FOREIGN DIRECT INVESTMENT IN INDIA: A LOST OPPORTUNITY

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HISTORICAL BACKGROUND

India:

After nearly 400 years under the British rule, India attained independence on August 15, 1947. The country has a large section of highly educated English speaking population, and well-defined, transparent administrative systems with checks and balances (Balakrisanan, 2,000). But, from the very outset, India launched upon an economic policy known as a "Socialistic Pattern of Society" with central planning and tight government regulations, permits and controls. The ever increasing state controls were carried on to such a point where, after nearly four decades of governmental intervention, the nation had become virtually bankrupt in almost every sphere – economic, political, and commercial (Salve, 1993). Eventually, the utter futility of the closed, economic policy was recognized by the administration under Prime Minister Narasimha Rao and starting in the early 1990s, India began to liberalize the economic policies and started opening the Indian markets to foreign investments. Foreign Direct Investment (FDI) started flowing into India.

Foreign Direct Investment is an important component of every nation's efforts toward economic development and also is an integral part of the globalization of the world economy (Festervand, 1999). All nations eagerly try to attract FDI. The success of any nation in attracting foreign investment is directly proportional to that nation's resources and the existence lucrative investment opportunities.

China:

Around about the same time India gained independence, China was going through cataclysmic changes in her political economy. Mao's red army successfully ousted the Kuomintang government and brought the entire country under a rigid centrally controlled rule with a communist administration. China became a tightly closed economy completely isolated from the global markets. The country went through major upheavals. Just like India, the closed economic policies almost brought the country to economic ruin. Eventually, around 1980, under the leadership of Deng Xiaoping China introduced market-oriented policies (Milman, 1999). The Chinese government began to liberalize their closed economy and started opening their domestic markets to foreign investment. FDI funds started flowing into the country.

FOREIGN DIRECT INVESTMENT

The FDI inflows into the two countries during the last decade present a picture of striking contrast. FDI inflows into India and China are presented in Table 1

FDI – India And China:

The FDI inflow into India in 1990 was $162 million. Over the years, the growth in FDI into India was very slow, reaching $3.370 billion by 1998. During the same period, China showed phenomenal performance, starting with $3.487 billion in 1990 and reaching a startling $45.600 billion in 1998. The total FDI into China during this period was as much as $208 billion whereas, during the same period, India attracted a paltry sum of about $11billion FDI.

Table 1
Foreign Direct Investment in
India and China
1990 – 1998 ($billion)

	India	China
1990	$0.162	$3.487
1991	0.141	4.366
1992	0.151	11.560
1993	0.273	27.515
1994	0.620	33.787
1995	1.750	37.500
1996	2.400	41.400
1997	3.351	44.236
1998	3.370	45.600

Source: United Nations Center for Trade and Development (UNCTAD), World Investment Report 1999.

PARADOX:

The comparative FDI picture presents a paradox in global investment. India and China have started liberalizing their economics around about the same time. India is the world's largest democracy, with its administration operating under rule of law, and with a very stable and long established judiciary system. Contrarily, China has been and still is an authoritarian, communist country, a far cry from the democratic society that India is. Rule of law does not exist in China. Most of the developed countries are democracies with capitalistic market economics. It appears only natural that capital investments from developed countries would find it safe to invest in democratic countries, with open market economies, and rule of law. India, with a large emerging market, still remains a country that is often overlooked by investors in favor of its neighbors in the east. As Acharya (1998) points out, India with its large middle class, and as a country that was left virtually unscathed by the recent South-East Asian crisis, offers enormous business opportunities to the worldwide investors

But, the level of FDI that came into India as a percentage of total global investment is about ½ percent only. "It does not reflect India's vast industrial capability, its well-developed political, legal and corporate institutions, the prevalence of the English as a national language, its highly educated labor force, nor its

achievements in sectors as diverse as computer software, engineering, medicine, literature and film making" (Acharya, 1998). But, global FDI is rushing to China, still a centrally administered communist country, by-passing India, which, by all standards, should have been a natural choice for foreign investors. Obviously, something is seriously wrong in India's approach to attract FDI.

LOST OPPRTUNITY:

As the largest democracy with the second largest population in the world and with rule of law and a highly educated, English speaking work force, India must have been 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 to global investors by implementing full scale economic reforms. India seems to have lost a golden opportunity for attracting a sizable amount of FDI at least commensurate with that of China. 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.

