An Analytical Study of Role of Foreign Direct Investment (FDI) In India and Its Impact on Trade Development-I.

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***Abstract*: The purpose of the paper is to highlight the conceptual framework of Foreign Direct Investment (FDI), its role, the problems associated with the provisions of Foreign Direct Investment in India. In this paper an attempt is also made to discuss the various constraint and limitations of Foreign Direct Investment. The findings of the paper will help the planners to frame an exact and benefiting policy for Foreign Direct Investment and its role in economic development of India.**

***Keywords*: Foreign Direct Investment, Economic Development, Investment.**

INTRODUCTION:

Foreign direct investment (FDI) plays an extraordinary and growing role in global business. It can provide a firm with new markets and marketing channels, cheaper production facilities, access to new technology, products, skills and financing. For a host country or the foreign firm which receives the investment, it can provide a source of new technologies, capital, processes, products, organizational technologies and management skills, and as such can provide a strong impetus to economic development. Foreign direct investment, in its classic definition, is defined as a company from one country making a physical investment into building a factory in another country. The direct investment in buildings, machinery and equipment is in contrast with making a portfolio investment, which is considered an indirect investment. In recent years, given rapid growth and change in global investment patterns, the definition has been broadened to include the acquisition of a lasting management interest in a company or enterprise outside the investing firm's home country. As such, it may take many forms, such as a direct acquisition of a foreign firm, construction of a facility, or investment in a joint venture or strategic alliance with a local firm with attendant input of technology, licensing of intellectual property. In the past decade, FDI has come to play a major role in the internationalization of business. Reacting to changes in technology, growing liberalization of the national regulatory framework governing investment in enterprises, and changes in capital markets profound changes have occurred in the size, scope and methods of FDI. New information technology systems, decline in global communication costs have made management of foreign investments far easier than in the past. The sea change in trade and investment policies and the regulatory environment globally in the past decade, including trade policy and tariff liberalization, easing of restrictions on foreign investment and acquisition in many nations, and the deregulation and privatization of many industries, has probably been the most significant catalyst for FDI's expanded role.

Foreign Direct Investment (FDI) acquired an important role in the international economy after the Second World War. Theoretical studies on FDI have led to a better understanding of the economic mechanism and the behaviour of economic agents, both at micro and macro level allowing the opening of new areas of study in economic theory.

To understand foreign direct investment must first understand the basic motivations that cause a firm to invest abroad rather than export or outsource production to national firms. The purpose of this unit is to identify the main trends in FDI theory and highlight how these theories were developed, the motivations that led to the need for new approaches to enrich economic theory of FDI.

Foreign direct investment (FDI) in its classic form is defined as a company from one country making a physical investment into building a factory in another country. It is the establishment of an enterprise by a foreigner. Its definition can be extended to include investments made to acquire lasting interest in enterprises operating outside of the economy of the investor. The FDI relationship consists of a parent enterprise and a foreign affiliate which together form a multinational corporation (MNC). In order to qualify as FDI the investment must afford the parent enterprise control over its foreign affiliate.

The International Monetary Fund (IMF) defines control in this case as owning 10% or more of the ordinary shares or voting power of an incorporated firm or its equivalent for an unincorporated firm; lower ownership shares are known as portfolio investment.

MAIN CONCEPT AND DEFINITION

Generally defined, foreign direct investment is the acquiring of a lasting and controlling interest in an enterprise operating abroad. Definitions for FDI can vary depending on the legal instrument being used, and the country asserting the definition. In defining FDI, multilateral institutions focus on the management characteristic asserted by the home (investing) country. For example, the WTO secretariat says that FDI "occurs when an investor in one country (the home country) acquires an asset in another country (the host country) with the intent to manage that asset. The management dimension is what FDI distinguishes from portfolio investment in foreign stocks, bonds, or other financial instruments."

However, the definition of FDI given by Organisation for Economic Co-Orporation and Development (OECD) which states that “Foreign direct investment reflects the objective of obtaining a lasting interest by a resident entity in one economy (‘‘direct investor’’) in an entity resident in an economy other than that of the investor (‘‘direct investment enterprise’’). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise. Direct investment involves both the initial transaction between the two entities and all subsequent capital transactions between them and among affiliated enterprises, both incorporated and unincorporated.” OECD also recommends that, a direct investment enterprise is an incorporated or unincorporated enterprise in which a single foreign investor either owns 10 per cent or more of the ordinary shares or voting power of an enterprise (unless it can be proven that the 10 per cent ownership does not allow the investor an effective voice in the management) or owns less than 10 per cent of the ordinary shares or voting power of an enterprise, yet still maintains an effective voice in management.

Organisation for Economic Co-Orporation and Development (OECD) also defined who is a Foreign Direct Investor. It states “a foreign direct investor is an individual, an incorporated or unincorporated public or private enterprise, a government, a group of related individuals, or a group of related incorporated and/or unincorporated enterprises which has a direct investment enterprise – that is, a subsidiary, associate or branch – operating in a country other than the country or countries of residence of the foreign direct investor or investors.”

