termed as the attribute that distinguishes FDI from FPI. A foreign portfolio investor does not go for control or lasting interest in a host country enterprise. Nevertheless, there is no consensus on what can be termed as controlling interest. A ten per cent shareholding in the host country enterprise is generally regarded as permitting the foreign firm to inflict a prominent influence on the key policies of the underlying project.

The following section describes the mode of FDI accounting in India.

### 3.2.2. FDI Accounts in India

The IMF's definition of FDI incorporates equity capital, reinvested earnings (retained earnings of FDI companies) and 'other direct investment capital' (short term and long term intra-company loans or intra-company debt transactions, trade and supplier credit, financial leasing, financial derivatives, debt securities and land and buildings). However, FDI statistics compiled by the RBI in the balance of payments prior to 2000 included only equity capital. This led to an underestimation of FDI inflows to India. Taking this in to account, the FDI statistics in India got revised to include reinvested earnings and other direct investment capital.

FDI is all about owning and controlling a foreign company in a foreign country. It is also said that, in return for the ownership advantage, the investor has to give back its specialized financial, technical or managerial resources to the host country. Thus, FDI is also told as contributing to the technological, marketing and managerial resource base of the domestic company. However, in practice, it is not followed in India to consider an investment as FDI, and here FDI usually confines to the investment of ten per cent or more to the ordinary shares or voting power in the resident entity.

Thus the practice is that, all investments from abroad meeting the sole criterion of ten percent investment, irrespective of whether they are conducted by financial investors or national investors committing investment in the domestic company through any of the foreign routes get accounted as FDI.

In reality, the practice of FDI accounting in India is more ineffective. At present, all investments by persons or entities resident outside India in the capital of Indian companies *other than those through the portfolio investment scheme* are treated as FDI *irrespective of the extent of shares* held by them. RBI had made a clarification in this regard by saying that '*while as per the international definition, for an investment to qualify as FDI the foreign investor needs to have a ten per cent or higher stake in a given company, in India this has not been strictly adhered to'.* Regardless of the size of investment in a particular company, it is measured as FDI if the non-resident obtains shares in a company other than by means of purchase from the stock market, i.e., through initial public offerings (IPO) or through private arrangements.

In November 2017, the RBI came out with a diverse way of recognizing FDI when it issued the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2017.

The revised regulations defined FDI as an *"investment through capital instruments by a person resident outside India in an unlisted Indian company; or in ten per cent or more of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company."*

Thus, in an unlisted company, a single dollar foreign investment is counted as FDI. This approach follows the recommendations of the Arvind Mayaram Committee (2014). Thus, it is obvious that, the definition is not taking in to account the attendant characteristics of FDI such as technology enhancing, marketing and managerial capability enhancing etc.

RBI defines Foreign portfolio Investment (FPI) as any investment made by a person resident outside India in capital instruments where such investment is (a) less than ten percent of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company or (b) less than ten percent of the paid up value of each series of capital instruments of a listed Indian company. FPI comes to India through the routes viz.

Foreign Institutional Investors (FIIs) including mutual funds, Global Depository Receipts (GDRs) and Foreign Currency Convertible Bonds (FCCBs).

In the present study, however, FDI alone is considered for analysis.

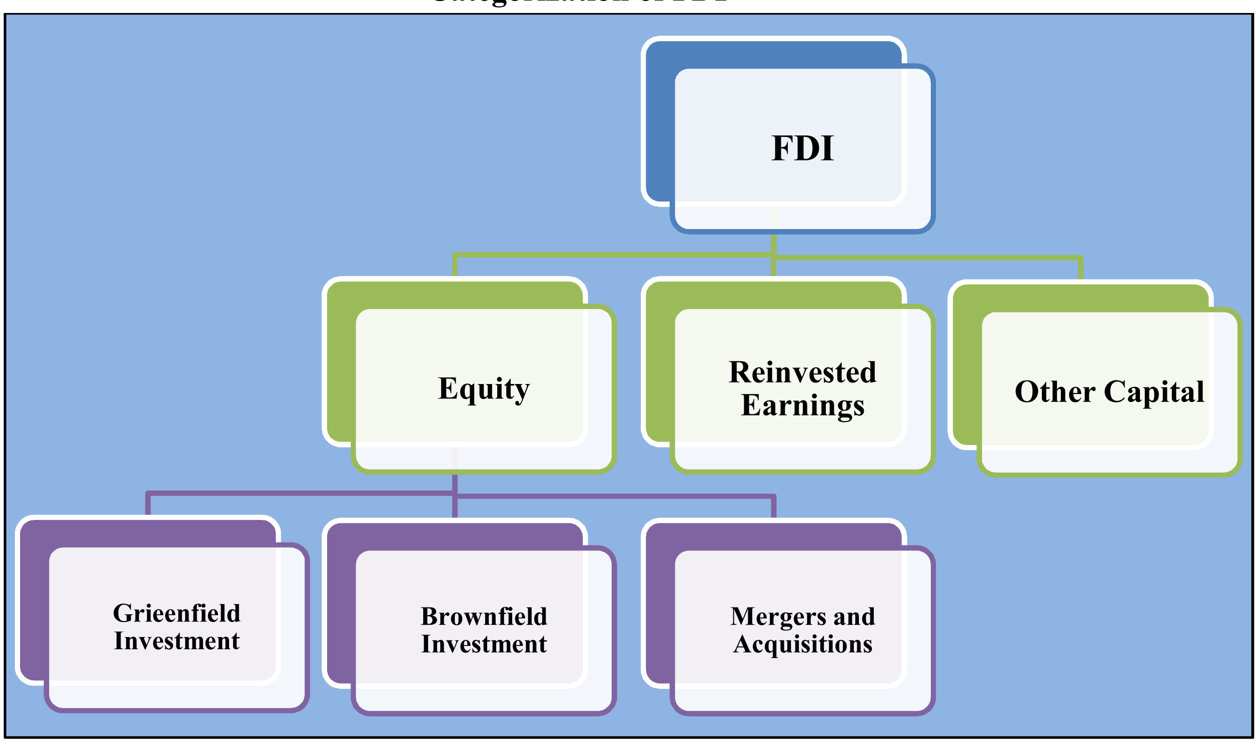
## 3.2.3 Classification of FDI

FDI is classified on many grounds. It is categorized on the basis of components, corporate forms, types of production activities etc.

### 3.2.3.1 Component wise Classification of FDI

Component wise, FDI can be categorized in to equity, reinvested earnings and other capital as shown in figure 3.1 below.

**Figure 3.1**
**Categorization of FDI**




FDI includes three components viz. equity, reinvested earnings and other capital (Figure 3.1). Equity capital is the value of the MNC's investment in shares of an enterprise in a foreign country. An equity capital stake of ten per cent or more of the ordinary shares or voting power in an incorporated enterprise, or its equivalent in an unincorporated enterprise is generally considered as a threshold for the control of assets. Equity form of FDI is further sub divided in to three categories as green-field investment, brown-field investment and mergers and acquisitions. Reinvested earnings indicate the difference between the profit of a foreign company and its distributed dividend and thus represents undistributed dividend. Other capital constitutes intercompany debt transactions of foreign entities.

Under green-field investment, a company establishes operations in a foreign country by setting new facilities like sales office, manufacturing facilities etc from the ground up. Under brown-field investment, a company makes investment in a foreign country in an existing facility to start its operations.

Mergers and acquisitions, or M&A for short, involves the process of combining two companies into one. The goal of combining two or more businesses is to try and achieve synergy - where the whole (new company) is greater than the sum of its parts (the former two separate entities).

#### 3.2.3.2 Corporate Forms of FDI

MNCs are the types of firms which invest in a foreign country by taking in to account a good deal of factors related to the host country business environment and they go for different kinds of shareholding in a foreign country on the basis of their interests. If the foreign company has the ownership of the whole capital of the host economy entity, such an entity will be regarded as a branch or fully owned subsidiary of the foreign firm. The affiliate with principal shareholding of the foreign collaborator will be under the dominance of the foreign partner and its dominance tends to decrease with decrease in the extent of shareholding. The corporate forms of FDI according to the extent of foreign shareholding have been given in the following table (Table 3.1).

