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Impact of FDI on Indian Economy

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Abstract: A foreign direct investment (FDI) is an investment in the form of a controlling ownership in a business in one country by an entity based in another country. It is thus distinguished from a foreign portfolio investment by a notion of direct control. Broadly, foreign direct investment includes "mergers and acquisitions, building new facilities, reinvesting profits earned from overseas operations, and intra company loans". FDI is the sum of equity capital, long-term capital, and short-term capital as shown in the balance of payments. FDI usually involves participation in management, joint-venture, transfer of technology and expertise. Stock of FDI is the net (i.e., outward FDI minus inward FDI) cumulative FDI for any given period. Direct investment excludes investment through purchase of shares (if that purchase results in an investor controlling less than 10% of the shares of the company).

Keywords: FDI, Indian, economy, business, technology, investment, company, shares.

Introduction

Foreign direct investment in India is a major monetary source for economic development in India. Foreign companies invest directly in fast growing private auspicious businesses to take benefits of cheaper wages and changing business environment of India. Economic liberalisation started in India in wake of the 1991 economic crisis and since then FDI has steadily increased in India,[1][2] which subsequently generated more than one crore (10 million) jobs.

On 17 April 2020, India changed its foreign direct investment (FDI) policy to protect Indian companies from "opportunistic takeovers/acquisitions of Indian companies due to the current COVID-19 pandemic", according to the Department for Promotion of Industry and Internal Trade.[3][4][5][6] While the new FDI policy does not restrict markets, the policy ensures that all FDI will now be under scrutiny of the Ministry of Commerce and Industry.[7][8]

Types

There are mainly two types of FDI—Horizontal and Vertical. However, two other types of FDI have emerged—Conglomerate and Platform FDI.

Horizontal: Under this type of FDI, a business expands its inland operation to another country. The business undertake the same activities but in foreign country.

Vertical: In this case, a business expands into another country by moving to a different level of supply chain. Thus business undertakes different activities overseas but these activities are related to main business.

Conglomerate: Under this type of FDI, a business undertakes unrelated business activities in a foreign country. this type is uncommon as it involves the difficulty of penetrating a new country and an entirely new market.

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Platform: Here, a business expands into another country but the output from the business is then exported to a third country.

Routes

There are two routes by which India gets FDI.[9]

Automatic route: By this route FDI is allowed without prior approval by Government or Reserve Bank of India.[9]

Government route: Prior approval by government is needed via this route. The application needs to be made through Foreign Investment Facilitation Portal, which will facilitate single window clearance of FDI application under Approval Route. The application will be forwarded to the respective ministries which will act on the application as per the standard operating procedure.[10] Foreign Investment Promotion Board (FIPB) which was the responsible agency to oversee this route was abolished on May 24, 2017. It held its last meeting on 17 April, which was the 245th meeting of the Board.[9][11] On 24 May 2017, Foreign Investment Promotion Board was scrapped by the Union Government.Henceforth, the work relating to processing of applications for FDI and approval of the Government thereon under the extant FDI Policy and FEMA, shall now be handled by the concerned Ministries/Departments in consultation with the Department for Promotion of Industry and Internal Trade (DPIIT), Ministry of Commerce, which will also issue the Standard Operating Procedure (SOP) for processing of applications and decision of the Government under the extant FDI policy[12]

Recipients

The World Investment Report 2020 by the UN Conference on Trade and Development (UNCTAD) said that India was the 9th largest recipient of FDI in 2019, with $51 billion of inflow during the year, an increase from $42 billion of FDI received in 2018, when India ranked 12 among the top 20 host economies in the world. In the " Development Asia" region, India was among top 5 host economies for FDI. The report said that global FDI flows are forecast to decrease by up to 40% in 2020, from their 2019 value of USD 1.54 trillon. According to Financial Times, in 2015 India overtook China and United States as the top destination for the FDI. In first half of 2015 India attracted investment of $31 billion compared to $28 billion and $27 billion of China and US respectively. Data for 2019-2020 indicates that services sector attracted the highest FDI equity inflow of US$7.85 billion, followed by computer software and hardware at US$7.67 billion, telecommunications sector at US$4.44 billion, and trading at US$4.57 billion.

