

The Changing FDI Policy Regime in India

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Abstract

FDI refers to capital inflows from abroad that invest in the production capacity of the economy and are “usually preferred over other forms of external finance as they are non-debt creating, non-volatile and their returns depend on the performance of the projects financed by the investors. FDI also facilitates international trade and transfer of knowledge, skills and technology.” Changes in the India’s political climate have precipitated a marked trend towards greater acceptability of FDI. The envisioned role of FDI has evolved from that of a tool to solve the crisis under the license raj system to that of a modernising force that could transform India. The primary focus of this paper is review the changes in the FDI regime since independence and its impact on the economic progress of India. The paper gives a detailed account of the evolution of policy on FDI in India and FDI reforms post 1991.

Keywords: liberalization, economic reforms, automatic approval, government approval

Introduction

Foreign direct investment (FDI) is an investment made by a company or individual in one country in business interests in another country, in the form of either establishing business operations or acquiring business assets in the other country, such as ownership or controlling interest in a foreign company.

It can further be described as a source of economic development, modernization, and employment generation, whereby the overall benefits (depending upon the policies of the host government), triggers technology spill overs, assists human capital formation, contributes to international trade integration particularly exports, helps create a more competitive business environment, enhances enterprise development, increases total factor productivity and, more generally, improves the resource allocation in a country. Hence FDI is seen as a catalyst of growth & development in most of the developing countries.

Evolution of the Policy Regime

India’s policy towards FDI has evolved over time in tune with requirements of development in different phases. It was a near “open door” policy during the 1950’s and became restrictive and selective in the late 1960’s and 1970’s. It experienced gradual and partial liberalisation in the 1980’s and full liberalisation in 1991 along with medium term adjustment and long term structural reforms. The evolution of policy regarding FDI in India can be discussed under four distinct phases:

- **Decade of 1950’s:** During the 1950’s India pursued an open door FDI policy. It was acknowledged that foreign investment was required industrial development. The official position on foreign investment was articulated by Jawaharlal Nehru on April 6, 1949 when he recognised foreign capital as an important supplement to domestic savings for facilitating national economic and technological progress. Foreign investors were given the assurance of compensation in case of any unforeseen

event of nationalization. The foreign exchange crisis of 1957-58 led to a further liberalization of the government’s attitude towards FDI (Kumar, 2003). The core objective of the foreign capital policy was to leave the control of industrial undertakings in the Indian hands. However full ownership was granted in certain cases. Foreign capital was preferred in specific areas which required new technology. Government also granted tax concessions to foreign enterprises and streamlined industrial licensing procedures to accord early approvals for foreign collaborations. In the case of 100 per cent export of output, foreigners were allowed to set up industrial units. To attract more foreign investment into the country, India offered many incentives and concessions to foreign 121 investors and set up the Indian Investment Centre in 1961 to promote foreign investment in India.

- **Restrictive policies of 1960’s & 1970’s:** The government policy on FDI turned restrictive from the late 1960’s. This was due to the improvement in the technical capacity of domestic industry on the one hand and the large scale outflows of foreign exchange from India in lieu of remittances of dividends, profits, royalties and technical fees by foreign investors on the other hand. Thus the government adopted a more restrictive attitude towards FDI in the 1970’s by not only limiting the scope of foreign investment to industries requiring sophisticated technology, but also making a deliberate attempt to divert FDI from consumer goods to capital and intermediate goods (Martinussen, 1988). Restrictive legislations such as Monopolies and Restrictive Trade Practices (MRTP) Act (1969), the Patent Act (1970) and allied measures such as nationalization of banks, insurance companies and coal mines were implemented. The industrial licensing policy of 1970 confined the role of big business houses and foreign companies to the core, heavy and export oriented sectors. The main objective behind adoption of restrictive measures towards FDI was the need to protect growing Indian industries from the threat imposed by private