**Table 3.1**
**Corporate Forms of FDI**

| Extent of Foreign Shareholding | Corporate Forms of FDI |
|---|---|
| **100 per cent** | Fully owned subsidiary |
| **> 50 per cent but < 100 per cent** | Subsidiary or majority foreign owned |
| **50 per cent** | Co-owned company |
| **> 25 per cent but < 50 per cent** | Minority owned company |
| **10 per cent to < 25 per cent** | Associates |

Source: Website of UNCTAD.

Table 3.1 articulates that if the foreign investor has cent per cent investment in a particular firm, it becomes the wholly owned subsidiary and with stake-holding level of 10 to 25 per cent, it is termed as an associate of the foreign investor.

**3.2.3.3 Vertical, Horizontal and Conglomerate Forms of FDI**

FDI can also be classified in to vertical and horizontal forms on the basis of the types of production activities they undertake. Caves (1982) explained horizontal FDI as establishing factory facilities in various countries for the purpose of making similar goods as they have been doing in other factory units. At the same time, vertical FDI is described as establishing plants in different countries to produce output that serves as an input in its other parent or subsidiary plants.

Besides, vertical FDI can be bifurcated in to downstream and upstream integration based on the flow of interrelated production process functions. In downstream vertical integration, foreign subsidiary performs an assembly function by using inputs supplied by the parent firm or other sister subsidiaries. Instead, in upstream vertical integration, the foreign subsidiary's function is to produce and supply the necessary inputs to the parent firm or sister subsidiaries.

A third category is conglomerate FDI. Under this, companies or individuals make foreign investment in businesses in the host economy which are unrelated to their existing businesses in the home country. Here, since the foreign investors have no previous experience with the new businesses in the host economy, it often ends up as a joint venture with a foreign company already operating in the industry.

**3.2.3.4 John. H. Dunning's Classification of FDI**

Dunning (1993)'s taxonomy of FDI which is built on the OLI Paradigm (Dunning, 1977) is one of the most cited. This taxonomy is made up of four categories as follows.

**3.2.3.4.1 Resource Seeking**

Resource seeking MNEs invest abroad by seeking particular types of resources which are not available in their home country (natural resources or raw materials) or which are available at a lower cost (such as unskilled labor that is offered at a cheaper price with respect to the home country).

**3.2.3.4.2 Market Seeking**

Here MNEs invest abroad to exploit the possibilities of greater market dimensions. FDI may be inspired by following suppliers or customers that have built foreign production facilities, to adapt goods to local needs or tastes, and to save the cost of serving a market from distance.

**3.2.3.4.3 Efficiency Seeking**

Efficiency seeking FDI occurs in two instances. First one is, "to take advantage of differences in the availability and costs of traditional factor endowments in different countries" and the second one is, "take advantage of the economies of scale and scope and of differences in consumer tastes and supply capabilities" Dunning (1993).

#### 3.2.3.4.4 Strategic Asset Seeking FDI

Under this category, FDI is motivated to acquire and complement a new technological base rather than exploiting the existing assets. Here the motivation of the firm investing abroad is gaining access to knowledge or competences that are not inside the firm.

## 3.2.4 Factors Affecting Foreign Investment

Foreign investors consider a good deal of factors prior to make investment in a foreign country. The most important factors affecting FDI inflows across the globe have been given below.

#### 3.2.4.1 Wage Rates

Countries with lower wages tempt foreign investors to shift labour oriented production functions to them. For instance, if the average wage in US is \$ 10 per hour and the same work is available in India at \$ 1 per hour, the foreign investor can substantially reduce his cost of production by shifting his production unit to India. Many western firms have made their investment in the clothing factories in the Indian subcontinent is to reduce the labour cost.

#### 3.2.4.2 Labour Skills

Pharmaceuticals and electronics MNEs which require high skilled labour may shift their location to those countries which have a combination of low wages, high labour productivity and high labour skills. For instance, India has attracted a major portion of investment in call centers, because of a high portion of English speaking population available at a low wage level.

#### 3.2.4.3 Tax Rates

Low corporate tax rates attract MNEs to certain countries. For example, Ireland has been successful in attracting a considerable volume of FDI because of its comparatively low corporate tax rates.

#### 3.2.4.4 Transport and Infrastructure

Transport cost and the level of infrastructure development are two crucial factors which fetch FDI to host economies. Countries with access to the sea attract more FDI than landlocked countries because of the cost differences in shipping goods.

#### 3.2.4.5 Size of Economy, Potential of the Economy for Growth and Economic Conditions

Size of economy and scope for the growth of economy are two important factors which fetch FDI to particular countries. Growing economies like India and China which have an emerging middle class population are likely to attract more and more FDI. Likewise, economic crisis sustaining in particular economies is also likely to curb foreign investors.

#### 3.2.4.6 Exchange Rate

A weak exchange rate in the host country will attract FDI as investors can buy assets at comparatively lower cost. Nevertheless, high volatility in the exchange rate in the host country will reduce the volume of FDI.

#### 3.2.4.7 Agglomeration Economies

Agglomeration economies or external economies of scale refer to the benefits from concentrating output and housing in particular areas. If an area specializes in the production of a certain type of good, all firms can benefit from various factors such as good supply networks, supply of trained workers, infrastructure built specifically for the industry, good transport links. Such areas or countries with regions of agglomeration capability attract more FDI.

The following section gives an account of the theoretical framework on FDI.

## 3.3 Theoretical Framework on FDI

The development of FDI began literally after the Second World War with the emersion of the forces of globalization. Thus during the 1950s and 60s, Multi National Corporations (MNCs) and foreign investment received unprecedented significance. During the same period, FDI inflows from USA to European countries enhanced at an increased rate. Such a backdrop stimulated numerous researchers to evaluate the aspect of MNCs and the subsistence of international production. Subsequently, plenty of theories were articulated to explicate the overseas movement of capital. Originally, direct investment was an international capital movement only (Kindleberger, 1969). Earlier, prior to 1950, FDI was subsumed under portfolio investment. Correspondingly, it was assumed that the prime reason behind the overseas capital flows was interest rate differences. By virtue of this approach, capital was thought to be streamed to those regions with highest rate of return when there were no uncertainties or risks. Nevertheless, this circumstance didn't expound the elementary difference between portfolio and direct investment- i.e. direct investment involves the element of control. Thus, the prominent drawback of the theory of interest rate was that it didn't explain the element of control as an attendant attribute of direct investment. Hymer (1976) recounted that if interest rates are higher abroad, an investor will consider lending money abroad, but there is no logical necessity for that investor to control the enterprise to which he or she lends to the money.

During 1960s, it was sought to appropriately describe FDI. Moreover, realizing the augmenting role of FDI, academicians endeavored to integrate their works with the theories of FDI (Rayome & Baker, 1995). Thenceforth, theories began to emphasize on various factors which govern the overseas circulation of capital. Thus theories started to encompass factors like market imperfections, oligopolistic and monopolistic advantages etc to explain FDI. Some theroies also established interrelationship between FDI and international trade. In compliance with the above observations, the following section examines the principal theories on FDI. The subsisting theoretical literature on FDI can be basically bifurcated in to; (1) Theories on the *Determinants of FDI to host economies* and (2) Theories on the *impact of FDI on the host economy*.

## 3.3.1 Determinants of FDI: Theoretical Approach

The theories on the determinants of FDI can be classified in to two as; (1) FDI theories based on perfect market and (2) FDI theories based on imperfect market.

### 3.3.1.1 FDI Theories Based on Perfect Market

In the earlier periods, theories on FDI were formulated in the assumption of perfect market. Perfect market is a hypothetical market characterized by a large number of buyers and sellers with possession of perfect knowledge about the market. MacDougall (1958) is regarded as one of the pioneers of FDI theory based on perfect market. Kemp (1964) contributed further to the perfect market assumptions on FDI. They presumed a two-country model where prices of capital equated to its marginal productivity. Moreover, both Kemp and MacDougall stated that when there takes place free capital movement from one country to another, the marginal productivity of capital tended to be equalized between them. Following are the major theories on FDI assuming the prevalence of perfect market.