Discussion

The Government of India has amended FDI policy to increase FDI inflow. In 2014, the government increased foreign investment upper limit from 26% to 49% in insurance sector. It also launched Make in India initiative in September 2014 under which FDI policy for 25 sectors was liberalised further.[13][14] As of April 2015, FDI inflow in India increased by 48% since the launch of "Make in India" initiative.[15] In May 2020, government increased FDI in defence manufacturing under the automatic route from 49% to 74%. In April 2020, government amended existing consolidated FDI policy for restricting opportunistic takeovers or acquisition of Indian companies from neighbouring nations.In March 2020,government permitted Non Resident Indians (NRIs) to acquire up to 100% stake in Air India

India was ranking 15th in the world in 2013 in term of FDI inflow, it rose up to 9th position in 2014[16][unreliable source?] while in 2015 India became top destination for foreign direct investment.[17] The Department for Promotion of Industry and Internal Trade and Invest India has

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developed the India Investment Grid (IIG) which provides a pan-India database of projects from Indian promoters for promoting and facilitating foreign investments.

Coronavirus pandemic impact

On 18 April 2020, the government of India passed an order that would protect Indian companies from FDI during the pandemic. All countries sharing a land border with India would now face scrutiny from the Ministry of Commerce and Industry before any FDIs.[18] These changes were incorporated in the Consolidated FDI policy released on 28 October 2020.[19]

Sectors

During 2014–16, India received most of its FDI from Mauritius, Singapore, Netherlands, Japan and the US. [20] On 25 September 2014, Government of India launched Make in India initiative in which policy statement on 25 sectors were released with relaxed norms on each sector.[21] Following are some of major sectors for Foreign Direct Investment.

Infrastructure

10% of India's GDP is based on construction activity. Indian government has invested $1 trillion on infrastructure from 2012–2017. 40% of this $1 trillion had to be funded by private sector. 100% FDI under automatic route is permitted in construction sector for cities and townships.[22][23][non-primary source needed][24]

Electronics system design and manufacturing

The Electronics system design and manufacturing (ESDM) sector in India is rapidly growing and India is poised to become a global electronics manufacturing hub in the future with targeted exports of 180 billion USD within 2025.[25]

Information technology

FDI in IT sector is one of the biggest in India. Lots of global companies got their R&D offices in India. Bangalore,Pune,Mumbai and Hyderabad are conisderd to be global IT hubs.[26]

Automotive

FDI in automotive sector was increased by 89% between April 2014 to February 2015.[27] India is 7th largest producer of vehicles in the world with 25.5 million vehicles annually. 100% FDI is permitted in this sector via automatic route. Automobiles shares 7% of the India's GDP.[28]

Pharmaceuticals

Indian pharmaceutical market is 3rd largest in terms of volume and 13th largest in terms of value. Indian pharma industry is expected to grow at 20% compound annual growth rate from 2015 to 2020.[29] 74% FDI is permitted in this sector.[30][31][32]

Service

FDI in service sector was increased to 46% in 2014–15. It is US $1.88 billion in 2017. Service sector includes banking, insurance, outsourcing, research & development, courier and technology testing.[33] FDI limit in insurance sector was raised from 26% to 49% in 2014.[34] FDI limit in Insurance has been further increased to 74% in 2021.

Railways

100% FDI is allowed under automatic route in most of areas of railway, other than the operations, like High speed train, railway electrification, passenger terminal, mass rapid transport systems etc.[35][36]

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Mumbai-Ahemdabad high speed corridor project is single largest railway project in India, other being port rail network, electrification of Indian railways. Foreign investment more than ≠90,000 crore (US$11 billion) is expected in these projects so far.[37]

Chemicals

Chemical industry in India earned revenue of $155–160 billion in 2013.[38] 100% FDI is allowed in Chemical sector under automatic route. Except Hydrocynic acid, Phosgene, Isocynates and their derivatives, production of all other chemicals is de-licensed in India.[39] India's share in global specialty chemical industry is expected to rise from 2.8% in 2013 to 6–7% in latest.[40]

Textile

Textile is one major contributor to India's export. Nearly 11% of India's total export is textile. This sector has attracted about $1647 million from April 2000 to May 2015. 100% FDI is allowed under automatic route.[41] During year 2013–14, FDI in textile sector was increased by 91%.[42] Indian textile industry is expected reach up to $141 billion till 2021.[43]

Airlines

Foreigner investment in a scheduled or regional air transport service or domestic scheduled passenger airline is permitted to 100%.

