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FDI inflows in India: Major impediments

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ABSTRACT

All over the world, FDI is seen as an important source of non-debt inflows, and is increasingly being sought as a vehicle for technology flows, and as a means of building inter-firm linkages in a world in which multinational corporations are primarily operating on the basis of a network of global interconnections. In the current global scenario, it is possible for India to achieve very dynamic growth based upon labor intensive manufacturing that combines the vast supply of Indian labor, including skilled managerial and engineering labor, with foreign capital, technology, and markets. In this paper, an attempt is made to identify the issues and problems associated with India's current foreign direct investment regime, and more importantly the other associated factors responsible for India's unattractiveness as an investment location. Despite India offering a large domestic market, rule of law, low labor costs, and a well working democracy, her performance in attracting FDI flows has been far from satisfactory. A restrictive FDI regime, high import tariffs, exit barriers for firms, stringent labor laws, poor quality infrastructure, centralized decision-making processes, and a very limited scale of export processing zones make India an unattractive investment location.

Key Words : Economic policy reform, FDI, Foreign direct investment, India

India's economic policy reforms have played a crucial role in the performance of the Indian economy since 1991. Among other things, the reforms have involved opening the economy, making it more competitive, getting the government out of the huge morass of regulation, empowering the states to take more responsibility for economic management and thereby creating a kind of competition between the states for foreign investors.

In the backdrop of the East Asian crisis, growth did slow down a little bit, but India has kept growing and has avoided the worst of the crisis. From the narrow financial point of view two things that India did were quite helpful. One, it did keep some limit on the short-term capital inflows and did not go overboard in borrowing short term from abroad. This helped India to avoid the financial reversals of some of its neighbours. Second, it kept the rupee flexible and the depreciation of the rupee definitely helped keep the Indian economy more competitive and kept economic growth going.

It is significant to point out here that India went through a near disaster in 1991 that was, among others causes, based on short-term borrowing. Of course, at that time it was short-term borrowing from the non-resident Indians, (NRIs) but it was the same kind of phenomenon - lots of short-term capital had come in and lots had moved out and created a severe payments crisis. In terms of foreign investment, it is the direct investment that should be actively sought for and doors should be thrown wide open to foreign direct investment. FDI brings huge advantages (new capital, technology,

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managerial expertise, and access to foreign markets) with little or no downside. There are lots of international investors who would flock to India right now, especially now that they see that India has a lot of safety for them in comparison with China, for example. But, they are put off by the fact that they cannot get reliable power or that the road system is so dreadful that even if they are producing effectively, they will not be able to get the goods to the market or back to the port for exports. Continuing fiscal difficulties that are often linked to the chronic infrastructure difficulties remain a major challenge for India.

A few of the Indian States have been more reform-oriented, such as Andhra Pradesh, Gujarat, Karnataka, Maharashtra, and Tamil Nadu, but states, such as Haryana, Kerala, Orissa, Madhya Pradesh, Punjab, Rajasthan and West Bengal have a lot to catch-up with. Of course, Bihar and Uttar Pradesh are even further behind. States that are ahead in the reform efforts right now are going to find that if they move against the populist policies and set up regular markets for services, such as power and water then they are going to be ahead of the rest in the game. There are rather significant differences in reform interest and economic performance between a large part of northern India and southern India where Karnataka, Tamil Nadu and Andhra Pradesh are quite dynamic now in trying to get the infrastructure, and the policy regime right to attract large-scale foreign investment. In the north, in Bihar, Uttar Pradesh one does not see the same kind of reform dynamism and the results are therefore poor in terms of economic growth. These differences will be noticed politically sooner rather than later, (as inequalities will become glaring) and the states that are ahead will be rewarded with better performance and the states that are behind will find that there is the demand to catch up with the states that are growing. That will spur a kind of competition among the Indian states and make the reform process go much faster. State-wise approvals of FDI in India suggest differing performances among Indian states. States are now in competition with one another to attract private investment, both domestic and foreign. State-level data on FDI approvals suggest that the relatively fast moving reformers have tended to attract higher investments, both from foreign and domestic investors.

From the long-term development point of view, we are of the view that India has tremendous growth prospects through export-led growth and that export-led growth involves a broad range of sectors, both traditional and new . The most interesting by far of the new sectors is software and information technology. India is becoming one of the most important players of the world in this sector and it is the fastest growing foreign exchange earner for India. Export-led growth in services is one of the most interesting developments, and export-led growth in manufactures, the more traditional textiles and apparel, in electronics and other labour-intensive operations remains an area where India could do a lot more than in the past.

India's neighbours that are relying heavily on FDI, such as China, Indonesia, Malaysia, and Thailand, have been pulling far ahead of India in economic growth, income levels, and productivity, while also increasing their security and geopolitical influence in the world community. India's continuing ambivalence to FDI, as a result, exacts a heavy toll on the Indian economy. Undoubtedly, India is ceding billions of dollars of FDI to its neighbours each year, flows that otherwise would have come to India.

Findings of various survey suggest that countries that are more competitive have better prospects of attracting FDI, especially by an exporting firm. Empirical results bear testimony to this relationship, which is statistically significant. Yet another factor determining FDI is the ability to repatriate capital and remit profits. With regard to this factor too, there is strong statistical evidence to suggest that investors view inability to repatriate capital and remit profit as one of their main concerns. The more open an economy to the rest of the world, the more likely it is to offer freedom in capital movement across national borders. High degree of openness would imply lesser restrictions on remittance of capital income that may be in the form of interests, dividends, profits, or capital gains. The remaining two factors cited by executives as determinants of FDI are productivity and work habits of workers

and quality of infrastructure.