#### 3.3.1.1.1 Theory of Differential Rate of Return

This theory is one of the first attempts to explain the cross-border capital flows. As per this theory, FDI occurs when investors move from one region with low return to another with high return and it will end up with equality in the real rate of return. This theory presumes risk neutrality, making the rate of return the only variable upon which the investment decision relies on. Risk neutrality here implies that the investor takes in to account domestic investment and FDI to be perfect substitutes. Until the 1960s, FDI was regarded to occur as a consequence of differences in rates of return on capital investment. Even if this presumption seemed to be consistent with the pattern of FDI flows occurred in the 1950s (many US MNEs gained high returns from their investments in Europe), the insight of the theory weakened a decade later when US investment in Europe continued to increase irrespective of the higher rates of returns obtained (Hufbauer, 1975). The embedded assumption of a single rate of return across industries, and the implication that bilateral FDI flows between two countries could not occur, also made the hypothesis theoretically unconvincing.

#### 3.3.1.1.2 Theory of Portfolio Diversification

The theory of portfolio diversification sufficiently delineates the emergence of FDI, and it also explicates the necessity of examining the role of risk unlike the theory of differential rate of return. As per this theory, generally it is the habit of a firm to assess the expected returns and to choose ways for risk reduction at the time of undertaking investment activities. Return on investment differs from nation to nation and a firm tries to restrain its risk by investing in more than one nation. Thus, here FDI becomes a channel for international portfolio diversification. This theory has been experimented in several countries by associating FDI with average returns and also the risks related to it. Another thing that could observe is that large firms with massive and widespread investment exhibited only small fluctuations in their profits. However, this theory also couldn't sufficiently explain foreign investment as it ignores the difference of propensity to invest across different industries. It also fails to explain why foreign investors increasingly focus on certain industries.

#### 3.3.1.2 FDI Theories Based on Imperfect Market

Hymer was one of the pioneers who founded a systematic approach towards the study of FDI. Hymer (1976) expanded the 'Theory of Industrial Organization' [(in 1960, in his doctoral dissertation), Hymer's dissertation was subsequently published in book form in 1976]. His theory was one of the first works which outlined international production in the prevalence of imperfect market. The theory was supported by Lemfalussy (1961), Kindleberger (1969), Knickerbocker (1973), Caves (1974), Dunning (1974) and Cohen (1975). The following are the major theories on FDI under imperfect market.

##### 3.3.1.2.1 Theory of Industrial Organization

The theory of industrial organization was developed by Hymer (1960, 1976). The substance of Hymer's theory is that foreign firms will need to rival with domestic firms which enjoy superiority in the form of culture, language, legal system and consumer's preference. Additionally, foreign firms will also have to confront with foreign exchange risk. Amidst these impediments, some form of market power held by foreign firms will lead to profitability in overseas investment. The sources of market power include patentprotected superior technology, brand names, marketing and management skills, economies of scale and cheaper sources of finance (firm-specific advantages in Hymer's term and monopolistic advantages in Kindleberger's term). Followed by Hymer's hypotheses, it was regarded that technological predominance is the most momentous influence that it facilitates the introduction of new products with novel traits. Furthermore, the enhancement of knowledge base enables to build other traits such as marketing and improvement in production processes. Caves (1971) specified that one of the prominent features of this theory is, it explicated that the benefits are passed on effectually from one unit of a firm to another unit of that firm regardless of the fact that they are positioned in the same country or in different countries. Overseas investment delivers better volume of profit to firms, derived from the advantage of their market power in the imperfect market. This contention was favoured by some of the researchers. To cite one example, Graham and Krugman (1989) referred that in the earlier period, European firms were headed to invest in US owing to their technological advantages. Nevertheless, critics such as Robock & Simmonds (1983) argued that occupancy of firm specific advantages need not necessarily mean invetsment abroad as firms might very well exploit their advantages through exporting or licensing.

Nevertheless, it can't be regarded that Hymer's thesis did explain FDI fully as some failures occurred from his part to expound matters such as where and when FDI takes place. This has been overcome by Vernon's (1966) Product Life Cycle (PLC) theory, the eclectic approach by Dunning (1977, 1979 and 1988) and the internalization theory by Buckley and Casson (1976).

#### 3.3.1.2.2 FDI Theory Based on Monopolistic Power

Its Kindleberger (1969) propounded the theory of FDI on the basis of monopolistic power by expanding the work of Hymer. The contention of Kindleberger was that the benefits enjoyed by MNCs will be helpful only in the subsistence of imperfect market. The attendant advantages with foreign firms are superior technology, managerial expertise, patents etc. and these advantages inspire them to invest in a foreign country for the purpose of fully exploiting those in lieu of dividing them with the potential competitors in the foreign market. The greater the chances of earning monopoly profits, the higher will be the encouragement among firms to invest directly. Though, Kindleberger gave a description of several kinds of benefits broadly enjoyed by a foreign firm over the host country firm, he didn't explain on which advantage a firm should focus on to succeed in the host economy. The contention of harvesting of monopolistic profit by the foreign firm in the host economy is also a matter of uncertainty since the firm can make use of its monopolistic advantages only if the policy atmosphere of host economy nods assent for it. Commonly, for the sake of national interest, the host government would not be allowing free entry of foreign firms to their country.

#### 3.3.1.2.3 Theory of Internalization

Buckley & Casson (1976) explained FDI in another way stressing on intermediate inputs and technology. Thus, there occurred a shift in the focus of overseas investment theory from country-specific to industry and firm level determinants (Henisz, 2003). The theory of Buckley and Casson has been called as internalization theory because the emphasis of the theory was on the aspect of internalization with regards to the creation of MNCs. The theory has three hypotheses.

a. Firms maximize profit under imperfect market conditions.

b. when markets for intermediate products are imperfect, there is an incentive to bypass them by creating internal marktes.

c. Internalization of markets across the world leads to MNCs.

A new technology or process or inputs may be invented by a firm immersed in research and development. After invention, they may confront with the difficulty of transferring technology or sell the inputs to other unrelated firms because those other firms wouldn’t be able to bear the high transaction costs. In such a circumstance, the firm will go for internalization with backward and forward integration, i.e. the output of one subsidiary can be used as an input in the production process of another, or technology developed by one subsidiary may be utilized in others. When this kind of internalization takes place overseas, it means FDI. Buckley & Casson (1976) distinguished five forms of market imperfection which leads to internalization. They are as follows:

a. The co-ordination of resources requires a long time lag:

b. The efficient exploitation of market power requires discriminatory pricing;

c. A bilateral monopoly produces unstable bargaining situations;

d. A buyer cannot correctly estimate the price of the goods on sale; and

e. Government interventions in international markets create an incentive for transfer pricing.

Buckley & Casson had admitted the risk of host governement intervention. However, they didn’t take in to account the difference in the volume of this risk across various industries. To cite one example, industries such as power generation and telecom may confront with greater risk of goernemnet intervention since it requires the balancing of private objectives with social objectives.

**3.3.1.2.4 Oligopolistic Theory of FDI**

Knickerbocker (1973) too developed a theory based on market imperfections. In the economic literature, it has been affirmed that there are two significant motives behind the selection of a particular country as an investment location.

a. Firms seek enhanced access to the market of the host country.
b. Foreign firms also want to utilize the comparatively abundant factors in that country.

Besides these factors affirmed by the economic literature, Knickerbocker identified a third factor which leads foreign firms to carry out investment activities in a host economy- i.e. foreign firms will move to a foreign country to suit its competitor's action (Head et al., 2002). Otherwise stated, firms express emulative behavior i.e. they attempt to follow the internalization practices of their competitors in order not to lose their strategic advantage. Knickerbocker contented that firms in the similar industrial sector tries to follow each other's location decision. The case is that, firms confront an uncertainty of cost of production in the host country to which they are currently exporting and they are likely to face a threat of being undercut by a competitor switching from exporting to FDI (establishing a manufacturing subsidiary) in the host country. Thus, if the firm emulates the rival, it can evade the risk of being underpriced (Altomonte & Pennings, 2003).

Nevertheless, the hypothesis of oligopolistic reaction by Knickerbocker posits true only during the subsistance of uncertainty about costs in the host country. i.e. only oligopolistic firms which want to evade risk sufficiently is more probable to establish a unit in a host economy after its competeter (Head and others, 2002). During certainty, the incentive of a firm to invest overseas decreases with competeter's investment. Another drawback of the theory is that it does not explain what inspired the rival firm or the first firm to carry out FDI.

