Attracting Foreign Direct Investment (FDI) to India

Ramkishen S. Rajan[a], Sunil Rongala[b] and Ramya Ghosh[c]

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a) George Mason University, Virginia, USA. E-mail: rrajan1@gmu.edu .
b) International Professional Services Organization, Hyderabad, India. E-mail: sunil.rongala@gmail.com
c) Claremont Graduate University, California, USA. Email: ramya.ghosh@cgu.edu

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1. Introduction

Economic policymakers in most countries go out of their way to attract foreign direct investment (FDI). A high level of FDI inflows is an affirmation of the economic policies that the policymakers have been implementing as well as a stamp of approval of the future economic health of that particular country. There is clearly an intense global competition for FDI. India, for its part, has set up the "India Brand Equity Foundation" to try and attract that elusive FDI dollar.

According to UNCTAD (2007), India has emerged as the second most attractive destination for FDI after China and ahead of the US, Russia and Brazil. While India has experienced a marked rise in FDI inflows in the last few years (doubling from an average of US$5-6 billion the previous three years to around US$ 19 billion in 2006-07) (Figure 1), it still receives far less FDI flows than China or much smaller economies in Asia like Hong Kong and Singapore was ahead of India (Figure 2). Not surprisingly India's growth strategy has depended predominantly on domestic enterprises and domestic demand as opposed to FDI and export demand.[1] For instance, India's FDI as a share of GDP in 2007 represented only about 1.7 percent compared to 2.8 percent in China and even below Pakistan, and its share of gross fixed investment is 5.2 percent compared to 7.0 in China and 16.7 percent in Pakistan (Table 1). FDI has been a relatively limited source of external financing and reserve buildup in India.[2]

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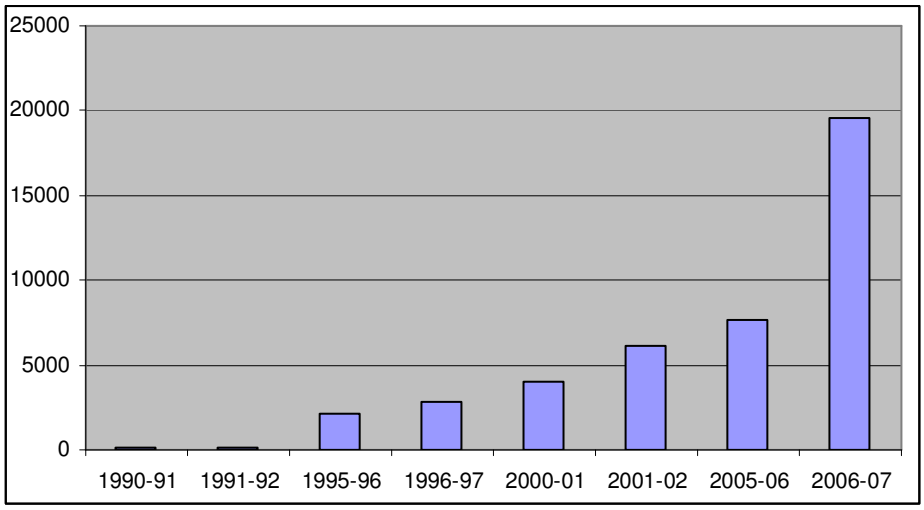
[1] A host of studies has found that FDI has been a major conduit to China's export and overall economic growth (Lardy, 1994, Lemoine, 2000 and Wei, 1996), as it did in the rest of the Asian Newly Industrializing Economies (NIEs) since the 1980s until mid 1990.

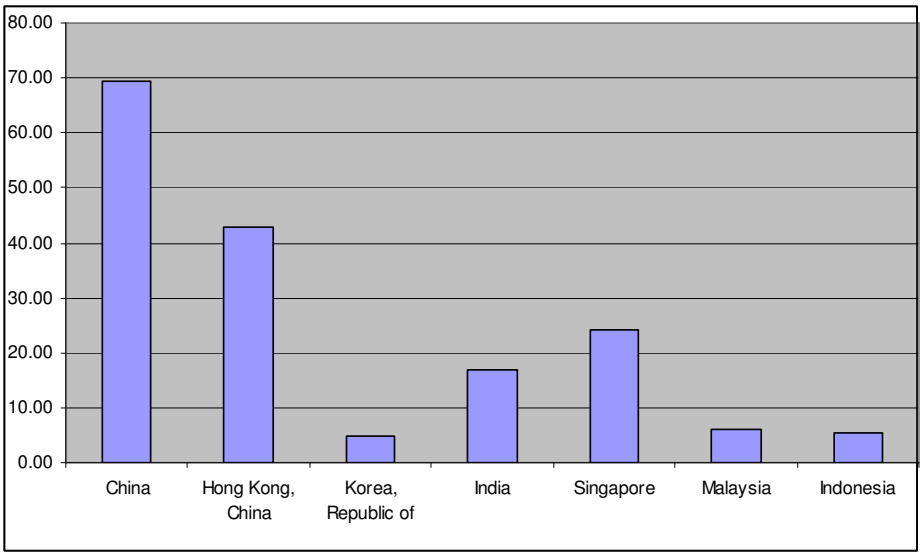
[2] Since both China and India have also experienced significant outward FDI, gross FDI inflows would have added much more to reserves. For a discussion of FDI outflows from India and other emerging Asian economies, see Rajan, Kumar and Vargill, eds. (2008)

Figure 1: FDI Inflows into India, 1990-2007 (US$ millions)



Source: Reserve Bank of India (RBI)
Note: Data includes acquisition of shares of Indian companies by non-residents.

Figure 2: FDI Inflows into Asian Countries in 2006 (US$ billions)



Source: UNCTAD, World Investment Report 2007 database

Table 1: Comparative Inward FDI

FDI (percent of GDP)								
	2003	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
India	0.7	0.8	0.8	1.9	1.7	1.8	2.0	2.1
China	2.9	2.8	3.4	2.8	2.9	2.1	1.8	1.6
Pakistan	0.6	1.1	2.0	3.4	2.7	2.2	2.1	2.1
Vietnam	3.7	3.5	3.7	6.5	8.7	8.1	7.6	7.4
FDI (percent of gross fixed investment)								
	2003	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
India	2.9	3.2	2.9	6.4	5.2	5.5	5.9	6
China	7.3	7	8.4	6.9	7	5	4.3	3.8
Pakistan	4.2	7.6	11.5	16.7	12.7	10.2	9.7	9.5
Vietnam	11	10.7	11.2	20.4	26.7	24.8	23.1	22.3
FDI per head (US$)								
	2003	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
India	4	5	6	16	16	16	18	19
China	37	43	61	60	60	64	65	68
Pakistan	4	7	14	27	18	16	17	18
Vietnam	18	20	24	49	52	70	80	85

Source: EIU (2007)
Note: Data from 2007 on are estimates for India, China and Pakistan while it is from 2006 on for Vietnam. 2008-2010 are projections.

