

## FOREIGN DIRECT INVESTMENT AND ECONOMIC GROWTH IN INDIA

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### ABSTRACT

Foreign Direct Investment (FDI) plays a very important role in the development of the nation. It is very much vital in the case of underdeveloped and developing countries. A typical characteristic of these developing and underdeveloped economies is the fact that these economies do not have the needed level of savings and income in order to meet the required level of investment needed to sustain the growth of the economy. In such cases, foreign direct investment plays an important role of bridging the gap between the available resources or funds and the required resources or funds. It plays an important role in the long-term development of a country not only as a source of capital but also for enhancing competitiveness of the domestic economy through transfer of technology, strengthening infrastructure, raising productivity and generating new employment opportunities. In India, FDI is considered as a developmental tool, which helps in achieving self-reliance in various sectors and in overall development of the economy. India after liberalizing and globalizing the economy to the outside world in 1991, there was a massive increase in the flow of foreign direct investment. This paper analyses FDI inflow into the country during the Post Liberalization period. Further, the trends of FDI inflow into the country are projected for a period of five years from 2010-11 to 2014-15 using Autoregressive Integrated Moving Average (ARIMA) forecasting technique. The paper tries to examine the various set of factors which influence the flow of FDI Identifying the causes for low inflow and suggestive remedial measures to increase the flow of FDI in India with that of other developing nations in the world.

**KEYWORDS:** Determining factors, Foreign Direct Investment, Pre & Post Liberalization period.

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### INTRODUCTION

Foreign direct investment (FDI) has played an important role in the process of globalization during the past two decades. The rapid expansion in FDI by multinational enterprises since the mid-eighties may be attributed to significant changes in technologies, greater liberalization of trade and investment regimes, and deregulation and privatization of markets in many countries including developing countries like India. Capital formation is an important determinant of economic growth. While domestic investments add to the capital stock in an economy, FDI plays a complementary role in overall capital formation and in filling the gap between domestic savings and investment. At the macro-level, FDI is a non-debt-creating source of additional

external finances. At the micro-level, FDI is expected to boost output, technology, skill levels, employment and linkages with other sectors and regions of the host economy.

In India FDI inflow made its entry during the year 1991-92 with the aim to bring together the intended investment and the actual savings of the country. To pursue a growth of around 7 percent in the Gross Domestic Product of India, the net capital flows should increase by at least 28 to 30 percent on the whole. But the savings of the country stood only at 24 percent. The gap formed between intended investment and the actual savings of the country was lifted up by portfolio investments by Foreign Institutional Investors, loans by foreign banks and other places, and foreign direct investments. Among these three forms of financial assistance, India prefers as well as possesses the maximum amount of Foreign Direct Investments. Hence FDI is considered as a developmental tool for growth and development of the country. Therefore, this study is undertaken to analyze the flow of FDI into the country identifying the various set of factors which determine the flow of FDI.

## REVIEW OF LIERATURE

Balasundaram Maniam and Amitiava Chatterjee (1998) studied on the determinants of US foreign investment in India; tracing the growth of US FDI in India and the changing attitude of the Indian Government towards it as a part of the liberalization program. Nagesh Kumar (2001) concluded that the magnitudes of inflows have recorded impressive growth, as they are still at a small level compared to the country's potential. Balasubramanyam.V.N and Vidya Mahambre (2003) concluded that FDI is a very good means for the transfer of technology and knowhow to the developing countries. Birendra Kumar and Surya Dev (2003) with the data available in the Indian context showed that the increasing trend in the absolute wage of the worker does not deter the increasing flow of FDI. Laura Alfaro (2003) finds that FDI flows into the different sectors of the economy (namely primary, manufacturing, and services) exert different effects on economic growth. FDI inflows into the primary sector tend to have a negative effect on growth, whereas FDI inflows in the manufacturing sector a positive one. Evidence from the foreign investments in the service sector is ambiguous. Sebastin Morris (2004) has discussed the determinants of FDI over the regions of a large economy like India. He argues that, for all investments it is the regions of metropolitan cities that attract the bulk of FDI. Peng Hu (2006) analyses various determinants that influence FDI inflows in India which include economic growth, domestic demand, currency stability, government policy and labour force availability against other countries that are attracting FDI inflows. Analyzing the new findings, it is observed that India has some competitive advantages in attracting FDI inflows, like a large pool of high quality labour force which is an absolute advantage of India against other developing countries like China and Mexico. Chandana Chakraborty and Peter Nunnenkamp (2008) said that booming foreign direct investment in post-reform India is widely believed to promote economic growth. Chew Ging Lee (2009) has pointed out that GDP per capita has a positive effect on FDI inflows in the long run. Krishna Chaitanya Vadlamannatia, Artur Tamazianb and Lokanandha Reddy Iralac (2009) analyses about the determinants of FDI in Asian economies. The determinants are analyzed under four heads, viz. economic and policy factors, socioeconomic factors, institutional factors and political factors. The findings in the baseline models show that poor socioeconomic conditions and labour-related issues are the major determinants. Shiralashetti.A.S and S.S.Huger

(2009) have made a comparison of FDI inflows during pre and post liberalization period, country-wise, sector-wise and region-wise. Subash Sasidharan and Vinish Kathuria (2011) examine the relationship between FDI and R&D of the domestic firms in the post-liberalization regime.