**3.3.1.2.5 Eclectic Paradigm to FDI**

One of the most persistent and comprehensive theories of FDI was developed by Dunning in 1970s (Read, 2007). In his trailblazing work, Dunning (1977 and 1979) consolidated the principal theories on FDI based on imperfect market conditions-the oligopolistic and internalization theories-and inserted a third dimension, in the form of location theory which expounds the opening of a foreign subsidiary by a firm. His location theory addresses prominent questions like; 1) Who produces? 2) What goods or services are being produced? 3) In which locations the production takes place? and 4)Why the foreign firm chooses overseas production? Various researchers gradually applied the location theory for understanding the factors influencing the location choice of MNC units. The factors identified include host economy policies, economic fundamentals, firm strategy and agglomeration economies.

Based on the above, Dunning(1993) recounted his theory, which is called as the *eclectic paradigm* or OLI paradigm. The proposition of Dunning was that a firm would undertake FDI only with the fulfillment of the three conditions as mentioned below:

a. It should have ownership advantages vis-à-vis other firms (O)

b. It is beneficial to internalize these advantages rather than to use the market to transfer them to foreign firms (I);

c. There are some location advantages in using a firm's ownership advantages in a foreign locale (L).

Ownership advantages are specific to firms. The ownership advantage enjoyed by firms over domestic and foreign competitors is in the form of both tangible and intangible assets. Such advantages result in the contraction in the production cost of the firm and permit it to rival with firms in the host country.

MNCs also consider the location advantages of various host economies before beginning their activities. After evaluating the location advantages in several countries, they choose a location that matches with their activities.

A firm can evade risks such as uncertainty, problems of control etc by avoiding market imperfections. Internalization makes a firm more profitable when the firm is not going to external markets to get its transactions done.

The prime attribute of the eclectic theory is that all the three conditions mentioned above must be fulfilled before the occurrence of FDI. Dunning (1980) mentioned that the "OLI triad of variables determining FDI and MNCs activities may be likened to a three-legged stool; each leg is supportive of the others, and the stool is only functional if the three legs are evenly balanced".

This implies that a firm with ownership and internalization advantages, but no location advantage is incurred by setting up a unit in a foreign country, will very likely choose to increase its production at home and export its product(s) abroad. In the same way, a firm having ownership and location advantages will find it more profitable to produce abroad than to produce domestically and export its product(s); however, if there are no internalization gains then the firm will be better off licensing its ownership advantage to foreign firms (Nayak & Choudhury, 2014).

Thus, Dunning could consolidate several complementary theories and he identified a bunch of factors which influenced the activities of MNCs. Accordingly, his theory received broad acceptance than other theories based on imperfect market. However, critics mentioned that the theory includes too many variables and because of that reason, it has no operational practicality.

In order to overcome this shortcoming, Dunning brought forward the theory of Investment Development Cycle or Path (IDP).

**3.3.1.3 FDI Theories Based on Strength of Currency**

Aliber (1970) principally made an effort to explain FDI on the basis of strength of currency. He focused on the relative strength of various currencies to explain FDI. His postulation was that weaker currencies compared with stronger investing country currencies had a higher capacity to attract FDI in order to take advantage of differences in the market capitalization rate. He experimented with this presumption and confirmed the result with FDI in U.S, U.K and Canada. However, this theory was criticized on the ground that it does not give explanation for investment between two developed countries that have currencies of equal strength. Besides, the theory also fails to explain the investment goes from a developing country (Weaker currency) to a developed country (Stronger currency).

Most of the above described theories are based on a Western developed world perception. In this circumstance, it is to be noted that developed Asian countries like Japan has also contributed to the theoretical framework on FDI.

Kojima (1973, 1975 and 1985) put forward one of the first theories on FDI from Asian developed countries mainly concerned with the FDI outflow from Japan. He delineated that firms from Japan went for overseas investment mainly due to their inability to compete with the domestic firms in Japan. He argued that the more efficient local firms were pushing the less competent firms out of the local market. Consequently, the weaker firms are compelled to move overseas, especially to other developing countries. However, this hypothesis failed as it does not give description about the internationalization of competent domestic firms.

## 3.3.2 Impact of FDI on the Host Economy: Theoretical Approach

Regarding the impact of FDI on host economy, primarily there are two models viz. (1) The benevolent (benign) model of FDI and development and (2) The malign model of FDI and development.

### 3.3.2.1 The Benign Model of FDI and Development

As per this hypothesis, FDI is more useful for underdeveloped economies. FDI has the ability to break the vicious circle of poverty in developing economies by contributing to domestic savings and by giving more effective managerial, technological and marketing support to improve productivity (Cardoso and Dornbusch 1989). However, the gain in the national income from FDI relies on the size of the capital flows and the elasticity of the demand for capital. Moreover, technological and managerial inputs, transfers and spillovers to local firms, etc. from FDI may result in the upward shift of the host economy's production function. Thus, under competitive conditions (which the presence of foreign firms and FDI may enhance), FDI should raise efficiency, expand output and lead to higher economic growth in the host economy. This model has two assumptions.

First, the gap in savings and in foreign exchange determines the long terms growth at the macro level. Second, the additional supply of capital through FDI should lower the relative returns on capital while the additional demand for labour should bid up the wages of workers. In reality, these assumptions may not be valid to validate the argument of this model.

#### 3.3.2.2 The Malign Model of FDI and Development

Being the alternative theory to the 'Benign model' the 'Malign model' claims that FDI can have negative effects on the economic growth of the host country. Advocates of this model argue that foreign companies in imperfectly competitive international industries will harm the economic growth of a host country with an imperfectly competitive domestic market. People of the developing countries used to suspiciously view FDI and it is just recently they turned to change their unfavorable attitude towards FDI. Initially, some studies, including that of Singer (1950) showed that foreign capital had negative impact on the growth of developing economies. The foreign firms made destructive impact on the host economy because they operated in industries where there substantial barriers to entry and increasing market concentration (Grieco, 1986). In such a case, the foreign firms lowered the domestic savings and investment by extracting rent.

## 3.4 Foreign Direct Investment (FDI) Policy in India

In India, the Policy on foreign direct investment, in point of fact is a comprehensive one which covers aspects like incentives and disincentives to the foreign investors, technology transfers, foreign trade, foreign currency and general industrial policy. On the eve of independence, government of India led by the British received a policy of accepting unconditional and unrestricted flow of foreign capital due to political dependency. After independence, policy makers in India recognized the prominence of receiving foreign capital as a source of fund, and introduction of novel technology. The country distinguished FDI as a factor to deplete the dearth of capital and technology in its key sectors. The government's FDI policy after independence can be described as the one which evolved over time in tune with the requirements of process of development in different phases. Immediately after independence, the government started to frame its policies focusing on import substitution for improving the local capability in heavy industries including machinery manufacturing. The industrial policy resolution of India from 1948 to 1956 reflects the desire of the government to achieve self-sufficiency in industrial production. This strategy of import substitution and achieving self-sufficiency guided the country's industrial sector until mid-1980s and it resulted in Indian industrial sector having inferior technology. It didn't give the sector an exposure to sustain effectively in the vast world of competition, and finally led to low efficiency. With economic reforms in 1991, investment policies in India have been gradually liberalised, increasing the receptiveness of the economy to foreign investment flows. Therefore Indian foreign investment policy evolution is bifurcated as policy in Pre-Liberalisation Period and Post-Liberalisation Period.

Pre- liberalization period witnessed crucial shortage in the consumption of fixed capital. Consumption of fixed capital is decisive in the process of growth and development. Table 3.2 presents the statistical characteristics of major economic parameters in Indian economy. It shows the averages of growth for two periods i.e. before liberalization and after liberalization.