While there is an intense "global race" for FDI, how important is FDI to a country's economic growth? It is certainly a difficult ask to separate and quantify the complex package of resources that FDI confer to the host country. There have been a number of macro studies attempting to determine the nexus between FDI and growth. These are summarized in Table A1 in the Annex. By and large, studies have found a positive links between FDI and growth, though FDI appears less positive in least developed economies, suggesting the existence of "threshold level of development" (Blomström and Kokko, 2003 and Blomström et al., 1994).

In addition, the FDI and growth studies are open to a number of criticisms. For instance, an important critique has to do with causality: does FDI lead to greater productivity and overall economic growth, or are these prerequisites for attracting FDI? Athreye and Kapur (2001) have recently emphasized that since the contribution of FDI to domestic capital formation is quite small, *growth-led FDI* is more likely than *FDI-led growth*. This is so, as increased economic activity expands the market size, offering

greater opportunities for foreign investors to reap economies of scale in a large market economy like India. A similar conclusion arises from an empirical study by Dua and Rasheed (1998) which finds that industrial production in India has had a unidirectional positive Granger-causal impact on inward FDI flows (both approval and actual), thus inferring that economic activity is an important determinant of attracting FDI inflows in India, and not vice-versa. Similar questions regarding causality between market size/growth and magnitude of FDI inflows hold in the case of China (Tseng and Zebregs, 2002).

These important caveats notwithstanding, it is almost universally acknowledged that FDI inflows offer significant potential benefits to an economy in ways that are not readily obvious in the data. The UNCTAD (1999) notes that transnational corporations (TNCs) can complement local development efforts by: (a) Increasing financial resources for development; (b) boosting export competitiveness; (c) generating employment and strengthening the skills base; (d) protecting the environment and social responsibility; and (e) enhancing technological capabilities (transfer, diffusion and generation of technology). Technology transfer operates via four related channels: (i) vertical (backward and forward) linkages with suppliers or purchasers in the host countries; (ii) horizontal linkages with competing or complementary companies in the same industry; (iii) migration skilled labour; and (iv) the internationalization of R&D (OECD, 2002, Chapter 1).

While the transfer of technology from FDI to the domestic economy could be potentially significant, they are certainly not automatic. Indeed, the links between technological development and FDI are mixed at best (see Te Velde, 1999; also see Blomström and Kokko, 2003 and OECD, 2002, Chapter 5). Absent pro-active government policies, there are risks that TNCs may actually inhibit technological development in a host economy with few vertical linkages (i.e. so-called “screw-driver operations with minimal value-added and minimal procurement from local suppliers and interactions with local businesses) and crowd out domestic investments. While the oft cited study by Borensztein, et al. (1998) reveals that FDI has a net crowding-in effect on domestic private and public investment thus advancing overall economic growth, the finding is not unambiguous. For instance, Lipsey (2000) notes, “past FDI inflows are not

a significant positive influence on the current period's investment ratio" (p.76). However, in a more nuanced study, Agosin and Mayer (2000) finds that the crowding-in effects of FDI varies with regions, with there been strong evidence of *crowding-in* in Asia but net *crowding-out* effects in Latin America.

A more careful examination of the empirical studies linking FDI and technological development suggests that FDI is more likely to be a significant catalyst to overall industrial development the higher the income of the host country. This in turn is often interpreted as signifying that the host country must be capable of absorbing the new technology manifested in FDI (e.g. see Blomström et al., 1994). In similar vein, another common finding is that greatest technological spillovers from FDI occur when the technological gap between local and foreign enterprises is not very large, and crowding in of FDI and technology transfer is more likely the higher the level of human capital (Borensztein, et al., 1998 and OECD, 2002).As the OECD (2002, Chapter 3) concludes:

> Apparently, developing countries need to have reached a certain level of educational, technological and infrastructure development before being able to benefit from a foreign presence in their markets. An additional factor that may prevent a country from reaping the full benefits of FDI is imperfect and underdeveloped financial markets (p.69).

India, with its relatively well developed financial sector, strong industrial base and critical mass of well educated workers, appears to be well placed to reap the benefits of FDI In view of this, it is appropriate that Indian policy makers continue to make concerted efforts to make India an attractive destination for FDI. Recognizing the potential benefits of FDI, the government seeks to double the FDI inflow to US$ 30 billion in fiscal 2009 in order to maintain a growth rate of 9 per cent per annum over the next five years. Section 2 takes stock of the current state of FDI in India, focusing on the country sources, state-wise destinations and main sectors that have attracted FDI. Section 3 discusses why India has problems in attracting FDI beyond the obvious and major infrastructural constraints. The final section concludes with a selective set of ten policy recommendations relating to Indian FDI policy going forward.

2. State of FDI in India

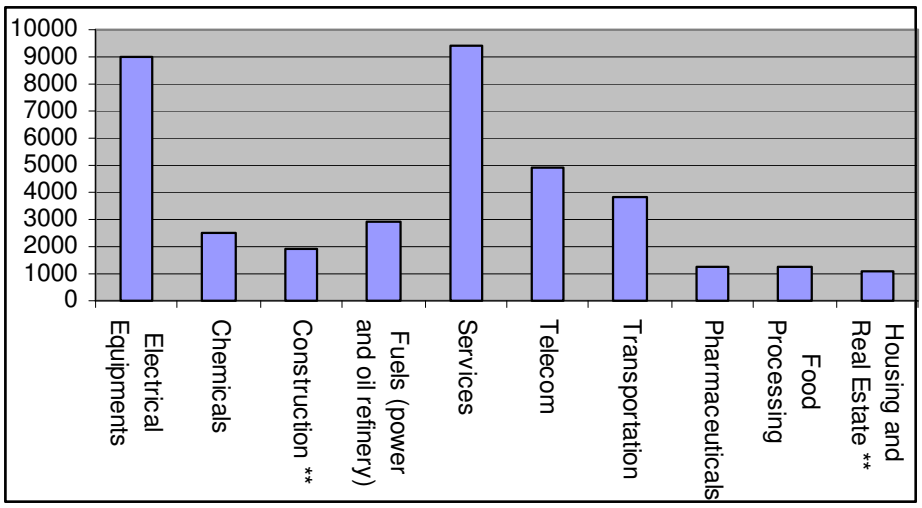
While it is clear that FDI inflows into India have been on the rise, what are the main sources of FDI and what is the sectoral and geographical distribution of FDI? We explore these issues in this Section.

