Analysis of Inflows of Foreign Direct Investment in India- Problems and Challenges

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Abstract
Countries around the world- both developed and developing, are taking concerted efforts in a bid to attract greater flows of FDI into their economies. Indian government is leaving no stone unturned in its attempt to attract greater FDI flows into India. But despite the fact that India offers a large potential market, possesses pool of talented, educated and skilled workforce, has relatively low labor costs and liberal democratic political structure, the FDI inflows into India have remained low in comparison to other emerging markets. In this backdrop, this paper seeks to analyze the status of FDI inflows into India and identify the problems and issues that have made India less attractive destination as compared to other nations. The study is exploratory in nature and secondary data has been collected from various reports and publications of Government of India, World Bank, OECD, World Economic forum etc. The study will enable us to get an insight on the steps that Indian government can take and also some lessons that India can learn from countries like China to increase the attractiveness of India as an FDI destination.

Keywords: Foreign Direct Investment, India.

1. Introduction
According to the IMF and OECD definitions, foreign direct investment is defined as a cross border investment made by an entity resident in one economy in an enterprise resident in another economy with the aim of acquiring a lasting interest and control. FDI has been associated with improved economic growth and development in the host countries which has led to the emergence of global competition to attract FDI. Many
countries are now offering a range of incentives to the foreign investor like tariff concessions, tax holidays, R&D support, infrastructure improvements, financial subsidies, low tax rates etc. India in its attempt to attract greater FDI flows has also established “India Brand Equity Foundation”.

After following inward oriented policies for nearly four decades, India marched on the path of liberalization in July 1991. The restrictions in FDI were gradually reduced, the sectoral caps were raised and FDI was allowed through automatic route in most sectors, except a few sectors which are of strategic importance. Many new sectors were opened up for FDI like defense, power, insurance etc. To enhance India’s potential to become an attractive FDI destination, Government of India has been actively taking steps to pursue a more open door policy for foreign investment. For instance, in August 2013, the government increased the FDI limits in twelve sectors, including telecom and insurance.

In spite of all these measures, FDI inflows in India have remained low in comparison to other emerging economies, especially China. India bagged 5th place in the 2013 Foreign Direct Investment Confidence Index, a survey conducted by a US consultancy firm A.T. Kearney of more than 300 executives from 28 countries. The 1st, 2nd, 3rd and 4th place were bagged by United States, China, Brazil and Canada respectively. Similarly, in the World Investment Report of 2013, India ranked 15th among the top twenty host economies of 2012. Emerging economies like China, Brazil, Hong Kong, and Mexico surpassed India as the most attractive destination. While China and Brazil continue to be the main competitors, some new countries namely Indonesia, Vietnam, Mexico, South Africa, Philippines and Myanmar are giving tough competition to India.

India with its strong industrial base, pool of talented and skilled workers and a well developed financial sector has the potential of emerging as the top destination of FDI. The policy makers in India have continuously made efforts to attract greater flows of FDI into India and should continue to do so. This paper is organized as follows: Section 2 lists the objectives for this study and the research methodology. Sections 3 discusses the current state of FDI in India, highlighting the research methodology. Sections 3 discusses the current state of FDI in India, highlighting the sector wise trends, country sources and inter country comparisons. Sections 4 addresses the problems and issues that have made India less attractive destination as compared to other nations. Finally, Section 5 concludes with some policy recommendations and some lessons that India can learn from China.

2. Objectives
India possesses several advantages like superior IT technology, well developed industrial base, large consumer market, and abundant supply of skilled and educated workers who can fluently speak English at relatively low wage rates. Still, India attracts lesser inflows of FDI in comparison to other nations. In this context, this study has following two objectives:
To analyze the status of FDI in India, pointing out the sector wise trends and country sources.

To identify the problems and reasons that have reduced India’s attractiveness as an FDI destination.

This study is exploratory in nature and secondary data has been collected from various reports and publications of Government of India, World Bank, OECD, World Economic forum etc.

3. Analysis of FDI Inflows

The introduction of New Economic Policy in July, 1991 has resulted in attraction of greater FDI inflows into India. The liberalization of foreign investment policy has resulted in an upward trend in FDI inflows, although the inflows have also witnessed fluctuations in the recent years. From an impressive amount of USD 22826 million in 2006-07, it reached peak level of USD 41902 million. In the next two years, FDI inflows witnessed a decline. After reaching another high at USD 46556 million in 2011-12, it reached USD 34298 in 2012-13, a decline of 26%. The trends in FDI inflows from 2005-06 to 2012-13 are depicted in Figure-1

![Trends in Inward FDI (in USD Millions)](source: Reserve Bank of India Database)

**Fig. 1:** Trends in Inward FDI (in USD Millions)

3.1 Comparative Inward FDI

There is an intense global race for FDI where every country is putting its best foot forward in order to attract greater inflows of FDI into their economies. In 2012, developing countries took a lead and absorbed about 52% of global FDI inflows. Four countries namely United States, China, Brazil, and the United Kingdom accounted for 36% of global FDI inflows. Among the developing economies China attracted the bulk of FDI. FDI inflows into many developing economies like India, Russia and South
Africa witnessed a decline in 2012. On the other hand, low income countries like Myanmar and Vietnam have emerged as an important destination for labor-intensive FDI. The FDI received by some countries and FDI as a percentage of GDP in 2012 is shown in Figure-1 and Figure-2 respectively. The FDI/GDP ratio is an indicator of the investment climate in the host economy. Countries with have investor friendly policies tend to have a higher FDI/GDP ratio.