Major impediments to larger FDI inflows in India :

In addition to India's poor performance in terms of competitiveness, quality of infrastructure, and skills and productivity of labour, there are several other factors that make India a far less attractive ground for direct investment than the potential she has. Given that India has a huge domestic market and a fast growing one, there is every reason to believe that with continued reforms that improve institutions and economic policies, and thereby create an environment conducive for private investment and economic growth that substantially large volumes of FDI will flow to India. Some of the major deterrents are listed below:

Restrictive FDI Regime:

The FDI regime in India is still quite restrictive. Foreign ownership of between 51 and 100 percent of equity still requires a long procedure of governmental approval. In our view, there does not seem to be any justification for continuing with this rule. This rule should be scrapped in favor of automatic approval for 100-percent foreign ownership except on a small list of sectors that may continue to require government authorization. The banking sector, for example, would be an area where India would like to negotiate reciprocal investment rights. Besides, the government also needs to ease the restrictions on FDI outflows by non-financial Indian enterprises so as to allow these enterprises to enter into joint ventures and FDI arrangements in other countries. Further deregulation of FDI in industry and simplification of FDI procedures in infrastructure is called for.

High tariff rates :

India's tariff rates are still among the highest in the world, and continue to block India's attractiveness as an export platform for labor-intensive manufacturing production. Much greater openness is required which among other things would include further reductions of tariff rates to averages in East Asia (between zero and 20 percent). Most importantly, tariff rates on imported capital goods used for export, and on imported inputs into export production, should be duty free, as has been true for decades in the successful exporting countries of East Asia.

Lack of decision-making authority with the state governments:

The reform process so far has mainly concentrated at the central level. India has yet to free up its state governments sufficiently so that they can add much greater dynamism to the reforms. In most key infrastructure areas, the central government remains in control, or at least with veto over state actions. Greater freedom to the states will help foster greater competition among themselves. The state governments in India need to be viewed as potential agents of rapid and salutary change. Brazil, China, and Russia are examples where regional governments take the lead in pushing reforms and prompting further actions by the central government. In Brazil, it is São Paulo and Minais Gerais which are the reform leaders at the regional level; in China, it is the coastal provinces, and the provinces farthest from Beijing, in the lead; in Russia, reform leaders in Nizhny Novgorod and in the Russian Far East have been major spurs to reforms at the central level.

Poor export processing zones:

The very modest contributions of India's export processing zones to attracting FDI and overall export development call for a revision of policy. India's export processing zones have lacked dynamism because of several reasons, such as their relatively limited scale; the Government's general ambivalence about attracting FDI; the unclear and changing incentive packages attached to the zones; and the power of the central government in the regulation of the zones, in comparison with the major

responsibility of local and provincial government in China. Ironically, while India established her first EPZ in 1965 compared with China's initial efforts in 1980, the Indian EPZs never seemed to take off — either in attracting investment or in promoting exports.

No liberalization in exit barriers :

While the reforms implemented so far have helped remove the entry barriers, the liberalization of exit barriers has yet to take place. In our view, this is a major deterrent to large volumes of FDI flowing to India. An exit policy needs to be formulated such that firms can enter and exit freely from the market. While it would be incorrect to ignore the need and potential merit of certain safeguards, it is also important to recognize that safeguards if wrongly designed and/or poorly enforced would turn into barriers that may adversely affect the health of the firm. The regulatory framework, which is in place, does not allow the firms to undertake restructuring.

Stringent labour laws :

Large firms in India are not allowed to retrench or layoff any workers, or close down the unit without the permission of the state government. While the law was enacted with a view to monitor unfair retrenchment and layoff, in effect it has turned out to be a provision for job security in privately owned large firms. This is very much in line with the job security provided to public sector employees. Labour-intensive manufacturing exports require competitive and flexible enterprises that can vary their employment according to changes in market demand and changes in technology, so India remains an unattractive base for such production in part because of the continuing obstacles to flexible management of the labor force.

Poor Financial sector :

Reform of India's financial sector is crucial for large FDI flows into India. However, only some partial steps have been undertaken and these are by no means going to make any meaningful changes to the existing system. India's banking and insurance companies were nationalized more than two decades ago. While a number of countries had undertaken such actions in the 1970s and early 1980s, for instance Mexico, France, and Chile, however, they have almost completely reversed this policy by now. Be that as it may, India still continues to rely on a state-owned, state-run banking system and the insurance sector till very recently remained a government monopoly. This as one would expect has had highly adverse results, both in terms of availability of funds for investment and a negligible presence of foreign banks and no presence of foreign insurance companies in the country.

High corporate tax rates and absence of clear cut sectoral policies for FDI:

Corporate tax rates in East Asia are generally in the range of 15 to 30 percent, compared with a rate of 48 percent for foreign companies in India. High corporate tax rate is definitely a major disincentive to foreign corporate investment in India. Expeditious translation of approved FDI into actual investment would require more transparent sectoral policies, and a drastic reduction in time-consuming red-tapism.

Indeed, all over the world, FDI is seen as an important source of non-debt inflows, and is increasingly being sought as a vehicle for technology flows, and as a means of building inter-firm linkages in a world in which multinational corporations (MNCs) are primarily operating on the basis of a network of global interconnections. In the current global scenario, it is possible for India to achieve very dynamic growth based upon labour-intensive manufacturing that combines the vast supply of Indian labour, including skilled managerial and engineering labour, with foreign capital, technology, and markets. The government of India has set for itself an ambitious target of achieving $10 billion in actual FDI inflows per year. In order for this target to be met, it is essential to undertake some hard

reform steps. Should the Government decide to implement some of the most critical reform actions necessary for making India an attractive investment destination, then it is very likely that India will not only be able to meet the target, but in fact do much better than that. Of course, additionally, availability of infrastructure services, such as uninterrupted power, good roads, and adequate port, and telecomm facilities are very essential.

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