Review on Policy Developments of FDI in India

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Abstract: India has been witnessing an extensive amount of foreign capital flowing to the market over the past twenty years after drastic changes made on its FDI policy. The aim of this research is to evaluate the policy developments of FDI during different stages since its independence and its impact on capital inflows. This research attempts also to uncover lessons that can be learnt from the case of India. A qualitative approach has been adopted for this research. The narrative analysis used in this study is based on secondary data that have been drawn from a pool of diverse sources including various databases, journal publications and books.

Keywords: Inward; competition; MNC; restrictions; advantages

JEL Classification: F; F30; F35; F39

1. Introduction

Right after its independence, the Indian government nationalized the core industries that were perceived to be vital during the industrial stage, to aid economic growth and development. Investments in such industries were restricted for foreign investors. Exemptions were lifted only in cases when government did not possess required knowledge, technology, expertise and machinery to run projects through its domestic agents. In addition, import-substitution policies via excessive restrictions and high tariffs were placed to prevent the flow of imported goods so that infant industries could develop, mature and become self-sustainable and able to withstand foreign competition. During this time, harsh bureaucratic controls were imposed on trade, production and investment as a result, inward FDI was very limited. However, after the 1990s' reforms, the overall impact of the

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policy framework changes that led to liberalizing the market for FDI, were very impressive because of the FDI boom, specifically in the last decade.

The general picture of FDI inflow to India shows that the government has been able to institute various policies and frameworks to ease the way of doing business and thus attract foreign investors. Many other developing economies have failed to persuade foreign investors to invest their capital in their own domestic markets because of unfriendly FDI policies. Hence, the objectives of this research are: to assess the role of Indian government policies in the success of attracting large sums of FDI inflows and to explore the lessons that can be learnt for developing economies from India's success. The following sections are divided in four phases that analyze FDI evolution, the situation associated with foreign investments and the impact on inflows. This strategy has been pursued because each phase carries out critical developments on FDI policy that has ultimately dictated the nature and amount of inward FDI in the immediate future.

Findings in this paper reveal that changes of FDI policies, especially after the reforms and liberalization of 1991 played an enormous role in the increased inflows. India managed to become among the most favorable FDI destinations from being one of the least attractive in the global scale. This research reveals several lessons learnt from the case of India which includes: market size does not ultimately determine the level of inward FDI, developing countries may seek the support of international institutions and experts to lay down appropriate reforms, import substitution policies can be useful only in the short-run, and the FDI liberalization process needs to follow a proactive pattern.

2. Ambitious Inward FDI (1943 -1961)

The year 1943 marks a milestone in the Indian economy. It is the time when FDI policies start to be dictated and influenced by indigenous Indian politicians and businesses regardless of the country still being ruled by the UK government. During this phase, the number of Multi-National Corporations (MNCs) was very limited accounting for not more than 14 across the whole country (Nayak, 2008). The majority of investments were from the UK and the total amount of FDI in the mid-1948 reached R.s 2,560 million. A sizeable number of MNCs were resource-seekers engaged in the raw materials and extractive industries, because of the abundance of cheap available resources (Kumar, 1995). This FDI motive of foreign investors is supported by UNCTAD (1998) and Dunning and Lundan (2008), who state that low cost resources are of paramount importance for MNCs' to sustain their operations and enhance their competitive level in the global market. Thus, India's market was attractive because of location distinctive advantages, as described by Dunning's (1973, 1998) OLI paradigm. This was a result of comparative advantages and market imperfections.

Right after independence, the Indian government encountered numerous problems relating to both industrial and economic growth and thus the need for foreign capital in domestic industries inevitably increased. In response, the government enacted the Industrial Policy Resolution (1948) to accelerate and support development through FDI and also to obtain the necessary technical, industrial, and scientific knowledge (Kumar, 1994). While the MNCs were provided guarantees of unconstrained remittances similar to domestic enterprises relating to dividends and profits, fair treatment and compensation, the actual legislation ensured that majority of ownership and the control of foreign capital still remained under the locals' hands. During this phase, twenty-seven foreign companies (Nayak, 2008) entered the Indian marketplace because changes in the FDI policy still did not prevent MNC's to generate profits. The comparative advantages of MNCs over the local enterprises were enormous as they lacked adequate knowledge in research, expertise and technology to support the needs of the emerging local industries.

