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FDI in India: History, Policy and the Asian Perspective by Prof. Manoj Pant and Deepika Srivastava, Orient Blackswan Pvt. Ltd. (2015), ₹695

Foreign Direct Investment (FDI), according to the IMF, is the category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise. FDI is often perceived as a channel of progress and development, as it promises to bring financial resources and technology. The counter view is that FDI is an instrument employed by rich countries to control resources in developing economies. This debate requires rigorous empirical country specific research to be able to assess the role of FDI in a country. *FDI in India: History, Policy and the Asian Perspective* provides a research-based analysis of FDI in India from the perspective of evolution of policy on FDI and its associated economic impact. Prof. Pant and Ms Srivastava address some specific issues such as the spillover effects of FDI on local firms and the substitutability/ complementarity between trade and FDI.

Though several books exist on this topic, the analytical rigour and the issues covered in this book set it apart from the others. Prof. Pant, who is an expert in international trade, has extensive experience in India's trade policies and the book reflects his rich academic background and involvement in the country's trade affairs over a long period. This book attempts to answer frequently asked questions, namely: Will large corporates monopolise and take over profitable sectors? Will the government have effective control over them? To what extent will local businesses be affected? FDI from developed to developing countries grows rapidly with some reverse in the 1980s accompanied by declining importance of developed countries.

The book is divided into nine chapters. Chapter 2 of the book provides an overview of the evolution of FDI policy in select South Asian countries while chapters 3 and 4 document developments in India's foreign investment policy. Chapter 5 makes a comparison between foreign and domestic firms in terms of various parameters. Export orientation, spillovers and trade linkages of FDI in India are discussed in chapters 6 to 8, while chapter 9 concludes the book with some policy recommendations.

Policymakers normally employ macroeconomic and tax policies to encourage FDI. This book provides a historical overview of the evolution of policy frameworks in select South Asian countries such as China, Malaysia, Thailand and Singapore, with an objective to draw relevant lessons for India. Apart from macroeconomic conditions, tax policy has been the key determinant of FDI in these countries. The effective tax rate for FDI firms can vary substantially from nominal tax rates for local firms because of several exemptions provided by a host country to FDI firms. Tax policy assumes significance due to differential tax treatment of residents and non-residents. The book mainly focusses on taxation in India relative to its South Asian neighbours.

The initial conditions in China, in the 1950s, were more or less similar to those in India. During the period 1979–88, FDI flows into China were of low technology and labour-intensive type and originated mostly from Hong Kong. A major factor that encouraged FDI in China was its relatively easier rules and regulations, facilitated by a decentralised system of authority that enabled quick decisions and eliminated bureaucratic delays. The taxation policies of China acted as a catalyst in attracting FDI inflows in the 1980s, wherein tax concessions were linked to the volume of FDI and the timeline for it was committed. Foreign joint ventures (JVs) were given preferential tax treatment, besides the additional tax benefits given to export-oriented JVs and those employing advanced technology.

In Malaysia, which is like India in terms of ethnic heterogeneity and dominance of an agricultural economy, its infrastructure availability, disciplined labour force and a tax haven status were the main factors contributing to FDI. Tax policy was used, post 1985, to help transnational

corporations (TNCs) tide over the effects of recession of the early 1980s. It gave exemptions on separate withholding tax on repatriated dividends. Dividend distribution income arising from sources outside Malaysia by a resident company (other than one in the business of banking, insurance, shipping and air transport) were exempted from tax. Foreign ownership up to 100 per cent was allowed if a company exported 80 per cent of its production or if it employed at least 350 Malaysians and its product did not compete with any locally-produced product.

