Foreign Direct Investment

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Introduction

Foreign investment in India has two components, viz., *Foreign Direct Investment (FDI)* and *foreign portfolio investment*. According to the notion referred to globally, FDI relates to a long-term relationship with 'lasting interest' of the foreign direct investor in the country where such FDI takes place. For an investment to qualify as FDI, the foreign investor needs to have a 10 per cent or higher share in a business or investment in a given company, whereas if the equity stake is less than 10 per cent, then such an investment falls under the foreign portfolio investment category. Until now, this has not been followed strictly in India. However, in the 2013-14 budget speech, the Union Finance Minister has proposed to follow such international norms in making the distinction between the two types of foreign investment; in order to examine the feasibility of following such a norm, the Union Government has constituted a separate committee, viz. "Committee for Rationalizing the Definition of FDI and FII".

As of now, in the Indian context in general, FDI comprises three components: (i) Equity, (ii) Reinvested earnings, and (iii) Other capital. Equity capital in FDI may be either greenfield investments (i.e. fresh investments), or brownfield investments (i.e. investments in / acquisition of existing shares in another company or by merging with another company). However, often brownfield investment is a hybrid of greenfield investment and Merger & Acquisition activity, and may be difficult to distinguish. Reinvested earning (i.e. the undistributed corporate profits) is the difference between profits of a foreign direct investor and dividends distributed to its shareholders. Other capital indicates the inter-company debt transactions of FDI entities.

Modes of FDI inflows

According to the present regulatory framework, an Indian company may receive FDI under two routes – (a) *Automatic route:* FDI is allowed under the automatic route without prior approval either of Government of India (GoI) or Reserve Bank of India (RBI) in all activities / sectors as specified in the consolidated FDI Policy, issued by the GoI from time to time; and (b) *Government route:* FDI in activities not covered under the automatic route requires prior approval of GoI, considered by the Foreign Investment Promotion Board (FIPB), Department of Economic Affairs, Ministry of Finance. FDI is strictly not permitted under either mode (automatic / government) in sectors like atomic energy, lottery business, gambling and betting, Nidhi Companies (i.e. *mutual benefit society* companies), and some other sensitive areas. The Department of Industrial Policy and Promotion (DIPP), Ministry of Commerce and Industry, GoI is the nodal department for the formulation of the policy of the government on FDI.

Modes of FDI outflows

Similarly, an Indian entity is allowed to make overseas FDI via either of the routes, namely, automatic or approval. Under the automatic route, an Indian entity is permitted to make FDI in overseas companies subject to certain conditions and exemptions. There are a number of Indian as well as foreign banks authorized by the RBI for facilitating such overseas FDI.

Significance of FDI for an economy

FDI has a significant potential for accelerating development in the recipient economy. Besides capital flows, FDI can generate employment opportunities, facilitate acquisition of new technology and knowledge, enable human capital development, and create a more competitive business environment, among other things. While FDI is generally expected to have beneficial effects, it is also vulnerable to certain adverse effects on the recipient economy. The costs to the host economy can arise from the market power of large foreign firms that may outweigh small domestic producers. This may have distorting effects in the economy in terms of loss of employment opportunities for some sections, aggravating regional disparities etc. Possibility of interference by multinational corporations in domestic policy processes is also a potential threat, particularly in underdeveloped economies, which might adversely impact policy priorities of the host country.

FDI in India

FDI-enabled plants in India are spread across various States, but with relatively high concentration in Maharashtra, Gujarat, Tamil Nadu, Andhra Pradesh, and Karnataka. These States either possess a strong industrial base (like, Gujarat) or software hubs (like, Karnataka). This could also be attributed to their better infrastructure (e.g. roads and Power), among other factors. However, it has been pointed out that even among these few States, only a handful of cities have attracted significant amounts of FDI, e.g. Ahmedabad, Bangalore, Chennai, Hyderabad, Mumbai, Pune etc. indicating that the geographical distribution of FDI in India is somewhat skewed in favour of relatively large cities. High-tech industries, drugs and pharmaceutical sector, automobile industries, and services sector have been especially dominant in attracting FDI. In the services sector, financial services remain the most dominant sector in this regard, followed by banking and other services sector.

Concluding Remarks

For a country like India, running *current account deficits* persistently, it could be tempting to depend on FDI inflows, which are non-debt creating flows of resources from other countries. However, FDI should be viewed as an investment having ‘lasting and long-term investment objectives’ in the recipient countries aiming at broader socio-economic implications such as enhancing technical knowledge, employment generation etc. unlike short-term portfolio investments that are volatile. While the quantity of FDI is important, equally important is the quality of FDI.

Also, the fear of ‘monopoly power’ of FDI cannot be ruled out. According to a Report of the Parliamentary Standing Committee on Commerce (One Hundred and Tenth Report on FDI in Pharmaceutical Sector, presented to the Rajya Sabha on 13th August 2013), growing acquisition of domestic pharmaceutical companies by foreign multinationals is affecting the availability of crucial medicines at affordable rates.

FDI in retail and insurance sector in India has also generated a lot of debate. Regarding FDI in retail, while the supportive argument is that it would eliminate middlemen and provide more employment opportunities as well as much wider variety of consumer products, the opposing argument regarding FDI in retail is that it would adversely impact local traders (kirana shops) and small-scale enterprises by creating monopoly power of the big retailers like Walmart (i.e. small-scale domestic firms would not be able to compete with such big foreign retailers).

Also, in some cases, it may be difficult to attract FDI in priority sectors (e.g. infrastructure) as foreign investors may not be interested in such sectors due to less profit opportunities as well as long gestation period involved with the sector; instead, such investors may prefer to invest to expand businesses in certain areas (e.g. e-commerce, retail etc.).

It would be worthwhile to note here that India has a large and growing market, a large magnitude of skilled and semi-skilled labour force, and internationally competitive technical knowledge base (in a number of sectors); hence, instead of policies that would promote higher dependence on FDI inflows merely for meeting the *current account deficits*, the country should promote FDI policies for better regional development, generation of employment opportunities, acquisition of new technology and knowledge, and human capital development.

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