

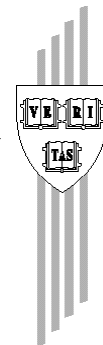
Foreign Direct Investment in India: **How Can \$10 Billion of Annual Inflows Be Realized?**

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Report Presented to the Honorable Murasoli Maran
Minister of Commerce and Industry, Government of India

11 January 2000

Center for
International
Development
at Harvard University



THE BOSTON CONSULTING GROUP

Foreign Direct Investment in India: How Can \$10 Billion of Annual Inflows Be Realized?

What are the highest leverage areas of action for the Indian government to substantially increase the inward flow of foreign direct investment? A team of consultants from Harvard University and the Boston Consulting Group, led by Professor Jeffrey Sachs of Harvard, has applied themselves to this question. We are pleased to present our report to the Honorable Murasoli Maran, Minister of Commerce and Industry in the Government of India.

We considered three sectors for investment in India:

- Investment in the infrastructure sector
- Investment directed at the domestic market
- Investment for export from India

We looked at the issue of foreign direct investment (FDI) from two angles:

- The Harvard University team members examined the economic and development policy issues, comparing India and other countries, especially China, that are competing with India for attracting foreign investments.
- The Boston Consulting Group team members examined the factors that influence the decisions of individual companies, and for this purpose interviewed executives in 30 major international companies that have made investments in India or may be considering doing so.

Views from these two perspectives have been synthesized to make our recommendations. In summary, change is required in six areas. These are explained in more detail in the report.

1. Legislative and policy reforms:

- Remove unnecessary restrictions on equity participation by foreign companies
- Standardize guidelines for environmental issues
- Strengthen intellectual property rules, especially in sectors where India has a comparative advantage with its educated and skilled workforce
- Reduce the variance of FDI laws based on sector
- Increase trade openness

2. Government processes and machinery:

- Increase areas for automatic approval
- Reduce the role of the FIPB
- Streamline the number of agencies involved when approvals are necessary

3. Center-State dynamics:

- Devolve more authority in selected areas to the States to negotiate FDI projects

4. Infrastructure:

- Increase political commitment, regulatory transparency, and dispute resolution mechanisms to attract foreign participation in infrastructure
- Focus immediately on the infrastructure of airports, telecommunications, ports, and roads in selected areas to make the country more attractive to foreign investors

5. Concentrated zones for FDI activity:

- Expand export processing zones to provide modern infrastructure for export-oriented projects
- Use EPZs to provide special procedures for these projects and increase trade openness
- Expand the use of technology parks and other zones that increase the opportunities for agglomeration of industries for which India is particularly attractive
- Allow the private sector to set up and operate some of these sites

6. Engagement of foreign investors:

- Create a council of senior Union and State government officials and representatives of large foreign-invested companies
- Use the council to deepen the insights into issues that impede FDI
- Use the council to develop high impact actions
- Use the council to learn from these actions and adjust quickly
- Use the council to build mutual respect and trust

We would be pleased to help set up and facilitate this council, and look forward to seeing India expedite the recommendations of this report.

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Introduction

Jeffrey D. Sachs and Nirupam Bajpai

India's economic policy reforms have played a critical 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. The GDP growth rate which had collapsed to 0.8 percent in 1991-92 rebounded to a near normal 5.3 percent in 1992-93, and then accelerated to 6.2 percent in 1993-94. Subsequently, the GDP grew at an average rate of 7.5 percent in the three years 1994-95 to 1996-97, before slowing down to 5.1 percent in 1997-98. It is important to note that despite the slowdown, the average growth rate in the four years 1994-95 to 1997-98 was 6.9 percent, significantly higher than the growth rate of 5.6 percent achieved in the 1980s. In 1998-99, the GDP is estimated to have grown at 5.9 percent. The positive trends being seen in most sectors had the capability to more than neutralise the debilitating effects of two general elections in two years, the crisis in East Asia, Kargil operations, the nuclear explosions, and the U.S. sanctions that followed.

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 neighbors. 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 during this period.

In the context of the East Asian crisis, certain kinds of money fled while other kinds did not. The hottest money was short-term loans from international banks. Indeed, the reversal of short-term bank lending constituted a very large proportion of the overall \$105 billion reversal in capital flows. The banks put in \$56 billion in net lending in 1996, and then withdrew an estimated \$21 billion in net loans in 1997, for a swing of \$77 billion (or 73 percent of the overall reversal). Portfolio equity investors (e.g., country equity funds) also reversed gear, to the extent of \$24 billion. Foreign direct investors, by contrast, were very stable. It is estimated that net foreign direct investment remained roughly unchanged between 1996 and 1997, at around \$7 billion in net flows each year.

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, 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.

The government 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. We will discuss these in section VI. 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.

In order to achieve the government's goal, it is crucial to raise the FDI approvals to actual ratio. On a cumulative basis, FDI approvals between April 1991 and September 1998 were of the order of \$54,268 million, whereas, actual FDI during the same period was a mere \$11,806 million. Therefore, actual FDI as a proportion of FDI approved was only 21.7 percent (Table 1). The same ratio is much higher in China, Indonesia, Korea, Malaysia, Philippines, and Thailand. 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 Bajpai and Sachs (1999). 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 (aggregate FDI approvals between 1991-97) 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 Bajpai and Sachs (1998). 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 labor-intensive operations remains an area where India could do a lot more than in the past.

China has achieved a lot more in manufactured export production than India and for no particular reason. India has the resource base, it has the entrepreneurship, has the access to the sea coast, a vast labor force, it has everything that coastal China has had except the interest of government which neglected this for a long time and which even today underemphasises the role of industrial facilities, underemphasises the role of infrastructure, of land area, of effective port facilities that one needs to be able to compete with China in this area Bajpai, Jian and Sachs (1997). But it is, we believe, a place where one could find tens of millions of jobs over the next few years in real, significant foreign exchange earning private sector activity. This would require a change of attitude, a real promotion of these sectors both at the state and central government levels.

India's neighbors 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 neighbors each year, flows that otherwise would have come to India. While China achieved actual FDI inflows of around \$45.3 billion in 1997, India settled for a mere \$3.2 billion! (Table 2). Why is it that India, which provides the largest market after China in the developing world is unable to attract substantial volume of FDI? Further, when it comes to comparing China and India, why can India not match or even outpace China in attracting FDI given India's superior conditions regarding the rule of law, democracy, and the widely spoken English language? We will try to provide answers to some of these questions in Section III.

The remaining parts of this Report are organized as follows. Section II deals with the determinants of FDI. Here we undertake an analytical overview of FDI issues, distinguishing FDI directed at exports, home market, infrastructure, and discussing key factors, such as regulatory/approval process, infrastructure, taxation, labor costs, labor skill levels, etc. Section III compares China and India with regard to competitiveness and FDI flows. Section IV focuses on investor perceptions about India as an investment location using survey data from foreign firms, both already in India as well as those that have not entered India as yet. Section V we attempt to identify the issues and problems associated with India's current FDI regime, and more importantly the other associated factors responsible for India's unattractiveness as an investment location.

Table 1: Foreign Direct Investment: Actual Inflows vs. Approvals
(US \$ million)

	1991	1992	1993	1994	1995	1996	1997	1998 *	1991- 98 totals
Approvals	325	1,781	3,559	4,332	11,245	11,142	15,752	6,132	54,268
Actual Inflows	155	233	574	958	2,100	2,383	3,330	2,073	11,806
Actual as percent of Approvals	47.7	13.1	16.1	22.1	18.7	21.4	21.1	33.8	21.7

* Up to September 1998

The approval and actual inflows figures include NRI direct investments approved by the RBI

Source: *Economic Survey, 1998-99*, Government of India

Table 2: FDI by Host Region
(US \$ Million)

	1992	1993	1994	1995	1996	1997*
Country						
China	11,156	27,515	33,787	35,849	40,800	45,300
India	233	574	973	1,964	2,382	3,264
Indonesia	1,777	2,004	2,109	4,348	6,194	5,350
Korea, Rep. Of	727	588	809	1,776	2,325	2,341
Malaysia	5,183	5,006	4,342	4,132	4,672	3,754
Philippines	228	1,238	1,591	1,459	1,520	1,253
Thailand	2,114	1,804	1,322	2,002	2,268	3,600
All developing countries including China	51,108	72,528	95,582	105,511	129,813	148,944
Share of India in developing countries (%)	0.5	0.8	1.0	1.9	1.8	2.2

* Estimates

Source: *Economic Survey, 1998-99*, Government of India

Determinants of Foreign Direct Investment and Areas for Action

Jeffrey D. Sachs, Arun Maira, and Howard J. Shatz

Foreign direct investment inflows in India grew rapidly from start of the New Industrial Policy in 1991 through 1997. From approximately \$154 million in 1991, they increased every year, peaking at an estimated \$3.4 billion in 1997. Inward stock grew likewise, from \$1.8 billion in 1991 to an estimated \$11.0 billion in 1997.

These aggregates tumbled in 1998, however, a setback to India's efforts to absorb more multinational activity and open to the world. According to the latest figures from the United Nations Conference on Trade and Development (UNCTAD), inward flows totaled only \$2.3 billion in 1998. India's flows fell by 32.6 percent, while flows to South Asia, Southeast Asia, and East Asia fell by 12.0 percent, and flows to developing and transition countries as a whole fell by only 3.7 percent. Flows to China actually *rose* by 2.8 percent.¹

This chapter reviews the key results of research regarding the determinants of FDI, overseas investment meant to control a productive enterprise, in order to clarify issues India must face as it works towards the realistic goal of \$10 billion worth of annual direct investment inflows. While the "determinants of FDI" are often the object of research, it is analytically cleaner and operationally more powerful to consider the determinants of different types of FDI. For India, these types are export-oriented FDI, domestic market-oriented FDI, and infrastructure FDI. All three bring benefits. All three have overlapping determinants, but each has its own special set of attractors. And all three—even domestic market-oriented investment—are desperately needed by India. The next section briefly describes the benefits of all three, and the following sections go into more detail about the requirements for attracting each. A final section concludes.

Benefits of FDI

At its most basic level, investment by multinationals brings capital into the economy. Even if the investor imports the equipment, it likely buys the property and plant locally, adding to local economic activity. More importantly, multinational investment brings in new technologies and new methods of doing business, and widens the set of employment opportunities available to local workers. This, in turn, can serve as a powerful force for increasing the skills of the labor pool. All three types of FDI also bring the potential for linkages to the domestic economy and increased domestic economic activity through purchase of local inputs and the production of inputs for use by local producers. Each form of FDI brings its own set of benefits as well.

Export-oriented FDI links the local economy to the international economy. Openness to both imports and exports has been shown to be a powerful force for growth (Sachs and Warner, 1995), and growth has so far been the only credible means of alleviating absolute poverty. Nearly every episode of rapid growth by a developing country after World War II has involved

¹Data from UNCTAD (1999a), UNCTAD (1999b), and the UNCTAD web site, <http://www.unctad.org>.

the expansion of manufactured exports. In many cases, this has come through the mediation of multinationals.

As an example of the relationship between multinationals and trade, consider the U.S. In 1996, the U.S. imported \$803.2 billion worth of goods on a balance of payments basis. Of this total, \$162.3 billion (20.2 percent) came from U.S.-owned affiliates overseas, and \$130.9 billion (16.3 percent) came from majority-owned affiliates to their U.S. parents (U.S. Bureau of the Census, 1997, and U.S. Bureau of Economic Analysis, 1998).

Domestic market-oriented FDI brings new products and services to market. These may be new on many dimensions—either goods and services that were previously unavailable, or goods and services that were previously available but at a different level of quality. In some cases, domestic market-oriented FDI can supply intermediate inputs that otherwise would be unavailable or much more expensive, helping expand not only the efficiency and profit opportunities of local industry, but also the range of local industries that may exist. Domestic market-oriented FDI also exposes other domestic firms to increased competition, forcing them to act efficiently and to improve their products and service to retain and attract new customers.

The last of these benefits can lead to political difficulties. Competition can not only help incumbent firms, but hurt them as well, leading affected owners and workers to lobby the government for special protection. Managing the demands of narrow interest groups hurt by policy changes is one of the toughest tasks facing reformist governments worldwide, even if the vast majority of the population—unorganized and often unaware of the stakes—will benefit from the projected changes. Therefore, an FDI attraction strategy must involve identifying the groups that will most benefit, making sure they understand those benefits, and encouraging their political activity as a counterweight to those who might be hurt. Sheel and Gupta (1999) show that India certainly already has citizens aware of the competitive benefits of global competition.

Infrastructure FDI is at once the riskiest for the investor and probably the most promising and sensitive for the country receiving the FDI. The benefits are clear. Without reliable power, telephone, and transport networks—and now information technology networks—a country cannot hope to increase its industrial production and economic growth. This is especially true with increased globalization (Ahluwalia, 1998, p. 88). The sensitivity is also clear. Countries are reluctant to have foreign involvement in an important part of their economy. We believe these worries are vastly overblown, however. For India, the correct decision is clear, and that is to move forward aggressively with private provision of infrastructure. Without foreign involvement, it is highly unlikely the country can ever build the infrastructure it needs and still take care of other important objectives, such as education and health.