**Table 3.2**
**Descriptive Statistics of Major Economic Parameters – Before and after Liberalization**

| | Population (Crore) | Consumption of Fixed Capital | GDP at Market Prices | Personal Disposable Income |
|---|---|---|---|---|
| **Average** | 2.15 (1.75) | 12.40 (14.33) | 10.76 (13.85) | 10.59 (13.53) |
| **Minimum** | 1.67 (1.37) | -9.16 (7.57) | -5.42 (7.63) | -6.40 (5.88) |
| **Maximum** | 2.47 (2.29) | 28.82 (22.75) | 21.71 (20.17) | 23.58 (21.33) |
| **Median** | 2.18 (1.81) | 12.04 (14.92) | 10.85 (14.81) | 10.58 (14.25) |
| **Std Dev** | 0.18 (0.28) | 7.09 (3.32) | 5.96 (3.32) | 6.53 (3.84) |
| **Skewness** | -0.65 (0.12) | -0.67 (0.29) | -0.46 (-0.52) | -0.13 (0.08) |
| | **Net Domestic Capital Formation** | **Net Domestic Saving** | **Per Capita NNP at Factor Cost (Rs)** | **Net National Disposable Income** |
| **Average** | 16.96 (17.55) | 15.35 (17.62) | 8.12 (12.03) | 10.63 (13.97) |
| **Minimum** | -51.17 (-17.68) | -26.64 (-8.45) | -7.71 (5.04) | -5.34 (7.06) |
| **Maximum** | 64.88 (51.79) | 62.47 (36.12) | 20.07 (16.80) | 21.91 (19.20) |
| **Median** | 14.81 (22.11) | 13.43 (20.48) | 8.06 (13.00) | 10.64 (14.73) |
| **Std Dev** | 22.92 (16.53) | 18.72 (12.82) | 6.16 (3.30) | 5.98 (3.44) |
| **Skewness** | -0.08 (-0.24) | 0.22 (-0.71) | -0.24 (-0.80) | -0.39 (-0.61) |

Source: Author's compilation from the Handbook of Statistics on Indian Economy, various years, RBI.
Note: Figures denote averages of growth for the period of forty years i.e., 1951-52 to 1991-92. Figures in the parentheses show averages of growth for the period of ten years i.e., 1991-92 to 2010-11

The inadequate growth in the economic parameters such as GDP, Personal Disposable Income, Savings, Per Capita NNP and Net National Disposable Income also shows that the Indian economy before liberalization had continued downtrends. A brief account of these aspects is outlined in Appendices (Table 1). It necessitated the opening of Indian economy, especially through the upbringing of direct foreign investment.

## 3.4.1 Pre -Liberalization Era

The government was revamping its policy on FDI in each period, as a stimulus to the foreign exchange crisis prevailed during that particular period. It denotes the role of the underflow of balance of payment crisis in shaping the country's policy towards FDI. For instance, it was amongst the foreign exchange crisis in 1957-58, the government of India, for the first time, attempted on attenuating its policy towards FDI. As a result of that reformation, the country's foreign exchange position improved in the late sixties, the government again began to restrict foreign investment inflows. During this circumstance, the government enacted Foreign Exchange Regulation Act (FERA) in 1973 and the Act played a crucial role in guiding and controlling foreign investment inflows.

By the early eighties, the second oil crisis emerged and India failed to augment its exports, which resulted in the deterioration of forex reserves in the country. The then government adopted a multi-pronged strategy for export promotion. As a part of that, TNCs were encouraged to undertake export-oriented manufacturing. In the eighties, the government thus had selective efforts to promote FDI, especially in high technology and export-oriented sectors. As a part of that, restrictions on large firms and FERA companies were minimized, and it indicated the formation of a more conducive environment for private investment including foreign investment inflows. The eighties were in a way, the precursors of the liberalization policy of the nineties.

Later in the early nineties, when the Indian economy slid in to serious balance of payment crisis, the then government was compelled to go for more comprehensive macro economic reforms with focus on liberalization and privatization aspects. During this period the policy on foreign investment of India was featured with transparency and openness. However in the pre-liberalization era FDI policy has been evolved principally through three phases as follows.

a. Phase 1-*Cautions Welcome Policy* from independence to the emergence of crisis in the late sixties (1948-66).
b. Phase II-*Selective and Restrictive Policy* from 1967 till the second oil crises in 1979.
c. Phase III- *Partial Liberalization Policy* from 1980 to 1990 with progressive attenuation of regulations.

### 3.4.1.1 Phase – I: 1948 to 1966 – The period of Cautious Welcome Policy

India's industrial policy resolution in 1948 itself had distinguished the importance of foreign capital, particularly, the industrial techniques and management expertise that can be gathered from it, as central to the industrialization process in the country. However, for protecting national interest, the entry of foreign capital during those days had to be carefully regulated. The policy during those days was major interest in ownership and effective control would remain in the hands of Indians even if there were privileges for special cases.

In April 1949, the then Prime Minister Shri. Jawaharlal Nehru proclaimed that foreign investors would be given non-discriminatory treatment inside the country. Firms with foreign investment would be treated at par with Indian firms. Free remittance of profits, dividends, interest and repatriation of capital etc was assured for foreign investors. If any of the foreign firms were nationalized, they were offered reasonable compensation. Foreign investors approached India in the mid 1950s principally with technical collaborations. During that period, industrialization was progressing in India. However, India had to face a foreign exchange crisis in 1958 and it entirely changed the nature of foreign investment in India in two ways: (1) Foreign investors began to have equity participation more frequently in the Indian firms (2) Instead of royalties and fees for technical collaborations, the foreign investors started to have equity participation in the Indian firms. Indian entrepreneurs were allowed to take provisional license for securing part or all of the foreign exchange by way of foreign investment after 1958. The licensing procedure was streamlined to avoid delays in the approvals of foreign collaborations. India government signed double taxation avoidance agreements with countries like West

Germany, France, Finland, USA, Pakistan, Ceylon, Sweden, Norway, Denmark, Japan etc. In May 1966, the government took a decision that unlimited investments by Non Resident Indians (NRIs) would be allowed in public limited industrial firms in India. In private limited industrial concerns with a minimum issued and paid up capital of Rs. 10 lakhs, their investment would be allowed up to 49 percent. In special cases, it would be increased to 51 per cent or even more, provided resident Indian participation would go up to 49 per cent within a period of, say five years. But they would not be allowed to invest in proprietorship or partnership and dividends would not be allowed to be repatriated.

**3.4.1.2 Phase – II: 1967 to 79 – The Period of Selective and Restrictive Policy**

Policy of India on FDI can be evaluated as moderately liberal till the mid 1960s. However, in the late 1960s, with the enactment of the Monopolies and Restrictive Trade Practices Act (MRTP) in 1969, the industrial policy regime in India became highly restrictive. The government received such a restrictive policy in the mid 1960s because of the progress occurred in the technical capacity of domestic industry on one hand and the large scale outflows of foreign exchange from India in the form of dividends, profits, royalties and technical fees by foreign investors on the other hand. The Act demanded that all firms with a capital base of over 20 million Rupees to be classified as MRTP firms and were allowed to enter only in selected industries and that too was on a case by case basis. Besides industrial licensing, all additional investment proposals by these MRTP firms necessitated separate permission from the department of company affairs.

The industrial licensing policy of 1970 confined the role of large business houses and foreign companies to the core, heavy and export oriented sectors (Palit, 2009). The government had such a restrictive attitude towards foreign investment for the reason that they wanted to protect the growing Indian industries from the threat of foreign and private investment. There was a presumption that the sophisticated products from foreign investors may challenge the Indian products and industry.

In 1973, the new Foreign Exchange Regulation Act (FERA) came into force, requiring all foreign companies operating in India to register under Indian corporate legislation with up to 40 percent equity (Sahoo, 2006). The Industrial Policy Statement of 1973, inter alia, identified high-priority industries where investment from large industrial houses and foreign companies would be permitted (Statement on Industrial Policy, 1991).

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.

Amongst the raising concerns about the foreign exchange cost of repatriated profits and dividend, the government introduced a new clause in FERA in 1973 that required firms to dilute their foreign equity holdings to 40 per cent if they wanted to be treated as Indian companies (Athreye and Kapur 2001). It was the FERA which provided the regulatory framework for the commercial and manufacturing activities of the branches of foreign companies in India and Indian joint stock companies with foreign equity participation of over 40 per cent. The Act insisted a list of industries where such firms with high equity participation would be allowed to operate and all new investments by such firms necessitated separate approval from the department of company affairs. Besides, there were more restrictions on technology imports. Technology acquisitions were allowed mostly through licensing rather than through financial collaborations.

