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Foreign Direct Investment in India and Its Economic Significance In Relation To Development of Various Sectors

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Abstract: This paper investigates the impact of foreign direct investment and policies on economic development of various sectors of the economy by considering factors affecting FDI, and includes comparative analysis with the help of statistics relating to sectors attracting highest FDI equity inflows for the financial years 2008-09 to 2010-11. One of the most liberal policies for foreign investment and technology transfer is followed by India. Foreign investment gives the Indian industry a chance for technological up gradation, access to global managerial skills and practices, optimum utilization of human capital and natural resources, and to compete efficiently in the international market. FDI is vital for India's integration with the universal production chains that are engaged by various multinationals across the world. FDI is vital for India's integration with the universal production chains that are engaged by various multinationals across the world. There is a mountain of cash available in the world financial markets, some of which is awaiting Indian government signal to flood in. A few rules and policy changes have to be made before the floodgate is open. This money will also bring with it foreign participation, which is sorely needed for this very complex and highly technical sector. FDI has transformed China. It will do the same to India. The question is 'what is the delay'. The first and foremost is to understand bureaucratically how to manage the FDI in the infrastructure sector and how to pay it back with export earnings.

Key words: Development, economy, foreign direct investment, multinationals, policies and sector.

Introduction:

Export growth in India has been much faster than GDP growth over the past few decades.Several factors appear to have contributed to this phenomenon including foreign direct investment (FDI). However, despite increasing inflows of FDI especially in recent years there has not been any attempt to assess its contribution to India's export performance one of the channels through which FDI influences growth. The Government of India recognizes the significant role played by foreign direct investment in accelerating the economic growth of the country and thus started a swing of economic and financial reforms in 1991. India is now initiating the second generation reforms intended for a faster integration of the Indian economy with the world economy. As a consequence of the introduction of various policies, India has been quickly changing from a restrictive regime to a liberal one. Now FDI is also encouraged in most of the economic activities under the automatic route.

Studies about Western firms propose that market size and expected growth are the most essential determinants of FDI into the area. Political and economic stability is also an important factor affecting FDI. Over the past 30 years, there have been various studies done on the impact of outbound and inbound activity of multinationals on the growth and fiscal restructuring of the economies that they operate in (Dunning and Narula, 1996). These studies suggest that this is dependent on three main variables; the type of FDI taken on, the composition of the local resources and capabilities of the country, and the economic and organizational policies followed by governments. Firms employ FDI in order to best utilize or manage more efficiently the existing competitive advantages.

Literature review

Determinants of FDI Policies in India

The study conducted by Aqeel and Nishat (2004) tests if tariff rate, exchange rate, tax rate are significant for FDI. It states that these policy variables draw FDI and determine the growth in Pakistan. It also shows a positive impact of reforms on FDI in Pakistan. A wide spread of determinants have been examined related to FDI in the past. Several studies (Chakrabarti, 2001) on the determinants of FDI direct to the selection of a set of descriptive variables that are used and are important factors affecting FDI. Some researchers underline how the domestic market size and differences in factor costs are related to the FDI location (Markusen and Maskus, 1999). This magnifies the significance of market size and its expansion for foreign firms functioning in industries having large scales economies. As the economies of scale cannot be exploited before the market achieves a certain size. The measures of market size that are used extensively are GDP, GDP per capita and growth in GDP.

Labour cost which is one of the main components of the cost function also influences FDI. Some studies find very little or negative relationship between wages and FDI, Some studies suggest that higher wages do not always discourage FDI in some markets and therefore there is a positive relationship between wages and FDI (Love and Lage-Hidalgo, 2000). As higher labour costs leads to higher productivity which gives better quality goods. Lately studies are aimed towards the impact of specific policy variables on FDI in the host country. Trade, tariff, taxes and exchange rate are included in these policy variables. Asiedu (2002). Emphasize on policy reforms in developing countries that act as a determinant of FDI. They state the corporate tax rates and the sincerity to foreign investment are important determinants of FDI. Horizontal FDI is linked with market seeking behavior and is induced by low trade costs. Therefore high tariff barriers motivate firms to take on horizontal FDI. Thus production abroad by foreign subsidiaries replaces exports. This 'tariff jumping' theory entails a positive relation between FDI and import duty (Aqeel and Nishat, 2004).