To consider the role of infrastructure, one need only look at the Ministry of Finance's annual economic surveys. In both the 1997-98 and 1998-99 editions, the Ministry identified deficiencies in infrastructure services as being a cause of slowing industrial growth (Indian Ministry of Finance, 1998 and 1999). Because of India's needs and its power to regulate and enforce legal agreements, we view the issue of "foreign control of infrastructure" as a non-issue that, like the issue of domestic competition, must be managed rather than capitulated to.

India is in the enviable position of not having to make difficult choices about which form of FDI it desires. It is badly underinvested in all three. Additionally, all three will be good for India for the reasons discussed above. However, the determinants of the three are different, and this is where smart policies by this government can make a significant difference for the future path of India's economy and Indian citizens' welfare. The rest of this chapter focuses on the determinants of FDI.

Determinants of FDI

At a very basic level, size of the host country in terms of aggregate and per-capita gross domestic product (GDP) and proximity of the host country to investing countries are the two key determinants of inward FDI (Shatz and Venables, 1999). The United States is a major investor in Mexico and Canada, the members of the European Union are major investors in other advanced European countries and Central Europe, and Japan is a major investor in Asia.

Beyond these two essentially exogenous forces, a number of other factors play an important role in attracting FDI, many of which are under the control of the government. Policies can influence three broad areas relevant to investors: 1) administrative rules and regulations for establishing investments, safeguarding the security of investments, and repatriating capital and profits; 2) the process and machinery for applying the rules; 3) infrastructure, particularly electricity service, communications, and internal and external transport; 4) labor costs and tax rates. The main goals should be to make investment procedures transparent, business practices efficient, and expected profits rewarding.

In its efforts to attract investment, India has one other advantage, and that is its numerous states. Given their broad regulatory power, they should be granted significant leeway in competing for foreign investment. While this may result in overly generous incentives, it more likely will result in 25 different policy experiments and continuous learning about which policies work and which do not. Success in one state will encourage other states to take similar measures and interested lobbying groups to advocate successful policies. Unfortunately, this process of competition amongst the states, and of experimentation and learning, can also be painful for foreign investors. They are often confused by the contradictions and changes during this process of learning and improvement. As a result, officials must make extra efforts to keep investors informed and aware of the changes while the states undergo this necessary process.

Determinants of Export-Oriented Investment

Location, factor costs, and trade policy play particular importance in attracting export-oriented investment. All of these elements are crucial in lowering costs, and export-oriented investment is the most sensitive of the three types to costs. Costs should be taken to mean not just labor costs, but all costs associated with producing a good and bringing it to market. Multinationals choosing export platforms can scan the world before settling on a location and therefore face rich opportunities for productivity-adjusted cost minimization.

Location plays an especially large role as a determinant of investment for production of goods intended for export back to the investing country (Shatz, 1999). The major investing countries

all produce inputs and goods for export back home in neighboring countries. The U.S. has an enormous level of such investment in Mexico. Germany moved very quickly into Hungary during the 1990s. And Japan maintains an expanding web of intermediate-goods affiliates in developing Asia.

This has two implications for India. First, the E.U. and the middle- and upper-income countries of East Asia, particularly Japan, Korea, Taiwan, Hong Kong, and Singapore, likely are the best sources of export-oriented direct investment. Second, since the primary effect of distance is through trade costs, India can overcome geographic disadvantages by improving port facilities and customs clearance procedures so that trade costs are low. For example, despite a distance of almost 8,800 miles from the U.S., Singapore is consistently one of the top two locations that U.S. multinationals choose for production of manufactured goods that will be sold back to the U.S. (Mexico is the other). Singapore also has extremely low transport costs, partly because of its excellent port facilities.

Evidence suggests that India has an opportunity to grow its exports in knowledge-intensive sectors and as engineering-intensive manufacturers, software, and pharmaceuticals. While proximity and infrastructure will be issues in these sectors also, they may have different effects than in low-cost manufactured goods. It will be worthwhile to focus on the infrastructure and communication needs of these knowledge-intensive sectors also.

In fact, general trade openness is also an important correlate of export-oriented investment. Trade-enhancing policies may include low uniform tariffs, equilibrium real exchange rates, and limited or no non-tariff barriers. Short of these, or preferably in addition to these, export processing zones can go a long way towards facilitating trade. There is evidence that EPZs operate with a lag, but that eventually they can have an important impact on export-oriented investment. The core element of these types of export enhancement schemes seems to be a mechanism that allows exporters to import capital and intermediate goods without paying import duties on them (Radelet, 1999). This keeps exporters globally price-competitive.

Two other important elements in attracting export-oriented investment are labor costs and tax rates. India certainly has an advantage in its raw labor costs, but what matters in the end is unit labor costs, the total compensation paid by the firm per unit of output. In fact, there is some evidence that firms pay special attention to labor quality, and here India's record is mixed. It has at once widespread illiteracy and an enormous number of highly trained scientists and engineers. Unfortunately, a recent firm-level survey of Japanese firms and their investments in Asia revealed relatively poor perceptions of Indian labor quality (Mody, Dasgupta, and Sinha, 1999).

Restrictive labor laws that add to labor costs and force firms to retain employees whose services are no longer necessary act as a counterweight to raw labor costs and discourage investment—and not just foreign investment. Countries that are most successful at attracting export-oriented investment—particularly Singapore, Malaysia, Taiwan, and Ireland—have struck a balance between labor flexibility and social protection that has encouraged investment and allowed steady increases in employment and wages through productivity improvements and movements by firms up the technology ladder.

Along with labor costs, low tax rates play a role in attracting export-oriented investment. India has recognized this by offering generous incentives to export-oriented units and companies established in export processing zones, and by exempting export earnings from corporate income taxes. Research results regarding the effect of tax rates on investment are mixed, but this is in part because it analyzes total foreign investment, not export-oriented investment. Results clearly favor a tax impact on export-oriented investment.

Finally for some types of export-oriented investment, administrative openness has been shown to be an important determinant (Shatz, 1999, and Markusen and Maskus, 1999). This involves the approval process and other administrative tasks a company must go through before investing. In this respect, India has made great strides since 1991. It is telling that “automatic approval” is available in 48 high-priority industries, covering most of industrial activity (U.S. Department of Commerce Foreign and Commercial Service, 1999). However, it is not clear how meaningful this process has been. On average, from April 1991 to December 1998, only 8.6 percent of actual FDI flows have entered the country through the Reserve Bank of India automatic approval route. And from April 1995 to December 1998, the annual average was actually lower.² A high and growing share of FDI comes through the Secretariat for Industrial Assistance/Foreign Investment Promotions Board approval route. If these procedures present significant barriers, the government should rethink its approval policy.

Determinants of Domestic Market-Oriented Investment

At first glance, India appears to be an excellent location for domestic market-serving investment. Market size plays a key role, and with almost one billion people India appears to be one of the largest markets in the world. In addition, it is far from the industrial powerhouses of North America and Europe. Research by Brainard (1997) and Ekholm (1998) shows that greater distance from producing countries actually encourages domestic market-oriented investment, since the cost of exporting to that market acts as a trade barrier.

Indian market size, however, is not all it is cracked up to be. A great deal of multinational investment takes place in differentiated products industries with high fixed costs and oligopolistic market structures. Output frequently includes branded goods or goods of many varieties that are a bit more expensive and that appeal to middle- and upper-income consumers. As a result, the purchasing power of Indian consumers will influence India’s attractiveness as a location for domestic market-oriented investment, and this purchasing power is well below that of many other countries.

In light of this difficulty facing foreign-owned producers, the rationale for India’s policy of dividend balancing by 22 consumer goods industries is not clear. Currently, foreign-invested producers in these 22 industries must balance their dividend remittances against export earnings for seven years from the start of production. Yet such limits on profit remittances have been shown to act as a brake on investment. Analyzing the previously mentioned Japanese firm

²The figure presented is the average of annual ratios of automatic approval FDI relative to total FDI. The figure for the final year is actually for April through December 1998. Figures are from the Ministry of Finance’s Economic Survey, 1998-99.

survey, Mody, Dasgupta, and Sinha showed that firms that viewed repatriation of earnings as a serious problem lowered their Asian investments. If India wants the salutary effects of increased competition, more varieties of goods, and higher quality, it will need to reconsider this policy. Finally, the policy is an inefficient tool for boosting exports as well.

Determinants of Infrastructure Investment

Well-developed infrastructure has been shown to be a determinant of capital investment by multinationals (Wheeler and Mody, 1992). The implications for India go well beyond this, however. Better transport, communications, and power generation will certainly attract foreign investment, but it will help domestic industry as well. India thus faces two tasks—attracting export- and domestic market-oriented FDI through better infrastructure, and attracting major international infrastructure companies to invest in India.

It is this last point that is proving the toughest because of what has long been known as “the obsolescing bargain” (Caves, 1996, p. 104-105; originally used in the context of natural resource investments). Infrastructure investments involve large up-front capital expenditures. Combined with uncertainty about future government policies, there is uncertainty about future returns, and so the investor will negotiate for higher expected profits up front. In India, this has taken the form of higher prices for privately generated power to be sold to the State Electricity Boards (Cameron-Moore, 1999). Once the multinational starts actually earning these profits, popular indignation can either lead a sitting government to try to renegotiate the contract or it can lead to a change of government and subsequent renegotiation effort.

The recent Mangalore Power incident provides an unfortunate example. Initiated in 1992 as one of eight fast-track projects (along with the controversial Dabhol Power project), the facility is now in question after seven years and \$27 million spent. Joint venture partners Cogentrix, Inc., of North Carolina, and CLP Power International, a subsidiary of Hong Kong power company CLP Holdings Ltd., walked out of the project citing delays in obtaining required government approvals and agreements and in settling public interest litigation (Reuters, 1999). The project may well be revived, but the incident—combined similar problems regarding Enron’s Dabhol Power Company project earlier this decade—cannot help but send a terrible signal to prospective investors.

Infrastructure projects are different from other types of investments because the government is involved not just as a buyer and supplier, but as a regulator (International Finance Corporation, 1996, p. 2). Because of this, political commitment is essential. It is particularly important that India establish and enforce fair rules of the game for infrastructure investors.

Fortunately, fully functioning regulatory frameworks and international competitive bidding, have not proved to be necessary to successful foreign-invested infrastructure projects. Most important to the success of private infrastructure are government use of impartial outside advisors and transparency in all parts of the transaction, according to the IFC, which has been involved in

dozens of private infrastructure projects. Transparency involves clarity in procedures for awarding and operating projects and predictability in implementing government commitments. A third element of transparency involves striking a balance between a fair expected return on the project and a fair price for the government. Pricing and profits must be competitive, but the government also must recognize that early projects may demand a premium because of the risks involved.

A final elements necessary to infrastructure success is a long-run dispute resolution mechanism. An infrastructure project may last for decades, and disputes may develop in contracts or regulatory procedures. A mechanism for dealing efficiently with unforeseen disagreements will help seal infrastructure deals and, just as importantly, encourage new ones.

Conclusions

The patterns of direct investment in fiscal years 1999/2000 and 2000/2001 will provide strong indications as to whether the recent drop in FDI inflows was an anomaly or the start of an unfortunate trend. If an anomaly, then India can start to build on past successes. If the start of a trend, then further policy measures will be required. Either way, there are steps India can and should take to increase its inward direct investment. Research and experience indicate that:

- Costs are crucial to attracting export-oriented investment. Labor flexibility, low tax rates, export processing zones, and simpler entry procedures can help.
- Market size is crucial to domestic market-oriented investment, but so are entry procedures and the ability to remit earnings. In addition, such investment is not to be feared, though affected interest groups may require astute political management.
- Infrastructure investment demands transparency in establishing the contract, a commitment to abide by the agreement, and a mechanism for handling unforeseen disagreements efficiently.

All three forms can bring large benefits to India. Ultimately, the deciding factor for each investor will be the ability to make a profit. All investment facilitation measures should aim to enhance that goal. The purpose of this report is to suggest areas for action by the Indian government that could have the highest leverage to increase the inflow of FDI to meet the goal of \$10 billion. We have combined macro-level economic policy analysis with insights from interviews with large foreign business investors to recommend the areas for action. These are summarized in the attached table, and are explained in later chapters.

Areas for Action by Government to Increase FDI

(Relative impact indicated by number of stars)

Areas for Action	Sectors		
	Export-oriented	Domestic-market focused	Infrastructure
1. Legislative and policy reforms	*	**	***
2. Government processes and machinery	***	***	***
3. Center-state dynamics	*	**	**
4. Infrastructure	***	***	**
5. Concentrated zones for FDI activity	***	*	
6. Engagement of foreign investors	**	**	**

Foreign Direct Investment and National Competitiveness: A Comparison of India and China

Sara Sievers and Shang-Jin Wei

Foreign Direct Investment (FDI) is highly prized in developing countries for providing a catalyzing boost to significant economic growth through technology transfers, employment generation, international business relationships, and management and training modernization, in addition to the underlying cross-border investment itself. While the desirability is not in question, the competition to attract serious international investors is keen indeed, and requires a serious commitment on the part of government leadership if the necessary policy stability, business conditions and competitive environment are to be in place. This paper outlines current levels of FDI in China and in India and provides a brief history of the policies both countries have implemented to facilitate its attraction. Attention then turns to the variables that comprise a competitive national economy, and analyzes India and China's relative positions. Finally, a measure of the specific costs to businesses and national economies when even one or two variables is lacking demonstrates the extreme cost of inadequate government reform to competitiveness and growth.