In Thailand, FDI was sought mainly to generate employment and increase exports. The government undertook a massive restructuring of processes followed for FDI approvals, which facilitated a sharp increase in FDI in the country. The labour intensity of exports increased from 1.4 per cent in 1970 to 31 per cent in 1986. Singapore, a classic ‘small’ economy with a limited resource base, has naturally emerged as a re-export economy. The policy initiatives undertaken by Singapore to attract FDI included the development of world-class infrastructural facilities, with a focus on developing the financial sector, upgrading the skills of its labour force and a periodic economic review with a view to restructure the economy to respond to the changing external environment. The factors attracting FDI in Singapore were more related to a sound macroeconomic policy framework rather than tax benefits *per se*. The lessons which could be drawn from the experience of these countries is that the changes in laws in line with the interests of TNCs is a key determinant of FDI flows.

The book provides a historical evolution of India’s foreign investment policy and its impact on the role of foreign investment in the economy. The policy during the period 1950–80 was largely shaped by the struggle between the state and monopoly foreign interests, where the major TNCs were oil companies. The setting up of Free Trade Zones (FTZs) with a host of tax and other concessions failed to attract FDI. In 1969, the government defined three groups of industries for the purpose of foreign investment – FDI without technical collaboration, FDI with technical collaboration, and FDI with no foreign participation. After the announcement of the Industrial Policy Statement of 1973, the Foreign

Exchange Regulation Act (FERA) came into force in 1974, which specified the detailed list of industries in which foreign firms could participate with or without FDI, with exemptions in tea plantations, and drugs and pharmaceuticals sectors. Thus, 1970–80 was considered a ‘FDI restrictive period’, as FERA acted as an instrument of control rather than provider of incentives.

The government began liberalising FDI during 1980-91 with the Industrial Policy Statements of 1980 and 1982 followed by the Technology Policy Statement in 1983. This period also witnessed a considerable degree of trade liberalisation in terms of reductions in tariffs and the shifting of many import items from licensing to open general license (OGL) category. During the first half of the 1990s, FDI emerged, for the first time, as a preferred route for mobilising financial resources over loans and other forms of financial channels. Foreign equity up to 51 per cent was permitted under the automatic approval route by the RBI in specified industries producing intermediate and capital goods. FDI was considered as an instrument to bring in foreign technology not available domestically and which subsequently replaced the phrase ‘indigenous’ by ‘sophisticated and high technology’.

A comparison of tax policies of the four countries analysed in the book with that of India’s tax policy suggests that these countries insisted on a certain minimum level of FDI for availing tax exemptions. India’s policy on FDI, on the other hand, discouraged long term investment till 2000 unless a very large export commitment existed and was relatively backward in renegotiating tax treaties. Though others also imposed restrictions on foreign ownership, the relaxation or tax concessions were not linked only to export performance but also to important domestic policy issues like employment, local content and location. After 1995, India’s foreign investment policy was largely influenced by the Uruguay Agreement of 1995 wherein foreign firms could no longer be treated on less favourable terms. Also, the revolution in the communications sector created a whole new set of businesses which were classified as ‘industries’ in terms of FDI regulations. The series of measures initiated to encourage FDI included: (a) introduction of a dual route – RBI’s automatic route and the government’s approval route; (b) automatic permission for technology agreements in high priority industries and

removal of restriction in low technology areas as well as liberalisation of technology imports; (c) permission to NRIs and overseas corporate bodies to invest up to 100 per cent in high priority sectors; (d) hike in foreign equity participation limit to 51 per cent for existing companies and liberalisation of using foreign 'brand name'; and (e) signing the Multilateral Investment Guarantee Agency for the protection of foreign investments. These measures resulted in a significant increase in FDI even as portfolio investment declined due to the East Asian crisis after 1997. To further encourage FDI, foreign equity participation up to 100 per cent with a cap of ₹15 billion, was permitted under the automatic route for the infrastructure sector which included power supply, roads, ports and harbours.