![Figure 2: FDI inflows in Developing Economies 2012](source: UNCTAD Database)

![Figure 3: FDI as a % of GDP in 2012.](source: World Bank Database)
Thus, as shown in the Fig. above, India is behind China, Brazil and Russia in attracting FDI inflows. While for India, the FDI inflows declined by 29.5% in 2012, the FDI inflows in many emerging economies like Indonesia, Myanmar, Philippines, Thailand, and Vietnam witnessed a rising trend.

3.2 FDI in India- Country and Sector specific analysis
FDI has grown in its importance in India in the last two decades. Cumulative FDI inflows reached USD 290,078 million between April, 2000 to March, 2013. Since 2000, sectors such as services, construction, hotels and tourism, drugs and pharmaceuticals, metallurgical industries, power, automobile, computer hardware and software have performed well in attracting FDI. Services sector took the lion’s share in 2012-13 accounting for about 21% of total FDI inflows. It was followed by hotels and tourism (14.5%), automobile (7%), metallurgical (7%), Construction (6%) and drugs and pharmaceuticals (5%). The sectors attracting highest FDI equity inflows for the year 2012-13 in depicted in Figure-4 below.

![Figure 4: Sectors attracting highest FDI inflows in 2012-13 (in USD millions)](source: Department of Industrial Policy and Promotion, Ministry of Commerce & Industry, Government of India)

Country wise, in 2012-13, Mauritius has been the largest investor in India accounting for 42% of the total FDI inflows. Singapore is the second largest investor in India accounting for 10.2% of inflows, followed by Japan (9.9%), Netherlands (8.3%) and U.K (4.8%). The investments from these countries are primarily concentrated in telecom, power, transportation and service sectors.
Table 1: Top 5 investor economies in 2012-13

<table>
<thead>
<tr>
<th>Country</th>
<th>FDI inflows (in USD millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mauritius</td>
<td>9497</td>
</tr>
<tr>
<td>Singapore</td>
<td>2308</td>
</tr>
<tr>
<td>Japan</td>
<td>2237</td>
</tr>
<tr>
<td>Netherlands</td>
<td>1856</td>
</tr>
<tr>
<td>U.K</td>
<td>1080</td>
</tr>
</tbody>
</table>

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

4. Attracting Larger FDI Inflows in India- Problems and Challenges

Both India and China are competing to get a larger share in world trade and investment. Although China continues to be India’s major competitor, many new economies like Indonesia, Vietnam and Philippines have emerged as strong competitors. India’s main competitive advantage lies in its lower labor costs and remunerative domestic markets. But India is fast losing its competitive advantage to countries like Indonesia and Vietnam as investors are shifting FDI away from known growth engines towards these new emerging economies. No doubt Indian government has implemented several reform measures in order to attract greater FDI but there are several studies which have highlighted India’s weak spots. One such report is “Doing Business 2014”, an annual report co-published by the World Bank and International Finance Corporation that brings out the differences in business regulations and their implementation across economies. This study covers 189 countries, ranking them on 11 indicators. These indicators reflect the quality of the investment climate in a country and better performance on these indicators is frequently associated with greater inflows of FDI.

Table 2: Doing Business in India

<table>
<thead>
<tr>
<th>Rank</th>
<th>Ease of doing business</th>
<th>Starting a business</th>
<th>Dealing with construction permits</th>
<th>Getting electricity</th>
<th>Registering property</th>
<th>Getting credit</th>
<th>Protecting investors</th>
<th>Paying taxes</th>
<th>Trading across borders</th>
<th>Enforcing contracts</th>
<th>Resolving insolvency</th>
</tr>
</thead>
<tbody>
<tr>
<td>134</td>
<td></td>
<td>179</td>
<td>182</td>
<td>111</td>
<td>92</td>
<td>28</td>
<td>34</td>
<td>158</td>
<td>132</td>
<td>186</td>
<td>121</td>
</tr>
</tbody>
</table>
The table 2 above indicates that India is performing well only on two indicators, namely, getting credit and protecting investors. India’s performance on three indicators, namely, starting a business, dealing with construction permits and enforcing contracts shows a dismal picture of the investment climate in India.

Another report “Global Competitiveness Report” published annually by “World Economic Forum” ranks 148 economies on their competitiveness with respect to indicators like infrastructure, institutions, macro-economic stability, innovation etc. India’s overall rank for 2013-14 on the Global Competitiveness Index was 60. The most problematic factors for doing business identified in the report are inadequate supply of infrastructure, corruption, inefficient government bureaucracy, policy instability, tax regulation and restrictive labor regulations.