China, which had virtually no foreign investment in the 1970s, is now a major host country of FDI. These foreign-invested firms have contributed significantly to China's impressive export expansion and to China's overall economic growth. According to officially reported values of FDI into China (China State Statistics Bureau, 1999), it has, for the last few years, been the largest developing country host of FDI, and the second largest in the world (after the U.S.). In fact, the numbers on China's inward FDI look so impressive that some observers call China "the world's strongest magnet for overseas investment"³, or use the phrase "China fever"⁴ to describe the inflow of FDI into the country.⁵

India's "open door" policy that started in 1991 has brought in more investment, but its total FDI is still less than a tenth of that headed to China. Table 1 exhibits the trajectory of the realized flow of FDI going into China and India every year from 1983 to 1998. It is worth remembering while looking at these figures that the world in general experienced a dramatic FDI boom beginning in the early 1990's, a trend that continues today, despite the financial crisis of 1997-98, which hit portfolio flows but not FDI. Thus some of the increase noted in both India and in China can be attributed to a global trend towards investment flows across borders. In addition to raw FDI levels, it is interesting to note each country's *percentage* of global FDI inflows. Inflows to Africa, for example, more than tripled between 1990 and 1998, while Africa's share of global inflows started the decade at 1.1 percent and hit only 1.2 percent 1998."

3 *The Economist* (US edition), March 1, 1997 p38.

4 P.T. Bangserg, *Journal of Commerce*, December 27, 1996, p3A.

5 Some of Wei's work suggests that China's official FDI statistics may be overestimated by as much as 50-60%. Even controlling for this potential exaggeration, however, Chinese FDI flows remain many times higher than India's.

Table 1: Realized Foreign Direct Investment in China and India
Annual Flows, 1980-1999
(Billions of U.S. Dollars)

Year	China	India
1980	0.15	0.008
1981	0.38	0.010
1982	0.41	0.065
1983	0.64	0.063
1984	1.26	0.062
1985	1.66	0.160
1986	1.88	0.208
1987	2.31	0.181
1988	3.19	0.287
1989	3.39	0.350
1990	3.49	0.097
1991	4.37	0.136
1992	11.00	0.258
1993	27.52	0.569
1994	33.77	0.946
1995	37.52	1.930
1996	41.73	2.420
1997	45.28	3.050
1998	45.58	3.000

Source: China: 1) 1980-1982: *World Investment Directory 1992*.

2) 1983-1996: China State Statistics Bureau.

3) 1997-1999: MOFTEC Statistics Data. 1999 estimate = \$18.566b (Jan-June) X 2.

India: 1) 1980-90, 98: The World Bank.

2) 1980 in Rs.Crores: *World Investment Directory 1992*.

3) 1990 in Rs.Crores: Statistical Abstract India 1997.

4) 1991-1997: <http://strategis.ic.gc.ca/SSG/da90893e.html> based on data provided by the Reserve Bank of India.

Both countries eagerly hope to attract ever more FDI. China, for example, offers super-national treatment to foreign firms in a variety of ways, for example through reduced or exempted taxes that are not available to domestic firms. Another tool that China, and much of East and Southeast Asia more generally, have employed with great success is the institution of free trade export zones. These “nodes of growth” have offered foreign investors islands within which they can operate under favorable conditions, without requiring the wholesale national reform which often proves politically challenging and time-consuming, but without which few multinationals are willing to make serious investment. While India has explored several innovative growth nodes on the IT front, in particular Bangalore, Chennai, and Hyderabad, it has yet to create well-functioning free trade or export processing zones in the way that China has done since 1979.

Table 2 lists the evolution of all the major laws/regulations that are promulgated by the Chinese and India central governments with regard to foreign direct investment. Three things are worth noting. First, China began its policy of economic liberalization a decade ahead of India. On the other hand, when the India government decided to open up in 1991, it chose to liberalize more quickly than China – a “big bang” reform. Second, on several occasions over the last two decades, the Chinese government promulgated laws and regulations specifically designed to attract investment from overseas-Chinese, particularly those from Hong Kong, Taiwan and Macao. In India, efforts to attract expatriate investment have, to our knowledge, been significantly less systematized. Third, China offers super-national treatment to foreign firms, who typically receive an exemption of income tax for the first two profitable years followed by three additional years of 50 percent tax reduction. Such benefits are not offered to domestic Chinese firms. Again, to the best of our knowledge, India so far has not offered comparable incentives.

While China’s ability to attract FDI has been stunning, we believe both it, and India, are underperformers relative to their economic potential. Both countries have many natural competitive advantages that make them of inherent interest to investors, perhaps two of the world’s most attractive destinations for foreign investment in this age of global markets. Huge market size, competitive labor rates, favorable natural ports and river systems, and other non-transferable advantages are characteristic of both countries, and of significant interest to investors. Where then does the attraction fail to materialize into reality? Government trade and openness policies, transparency in business and legal systems, and investment in human capital and infrastructure tell most of the story.

Table 2: Evolution of Laws and Regulations on FDI in China and India

Year	China	India
1979	Law on Chinese-foreign equity joint ventures	
1986	Law on foreign capital enterprises: China permits foreign enterprises, other foreign economic organizations and individuals to set up enterprises with foreign capital in China and protects the lawful rights and interests of such enterprises.	
1988	Law on Chinese-foreign contractual joint ventures	

Year	China	India
1990	<p>Interim provisions for the duration of Chinese-foreign equity joint ventures Regulations of the state council for encouraging investment from overseas Chinese and compatriots from Hong Kong and Macao: to encourage investment within the territory of mainland from overseas Chinese and compatriots from Hong Kong and Macao Regulations for contracted operation of Chinese-foreign equity joint ventures.</p> <p>Rules for the implementation of the law on foreign-capital enterprises</p>	
1991	<p>Rules for the implementation of the income tax law for enterprises with foreign investment and foreign enterprises Income tax law for enterprises with foreign investment and foreign enterprises</p>	<p>A new industrial policy provided: Automatic approval for projects with foreign equity participation up to 51 percent in 35 high priority sectors. All other proposals up to US\$ 171 million and 100 percent equity approved by Foreign Investment Promotion Board (FIPB) or Secretariat of Industrial Approvals (SIA) on a case by case basis. Proposals for investment in excess of the above amount to be approved by the Cabinet Committee on Foreign Investment. Automatic approval of foreign technology agreements up to a lump-sum payment of US\$ 2 million net of taxes with 5 percent royalty on domestic sales and 8 percent for exports. Foreign investment up to 100 percent permitted in approved domestic venture capital funds/companies, with FIPB approval and for establishing asset management companies. Liberalization of the Foreign Exchange Regulation Act Reduced list of industries requiring industrial licensing Dilution of MRTP Reduction in the number of industries reserved for the public sector Liberalization of imports and reduction in tariffs Convertibility of the Rupee on current account Opening up of the capital market to foreign investors</p>
<u>ENote1</u> 1992		
1994	<p>Law of the People's Republic of China on the protection of investment of Taiwan compatriots: to protect and encourage investment of Taiwan compatriots, and to promote the economic development on both sides of the Straits. Regulations on labor management in enterprises involving overseas investment: to protect the legitimate rights and interests of both foreign-invested enterprises and the employees working in these enterprises and to establish, maintain and develop stable and harmonious work relationship between the enterprises and their staff.</p>	

Year	China	India
1995	<p>Detailed rules for the implementation of the law on Chinese-foreign cooperative joint ventures</p> <p>Provisional regulations on the establishment of foreign-funded joint stock companies limited: foreign companies, enterprises and other economic entities or individuals are allowed to jointly set up foreign funded joint stock companies limited in China jointly with Chinese companies, enterprises and other economic entities or individuals, under the principle of mutual benefit. Provisional regulations on investment companies established by foreign investors: foreign investors are permitted to establish investment companies in China in accordance with relevant Chinese laws and regulations concerning foreign investment. Provisions on the establishment of foreign-funded construction enterprises: to meet the needs of opening up, strengthening the management of foreign-funded construction enterprises, and to safeguard the order of the construction market. Implementation measures for the administration on import by foreign-funded enterprises Catalogue for the guidance of foreign investment industries recognizing encouraged projects for foreign investment Interim provisions on guidance for foreign investment: to guide foreign investment, adapt foreign investment to China's national economic and social development programs, and adequately protect the legal rights and interests of investors. Rules on the approval and control of resident representative offices of foreign enterprises: foreign enterprises, when applying to set up resident representative offices within the territory of People's Republic of China, must have the approval of the MOFTEC or its empowered foreign trade and economic cooperation commissions. Detailed Rules on the Implementation of the Law on Sino-Foreign Joint Cooperative Ventures Urgent Notice on Issues Relating to Current Examination and Approval of Enterprises with Foreign Investment</p>	

Year	China	India
1996	Regulations on the examination and approval of foreign-funded enterprises serving as agents for international cargo transport: to standardize the work to examine and approve foreign-funded enterprises serving as agents for international cargo transport, and in accordance with State laws and regulations concerning foreign-funded enterprises and the provisions of China on the management of international cargo transport agency business. Procedures for Liquidation of Foreign-Funded Enterprises: to ensure the smooth progress of the process of liquidation of the foreign-funded enterprises (FFE), protect the rights and interests of the creditors and investors and safeguard the social and economic order related to the liquidation. Circular of the State Council Concerning the Extension of the Limits of Power Vested with the Inland Provinces, Autonomous Regions, Cities Separately Listed in the State Plan and the Departments Concerned Under the State Council in Examining and Approving Direct Foreign Investment Projects Provisional Measures on the Establishment of Sino-Foreign Joint Venture Trading Companies on A Pilot Basis Regulations Concerning the Examination and Approval of International Freight Forwarding Agencies With Foreign Investment: for standardizing the examination and approval of international freight forwarding agencies with foreign investment.	
1997		
1998	Preferential taxation policies for FDI included exemptions from tariffs and import value-added tax for imports of capital goods by foreign-funded high-tech projects and 50 percent reduction of tariffs and import value-added tax for imports of capital goods by sectors where foreign investment is encouraged.	<u>E</u> Note ² Indian companies no longer require prior clearances from the Reserve Bank of India for inward remittances of foreign exchange or for the issuance of shares to foreign investors. <u>E</u> Note ³

Notes: 1) Information on rules, regulations and laws for China are obtained from Ministry of Foreign Trade and Economic Cooperation (MOFTEC) (http://www.moftec.gov.cn/moftec/official/html/laws_and_regulations/foreign_investment.html).
2) Information on rules, regulations and laws for India is from:
<http://www.docuweb.ca/India/news/9612.html#S0135>
<http://www.linktochina.com/Invest/indexinvest.html>
<http://strategis.ic.gc.ca/SSG/da90887e.html> (U.S. Department of Commerce)

Each year the Center for International Development and the World Economic Forum produce *The Global Competitiveness Report*, a document which measures, based on statistical data and a worldwide survey of businesses in 59 countries, national competitiveness (defined as prospects for medium-term economic growth). While clearly not a perfect predictor, the results of the GCR do often correlate with a country's ability to attract FDI (on a per capita basis). More importantly, the eight sub-indexes which, averaged together, comprise the competitiveness

index, cover many of the factors which multinationals report are most relevant to both location choice for cross-border investment, and to business success and prosperity once in country.

The 1999 report ranks Singapore in first place, the US second, China 32nd, and India 52nd ...just before Ecuador and behind Brazil (Table 3). These results are approximately the same rank ordering as in previous recent years. Looking more deeply into the sub-indexes, we see these four countries' rank orders, where India and China lose competitive advantage vis-a-vis the rest of the world, and how the two giants differ between themselves.

Without going into too much detail, a brief look at the factors that impede India's competitiveness, compared both globally and to China, provides a window into appropriate reform priorities.

Turning now to the factors which figure prominently in lowering India's standing in the global rankings, we focus first on openness, where India scores 59th of 59 in our sample, dead last. India places a tremendous burden on its economy by restricting, almost more severely than any other region in the world, the free flow of goods and capital across its borders. It ranks within five places of the bottom on all measures of levels of tariffs and quotas, cross-border access to capital markets (both into and out of India), and cross-border ventures more generally. The good news is that these factors can often be changed very quickly, if the resolve of the government is to reform. Most of the factors that cause India to sink in the openness index are fatal to attracting large-scale FDI (or significant portfolio flows, for that matter), but are a penstroke away from being eliminated by a determined union government. Tariffs can be lowered, quotas phased out, and capital controls brought in line with competitive international norms. A long-term global trend towards freer trade and capital flows makes maintaining an already costly status quo for India even more so if left unattended.