## **OBJECTIVES**

This study is based on the following objectives-

- ◆ To compare FDI inflow during the post liberalization period with pre liberalization period and to forecast FDI inflow to India for a future period of 5 years.
- ◆ To identify the factors which influence the flow of FDI in India.
- ◆ To identify the problems relating to inflow of FDI and to make suitable suggestions for attracting more FDI inflow to India.

## **METHODOLOGY**

### **❖ SOURCES OF DATA COLLECTION**

The study is based on published sources of data collected from various sources. The data was extracted from the following sources:

Handbook of Statistics on the Indian economy, RBI, various issues

Economic Survey, Government of India, various issues

Department of Industrial Policy and Promotion (DIPP)

Secretariat of Industrial Assistance (SIA)

Central Statistical Organization (CSO)

### **❖ PERIOD OF STUDY**

The magnitude of FDI inflows is analyzed during the Pre and Post Liberalization period, hence the study is undertaken for a period of 30 years from 1980-81 to 2009-10. The factors which influence the flow of FDI into the country is analyzed during the Post Liberalization period i.e., from 1991 to 2010.

### **❖ TOOLS USED FOR ANALYSIS**

The Annual Growth Rate (AGR) and Compounded Annual Growth Rate (CAGR) are used to analyze the FDI inflows during the Pre and Post Liberalization period to find out the magnitude of FDI inflows. Further, Autoregressive Integrated Moving Average (ARIMA) model is used to

forecast FDI inflows. Factors which influence FDI into India are analyzed by using Multiple Regression analysis.

### FDI INFLOWS DURING PRE & POST LIBERALIZATION PERIOD IN INDIA

The first objective on which the study is made is to analyze the magnitude of FDI inflows in India. In this context, the period of study from 1980-81 to 2009-10 is divided into two phases, Phase I is the Pre-Liberalization period, that is, FDI inflows from 1980-81 to 1990-91 are taken into account. The Phase II is the Post-Liberalization period from 1991-92 to 2009-10. The annual and compounded growth rates during the Pre and Post Liberalization period are calculated to find out the magnitude of FDI inflows into the economy during the periods.

Table1 shows the Annual Growth Rate (AGR) of FDI inflows for each and every year and Compounded Annual Growth Rate (CAGR) during the pre and post liberalization period. The Annual Growth Rate is calculated by using the formula:

$$AGR = (X2 - X1) / X1$$

Where, X1 = first value of variable X

X2 = second value of variable X

Further, Compounded Annual Growth Rate (CAGR) for the Pre liberalization and Post Liberalization period is calculated by using the formula:

$$CAGR (t_0, t_n) = (V(t_n)/V(t_0))^{1/t_n - t_0} - 1$$

Where, V (t<sub>0</sub>): start value, V (t<sub>n</sub>): finish value, t<sub>n</sub> – t<sub>0</sub>: number of years

**TABLE 1: VOLUME OF FDI INFLOWS DURING PRE & POST LIBERALIZATION PERIOD**

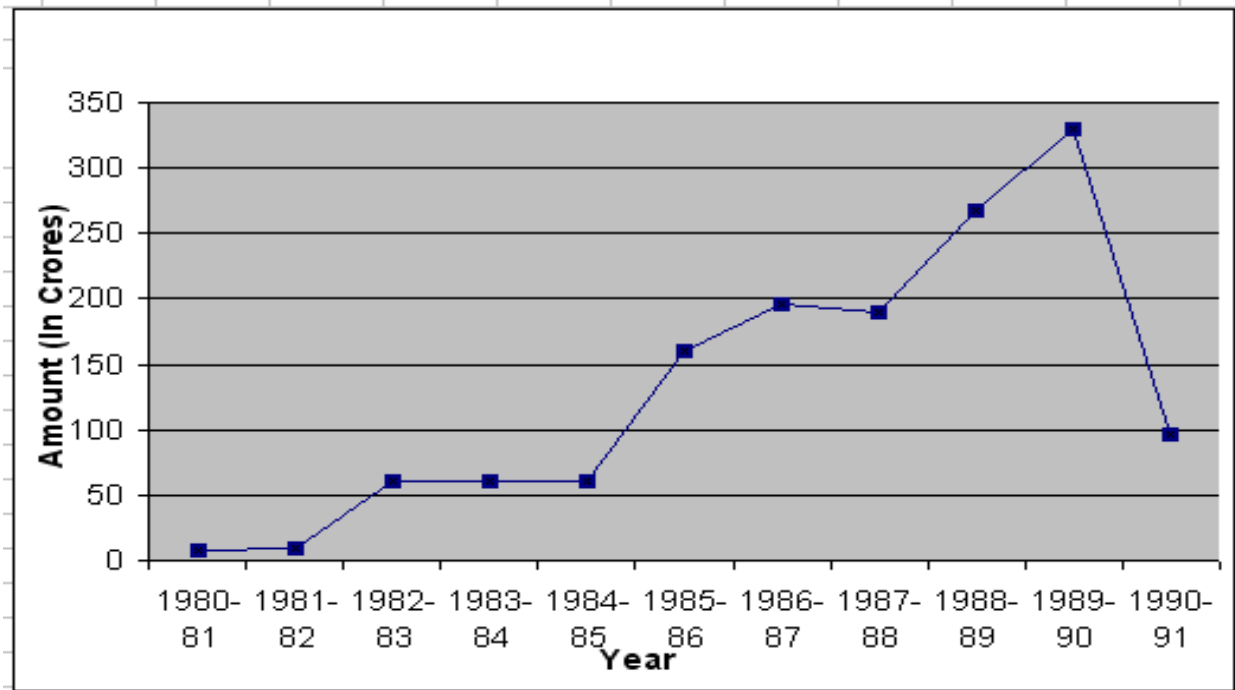
(AMOUNT IN US \$ MILLION)