Vertical FDI is when individual firms specialise in different production stages of the output. The semi finished goods are exported to other subsidiaries for further production. This fragmentation of the production process gives the company an advantage of different factor prices across different countries. Vertical FDI reduces the cost of production and marketing of the product and in turn leads to higher profits. Foreign investors give great importance to fiscal incentives and the taxation structure. They hunt for markets with low taxes as it affects the profitability of the investment. To draw FDI several tax break rules are presented to the MNEs as an inducement. The researches done on FDI empirically have found a negative correlation between taxes and location of the business (Shah and Masood, 2002).

Some studies found no significant impact of taxes on FDI (Hines, 1996). Whereas, the study by Froot and Stein (1991) suggests that there is a positive effect of taxes on foreign investment. The study conducted by Basile et al (2005) suggests that Italy is not greatly affected by tax rates. Fluctuations in the corporate tax rate do not significantly influence FDI. Hence there is a strong negative rooting from the national institutional and policy system.

Factors Affecting FDI

1.1 Political stability

Political stability is one of the factors that affect FDI decisions globally. Firms do not prefer to make profitable investments in countries that are politically instable or there is a volatile or unpredictable political situation. Threats of civil disorder, unrest or even civil war are also factors that dissuade foreign investment. The extent and reliability of political stability remains an important issue in many economies. In some countries, commitment to the reform process and to a market economy is soundly based (Estrin et al, 1997). Political power is often fragmented, and previous communists have started to win elections. There is a close inter-relationship among commitment to reform and FDI. Successful countries can use this as a signal of their commitment to reform policies. FDI is attracted by thriving reforms.

1.2 Policy Environment

A second concern for firms considers FDI into a specific country is the policy environment. These policies vary from country to country and time to time. Macro-economic policy- Limp macro- economic policy and high inflation are common in stable emerging markets. It considerably adds to exchange rate and other risks undertaken by foreign investors. Governments are in a position where expenditures for social policies or defence are soaring, but habits of a low occurrence of personal taxation make it difficult to finance which leads to fiscal production and inflation tax.

Inflation rates that are high imply abating and uncertain exchange rates, which damage foreign investment. Debt or input supplies that are denominated in foreign currencies are a good example. Exchange rate indecision leads to more costs in terms of hedging risks. Stabilization programmes address the primary disparity which may lead to capital losses related to radical currency depreciation. The path taken by a country depends on its economic structure. The character of government policy linked to a specific system differs from country to country having the same economic system and at the same stage of development. There are two main areas of government strategy that directly imposes on the nature of the investment development path of an economy: macro – economic strategy and macro – organisational strategy (Dunning, 1992).

The government plays a good part in determining the macro - economic policy which is often associated with the economic system. There is substantial discrepancy between countries in the position of governments in forming macro – organisational strategy. It mainly affects the organization of economic activity and the nature of the policies most suitable changes as the country evolves. This mirrors the nature of market imperfections that the policy is. The government plays a part in facilitating the market where its macro – organizational policy advances over time. Increasing economic specialization related to economic development leads to an expansion in market collapse and boosts the benefits of government macro – organizational policy.

A positive government action basically to supply information to foreign investors can be important. Firms that have traditional links with an economy, motivates them to become the first movers, example- geographical, cultural or historical reasons. Firms are also sensitive to other related fundamentals of economic policy, including personal tax rates for their staff, and the nature and effectiveness of a countries government policy.

1.3 Institutional and Infrastructure Development

The third factor that influences firms concerns the institutional arrangements in the area in question and its infrastructure. Multinationals will be cautious of committing themselves to economies whose laws are disorganized, because of which their assets and earnings will be poorly protected. Such economies might have corrupt public administrations, which can drastically decrease the profit of the firm, as the administration may seek to make profits for itself. Countries where telecommunications is poor, transport is costly and utilities such as energy is unreliable, are the countries that receive the least amount of FDI. These problems mainly occur in communist countries where it is now being rectified.