When asking businesses what factors present the most serious practical challenges to "getting things done" in the developing world, the quality of infrastructure virtually always emerges as a top contender. Unlike the openness variables, improving infrastructure requires significant time and financial commitment. On the GCR scales, India ranks again close to the bottom on most measures of infrastructure quality. While road penetration is extensive, it is judged by businesses inefficient for transporting goods, placing 54th of 59. Railroads fare better, at 28th, ports a dismal 53rd. Where India loses most ground, however, is in measures of telecommunications, with significant unmet demand for telephones, unduly expensive international telephone service, and low penetration of cellular phones, fax machines and telephone lines. Overall, businesses in India rated the quality of their infrastructure 55th in our survey sample. Our calculation (which includes statistical data in addition to survey responses) shows India in 51st place. Attempting to draw policy conclusions may appear daunting, but a focus on liberalizing and privatizing the telecommunications industry is the obvious first place to start, followed closely by the creation of at least one well-functioning free trade zone at a major port. We would also advocate a brief analysis of the road infrastructure, with attention focused on which thoroughfares most benefit trade flows, and government resources carefully targeted to maintain these routes, again perhaps as special economic zones as has been proposed in Eastern Europe and elsewhere.

Table 3: Global Competitiveness Index and Sub-index Rankings*(measured by rank order; sample size is 59 countries)*

	Singapore	India	China	United States
Overall Rank	1	52	32	2
<u>Sub-indexes:</u> ⁶	2	59	52	9
Openness				
Government	1	27	13	15
Finance	2	46	19	3
Infrastructure	7	51	49	1
Technology	2	38	43	1
Management	12	41	53	1
Labor	1	56	15	12
Institutions	2	35	36	8

Source: *Global Competitiveness Report, 1999*

6 Pages 96-98 of the 1999 GCR explain in detail the index calculation. I will quote the definitions of each sub-index below, for clarity's sake, but encourage a full reading of the methodology at the reader's convenience.

Openness focuses on openness to foreign trade and investment, openness to foreign direct investment and financial flows, exchange rate policy and ease of exporting.

Government estimates the role of the state in the economy. This includes the overall burden of government expenditures, fiscal deficits, rates of public saving, marginal tax rates and overall competence of the civil service.

Finance measures how efficiently the financial intermediaries channel savings into productive investment, the level of competition in financial markets, the perceived stability and solvency of key financial institutions, levels of national saving and investment, and credit ratings given by outside observers.

Infrastructure considers the quality of roads, railways, ports, telecommunications, cost of air transportation and overall infrastructure investment.

Technology analyzes computer usage, the spread of new technologies and the level and quality of research and development.

Management looks at the overall management quality, marketing, staff training and motivation practices, efficiency of compensation schemes and the quality of internal financial control systems.

Labor measures the efficiency and competitiveness of the domestic labor market. It combines a measure of the level of a country's labor costs relative to international norms, together with measures of labor market efficiency, the level of basic education and skills, and the extent of distortionary labor taxes.

Institutions measures the extent of business competition, the quality of legal institutions and practices, the extent of corruption and vulnerability to organized crime.

Labor issues pose significant challenges to India, and underscore the most striking difference between China's competitiveness and its own. In our sample, India ranks 56th in the labor sub-index; China 15th. Some of this difference can be credibly attributed to political economy variables highly correlated with democratic government. For example, labor regulations, hiring and firing practices and organized labor and strikes are all very commonly associated with governments that are freely elected, in the developed but even more so in the developing world where poverty rates are higher. There is limited input outside advisors can provide in this regard, except to say that if labor is overly strong, lower labor costs disappears as a competitive advantage for a developing country, significantly diminishing that country's appeal as a site for export-oriented manufacturing FDI.

The consequences of an open political system are by far less significant in lowering India's competitiveness on the labor front than a host of variables directly correlated to the investment in human capital made by governments at the union, state, and local level. India scores again near the bottom of the list in virtually all measures of education – whether at the primary, secondary or tertiary level. Average years of schooling is low, enrollment ratios are low, and in particular investment in educating women and girls is astoundingly low. Companies complain of substandard work ethics among employees, a factor highly correlated with education levels and often remedied by a rigorous primary education. While the exact links between investment in human capital and increases in economic growth have yet to be properly explained, it is clear from case studies of economies that have grown at rapid rates, including most of East Asia's tigers, that all invested tremendous resources in universal primary health and education. It is difficult to imagine any economy or country prospering in the modern age without a well educated, healthy population. The information age requires, above all else, skilled labor.

In examining the institutions sub-index, we will look only at the areas where India scores lowest: measures of corruption, particularly in the public sector. Rather than to explain the relative position, as has been done with the previous sections, we will demonstrate the practical costs of non-transparency, both in terms of lost FDI and vis-à-vis the increased burden to those firms currently operating. We will look both at India, and at China, where institutions are similarly weak, often for similar reasons.⁷

Both countries (are perceived to) have relatively high levels of bureaucratic corruption. A subjective corruption index promulgated by Transparency International on a 0-10 scale where 10 is the most corrupt, rated China and India as 6.5 and 7.1, respectively. In comparison, Singapore was rated as 0.9. Both China and India also have a Byzantine maze of bureaucratic red tape. According to a survey of firms around the world by the World Bank (1997), on a 1-7 scale where 7 indicating the highest level of regulatory burden, China and India received a rating of 4.58 and 5.1, respectively. In comparison, Singapore's bureaucratic burden received a score of 2.08.

Reducing red tape and corruption in India and in China to a level comparable to Singapore, we believe, could more than double inflows of FDI. To be more specific, after a series of

⁷ In the GCR99 index, India and China rank side-by-side on the institutions sub-index, but the reasons differ. In India's case, extreme bureaucratic corruption explains the low rank, while in China rule of law variables play a larger role. We know from a variety of sources, including those cited in this section, that both rule of law and bureaucratic corruption are challenges for both India and China, and therefore examine both countries in both dimensions.

calculations comparing predicted levels of Chinese and Indian FDI to actual levels, then breaking down the difference between these two numbers to component parts, we conclude that reducing corruption and red tape to the Singapore level would mean an increase in FDI to India of 348 percent above its current level, 218 percent for China. While these are rough estimates, and we realize that reducing corruption and red tape is not an easy task, our results suggest the possibility that both China and particularly India could increase inward FDI dramatically if they manage significant improvement in the quality of public governance. First-hand evidence collected by the Boston Consulting Group after a series of interviews with large multi-nationals further confirms that transparency in public governance is key to a smoothly-functioning business community, and hence, the attractiveness of a country or location to discerning international investors.

The relative quantitative effect of corruption (which is closely linked to the levels of bureaucratic red tape) on FDI is also significant, and we assume a significant reason for the dampened levels of FDI described above. Again, without assuming exact precision in the following calculations, we show that a one-step worsening in the corruption rating measured (on a scale of 1 [high] to 7 [low]) by the GCR99, would be equivalent to raising the marginal tax rate by 5 percentage points. To return to the Singapore benchmark, an increase in the host country corruption rating from the Singapore level (GCR99 value=6.6) to the China level (GCR99 value=3.8) has the same effect on inward FDI as raising the tax rate by 14 percentage points (=2.8x5). In other words, the (perceived) corruption in China is likely to have significantly discouraged foreign direct investment. In India (GCR99 value=3.0), the analogous figure is 18 percent (=3.6x5).

We conclude by saying that FDI and national competitiveness are key to achieving India's potential for high rates of economic growth. Quantitative, collective, comparative measures show areas where national policy priorities could – both in the short term and long term – improve India's ability to attract and maintain foreign investors. Perhaps even more important is our final result to present: after controlling for foreign or domestic ownership in our business surveys, we find that the factors which make a country attractive for FDI are virtually identical to those which facilitate domestic businesses as well. An enabling business environment lifts all seaworthy ships, not only those of foreign flag.

High-Leverage Actions to Attract Foreign Direct Investment

Mark F. Blaxill and Arun Maira

Foreign direct investment will flow when business investors are attracted to make investments in India. Changes in the policies and actions of the Indian Government have to influence the behavior of foreign business investors to increase the flow of FDI. It is important, therefore to understand the factors that business people consider, and criteria they use, when deciding to make investments in other countries. In addition, it is necessary to understand what their perceptions are at present of India as a potential opportunity. An understanding of the mindset of foreign business investors will provide the basis for making changes that can have real effect in increasing inflow of investments to India.

Whom We Interviewed

The Boston Consulting Group interviewed a high quality sample of 28 executives in large, multinational companies in Europe, North America, and Asia. They represent many industries, all of which India is interested in.

- These companies have a track record of doing business and investing outside their home countries
- Many of these companies have been in India for decades and can talk with knowledge of the conditions in India and the improvements that have been made in recent times
- Several of the companies we interviewed have experience in China as well
- Some of these companies are in infrastructure businesses that have more recently been opened to foreign investors. While they may not have much experience in India yet, their perceptions are important because India is interested to attract foreign investments in the infrastructure sector.
- The executives in these companies we spoke to were well placed to describe their company's views. For companies that were very active in India already, we spoke to heads of their Indian operations, and for companies that were in the stages of screening India or planning investments in India, we spoke to the heads of their international operations who had oversight of India.

Table 1 is a list of the companies. We spoke with 11 regional heads, eight managing directors, three CFOs and three managers in other roles. Table 2 shows where the companies fall in terms of their targeted market in India. Figure 1 shows the geographic diversity of our sample. We are very pleased with this response particularly given the short notice and the year-end timing of our requests.

Table 1: Companies We Interviewed

Company and Headquarters	Nature of Business	1998 Revenues (US\$ mil.)	Number of Countries	Activity in India
ANZ Grindlays Melbourne, Australia	Banking	6,878	43	Personal & business banking services
Asahi Glass (Mitsubishi) Tokyo, Japan	Glassware	10,120	22	Two JVs
Bell South Atlanta, GA, USA	Telecommunications	23,123	13	Two JVs—divesting
Bosch Stuttgart, Germany	Automobile components	30,200	36	Manufacturing, sales, service—4 locations
BP Amoco London, UK	Oil	68,304	26	Solar and oil operations
Cemex Monterrey, Mexico	Cement	4,317	23	None yet
DaimlerChrysler Stuttgart, Germany	Automobiles	154,615	34	Manufacturing and sales
Gillette Boston, MA, USA	Razors, blades and personal products	1,081	26	Manufacturing and sales
Fiat Turin, Italy	Automobiles	56,535	60	Two sales centers
Henkel Dusseldorf, Germany Henkel-Chembond Henkel-Spic Henkel-Teroson	Chemicals, cleansers, and cosmetics	12,802	70	Three JVs as listed
International Paper Purchase, NY, USA	Paper products	19,541	50	None yet
John Deere Moline, IL, USA	Earth moving equipment	13,626	13	Manufacturing and sales
Loctite Hartford, CT, USA	Adhesives	4,518	80	Sales
Nestle Vevey, Vaud, Switzerland	Confectionery	52,168	70	37-year sales presence
Norsk Hydro Oslo, Norway	Industrial goods	12,827	13	Imports, four JVs, two gas companies
Pepsico Purchase, NY, USA	Soft drinks and snack foods	22,348	170	Manufacturing and sales, exports
Toshiba Tokyo, Japan	Computers and electronics	41,020	21	One liaison office
Vivendi Paris, France	Water utilities	5,650	90	None yet
Volvo Goteborg, Sweden	Automobiles	26,276	27	One 100% subsidiary
Whirlpool Benton Harbor, MI, USA	White goods	10,323	13	Manufacturing and sales
Large drug company	Pharmaceuticals	>10,000	20	
Large electronics company	Electronics	>50,000	48	
International energy company	Power generation	>3,000	5	

Table 2: Reasons for Operating in India

Export	Domestic market	Infrastructure
<ul style="list-style-type: none"> • Deere ⁽¹⁾ • Henkel-Chembond⁽¹⁾ 	<ul style="list-style-type: none"> • ANZ Grindlays • Asahi Glass • Bosch • DaimlerChrysler • Deere • Fiat • Gillette • Henkel-Chembond • Henkel-Spic • Henkel-Teroson • International Paper⁽¹⁾ • Nestlé • Pepsico • Toshiba • Volvo • Whirlpool • Large drug company • Large electronics co. 	<ul style="list-style-type: none"> • BellSouth • BP Amoco⁽¹⁾ • Cemex⁽¹⁾ • Loctite • Norsk Hydro • Vivendi • International energy company

Figure 1: Geographic Diversity of Companies Interviewed



What We Asked

We used a framework to structure our interviews. Major foreign investment projects typically go through a lifecycle of decisions and actions. There are broadly four stages, as shown Figure 2. They are:

- *Screening*: The first stage is to choose a country to pay further attention to. Companies have various factors they consider, depending on the business the companies are in, their growth and investment strategies, and their own experiences with foreign ventures.
- *Planning*: Once a country filters through the initial screen, the company considers what specific opportunities there could be. At this stage, specific market segments may be investigated, joint venture partners sought, financing schemes considered, regulations examined, high level approvals sought, etc.
- *Implementing*: If a project makes business sense, and the decision is taken to proceed, personnel are appointed, project sites secured, local actions initiated, money expended, etc. FDI begins to flow in.
- *Operating and Growing*: Investors like to get their projects running fast, to get their investments to begin to work quickly. At this stage, they begin to engage with the nitty-gritty of local operations, and to actually make and/or sell within the country.