FDI Inflows during Pre-Liberalization Period			FDI Inflows during Post-Liberalization Period		
Year	Amount	Annual Growth Rate (AGR) %	Year	Amount	Annual Growth Rate (AGR)
1980-81	8	-	1991-92	129	-
1981-82	10	25.00	1992-93	315	144.18
1982-83	60	500.00	1993-94	586	86.03

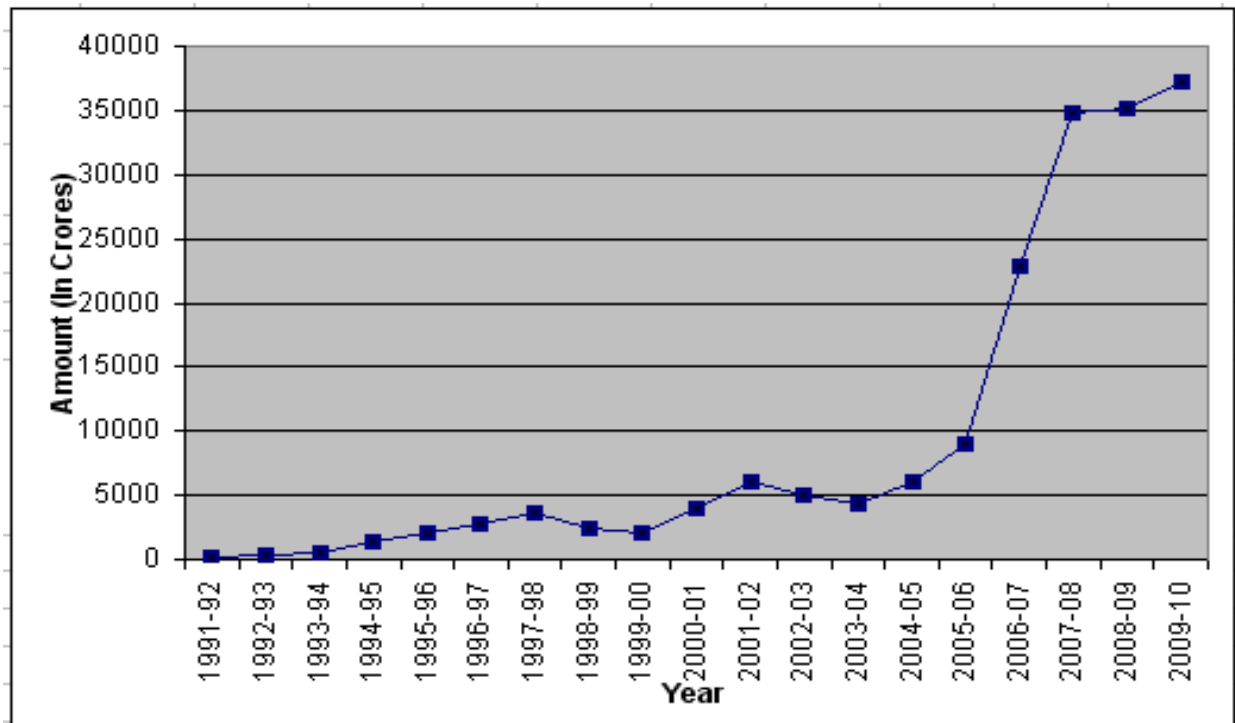
1983-84	60	-	1994-95	1314	55.40
1984-85	60	-	1995-96	2144	63.16
1985-86	160	166.67	1996-97	2821	31.57
1986-87	196	22.50	1997-98	3557	26.09
1987-88	190	-3.06	1998-99	2462	-30.78
1988-89	267	40.52	1999-00	2155	-12.46
1989-90	330	23.60	2000-01	4029	86.96
1990-91	97	-70.60	2001-02	6130	52.14
			2002-03	5035	-17.86
			2003-04	4322	-14.16
			2004-05	6051	40.04
			2005-06	8961	48.09
			2006-07	22826	154.72
			2007-08	34835	52.61
			2008-09	35180	0.99
			2009-10	37182	95.69
<b>CAGR</b>		<b>25.46%</b>	<b>CAGR</b>		<b>34.73%</b>

Source: SIA, Newsletter, various issues and compiled by the author

**CHART 1: FDI INFLOWS DURING PRE LIBERALIZATION PERIOD**



**CHART 2: FDI INFLOWS DURING POST LIBERALIZATION PERIOD**



The above table and chart shows that FDI inflow into India before 1991 was minimal with the Compounded Annual Growth Rate showing only 25.46 percent. During this period, foreign investments into India were restricted and allowed moderately in few sectors. This is mainly because of the kind of policies which the government of India has adopted over the years which includes, 'inward looking strategy'; and dependence of external borrowings. In turn, the borrowings resulted in foreign debts which were preferred to the foreign investments to bridge the gap between domestic savings and the amount of investments required. In 1991, when the government of India started the economic reforms program, FDI had suddenly become important for India which was looked upon as a key component of economic reforms package. The New Industrial Policy of 1991 gave utmost priority in attracting FDI inflows. In this process, the government started opening up of domestic sectors to the private and foreign participation which was earlier reserved only for the public sector. This was followed by slow but with significant relaxation of regulatory and entry restrictions on FDI inflows. Later substantial increase in the volume of FDI inflows into India was observed during the Post Liberalization period.