1.4 Exchange Rate Effects

The outcome of exchange rates on FDI has been studied both with respect to variations in the bilateral level of the exchange rate amongst economies and in the volatility of exchange rates (Blonigen, 2005). Various studies have been done on the consequence of exchange rate fluctuations on FDI. But none of these studies help in concluding the direction and magnitude of its influence. State an imperfect capital market where a currency appreciation in the host country might increase outward FDI. When the markets are imperfect, the in-house cost of capital is lesser than borrowing from outside resources. An appreciation of money directs to increased company wealth and supply the company with superior low cost funds to invest into the subsidiary firms abroad that are going through devaluation of their currency. Depreciation in the host currency raises FDI into the host country and on the other hand an appreciation in the host currency reduces FDI (Froot and Stein, 1991).

The research by Blonigen (1997) suggests another way in which alterations in the exchange rate level in the host country affects its inflow of FDI. If the foreign investment made by a company is encouraged by the attainment of assets that can be transferred within a company across different economies without a monetary deal such as technology and managerial skills, then an appreciation in the exchange rate of the foreign currency will lessen the cost of the asset in that particular foreign currency, but it might not lower the nominal returns. Several studies have found evidence than short term fluctuations in exchange rates leads to higher inward foreign investment.

1.5 Taxes

Both international and local economists have great interest on the effects of taxes on FDI. It is an obvious fact that higher taxes dishearten foreign investors. De Mooij and Ederveen (2003), highlights that the influence of taxes on FDI varies considerably by the type of taxes, amount of FDI activity and the treatment of taxes in the host and parent economies. Multinationals face tax restrictions in both the host and home countries which are another important issue. Different economies have different ways of acknowledging the double taxation issue that complicates the usual influence of taxes on FDI.

The paper by Hartman (1985), suggests that profits earned by affiliate abroad will finally be subject to parent and host country taxes in spite of them being repatriated and reinvested in the foreign subsidiary to create further income. These foreign taxes cannot be avoided at any cost. New investment judgments take transfer of new capital from the parent to the subsidiary into consideration. These do not originate from the host country and still have not sustained any foreign taxes. This has two significant propositions. First, that company will finance new direct investment through retained earnings and later through new infusions from the parent firm.

Second, is that FDI done by using retained earnings will react only to host country tax rates and not to the parent nations taxes or its way of dealing with double taxation issues. On the other hand the investment made by using new transfers of capital, will respond to home and host nations taxes and rates of return obtainable in both the markets.

1.6 Trade Protection

There is a fairly clear link between FDI and trade protection. Higher trade protection makes companies more likely to replace exports with subsidiary production. This is known as tariff jumping foreign investment. There has been very little research done on this as this approach is simple and general. This theory is data driven and therefore it is hard to measure non tariff type of protection in a reliable manner across markets. Many studies have been done using industry level measures to test the trade protection programs which \ have not been conclusive (Blonigen, 1997).

2 Host Country Determinants

As the global economy has opened to international business dealings, the nations compete increasingly for FDI not only by improving their policy and economic determinants, but also by executing proactive facilitation measures that may go beyond policy liberalisation.

2.1 FDI Policies

FDI policies consist of rules and regulations prevailing admission and functions of foreign investors, the standards of treatment accorded to them and the operation of the markets within which they function. The policies range from absolute ban of FDI to non discrimination in the handling of foreign and domestic companies. The trade policy plays the most important role amongst the complementary policies employed to influence location decisions. Other policies that are related embrace privatisation policies and policies determined by the international agreements a nation might sign. Policies that are used deliberately to attract FDI and their locations comprise the 'inner ring' of the policy system of FDI.

2.2 Business Facilitation Measurers

The liberalisation of FDI policies is seen as an enabling act meant for creating a level playing field for all investors. This act is progressively complemented by proactive measures, intended to assist the business undertaken by foreign investors in the host nation. They encompass promotion attempts, the prerequisites for foreign investors, decrease in costs of doing business such as reducing corruption and improving administrative competence and provision of services that contribute to the excellence of the expatriate.