Similarly International Monetary Funds (IMF) defines Foreign Direct Investment as:-

“Direct investment refers to investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor’s purpose being to have an effective voice in the management of the enterprise.”

“Lasting interest”, according to the definition of the Organisation for Economic Co-operation and Development, means at least 10% ownership of the voting shares. Nevertheless, most of the money invested through foreign direct investment constitutes a much larger share of ownership, usually providing a majority vote for the investors.

Foreign direct investment is distinguished from the so-called portfolio investment, which is placed through the capital markets without entrepreneurial commitment and with the sole purpose of obtaining profit without influencing corporate management. Portfolio investors are believed to be subject to less risk inherent in investment activity as a result of the free transferability of their assets

Foreign investment is believed to benefit both the investor and the host country. As it is noted in the Preamble to the World Bank Guidelines on the Treatment of Foreign Direct Investment:

A greater flow of foreign direct investment brings substantial benefits to bear on the world economy and on the economies of developing countries in particular, in terms of improving the long-term efficiency of the host country through greater competition, transfer of capital, technology, managerial skills and enhancement of market access and in terms of the expansion of international trade.

The definition of foreign direct investment presents an interesting dichotomy. On one hand, bringing investment funds directly to developing nations and their emerging markets offers a surge in capital, and the economy of the developing nation seeks to benefit, through increased opportunities for labour and training, from the presence of large multi-national enterprises. On the other hand, the definition of foreign direct investment illustrates that the management of the investment does not rest with the host nation but rather with the entity supplying the funds from the foreign country.

While the locus of management control for the foreign investor is in the investment itself and not in the overall structure of the host economy, there is a fear in developing nations that in order to attract foreign direct investment government policies will need to be catered to the demands of foreign direct investors. Many developing nations are eager to attract investors, but they want to do so while retaining autonomy over policies specific to the needs of their nation. Indeed, the scope of the definition of FDI favoured by capital exporting countries over capital importing countries illustrates this pattern of developing countries favouring control over as much of their infrastructure as possible. Not surprisingly, the scope of the definition of FDI favoured by capital exporting countries is broader than that of capital importing countries. Countries that invest their capital in foreign markets want to ensure that the investment is protected, and therefore they favour a broad definition of FDI that regulates and legally protects a range of investments. In contrast, countries importing capital want to retain as much of their own sovereignty as possible and therefore support "a narrow definition of FDI in order to minimize their liberalization obligations in an international agreement”.

HISTORICAL BACKGROUND

Compared to most industrialising economies, India followed a fairly restrictive foreign private investment policy until 1991 – relying more on bilateral and multilateral loans with long maturities. Inward foreign direct investment (FDI, or foreign investment, or foreign capital hereafter) was perceived essentially as a means of acquiring industrial technology that was unavailable through licensing agreements and capital goods import. Technology imports were preferred to financial and technical collaborations. Even for technology licensing agreements, there were restrictions on the rates of royalty payment and technical fees. Development banks largely met the external financial needs for importing capital equipment. However, foreign investment was permitted in designated industries, subject to varying conditions on setting up joint ventures with domestic partners, local content clauses, export obligations and so on broadly similar to those followed in many rapidly industrialising Asian economies.

Foreign Exchange and Regulation Act (FERA), 1974 stipulated foreign firms to have equity holding only up to 40 per cent, exemptions were at the government's discretion. Setting up of branch plants was usually disallowed; foreign subsidiaries were induced to gradually dilute their equity holding to less than 40 per cent in the domestic capital market. The law also prohibited the use of foreign brands, but promoted hybrid domestic brands (*Hero-Honda*, for instance). However, pragmatism prevailed to ensure stable domestic supply at reasonable prices.

Such a restrictive policy is believed to have retarded domestic technical capability (as reflected in the poor quality of Indian goods); it also meant a loss of export opportunity of labour intensive manufactures – in contrast to many successful east Asian economies. Moreover, such a policy is said to have encouraged 'rent seeking' by domestic partners on imported technology – with little efforts to improve product quality, undertake innovation, and seek export markets. This popular perception was perhaps best illustrated by the passenger car industry that produced obsolete (and fuel inefficient) models of the 1950s at very high costs in small numbers.

Without denying some of these arguments and evidence, others have shown that the regulation reduced costs of technology imports, and promoted export of goods with relatively stable technologies where domestic firms had the opportunity of 'learning by doing' by catering to the large domestic market – as illustrated by successful firms like TELCO (commercial vehicles) and BHEL (heavy electrical equipment). The recent international achievements of some Indian pharmaceutical firms (Dr Reddy's Laboratories, for instance) is also attributed to the regulatory and promotional policies, and the patent laws that sought to encourage domestic production to reduce drug prices.