1. **Political instability:** Indian politics is cacophonous and fractious, playing itself out in one of the most socially heterogeneous societies in the world with sharp social inequities, a corrupt and inefficient bureaucracy, and poor accountability of politicians (Kapur and Ramamurti, 2001). Adding to these problems is the political instability at the central government arising out of the multiplicity of regional political parties and the need to form shaky coalition governments. Consequently, there were four general elections and six prime ministers during the last decade. In such an environment, the much needed economic reforms have been slow and inadequate. Even though the present Vajapayee's government is more stable than the three previous ones, it is still a shaky coalition of 24 disparate parties with divergent agendas. There is a general consensus across party lines to push for sustained economic reforms and growth but, in reality, governments are repeatedly obliged to dilute the reforms in order to keep their coalition partners on board (Kripalani, 1999).

2. **Infrastructure:** It is generally recognized that the state-controlled physical infrastructure is the weakest link in the economy (Sheel, 2001). : Lack of adequate infrastructure is cited as a major hurdle for FDI inflows into India. Badale (1998) states that regional differences in infrastructure have become critical determinants for outside investors. The Indian government has vowed to bring its infrastructure up to date, but power cuts remain daily events, and transporting goods from place to place takes weeks (Lane, 1998). This bottleneck in the form of poor infrastructure may discourage foreign investors from putting their money in India. However, this in itself can be an opportunity for investment with the government's willingness to open the infrastructure sector to foreign investors. Even state governments are welcoming projects like roads, rural electrification, and power generation and transmission (Pathak, Venugopal and Chandra, 2000). India's age old and biggest infrastructure problem is the supply of electricity. Power cuts

are so common that most businesses stopped depending on state electricity supply and started having their own power generators. Even the little power supplied by state-owned electricity boards, the power is so uncertain and uneven that it leads to burnt out motors and lost output. It is no surprise that India is the world's biggest market for items such as voltage regulators and power stabilizers.

Enron Corporation came with the largest FDI project so far in India and started the $2.9 billion Dhaboli power project six years ago. But continuous litigation with its sole customer, the State of Maharashtra, resulted in Enron stopping work and finally pulling out of India. Enron accused the state government of slowing the project for political reasons. Enron decided to pull out of India and the company's decision to flee is having a chilling effect on other foreign power companies (Kripalani, 2001) If the dispute is not resolved soon, India could harm its already blighted image as destination of FDI.

3. **Commercial Law and Government regulations:** Indian company law has undergone a number of significant changes in 1999, supposedly paving for smoother inflow of FDI. The Companies (Amendment) Act of 1999 allowed Indian companies for the first time to buy back their shares and substantially relaxed the restrictions on inter-corporate loans and investments. However, an indirect amendment of the law by the new guidelines of the Ministry of Industry has effectively rendered investments by international investors subject to veto by their local partners (Viswanathan, 2000). Several joint ventures between foreign and Indian companies have unraveled, forcing the investors to waste a lot of time negotiating with their Indian partners over the premium demanded for a buy-out. Under the new law, written approvals have to be obtained from both past and present joint venture partners and technology and trade mark licenses in order for a foreign company to do anything in India. Restricting foreign investment is a recurring theme throughout the 1999 amendments to the Companies Act. Additionally, the new Guidelines of the Ministry of Industry effectively put the Indian companies in a position to dictate terms to their joint venture partners and licensors of technology and trademarks (Viswanathan, 2000).

4. **Tax and Tariff:** India has been sending mixed signals to investors by changing it tax and tariff policies without notice. When India opened its economy to FDI initially in the early 1990s, several foreign investors decided to base their business operations in Mauritius (a beautiful island state in the Indian Ocean), because Mauritius does not tax dividends or capital gains, as India does. However, India has a long-standing tax treaty with Mauritius under which residents of Mauritius are to be taxed under Mauritius law rather than Indian law (Rao, 2000). But, on March 31, 2000, Indian tax authorities sent notices to five foreign institutional investors (FII) based in Maritius, demanding income taxes worth about $2 million. The tax notices caused havoc and several of these FIIs pulled out of the Indian market (Dasgupta, 2000).