During the initial phase of post liberalization period i.e., from 1991 to 1998, there was continuous increase in the FDI inflows. The total amount of the FDI inflows during the period 1991-92 to 1997-98 had amounted to US\$10,868 million. The increase was largely due to the expanded list of industries or sectors which were opened up for foreign equity participation. This was followed by relaxation of various rules, regulations and introduction of various policies by the government to promote the FDI inflows. FDI inflows declined to the level of US\$2,462 million in the year 1998-99 and further to US\$2,155 million in 1999-2000. The reasons for the declining trend of FDI inflows were due to various set of factors. Firstly, the most important factor was the several restrictions imposed on India by the USA on account of the nuclear test carried out by India at Pokhran. The second factor was the slowdown of the Indian economy due to the mild recession in US and global economy. The third one was about unfavorable external economic factors such as the financial crisis of South-East Asia. Fourthly, the decline was due to the political instability and the poor domestic industrial environment.

In 2002-03, FDI inflows were declined to US\$ 5035. They were also reduced to US\$ 4322 during 2003-04. This fall in flow of FDI into the country was due to the Global economic recession. Then, from 2004-05 onwards, there has been steady increase in the flow of FDI into the country with highest annual growth rate which has reached 154.72 percent during 2006-07. Further, the table shows that the compounded annual growth rate (CAGR) which was 25.46 percent during Pre liberalization has increased to 34.73 percent during the Post liberalization period. This shows the openness of the Government in liberalizing and globalizing the economy to the outside world through relaxation of regulatory and entry restrictions on FDI inflows.

Thus, on analyzing FDI inflows into the country over a period of 30 years it is observed that the compounded annual growth rate (CAGR) is 25.46 percent during 1980-81 to 1990-91 i.e., during the pre liberalization period. On comparison with the post liberalization period, it is found that the annual compounded growth rate has excavated to 34.73 percent showing the relaxation of regulatory and entry restrictions on FDI inflows in the economy. This shows that the importance of FDI into the country is realized by the Government during the Post liberalization period. In this period of 19 years, steady increase of FDI inflow was observed from

1991-92 to 2009-10 except the period from 1998-99 to 1999-00 and again the period from 2002-03 to 2003-04.

## PROJECTION OF FDI INFLOWS TO INDIA

After analyzing the volume of FDI Inflows in India, during the Pre and Post Liberalization period the trend in FDI inflows for next five years i.e., from 2010-11 to 2014-15 is being projected. The projection of FDI inflow to the country is estimated by using Autoregressive Integrated Moving Average (ARIMA) model. The results of the model are summarized in table 2 and the estimated FDI inflows from 2010-11 to 2014-15 is tabulated in table 3.

**TABLE 2: RESULT OF ARIMA MODEL OF FDI INFLOWS**

Model	Coefficient	Std. Error of Coefficient	t value	p value
AR1	1.449	0.189	7.649	0.000**
AR2	-.652	0.218	2.988	0.009**
Year	8409.651	2517.263	3.340	0.004**
Constant	-16780248.439	5037067.20	3.331	0.004**

\*\* denotes significance at 1% level

Log Likelihood : - 206.973

Alkaline's Information Criterion (AIC) : 421.946

Schwarz's Bayesian Criterion (SBC) : 425.724

From the above result, the p-value of the constant, first and second lag is very less. This indicates that the fit is good. Further, the Alkaline's Information Criterion (AIC) and Schwarz's Bayesian Criterion (SBC) both measure goodness of fit and account for model complexity. The ARIMA model equation is fitted as ,

$$(\Delta FDI)_t = -16780248.439 + 1.449 (\Delta FDI)_{t-1} - 0.652 (\Delta FDI)_{t-2} + \varepsilon_t$$

Where,  $(\Delta FDI)_t =$  first order difference in FDI =  $(FDI)_t - (FDI)_{t-1}$



**TABLE 3: ESTIMATED FDI INFLOWS IN INDIA DURING 2010-11 TO 2014-15**

(AMOUNT RS. IN CR.)

Year	Estimated Amount	% of Growth in FDI over Previous year	95% Confidence Limit	
			Lower CL	Upper CL
2010-11	178,110	1	146,101	210,120
2011-12	172,800	-3	111,528	234,071
2012-13	165,622	-4	79,279	251,966
2013-14	160,380	-3	55,166	265,595
2014-15	159,161	-1	41,180	277,142

