Impact of Foreign Direct Investment on Indian Economy

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Abstract: ***Foreign direct investment plays a crucial role in channelizing transfer of capital and technology and perceived to be a potent factor in promoting economic growth in developing countries like India. They act as a long term source of capital as well as a source of advanced and developed technologies. The investors also bring along best global practices of management. As large amount of capital comes in through these investments more and more industries are set up. This helps in increasing employment. FDI also helps in promoting international trade. This investment is a non-debt, non-volatile investment and returns received on these are generally spent on the host country itself thus helping in the development of the country. This paper tries to find out how FDI seen as an important economic catalyst of Indian economic growth by stimulating domestic investment, increasing human capital formation and by facilitating the technology transfers. FDI is a predominant and vital factor in influencing the contemporary process of global economic development. The study attempts to analyze the important dimensions of FDI in India.***

Keywords: Foreign exchange; portfolio; disposable income; Gross Domestic Product

1. Introduction

Foreign Direct Investment (FDI) is fund flow between the countries in the form of inflow or outflow by which one can able to gain some benefit from their investment whereas another can exploit the opportunity to enhance the productivity and find out better position through performance. The effectiveness and efficiency depends upon the investors perception, if investment with the purpose of long term then it is contributes positively towards economy on the other hand if it is for short term for the purpose of making profit then it may be less significant. Depending on the industry sector and type of business, a foreign direct investment may be an attractive and viable option. Any decision on investing is thus a combination of an assessment of internal resources, competitiveness, and market analysis and market expectations. The FDI may also affect due to the government trade barriers and policies for the foreign investments and leads to less or more effective towards contribution in economy as well as GDP of the economy

2. Review of Literature

Aggarwal (2005) found that rigid labour markets in Indian states discourage FDI. The effect of labour market rigidities and labour cost, however, was more pronounced for the export-oriented as compared to the domestic market seeking FDI. The study also pointed out that the presence of EPZ worked as a relevant pull factor for export oriented FDI. Econometric evidence found in the study suggested that infrastructure, regional development and human development were also key factors in attracting higher FDI both in the export and domestic market sectors. In a study on business environment, clustering and industry location in the Indian Cities, using firm level data collected in the 2003 round of the Investment Climate Survey (ICS) for India.

Chidlow and Young (2008) found that Polish regions differed substantially in attracting foreign capital and the regional characteristics mattered in the selection of location. using survey data from an online questionnaire and a multinomial logit model incorporating investor specific characteristics, they showed that knowledge-seeking factors alongside market and agglomeration factors, acted as the main drivers of FDI to Mazowieckie region (including Warsaw), while efficiency (low input cost, availability of labour and resources) and geographic factors encouraged FDI to the other areas of Poland.

In the context of the United States, Coughlin, Terza and Aromdee (1989) found that the number of potential sites, state per capita income, manufacturing density within a state, better transportation infrastructure, higher unemployment rates and higher expenditures to attract FDI were positively linked to FDI flows. On the other hand, higher wages and higher tax rates had negative impact on FDI flows. Fisher and Peters (1998) found that incentives offered by various states had a positive impact on investment flows to the US. Incentives considered in their study include job credits, property tax abatements, sales tax exemptions, grants, loan guarantees, firm specific job training and infrastructure subsidies. Within the European Union member states, the long term trends point out the existence of a negative relationship between taxation and FDI inflows.

Ramachandran and Goebel (2002) pointed out that Tamil Nadu had emerged as one of the most favored investment destination in India on account of a number of advantages viz., strong and stable government with pro-active government policies, investor-friendly and transparent decision making process, sound diversified industrial infrastructure, comfortable power situation, abundant availability of skilled manpower, harmonious industrial relations and absence of labour unrest, high quality of work culture and peaceful life, best incentives package in the country, highly cosmopolitan composition and high proportion of English speaking population. FDI in Tamil Nadu is dominated by investments in the IT sector. Santis, Mercuri and Vicarelli (2001) found that FDI flows within the European Union member states were more influenced by the total fiscal wedge on labor than corporate tax rates. This suggests that multinationals, while making their location choices, focus their attention more to the overall tax burden than on single corporate tax rates, which provide only partial information. Apart from tax burden, bilateral degree of trade openness and infrastructure also play an important role to attract FDI.