However, the 1980s witnessed a gradual relaxation of the foreign investment rules – perhaps best symbolised by the setting up of Maruti, a central government joint venture small car project with Japan's Suzuki Motors in 1982. It was followed by Pepsi's entry in the second half of the decade, to primarily export processed food products from Punjab, and also to bottle its well known beverages for the domestic market.

REFORMS IN THE 1990S

All this changed since 1991. Foreign investment is now seen as a source of scarce capital, technology and managerial skills that were considered necessary in an open, competitive, world economy. India sought to consciously 'benchmark' its policies against those of the rapidly growing south-east Asian economies to attract a greater share of the world FDI inflows. Over the decade, India not only permitted foreign investment in almost all sectors of the economy (barring agriculture, and, until recently, real estate), but also allowed foreign portfolio investment – thus practically divorcing foreign investment from the erstwhile technology acquisition effort. Further, laws were changed to provide foreign firms the same standing as the domestic ones.

INDUSTRIAL POLICY OF 1991

Notwithstanding that stated above, India has made many great improvements over the last decade in achieving economic growth and poverty reduction. The most significant advancement came in 1991 when India removed governmental obstacles and allowed its doors to open to foreign investment. The Industrial Policy of 1991 greatly enhanced the business climate in India and provided clarity to foreign businesses looking to invest in India. Prior to the implementation of this policy, foreign investment was allowed on a case-by-case basis. It was usually capped at 40% of the total equity capitalization, unless the investment included sophisticated technology that was unavailable in India, or the venture was predominately export-oriented. The new welcoming attitude of the government was reflected in the Industrial Policy, which liberalized the internal licensing requirements for businesses and retained only minimum procedural formalities. In the words of policy makers: "The industrial policy reforms have reduced the industrial licensing requirements, removed restrictions on investment and expansion, and facilitated easy access to foreign technology and foreign direct investment." Under this policy, most investments can come in under the automatic route. There are also categories of investment that, while not listed as eligible for automatic approval, may be eligible as such if the investment falls within the foreign investment caps.

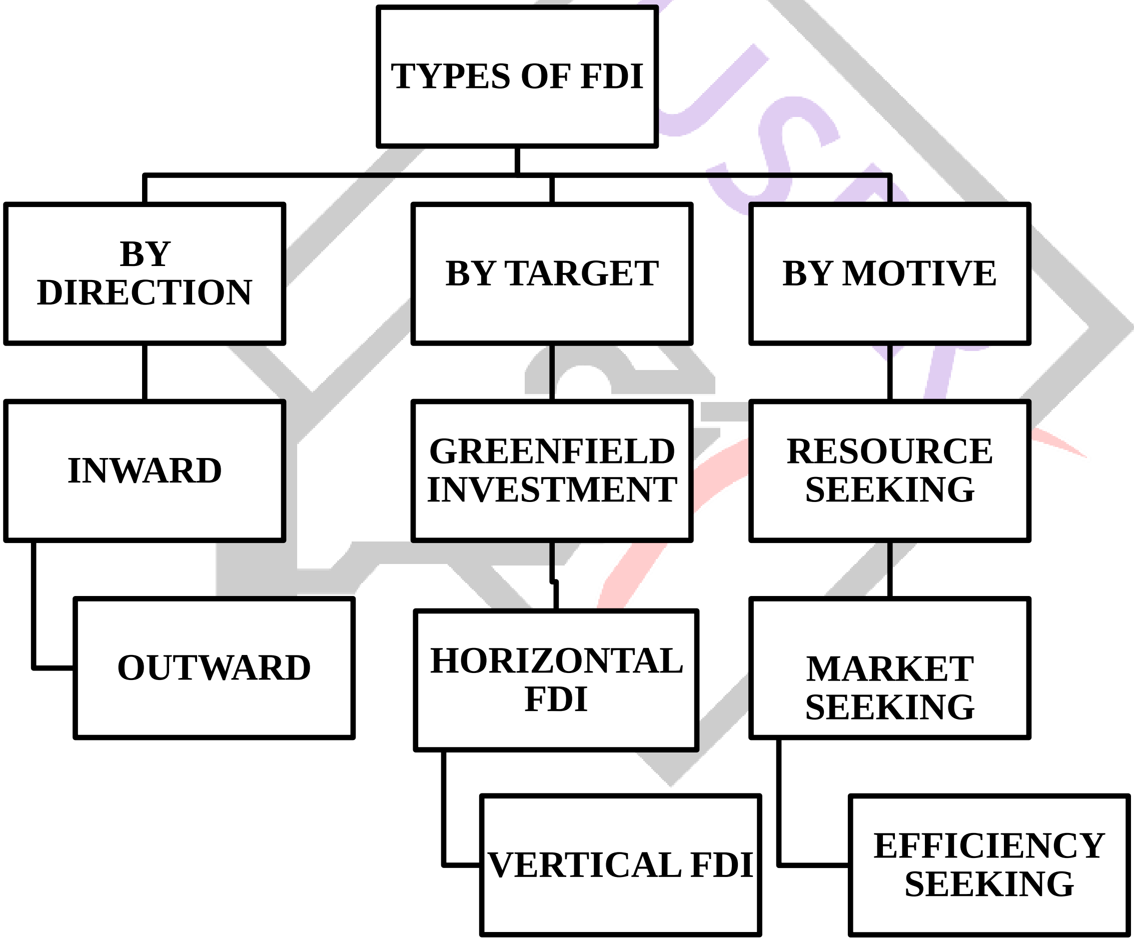
Prior to 1998, however, non-residents had to obtain prior approval pursuant to the terms of the Foreign Exchange Regulatory Act (FERA), even for investments eligible for automatic approval. This policy was further liberalized on January 20, 1998, when the Reserve Bank of India (RBI) changed the foregoing rule by allowing Indian companies to issue and export equity shares to foreign investors without prior approval. The automatic route now requires only that investors file the required documents, a declaration on Form FC, with the concerned Regional Office of the RBI within thirty days after the issue of the shares to foreign investors. The RBI gave this permission to Indian companies in an attempt to simplify FDI procedures under this "automatic route." The prior licensing procedures represented many hurdles for foreign companies looking to do business in India. The Industrial Policy of 1991 was expected to avoid the red tape and corruption in the bureaucracy, and liberate Indian business. Now that the many restrictions have been lifted, companies with non resident interests are placed on equal footing with Indian wholly-owned companies.