4.1 Major Impediments
The major deterrents to larger flows of FDI to India are listed below:

- **Weak infrastructure:** Infrastructural bottlenecks continue to be a major cause of concern in India. When it comes to competition, India doesn’t stand against other emerging markets in terms of ports, roads, skills sets, education etc. Even after six decades of planned economic development, India suffers from poor transport links, inadequate power supply, poor roads, frequent power cuts, delays in ports, water and sewerage problems and so on. A study conducted by the Federation of Indian Chambers of Commerce and Industry in 2013, revealed that each day Indian companies are losing upto Rs. 40,000 because of power shortages; and due to power cuts, 61% companies suffer more than 10% loss in production. Warehousing and cold storage facilities are also in short supply, because of which 40% of the fruits, vegetables and other perishable products get destroyed before reaching the markets. In the World Competitiveness Index for 2013-14, India ranked 85 out of 148 countries for its infrastructure, much behind China which ranked 48.

- **Complicated tax structure:** Stability and transparency in tax regime along with clarity in tax laws can have far reaching impact on investments in any country. The taxation policies in India remain inherently complex despite the fact that government has taken several steps to simplify and redesign it. In the recent years, India has witnessed several tax disputes with respect to cross border transactions involving big MNCs. According to a report in 2011-12, 30 corporations which comprise the BSE Sensex had USD 7 billion clogged in tax law suits. Again, while corporate tax rates in most of the nations are in the range of 15 to 25%, in India foreign companies are taxed at a rate of 40%. The corporate tax rate for foreign companies is 25% in China along with tax holidays for qualified tax payers. India’s indirect tax regime is also very complex, imposing several taxes such as central sales tax, VAT, service tax, central excise duty, octroi etc. and calls for a number of compliances increasing
the burden on companies. Moreover, there is a lack of uniformity in the tax rates across the country increasing the complexities for tax payers.

- **Restrictive labor laws:** India is known worldwide for its stringent and rigid labor laws and over-regulated labor market. Over the years, Indian government has enacted a large number of legislations to protect the interests of labor covering different aspects namely fixation and revision of wages, worker’s health and safety, mode of payment of wages, payment of compensation in the event of industrial accident, provision of social security such as provident fund, gratuity, insurance and so on. Indian economy has turned highly inflexible due to these laws. These laws contain strict rules regarding overtime and imposes financial obligation on the employer upon worker retrenchment. Laws such as taking prior permission from the government before firing any worker in an organization employing more than 100 workers continues to haunt corporations. On several occasions OECD and World Bank studies have highlighted the need to bring reforms in Indian labor laws.

- **Bureaucracy, regulations and corruption:** Yet another handicap that India suffers from is bureaucracy, red tapism and corruption. It takes months to obtain licenses, approvals and permits. As per the doing business report, it takes 67 days for a company to obtain electricity connection, 16 days to obtain clearances and export goods from India, 182 days for dealing with construction permits and 1420 days for enforcing contracts. It takes 4 to 8 weeks for a new company to get itself registered in India as compared to few days in most developed and developing markets. Many a times, the FDI approvals are kept pending for months that prompts the investor to drop out. With respect to FDI policies, even though several liberalization measures have been undertaken by the government but FDI regulations continue to remain restrictive as compared to many other nations. India has been selective in opening sectors for FDI and FDI in India is subject to sectoral caps ranging from 20 to 100%. The FDI Regulatory Restrictiveness Index 2013, prepared and published by OECD has ranked India 6th (indicate restrictive FDI policies) out of 58 countries. Again, corruption in India is rampant where; licenses, clearances, and contracts are given not on merit basis but based on bribes. Uncertain government policies and frequent changes in them, inefficient administrative, overlapping jurisdictions, excessive governance increases the transaction costs for companies making India a less preferred destination.

5. **Policy Recommendations**

There is no denying the fact that India is receiving FDI inflows far below her potential. Indian government has taken several steps to make the FDI policies simplified and transparent, have increased the FDI limits in different sectors, opened many new sectors for FDI, and have placed many sectors on the automatic approval route. In spite of all this, India receives much lesser FDI as compared to developing economies of
China and Brazil. India stands the chance of losing its comparative advantage in lower labor costs and large domestic markets to the newly emerging low cost economies of Indonesia, Vietnam and Philippines. If some reform measures are not implemented quickly, chances will soon take the shape of reality.

Even in the Global Competitive Report of 2013-14, India is ranked at 60 out of 148 countries, much below other developing economies like Malaysia (rank 24), China (rank 29), Thailand (rank 37), Indonesia (rank 38), Turkey (rank 44), South Africa (rank 53), Mexico (rank 55), Brazil (rank 56), and Philippines (rank 59).

Therefore, it is high time that India learns some lessons from other countries and launch second generation of reforms. Reforms in labor laws; liberalizing FDI policies in sectors like retail, insurance, airports and media; introduction of Goods Sales Tax to avoid the levy of multiple taxes; reduction in corporate tax rates; cutting down the bureaucratic hurdles; and simplification of regulatory procedures and development of world class infrastructure is the need of the hour. Only by implementing these reforms, can India expect to attract larger flows of FDI in the years to come.

References