**CHART 3: PROJECTION OF FDI INFLOWS IN INDIA FROM 2010-11 TO 2014-15**

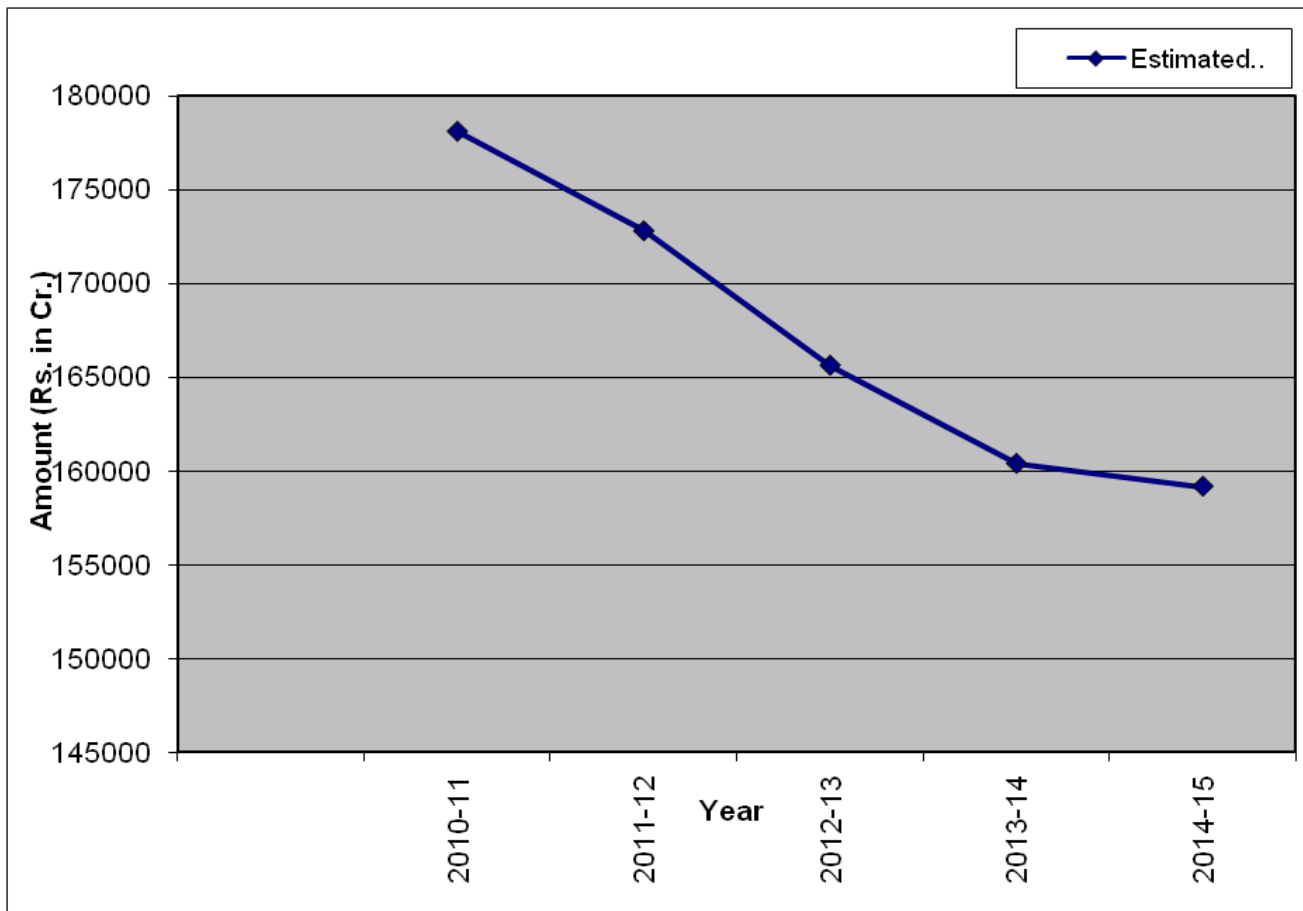


Table 3 shows a marginal increase of one percent in FDI inflow as when compared to the period 2009-10. Then from the period 2011-12 to 2014-15 a downtrend of FDI inflow is observed. FDI inflow into India is estimated to be Rs.172800 crore in 2011-12 as against Rs.178110 crore in 2010-11, that is, the growth trend of FDI inflow into the country shows a decline of 3 percent in 2011-12 as when compared to 2010-11. This fall in FDI inflow into the country is expected to further decline during 2012-13, that is, a 4 per cent decline will be anticipated as against the previous year. During 2013-14 and 2014-15, the fall in growth rate of FDI inflow is found to be reduced to 3 percent and one per cent as against the previous years. The projection of FDI inflow in India for the next five year period from 2010-11 to 2014-15, shows that FDI into the country will have a downward trend from 2011-12 onwards. Therefore, Government should take suitable steps to overcome this situation.

## **DETERMINANTS OF FDI INFLOW TO INDIA**

The FDI inflows into India have gone up especially in the post-reform period. The share of FDI inflows to India is not significant when it is compared to other developing economies. However, India is a competitor in the market for FDI inflows with the other developing countries. In this context, it is pertinent to assess the determining forces of the FDI inflows into India so as to take policy initiative to create a favorable atmosphere for FDI. Thus, the present section tries to explore the determining factors of FDI inflows into India at the macro level and the factors are known as the pull factors of FDI inflows.

## **HYPOTHESIS**

The null hypothesis framed for the study is that there are no significant factors which influence FDI flow into the country.

## **SELECTION OF VARIABLES**

Macroeconomic indicators of an economy are considered as the major pull factors of FDI inflows to a country. The analysis of various theoretical rationale and existing literature provides a base in choosing the right combination of variables that explains the variations in the flows of FDI in the country. In order to have the best combination of variables for the determinants of FDI inflows into India, different alternative combination of variables were identified and then estimated. The alternative combinations of variables included in the study are in tune with the famous specifications given by United Nations Conference on Trade and Development, (UNCTAD 2007).