While the Indian government acknowledged the need and had ambition to ensure systematic increase in FDI inflows to promote development, many domestic producers faced difficulties to compete in the market with MNCs and felt the need for protective measures to prohibit the entrance of foreign companies in the area where locals lacked capability to counter their dominance. Therefore, the import substitution policy (Kumar, 1994) was launched to protect development of the domestic manufacturing sector and other heavy industries and replace foreign imports with domestically manufactured goods.

As a result, very high tariffs and restrictions were put in place to reduce the flow of imported goods. The profit margins of MNCs that were engaged in exporting their products from home countries to India, decreased drastically due to the protective measures. As a result, they had to switch their strategies and instead seek FDI to ensure access to India's marketplace. Endorsement of this tactic is supported by the research done from Lipsey (2003) who states that protection of domestic industries through barriers on imports, is inclined to push MNCs to engage in horizontal FDI.

Moreover, the sectors of the economy perceived to be strategic for India were nationalized through a five year plan (1951-1955) aimed to aid development and industrialization (Nayak, 2008). This included insurances, airlines, mining, power, oil and petroleum. Besides inviting both foreign and domestic companies to expand their investments in the core industries, deemed to accelerate social development and economic growth, the Indian government asked MNCs to include domestic companies to participate in their equity in order to be able to further continue their operations (Davenport & Slim, 1992). As a result, a few companies such as General Motors, Ford and Pepsi found such requests to be unacceptable and thus decided to exit India.

The second five year plan was introduced from 1956-1961 to further support the industrial development process. When this plan was compiled, many prestigious economists were engaged from all over the world including Nobel Laureates Jan Tingergen and Ragnar Frisch from Norway and Netherlands respectively and others from US programs with the aim of supporting India's development (Bhagwati, 1993). The idea was to create advantages in the internal market (Kumar, 1995) where local firms in heavy industries can become self-sufficient through development , which eventually ought to strengthen and enhance their capabilities to compete with MNCs, not only domestically but also in other foreign markets. To this end, protection measures were further strengthened in many of the industries where goods/and products could be locally manufactured. Particular attention was made to programs of infrastructure development and of those relating to human resources specifically in the engineering, scientific, technical and technological fields (Kumar, 1994).

However, in the preceding years, 1957-1958, Indian autarkic policies and bureaucratic ways of conducting business in reference to foreign companies had severe consequences for the country's foreign exchange reserves. The crisis that occurred in the balance of payments (Kumar, 1995) made the government reconsider its strategy and seek ways to encourage FDI in order to increase foreign exchange reserves and further support industrial growth. The concrete actions that followed, led to an increased liberalization of FDI policy. The concessions and incentives made included openness in the manufacturing industries, such as of heavy electric equipment, drugs, synthetic rubber and fertilizers.

The literature shows a general consensus on the perceived relevance of trade openness and liberalization to attract foreign investors in the host countries (Oman, 2000; Cohen, 2007). FDI developments in India during this period do not support such findings at this stage. Despite nationalization of core industries, perceived strategic limitations were set for MNCs in reference to domestic capital participation and rigid restrictions and tariffs on imports. The levels of FDI inflows from 1948 to 1961 increased 143 percent from INR 2,558 million to INR 5,285, and the number of joint venture rose 14-fold during this period (Nayak, 2008).

This phenomenon can be explained by Asiedu (2002), where he emphasizes that some MNCs favor markets that impose barriers on imports as it provides opportunities to maximize profits in the domestic markets. Given the size of its marketplace, India at this stage was a heaven for foreign investors. Apart from protectionist measures on imports, domestic competitiveness was relatively low, local manufacturers had inadequate infrastructure and very poor technological capabilities.

3. Controlled Inward FDI (1962-1977)

The strategy that was put in place to protect infant domestic industries from experienced MNCs in order for indigenous firms to mature and also to create a viable domestic base, turned out to be fruitful. At this point in time, some expertise was developed in engineering. Domestic firms also acquired certain types of knowledge, to some extent, for processing and product adoption. These findings support other research (Crespo & Fontoura, 2006; Abraham et al., 2010) that emphasize the profound positive spillover effects of FDI on domestic firms. Such externalities occur either through increased competition or close relationships with MNCs that enables local firms to replicate the business culture of their foreign counterparts. It can also result in job mobility for local employees from MNCs into domestic firms.