capital in India. It was felt that the foreign sophisticated products would pose challenge for upcoming Indian industries which were not as perfect as their foreign counterpart. The new Foreign Exchange Regulation Act (FERA) of 1973 further imposed that all foreign companies operating in India had to register under Indian corporate legislation with up to 40 percent equity. The Industrial Policy Statement of 1973 identified high-priority industries where investment from large industrial houses and foreign companies would be permitted. The Industrial Policy Resolution (IPR) of 1973 limited foreign capital participation to only export-oriented industries that were strategically important for long term growth prospects of the country. The most restrictive controls were enforced through the Foreign Exchange Regulation Act (FERA) of 1973. FERA consciously discriminated between domestic and foreign investors making it mandatory for branches and subsidiaries of foreign firms to convert foreign equities to minority holdings with a few exceptions of those firms using sophisticated technology. But even these firms had to fulfil export obligations by exporting certain minimum parts of their annual turnovers. Foreign brand names, setting up of branch plant, etc. were not allowed. In 1977, it was stated that foreign companies that diluted their foreign equity up to 40 per cent under Foreign Exchange Regulation Act (FERA) 1973 were to be treated at par with the Indian companies. The main goal during this phase was to raise production of domestic industries and FDI was considered to supplement its requirements.

- **The decade of 1980's:** The decade of eighties was a turning point in the history of FDI policies in India. During this phase FDI was seen as a source to earn foreign exchange reserves rather than acting as a supplement to local industries. Too much protection of the local industries resulted in low productivity and inefficiencies. Therefore policies on FDI in India were reformed by introducing liberal measures. A number of measures were gradually initiated towards technological and managerial modernization to improve productivity, quality and reduce cost of production. The restrictions imposed on foreign industries by FERA were abolished. The public sector was freed from a number of constraints and was provided greater autonomy. Real estate, Telecommunications, Banking sector were opened to foreign capital. All industries, except 26 industries specified in the negative list, were exempted from licensing in 1988. The automotive industry, cement, cotton spinning, food processing and polyester filament yarn industries witnessed modernization and expanded scales of production during the 1980s (Industrial Policy, 1980). The Industrial Policy Statement of 1980 focussed on the need for promoting competition, technological upgradation and modernisation in the domestic market. 100 percent equity in export oriented industries was allowed. However, prior approval of government was required on all foreign investments in India and capital remitted abroad. Foreign majority holdings for foreign exchange were rarely allowed under Foreign Exchange Regulation Act. As a result environment for foreign investment in India remained largely hostile.

- **Liberalisation in 1991:** The liberalisation, globalisation & privatization reforms (LPG) marked the beginning of the 4th phase of FDI policy regime. With the liberalisation reforms many steps were taken to encourage FDI in India. The Industrial Policy of 1991 laid stress on the full exploitation of foreign investment opportunities. Post 1991 government has brought in many policies to suit the needs of the growing economy.

FDI Policies Post 1991

With economic reforms the government of India made many changes in the ongoing policies to encourage FDI in India. The liberalisation of Industrial Policy in 1991 introduced a two-way approval process for foreign direct investment. First route was the automatic approval route which was applicable to all items of manufacture activity which did not require an industrial license and was not reserved for the small scale sector. The limit for investment under automatic approval was set to 51%. Those seeking to invest under the automatic approval process were required to formally inform the Reserve Bank of India (RBI).

The second route was through formal process of government approval which was applicable to foreign investors who wanted to enter other industries or wanted to have a larger share of equity (more than 51%)

The Foreign Investment Promotion Board (FIPB) was constituted to handle the formal government process. The FIPB handles all matters related to FDI. The major responsibilities of the FIPB was to [i] undertake investment promotion activities, [ii] facilitate foreign investment, [iii] purposeful negotiation/discussion with potential investors, [iv] early clearance of proposals, and [v] reviewing policy and putting in place appropriate institutional arrangements, transparent rules and procedures and guidelines for investment promotion and approvals.

Two more bodies were setup to provide assistance to investors

- The Secretariat for Industrial Assistance (SIA), Ministry of Commerce & Industry was setup to provide entrepreneurial assistance, investor facilitation, receiving and processing all applications, assisting entrepreneurs and investors in setting up projects (including liaison with other organisations and state governments) and in monitoring the implementation of projects.
- Foreign Investment Implementation Authority (FIIA) was setup to help foreign investors obtain necessary approvals and solve their operational issues.

The highlights of the FDI reforms of 1991 were

- Abolition of industrial licensing system except for 18 industries specified in the Annex-II of the statement, which includes those industries which manufactured, hazardous chemicals and items of elitist's consumption or of national concerns social well-being and the environment concerns.
- Ceiling of 40 percent foreign equity under FERA was abolished
- Registration under MRTP Act was removed
- FIPB was established to provide clearance for all project proposals regarded by it.