Other results of the 1991 policy included increasing income and improving the living standards of Indian residents over the last decade. The reform program has been the driving force behind accelerating economic growth, further declining poverty, and strengthening India's external position.

CHANGES IN LABOUR POLICY

Another great benefit for businesses looking to invest in India, in addition to the liberal governmental policy, is the local employment population. Labour is the most dominant input for production in virtually every type of business. India is well positioned with regard to local market size and labour costs as it has one of "the largest domestic markets in the world and it has a large labour force available at relatively low cost." These workers are also very well-educated, especially in the areas of engineering and science "India's vast reservoir of knowledge resource-engineers, scientists, technicians, managers and skilled personnel, are among the best in the world." In fact, India placed second in a poll of 400 executives who were asked to rank the labor forces of developing nations, ranking it ahead of China. Indeed, historically the Indian labor force has a generally favorable attitude toward foreign investment. This is generally because of a perception of a greater degree of professionalism in foreign business, and because of a lingering expectation of higher wages. The foreign company may, however, continue to employ foreign nationals, as "the government of India has not introduced any legislation to provide for the Indianization of employment."

TYPES OF FOREIGN DIRECT INVESTMENT



1. BY DIRECTION

(i) INWARD FDI

Inward foreign direct investment is a particular form of inward investment when foreign capital is invested in local resources.

Inward FDI is encouraged by:

- Tax breaks, subsidies, low interest loans, grants, lifting of certain restrictions

- The thought is that the long term gain is worth short term loss of income

Inward FDI is restricted by:

- Ownership restraints or limits
- Differential performance requirements

(ii) OUTWARD FDI

Outward foreign direct investment, sometimes called "direct investment abroad", is when local capital is invested in foreign resources. Yet it can also be used to invest in imports and exports from a foreign commodity country.

Outward FDI is encouraged by:

- Government-backed insurance to cover risk

Outward FDI is restricted by:

- Tax incentives or disincentives on firms that invest outside of the home country or on repatriated profits
- Subsidies for local businesses
- Leftist government policies that support the nationalization of industries (or at least a modicum of government control)
- Self-interested lobby groups and societal sectors who are supported by inward FDI or state investment, for example labour markets and agriculture.
- Security industries are often kept safe from outwards FDI to ensure localized state control of the military industrial complex.

2.BY TARGET

(I) GREENFIELD INVESTMENT

Direct investment in new facilities or the expansion of existing facilities. Greenfield investments are the primary target of a host nation’s promotional efforts because they create new production capacity and jobs, transfer technology and know-how, and can lead to linkages to the global marketplace. The Organization for International Investment cites the benefits of Greenfield investment (or insourcing) for regional and national economies to include increased employment (often at higher wages than domestic firms); investments in research and development; and additional capital investments. Criticisms of the efficiencies obtained from Greenfield investments include the loss of market share for competing domestic firms. Another criticism of Greenfield investment is that profits are perceived to bypass local economies, and instead flow back entirely to the multinational's home economy. Critics contrast this to local industries whose profits are seen to flow back entirely into the domestic economy.