2.1 FDI Inflows by Sector

Cumulative FDI inflows reached just over US$60 billion between August 1991 and July 2007. Since 2002, some sectors such as electrical equipment, services, drugs and pharmaceuticals, cement and gypsum products, metallurgical industries have also been doing very well in attracting FDI. The electrical equipment sector and the services sector in particular received the largest shares of total FDI inflows between August 1991 and July 2007. These were followed by the telecommunications, transportation, fuels, and chemicals sectors (Figure 3).

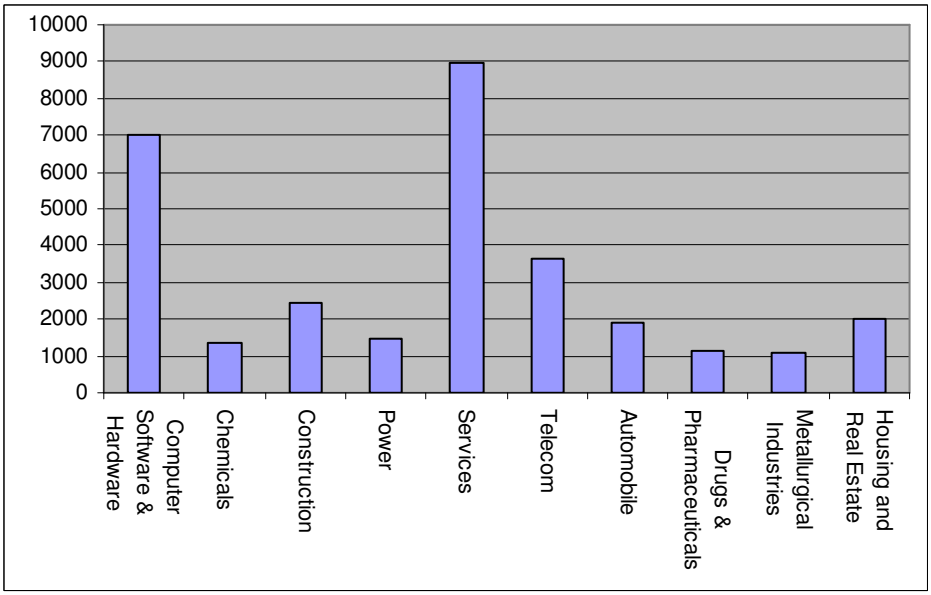
The Department of Industrial Policy and Promotion has recently modified the classifications of the sectors and data released from August 2007 has been based on the new sectoral classifications. According to that classification, the top performers are the services and computer software & hardware sectors (Figure 4). Clearly, India has attracted significant overseas investment interest in services. It has been the main destination for off-shoring of most services as back-office processes, customer interaction and technical support (UNCTAD, 2007). Indian services have also ventured into other territories such as reading medical X-rays, analyzing equities, and processing insurance claims. According to some reports, however, increasing competition is making it more difficult for Indian firms to attract and keep BPO employees with the necessary skills, leading to increasing wages and other costs.

Figure 3: Cumulative FDI Inflows, August 1991 to July 2007 (US$ millions)



Source: Department of Industrial Policy and Promotion, Ministry of Commerce & Industry, Government of India.
Note: ** Year-wise/data available from January 2000 onwards only.

Figure 4: Cumulative FDI Inflows, April 2000 to Dec 2007 (US$ millions)



Source: Department of Industrial Policy and Promotion, Ministry of Commerce & Industry, Government of India

2.2 Country Sources of FDI

Among countries, Mauritius has been the largest direct investor in India. Firms based in Mauritius invested over US$20 billion in India between August 1991 and July 2007 or over two-fifth of total FDI inflows during that period (Table 2). However, this data is rather misleading. Mauritius has low rates of taxation and an agreement with India on double tax avoidance regime. To take advantage of that situation, many companies have set up dummy companies in Mauritius before investing to India. Also, a major part of the investments from Mauritius to India are actually round-tripping by Indian firms, not unlike that between Mainland China and Hong Kong.

The United States (US) is the second largest investor in India. The total capital flows from the US was around US$6. billion between August 1991 and July 2007, which accounted for 12 percent of the FDI inflows. Most of the US investments were directed to the fuels, telecom, electrical equipment, food processing, and services sectors. The United Kingdom (UK) and the Netherlands are India's third and fourth largest FDI inflows. The investments from these countries to India are primarily concentrated in the power/energy, telecom, and transportation sectors. Japan was the fourth largest source of cumulative FDI inflows in India between 1991 and 2007, but inflows from Japan to India have decreased during this time period. This is opposite to the general trend. This is particularly interesting because Japan's FDI outflows in 2006 increased by 10 percent to reach a record US$50 billion, the second highest since 1990.[3] It is hard to explain the recent decline of Japanese FDI to India and it might as well be a temporary anomaly.[4] India, however, continues to be one of the biggest recipients of Japanese Official Development Assistance (ODA). Most of the assistance was in building infrastructure, including electricity generation, transportation, and water supply. It is plausible that Japanese government assistance has crowded out some private sector investment from Japan. The top sectors attracting FDI inflows from Japan to India (January 2000 to

[3] This is according to the World Investment Report (2007) by UNCTAD. See Daisuke (2008) for a discussion of Japan's outward FDI.

[4] See Asher (2007) for a more general discussion of India-Japan economic relations.

November 2006) have been transportation (54 percent), electrical equipment (7 percent), telecom, and services (3 percent).