This four-stage process is a funnel, through which FDI flows from foreign investors into India. The greater the number of potential investors who view India favorably at the screening stage, the greater the number of proposals for investment in India. The lower the mortality at the subsequent stages, the greater the actual investment. The faster the speed with which the decisions and actions proceed through all the stages, the faster the flow of FDI as well as the greater the benefit to the investors, who want their money to get to work fast. And the more successful the business investors are in the last stage, the more they are interested in bringing in more investments.

We used this four-stage funnel framework to tease out the most important issues that impede the flow of FDI from business investors into India. These issues are presented in this chapter. Table 3 shows where each of the companies interviewed falls along the framework timeline.

Figure 2: The Project State Framework

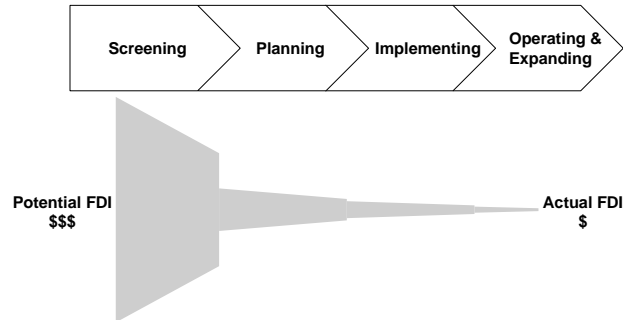


Table 3: Where the Interviewed Companies Fall within the Framework

Screening	Planning	Implementing	Operating & Expanding
<ul style="list-style-type: none"> • BP Amoco • Cemex • International Paper • Vivendi • Large drug company 	<ul style="list-style-type: none"> • BellSouth • International energy company 	<ul style="list-style-type: none"> • DaimlerChrysler • Deere & Company • Fiat • Loctite • Volvo • Whirlpool 	<ul style="list-style-type: none"> • ANZ Grindlays • Asahi Glass • Bosch • Gillette • Henkel • Nestlé • Norsk Hydro • Pepsico • Toshiba • Large electronics company

What We Found

We were pleased that, not only were our interviewees well placed to talk about the strategies and investment criteria of their companies, which they often shared with us with surprising candor. But they were also very interested to share their perceptions of India, generally with great respect for the opportunities and challenges the Indian Government faces.

Our interviews give us hope that the flow of FDI could be accelerated. Many companies have the impression that the business climate in India is improving. For some of our interviewees, the mere fact that they were being asked individually for their views for a report to the Minister of Commerce and Industry was another positive development.

By and large, these executives have empathy with the different situation of India with respect to China. They recognize the complication that the democratic process introduces in policy-making in India. They sense, however, that there are opportunities to improve the process of attracting FDI within the democratic Indian framework. The executives were candid in their observations and, with very few exceptions very constructive in their suggestions. They would like to be successful in their businesses in India. They are looking for the key to their success, even as the Indian Government is looking for the lever to increase the flow of their FDI into India. As an

executive of one of the largest corporations in the world said to us, “There is a prejudice in our entire industry. It is obvious to us all that India is ‘the most amazing, huge, developing market in the world. But we all have the impression that it is impossible to do business in India. We have not yet found the key to the Indian market.’”

In this chapter we present ideas, from a foreign business investors’ perspective, for high leverage actions by the Indian Government to increase FDI.

What We Learned

The main theme that runs through the suggestions is “Focus.” Focus on the few, high leverage actions. Focus on fewer, higher impact, and higher visibility inward investments to catalyse the process. Focus on results.

The 10 areas for action are summarized in the Table 4 below. The percentage of interviewees who mentioned the various areas as opportunities for action is indicated. However, the number who discussed the area is not by itself an indication of the impact the area has. Nor does it provide the insight into what the nature of effective action may be. The insights came from the qualitative discussion with the executives. For example, only 29 percent of our sample commented on corruption as being a major barrier. Corruption is an important issue—as are all the eight issues we have listed. However, amongst these eight most important issues, it was cited less often than the bureaucratic maze (discussed by 71 percent of the sample) as a hurdle to business in India. And those who discussed corruption pointed to some pragmatic steps that can be taken to mitigate the effect of corruption on the foreign investor. Therefore we recommend your attention to the views of these executives on all eight areas.

Table 4: Barriers and Success Factors that Affect Flow of FDI into India

Factors	Number of Respondents	Stages of FDI Project			
		Screening	Planning	Implementation	Growing & Expanding
BARRIERS					
• Image of India	29%	██████████			
• Marketing India	33%	██████████			
• Attitude to FDI	29%		██████████		
• Bureaucracy	71%		██████████		
• Tariff and taxation structure	38%			██████████	██████████
• Corruption	25%			██████████	
• Infrastructure	50%			██████████	██████████
SUCCESS FACTORS					
• Indian Partner	38%		██████████	██████████	
• Leveraging India's Educated workforce	29%			██████████	██████████
• Focus on Indian consumer	25%		██████████		

1. “Bureaucracy”

Delays in decision-making, due to the multiplicity of agencies, at Central and State levels, the plethora of rules, and the bureaucratic mind-set of the many officials who have to be approached for permissions, was by far the most frequently cited obstacle. (71 percent versus 48 percent for the next most frequently mentioned obstacle). The attitude to foreign companies of many of the people whose clearance is required makes the process even more aggravating. As one person said to us, “Stories like Enron have entered the business lore in the USA. There is now a new verb in the business language—to be “Enroned in India!”

Several investors empathized with the different conditions in which the Indian Government has to operate compared to the Government in China. An American executive said, “There is a tension within India that makes life difficult for both Indian policy makers and foreign businessmen. India is the world’s largest democracy. Politicians at the grass-roots level say they have to protect people from businessmen especially foreigners. It is frustrating to navigate through the tangle of difficulties that this tension causes. Navigation is much easier in China where when the Government takes a decision it can see it through all the way quickly.”

This tension notwithstanding, the Indian Government must find ways to simplify and speed up decision-making. Consolidation of regulatory agencies for a sector, and “single window” clearance procedures are beginning to improve the situation in India. Some of our interviewees commented favorably on this. “Seems the country has decided to dismantle the bureaucracy”, said one whose company got all the approvals required in three months. However, much more needs to be done, and quickly, to reduce the bureaucratic tangles that many other foreign business people said they continue to experience in India.

Another executive pointed out that there must be more transparency in the working of these single agencies. “Government has set up boards to take decisions—one stop clearance etc. However, investors have to lobby with each member of these boards separately because they represent so many different interests. Even the senior bureaucrats on these boards follow the lines of their respective ministers. And in coalition Governments, ministers have very different views. The Minister who chairs the Board may say that the investors should bring their issues straight to him. This cannot work in India—though this may work in China. You cannot rely on power here to ram through decisions. You have to make the guidelines, as well as the process of decision-making in these bodies, very transparent.”

2. Tariff and Tax Structure

Foreign businessmen are frustrated by the complicated tax and tariff structure in India, just as much as Indian businessmen are we suspect. “A single, harmonised tax regime is required to support movement of people and goods. Recent discussions of a VAT are a step in the right direction. The overall levels are OK...but the structure is too complicated and requires too much overhead to administer.” The complicated tax structure contributes to hassles with the bureaucracy, to lengthy litigation, and corruption. All of which muddy the image of India as a good place to do business.

One interviewee suggested that taxes at local levels were discriminatory against the products of foreign companies. “State level officials have the impression that since large multinationals have

‘deep pockets’ they could be taxed more heavily. However, we have to compete with local producers and at the end of the day we must make money as well. So this discrimination discourages us from investing further.”

A theme that ran through the discussions about bureaucracy, taxation, and corruption was that the problems are more acute at State and local levels, rather than at the Center. Perhaps the competition amongst the States for FDI, since they cannot count on the Center for more financial support and cannot raise more taxes themselves, may get some of them to tackle these issues more vigorously.

3. Corruption

Corruption is major issue in India. We sensed from our interviewees that they are more affected by corruption at local levels, rather than at the Central Government level. Several of the interviewees said that they were able to get their work done without recourse to any corrupt practices. Almost all those who did not have a negative experience said that they had good, ethical local partners, with whom they had learned how to operate in India without succumbing to pressure for corrupt practices.

A couple of executives pointed out that bad Indian business partners were often the source of the corruption. The Head of International Strategy of one company that has decided to pull out of India said, “There are hidden agendas that just don’t know about and can’t deal with. There is always a sense that if you want to move to the next step, it won’t be done unless you compensate your business partner not only business-wise but personally.”

Therefore, the foreign investor must be careful in choosing a partner. An executive of a European company that has had long experience in both India and China said, “We have learned how to get things done in India without paying anyone anything. We have been working with the right partners here. Unfortunately, there are a few ‘business crooks’ and if a foreign investor gets into a venture with them, things will go wrong, there will be bad publicity, and a bad image for India.”

4. Infrastructure

The abysmal condition of the Indian communication and transportation infrastructure was the second most frequently raised issue. As well as the power supply. It was pointed out that the condition of the infrastructure not only affects the operations of the business, but tarnishes the image of the country for potential investors in a very tangible way. The condition of international airports, the roads from airports into cities, the difficulty of making phone calls, and the interruptions of power supply, do not create an attraction to India.

Improvement of the infrastructure is of course a priority for the Government. However, improving the infrastructure of the country at large may take a fairly long time. It would be pragmatic to concentrate initially on improving the infrastructure for communications, continuous power supply, and easy access to transport in smaller zones of the country. Major projects with foreign investment, especially export-intensive and knowledge-intensive projects, could be initially concentrated in these zones. The success of these ventures would have many benefits that could percolate to the rest of the country. Not least amongst these benefits would be

the creation of a few more success stories of foreign investments in India. India has established a few export processing zones, and some States such as Andhra Pradesh are establishing “technology parks”. However the impact of these has not been so far as large as that of the zones in China, and the reasons for this should be investigated further.

In addition to these special zones for operations, priority attention should be given to airports and access roads to airports, through which every foreign visitor enters the country.

5. Image

Thirty-three percent of the executives urged the Indian Government to focus on improving India’s image. And most of these executives said this should be the highest priority action to attract more FDI. Many of these executives (or their companies) have been in India for some time now. They have seen the improvements in India in the past few years. They think the good story of India is not getting across to business people outside India, while the bad stories are circulated widely.

One American executive said, “There are too many high profile debacles. The travails of Kentucky Fried Chicken, and Enron, leave a very bad taste of India which has to be washed off. India has to work smartly and fast on improving its reputation.” An European executive adds, “What the Indian Government must concentrate on now is to change the image of India. It is not a country of crooks. The bureaucracy is becoming easier to deal with. Things are improving. Good things are happening in the economy and many foreign companies are successful in India. This is the opportunity in India. Not the ‘huge middle class’ which has been overemphasized.”

6. Marketing India

There was near unanimity amongst these executives that the Indian Government needs to be much more focussed in its image-building activities. It should concentrate directly on discussions with the leaders of the large, potential investors, rather than on seminars and delegations to reach a wider business audience which all our interviewees considered a waste of time. In the discussions with the targeted business leaders, the Indian side must focus on these investors concrete business opportunities rather than on generalities. Potential investors should be brought to see the successes in India itself. Many foreign business people are pleasantly surprised with the professional and technical qualities of successful companies in India, in spite of the poverty and the poor infrastructure of the country. In addition, the business press in the major foreign countries must be lobbied much more effectively, to get out the stories of successful ventures in India.

Said one, “Whenever people from German companies see what is actually being done by companies in India they are very impressed. They say, ‘We never expected to see this here’. So the hurdle that individual investors have to cross is this ‘image problem’ and the only way they can do this at present is by actually coming to India “with courage.”

Another said, “I would never expect to get the ‘real story’ of any country from its Government officials. I listen to other foreign and local business people. My own company is doing fairly well in India and we will be investing a large amount in the next few years to source our entire international requirements of [deleted] from India. Business people in my own country are very

interested to hear how we are doing. And a bit surprised because all else they hear is the negative views of India in the press.”

7. Attitude toward FDI

Foreign investors feel less welcome in India than in other countries, including China. This thread ran through many of our interviews. Said one, whose company has invested over half a billion dollars in India already by his reckoning, “The very most important thing the Government must do if they want more FDI is to really welcome it, not just tolerate it as they do now. They have to be able to show this welcome in their attitude and in their body language.”

Another said, “There is an impression that foreign investors are trying to take something away from India. But we also bring something. We have to make this a Win-Win proposition. We must have more direct discussions between us and the concerned people in this ‘win-win’ spirit.” The tone of the Ministers and senior-most officials towards foreign investors, which they may be adopting for internal political expediency, influences the attitude of the officials lower down. As one European executive, describing the hassle of working through the lower levels of bureaucracy said, “Their attitude is, “Why grant an approval in a timely fashion when we don’t really need these foreigners?” The attitude is very different in China.”

8. Find the Right Partner

A piece of advice that our interviewees would give other investors is, “Find the right partner.” The plethora of regulations and agencies make it difficult for a foreign investor to navigate in India. A good local partner can be a good guide. Invariably, those who have succeeded in India have a good local partner. Several of our interviewees commented that good local partners have taught the foreign company how to get things done in India without yielding to corrupt practices.