Wolff (2006) found that within the European Union, the different sub-components of FDI (equity, re-invested profits and other investments) react differently to taxes. Contrary to the public belief that high corporate tax rates act as the key reasons for low investment rates from abroad, the author found that after controlling for unobserved country characteristics and common time effects, the top statutory corporate tax rate of both, source and host country, turned insignificant for total FDI and investment into equity. There were, however, definite indications that high source country taxes increased the probability of firms to reinvest profits abroad. However, overall experience revealed that global companies give more importance to the simplicity and stability of a country's tax system than generous tax rebates. Overall, the theory and the empirical literature suggest that the most important determinants of the regional distribution of FDI flows within a country include the size and growth of the local market, the level of industrial activity, the growth of the services sector, the availability and quality of physical infrastructure, labour market conditions and quality of labour, policy environment and tax incentives, business climate and the presence of agglomeration economies.

2.1 FDI in Infrastructure

The number of FDI projects in the Infrastructure sector grew by 90% in 2011 in India. The sector contributed 4% to the total number of FDI projects and 9% to the total jobs created. Development in the country's infrastructure is poised to accelerate as the Government of India (GOI) plans to double its infrastructure spending from US$500 billion to US$1 trillion during FY2012–17. The GOI is aggressively focusing on minimizing India's infrastructure deficit and would like to generate investor interest in the sector. The GOI allows investors full access to most infrastructure sectors, including: roads and highways; ports and harbors; power plans and airports. To increase infrastructure's attractiveness further, the GOI has extended tax holiday periods, and facilitated the creation of public-private partnership (PPP) projects. Drawn by the various opportunities available in the sector, a number of private players, including foreign players, have started participating in building the infrastructure sector. International players, such as Toyo Engineering, Jacobs H&G, Tecnimont and Aker Solutions, are already investing substantially in the country's infrastructure space. However, land acquisition and environmental clearance issues, along with persistently high inflation and interest rates, hamper new investments projects, especially their timely completion. Furthermore, India's regulatory environment can periodically block the injections of foreign money into the sector.

2.2 FDI in Automotive sector

The automotive sector in India attracted 78 FDI deals during 2011, an increase of 28% in comparison to the same period in 2010. Although the sector made up 8% of total FDI projects in India, it created most jobs (16%). India is now the world's seventh-largest passenger vehicle (PV) manufacturer, and the second-largest medium and heavy commercial vehicles (MHCV) and 2-wheelers market. The GOI created the Auto Policy 2002 to attract FDI to establish the country as a manufacturing and export base. The policy provides automatic approval of foreign equity investment of up to 100% for the manufacture of automobiles and auto components. India's automotive sector has five key manufacturing hubs — Chennai (Tamil Nadu), Pune (Maharashtra), National Capital Region (NCR), Pantnagar (Uttarakhand) and Sanand (Gujarat). These states have provided incentives to attract investment, including tax breaks, facilitated access to land and guaranteed access to energy. To further promote automotive exports, the GOI has created the Focus Market Scheme (FMS), which provides manufacturers with cash incentives of up to 5% for export of vehicles. Investors find India an appealing destination for automotive manufacturing given its skilled technical labor force, low-cost supplier base and strong domestic demand. Furthermore, they increasingly see India as a base to manufacture and export cars, bringing in competition with Thailand, the current automotive manufacturing destination of Asia. According to our survey, investors believe that improvement in the quality of products and increased focus on R&D will enhance the position of Indian auto-component players in the global automotive supply chain.