(II) MERGERS AND ACQUISITIONS

Transfers of existing assets from local firms to foreign firms takes place; the primary type of FDI. Cross-border mergers occur when the assets and operation of firms from different countries are combined to establish a new legal entity. Cross-border acquisitions occur when the control of assets and operations is transferred from a local to a foreign company, with the local company becoming an affiliate of the foreign company. Unlike Greenfield investment, acquisitions provide no long term benefits to the local economy-- even in most deals the owners of the local firm are paid in stock from the acquiring firm, meaning that the money from the sale could never reach the local economy. Nevertheless, mergers and acquisitions are a significant form of FDI and until around 1997, accounted for nearly 90% of the FDI flow into the United States. Mergers are the most common way for multinationals to do FDI.

(III) HORIZONTAL FDI

Investment in the same industry abroad as a firm operates in at home.

(IV) VERTICAL FDI

Backward Vertical FDI

Where an industry abroad provides inputs for a firm's domestic production process.

Forward Vertical FDI
Where an industry abroad sells the outputs of a firm's domestic production.

3. BY MOTIVE

FDI can also be categorized based on the motive behind the investment from the perspective of the investing firm:

(I) RESOURCE-SEEKING

Investments which seek to acquire factors of production that are more efficient than those obtainable in the home economy of the firm. In some cases, these resources may not be available in the home economy at all (e.g. cheap labor and natural resources). This typifies FDI into developing countries, for example seeking natural resources in the Middle East and Africa, or cheap labor in Southeast Asia and Eastern Europe.

(II) MARKET-SEEKING

Investments which aim at either penetrating new markets or maintaining existing ones. FDI of this kind may also be employed as defensive strategy; it is argued that businesses are more likely to be pushed towards this type of investment out of fear of losing a market rather than discovering a new one. This type of FDI can be characterized by the foreign Mergers and Acquisitions in the 1980's by Accounting, Advertising and Law firms.

(III) EFFICIENCY-SEEKING

Investments which firms hope will increase their efficiency by exploiting the benefits of economies of scale and scope, and also those of common ownership. It is suggested that this type of FDI comes after either resource or market seeking investments have been realized, with the expectation that it further increases the profitability of the firm.

(IV) STRATEGIC-ASSET-SEEKING

A tactical investment to prevent the gain of resource to a competitor. Easily compared to that of the oil producers, whom may not need the oil at present, but look to prevent their competitors from having it.

NEED AND IMPORTANCE OF FOREIGN DIRECT INVESTMENT IN INDIA

"*Globalization must mean more than creating bigger markets. To survive and thrive, a global economy must have a more solid foundation in shared values and institutional practices*."

In the second half of the twentieth century, apart from the international law on the use of armed force, no area of international law has generated as much controversy as the law relating to foreign investment. Yet it has emerged as the most important phenomenon in today's economic relations.

This is not surprising considering the fact that FDI is of paramount importance to developing nations in their dream to achieve a sustained growth rate. Today when almost 4/5th of the world is still reeling under poverty FDI and other forms of capital inflows seem to be the only way for these developing nations to come out of the vicious cycle of poverty. The world is more unequal today than at any time in world history. Only 240 years ago, at the beginning of the industrial revolution, most everybody was poor. Author Lant Pritchett explains that very poor nations today are just barely above the subsistence level as measured in income per person. Since subsistence is defined as not starving to death, the poorest nations today have about the same income in real terms today as they did two centuries ago. It could not be less, because that would mean they were below subsistence level, which, by definition, cannot be true. The period of economic growth is a fairly recent one, but it has been a period of extreme divergence in economic performance. A relatively small part of the world achieved what economists call modern economic growth. Most of these countries sustained increases in the growth rate year after year. Some poor countries grew very slowly, while others, such as most African nations, did not grow at all. This created a huge gap between the countries that enjoyed sustained growth and the rest of the world. Developing countries are not only relatively poorer, they are worse off by absolute measures as well. The median per capita growth in developing countries between 1980 and 1999 was zero.

In such circumstances, as stated above, FDI gains significant importance. Not only does is give the developing nations a chance to grow, it brings in new technologies, creates human capital and encourages creativity. Most of all, it creates equity. This can be explained with the help of a historical example.

The classic example is the solving of the longitude problem. Up until the middle of the eighteenth century, sea travellers could not determine the longitude of their location. A generous prize of £20,000 offered by the British Board of Longitude drove a clockmaker named John Harrison to spend many years building a chronometer that solved this navigation problem. The prize money clearly did not reflect the huge benefit realized by society from the ability to navigate accurately. In other words, usually, inventors in developed nations do not capture the full value of their inventions and society benefits from positive externalities, also known as spillover effects. In other words, the social rates of return far exceed the private returns to the investor

Most of the world's technological progress takes place in about twenty countries. It is then transferred to other parts of the world through international trade, cross-border education, and foreign direct investments (FDI). FDI is an important avenue of transfer, especially for knowledge such as management techniques and blueprints.