The promotional activity is increasingly becoming more important. Nations that have changed their FDI policies, countries that want to regain their investor's attention and countries that are invisible or unattractive to the investors have all started to resort to it (UNCTAD, 1995).

Increased competition for FDI has led to more proactive policies meant for actually bringing in FDI. Investment producing measures include industry specific investment assignments. But the most capable and important activity, though costly, targets firms that are likely to respond to promotion efforts. They also invest in a given host country, especially in transactions considered desirable for the host country.

Investment facilitation service is another increasingly important element of promotional activities in both the developing and developing nations. These services consist of counselling, accelerating the several phases of the approval process and providing assistance in acquiring all the necessary permits. This includes the creation of 'one stop shops', that is single organisations that are able to handle all matters related to FDI, in developing countries and some developed countries (Wells and Wint, 1990).

2.3 Incentives as Facilitation

Incentives are any measurable economic advantages given to specific enterprises by the government, in order for them to act in a certain manner. They contain measures either to raise the rate of return of a specific investment or to lessen its risks or costs. Governments make use of incentives to draw FDI to guide investments into preferable sectors, activities or regions, to influence the character of an investment and to influence the ranges of investment presented to foreign investors. Since the mid 1980's as the barriers to trade and investment have declined, the number of countries that present opportunities have increased significantly. A lot of studies reveal that incentives play a minor role in the location decisions of multinationals. The key location factors include market size and expansion, manufacturing costs, level of ability, infrastructure, economic stability and the quality of the general regulatory framework. The study by Guisinger et al (1992) reports that incentives are often not even taken into consideration and that the investment decisions are made essentially based on the economic and long term strategic considerations pertaining to inputs, production costs and markets. The empirical literature on determinants of FDI persists to grow unabated. It can briefly be summarised in the following points:

- Host countries with large domestic markets, evaluated by GDP per capita and constant expansion of these markets, measured by the growth GDP rates, attract large volumes of foreign direct investment.
- Resources available in the host economy including natural and human resources are an important issue in the investment decision making process by foreign investors.
- Infrastructure amenities such as transportation and communication networks are vital determinants of FDI.
- Macroeconomic stability, implied by steady exchange rates and low rates of inflation is an important factor which helps in attracting foreign investment.
- Political stability in the host country motivates inward foreign investment.
- A steady and transparent policy framework towards FDI attracts potential investors.
- Fiscal and monetary incentives such as tax concessions play a vital role in attracting FDI, but they are of very little importance in the absence of a secure economic environment.

Table 1. Sectors Attracting Highest FDI Equity Inflows:

Amount ` in` crores (US$ in million)

Ranks	Sector	2008-09 (April-March)	2009-10 (April-March)	2010-11 (April-Jan.)	Cumulative Inflows (April '00 - Jan. '11)	% age to total Inflows (In terms of US$)
1.	SERVICES SECTOR (financial & non-financial)	28,516 (6,138)	20,776 (4,353)	13,652 (2,987)	118,923 (26,597)	21 %
2.	COMPUTER SOFTWARE & HARDWARE	7,329 (1,677)	4,351 (919)	3,225 (708)	47,340 (10,644)	8 %
3.	TELECOMMUNICATIONS (radio paging, cellular mobile, basic telephone services)	11,727 (2,558)	12,338 (2,554)	6,041 (1,332)	46,746 (10,262)	8 %
4.	HOUSING & REAL ESTATE	12,621 (2,801)	13,586 (2,844)	4,791 (1,048)	42,163 (9,405)	7 %
5.	CONSTRUCTION ACTIVITIES (including roads & highways)	8,792 (2,028)	13,516 (2,862)	4,540 (1,006)	40,233 (9,059)	7 %

6.	AUTOMOBILE INDUSTRY	5,212 (1,152)	5,754 (1,208)	5,375 (1,191)	26,198 (5,788)	5 %
7.	POWER	4,382 (985)	6,908 (1,437)	4,711 (1,033)	25,715 (5,680)	4 %
8.	METALLURGICAL INDUSTRIES	4,157 (961)	1,935 (407)	4,632 (1,011)	18,073 (4,141)	3 %
9.	PETROLEUM & NATURAL GAS	1,931 (412)	1,328 (272)	2,471 (541)	13,585 (3,120)	2 %
10.	CHEMICALS (other than fertilizers)	3,427 (749)	1,707 (362)	1,739 (382)	13,007 (2,876)	2 %