Table 2: Top Country Investors in India

Country	Cumulative FDI Inflows, August 1991 to July 2007 (US$ millions)	Share of FDI Inflows. August 1991 to July 2007 (percent)
Mauritius	20,808	41.9
US	6,215	12.0
UK	3,979	8.0
Netherlands	2,789	5.6
Japan	2,585	5.1
All Other	13,297	27. 4
Total	49,673	100

Source: GOI (2007)

2.3 Distribution of FDI within India

Mumbai and New Delhi have been the top performers, with the majority of FDI inflows within India being heavily concentrated around these two major cities. Chennai, Bangalore, Hyderabad and Ahmedabad are also drawing significant shares of FDI inflows. For statistical purposes, India's Department of Industrial Policy and Promotion (DIPP) divides the country into 16 regional offices. The top 6 regions account for more than two-thirds of all FDI inflows to India between January 2000 and July 2007 (Table 3).

Table 3: FDI Equity Inflows by Region, (January 2000–July 2007)

Rank	RBI Regional Office	State(s) Covered	FDI Inflows (US$ millions)	Share of Total (percent)
1	Mumbai	Maharashtra, Dadra & Haveli, Daman & Diu	**9,594.6**	**24.64**
2	New Delhi	Delhi, Parts of UP and Haryana	**9,194.2**	**23.55**
3	Bangalore	Karnataka	**2,824.2**	**7.21**
4	Chennai	Tamil Nadu, Pondicherry	**2,774.7**	**7.17**
5	Hyderabad	Andhra Pradesh	**1,509.8**	**3.88**
6	Ahmedabad	Gujarat	**1,092.9**	**2.85**
7-16	All Others		**11,838.1**	**30.49**
Total			**38,828.5**	

Source: GOI (2007)

The foregoing data is based on both Greenfield and Mergers and Acquisitions (M&As). However, a recent study that examines only Greenfield projects makes a largely similar set of points (USITC, 2007). That data shows that the 5 Indian states that received the largest number of Greenfield FDI projects in 2006, based on the total number of projects reported, were Maharashtra (20 percent, includes the city of Mumbai). The key sectors attracting FDI to the Mumbai-Maharashtra region are energy, transportation, services, telecommunications, and electrical equipment. Delhi attracts FDI inflows in sectors like telecommunications, transportation, electrical equipment (including software), and services.

Karnataka (15 percent, includes the city of Bangalore), Tamil Nadu (13 percent, includes the city of Chennai), Delhi (9 percent, includes the city of New Delhi), and Andhra Pradesh (8 percent, includes the city of Hyderabad). The states of Uttar Pradesh and Haryana (especially those parts of the National Capital Region) have also performed really well in recent years. Due to its abundance of natural resources, Uttar Pradesh attracts FDI in chemicals, pharmaceuticals, and mining and minerals whereas Haryana attracts FDI in the electrical equipment, transportation, and food processing sectors.

Tamil Nadu has done well in sectors related to automotive and auto components. Ford, Hyundai, and Mitsubishi have made major investments in Tamil Nadu. The state has attracted FDI in other sectors as well such as port infrastructure, ICT, and electronics. Andhra Pradesh and Karnataka have attracted FDI mainly in areas associated with software and, to a lesser extent, hardware for computers and telecom. Hyderabad and Bangalore are the cities which received the major share of the projects in these two states. Karnataka has done well in the automotive sector as well.

India's rural areas have also attracted some big projects. Orissa, for example, has secured some large Greenfield FDI projects in bauxite mining, aluminum smelting operations as well as in steel and automotive facilities. For example, Luxembourg-based Arcelor-Mittal, the world's largest steel maker, has also signed a memorandum of understanding with the Orissa state government to build an US$8.7 billion steel mill.

3. Why India Gets Limited FDI

In 2006 the Government of India undertook a comprehensive review of the FDI policy and associated procedures (GOI, 2006). A number of measures have been undertaken to make India a more attractive destination for FDI. Some key measures include allowing FDI in new sectors, dispensing with the need of multiple approvals from Government and/or regulatory agencies that exist in certain sectors, and extending the automatic route to more sectors.

According to the current policy, under the automatic route, FDI up to 100 percent is allowed in most sectors/ activities. No prior approval from the Government of India or the Reserve Bank of India (RBI) is required for FDI under the automatic route. Investors are only required to notify the concerned Regional office of RBI within 30 days of receipt of inward remittances and file required documents with that office within 30 days of issue of shares to foreign investors.

In some sectors, FDI is allowed, subject to certain equity limits and/or other conditions. For example, the FDI cap in Air Transport Services is 49 percent. However, there is no restriction in that sector if there is NRI investment. The FDI limit for the insurance sector is only 26 percent even though it is under the automatic route. For Single Brand product retailing, the limit is 51 percent. FDI in all sectors/activities is subject to guidelines and requirements. FDI is not permitted in Retail trade (except Single Brand product retailing); Lottery; Gambling and Atomic Energy. In the remaining sectors/activities, FDI up to 100 percent would be allowed on the automatic route.

While the relaxation of these FDI norms may have helped attract greater FDI inflows, prima facie, India's inward FDI should be huge or at least much bigger than what it currently receives. If one goes through research output from investment houses, India has been portrayed as nothing short of the "Promised Land". Research report after research report from major investment banks shows the upward potential growth trajectory of India. For instance, the well-known BRICs report from investment bank Goldman Sachs wrote the following a few years back:

> In US dollar terms, China could overtake Germany in the next four years, Japan by 2015 and the US by 2039. India's economy could be larger than all but the US and China in 30 years…… India has the potential to show the fastest growth over the next 30 and 50 years. Growth could be higher

> than 5 percent over the next 30 years and close to 5 percent as late as 2050 if development proceeds successfully. (Wilson and Purushothamam, 2003).