On the other hand, some interviewees complained about the unfair, even crooked business demands of their local partners. These investors are turned off more by the corrupt practices of their own partners than those of Government agencies. Therefore, it is very important that foreign investors find a good, trustworthy and clean business partner. Some executives wondered whether the Indian Government and/or local business associations could play a role in guiding first-time investors to potential partners. The positive role played by the Indo-German Chamber of Commerce in this regard was commended by one German executive.

9. Leveraging India’s “Educated Work Force”

Focus on a few selected sectors will help India to leverage its comparative advantages and investors to realize the benefits. India’s highly educated and skilled, English-speaking manpower was cited by almost all our interviewees as the unusual strength of India. Even companies that have come to India to sell to the domestic market have established valuable flows of software, products, and people to support their international operations. This is a modern India that exports knowledge-intensive products, whereas the traditional India continues to produce and export some of the finest handicrafts.

This is one area in which India scores over China. India’s visible success in the software business is of course one manifestation of this strength. But foreign companies in the engineering industries also cited how they are leveraging Indian engineering and production capabilities to

source precision components for their international operations. Others are developing people in India for their international management requirements. One chief executive said that his company now has not a single expatriate in India, and has 40 expatriates in China including people deputed from their Indian company! International pharmaceutical companies expect that their Indian organizations could contribute to the research and development of new drugs. “The India pharmaceutical industry has developed world-class abilities to mass-produce drugs. It could move up to R&D, where there is greater value added, and less competition from other developing countries in the medium term.”

In all these ways, India could be a significant player in higher value-added exports, in which so far it has a factor advantage over all other developing countries including China. Of course, in all such knowledge-intensive sectors protection of their intellectual property rights becomes a concern for both foreign and Indian business people. The Government must move faster and with more clarity to comply with international standards of protection. The uncertainty on this vital issue is making investors hold back, in the pharmaceutical industry for example, and India could be losing a valuable window of opportunity while it is still ahead of other countries in the scale and quality of its educated workforce.

10. Focus on the Indian Customer

The myth of the “200 million strong middle class” has drawn many investors to look at India. Some have hoped, perhaps naively, to sell these “middle class” consumers whatever products and services they sell to “middle class” consumers in other markets. A couple of our interviewees admitted that they had not done their homework initially.

On the other hand many have been able to match their products and services with the needs of Indian consumers. And some of these continue to see a huge and real market for their products. A Japanese consumer products company that has been in India for a decade estimates the size of the Indian market with buying power for electric and electronic items may be close to the size of the Japanese market now. A cement producer sees the large size, and growth of India’s population as a huge market for cement. The cost of adaptation of products if any is required must be factored into the analysis of financial viability of the project. In other words, investors must manage their own expectations as well!

Moving into Action

We sensed that India could be poised at the turn of the millennium to change its image, and to accelerate internal changes in a focussed way. And thereby to increase the inflow of FDI. As one friend of India said to us, “India, your moment has come. Don’t fluff it now.”

The ideas we have obtained from these 28 executives, who represent a large pool of potential investment, can be further validated by direct discussions with them and others in their companies. Many have invited us to talk to them again in the New Year. Besides many others we approached expressed an interest to talk to us, but could not do so in the short time that was available.

A focussed marketing campaign could be implemented to get India's success stories, and the opportunities in India directly to such business people. This campaign could be expanded to include other potential investors as well.

A forum could be set up in India to debrief those who are already in India, and those who will come to India, to learn from their experiences and to resolve their problems. Some problems appear trivial compared to the issues we have described in this chapter. For example, an executive who is developing a large foreign investment strategy for his company and has India very much in his sights, said he has a big problem obtaining visas to come to India. The process takes two to three weeks and he cannot be without his passport for that long. Besides he is required to divulge the names of the people he will be meeting and he sometimes considers this inappropriate in view of the confidentiality of the discussions with his potential Indian partners. The identification and speedy removal of such irritants could make foreign investors feel more welcome. And the frank discussions with them would increase trust.

The quality of the process with which foreign investors are engaged by the Indian government will in itself create confidence that India is changing in a business-like way. As the saying goes, "Tell me and I will forget. Show me and I will remember. Involve me and I will care."

India-China Comparison

Most (three quarters) of the companies we interviewed, compared their experience in China with India. The remainder of the interviewees either did not have sufficient knowledge of China or chose not to make comparisons.

Governmental processes:

In comparing the two, the majority (55 percent) commented on the process of obtaining the required decisions from the Government machinery. Almost all of them said that the process was much more effective in China, with some drawing a quite stark contrast in China's favor. There were only two exceptions: both in the infrastructure sectors. One of these said the Indian process was a little quicker, and the other that both were equally slow but the Chinese stuck to their decisions once taken. Some other companies also said that the process took as long in China as in India but even these companies said that in China once the decisions were taken they were firm, whereas in India decisions were often changed. The majority said that the process was actually much faster in China. And some commented that since they were in partnership with Government-owned companies in China, they did not have to hassle with the Government machinery at all!

Skill levels:

The next most often cited factor in comparing the two countries was skill levels (22 percent of companies). Perhaps surprisingly, all of them said that India was fairly well ahead of China. They commented very favorably on Indian managers as well as the high levels of technical skills. In the case of China, although there was great respect for the commercial and technical energy of the Chinese people, some executives expressed the view that China was still developing the skills required to manage a modern economy and that those skills were often scarce. In India, by contrast, there was a great and underutilized people resource base that provided important advantages to Indian operations.

Legal system and business culture:

Other factors were the legal system (17 percent of companies) and the business culture (also 17 percent). On both these, India was ahead of China in the views of all those who mentioned them. However, some did say that the legal system in India was a mixed blessing, in that one could get caught in lengthy litigation.

Market size and potential:

Market size was mentioned by 17 percent, all in favor of China. These companies tended to group China and India together in their corporate strategies. They have similar characteristics: the world's largest, emerging markets with low average per capita income levels and promising futures. Along each dimension, China scores above India, with larger markets, slightly higher income levels (especially in the coastal cities) and higher projected growth. If forced to make a choice between the two countries, almost all would choose China as the preferred location for investment. Some had already done so, by investing in China but not India, whereas one company was pulling out of India while maintaining its investment in China.

Making Profits:

17 percent also mentioned the ability to generate profits, which must be at the end of the day a key measure of attractiveness of a market. The experience of our respondents is very mixed in China so far. Some have begun to make profits and some continue to lose money. China has developed a reputation with some of the companies as a place where substantial over-investment has led to excess capacity and heavy price-cutting. But even the losers say they are in for the long haul because of the attractiveness of the market.

Some issues to consider while determining how to increase the inflow of FDI:

We wanted to explore the decision patterns of experienced MNC business leaders to understand what they considered in the various steps of making investments in other countries. We used a project-flow framework to guide our interviews. Comparative macro-economic factors were not top-of-mind for our most of our interviewees, in part because our discussions focused on India, and less on the comparison with China. In addition, many of these globally experienced companies had already gone through corporate assessments of market potential that were ingrained in their thinking as givens. Consequently, at this point, for both these countries the size and health of the economies was not the most important issue driving their decisions. Our interview respondents concentrated on the practical business issues of market-size for their products and the processes of planning and implementing projects.

We must remember also that all our respondents were multinational companies. They are not the only sources of FDI. In China, a substantial amount of FDI has come from overseas Chinese investors. We did not investigate what factors they consider in investing in China. So our analysis cannot be a complete explanation of the very much larger FDI in China than India described in the previous chapter. However, our analysis should be helpful for the Government to attract multinational corporations who should be an important source of FDI for India.

Foreign Direct Investment in India – Issues and Problems

Jeffrey D. Sachs and Nirupam Bajpai

As against the pre-1991 policy of considering all foreign investment on a case by case basis and that too within a normal ceiling of 40 percent of total equity investment, the new policy provides for automatic approval of FDI up to 51 percent of equity in a specified list of 34 specified high-priority, capital intensive, hi-technology industries, provided the foreign equity covers the foreign exchange involved in importing capital goods and outflows on account of dividend payments are balanced by export earnings over a period of seven years from the commencement of production. Investment above 51 percent equity is permitted on the basis of case by case approvals given by a specifically constituted Foreign Investment Promotion Board (FIPB). Foreign technology agreements were also liberalized for 34 industries with firms left free to negotiate the terms of technology transfer based on their own commercial judgement and without the need for government approval for hiring of foreign technicians and foreign testing of indigenously developed technologies. This is subject to a registration procedure with the Reserve Bank of India (RBI).

In December 1996, the government allowed automatic approval of FDI up to 74 percent by the RBI in nine categories of industries⁸. Subsequently, in January 1997, the government announced the first ever guidelines for expeditious approval of FDI in areas not covered under automatic approval. Priority areas for FDI proposals, as mentioned in the guidelines include infrastructure, export potential, large scale employment potential particularly for the rural areas, items with linkages with the farm sector, social sector projects like hospitals, health care and medicines, and proposals that lead to induction of technology and infusion of capital. Refer to Appendix I for a chronological listing of policy reform in the FDI regime and related areas.

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 labor-intensive manufacturing, that combines the vast supply of Indian labor, including skilled managerial and engineering labor, with foreign capital, technology, and markets Bajpai and Sachs (1997). On this basis, the East Asian economies have achieved growth rates consistently above six percent per year, and China has managed growth in excess of 10 percent per year in the 1990s. Malaysia, to cite another example, has shifted from being a raw-material exporter in the 1970s (with commodities accounting for 80 percent of exports) to a manufacturing exporter (with manufactures, mainly electronics, accounting for 70 percent of exports), and with GDP growth of eight percent per year. MNCs offer the capital, international market access, and technology that India lacks, and are therefore vital to remolding India as a strong and rapidly growing economy.

⁸ Some of these industry categories are construction and maintenance of roads, bridges, ports, harbors, runways; electricity generation and transmission; exploration and production of POL and gas; and mining services except for gold, silver, and precious stones.

Usually, there are a number of firm-specific and country-specific factors that affect location decisions of individual FDI projects. Be that as it may, the WEF's 1997 global executive survey identified six important factors that determine FDI location. Of course, there are a complex set of considerations, including tax rates, exit barriers, wages, project approval procedures, and decentralized decision-making and so on that matter. According to the results of the survey, *market size* is supposed to be the most important factor that a firm has in mind while making a decision on investment location. In addition, the *expected growth in market size* is another significant factor. Empirical analysis confirms the significance attached by the investors on both the current market size and the expected growth in market size. There exists a strong positive correlation between FDI inflows and the market growth index. Another important factor in the determination of FDI flows is *competitiveness*.

Findings of the survey suggest that countries that are more competitive have better prospects of attracting FDI⁹, 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*.

In the analysis of each of these above-mentioned factors in relation to India, it turns out that India does poorly on competitiveness, infrastructure, and skills and productivity of labor. With regard to the overall ranking based on the competitiveness index, India is ranked 52nd out of a total of 59 countries ranked in the GCR 1999 (Table 1). This is primarily because India ranks 59th in openness; 56th in labor; 55th in overall infrastructure, 46th in finance; and 38th in technology. However, in terms of both the current market size and the expected growth in market size, India was placed second after China. For this reason, India is ranked third among the top five countries to attract the most FDI inflows in the medium term, and as per the FDI outlook index¹⁰, India ranks sixth in a total of rankings for 53 countries as per the GCR 1997. Of course, among the countries that offer large and growing markets, factors such as the regulatory regime, competitiveness, quality of infrastructure, openness, and cost of labor play a significant role in determining which countries get the most FDI. On repatriation of capital and remittance of profits, India allows repatriation of capital along with capital appreciation. Remittance of dividends is freely permitted and remittance of principal and interest on foreign loans is also freely allowed if repayment terms have been previously approved by the Reserve Bank of India (RBI). Remittance of royalties, technical fees, and salaries to foreign employees are allowed according to the terms and conditions of specific collaboration agreements.

⁹ Competitiveness is defined as a country's ability to achieve sustained high rate of growth in per capita real income, as measured by per capita GDP in constant prices. It is judged by the overall competitiveness index (CI). Eight factors make up the CI. These are openness, government, finance, technology, infrastructure, management, labor, and institutions.

¹⁰ The FDI outlook index captures the central role of market size and its expected growth in driving FDI flows.

Table 1: Factor Rankings for India and Selected Countries

Country	India	Singapore	Malaysia	Korea	Thailand	Mexico	China	Philippines	Indonesia	Brazil
Overall Rank	52	1	16	22	30	31	32	33	37	51
Openness	59	2	23	35	33	28	52	42	21	53
Government	27	1	4	17	9	24	13	12	5	50
Finance	46	2	10	18	25	44	19	38	51	53
Infrastructure	51	7	25	27	36	40	49	46	41	44
Technology	38	2	24	19	44	31	43	41	51	37
Management	41	12	26	32	40	28	53	24	46	29
Labor	56	1	19	26	48	34	15	28	42	53
Institutions	35	2	30	32	34	45	36	49	55	41

Source: *The Global Competitiveness Report, 1999*

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 labor, 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. We list some of the major deterrents below:

1. Restrictive FDI regime

The FDI regime in India is still quite restrictive. As a consequence, with regard to cross-border ventures, India ranks 57th in the GCR 1999. 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.