Only a small fraction of the world's FDI is located in developing countries, and multinational corporations (MNCs) are the main carriers of FDI. They bring host economies valuable tangible and intangible assets such as capital, technology, market access, and management skills. FDI in general, and FDI by MNCs in particular, *169 can strengthen or even build economic markets and institutions. Developing countries benefit from the positive externalities created by the existence and activities of MNCs, and these externalities may help create market discipline.

NEED AND SIGNIFICANCE OF FDI

It has been increasingly recognised that growing foreign direct investment inflows can contribute to economic development and promise a variety of potential benefits to poor country recipients. Due to the potential role foreign direct investment can play in accelerating growth and economic transformation, many developing countries seek such investment to accelerate their development efforts. Consequently, foreign direct investment has become an important source of private external finance for developing countries.

Developing Countries see investment by foreign companies as a means to stimulate domestic industries, grow the domestic economy, and, most importantly, provide a technological basis for the domestic production of IP. Developing countries expect that these advances will lead to increased exports and a more significant role in the global economy. In addition, the flow of FDI can be an indicator of "the relative attractiveness of the business climate of competing economies." Developing countries provide a barometer for additional investors who may be seeking assurances that their investment decision is appropriate and will provide sufficient returns.

The foreign direct investment can increase growth in two ways. The investment increases total investment by attracting higher levels of domestic investment. Also, through interaction of the more advanced technology with the host country's human capital, foreign direct investment is more productive than domestic investment. Indeed, the most significant channel through which foreign direct investment contributes to productivity growth is perhaps increased access to technology.

While foreign direct investment represents investment in production facilities, its significance for developing countries is much greater. Not only can foreign direct investment add to investible resources and capital formation, but, perhaps more important, it is also a means of transferring production technology, skills, innovative capacity, and organisational and managerial practices between locations, as well as of accessing international marketing networks. In particular, the foreign investment could increase competition in the host-country industry, and hence force local firms to become more productive by adopting more efficient methods or by investing in human and/or physical capital. Multinational firms large size, advanced technology, and advertising expertise often enable them to invest in industries in which barriers to entry, such as large capital requirements coupled with trade restrictions, reduce the access of potential local competitors.

Moreover, foreign direct investment can boost domestic investment. For instance, a recent empirical work indicates a strong link between the volume of foreign direct investment and domestic investment. A dollar of foreign direct investment results in an almost one-dollar increase in investment. In addition to the impact of foreign direct investment on the volume of investment, the presence of foreign firms can generate important benefits for domestic firms by increasing their knowledge of, and access to, advanced technology, by improving the overall skills of the work force (through valuable training opportunities to workers), and by increasing demand for domestic firms products and the supply of inputs.

Investment from developed economies facilitates access to modern technologies with possible spillovers to the rest of the host economy or domestic firms. Technology spillover is a channel through which capital account liberalisation can have a positive impact. These spillovers are most clear in the case of foreign direct investment, especially through foreign firms incorporating new technologies in their subsidiaries. As new technologies are generally developed and adapted by firms in industrial countries, foreign direct investment may be the most efficient way for developing economics to gain access to them. In addition, this knowledge may become more widely available in the country over time, as employees with experience in the techniques used in foreign companies switch to other firms.

The flow of ideas, methods, and inventions is the impetus for increased productivity and improved processes and result in better products reaching the marketplace. It is these technological innovations that create a base for a strong economy and drive long-term economic growth. Foreign Direct Investment can also improve labour skills through on-the-job training, seminars, and formal education. For example, foreign direct investment to Malaysia facilitated technology transfer and improved the skills of the labour force. Foreign direct investment also contributes indirectly to growth through emulation of foreign affiliates by domestic firms and diffusion of skills throughout the economy as employees move to domestically owned firms. These spillover benefits of foreign direct investment are greatest in countries with sound investment climates marked by well-developed human capital, efficient infrastructure services, sound governance, and strong institutions.

Recent analyses using macroeconomic data suggest that foreign direct investment can have a positive impact on growth, particularly when the receiving country has a highly educated workforce (a measure of its absorptive capacity), allowing it to exploit foreign direct investment spillovers. Similarly the interaction between foreign direct investment and an indicator of human capital in cross-country regressions has a significant impact on growth in developing countries, but that foreign direct investment alone does not.

Furthermore, foreign direct investment can help boost host country exports. Multinational enterprises may help developing host countries process and export locally produced raw materials, using their marketing skills, superior technology, and general know-how. They facilitate the export of local production through their distribution networks, and they often account for a significant share of host country exports.

In conclusion, it is important for developing countries to attract both the money necessary to build facilities and employ the populace and also the technological know-how and training incidental to research and development (R&D) and high-technology manufacturing investments.