Using the balance sheet data of 440 firms in two industry groups, namely, 'chemical' and 'electrical and non-electrical' for two periods, *i.e.* 1985–90 and 2001–10, the book draws a comparison between domestic and foreign firms in terms of seven firm characteristics — export intensity, import intensity, capital intensity, value-added, tax payments, profitability and the effective tax rate defined as the ratio of tax provisions to gross profit. The foreign firms, as expected, were generally more vertically integrated than domestic firms in both the periods, *albeit*, at a low level of statistical significance. The study strongly suggests that for the period 1985–90, while the outward orientation of firms (measured by export intensity) was the same for domestic and foreign firms, the import dependence of domestic firms was much higher. However, during the period 2001–10, foreign firms were more outward-oriented than domestic firms. Contrary to the general perception, domestic firms were found to be more capital-intensive than foreign firms. Therefore, the fear that foreign firms promote capital-intensive techniques and reduce employment opportunities may not be true. There was little difference in the effective tax rates and the profit rates of domestic and foreign firms. In the case of foreign firms, share of their sales revenue going to the exchequer declined significantly in the period 2001–10 from that in 1985–90.

The liberalisation process followed in Less Developed Countries (LDCs) gave emphasis to greater outward-orientation, thereby increasing

export earnings. These countries generally reduced import duties over time. In India, the general rate of import duties fell from about 300 per cent in 1990 to 80 per cent by 1994 and further to around 12 per cent at present. The direction liberalisation took was influenced by the belief that permitting TNCs (or FDI) in certain sectors will greatly help promote exports. As a result, FDI has switched from natural resources-based industries to manufacturing, and more recently to the service sector. The empirical research relating to the export performance of TNCs, which has largely focused on the manufacturing sector, indicates that there is no significant difference in the export propensities of domestic and foreign firms in India in both the periods studied in the book, *i.e.* 1985–90 and 2000–10. The export performance of firms was determined by firm and industry-specific factors, rather than difference in ownership (foreign/ domestic) of a firm, *per se*, and this is found to be true since 1989.

Horizontal technology spillover often occurs through competition from foreign firms, demonstration impact and labour turnover; though it can be delayed or prevented intentionally. Foreign firms generally have less incentive to prevent vertical spillovers. The factors influencing technology spillover from foreign firms include absorptive capacity, competitive environment and openness of the concerned sectors. Technology spillover from foreign subsidiaries was considered a major benefit by LDCs. There are studies which have found that the firms with higher research and development activity often happen to be the major recipients of technology spillover due to foreign presence. At the same time, some studies indicate that technology import alone does not improve firms' efficiency. During 2001–07, the presence of foreign firms helped domestic firms improve their productivity *via* indirect 'learning by doing' rather than attempts to import technology embodied in drawings and designs.

Traditionally, 'trade and FDI' were treated as two separate issues, until the 1980s when FDI, like other forms of international investment, was seen to be determined by differences in the rates of return on capital across countries. Horizontal FDI arises among similar countries in the absence of trade costs where trade and FDI are substitutes. In

the case of dissimilar countries in the presence of trade costs, there exists a complementary relationship. Empirical investigations have found broad support for the complementary relationship as compared to substitution.

The authors conclude the book with some policy recommendations. FDI policy should focus on improving access to world-class technologies with no sectoral caps. The objective of FDI policy should be to improve competition and bring technology spinoffs for the local industry. There should be no distinction between FDI and trade, where international production and trade and investments are increasingly being organised within 'global value chains'. There is a need to remove administrative complexities by achieving synergy among various government machineries. The experience of other Asian economies that have been analysed in the book, particularly that of China, offers an important policy lesson for India, *i.e.* decentralisation of powers may facilitate considerable freedom to make quick decisions and encourage FDI in desired sectors.

The book is useful addition to the literature on the subject and can meet the expectation of both students and researchers giving its delicate balance between clear illustrations and empirical inferences, though it does not deal in distinguishing the various components of FDI. Thus, it would be of considerable benefit to those particularly interested in understanding the nuances of FDI in India.

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