For bringing investment from NRIs, the government granted permission for NRIs and Persons of Indian Origins (PIOs) to invest in the equity capital of permitted industries, i.e. up to a maximum of 20 per cent of new issues of capital of new Industries.

### 3.4.1.3 Phase – III: 1980-90 – The Period of Partial Liberalization

The decade of eighties witnessed partial liberalization in the FDI policy of India. During this decade, policy makers began to perceive FDI as a source for earning foreign exchange rather than it being a supplement to local industries. '*Hindu rate of Growth*' was the term used to describe the pathetic socio-economic performance of India in the past thirty years. Low productivity, inefficiency of local industries etc. which country had during those periods were presumed to be the outcome of too much protection rendered to Indian industrial sector from foreign markets. Such protectionist policies of the Indian government resulted in the inefficiencies of the industrial sector of the country compared to those other developing countries which were having liberal FDI policies.

The major reform occurred as part of liberalization was the abolition of restrictions imposed on industries by FERA. The public sector was freed from a number of constraints and was provided greater autonomy. Services sector such as real estate, telecommunications and banking sector was opened to foreign direct investors. In 1988, all industries, except 26 industries specified in the negative list, were exempted from licensing. The exemption was, however, subject to investment and location limitations. The automotive industry, cement, cotton spinning, food processing and polyester filament yarn industries witnessed modernization and expanded scales of production during 1980 (Industrial Policy, 1980). Promotion of competition in the domestic market, technological up-gradation and modernization etc. were emphasized in the industrial policy statement of 1980. The industrial policy motivated foreign investment in complicated-technology areas. Limitations under FERA on foreign equity to 100 percent export oriented units were liberalized. However, prior approval of government was required on all foreign investments in India and repatriation of capital. Foreign majority holdings for foreign exchange were rarely allowed under Foreign Exchange Regulation Act. As a result environment for foreign investment in India remained largely hostile.

## 3.4.2 Post - Liberalization Era

FDI policy in the post-liberalization era has been classified in to two as (a) 1991 to 2000: The Period of Liberalization and Open Door Policy and (b) from 2000 and onwards: Further Liberalization in the FDI Regime.

### 3.4.2.1 Phase IV – 1991 to 2000: The Period of Liberalization and Open Door Policy

It was in July 1991, India initiated its full-fledged economic reform activities. Policy makers brought drastic change and liberalization in the country's FDI policy regime also in order to increase the inflow of foreign investment. The industrial policy statement of 1991 emphasized on the complete exploitation of the foreign investment opportunities.

For bringing FDI to high priority industries which demanded large investments and advanced technology, the government took decision to allow foreign equity holding up to 51 per cent in such industries (Statement on Industrial Policy, 1991). This group of industries was the 'Appendix I Industries' and were areas in which FERA companies had already allowed foreign investment on a discretionary basis. FDI equity was allowed up to 51 per cent for the reason that it will allow foreign firms to amalgamate profits and losses from such a company in to those of the parent company for tax purposes. Technology import was also put under the automatic route subject to conditions on royalty (< 5% domestic, < 8% export) and lump sum payment (< Rs. 1 crore) (Virmani, 2001).

One of the sea changes brought in by the FDI reforms in 1991 was the two-way approval process for FDI. First was the automatic approval route. Under this route, the proposed manufacturing or industrial activity does not require an industrial license. Initially, the limit on foreign investment was 51 per cent. For bringing investment under the automatic route, it needed to formally inform RBI. However, the condition has been removed and the firms are required to inform RBI about foreign investment only after the issue of shares to the foreign firm. The top limit for foreign equity investment under automatic approval route was augmented from 51 to 74 per cent of the equity capital (100 per cent in case of NRIs) in select industries in January 1997. The list of industries to which investment can be brought down under automatic route was also expanded. It was proclaimed further in the budget speech of 1999-2000, that the range of automatic approval route would be further expanded. If the foreign investors wanted to enter other industries or secure higher per cent of foreign equity for themselves, they had to go through a formal process of case by case approval by the government with the Foreign Investment Promotion Board (FIPB) playing the main role (Rao, Murthy and Ranganathan, 1999). The FIPB was set up in the early 1990s, as the nodal and single window agency for all matters relating to FDI, with a view to promote FDI into India, (i) by undertaking investment promotion activities, (ii) facilitating foreign investment, (iii) purposeful negotiation/discussion with potential investors, (iv) early clearance of proposals, and (v) reviewing policy and putting in place appropriate institutional arrangements, transparent rules and procedures and guidelines for investment promotion and approvals.

Besides FIPB, there are several other bodies also like Secretariat of Industrial Assistance (SIA) and Foreign Investment Implementation Authority (FIIA).

SIA, Ministry of Commerce & Industry, offers a single window service for entrepreneurial help, investor facilitation, accepting and processing all applications, assisting entrepreneurs and investors in setting up projects (including liaison with other organizations and state governments) and in monitoring the implementation of projects.

FIIA provides a pro-active one stop after service care to foreign investors by helping them obtain necessary approvals, sort out operational problems and meet with various government agencies to find solution to their problems (Sahoo, 2006).

Additional liberalization measures during the period included: (i) FERA amended to abolish the general ceiling of 40 per cent on foreign ownership in FDI projects. (ii) The ban existed on the use of foreign brand names in the domestic markets was removed. (iii) The dividend balancing condition was withdrawn for all foreign investment approvals except for 22 industries in the consumer goods sector (iv) export obligations were relaxed (v) The terms of technology and royalty agreements were liberalized and ; (vi) The sectors reserved for the SSI were opened up for foreign investments up to 24 per cent of equity ownership. In 1997, automatic route approval was expanded to 111 high priority sectors with various equity ownership limits between 50 per cent and 100 per cent, OECD, (2009).

#### 3.4.2.2 Phase V – From 2000 and onwards: Further Liberalization in the FDI Regime

The fourth phase of the FDI policy, between 2000 till date, has been reflecting the intention of increasing globalization of the country. The year 2000 and onwards have been depicted as a separate phase in the FDI policy regime because, the FDI policy framework did undergo for sea changes during the year. It was in this year, majority of the sectors were placed under the automatic route, except a few. The dividend balancing condition was also removed during the same year. In several sectors, the threshold limit for equity holding elevated progressively. Foreign investment sector of NBFCs was brought under automatic route. The insurance and defence sectors were opened up to a cap of 26%. The cap for telecom services was increased from 49% to 74%. FDI was permitted up to 51% in single brand retail. A sea-change happened in 2009 with regard to the differentiation between 'ownership' and 'control'. It was with the purpose of calculating the total foreign investment-direct and indirect-in an Indian company. Indian companies having FDI, owned and controlled by Indian residents were permitted downstream investments without government approval. Restrictions on disbursement of royalty were eliminated.

The liberalization efforts in the FDI regime continued in the year 2010 also. For ensuring transparency, all existing regulations on FDI were consolidated in to a single document. Downstream investment through internal accruals was specifically permitted (Discussion Paper, DIPP, 2011). *DIPP's* Circular 1 of 2011 allowed issue of shares against non-cash considerations (*in respect of import of capital goods/ machinery/ equipment and pre-operative/ pre-incorporation expenses)* and also provided flexibility in fixing pricing of convertible instruments through a formula, rather than upfront fixation. The requirement of Government approval for establishment of new joint ventures in the *'same field'* was also done away with. As a result, non-resident companies were allowed to have 100 per cent owned subsidiaries in India. Government allowed FDI, in Limited Liability Partnerships *(DIPP's Press Note 1 of 2011).* It may be observed that the overall effect of liberalization is favourably reflected in the economic parameters of economy. A brief account of the parameters is shown in Appendices (Table 2).