In order to choose the best variables, firstly, the major factors which influence the flow of FDI into the country are identified. Then, proxy variables representing the factors are selected for the purpose of analysis. However, the following are the factors and the proxy variables which are selected for analysis.

S.No	Factors	Proxy Variables
1.	Market size	Gross Domestic Product (GDP)
2	Availability of natural resources	Coal Production
3	Availability of human resources	Total Wages paid
4	Infrastructure	Electricity generated
5	Economic stability	Inflation, Deficit in Balance of Payment
6	Government policies	Trade Openness

The study applies the multiple regression method to find out whether the variables influence the flow of the FDI in to the country. After thorough analysis of the different combination of the variables, the present study includes the following macroeconomic indicators: Gross Domestic Product at Factor Cost (GDP), Coal Production (COAL), Wages paid (WAGE), Electricity generated (ELEC), Inflation (INFL), Deficit in Balance of Payment (DEFICIT) and Trade Openness (OPEN), as independent variables which influence the flow of FDI into the country. These macroeconomic indicators are considered as the pull factors of FDI inflows in the country. Thus, the principal determinants of FDI inflows are put in the equation as follows:

$$FDI_t = a + b_1GDP_t + b_2COAL_t + b_3WAGE_t + b_4ELEC_t + b_5INFL_t + b_6DEFICIT_t + b_7OPEN_t + e$$

where,

FDI = Foreign Direct Investment net inflows measured as BOP current Rs. in crores

GDP = Gross Domestic Product at Factor Cost measured Rs. in crores

COAL = Coal Production measured in Million tonnes

WAGE = Total emoluments paid to the workers measured in terms of Rs. in crores

ELEC = Electricity Generated measured in billion Kwh

INFL = Inflation measured in terms of percentages

DEFICIT = Deficit in Balance of Payment position measured in

OPEN = Trade Openness i.e., sum of Exports + Imports divided by GDP  $\{(Ex+Im) / GDP\}$  measured in terms of Rs. in crores

T = time frame

**TABLE 4: RESULT OF MULTIPLE REGRESSION DETERMINING FDI INFLOWS**

Variables	Unstandardized		Standardized Coefficient	t value	SE
	Coefficient	SE			
FDI Inflow (FDII)	161.15	-371.47		5.350	0.001**
GDP at Factor Cost (GDP)	0.201	0.032	6.170	6.342	0.000**
Coal Production (COAL)	-345.722	511.783	-0.516	-0.676	0.515
Wages paid (WAGE)	1.626	0.614	0.773	2.649	0.024
Electricity generated (ELEC)	-854.930	156.469	-2.855	5.464	0.001**
Deficit in BOP (DEFICIT)	-0.273	0.114	-0.745	2.395	0.048*
Inflation (INFL)	-2189.152	602.644	0.202	3.633	0.008**
Trade Openness (OPEN)	-1594.677	966.640	0.069	1.650	0.143

\* denotes significance at 5% level

\*\* denotes significance at 1% level

Multiple R value = 0.998

R Square value = 0.996

F - value = 203.181

Durbin – Watson test value = 3.051

The Multivariate Regression was applied to find how the institutional factors influencing the flow of FDI into India. The Regression result as in table 4 shows that the calculated F value is 203.18 which is greater than the table value of 161.15 at 1 % level of significance. Since the calculated value is greater than the table value the hypothesis is rejected. Hence, it is inferred that the above variables have influenced the flow of FDI in India. Further the estimated results are analyzed by using the relevant econometric techniques viz. coefficient of determination, standard error, f- ratio, t- statistics, Durbin Watson (D-W statistics) etc.

The multiple correlation coefficients which measure the degree of relationship between the independent values are 0.998 and they indicate that the relationship between the independent variables is quite strong and positive. The Coefficient of Determination R-square measures the goodness-of-fit of the estimated Sample Regression Plane (SRP) in terms of the proportion of the

variation in the dependent variables explained by the fitted sample regression equation. Thus, the value of R square is 0.996 means that nearly 99.6 percent of the variation in adjustment is explained by the estimated SRP. In order to take care of autocorrelation problem, the Durbin – Watson (D-W statistics) test is used. The D-W Statistic is found to be 3.051, which confirm that there is no autocorrelation problem in the analysis. Further, the value of adjusted R-square and F-ratio also confirms that the model used is a good statistical fit.

The multiple regression equation fitted for the analysis is,

$$5.350(\text{FDII}) = (6.342 \text{ GDP}) + (-0.676 \text{ COAL}) + (2.649 \text{ WAGE}) + (5.464 \text{ ELEC}) + \\ (0.001) \quad (0.000) \quad (0.515) \quad (0.024) \quad (0.001) \\ (2.395 \text{ DEFICIT}) + (3.633 \text{ INFL}) + (1.650 \text{ OPEN}) \\ (0.048) \quad (0.008) \quad (0.143)$$

#### ◆ GROSS DOMESTIC PRODUCT (GDP)

Gross Domestic Product is used as one of the independent variables. GDP reflects the potential market size of Indian economy. In India GDP is calculated at market price and at factor cost. GDP market price is the sum of market values of all the final goods and services produced in the domestic territory of a country in a given year. Similarly, GDP factor cost is equal to the GDP at market prices minus indirect taxes plus subsidies. It is called GDP at factor cost because it is the summation of the income of the factors of production. The present study uses Gross Domestic Product at Factor cost (GDPFC) as the macroeconomic variable of the Indian economy is one of the pull factors of FDI inflows into India at national level. There is direct relationship between the market size and FDI inflows. If market size of an economy is large than it will attract higher FDI inflows and vice versa i.e. an economy with higher GDPFC will attract more FDI inflows.