The Goldman Sachs report has been the rule rather than the exception. The *FDI Confidence Index 2007*, an annual report from consultancy firm A.T. Kearney has ranked India at second place, a position it has held since 2005. The report notes:

> India retains second place in the Index, a position it has held since displacing the US in 2005. India continues to attract investors in the high value-added services industries, particularly financial services and information technology. Three quarters of respondents who are 'highly likely' to invest in India over the next few years are from outside Asia."[5]

As noted previously, India has experienced a sharp jump from US$6.7 billion in 2005 to US$17.5 billion in 2006. However, that number becomes a far less impressive when you consider that US$4.6 billion of the US$17.5 billion in 2007 was because of an accounting transaction between UK based Cairn energy and its Indian partner. In addition, a greater deal of their FDI into India in 2006 was concentrated in property development (The Economist, 2007). In fact, a significant portion of India's FDI is M&A related and not Greenfield investment.[6]

When India's inward FDI numbers are compared with other countries (see Table 1), the picture that emerges is far from encouraging, in fact rather dismal. In terms of inward FDI, India lags very badly behind China and according to the EIU; it is set to lag even into the near future. The EIU (2007) writes:

> Although China has been the top investment destination in Asia for some years, investor interest in India is a more recent development. Whereas China's FDI is concentrated in capital-intensive manufacturing, FDI flows into India are mostly in information technology (IT) and communications centres, which are not accompanied by sizeable FDI flows. Despite India's successful positioning as a business processing and IT outsourcing hub, these activities often translate into Indian services sector exports via third-

[5] Available at http://www.atkearney.com/main.taf?p=5,4,1,130.

[6] We are, however, unable to divide the share of FDI into Greenfield and M&A. There is no official data related to M&A in India. A study done by the U.S. International Trade Commission uses private databases to illustrate the trends related to M&As as well as Greenfield FDI in India (USITC, 2007). However, according to that report, the data from those private databases is not consistent with official FDI inflows data. The numbers related to total investment via Greenfield FDI and M&A investment are considerably larger than the values for total FDI inflows reported by the government of India.

party transactions—not FDI. Despite strong growth in FDI inflows in 2005-06, India has yet to build a critical mass in FDI.

This is an important point. While India's manufacturing sector has certainly undergone a renaissance in the last few years (Rajan and Rongala, 2007), foreign investors have not viewed India as a major manufacturing hub for labour-intensive exports, preferring China, Vietnam and other Asian economies instead. Indian Commerce Minister Kamal Nath calls manufacturing FDI "the sweetest of all FDI" (The Economist, 2007). Manufacturing investments have significant potential to develop ancillary industries and provide large-scale employment to people who are relatively unskilled compared to the service sector. The employment factor is especially critical to a country like India where there is substantial under-employment in the agricultural sector and sooner or later people will start moving out in search of other jobs and these people are not suited for service sector jobs. Low-end, labour intensive manufacturing jobs (such as assembly) appear to be the best alternative for them. But why does not India receive much FDI into the manufacturing sector?

3.2 Why India Lags as a FDI Destination for Manufacturing?

Two oft-noted problems that are often highlighted in India have been the poor state of the country's infrastructure as well as the acute labour market rigidities. Any trip outside urban areas highlights the problem of bad infrastructure in India. To start with roads, they are best described as shoddy and are strewn with potholes and these are roads that are described as "national highways". Most of these highways are two-lane roads at best though there is the construction of the Golden Quadrilateral, a four to six lane highway linking major cities in India going on. However, the Quadrilateral does not link much of India. This is not to say that infrastructure in urban areas is any good. Urban infrastructure in the country remains woeful. The fact is that they are terrible in absolute terms and not just in comparison to any Western city. The other problem is power. It is very common for towns and villages to face daily blackouts averaging more than 8 hours a day. The other infrastructure issues are the ports, airports; both which are either too small or bad when compared to world-class ports or airports.

Added to the acute infrastructure woes are the rigidities in Indian labour markets which makes it practically impossible to shed excess labour or get rid of non-performers. Looking beyond these two constraints, a number of studies and reports have highlighted other weaknesses that hinder India's development as a major export-oriented manufacturing base. We highlight some of these studies below.

a) Doing Business in India – World Bank

The World Bank conducts an annual study on "Doing Business in India". The latest report available is Doing Business 2008 and in this report, India is ranked a rather inglorious 120 out of 178 economies. The report is based on a "series of annual reports investigating the regulations that enhance business activity and those that constrain it. Doing Business presents quantitative indicators on business regulations and the protection of property rights that can be compared across 178 economies-from Afghanistan to Zimbabwe-and over time." The report considers 10 indicators and they are fairly self-explanatory. These indicators are; starting a business, dealing with licenses, employing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and closing a business.

Table 4: Doing Business in India

		Rank
	Ease of Doing Business	*120*
1	**Starting a Business**	111
2	**Dealing with Licenses**	134
3	**Employing Workers**	85
4	**Registering Property**	112
5	**Getting Credit**	36
6	**Protecting Investors**	33
7	**Paying Taxes**	165
8	**Trading Across Borders**	79
9	**Enforcing Contracts**	177
10	**Closing a Business**	137

Source: Doing Business: World Bank

India fairs "decently" in only two areas, viz. getting credit and protecting investors' categories. Perhaps the truly embarrassing rank is for the "enforcing contracts" category

in which India is ranked a dismal 177 out of 178 countries. According to the report, it takes 1420 days to enforce a contract and the cost to enforce that contract is almost two-fifths of the claim. This is a key concern for businesses.

b) Global Competitiveness Index 2007-08 – World Economic Forum

The World Economic Forum (WEF) has an annual index which tries to measure "competitiveness". The WEF define competitiveness as:

> The set of institutions, policies, and factors that determine the level of productivity of a country. The level of productivity, in turn, sets the sustainable level of prosperity that can be earned by an economy. …. The productivity level also determines the rates of return obtained by investments in an economy. Because the rates of return are the fundamental determinants of the growth rates of the economy, a more competitive economy is one that is likely to grow faster over the medium to long run.

Table 5: Ranking of India in World Competitiveness Index

	Rank
Global Competitiveness Index 2007-2008 (131 countries)	**48**
Global Competitiveness Index 2006-2007 (122 countries)	**42**
Sub-index A: Basic Requirements	**74**
1st Pillar: Institutions	48
2nd Pillar: Infrastructure	67
3rd Pillar: Macroeconomic Stability	108
4th Pillar: Health and Primary Education	101
Sub-index B: Efficiency Enhancers	**31**
5th Pillar: Higher Education and Training	55
6th Pillar: Goods Market Efficiency	36
7th Pillar: Labour Market Efficiency	96
8th Pillar: Financial Market Sophistication	37
9th Pillar: Technological Readiness	62
10th Pillar: Market Size	3
Sub-index C: Innovation and Sophistication Factors	**26**
11th Pillar: Business Sophistication	26
12th Pillar: Innovation	28

Source: World Competitiveness Report 2007-08: World Economic Forum

The pillars are by themselves self-explanatory and each pillar has several factors that contribute to its scoring.[7] While India's ranking by the GCI scoring is not as bad as the World Bank's *Doing Business Index*, it is still rather poor for a country that aims to be attract significant FDI, especially in the manufacturing sector. India's ranking also slipped by 6 places. Countries that India would compete with for FDI inflows are all ranked above India. China has been ranked at 34, Taiwan at 14, Singapore at 14, and Thailand at 28.