But, the Indian government was not satisfied with the level of development and decided that protection of infant industries should be further extended because local firms were not able to stand foreign competition. Thus, the Foreign Exchange Regulation Act (FERA) was formally ratified in 1973, placing restrictions on foreign equity (Kumar, 1995). This allowed foreign companies to possess only 40 percent of the equity, with the remainder having to be transferred to the local counterparts. Only limited companies operating in specific activities were excluded and granted special permission to have more equity ownership.

In addition, the size of MNCs' operations and pricing strategies was limited through enacted legislation called Monopolies and Restrictive Trade Practices Act (MRTP) (Kumar, 1994). The idea was to regulate trade, control monopolistic behaviors and restrict the economic power of foreign companies in the Indian marketplace. As a consequence, many companies including IMB and Coca Cola decided to cease their operations and leave the country. The decreased number of joint ventures and overall reduction of FDI inflows was a blow to the Indian economy. Immediately, upon the reinforcement of both legislations, the FDI trend from 1962 to 1968 was negative and volatile from 1969 to 1977 (Nayak, 2008). These findings are in line with the research done by Brewer (1992) and Dunning and Lundan (2008). They argued that policies which undermine the profit-maximizing strategy of MNCs and those that limit their bargaining power, create negative imperfections and thus ultimately lead to a decrease of FDI inflows.

However, some of the MNCs repositioned themselves in the market to ensure the policy changes do not hinder their operations to a large extent. Facing such a serious position, the government decided to provide incentive packages for export based companies. It examined the increasingly significant importance of export processing zones (EPZs) for inward FDI, to attract export based MNCs. It was the first country in Asia to have built the first EPZ in 1965, which was located in Kandla and the second one in Santa Cruz in 1972. As a result, a considerable

number of MNCs from Japan, USA, and the European Union entered India (Nayak, 2008).

The overall developments of the controlled FDI flow during this stage can be judged from two perspectives. The drastic decrease of inward FDI and departure of many MNCs in response to the government's FDI policies can be considered a negative consequence in the short-run. However, on the long-term basis, pursuing a strategy to strengthen the local base (Kumar, 1995) showed positive results. Domestic companies were able to consolidate their operations, build up local ownership advantages acquire gradually the technology, expertise and know-how of many different business aspects. As a result, this not only changed the pattern of FDI inflows, but also had a significant positive effect on the outward FDI of domestic companies. Therefore, it can be said that maneuvering FDI policies has also laid down strong foundations for domestic companies to mature and withstand competition from MNCs based in well-developed industrial countries.

4. Cautious Inward FDI (1978-1990)

The State sponsored protection of domestic firms started to erode the country's industrial development pace. Firms were unable to purchase advanced technological equipments and machinery and thus domestic companies were lagging behind in comparison with MNCs (Kumar, 1994). The quality of their products appeared to be lower, more expensive and quite restricted in range. Therefore, domestic firms lost their competitive edge and were unable to keep up with their foreign counterparts because their manufactured products became unattractive for exports.

The characteristics of this period relate to the change of attitude by India's government towards foreign investors. The idea behind the reforms was to strengthen the competition of Indian companies in the international markets through the increased presence of more MNCs in India. The previous rigid restrictions of high tariffs and restrictions on imports along with limitations on domestic capital participation started to noticeably relax to some extent (Balasubramanyam & Mahambare, 2003). The new incentive package offered included tax incentives, special infrastructure for 100 percent export based MNCs, reduction of tariffs and import taxes, expediting clearance and ease in the FDI approval procedures without having a local business partner. Part of the plan for infrastructure development covered establishment of other EPZs to attract a larger number of foreign investors (Kumar, 1995). However, as argued by Bhagwati (1993), the reforms were limited and did not bring expected results because of the associated widespread bureaucratic controls imposed by the government relating to production, trade and investment.