(Source: Fact Sheets on FDI, Department of Industrial Policy and Promotion, 2011)

In sectors attracting highest FDI equity inflows service sector leads with 21% and computer software and hardware stands second with telecommunication holding 8% of the total inflow followed by housing and construction activities shares 3 position with 7%, automobile industry with 5%, power with 4 %, metallurgical industry with 3% and least contribution is from petroleum natural gas and chemicals with 2%. The Sector wise Analysis of FDI Inflow in India reveals that maximum FDI has taken place in the service sector

Including the telecommunication, information technology, travel and many others. The service sector is followed by the computer hardware and software in terms of FDI. High volumes of FDI take place in telecommunication, real estate, construction, power, automobiles, etc. The rapid development of the **telecommunication** sector was due to the FDI inflows in form of international players entering the market and transfer of advanced technologies. The telecom industry is one of the fastest growing industries in India.

FDI inflows to **real estate sector** in India have developed the sector. The increased flow of foreign direct investment in the real estate sector in India has helped in the growth, development, and expansion of the sector. FDI Inflows to **Construction Activities** has led to a phenomenal growth in the economic life of the country. India has become one of the most prime destinations in terms of construction activities as well as real estate investment. The FDI in **Automobile I**ndustry has experienced huge growth in the past few years. The increase in the demand for cars and other vehicles is powered by the increase in the levels of disposable income in India. The options have increased with quality products from foreign car manufacturers. The introduction of tailor made finance schemes, easy repayment schemes has also helped the growth of the automobile sector. The basic advantages provided by India in the **automobile** sector include, advanced technology, cost-effectiveness, and efficient manpower. Besides, India has a well-developed and competent Auto Ancillary Industry along with automobile testing and R&D centres. The automobile sector in India ranks third in manufacturing three wheelers and second in manufacturing of two wheelers. Opportunities of FDI in the Automobile Sector in India exist in establishing Engineering Centres, Two Wheeler Segment, Exports, Establishing Research and Development Centres, Heavy truck Segment, Passenger Car Segment. The increased FDI Inflows to **Metallurgical** Industries in India has helped to bring in the latest technology to the industries. Further the increased FDI Inflows to Metallurgical Industries in India has led to the development,

expansion, and growth of the industries. All this has helped in improving the quality of the products of the metallurgical industries in India. The increased FDI Inflows to **Chemicals** industry in India has helped in the growth and development of the sector. The increased flow of foreign direct investment in the chemicals industry in India has helped in the development, expansion, and growth of the industry. This in its turn has led to the improvement of the quality of the products from the industry. Based upon the data given by department of Industrial Policy and Promotion, in India there are sixty two sectors in which FDI inflows are seen but it is found that top ten sectors attract almost seventy percent (70%) of FDI inflows. The cumulative FDI inflows from the above results reveals that service sector in India attracts the maximum FDI inflows amounting to Rs. 106992 crores, followed by Computer Software and Hardware amounting to Rs. 44611 crores. These two sectors collectively attract more than thirty percent (30%) of the total FDI inflows in India. The housing and real estate sector and the construction industry are among the new sectors attracting huge FDI inflows that come under top ten sectors attracting maximum FDI inflows. Thus the sector wise inflows of FDI in India shows a varying trend but acts as a catalyst for growth, quality maintenance and development of Indian Industries to a greater and larger extend. The technology transfer is also seen as one of the major change apart from increase in operational efficiency, managerial efficiency, employment opportunities and infrastructure development.

Table 2. Relatuion Between FDI, GDP and Exports

Year	FDI	GDP	Exports (US $)
1992	277	246000	17233
1993	550	276000	21579
1994	973	324000	25538
1995	2144	356000	31797
1996	2426	388000	33470
1997	3577	411000	35006
1998	2635	416000	33218
1999	2169	450000	36715
2000	2657	460000	44076
2001	4334	478000	43827
2002	3030	507000	52719
2003	4118	599000	63843
2004	4429	701000	83536
2005	4740	810000	103091
2006	5051	915000	126263
2007	5362	1180000	162984
2008	5673	1220000	182984

All values in million US $.