The highest rank for India is the market size pillar but that is a "no-brainer" given the size of the population. However, one number of significant concern is the macroeconomic stability pillar, where India is ranked 108; something that is surprising given projections of India's rapid medium-term economic growth. The reason stated by the GCR report for why the macroeconomic stability pillar was ranked so low was because of the government's growing fiscal deficit. This is something to take note of. The Economist (2008) writes:

> India, though improving, has one of the worst fiscal positions in the world. The government tries hard to conceal this fact, boasting that it has reduced its deficit to an estimated 3.3% of GDP in the year ending March, from 6.5% in 2001-02. However, in a recent report the IMF argued that the true total deficit is closer to 7% of GDP once you add in the state governments' deficits and various off-budget items. If the losses of state electricity companies are also added in, the total deficit could top an alarming 8% of GDP.

The report also highlights the labour market inefficiencies, a problem emphasized in nearly every report on India. Another pillar that has been ranked low is the 'health and primary education' pillar where India has been ranked an absymal 101. This pillar is very telling because poor primary education is what has essentially caused India's so-called 'demographic dividend' to be somewhat illusionary. Despite the country's huge working age population, there is already an acute shortage of talent in India which is having a negative repercussion on businesses – both domestic and foreign. Unfortunately there is very little concrete action being taken to address this issue.

[7] More information can be found at http://www.weforum.org/en/initiatives/gcp/Global%20Competitiveness%20Report/index.htm

c) World Economic Prospects to 2011: Economist Intelligence Unit

According to the EIU, FDI into India has been sub-par and will continue to be so because its business environment is rather poor. The report states: "FDI inflows are set to increase substantially during the forecast period, but will still remain well below potential because of persistent business environment problems." (p. 11)

Table 6: India's Business Environment Rankings

Business Environment Rankings	**Score (out of 10)**	**Rank (out of 82)**	**Score (out of 10)**	**Rank (out of 82)**
	2002-06	**2002-06**	**2007-11**	**2007-11**
Overall scores and ranks	**5.27**	**62**	**6.37**	**54**
Political environment	5.2	50	5.7	50
Political stability	5.5	55	6.3	49
Political effectiveness	4.9	45	5.2	46
Macroeconomic environment	7.5	39	7.5	44
Market opportunities	7.6	10	7.7	9
Policy towards private enterprise & competition	5	51	6	50
Policy towards foreign investment	5.1	66	6.9	49
Foreign trade & exchange controls	3.7	76	6.4	68
Taxes	5.1	60	6.3	42
Financing	4.8	59	6.6	48
Labour market	5.6	64	6.2	56
Infrastructure	3.3	76	4.5	72

Note: The numbers for 2007-11 are forecasts based on trend.
Source: Economist Intelligence Unit. 2007. "World Investment Prospects to 2011".

The rankings for both time periods are fairly awful and the only reasonable ranking, like before, is for the 'market opportunities' factor. Apart from infrastructure and labour market, India ranks low in terms of policy towards private enterprise and competition, taxes as well as external trade and exchange controls.

What is certainly of concern is the forecast for the period 2007-11. While India's ranking does go up by a few notches to 54 from 62, it is still in the bottom half. What again emerges is that infrastructure is the biggest problem in terms of business environment ranking; it is ranked at 72 of 82. When writing about India's potential to get inward FDI, the report says that "India's potential to attract increased FDI inflows is vast,

although poor infrastructure, excessive bureaucracy and interdepartmental wrangling will slow the pace of opening in many sectors." (p.133).

All in all, looking at the about four studies, there is no surprise why India's inward FDI is well below her potential. While there may be some who will argue that India is portrayed badly in these rankings because of subjective methodological flaws, the fact remains that India is performing well below her potential, particularly as an export-oriented manufacturing base. However, India can clearly improve on upon these factors. The next section highlights what changes India needs to undertake in order to achieve her potential.

4. Policy Recommendations

Table 7 shows the level of FDI that has been forecasted by the EIU for India. The numbers, by any stretch, show a quantum leap in terms of levels of inward FDI with big numbers such as $50 billion for 2011 and $60 billion for 2012. However, it should be noted that India will still only account for 4.2% of total world inward FDI flows. Clearly forecasts have flaws, especially those that look beyond a year; the forecasts in Table 7 are based on expectations that India has a great growth story.[8] They also are forecasts made on the expectation that the government will fix the impediments that are responsible for the current low of levels of FDI. The remainder of this section focuses on ideas as to what India can do to ensure that actuals match, if not better, the medium-term forecasts.

[8] The forecast methodology used in Table 7 is based on EIU assessments but the forecast model used is not disclosed. It is however most likely a model based on current trends. By way of comparison, China is expected to receive over $95 billion of FDI inflows by 2012 and this is expected to account for 6.7% of total world FDI inflows.

Table 7: Forecast of FDI in India

	2008	2009	2010	2011	2012
Inward direct investment (US$ billion)	25	35	40	50	60
Inward direct investment (% of GDP)	1.8	2.1	2	2.2	2.3
Inward direct investment (% of gross fixed investment)	5	5.7	5.4	5.7	5.7
Outward direct investment (US$ billion)	-15.0	-20.0	-25.0	-30.0	-35.0
Net foreign direct investment (US$ billion)	10.0	15.0	15.0	20.0	25.0
Stock of foreign direct investment (US$ billion)	116.2	151.2	191.2	241.2	301.2
Stock of foreign direct investment per head (US$)	103	133	166	206	254
Stock of foreign direct investment (% of GDP)	8.3	8.9	9.7	10.6	11.4
Memorandum items					
Share of world inward direct investment flows (%)	2.07	2.81	3.09	3.69	4.24
Share of world inward direct investment stock (%)	0.83	1	1.16	1.36	1.57