The policy changes that were underway during this timeframe aimed to have significant implications for trade liberalization and ultimately, positively influenced inward FDI, the number of joint ventures and technological transfers. The picture of the overall FDI inflows reflects a fluctuating pattern. The downturn occurred from 1982-1983. However, from this point onward, the trend reversed with a slight decline in 1988. FDI rose from $ 79.16 million (1980) to $236.69 million (1990) (table 1). The joint ventures between MNCs and Indian counterparts more than doubled during this period from 307 (1978) to 703 (1990) (Nayak, 2008). Indian domestic companies were able to acquire advanced technology from industrial countries and diversify their products. The Indian outward FDI rose in the USA, Western Europe, the Middle East and Africa (Kumar, 1995).

Table 1. FD Inflows from 1980 to 1990 ($ millions)

1980	79.16
1981	91.92
1982	72.08
1983	5.64
1984	19.24
1985	106.09
1986	117.73
1987	212.32
1988	91.25
1989	252.1
1990	236.69

Source: UNCTAD Stat (2012)

5. Globalized Inward FDI (1991-2011)

This period is a turning point in the history of India's FDI developments. In the early 1990s, the issue of the foreign exchange market crisis was so critical for India that it almost put the country on the brink of bankruptcy because of enormous deficits in fiscal and current accounts, high inflation rates, rising debts to finance obligations and inadequate maintenance of the foreign exchange market (Ghosh, 2006). To avoid the worst and put the situation on the right track, India in 1991 appointed Manmohan Singh (Khandare & Babar, 2012), a non-political figure as a Finance Minister to lead the reform of India's economy.

The phase of liberalization that finally reversed the unsatisfactory FDI trends in India and changed the investment climate, had been implemented through critical programs supported by both the World Bank and IMF in a bid to obtain loans to

overcome the serious foreign exchange market crisis. Further liberalization of its market was required as a trade-off to obtain loans and access development programs. This process carried risks as well because if India was unable to live up to its promises for reform, investors were ready to exit the country. However, if the government pushed hard on reforms, it was likely to cause turbulence and severe reactions from internal oppositions (Ghosh, 2006).

The concrete implications of reforms that India had to abide by included an allowance of up to 51 percent of equity for thirty-four industries that were on the priority list, extensive reduction of tariffs on imports, abolishment of industrial licensing excluding only a few industries and immediate approval of FDI for the majority of the Indian economic sectors (IMF, 2005). In addition, there were also other incentives in property and sales taxes, capital grants, direct financial support and state sponsored assistance to aid investors through feasibility studies for project analysis of their specific areas of interests (Oman, 2000). Throughout this period, to ensure that India retained and enhanced competitiveness, the government continuously conducted systematic revisions of the existing FDI guidelines and enacted updated regulations to further liberalize the market (DIPP, 2012b).

These new reforms had very significant positive implications in the following years. The introduced FDI policy changes opened the door for many prestigious MNCs to target India's marketplace because of the favorable investment incentives and institutional environment to conduct business there. Many structural reforms that were initiated and instituted along with new approaches that eased the FDI approval procedures and relaxed extensive bureaucratic conduct turned out to be rewarding. While the total inflows from 1980 to 1990 (table 1) was about $1,284 million, the inward FDI from 1991-2000 increased more than 14-fold to account more than $18,516 million. Moreover, in the next 10 years, FDI inflows boomed with the largest amount received in India's history (table 2).

Table 2. FD Inflows from 1991 to 2010 ($ millions)

1991	75	2001	5477.638
1992	252	2002	5629.671
1993	532	2003	4321.076
1994	974	2004	5777.807
1995	2151	2005	7621.769
1996	2525	2006	20327.76
1997	3619	2007	25349.89

1998	2633	2008	42545.72
1999	2168	2009	35648.78
2000	3587.9897	2010	24639.92

Source: UNCTAD Stat (2012)

The characteristics of the increased number of registered foreign companies in India during this period was the return of MNCs like Ford, General Motors and IBM that had ceased their operations and left the country in previous decades due to imposed restrictions on foreign investors. In addition, the largest number of MNCs that entered the marketplace from 1991 to 2000 was from the European Union and Asia. They accounted for about 65% of total inflows (Nayak, 2008) whereas, in the previous years, companies from the UK and USA were the majority.