2.3 FDI in Financial services

In 2011, the number of projects in the Indian financial services sector increased by 21%, whereas the value of FDI projects increased by 75%. Despite a high growth potential, FDI in the industry remains low compared with other rapidly developing economies, due to capital account convertibility, capital lock-ins and numerous regulations. About 22% of the financial services companies surveyed said that capital convertibility is the main concern faced by investors and 21% believed that capital lock-ins are a key challenge in the sector. However, the demand for a wide array of financial services products, ranging from credit to insurance, is growing. Currently, only 47% of the Indian population has access to banking facilities, while only 15% of the total insurable populations have life insurance coverage. This is a tiny portion of the giant Indian market, underlining the domestic growth potential in the sector. Industry experts anticipate India will become the world's third-largest banking market by 2025 and the third-largest life insurance market by 2015. India's vast potential in financial services, and particularly in insurance, will increasingly attract investors as the GOI relaxes restrictions on investment. According to our survey, 38% of financial services companies believe that relaxing Insurance Regulatory and Development Authority (IRDA) caps on marketing commissions will attract more foreign participation in the sector, while 26% feel that it will be made more attractive by relaxing FDI caps.

2.4 FDI in Technology

The technology sector in India has a major impact on the Indian economy. The industry has grown from US$4 billion in 1998 to more than US$80 billion in 2011, employing directly and indirectly more than 10 million people. Riding on the services outsourcing wave, domestic and international companies have leveraged India's value proposition to enhance their competitiveness in the global market. Key government initiatives, such as setting up of tax free zones, Software Technology Parks of India (STPI) and Special Economic Zones (SEZ), have given strong impetus to the export of IT services. These zones exempt companies from a variety of taxes while setting and running in the initial years of operations. The technology sector in India received US$6,197 million through FDI in 2011, showing an increase of 46% from the previous year. The investment has created 153 projects with an estimated 41,607 jobs in the industry. Five principle sectors in the IT industry, namely online businesses, IT services, IT-enabled services and software and hardware merchandise received most of the investments. Compelling cost advantage coupled with available skilled force has driven this spectacular growth. India's domestic IT demand is growing fast and is expected to surpass US$90 billion in next decade. Technology is integrating with the conventional ways of doing business; a lot of business transactions are happening online. India's burgeoning economy needs more hardware, software and other IT services. Many Tier II and Tier III cities have the potential to support the growth expansion of the IT industry, along with providing the cost advantage compared with that in Tier I cities. Although many low-cost delivery destinations, such as China, Philippines and Vietnam, are emerging, India's leadership position cannot be challenged. Its benefit of long term cost competitiveness, supply of highly trained engineers and its expertise in processes and quality will continue to foster its growth.

2.5 FDI in Retail

Growing urban Indian population has been driving organized retail in India. In addition, shift in the preference for branded products; convenient spending through debit/credit cards; and greater propensity to spend act as drivers for the sector. However, investors' confidence was dampened because of the GOI's decision to put FDI in multi-brand retail policy on hold. Investors, in 2011, were anxiously waiting for the liberalization of the Indian retail sector, allowing big box retailers to come in and set up shop. Not only did this plan portend the creation of 10 million jobs in India, it also offered a way to alleviate supply bottlenecks and food price inflation. But only days after introducing the plan, political squabbles forced its retraction. This has damaged the GOI's credibility to foreign investors to a certain extent, who may decide to look elsewhere in the coming year. The decision is a big disappointment for players such as Wal-Mart Stores Inc. and Tesco plc, which were planning to make major investments in the country. The GOI, however, did not back down from allowing 100% foreign investment in single brand retail from the current 51%. This will help some of the well-known apparel single- brand firms that are keen on entry into India.

2.6 FDI in Consumer Products (CP)

The number of projects in the CP sector grew by 31% in 2011. The sector made up 10% of total FDI projects in India and created over 28,400 jobs. Investors in consumer products are interested in accessing India's rapidly growing middle class, which is increasingly able to afford consumer products. In particular, investors have observed growth in the packaged food and beverages sector. India's large population and rapid economic growth position it to become the fifth largest country in terms of consumption by 2025. The strong demand of the rising middle class is only part of this story; in fact, an emerging rural consumer base is also increasingly able to purchase consumer products. The specific requirements of the consumer products market in India have forced companies to innovate, adapting to the needs of Indian consumers, with diversified products portfolios. However, inflation is catching up with companies' cost structures and has resulted in rapidly rising input, packaging and fuel costs. This, in turn, has squeezed profit margins while forcing prices upward. Consumer products are likely to witness continued demand driven by healthy disposable income growth and lower absolute spends on FMCG products. Although companies may some face margin pressure due to high raw material prices, rural markets will remain a big opportunity.