Aerospace

Indian aerospace manufacturing is also growing rapidly and has attracted huge investments. The industry is projected to reach USD 70 billion in 2030.[44]

Results

A foreign direct investment (FDI) refers to purchase of an asset in another country, such that it gives direct control to the purchaser over the asset (e.g. purchase of land and building). In other words, it is an investment in the form of a controlling ownership in a business, in real estate or in productive assets such as factories in one country by an entity based in another country.[1] It is thus distinguished from a foreign portfolio investment or foreign indirect investment by a notion of direct control.The origin of the investment does not impact the definition, as an FDI: the investment may be made either "inorganically" by buying a company in the target country or "organically" by expanding the operations of an existing business in that country.

Broadly, foreign direct investment includes mergers and acquisitions, building new facilities, reinvesting profits earned from overseas operations, and intra company loans. In a narrow sense, foreign direct investment refers just to building new facility, and a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor.[2] FDI is the sum of equity capital, long-term capital, and short-term capital as shown in the balance of payments. FDI usually involves participation in management, joint-venture, transfer of technology and expertise. Stock of FDI is the net (i.e., outward FDI minus inward FDI) cumulative FDI for any given period. Direct investment excludes investment through purchase of shares (if that purchase results in an investor controlling less than 10% of the shares of the company).[3]FDI, a subset of international factor movements, is characterized by controlling ownership of a business enterprise in one country by an entity based in another country. Foreign direct investment is distinguished from foreign portfolio investment, a passive investment in the securities of another country such as public stocks and bonds, by the element of "control".[1] According to the Financial Times, "Standard definitions of control use the internationally agreed 10 percent threshold of voting shares, but this is a grey area as often a smaller block of shares will give control in widely held

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companies. Moreover, control of technology, management, even crucial inputs can confer de facto control."[1]

Before Stephen Hymer's landmark work on FDI in 1960, no theory existed that dealt specifically with FDI.[4] However, there are theories that dealt generally with foreign investments. Both Eli Heckscher (1919) and Bertil Ohlin (1933) developed the theory of foreign investments by using neoclassical economics and macroeconomic theory. Based on this principle, the differences in the costs of production of goods between two countries cause specialisation of jobs and trade between countries. Reasons for differences in costs of production can be explained by factor proportions theory. For example, countries with a greater proportion of labour will engage in labor-intensive industries while countries that have a greater proportion of capital will engage in capital-intensive industries. However, such a theory makes the assumption that there is perfect competition, there is no movement of labour across country borders,[5] and the multinational companies assumes risk neutral preferences. In 1967, Weintraub tested this hypothesis by collecting United States data on rate of return and flow of capital. However, the data failed to support this hypothesis. Data from surveys on the motivation of FDI also failed to support this hypothesis.[6]

Intrigued by the motivations behind large foreign investments made by corporations from the United States of America, Hymer developed a framework that went beyond the existing theories, explaining why this phenomenon occurred, since he considered that the previously mentioned theories could not explain foreign investment and its motivations.[citation needed] Facing the challenges of his predecessors, Hymer focused his theory on filling the gaps regarding international investment. The theory proposed by the author approaches international investment from a different and more firm-specific point of view. As opposed to traditional macroeconomics-based theories of investment, Hymer states that there is a difference between mere capital investment, otherwise known as portfolio investment, and direct investment. The difference between the two, which will become the cornerstone of his whole theoretical framework, is the issue of control, meaning that with direct investment firms are able to obtain a greater level of control than with portfolio investment. Furthermore, Hymer proceeds to criticize the neoclassical theories, stating that the theory of capital movements cannot explain international production. Moreover, he clarifies that FDI is not necessarily a movement of funds from a home country to a host country, and that it is concentrated on particular industries within many countries. In contrast, if interest rates were the main motive for international investment, FDI would include many industries within fewer countries.

Another observation made by Hymer went against what was maintained by the neoclassical theories: foreign direct investment is not limited to investment of excess profits abroad. In fact, foreign direct investment can be financed through loans obtained in the host country, payments in exchange for equity (patents, technology, machinery etc.), and other methods.