LAW RELATING TO FOREIGN DIRECT INVESTMENT IN INDIA

India does not have one primary law governing foreign investment, but rather four laws that regulate different aspects of FDI, including investments, industries, securities, and corporations. Although one widely used reference guide to Indian foreign investment policies declares that "the entire foreign investment policy and procedures are duly incorporated under Foreign Exchange Management Act regulations," in fact this is not the case. Rather, the Industries Development and Regulation Act of 1951, the Companies Act 1956, and the Takeover Code of the Stock Exchange Board of India ("SEBI") all, directly or indirectly, regulate important aspects of FDI inflows.

The Foreign Exchange Management Act (FEMA) of 1999, however, does give essential approval authority over FDI inflows to the Reserve Bank of India ("RBI"), India's central authority responsible for monetary policy. By allowing the RBI to restrict and to regulate the "transfer or issue of any security by a person resident outside India," FEMA Section 6(3)(b) grants authority to RBI to set guidelines to determine if and when persons resident outside India may purchase shares of an Indian company. Pursuant to this authority, the RBI promulgated its "Foreign Exchange Management Regulations 2000" ("FEMA Regulations"), which outline the "automatic route" under which Indian companies may issue shares to persons resident outside India with automatic approval, but only if they are not engaged in certain scheduled industries. The FEMA Regulations also place restrictions on equity participation by foreign investors based on a company's intended sector or industry. Through these provisions, FEMA outlines the initial channels for, and roadblocks, to FDI in India. Nonetheless, FEMA merely serves as the starting point for FDI governance, after which several other equally applicable laws and regulations come into play.

In addition, the Industries Development and Regulation Act of 1951 ("IDRA"), the primary statute governing industrial activities in India, requires industrial licenses for manufacturing in certain industries. The government occasionally updates IDRA's provisions through its periodic Industrial Policies announcements. The latest update, the New Industrial Policy of 1991 ("NIP"), constituted part of the single most significant set of economic reforms in India since its independence in 1947. Besides focusing on fiscal deficit, deregulation, and trade and exchange rate policies, the 1991 reforms also aimed at liberalizing foreign investment policy. In conjunction with the several official Notifications of the Government of India in the Ministry of Industry (Department of Industrial Development) promulgated since implementation, the NIP has made significant headway in loosening the licensing restrictions under the IDRA. Using its power of exemption under Section 29B of IDRA, the central government has, since the NIP, shortened the lists of sectors either totally barred or restricted from foreign investment, including the "list of industries reserved for the public sector," the "list of industries in respect of which industrial licensing is compulsory," and the "list of items reserved for exclusive manufacture in the small-scale sector."

Mergers, acquisitions, and amalgamations are governed by two other statutes. Acquisitions are governed by the Stock Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 ("SEBI"), while mergers and joint ventures are regulated primarily by the Companies Act 1956. Because they involve the acquisition of equity shares, acquisitions must meet the provisions of the Companies Act 1956 and the listing agreements with the Indian stock exchange if the securities are listed. All three forms involving the issuance of shares of an Indian company to a foreign investor (a person resident outside India) are still restricted under the FEMA Regulations. The formation, incorporation, and operation of companies in India, including those established by foreign investors, are also regulated by the Companies Act 1956.

FDI APPROVAL PROCESS IN INDIA

Following are the methods of FDI entry into India: (1) the "automatic route" under powers delegated to the Reserve Bank of India, necessitating no prior approval by either the government or the RBI; and (2) the government approval route, whereby all activities not covered by the automatic route require approval by the Foreign Investment Promotion Board. The data from recent years reveal that the government approval route remains the primary conduit for FDI inflows and that the automatic route plays a much smaller role. The automatic and governmental approval routes will be discussed in turn.

1. AUTOMATIC ROUTE POLICY & PROCEDURES

RBI identifies those proposals for issuance and purchase of shares by a person residing outside of India that qualify for the automatic route in Section 5(1) and Schedule I of the FEMA Regulations. The FEMA Regulations state that all FDI (up to 100% equity participation) is channelled through the automatic route, except in four instances: (1) investments that require an industrial license; (2) proposals in which the foreign investor has a previously existing venture in the same field; (3) application for acquisition of shares in an existing Indian company; (4) investments falling outside sectoral caps or in sectors in which FDI is barred. In these four instances, government (Foreign Investment Promotion Board or "FIPB") approval is required before RBI approval, the final and necessary approval, can be given.

Neither government nor RBI approval is necessary for proposals that qualify for the automatic route; instead, the Indian company issuing shares must submit a report to RBI no later than thirty days from the date of receiving funds. In determining the corporate form of the new entity, foreign investors may choose whether or not to incorporate. If the investor opts to incorporate, the entity must be incorporated under the Companies Act 1956 in the form of a joint venture or wholly-owned subsidiary. The company must file for registration and incorporation with the Registrar of Companies and is then subject to Indian laws and regulations just as any other domestic Indian enterprise. Although they are created by a separate legal document, these new entities must still abide by the sectoral caps under the FEMA regulations introduced above. FEMA Regulations and restrictions on automatic route approval also apply to investments in existing companies.