   Sales taxes are levied by individual states and so these taxes vary from state to state. This complex sales tax structure can sometimes be a

deterrent to foreign investors. Coca Cola Company found that carbonated soft drinks face an excise tax of 40 per cent. These are also subjected to 17 different sales tax rates ranging from 12 to 25 per cent. Such complex tax structure can make it difficult for potential investors to project their returns accurately. Some of the new tax laws can be retroactive and collection from unrelated parties may be mandatory. In some cases, Indian government can tax companies not physically present in India but doing business there (Klein and Hirji, 2001).

5. **Labor Laws:** India is ranked very highly in the Global Competitive report for abundant and skilled labor, but very low on flexibility. This inflexibility is embedded mainly in the laws and regulation relating to disputes in change of service conditions. One of the biggest impediments to privatization in India is the lack of an exit policy, that is, a policy to govern the dismissal of redundant workers (Ramamurthi, 2000). The present Indian labor laws forbid layoffs of workers for any reason (Kripalani, 1998). 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 (Kripalani, 2000). Militant unions extort huge sums from companies through over-generous voluntary retirement schemes. Treadgold (1998) observes that "attempt to tap the cheap and often highly skilled labor of India can in itself be a trap and anyone thinking of investing directly into the Indian market must take care when dealing with these labor laws. Once workers are employed, it is virtually impossible to dismiss them". The pharmaceutical company Parke-Davis, India was recently reported to have paid $6.6 million to retire just 300 workers, about four times the usual rate (Treadgold, 1998).

6. **Corruption:** The word “corruption” does not surprise the Indians because they are expected to bribe everyone, from the traffic cop to the top officer in the civil service. It is common knowledge in India that corruption is the norm, not an exception. India is afflicted with what some refer to as a crisis in governance, with corruption in nearly every public service, from defense to distribution of subsidized food to the poor people, to the generation and transmission of electric power. Politicians in their honest moments admit that the system is thoroughly corrupt.

   The complex approval procedures confronting the foreign investors are also very often intimidating. As Treadgold (1998) states, foreign investors find it difficult to cut a path through the paper work of overlapping government agencies. The humongous bureaucratic structure has created a fertile ground for corruption. Transparency International (2000) recently ranked India close to the bottom of its list corrupt countries. 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. Most foreign investors have become leery of the country's history of discrimination against foreign companies and its reputation as a slow, difficult, bureaucracy ridden environment to do business (Teisch and Stoever, 1999). According to Lane (1998), the most telling evidence of the cost of delaying the reforms is the

sheer effort foreign investors have to put in to cope with the labyrinthine bureaucratic tangle.

Vittal (2001) states that corruption, the misuse of public office for private gain, is capable of paralyzing a country's development and diverting its precious resources from public needs of the entire nation. Corruption is anti-poor because it snatches away food from the mouths of the poor. Corruption is anti-development. According to the United Nations Development Project report for South Asia in 1999, if corruption levels in India come down to those of Scandinavian countries, India's GDP growth would increase by 1.5 per cent and FDI will grow by 12 per cent (Vittal, 2001).

CONCLUSIONS AND RECOMMENDATIONS

Even though India is a democracy, it has gone through a series of shaky coalition governments without much stability and with no steady policies toward foreign investors. Even though China is a communist country, the government's firm and unquestioned control over the policies acted as a great advantage in providing stability of policies, which made the foreign investors feel secure in investing in China. Contrary to the pathetic situation in India, there is no labor union problem in China. As with India, China also has a bloated bureaucracy, which is ridden with corruption. But, the Chinese government has been working hard to root out the corruption with severe punishment, including the death penalty.

It seems it is irrelevant to global investors as to whether the host countries are democracies with rule of law or communist countries with rigid controls. These investors' main interest is access to emerging markets of the developing countries, a safe and secure return on their investment and the stability of the host country's political environment. India is a country with enormous potential for development. India needs to wake up to the realities of the global investment markets, and start to notice the preferences of the foreign investors. India has to bring in sweeping reforms to completely liberalize its economy, abandon the inefficient protectionist policies regarding its inefficient domestic industry, curb the cancer of corruption and offer the appropriate tax incentives to the foreign investors. If the Indian government hesitates to bring in the much-needed economic reforms soon, India may face a tale of lost opportunity.

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