The main determinants of FDI is side as well as growth prospectus of the economy of the country when FDI is made. Hymer proposed some more determinants of FDI due to criticisms, along with assuming market and imperfections. These are as follows:

Firm-specific advantages: Once domestic investment was exhausted, a firm could exploit its advantages linked to market imperfections, which could provide the firm with market power and competitive advantage. Further studies attempted to explain how firms could monetize these advantages in the form of licenses.

Removal of conflicts: conflict arises if a firm is already operating in foreign market or looking to expand its operations within the same market. He proposes that the solution for this hurdle arose in the form of collusion, sharing the market with rivals or attempting to acquire a direct control of

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production. However, it must be taken into account that a reduction in conflict through acquisition of control of operations will increase the market imperfections.

Propensity to formulate an internationalization strategy to mitigate risk: According to his position, firms are characterized with 3 levels of decision making: the day to day supervision, management decision coordination and long-term strategy planning and decision making. The extent to which a company can mitigate risk depends on how well a firm can formulate an internationalization strategy taking these levels of decision into account.

Hymer's importance in the field of international business and foreign direct investment stems from him being the first to theorize about the existence of multinational enterprises (MNE) and the reasons behind FDI beyond macroeconomic principles, his influence on later scholars and theories in international business, such as the OLI (ownership, location and internationalization) theory by John Dunning and Christos Pitelis which focuses more on transaction costs. Moreover, "the efficiency-value creation component of FDI and MNE activity was further strengthened by two other major scholarly developments in the 1990s: the resource-based (RBV) and evolutionary theories"[7] In addition, some of his predictions later materialized, for example the power of supranational bodies such as IMF or the World Bank that increases inequalities (Dunning & Piletis, 2008). A phenomenon the United Nations Sustainable Development Goal 10 aims to address.[8]

Conclusions

The types of FDI investments can be classified based on the perspective of the investor/source country and host/destination country. On an investor perspective, it can be divided into horizontal FDI, vertical FDI, and conglomerate FDI. In the destination country, the FDI can be divided into import-substituting, export-increasing, and government initiated FDI.[6] Horizontal FDI arises when a multination corporation duplicates its home country industry chain into the destination country to produce similar goods. Vertical FDI takes place when a multinational corporation acquires a company to exploit the natural resources in the destination country (backward vertical FDI) or by acquiring distribution outlets to market its products in the destination country (forward vertical FDI). Conglomerate FDI is the combination between horizontal and vertical FDI.[6]

Platform FDI is the foreign direct investment from a source country into a destination country for the purpose of exporting to a third country.[citation needed]

Methods

The foreign direct investor may acquire voting power of an enterprise in an economy through any of the following methods:

by incorporating a wholly owned subsidiary or company anywhere

by acquiring shares in an associated enterprise

through a merger or an acquisition of an unrelated enterprise

participating in an equity joint venture with another investor or enterprise

Forms of FDI incentives

Foreign direct investment incentives may take the following forms:[9]

low corporate tax and individual income tax rates

tax holidays

other types of tax concessions

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preferential tariffs

special economic zones

EPZ – export processing zones

bonded warehouses

maquiladoras

investment financial subsidies

free land or land subsidies

relocation & expatriation

infrastructure subsidies

R&D support

energy[10]

derogation from regulations (usually for very large projects)

Foreign investment was introduced in 1991 under Foreign Exchange Management Act (FEMA), driven by then finance minister Manmohan Singh.[19][20] India disallowed overseas corporate bodies (OCB) to invest in India.[21] India imposes cap on equity holding by foreign investors in various sectors, current FDI in aviation and insurance sectors is limited to a maximum of 49%.[22][23] A 2012 UNCTAD survey projected India as the second most important FDI destination (after China) for transnational corporations during 2010–2012. As per the data, the sectors that attracted higher inflows were services, telecommunication, construction activities and computer software and hardware. Mauritius, Singapore, US and UK were among the leading sources of FDI. Based on UNCTAD data FDI flows were $10.4 billion, a drop of 43% from the first half of the last year.[24] In 2015, India emerged as top FDI destination surpassing China and the US. India attracted FDI of $31 billion compared to $28 billion and $27 billion of China and the US respectively

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