2. GOVERNMENT APPROVAL ROUTE POLICY AND PROCEDURES

As stated above, four circumstances regarding FDI necessitate government approval. In these cases, investment proposals are first sent to the Secretariat for Industrial Assistance ("SIA") and are then transferred for review to the FIPB, the board chaired by the Secretary of the DEA. It generally takes thirty days to receive a decision on a submitted proposal. The FIPB has complete discretion in rendering its decisions, including freedom from all predetermined parameters and procedural requirements and full authority to negotiate with investors to maximize FDI inflow potential. However, this same flexibility may slow down the process because it also allows the FIPB to consider a host of factors in determining whether or not to approve FDI proposals.

The FIPB's Guidelines for the Consideration of Foreign Direct Investment (FDI) Proposals by the Foreign Investment Promotion Board (FIPB) lists some of the factors it may consider in rendering its decisions, including sectoral requirements, the advantages and disadvantages of granting industrial licenses, the nature of technology collaboration, and export requirements. Furthermore, the FIPB is encouraged to prioritize investment proposals that do not qualify for automatic approval but that fall within sector limits, involve infrastructure projects, have export potential, or are likely to increase employment. The board is also advised to scrutinize proposals for the amount of equity held by foreign investors and the resultant balance of equity ownership, as well as, whether the induction of capital is characterized by new foreign equity or merely by expansion of the entity through the purchase of existing shares.

3. POST-APPROVAL PROCEDURES

After the foreign investor obtains RBI or government approval and before the foreign-owned entity's operations can commence, the investor must apply for and secure numerous other clearances at both the federal and state levels. At the federal level, investors must obtain registration and license approvals from the SIA, the Central Excise Department, as well as, the necessary clearances from the Factory's Inspector, Environmental Authority, and the Pollution Control Board. Then, at the state level, the investor must: (i) register with the Sales Tax Commissioner and Provident Fund Commissioner; (ii) obtain permission for land use/construction from the State DI, Department of Town and Country Planning, Local Authority/District Collector, and the municipality; (iii) secure a power connection from the Electricity Board; (iv) acquire a water connection from the Water Department; (v) procure a fire license from the Fire Service Department.

Guidelines For Calculation Of Total Foreign Investment I.E. Direct And Indirect Foreign Investment In Indian Companies: Salient Features

All investment directly by a non-resident entity into the Indian company would be counted towards foreign investment.

The foreign investment through the investing Indian company would not be considered for calculation of the indirect foreign investment in case of Indian companies which are 'owned and controlled' by resident Indian citizens and Indian Companies which are owned and controlled ultimately by resident Indian citizens .

For cases where this condition is not satisfied or if the investing company is owned or controlled by 'non resident entities', the entire investment by the investing company into the subject Indian Company would be considered as indirect foreign investment.

As an exception, the indirect foreign investment in only the 100 percent owned subsidiaries of operating cum-investing/ investing companies will be limited to the foreign investment in the operating-cum investing/ investing company. This exception has been made since the downstream investment of a 100 percent owned subsidiary of the holding company is akin to investment made by the holding company and the downstream investment should be· a mirror image of the holding company.

In the I & B (Information and Broad casting) and Defence sectors where the sectoral cap is less than 49 percent, the company would need to be 'owned and controlled' by resident Indian citizens and Indian companies, which are owned and controlled by resident Indian citizens. For this purpose, the equity held by the largest Indian shareholder would have to be at least 51 percent of the total equity.

Any foreign investment already made in accordance with the guidelines in existence prior to issue of this Press Note would not require any modification to conform to these guidelines. All other investments, past and future, would come under the ambit of these new guidelines.

Guidelines For Transfer Of Ownership Or Control Of Indian Companies In Sectors With Caps Resident Indian Citizens To Non-Resident Entities: Salient Features

Government/FIPB approval will be required in sectors with caps where: An Indian company is being established with foreign investment and is owned by a non-resident entity; or An Indian company is being established with foreign investment and is controlled by a non resident entity; or The control of an existing Indian company, currently owned or controlled by resident Indian citizens and Indian companies, which are owned or controlled by resident Indian citizens, will be/is being transferred/passed on to a nonresident entity, as a consequence of transfer of shares to non-resident entities through amalgamation, merger, acquisition etc; or The ownership of an existing Indian company, currently owned or controlled by resident Indian citizens and Indian companies, which are owned or controlled by resident Indian citizens, will be/is being transferred/passed on to a non-resident entity as a consequence of transfer of shares to non-resident entities through amalgamation, merger, acquisition etc.

Conclusion:
Undoubtedly, the role of Foreign Direct Investment is very important for economic growth in general and industrial development in particular. It helps in managing financial assets, and other assistance which are prerequisite conditions for industrial growth, especially large scale industries. After the introduction of Foreign Direct Investment there are tremendous improvement in the investment, employment and export, which in turn pace up the process of economic growth.

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