Source: Economist Intelligence Unit (EIU)

It is well known that FDI can complement local development efforts in a number of ways, including boosting export competitiveness; generating employment and strengthening the skills base; enhancing technological capabilities (transfer, diffusion and generation of technology); and increasing financial resources for development. It can also help plug a country in the international trading system as well as promote a more competitive business environment. In view of this, India should continue to take steps to ensure an enabling business environment to improve India's attractiveness as an investment destination and a global manufacturing hub. The investment climate in India has undoubtedly become friendlier and investing in India is a much more attractive proposition today than in yesteryears. Much of the FDI has been in the form of M&A activities rather than Greenfield investment and a great deal is aimed at the attractive domestic consumer market. Large-scale Greenfield FDI into labour intensive, export-oriented manufacturing has been very disappointing. To this end, much more remains to be done to improve the consistency in policymaking and implementation and quality of governance and overall regulatory framework.[9] This is particularly imperative in the case of investments in the infrastructure sector, such as the power sector which is so critical for overall growth and development.

[9] For a discussion of factors that have hindered FDI into India, see IMF (2005).

Apart from taking steps to improve infrastructural facilities and enhancing labour market flexibility, we highlight ten further policy recommendations for India's FDI strategy for policymakers going forward. Most of these recommendations are not 'game-changing' or innovative recommendations but are meant to be practicable.[10]

One, while the government has lifted sectoral caps for FDI over the last decade, policies have thus far been piecemeal and ad-hoc and a source of uncertainty. Particular attention should also be paid to the removal of restrictions on FDI in the services sectors -- including telecoms, banking and insurance, aviation, etc – as this will help ease transactions costs for both consumers and business. The World Bank (2002) has in fact proclaimed that "(i)n virtually every country, the performance of the service sectors can make the difference between rapid and sluggish growth" (p.69). Promoting greater competition in these sectors should be a matter of urgency as it will increase overall competitiveness of Indian businesses in global markets. More services sectors should be allowed through the through the RBI's automatic approval route in a large number of new sectors and raise cap restrictions. One sector that should certainly get this automatic approval is the education sector. Currently there is no FDI in education allowed. Since it is well known that the education sector in India has reached a plateau in terms of ideas or development, it is only fair that new ideas and methodologies from other countries be tried out. Critics point to how this will only benefit the elite but that should not be used as a benchmark for disallowing any FDI in the education sector.

Two, as a means of trying to overcome some of the hindrances to large-scale investments in the manufacturing sector, the Indian government enacted a Special Economic Zones (SEZ) law in February 2006 which covers issues pertaining to establishment, operation and fiscal oversight. It is often noted that such a strategy was successfully undertaken by China and used effectively by the government in policy experimentation before being replicated on a larger scale. Nonetheless, there are some concerns that the policy may not be nearly as successful in India given the relatively small size of the proposed SEZs (most are about 1 square kilometer compared to the mega-sized SEZs of 100 square kilometers in China). The extremely high population

[10] Clearly there could be wildcards such as global financial crisis and severe recession that will limit the extent of FDI globally. We deal with issues that are India-specific here.

density in India makes such large and seamless SEZs less viable. Apart from the scale-related issues, there are also valid concerns regarding the fiscal implications of the SEZs given the large tax breaks offered to businesses in the Indian SEZs. In other words, SEZs may merely lead to uneven regional development (via a diversion of investments from the other areas of the country to the SEZs) and worsen the country's fiscal position.[11] It is imperative that India have another look at this policy and establish SEZs in strategic locations, close to ports or major industrial locations. Concurrent to this establishment of SEZs in strategic locations, the government should also provide all necessary infrastructural facilities to ensure the success of the SEZ because the fact is that for an SEZ to do well, there must some level of active government intervention. The government needs to beyond the current policy of only allowing SEZs in areas that are already owned by companies applying for the SEZ: in effect, a SEZ should be like a huge industrial park rather than having one single company in it.

Three, focus should not just be on the absolute amount of gross FDI inflows but also the type. More specifically, while India has experienced an infusion of FDI inflows in recent times, a large portion of the new inflows have been in the form of M&As.[12] Given that the latter does not necessarily imply new capital infusion into a country, the macroeconomic consequences of the two types of FDI can be quite different.[13] The focus should not just be on the amount of Greenfield FDI inflows but also the positive externalities to be derived from them, including in terms of technological development. The best type of policy intervention would involve general steps to enhance overall human capital and technical capabilities of the domestic economy on a non-discriminatory basis rather than attempt selective intervention to maximize linkages between local firms and local subsidiaries of TNCs or technology transfer

[11] For detailed description and critical analysis of India's SEZs, see Ahya and Sheth (2006).

[12] See UNCTAD (2006, pp.15-21) for a discussion of Greenfield versus M&As.

[13] Apart from the issue of type of new equity, part of the reason for the marked rise since 2000-01 is the redefinition of India's FDI to make it consistent with international standards. This has involved the inclusion of reinvested earnings and intracompany loans. Reinvested earnings and private equity alone in 2006-07 were US$3 billion.

domestically.[14] To maximize spillover benefits from FDI on a sustained basis, host country characteristics (in terms of human capital, technological capacity, etc.) must be improved. Any other policy is likely to be ineffective or short-lived at best; distortionary and detrimental at worst.

Four, over and above the creation of a business-friendly environment, it may be important for a potential host country to actively undertake investment-promotion policies to fill in information gaps or correct perception gaps that may hinder FDI inflows. A commonly used definition of investment promotion is "activities that disseminate information about, or attempt to create an image of the investment site and provide investment services for the prospective investors" (Wells Jr. and Wint, 1990). Any investment promotion strategy must be geared towards the following: (a) image-building activities promoting the country and its regions and states as favourable locations for investment; (b) investment-generating activities through direct targeting of firms by promotion of specific sectors and industries, and personal selling and establishing direct contacts with prospective investors; (c) investment-service activities tailored to prospective and current investors' needs; and (d) raising the realization ratio (i.e. percentage of the FDI approvals translated into actual flows). The effectiveness of the Foreign Investment Implementation Authority (FIIA) needs to be enhanced. There is a need to fast track FDI inflows via the provision of a one-stop after-care service to foreign investors should be enhanced and be given wider powers. As Sanjaya Lall (2000) correctly notes, "unless the agencies have the authority needed to negotiate the regulatory system, and unless the rules themselves are simplified, this may not help. On the contrary, there is a very real risk that a 'one stop shop' becomes 'one more stop'" (p.10).[15]

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[14] In any event, policies such as domestic content or performance requirements, joint ventures, technology licensing requirements and the like have generally had mixed results at best (for instance, see OECD, 2002, Chapter 10). In fact, there may be a trade-off in the sense that "artificial" attempts to indigenize TNC activities may make the TNC's affiliate operations less integrated with the production network of the parent to the detriment of the host country.