2. Lack of clear cut and transparent sectoral policies for FDI

Expedient translation of approved FDI into actual investment would require more transparent sectoral policies, and a drastic reduction in time-consuming red-tapism.

3. High tariff rates by international standards

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. On tariffs and quotas, India is ranked 52nd in the 1999 GCR, and on average tariff rate, India is ranked 59th out of 59 countries being ranked. 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.

4. 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 Minas 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.

5. Limited scale of 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 1965¹¹ compared with China's initial efforts in 1980, the Indian EPZs never seemed to take off -- either in attracting investment or in promoting exports.

6. 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.

7. Stringent labor laws

¹¹ According to UNCTAD (1982), the first two EPZs were established in Mayaguez, Puerto Rico (1962) and Kandla, India (1965).

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. Most importantly, the continuing barrier to the dismissal of unwanted workers in Indian establishments with 100 or more employees paralyzes firms in hiring new workers¹². With regard to labor regulations and hiring and firing practices, India is ranked 55th and 56th respectively in the GCR 1999. Labor-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.

8. Financial sector reforms

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.

9. High corporate tax rates

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. With respect to tax evasion, India is ranked 48th in the GCR 1999.

¹² According to the Industrial Disputes Act (IDA), 1947 if a firm employs 100 or more workers, then workers cannot be laid-off without the prior permission of the concerned state government. Besides, the Act prohibits closure unless of course the state government has granted approval to do so.

Appendix I

Chronological listing of FDI Policy reform and related areas

1991-92

As against the previous policy of considering all foreign investment on a case by case basis and that too within a normal ceiling of 40 percent of total equity investment, new policy provides for automatic approval of FDI up to 51 percent of equity in a specified list of 34 specified high-priority, capital intensive, hi-technology industries, provided the foreign equity covers the foreign exchange involved in importing capital goods and outflows on account of dividend payments are balanced by export earnings over a period of 7 years from the commencement of production. Foreign technology agreements are also liberalized for the 34 industries with firms left free to negotiate the terms of technology transfer based on their own commercial judgement and without the need for government approval for hiring of foreign technicians and foreign testing of indigenously developed technologies. This only subject to a registration procedure with the Reserve Bank of India.

Investment above 51 percent equity is also permitted on the basis of case by case approvals given by a specifically constituted Foreign Investment Promotion Board (FIPB) charged with expeditious processing of governmental approvals.

The procedure for Indian companies to invest abroad and develop global linkages in this way was also streamlined.

The Foreign Exchange Regulation Act (FERA) was amended to remove a number of constraints earlier applicable to firms with foreign equity operating in India and also to make it easier for Indian businesses to operate abroad.

India signed the Multilateral Investment Guarantee Agency (MIGA) Convention and became a member of MIGA along with many other developing countries interested in promotion foreign investment.

Restrictions placed in March 1991 on sale of foreign exchange for import of capital goods, which were allowed initially only under foreign lines of credit available with financial institutions. Subsequently, in November 1991, this policy was relaxed permitting such imports up to a limited extent against suppliers' credit. Import of capital goods up to a value of Rs. 50 lakhs was also permitted against free foreign exchange and up to a value of Rs. 100 lakhs if the importer could arrange suppliers' credit for 360 days. Import of capital goods would be also be allowed (i) against a matching inflow of foreign equity, (ii) against release of free foreign exchange up to 15 percent of the cost of import up to a limit of Rs. 100 lakhs where 85 percent of the cost is financed by external commercial borrowing, (iii) for export-oriented entities against borrowings for a minimum period of two years provided the borrowings are liquidated out of the net foreign exchange earnings of the borrowing unit.

LERMS system introduced in March 1992. LERMS (Liberalized Exchange Rate System) replaced the previous eximscrips system. Under the LERMS system, virtually all capital goods and raw materials and components are made freely importable subject to tariff protection as long as foreign exchange to pay for the imports is obtained from the market.

Earlier prohibition against use of foreign brand name or trademark in goods sold in the domestic market withdrawn.

Abolished all industrial licensing, irrespective of the level of investment for certain

industries related to security and strategic concerns, concerns related to safety and overriding environmental issues, and manufacture of products of a hazardous nature. Certain locational guidelines remain designed to discourage the clustering of industries, particularly the polluting industries in the periphery of major urban centers. Existing industries also free to expand according to their market needs without obtaining prior expansion or capacity clearance from the government.

Abolition of industrial capacity licensing permits firms to freely manufacture any article in response to market demand (except those subject to compulsory licensing). Phased manufacturing programs which allow for the enforcement of strict local content requirements are abolished.

Mandatory convertibility clause allowing financial institutions to convert part of their loans into equity if felt necessary by their management is waived.

MRTP act amended removing the threshold limits of assets in respect of MRTP and dominant undertakings. Prior approval for investment in de-licensed industries from the government is no longer required. As amended, the MRTP act gives more emphasis to the prevention and control of monopolistic, restrictive and unfair trade practices.

1992-93

Many more industries delicensed. Competition promoted by the opening up of many areas previously reserved for the public sector to private and foreign investment. Policies put in place to attract foreign direct and portfolio investment. Amendment of SICA to permit public enterprises to be examined by BIFR. Financial Sector reforms.

The previous dividend balancing condition applicable to 51 percent equity is removed, except for consumer goods industries.

The list of high-priority industries was rationalized and revised including new industries and adding software.

Existing companies with foreign equity can raise it to 51 percent subject to certain prescribed guidelines. FDI is also allowed in exploration, production and refining of oil and marketing of gas. Captive coal mines can also be owned and run by private investors in power.

NRIs and overseas corporate bodies (OCBs) predominately owned by them are also permitted to invest up to 100 percent of equity in high-priority industries with repatriability of capital and income. NRI investment up to 100 percent of equity is also allowed in export houses, trading houses, star trading houses, hospitals, EOUs, sick industries, hotels and tourism-related industries and without the right of repatriation in the previously excluded areas of real estate, housing and infrastructure. Foreign citizens of Indian origin are now permitted to acquire house property without permission of the Reserve Bank of India.

Disinvestment of equity by foreign investors no longer needs to be at prices determined by the Reserve Bank. It has been allowed at market rates on stock exchanges from September 15, 1992 with permission to repatriate the proceeds of such disinvestment.

India signed the Multilateral Investment Guarantee Agency Protocol for the protection of foreign investments on April 13, 1992.

Provisions of the Foreign Exchange Regulation Act (FERA) are liberalized through ordinance dated January 9, 1993 as a result of which companies with more than 40 percent of foreign equity are now also treated on par with fully owned Indian companies.

Investment Promotion and Project Monitoring cell set up in the Department of Industrial Development to provide information and guidance to entrepreneurs regarding licensing policy, tariffs, corporate laws, current status of applications pending with the Department, infrastructure facilities and incentives available at state levels for setting up industries, etc. Peak import tariff brought down from a maximum of 150 percent to 100 percent. Rates for import duties on project imports, capital goods and general machinery were reduced. The Export Promotion Capital Goods (EPCG) Scheme made capital goods importable at 25 percent and 15 percent duty as long as the importers agreed to fulfill a stipulated export commitment.

Taxation of capital gains restructured to allow for inflation accounting. Double taxation of partnership firms abolished and financial assets such as equities and debentures are exempted from the wealth tax.

1993-94

States began exercising the initiative given to them by the Center's 1991 reforms. States in the vanguard of reform included Gujarat, Kerala, Maharashtra, Uttar Pradesh and Andhra Pradesh. Liberalization efforts undertaken include:

- Committees appointed to review laws relating to various aspects of liberalization.
- Private participation in development of ports, power stations and desalination of water supplies, etc.
- Restructuring of District Industries Centers (DICs) in progress.
- Walk-in-system for financial assistance by Gujarat Industries and Investment Corporation (GIIC) and Gujarat State Finance Corporation (GSFC).
- Green channel scheme introduced to expedite industrial clearance.
- A state level agency set up to deal with Board of Industrial and Financial Reconstruction (BIFR) cases of state-owned Public Sector Enterprises (PSEs).
- High-level development committees set up to investigate offers for taking over 10 PSEs listed for disinvestment in Kerala.
- District Collectors' permission to convert agricultural land into industrial use no longer required.
- Industrial location policy revised to permit setting up of non-polluting, non-hazardous and high-tech industries within the municipal zone of Greater Mumbai.
- Private participation encouraged in power projects and establishment of industrial estates.
- Committee set up under State Chief Secretary for expeditious decision on NRI and Foreign Direct Investment.
- District and Division level Authorized Committees with substantial decision-making powers set up to strengthen single-window clearance system.
- Simplification of inspection system by departments.
- Privatization/closure of loss-making public sector industrial undertakings and corporations.
- Involvement of private sector in development and management of industrial estates, generation and distribution of power.
- Special facilities to NRIs and foreign industrialists.
- Various aspects and procedures for obtaining power connection streamlined.
- Power Purchase Agreements have been signed with private developers for setting up of Power Projects. The offers received, for undertaking projects, from private parties are being evaluated in AP.

Specific Center initiated reforms include: 13 minerals earlier reserved for the public sector were opened to the private sector in March 1993. Consequently, the number of industries reserved for the public sector is reduced to 6 (defense, atomic energy, coal and lignite, mineral oils, railway transport, minerals specified in the schedule to the Atomic Energy Order of 1953).

Motorcar and white goods industries were delicensed effective April 28, 1993. Raw hides and skins, leather and patent leather, excluding chamois leather, also delicensed. Overall number of items in respect to compulsory licensing is reduced to 15.

Manufacture of readymade garments (formerly reserved for small-scale units) now open to large scale enterprises as of July 29, 1993. This is subject to an export of 50 percent and investment and assets in plant and machinery of the large unit to not more than Rs. 3 crore.

The Development Commissioners for Export Promotion Zones (EPZs) were delegated some specific powers for 100 percent Export Oriented Units (EOUs) and EPZs. These powers earlier rested with Zonal Authorities under the Ministry of Commerce. This brings down the level at which clearances are required.

Excise duties on capital goods are rationalized and import duties are reduced further to lower capital costs and stimulate investment.

Five-year tax holiday for new industries in industrially backward States and UTs and for power generation anywhere in India is introduced.

Export credit refinance limits are augmented; 90 percent of refinance credit is now available in US Dollars.

The limit for compulsory consortium lending is raised from Rs. 5 crore to Rs. 50 crore. This gives greater flexibility to corporate investors to choose their bank and take advantage of increased competition.

CRR and SLR are reduced to 14 percent and 34.75 percent respectively to make more credit available for the commercial sector.

Minimum lending rate for the highest credit slab is reduced to 15 percent

Sick Industrial Companies (Special Provision) Act, 1985 (SICA) amended in December 1993 to facilitate early detection of sickness in companies and speedy enforcement of remedial measures.

1994-95

Efforts made to facilitate private entry into infrastructure areas including natural resource sectors and non-tradable infrastructure services such as electricity, internal transport and telecommunications. Specific developments included in this area include:

- National Mineral Policy revised and the Mines and Mineral Development Act amended to open up the sector to private and foreign investment. Ten minerals were de-reserved for exploitation by the private sector.
- RBI based automatic approval policy for foreign investment made applicable to mining (except atomic materials and mineral fuels), subject to a limit of 50 percent on foreign equity.
- The new power sector policy framework attracted 138 private proposals for creating 58, 745 megawatts of capacity with an investment of Rs. 219,927 crore. Of these, 41 proposals are from foreign investors or joint ventures with foreign partners. Thirteen were cleared at the end of 94-95 fiscal year.
- National Telecom Policy of 1994 allows for private provision of basic telecom services. For value added services, government permits a maximum of 51 percent equity. Basic services, cellular mobile and radio paging limit is 49 percent. Open system of tendering/bidding of licenses is concluded.
- Enables private Air Taxi companies to operate as regular domestic airlines.

- Development and maintenance of airport infrastructure and material handling areas, etc., opened up to private participation.
- National Highway Act amended to enable toll collection on National Highway users. Further amendments are foreseen to permit private participation in construction, maintenance and operation of roads on a Build-Operate-Transfer (BOT) basis.
- Further private participation in the infrastructure is encouraged in the leasing of port equipment, operation and maintenance of container terminals, cargo handling terminals, creation of warehouse and storage facilities, transportation within ports, setting up private berths by coastal based industries, ship repairs and maintenance
- India took a major step toward current account convertibility in March 1993 when the exchange rate was unified and transactions on trade account were freed from exchange control. The determination of the exchange rate of the rupee was left to the market. The RBI on February 28, 1994 announced the liberalization of exchange control regulations up to a specified limit relating to:
 - (a) exchange earners foreign currency accounts;
 - (b) basic travel quota;
 - (c) gift remittances;
 - (d) donations; and
 - (e) payments of certain services rendered by foreign parties.
- Industrial licensing for almost all bulk drugs abolished.
- Automatic approval of foreign investment up to 51 percent and foreign technology agreements permitted for all bulk drugs and formulations, barring only a few.
- Import duties reduced to 15 percent on export related capital goods, 25 percent for project imports and most capital goods, and continuation of concessional duties at 20 percent for power projects, and 0 percent for fertilizer projects.
- MODVAT extended to capital goods and petroleum products.
- Corporate tax reduced from 45 percent for widely held companies and 50 percent for closely held companies to 40 percent for domestic companies. And from 65 percent to 55 percent for foreign companies.
- Five-year tax holiday to new industrial undertakings that was initially allowed for industrially backward states in the 93-94 budget now extended to all backward areas notified by the Department of Revenue.
- Major overhaul of the excise tax structure, including rationalization of rates, elimination of most end-use exemptions and a general shift from specific to ad valorem duties.
- Continued reform in customs duties, including reduction of the peak tariff rate, elimination of most end-use exemptions and removal of exemptions from countervailing duties.