It is observed from the results that the elasticity coefficient between FDI & GDP at Factor Cost is positive and highly significant at 1 percent significant level. The positive result portrays that size of the market as one of the important pull factors of FDI inflow. The coefficient between the two variables shows 6.17 which imply that one percent increase in GDP causes 6.17 percentage increase in FDI inflows in India. The positive relationship between GDP and FDI has to be read in conjunction with India's objective to achieve a higher growth rate.

#### ◆ COAL PRODUCTION (COAL)

Coal Production is taken as a proxy variable of availability of natural resources in the country. The results show that this variable is not statistically significant in the function. Availability of natural resources is found to be an insignificant factor as the flow of FDI in India is skewed into service sector from the period of liberalizing the country.

**◆ WAGES PAID (WAGE)**

Total wages paid to workers chosen as a proxy variable for availability of human resources shows the expected positive sign. The elasticity coefficient between FDI inflows and wages paid to workers is 0.773 which is significant at 1 percent level. This implies that one percent increase in wages causes 0.77 percent increase in FDI inflows.

**◆ ELECTRICITY GENERATED (ELEC)**

Electricity generated measured in billion Kwh is used as the proxy variable for measuring the level of infrastructure that is prevailing in the country. The variable shows the unexpected negative sign instead of positive sign and acts as a deterrent factor of FDI inflow into the country. The elasticity coefficient between FDI and Electricity generated is -2.855 which shows that one percent increase in the level of electricity in the country leads to a reduction of 2.855 percent of FDI inflows to the country.

**◆ DEFICIT IN BALANCE OF PAYMENT (DEFICIT)**

The elasticity coefficient between FDI and Deficit in Balance of Position reveals negative relationship which shows that one percent increase in the deficit level in the Balance of Payment causes a reduction of 0.75 percentages of FDI inflows to the country. This variable is considered as one of the pull factors of FDI inflow to India.

**◆ INFLATION (INFL)**

Inflation acts as an instrument in determining the economic stability of the country. The regression result reveals an unexpected positive relationship between FDI and Inflation as against the expected negative relationship. The elasticity coefficient between the variables is 0.202. It shows that one percent increase in the level of inflation in the country will lead to an increase of 0.20 percent of FDI flow to the country.

**◆ TRADE OPENNESS (OPEN)**

Government policy is one of the important factors and it determines the flow of FDI in to the country. The degree of openness of the economy is considered as a proxy variable to determine the effectiveness of government policy relating to foreign investment in India. The degree of openness of an economy is defined as the ratio of total trade to the real GDP of that economy. In the present analysis, the degree of openness of the Indian economy is calculated by dividing the total merchandise trade with the GDPFC. It means,  $OPEN = \frac{\text{Export f.o.b.} + \text{Import f.o.b.}}{\text{GDPFC}}$ . The results show Trade Openness as an insignificant factor for FDI inflow into the country.

**PROBLEMS FOR LOW FDI FLOW TO INDIA**

India, the largest democratic country with the second largest population in the world, with rule of law and a highly educated English speaking work force, the country is considered as

a safe haven for foreign investors. Yet, India seems to be suffering from a host of self-imposed restrictions and problems regarding opening its markets completely too global investors by implementing full scale economic reforms. Some of the major impediments for India's poor performance in the area of FDI are: political instability, poor infrastructure, confusing tax and tariff policies, Draconian labor laws, well entrenched corruption and governmental regulations.

- ◆ **LACK OF ADEQUATE INFRASTRUCTURE:** It is cited as a major hurdle for FDI inflows into India. This bottleneck in the form of poor infrastructure discourages foreign investors in investing in India. India's age old and biggest infrastructure problem is the supply of electricity. Power cuts are considered as a common problem and many industries are forced to close their business.
- ◆ **STRINGENT LABOR LAWS:** Large firms in India are not allowed to retrench or layoff any workers, or close down the unit without the permission of the state government. These laws protect the workers and thwart legitimate attempts to restructure business. To retrench unnecessary workers, firms require approval from both employees and state governments-approval that is rarely given. Further, Trade Unions extort huge sums from companies through over-generous voluntary retirement schemes.
- ◆ **CORRUPTION:** Corruption is found in nearly every public service, from defense to distribution of subsidized food to the poor people, to the generation and transmission of electric power. Kumar (2000) observes that a combination of legal hurdles, lack of institutional reforms, bureaucratic decision-making and the allegations of corruption at the top have turned foreign investors away from India. Vittal (2001) states that corruption and misuse of public office for private gain are capable of paralyzing a country's development and diverting its precious resources from public needs of the entire nation. Corruption is against the poor people because it snatches away food from the mouths of the poor. If corruption levels in India come down to those of Scandinavian countries, India's GDP growth will increase by 1.5 per cent and FDI will grow by 12 per cent (Vittal, 2001).
- ◆ **LACK OF DECISION MAKING AUTHORITY WITH THE STATE GOVERNMENTS:** The reform process of liberalizing the economy is concentrated mainly in the Centre and the State Governments are not given much power. In most key infrastructure areas, the central government remains in control. Brazil, China, and Russia are examples where regional governments take the lead in pushing reforms and prompting further actions by the central government.
- ◆ **LIMITED SCALE OF EXPORT PROCESSING ZONES:** India's export processing zones have lacked dynamism because of several reasons, such as their relatively limited scale; the Government's general ambivalence about attracting FDI; the unclear and changing incentive packages attached to the zones; and the power of the central government in the regulation of the zones. India which established its first Export Processing Zone (EPZ) in 1965 has failed to develop the zones when compared to China which took initiative for establishment only in 1980.