The major policy changes occurred in the FDI regime from 1991 to 2018 has been summarized in the following table:

**Table 3.3**
**A Round-up of FDI Policy from 1991 to 2018**

| Sl No | Period | Policy Change |
|---|---|---|
| 1 | **1990-1991** | • During this year, up to 51 per cent of foreign equity holding under automatic route was allowed in 34 high priority sectors (Mostly in manufacturing sectors and in a few service sectors) |
| 2 | **1992-1993** | • FDI was allowed in the mining sector. |
| 3 | **1993-1994** | • Permission for repatriating profits and capital was given to foreign investors and NRIs. |
| 4 | **1997-1998** | • Non-Resident Indians (NRI) and Overseas Corporate Bodies (OCB) were given automatic approval for equity in priority industries.<br>• FDI policy regime in mining was further liberalized in January 1997. Foreign equity holding of up to 50 per cent was allowed under automatic route in mining projects and the equity participation was raised to 74 per cent in the service sectors related to mining. |
| 5 | **1998-1999** | • FEMA was introduced instead of FERA which revealed the change in the government attitude towards FDI. |
| 6 | **1999-2000** | • Foreign Investment Implementation Authority (FIIA) was founded with the purpose of establishing a single point interface between foreign investors and the government machinery, including state authorities. This body was also empowered to give comprehensive approvals. |

| | | |
|---|---|---|
| 7 | **2000-2001** | • In the year 2000, a paradigm shift occurred, wherein, except for a negative list, all the remaining activities were placed under the automatic route.<br>• There came the abolishment of the dividend balancing condition on consumer goods.<br>• The NBFC Sector was placed on the automatic route. |
| 8 | **2005-2006** | • In March 2005, the government announced a revised FDI policy. As a part of that, decision was taken to allow foreign equity participation up to 100 per cent under automatic route in townships, housing, built-up infrastructure and construction development projects.<br>• The Special Economic Zone (SEZ) Act also came in to force in 2005, which enabled a good deal of construction and township development.<br>• The cap for telecom services was increased from 49% to 74%.<br>• FDI was allowed up to 51% in single brand retail. |
| 9 | **2009-2010** | • FDI regime in various sectors like commodity exchanges, credit information and aircraft maintenance were liberalized.<br>• Cent per cent FDI was allowed in Maintenance, Repair and Overhauling (MRO).<br>• Cent per cent FDI was allowed in the sector of mining of Titanium bearing minerals.<br>• Hike in the ceiling of FDI in the public sector oil refineries.<br>• Foreign investors were exempted from minimum capitalization and a three year lock-in period. |
| 10 | **2011-2018 February** | • In 2011, FDI was allowed in Limited Liability Partnerships (LLPs).<br>• India allowed full foreign ownership in parts of the agriculture sector, namely in the development and production of seeds and planting material, animal husbandry, pisciculture, aquaculture under controlled conditions and services related to agribusiness and related sectors<br>• In the defence sector, foreign investment beyond 49 per cent has been permitted through government approval route.<br>• Permitted FDI up to 100 per cent under automatic route in the sector of manufacturing of medical devices without any distinction of green-field or brown-field.<br>• 74% FDI under automatic route has been permitted in brown-field pharmaceuticals. FDI beyond 74% is allowed through government approval route. |

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| | | • Foreign equity caps in the activities of non-Scheduled air transport service etc have been increased from 74% to 100% under the automatic route. 100% FDI under automatic route has been allowed in brown-field airport projects. FDI limit for scheduled air transport services etc. raised to 100%, with FDI up to 49% permitted under automatic route and FDI beyond 49% through Government approval. Foreign investment in ***Air India*** has been allowed up to 49%.<br>• 100% FDI is permitted under the automatic route in Limited Liability Partnerships (LLPs) through the automatic route.<br>• 100% FDI under automatic route has been permitted in Single Brand Retail Trading (SBRT).<br>• Foreign investment in the private sector banking raised to 74 per cent.<br>• Foreign investment in the insurance sector elevated from 26 per cent to 49 per cent under automatic route.<br>• Raised the cap of foreign investment to 100 per cent under automatic route in several sectors and activities under rail infrastructure.<br>• 100% FDI under automatic route is permitted in marketplace model of e-commerce.<br>• Drastic changes in the FDI policy regime in sectors like broadcasting ,construction, plantation, manufacturing, trading, power exchanges, artificial satellites, white label ATM operations, food product retail trading, asset reconstruction companies, private security agencies, animal husbandry etc. |

Major changes accommodated in the FDI policy with regard to sectors such as defence industries, railway infrastructure, construction development, civil aviation, trading, pharmaceuticals, medical devices, broadcasting, insurance, pension and other financial services, ATMs, asset reconstruction companies, credit information companies, stock exchanges, plantations, Central Public Sector Enterprises (CPSEs), private security agencies and animal husbandry, from August 2014 to January 2018 (Table 3.4).

**Table 3.4**

**Major Modifications/Announcements (India's FDI Policy since August 2014)**

| Sector | Policy Changes |
|---|---|
| Defence Industries | 1. **Aug 2014:** While raising the general cap to 49 per cent, it was stated that the combined share of FII, FPI, NRI, FVCI and QFI investment cannot exceed 24 per cent (portfolio investors). However, the portfolio investment was allowed though the automatic route.<br>2. **Nov 2015:** The sub-limit of 24 per cent for portfolio investments within the 49 per cent foreign investment in defence industries was removed.<br>3. **Jun 2016:** The cap on FDI was completely removed. Investments up to 49 per cent can avail the automatic route. Govt. can permit shares beyond 49 per cent wherever it is likely to result in access to 'modern technology or for other reasons' |
| Railway Infrastructure | **Aug 2014:** FDI policy for railway infrastructure was relaxed -- construction, operation and maintenance of high speed trains, freight and passenger terminals and rolling stock, including train sets, and locomotives/coaches: 100 per cent FDI through the automatic route. |
| Construction Development | 1. **Dec 2014:** Relaxed the policy applicable to the sector.<br>• Development of serviced plots: minimum land area of 10 hectares removed.<br>• Construction-development projects: minimum floor area 20,000 square meters. Earlier, minimum built-up area 50,000 square meters.<br>• Minimum inflow \$5 million (earlier \$10 million) for both wholly-owned subsidiaries and joint ventures.<br>• Investor will be permitted to exit on completion of the project or after development of trunk infrastructure.<br>• The government may permit repatriation of FDI or transfer of stake from one non-resident investor to another before completion of the project.<br>• Earlier there was a lock-in of three years, with provision to exit with prior government approval.<br>2. **Nov 2015:** Minimum floor area and investment requirements were removed.<br>• Transfer of stake from one non-resident investor to another would neither be subject to lock-in period requirement nor would specific government approval be needed. |
| Civil Aviation, Ground Handling and Satellites | 1. **Nov 2015:** The limit of 74 per cent was abolished for non-scheduled air transport service.<br>• Ground Handling Services: 74 per cent cap and the requirement of approval for FDI beyond 49 per cent was removed.<br>• Satellites establishment and operation: 100 per cent through approval route. Earlier the limit was 74 per cent.<br>2. **Jun 2016:**<br>• Scheduled/Regional Air Transport Service: FDI limit was raised from 49 per cent to 100 per cent (automatic up to 49 per cent and |

| | |
|---|---|
| | approval route beyond 49 per cent).<br>• Existing airport projects, 100 per cent automatic.<br>• Earlier automatic up to 74 per cent and approval route beyond 74 per cent.<br>3. **Jan 2018:** Foreign investment was permitted in Air India Ltd. |
| Trading | 1. **Nov 2015:** 30 per cent sourcing norm could be relaxed in case of Single Brand Retail Trading for trading of products having 'state-of-art' and 'cutting-edge' technology and where local sourcing is not possible.<br>• Unlike earlier, Single Brand Retail Trading (SBRT) FDI companies can undertake retail trading through e-commerce also.<br>• New provision permitting 100 per cent FDI in Duty Free Shops through automatic route introduced.<br>2. **Mar 2016:** Share of a single vendor cannot exceed 25 per cent of the sales effected though market place based e-commerce entity. Influencing of sale prices was prohibited.<br>3. **Jun 2016:** Sourcing norms will not be applicable up to three years from commencement of the business for undertaking SBRT of products having state-of-art and 'cutting-edge' technology and where local sourcing is not possible.<br>• 100 per cent FDI under approval route is allowed for trading, including through e-commerce, in respect of food products manufactured and/or produced in India.<br>4. **Jan 2018:** 100 per cent FDI allowed in SBRT through the automatic route. |
| Pharmaceuticals | **Jun 2016:** Limit for automatic approval in case of brown-field investment was raised from 49 per cent to 74 per cent. |
| Medical Devices | **Jan 2015:** Carving out of medical devices and freeing it from the requirement of government approval in case of brown-field investments. |
| Broadcasting Sector | 1. **Nov 2015:** FDI limits applicable to the sector were relaxed substantially.<br>• For Teleports, DTH, Cable Networks, Mobile TV and Head-in-the Sky Broadcasting Service, the cap of 74 per cent removed: up to 49 per cent FDI through automatic route and beyond 74 per cent through approval route.<br>• For Cable Networks the limit was raised from 49 per cent to 100 per cent: automatic up to 49 per cent and approval route beyond 49 per cent.<br>2. **Jun 2016:** Teleports, DTH, Cable Networks, Mobile TV, Head-in-the Sky Broadcasting Service, Cable Networks: 100 per cent FDI through the automatic route (earlier up to 49 per cent through automatic route and approval route beyond 49 per cent). |