Source: Indiastat.com and Asian Development Bank (www.adb.org/statistics)

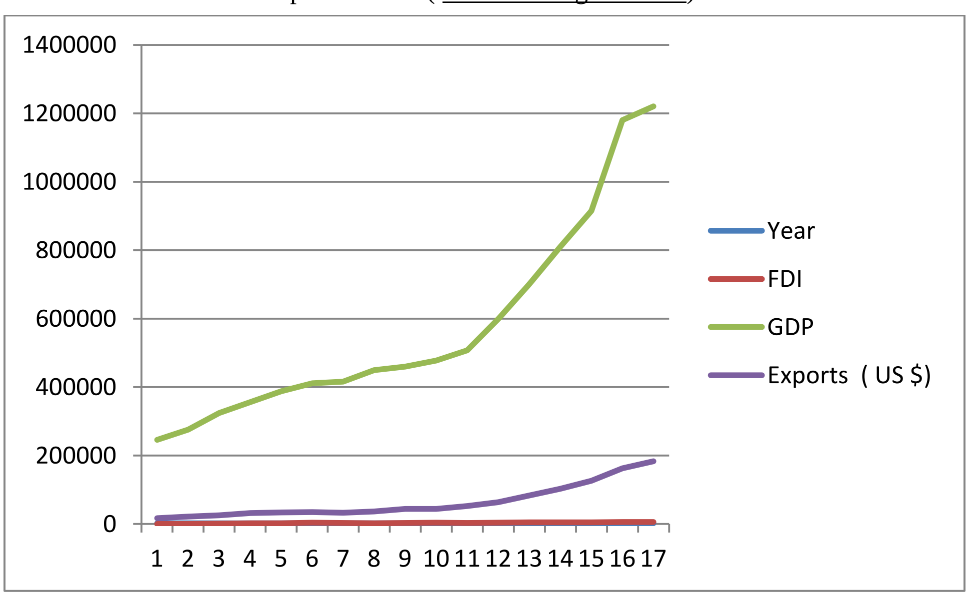

Figure 1. Relatuion between FDI, GDP and Exports

The exports have followed the FDI over many years and gradually have scored higher than FDI. The net inference is that FDI in India has fuelled more exports in India first and then indirectly impacted the GDP of India. FDI more related to exports than GDP. **FDI** is considered to be the life blood and an important vehicle of for economic development as far as the developing nations are concerned. The important effect of FDI is its contribution to the growth of the economy. FDI has an important impact on country's trade balance, increasing labour standards and skills, transfer of technology and innovative ideas, skills and the general business climate. FDI also provides opportunity for technological transfer and up gradation, access to global managerial skills and practices ,optimal utilization of human capabilities and natural resources, making industry internationally competiteve,opening up export markets,aceess to international quality goods and services and augmenting employment opportunities.

Conclusion:

One of the most liberal policies for foreign investment and technology transfer is followed by India. Foreign investment gives the Indian industry a chance for technological up gradation, access to global managerial skills and practices, optimum utilization of human capital and natural resources, and to compete efficiently in the international market. FDI is vital for India's integration with the universal production chains that are engaged by various multinationals across the world. There is a mountain of cash available in the world financial markets, some of which is awaiting Indian government signal to flood in. A few rules and policy changes have to be made before the floodgate is open. This money will also bring with it foreign participation, which is sorely needed for this very complex and highly technical sector. FDI has transformed China. It will do the same to India. The question is 'what is the delay'. The first and foremost is to understand bureaucratically how to manage the FDI in the infrastructure sector and how to pay it back with export earnings. Second is how to avoid future Enron type fiascos. The latter had ten years of shameful delay and cost escalation in the construction of much needed power plant. Nuclear power plants, which require imported technology and Uranium, will most certainly require FDI in big amounts. Modernization of transport sector, another area lagging far behind, is to be undertaken in earnest. It also requires foreign money and their technical expertise.

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