2.7 FDI in Cleantech

India continues to be one of the preferred destinations for cleantech investments. According to the November 2011 edition of Ernst & Young's Renewable energy country attractiveness indices, India ranked as the fourth most attractive country (after China, the US and Germany) out of 40 countries. Investors see potential in the sector, given the current Indian power generation deficit of 10.3%. The GOI has taken a number of initiatives to promote the sector. Its National Action Plan on Climate Change (NAPCC) stipulates a minimum renewable energy purchase target of 5% of total grid purchase, increasing by 1% each year for 10 years. Furthermore, the sector has been opened to foreign players, allowing investors to spend in renewable power generation on a build-own-operate basis in India. The Indian clean tech sector looks promising to investors. The market's concern over future energy price rises is expected to boost interest in power-saving technologies. This will likely support the country's goal of 15% of green electricity by 2020.

3. Policy Initiatives

The Government of India has released a comprehensive FDI policy document effective from April 1, 2010. Furthermore, the government has allowed the Foreign Investment Promotion Board (FIPB), under the Ministry of Commerce and Industry, to clear FDI proposals of up to US$ 258.3 million. Earlier all project proposals that involved investment of above US$ 129.2 -million were put up before the Cabinet Committee of Economic Affairs (CCEA) for approval. The relaxation would expedite FDI inflow. During April 2010, Mauritius invested US$ 568 million in India, followed by Singapore which invested US $434 million and Japan that invested US $327 million according to latest data released by DIPP. It shows that there has been a significant shift in the character of global capital flows to the India in recent years in that the predominance of private account capital transfer and especially portfolio investment increased considerably. The importance of FDI received special impetus towards the end of 1992 when the Foreign Institutional Investors (FIIs) such as pension funds, mutual funds, investment trusts, asset management companies, nominee companies and incorporated / institutional portfolio managers were permitted to invest directly in the Indian stock markets. In order to attract portfolio investments which prefer liquidity, it has been advocated to develop the Indian stock markets. The foreign portfolio investment not only do they expand the demand base of the stock market, but also stabilize the market through investor diversification. In order to have a flow of FDI, India maintained Double Tax Avoidance Agreements (DTAA) with nearly 70 countries of the world. India has signed 57 (up to 2006) numbers of Bilateral Investments Treaties (BITS). The numbers of BITS are signed with developing countries of Asia 16, the Middle East 9, Africa 4, and Latin America 1 apart from the developed nations 27. India as the founding member of General Agreement on Tariffs and Trade (GATT), World Trade Organization (WTO), asignatory member of South Asian Free Trade Area (SAFTA) and a member of Multilateral Investment Guaranty Agency (MIGA) is making its presence felt in the economic landscape of globalised economies which will help a conducive and healthy atmosphere for foreign investors and thus resulting in substantial amount of FDI inflows in the country. State wise FDI inflows show that Maharashtra, Delhi, Karnataka, Gujarat and Tamil Nadu together accounted more 75 percent of inflows during 2000-2010 because of the infrastructural facilities and favorable business environment provided by these states. Despite troubles in the world economy, India continued to attract FDI inflows mainly because Government of India open-up with flexible investment regimes and policies prove to be the horde for the foreign investors in finding the investment opportunities in the country.

4. Conclusion

No doubt, FDI plays a crucial role in enhancing the economic growth and development of the country. Moreover, FDI as a strategic component of investment is needed by India for achieving the objectives of its second generation of economic reforms and maintaining this pace of growth and development of the economy. Hence FDI is a significant factor which influences the level of economic growth in India. It provides a sound base for economic growth and development by enhancing the financial position of the country. It also contributes to the GDP and foreign exchange reserves of the country. MNCs should be allowed to set up in such a manner that they help increase the standard of living of our country instead of sole profit making.

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