| | |
|---|---|
| Insurance, Pension Sector and other Financial Services | 1. **Mar 2015:** FDI limit was raised from 26 per cent to 49 per cent: automatic up to 26 per cent and approval route for foreign share exceeding 26 per cent.<br>• Limit is composite for FDI, FPI (FII/QFI), NRI, FVCI and Depository Receipts.<br>2. **Apr 2015:** Pension sector opened to FDI. Applicable conditions same as for insurance.<br>3. **Mar 2016:** Foreign investment allowed in the insurance and pension sectors through the automatic route up to 49 per cent.<br>4. **Oct 2016:** 100 per cent FDI was allowed through the automatic route in 'other financial services'. |
| ATMs | **Oct 2015:** FDI up to 100 per cent was allowed in White Label ATMs (WLAs) through the automatic route. |
| Asset Reconstruction Companies | **May 2016:** 100 per cent FDI was allowed through the automatic route. |
| Credit Information Companies | **Nov 2015:** The 74 per cent cap on FDI was removed. |
| Stock Exchanges | 1. **Jul 2016:** Cabinet accorded approval for raising the limit of FDI in Stock Exchanges from five per cent to 15 per cent.<br>2. **Feb 2017:** FDI up to 49 per cent in infrastructure companies in Securities Markets. |
| Plantations | **Nov 2015:** 100 per cent FDI through Automatic Route was allowed in Tea, Coffee, Rubber, Cardamom, Palm Oil tree and Olive Oil tree plantations. Earlier 100 per cent FDI had been allowed in Tea plantations though the approval route. |
| Animal Husbandry | **Jun 2016:** The requirement of 'under controlled conditions' was removed. |
| Private Security Agencies | **Jun 2016:** FDI Limit was raised from 49 per cent to 74 per cent - approval route for FDI between 49 per cent and 74 per cent; earlier up to 49 per cent under approval route. |
| Definition | **Jun 2015:** Definition of ***NRI*** was expanded to include 'Overseas Citizen of India' in addition to 'Persons of Indian Origin' cardholders.<br>• Further, NRI investments were decided to be deemed as domestic investment at par with the investments by residents. |
| Central Public Sector Enterprises (CPSEs ) | **Feb 2016:** Budget Speech contained the following.<br>(i) The existing 24 per cent limit for investment by FPIs in Central Public Sector Enterprises, other than Banks, listed in stock exchanges, will be increased to 49 per cent.<br>(ii) Effective implementation of Bilateral Investment Treaties(BITs) signed by India with other countries will be ensured with a Centre State Investment Agreement in order to ensure the fulfillment of the obligations of the State Governments under these Treaties. |

Source: '*India's Recent Inward Foreign Direct Investment: an Assessment*', Rao & Dhar (2018)

## 3.5 Abolition of Foreign Investment Promotion Board (FIPB)

In February 2017, the then Minister for Finance Sri. Arun Jaitley in his budget speech, proposed for the exclusion of FIPB, which was constituted in the early 1990s. The Finance Minister in his Budget speech stated that over 90 per cent of total FDI inflows are through the automatic route and the country has now reached on a stage where FIPB can be weeded out. After he declared to dismiss FIPB, the union cabinet approved his proclamation. With the discharge of FIPB, applications for foreign investment are now considered by the concerned ministerial departments.

FIPB was formulated as a part of the restrictive attitude of the country towards foreign investment in the wake of economic liberalization. Throughout these years after economic liberalization, India has been recognizing the significance of more liberalization in the zone of foreign investment. Whenever the country recognized that it is imperative to free the sectors, it had not shown any languor to do so. Up to the year 2000, this Board had an influential role in approving foreign investments as more than 88 per cent of the foreign investment came through the government route during this period. This has been delineated in the following table (Table 3.5).

**Table 3.5**

**FDI through Various Routes (1991-00, US $ Million)**

| Year(Jan-Dec) | FIPB & SIA Route | RBI's Automatic Route |
|---|---|---|
| 1991(Aug-Dec) | 78 | 0 |
| 1992 | 188 | 18 |
| 1993 | 340 | 79 |
| 1994 | 511 | 116 |
| 1995 | 1264 | 169 |
| 1996 | 1677 | 180 |
| 1997 | 2824 | 242 |
| 1998 | 2086 | 155 |
| 1999 | 1474 | 181 |
| 2000 | 1474 | 395 |
| **Total** | **11916** | **1535** |
| **Per cent** | **88.58** | **11.41** |

Source: FIPB Review, 2009.

Table 3.5 outlines the quantity of FDI received both under automatic route and government route for the period 1991-2000. During this period, economic liberalization was in its infancy stage. The working paper of DIPP (2011) has clearly stated that up to 2000, India had not significantly liberalized its sectors for foreign investment, and allowed most of the investments to come through government route. The data in the table validates this statement, as it is perceptible that around 89 per cent of the FDI had come via government route during that period. It also signifies the prominent role played by FIPB during that phase. The following table (Table 3.6) shows the rout-wise FDI received between 2001 and 2008.

**Table 3.6**

**FDI Received Through Various Routes (2001-08, US $ Million)**

| Year(Jan-Dec) | FIPB&SIA Route | RBI's Automatic Route |
|---|---|---|
| 2001 | 2142 | 720 |
| 2002 | 1450 | 813 |
| 2003 | 934 | 509 |
| 2004 | 1055 | 1179 |
| 2005 | 1136 | 1558 |
| 2006 | 1534 | 7121 |
| 2007 | 2586 | 8889 |
| 2008 | 3209 | 23651 |
| **Total** | **14046** | **44440** |
| **Per cent** | **24.06** | **75.98** |

Source: FIPB Review, 2009.

The data on FDI (Table 3.6) is a factual mirror image of the policy frame that we had on FDI during those days. It signifies the paradigm shift occurred in the FDI policy regime in the year 2000, with which several sectors were placed under automatic route. As a result, more than 75 per cent of the foreign investment started to come up via automatic route and FIPB had to consider only the remaining 24 per cent. Thus, the role of FIPB began to shrink from that phase onwards. FIPB (2014) stated that more than 85 per cent of the foreign investment comes through automatic route now a day. This statement in the review connotes the insignificance of maintaining such an exclusive board for FDI approvals. Thus, the dismissal of the board can be perceived as an aftermath of the policy of inclusive liberalization of the country. Moreover, FIPB had more or less accomplished the objectives for which it had been formed in the wake of liberalization. A complete picture of the route - wise inflow of FDI in to India from 2000 to 2018 is provided in the next chapter (Chapter IV, Table 4.12).

The evaluation of the FDI policy of India after the period of independence shows that, '*Policy framework of FDI is apt with regard to the economic conditions of India'***.** However region centric reforms are to be incorporated in the policy.

## 3.6 Conclusion

This chapter reviewed three prominent aspects related to FDI; the concept, theory and policy framework of India. The concept of FDI is internationally established as the resident in one economy (the direct investor) obtaining a lasting interest in an enterprise resident in another economy (the direct investment enterprise). The practice of FDI accounting in India and internationally, is to be made more precise in order to accommodate the attendant traits of FDI such as the transformation of technology, marketing and managerial capabilities to the host country enterprise. The subsisting theoretical framework suffers from the drawback that it tries only to articulate the behavior of first world multinationals. The theoretical framework shall be enriched to narrate the foreign investment behavior of third world multi nationals also. Finally, the evaluation of policy framework showed that the landmark changes brought in the FDI policy have significantly improved the important macroeconomic parameters.