The overall findings derived from the post reform era of trade liberalization are supported by other research (Rolfe et al., 1993; Blomstrom & Kokko, 1998; Pradhan, 2000; Tian, 2007). New changes triggered an FDI boom, strengthened India's credibility, enabled the government to develop local industries and raised the competitive level for all actors involved in the market. Domestic firms benefited greatly from the new composition of foreign investors as they were exposed to new business strategies and organizational skills, while cooperating with their foreign counterparts through joint ventures and other forms of partnerships. The Indian labor force engaged with MNCs also managed to acquire a different and pertinent set of skills and capabilities from their experiences.

6. Current FDI Policy

According to the most recent consolidated Indian policy, 100 percent of FDI is allowed in the majority of sectors under the automatic route. The nature of conditions to which foreign investors may be subject prior to approval include requirements concerning the minimum lock-in periods or capitalizations. On the other hand, the only prohibited sectors for non-resident investors are: multi-brand retailing, lottery, manufacturing of tobacco related products, atomic industry, railways, chit fund, trading in transferable rights and Nithi company (DIPP, 2012a).

All these highly protected sectors are considered of national interest by the Indian government. Entrance of MNCs not only may create a monopoly in some of the highly protected industries, but it can also lead to allocation of enormous economic powers to limited foreign investors (Kumar, 1994). Liberalization of these sectors carries both risks and benefits. While relaxations of the FDI policy will ultimately

increase inflows, it can also create disturbances for local businesses and can drag them into bankruptcy if they are not able to withstand competition from their foreign counterparts. The most recent proposed significant change in the FDI policy relates to the retail sector which was aimed at attracting many large multi-brand MNCs across the world.

The proposed retail policy changes that were initially approved at the end of 2011, were supposed to allow MNCs to own a maximum of 51 percent. However, the decision was abolished because of the harsh criticism from opposition political parties and concerns raised by small shop owners throughout the country (Hu et al., 2012). Currently, investments are allowed only into single brand product retailing, allowing investors to own up to 100 percent of the equity. However, MNCs engaged beyond 51 percent are obliged to source 30 percent of their products from locals whose products are made in India (DIPP, 2012a).

7. Conclusion

Changes of FDI policies in India, especially after the reforms and liberalization of 1991 played an enormous role in the increased inflows. The historical FDI developments in India show how a government can maneuver with its FDI policy to strengthen domestic firms, develop core industries, protect areas of national interest and still ensure systematic flow of inward FDI. The overall picture of FDI developments in India, from its independence until now, depicts critical key lessons that can be learnt for other developing countries:

Firstly, India's experience shows that market size does not necessarily determine the levels of inward FDI. Despite its huge market, foreign investors ceased their operations in India when they deemed that unfriendly government policies would undermine their profit-making capabilities and limit their economic power to a large extent. However, appropriate reforms and policy relaxations had the opposite effect. This shows that economies can become successful regardless of their size only if respective governments are capable of coming up with efficient FDI policies that would maximize the levels of inflows while ensuring that MNCs presence does not create a disturbance in the markets and threaten the existence of domestic firms. Secondly, developing countries should seek the support of international institutions and experts if needed to speed up their reforms and catch up with other countries that are succeeding in this direction. The access to development programs helped India to arrive at this stage.

Thirdly, this case study shows that import-substitution policies can aid development of infant local industries and domestic firms in the short-run. Policies that are aimed at the establishment of a strong local base proved to be significantly important. However, this approach is not sustainable in the long-run. Exposure to

competition and not government protectionism measures ultimately helps local companies to catch up with their foreign counterparts in terms of technology, efficiency, knowledge and expertise. Fourthly, India's experience implies that the process of FDI liberalization ought to follow a proactive pattern rather than a reactive one. The relaxation of policies should be planned ahead and occur systematically, because if they emerge in response to a severe crisis, it may limit the bargaining and negotiation power of a government if the need for international support arises.

The main limitation for this paper is the single case approach endorsed for this study, as depicted by Stark and Torrance (2005) and Bryman (2008), which may relate to the issues of generalization. Sometimes, a single exploratory experience may not provide sufficient grounds and be used for all other scenarios. However, findings in this paper can greatly contribute for FDI policy-makers to be more cautious and more pragmatic in order to achieve desired goals and objectives. Further research on this matter for other countries will be vital to advance the role of FDI policy developments.

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