[15] In a recent empirical analysis of IPAs in 58 countries between February and May 2002 Morisset (2003) find that while there is some evidence that IPAs have a positive impact on FDI, this is more likely to be the case in circumstances where IPAs (a) have a high degree of political visibility (for instance, by being linked to the highest government official such as the prime minister's office); (b) have active private sector

Five, while India must do image-building exercises to promote it as a favourable investment location; it desperately needs to get rid of the tag that it can only do services and not manufacturing. Between India and China, ask any businessman about where they will invest their money: if it is service sector related, the answer, more often than not, is India and when it is manufacturing sector related, the answer is mostly always China. India does have a vibrant manufacturing sector but that rarely comes out internationally because it gets drowned out by the more glamorous software and other service related sectors. While one may think that companies will look at the fundamentals of a country when it comes to investing their money, which is not entirely wrong, they also invest based on perceptions. This perception is a fundamental one and goes well beyond reasons such as red-tape, corruption, poor infrastructure though they are inter-related to an extent. To get rid of this tag is easier said than done but the government can do more promotion activities to this end.

Six, is the desperate need to create a deep talent pool. Again an activity that is easier said than done because it takes time to create a deep talent pool. If one looks at investment bank reports on India, one point that gets constantly highlighted is the lack of talent at all levels. This is inherently dangerous for a country like India which has a tag of a services country; a sector that needs a deep talent pool to feed off. This lack of talent is reflected in the growth in wages which is one of the highest in the world. The one thing that makes India attractive is the cost arbitrage and if wages increase the way they are increasing, it is very likely that this arbitrage will disappear and along with it, valuable FDI dollars. The way to increase the talent pool has nothing to do with increasing the number of students coming out of colleges; there are already plenty of them. It has been estimated that only 30 percent of college graduates are 'employable' and what needs to be done is to make the other 70 percent employable. To this end, it is necessary to continuously monitor the quality of students as well as the quality of teachers in educational institutions.

Seven, UNCTAD (2002, chapter 3) continues to advocate a policy of targeted promotion, suggesting it has potentially high payoffs, though also acknowledging that it

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involvement via, for instance, participation on the IPA's board; and (c) operate in a country with an overall good investment environment.

can be a risky proposition. The UNCTAD position finds support from the successes of countries like Singapore whose investment promotion authority, the Economic Development Board (EDB), has quite successfully targeted specific global corporations to meet their specific locational requirements, or broad sectors to invest in the city state (Wells Jr. and Wint, 1999 and Oman, 2000, Chapter 2). However, this requires the investment promotion agency to have strong administrative capacity with sufficient resources. Absent this it may be advisable for countries to eschew selective policy intervention and focus on clear-cut and transparent policies and procedures and reducing procedural and bureaucratic hurdles.

Eight, while many policy barriers have been removed on FDI in India, results have at times been disappointing due to administrative barriers at the state level as well as lack of coordination between the central and state governments. There need to be greater coordination between the centre and states to ensure that the substantial foreign interest in investing in India gets translated into actual investment flows to the state. An example of this is the proposed $12 billion investment, India's single largest FDI investment, by South Korean steel giant, Posco. Posco signed an agreement in June 2005 to set up a steel plant in Orissa but as of March 2008, the steel plant is yet to be start construction, let alone any operations. Every kind of problem ranging from political to environmental to allegations of land grabbing has affected this project. The main problem has risen from the allegation that they would make some villagers landless and Posco cannot have a factory anywhere else because the raw material is in Orissa. This is a problem that the Orissa government could have easily foreseen but many governments in India have a tendency to promise too much and do too little. This clearly has impacted credibility of many state governments.

Nine, India should continue to work towards developing a deep and liquid corporate debt market. India is one of the few countries with a major equity market but with a highly illiquid corporate debt market. A well functioning corporate debt market does one major thing for companies looking to invest in India. It is very likely that when companies are investing their money in India or in any other country, they are more likely to use debt rather than their own cash. Therefore, they would go to debt markets in their countries of origin and raise money there. However, this could lead to a

considerable exchange rate risk because FDI is usually long-term and there is no good way of forecasting exchange rate movements in the long-run. If there a well functioning corporate debt market in India, it actually makes India that much more attractive. More generally, the importance of financial markets cannot be sufficiently emphasized. In an important study, Alfaro et al. (2004) find that while FDI has an ambiguous effect on economic growth in general, countries that have well-developed financial markets tend to benefits significantly from FDI inflows.

Ten, India should consciously work towards attracting greater FDI into R&D as a means of strengthening the country's technological prowess and competitiveness. If India is to do so, there needs to be a strengthening in intellectual property rights or IPRs (World Bank, 2003, Chapter 3). The role of IPR regime and dispute resolution mechanism warrants mention. While the empirical evidence regarding the impact of the quality of the IPR regime on the magnitude of FDI inflows remains uncertain, there is evidence to suggest that inadequate safeguards for protection of IPRs cause a diversion of investment from technology intensive industries ("second-generation investments") and more generally, from projects involving production -- especially longer-term investments -- to activities involving distribution (Smarzynska, 2002). While India extended patent protection to pharmaceutical and agricultural products in 2005, India still does not have in place a TRIPS-consistent data exclusivity regime for these products. There are also concerns about the quality of enforcement of India's existing trademark and copyright laws.

In the final analysis, India needs massive investments to sustain high-quality economic growth, particularly in the energy and infrastructure sectors (both physical and social). Policymakers are looking at FDI as the primary source of funds. It is important to keep in mind that FDI on its own is not a panacea for rapid growth and development. What India needs is to put in place a comprehensive development strategy, which includes being open to trade and FDI. This ought to go a long way to fulfilling the ultimate goal of permanently eradicating poverty over the medium and longer-terms.

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