- Existing companies were allowed to hike their foreign equity up to 51 percent in priority sector.
- Dilution of dividend balancing conditions and its related exports obligation except in case of 22 consumer goods industries.
- Removal of restrictions of FDI in low technology sectors.
- Automatic permission for technology agreement in high priority industries.
- Removal of condition for FDI with necessary technology agreements etc.

Post 1991 government has made several changes to increase the flow of FDI. The Table 1 shows the major changes in policies from 1990-91 to 2016-17 and Table 2 gives a summary of the FDI limit in few important sectors.

Table 1: Major Reforms post 1991

Year	Changes
1990-91	Automatic approval of up to 51% foreign ownership was granted in 34 priority sectors
1991-92	Indian mining sector was opened to FDI
1992-1994	Foreign investors and non-residents were given permission to repatriate their profits and capital
1997-98	NRI and Over Seas Corporate bodies were given automatic approval for priority industries
	Mining was further liberalised with automatic approval up to 50% in equity participation 7 74% in services related to mining
	The upper limit for automatic approval for equity participation was raised from 51% to 74 % in selected industries in January 1997
1998-1999	FEMA was replaced by FERA
1999-2000	Foreign Investment Implementation Authority (FIIA) was set up
2005-2006	The government revised the automatic approval limit to 100% in townships, construction and infrastructure
2009-2010	FDI norms in various sectors such as commodity exchanges, credit information, and aircraft maintenance were relaxed.
	Hundred percent FDI permitted in mining of titanium bearing minerals
	Hike in the ceilings on public sector oil refineries.
	Foreign investors were exempted from minimum capitalization and a three year lock-in period.
2012-13	FDI limit in single brand retail trading was raised to 100%
	FDI limit in multi brand retail trading was raised to 51%
	FDI limit Increased from 49% to 74% in certain broadcasting sector.
	Government has also increased the FDI from 26% to 49% in insurance sector.
	FDI up to 49% was permitted in the power exchanges registered under the Centre Electricity Regulation Commission.
2014-15	Foreign industries were permitted up to 49% of FDI in the Indian companies in the aviation sector operating scheduled and non-scheduled transport.
	Increase in FDI limit from 24% to 49% in insurance sector through automatic approval route
	FDI up to 100% permitted in pharmaceutical industry through automatic approval route
	FDI permitted in defence with a limit of 49% through the automatic approval route
	The limit for FDI in Telecom Sector was raised to 100% with 49% allowed through automatic approval beyond which government approval will be required
	The cap for FDI limit in single retail branding that was earlier 100% was revised to 49% under automatic approval and beyond prior government approval was required
2016-17	100% FDI was permitted in railways through the automatic approval
	Limit in civil aviation raised to 100% in greenfield projects under the automatic route and 74% in brownfield projects under the automatic route
	100% FDI permitted in Defence with 49% under the automatic route and beyond under government approval.

Table 2: Sector-wise limit on FDI

Sector	FDI Limit	Entry Route & Remarks
Agriculture & Animal Husbandry	100%	Automatic
Plantation Sector	100%	Automatic
Mining	100%	Automatic
Mining & Mineral Separation of Titanium, ores and integrated activities	100%	Government
Petroleum & Natural Gas Exploration & Products	100%	Automatic
Petroleum & Natural Gas Refining	49%	Automatic
Defence Manufacturing	100%	Automatic up to 49% Above 49% under Government route in cases resulting in access to modern technology in the country
Broadcasting	100%	Automatic
Broadcasting Content Services	49%	Government
Publication of facsimile edition of foreign newspapers	100%	Government
Civil Aviation – Airports Green Field Projects & Existing Projects	100%	Automatic
Civil Aviation – Air Transport Services	100%	Automatic up to 49% Above 49% under Government route 100% Automatic for NRIs
Civil Aviation	100%	Automatic
Construction Development: Townships, Housing, Built-up Infrastructure	100%	Automatic