- ◆ **HIGH CORPORATE TAX RATES:** Corporate tax rates in East Asia are generally in the range of 15 to 30 percent, compared with a rate of 48 percent for foreign companies in India. High corporate tax rate is definitely a major disincentive to foreign corporate investment in India.
- ◆ **INDECISIVE GOVERNMENT AND POLITICAL INSTABILITY:** There were too many anomalies on the government side during past two decades and they are still affecting the direct inflow of FDI in India such as mismanagement and oppression by the different company, which affect the image of the country and also deject the prospective investor, who are very much conscious about safety and constant return on their investment.

### SUGGESTIONS FOR INCREASED FLOW OF FDI INTO THE COUNTRY

- ◆ **FLEXIBLE LABOUR LAWS NEEDED:** China gets maximum FDI in the manufacturing sector, which has helped the country become the manufacturing hub of the world. In India the manufacturing sector can grow if infrastructure facilities are improved and labour reforms take place. The country should take initiatives to adopt more flexible labour laws.
- ◆ **RE LOOK AT SECTORAL CAPS:** Though the Government has hiked the sectoral cap for FDI over the years, it is time to revisit issues pertaining to limits in such sectors as coal mining, insurance, real estate, and retail trade, apart from the small-scale sector. Government should allow more investment into the country under automatic route. Reforms like bringing more sectors under the automatic route, increasing the FDI cap and simplifying the procedural delays has to be initiated. There is need to improve SEZs in terms of their size, road and port connectivity, assured power supply and decentralized decision-making.
- ◆ **GEOGRAPHICAL DISPARITIES OF FDI SHOULD BE REMOVED:** The issues of geographical disparities of FDI in India need to address on priority. Many states are making serious efforts to simplify regulations for setting up and operating the industrial units. However, efforts by many state governments are still not encouraging. Even the state like West Bengal which was once called Manchester of India attracts only 1.2% of FDI inflow in the country. West Bengal, Bihar, Jharkhand, Chhattisgarh are endowed with rich minerals but due to lack of proper initiatives by governments of these states, they fail to attract FDI.
- ◆ **PROMOTE GREENFIELD PROJECTS:** India's volume of FDI has increased largely due to Merger and Acquisitions (M&As) rather than large Greenfields projects. M&As not necessarily imply infusion of new capital into a country if it is through reinvested earnings and intra company loans. Business friendly environment must be created on priority to attract large Greenfields projects. Regulations should be simplified so that realization ratio is improved (Percentage of FDI approvals to actual flows). To maximize the benefits of FDI persistently, India should also focus on developing human capital and technology.
- ◆ **DEVELOP DEBT MARKET:** India has a well developed equity market but does not have a well developed debt market. Steps should be taken to improve the depth and liquidity of debt market as many companies may prefer leveraged investment rather than investing their own



cash. Therefore it is said that countries with well-developed financial markets tend to benefit significantly from FDI inflows.

- ◆ **EDUCATION SECTOR SHOULD BE OPENED TO FDI:** India has a huge pool of working population. However, due to poor quality primary education and higher education, there is still an acute shortage of talent. FDI in Education Sector is lesser than one percent. By giving the status of primary and higher education in the country, FDI in this sector must be encouraged. However, appropriate measure must be taken to ensure quality education. The issues of commercialization of education, regional gap and structural gap have to be addressed on priority.
- ◆ **STRENGTHEN RESEARCH AND DEVELOPMENT IN THE COUNTRY:** India should consciously work towards attracting greater FDI into R&D as a means of strengthening the country's technological prowess and competitiveness.

## CONCLUSION

FDI plays an important role in the long-term development of a country not only as a source of capital but also for enhancing competitiveness of the domestic economy through transfer of technology, strengthening infrastructure, raising productivity and generating new employment opportunities. India emerges as the fifth largest recipient of foreign direct investment across the globe and second largest among all other developing countries (World Investment Report 2010). The huge market size, availability of highly skilled human resources, sound economic policy, abundant and diversified natural resources all these factors enable India to attract FDI. Further, it was found that even though there has been increased flow of FDI into the country during the post liberalization period, the global share of FDI in India is very less when it is compared to other developing countries. Lack of proper infrastructure, instable government and political environment, high corporate tax rates and limited export processing zones are considered to be the major problems for low FDI into the country. To overcome this situation, the Government should revise the sectoral cap and bring more sectors under the automatic route. Further, India should sign the agreement of Double Taxation treaties with other countries in order to increase bilateral trade. Therefore, there is an urgent need to adopt innovative policies and good corporate governance practices on par with international standards, by the Government of India, to attract more and more foreign capital in various sectors of the economy to make India a developed economy.

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