Foreign Investment allowed for NRIs and persons of Indian origin in a wide range of construction and real estate related activities. Foreign investment also allowed in constructing and operating highways, expressways and bridges on a toll tax system, generating electricity on Build-Operate Own (BOO) basis, basic telephone services and certain operations in railways on Build-Operate-Lease-Transfer (BOLT) basis. Without prior approvals, foreign investors can now own up to 24 percent equity in any Indian firm and up to 20 percent in new private banks.

1995-96

Under zero duty import of capital goods scheme, which is available for imports of capital goods of at least Rs. 20 crore, there are now two windows to fulfill export obligation on FOB (free on board) or NFE (net foreign exchange earnings) basis.

Advance licenses have been made transferable after the export obligation has been

fulfilled and the Bank Guarantee/LUT (letter of undertaking) redeemed.

The concept of a back to back letter of credit has been introduced to enable an advance license holder to source his inputs from domestic suppliers.

The list of sensitive items has been pruned after taking into account the reduction in customs duties and excise duties. Besides, flexibility has been provided to the exporter for using un-utilized c.i.f. value of sensitive items for importing non-sensitive items.

Realization of export proceeds is no longer a condition for availing of facilities, including transferability of the duty exemption licenses or the goods imported under such licenses.

The Software Technology Park (STP) scheme and the Electronic Hardware Technology Park (EHTP) scheme are amended in several respects, including value addition norms and DTA (domestic tariff area) sales.

Definition of consumer goods is changed to suit needs of importers, so as to allow them to freely import parts, components and spares of consumer goods as well. These were earlier restricted to the extent they could only be imported by the actual user. With these changes, any person can import parts or components of consumer durables freely without a license and without actual user condition.

List of freely importable consumer goods is further expanded to include 78 items, including natural essential oils, instant coffee, refrigerated trucks, etc. Additionally, import of 90 consumer items is permitted by all persons against the freely transferable special import licenses (SILs) that are granted to the export and trading houses. The SILs are tradable in the open market at a premium to be determined by the market forces.

List of goods permitted to be imported against the freely transferable import licenses which are granted to the export houses/trading houses/star trading houses and super star trading houses, has been expanded to include items, *interalia*, electric drilling machines, blank 8mm video tapes/cassettes, bar code readers, electronic diaries, ropeway systems, cable cars, electric shavers, powered mowers for lawns, parks or sports grounds, marine containers, video monitors, and certain types of hand tools.

Newsprint including glazed newsprint, has been made freely importable, by all persons.

Import of mandatory spares up to 5 percent of the c.i.f. value of the license has been allowed.

An alternative route of the Pass Book scheme, for some categories of exporters, has been opened. Basic customs duty credit may be utilized for payment of customs duty against import of goods of a non-negative nature.

The Harmonized System (HS) of commodity classification, developed by the CCC (Customs Cooperation Council), Brussels has been in use the world over since the late eighties. India has adopted the system for Customs, Excise, Drawback and compilation of foreign trade statistics purposes. The first attempt to introduce the same system in the Trade sector was made with the publication of "Import Licensing Policy" in two volumes in October 1991. However, the sweeping changes which took place with the liberalization in the EXIM Policy, 1992-97, reduced the utility of the document. The entire exercise was thereafter taken up afresh at the eight digit extended level, and the new Indian Trade Classification (ITC) has now been brought out with the objectives of:

- i) Greater transparency in the import and export licensing policy.
- ii) Compatibility with the system of classification followed by Customs,

- Central Excise and the DGCI & S on Harmonized System (HS) of Commodity Classification.
- iii) Reduction in discretionary controls and areas of ambiguity and disputes on import policy matters.
 - iv) Development of the basic module for computerization and Electronic Data Interchange (EDI).

During the Uruguay Round of negotiations at the WTO, India sought under the GATS agreement to offer entry to foreign services providers in services sectors in which entry was considered to be advantageous in terms of capital inflows, technology and employment. In return, India sought greater access for its skilled personnel to the markets of its major trading partners. Broadly speaking, India's commitments cover a limited offer in the insurance sector as per existing practice. In the banking sector, India permits entry of eight new licenses per year both for new entrants and existing banks, subject to a maximum share of assets in India both on and off balance sheets of foreign banks not exceeding 15 percent of the banking system as a whole. As far as commitments in other financial services, such as merchant banking, financial leasing, factoring, venture capital, financial consultancy etc., all envisage locally incorporated joint venture companies with foreign equity not exceeding 51 percent except for stock brokering where the limit is 49 percent.

Several reforms in the Industrial sector relating to FDI include:

- The number of items, in respect to industrial licensing requirements is reduced to 15. These industries account for only 15 percent of the value added in the manufacturing sector.
- Number of industries reserved for the public sector is reduced to 6, viz. defense products, atomic energy, coal and lignite, mineral oils, railway transport, minerals specified in the schedule to the Atomic Energy Order 1953. Private participation in some of these sectors is also permitted on a case by case basis.
- More private initiative is encouraged in development of infrastructure like power, roadways, telecommunication, shipping and ports, airports and civil aviation etc.
- The manufacture of readymade garments—an item reserved for exclusive manufacture by the ancillary/small scale industrial undertakings opened to large scale undertakings, subject to an export obligation of 50 percent and investment limit of Rs. 3 crore.
- Automatic approval of foreign investment up to 51 percent and foreign technology agreements permitted for 35 priority industries which account for 50 percent value added in the manufacturing sector.

Foreign investment has also been liberalized in many sectors, including:

- a) 35 high-priority industries
- b) Export/Trading/Star trading houses
- c) Hotels & Tourism related industry
- d) 100 percent EOUs and units in FTZ and EPZ
- e) Sick industries
- f) Mining
- g) Telecommunications
- h) Power
- i) Medical clinics, Hospitals, Shipping, Oil exploration, Deep sea fishing, Ind. With licenses.
- j) Industries reserved for SSI
- k) Housing, real estate, business centers & infrastructure facilities.
- l) Portfolio investment (Inv. In shares & debentures).
- m) Government securities

- n) Units in UTI
- o) Public sector mutual funds
- p) Private sector mutual funds

1996-97

The Foreign Investment Promotion Council is set up.

The Foreign Investment Promotion Board (FIPB) is streamlined and made more transparent.

First ever guidelines are announced by the government for consideration of foreign direct investment proposals by the FIPB which are not covered under the automatic route in January of 1997. Priority areas addressed in the guidelines include infrastructure, industries having export potential, large scale employment potential particularly for rural areas, items with linkages to the farm sector, social sector projects like hospitals, health care and medicines, and proposals that lead to introduction of technology and infusion of capital. FDI approvals, are however subject to sectoral caps; 20 percent (40 percent for NRIs) in banking; 51 percent in non-banking financial companies without any special conditions (100 percent with specified minimum levels of foreign investment); 100 percent in power, roads, ports, tourism and venture capital funds; 49 percent (not to be offset against the FDI in an investment holding/company where there is a cap of 49 percent) in telecommunications (basic, cellular, paging services); 40 percent (100 percent for NRIs) in domestic air-taxi operations/airlines; 24 percent in small scale industries; 51 percent in drugs/pharma industry for bulk drugs; 100 percent in petroleum; and 50 percent in mining except for gold, silver, diamonds and precious stones.

The FIPB allows 100 percent foreign equity in cases where the foreign company cannot find a suitable Indian joint-venture partner, subject to the condition that the foreign investor divests at least 26 percent of its equity within three to five years.

New guidelines also allow foreign companies to set up 100 percent companies on the basis of these criteria:

- (a) where only holding operation is involved and all downstream investments to be carried out need prior approval;
- (b) where proprietary technology is sought to be protected or sophisticated technology is proposed to be brought in;
- (c) where at least 50 percent of production is exported;
- (d) consultancy proposals; and
- (e) projects in power, roads, ports and industrial towns and estates.

The FIPB will also allow proposals for 100 percent trading firms for exports, bulk imports, cash-and-carry wholesale trading and other import of goods and services provided that at least 75 percent is for procurement and sale of goods and services among group firms.

The list of industries eligible for automatic approval of up to 51 percent foreign equity is expanded, including three industries relating to mining activity for foreign equity up to 50 percent. An additional 13 industries for foreign equity of up to 51 percent are included. These 13 industries include a wide range of industrial activities in the capital goods and metallurgical industries, entertainment electronics, food processing, and the service sectors having significant export potential.

Foreign Institutional Investors (FIIs) are allowed to invest in unlisted companies and in corporate and government securities.

External commercial borrowing (ECB) guidelines are liberalized and made more

transparent.

In December, 1996, the government allows automatic approval of FDI up to 74 percent by the RBI in nine categories of industries, including electricity generation and transmission, non-conventional energy generation and distribution, construction and maintenance of roads, bridges, ports, harbors, runways, waterways, tunnels, pipelines, industrial and power plants, pipeline transport except for POL and gas, water transport, cold storage and warehousing for agricultural products, mining services except for gold, silver and precious stones and exploration and production of POL and gas, manufacture of iron ore pellets, pig iron, semi-finished iron and steel and manufacture of navigational, meteorological, geophysical, oceanographic, hydrological and ultrasonic sounding instruments and items based on solar energy.

1997-98

To increase the growth rate of industrial production, which had fallen to 7.1 percent in 1996-97 from 12.1 percent in 1995-96, the government

- a) cut personal and corporate income tax rates across the board;
- b) excise duties on intermediate goods and customs duties on imported raw materials brought down;
- c) "infrastructure" broadened to include telecommunications, oil exploration and industrial parks, to enable these sectors to avail of fiscal incentives such as tax holidays and concessional duties;
- d) Bank rate and Cash Reserve Ratio (CRR) reduced in the Credit policies announced during 1997-98;
- e) Banks given freedom in assessing credit requirement for borrowers by withdrawing restrictions on maximum permissible bank finance.

The list of industries eligible for foreign direct equity investment under the automatic approval route by the RBI increased in 1997-98. Equity investment up to 100 percent by NRIs/OCBs has been permitted in high priority industries in metallurgical and infrastructure sectors.

Number of industries subject to compulsory industrial licensing reduced from 14 to 9.

Investment ceiling on plant and machinery for small scale industrial undertakings enhanced from Rs. 60 lakh/Rs. 75 lakh to Rs. 3 crore and for tiny units to Rs. 25 lakh from Rs. 5 lakh. 15 items reserved for manufacture in the small sector are de-reserved.

1998-99

Projects for electricity generation, transmission and distribution and construction and maintenance of roads, highways, vehicular tunnels and vehicular bridges, ports and harbors are permitted foreign equity participation up to 100 percent under the automatic route. Automatic route is subject to a ceiling of Rs. 1500 crore on foreign equity.

FDI permissible under Non-banking Financial Services now includes "Credit Card Business" and "Money Changing Business".

Multilateral financial institutions are allowed to contribute equity to the extent of shortfall in NRI holdings, and within the overall permissible limit of 40 percent in private sector banks.

FDI up to 49 percent equity is allowed subject to license, in the companies providing Global Mobile Personal Communication by Satellite (GMPCS) services.

Unlisted companies are permitted to float Euro issues under certain conditions.

End use restrictions on GDR/ADR issue proceeds have been removed except those on

investment in stock markets and real estate.

India companies permitted to issue GDRs/ADRs in the case of Bonus or Rights issue of shares, or on genuine business reorganizations duly approved by the High Court.

Delicensed coal and lignite, petroleum (other than crude) and its distillation products and bulk drugs.

Delicensed sugar

De-reservation of coal and lignite and mineral oils

Companies permitted to buy-back their own shares subject to restriction of buy-back to 25 percent of paid up capital and free reserves.

National Task Force on IT and Software Development submitted 108 point Action Plan in July 1998. Recommendations accepted by government and directions for their implementation given to concerned parties.

Patent bill approved by Rajya Sabha and subsequently promulgated through ordinance.

Number of items, including some farm implements and tools, are removed from products reserved for exclusive manufacture by SSI sector.

April 1998 Exim policy further delicensed 340 items of import moving them from restricted list to OGL.

India unilaterally removed all quantitative restrictions on imports of around 2300 items from SAARC countries effective August 1, 1998.

Further encouragement of private sector participation and investment in infrastructure continues.

New Telecom policy is under preparation.

Source: "Economic Reforms: Two Years After and the Task Ahead" Discussion Paper, GOI, Ministry of Finance, Department of Economic Affairs.

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