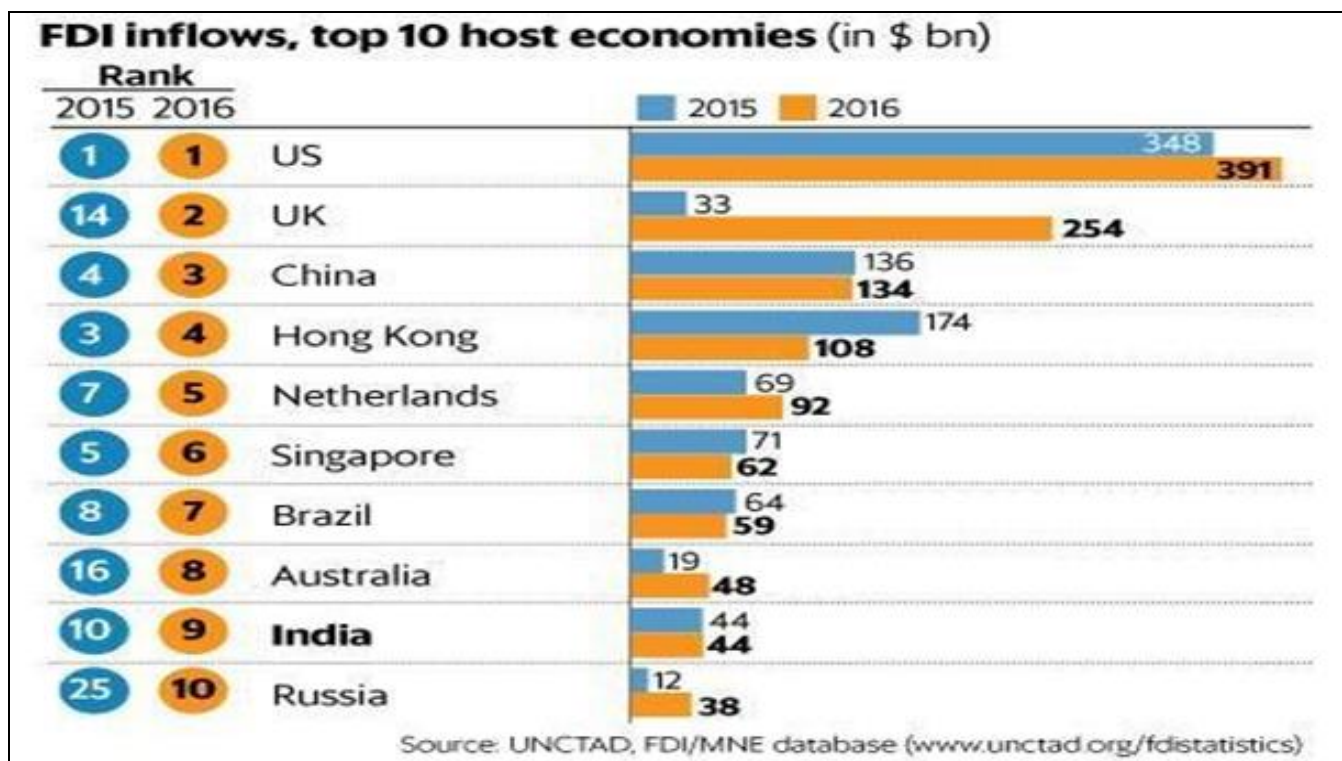
Industrial Parks	100%	Automatic
Satellites- establishment and operation, subject to the sectoral guidelines of Department of Space/ISRO	100%	Government
Telecom Services	100%	Automatic up to 49% Above 49% under Government route
Cash & Carry Wholesale Trading	100%	Automatic
E-commerce	100%	Automatic
Single Brand retail trading	100%	Automatic up to 49% Above 49% under Government route
Multi Brand Retail Trading	51%	Government
Railway Infrastructure	100%	Automatic
Asset Reconstruction Companies	100%	Automatic
Banking- Private Sector	74%	Automatic up to 49% Above 49% & up to 74% under Government route
Banking- Public Sector	20%	Government
Credit Information Companies (CIC)	100%	Automatic
Infrastructure Company in the Securities Market	49%	Automatic
Insurance	49%	Automatic
Power Exchanges	49%	Automatic
Non-Banking Finance Companies (NBFC)	100%	Automatic
Pharmaceuticals(Green Field)	100%	Automatic
Pharmaceuticals(Brown Field)	100%	Automatic up to 74% Above 74% under Government route
Food products manufactured or produced in India	100%	Government

Source: <https://factly.in/sectors-fdi-allowed-india/>

Change in Flows and India’s Global Position

FDI inflows in India risen from 129 million in 1991 to \$ 55.6 1billion in the year 2016-17 (UNCTAD, 2016) [12]. Data released by the Department of Industrial Policy and Promotion (DIPP) showed FDI inflows in 2016 were strongest in October

with \$6.2 billion inflows followed by \$5.1 billion in September. This has been possible due to building of investor friendly environment, thereby easing of business activity. India’s ranking in AT Kearney FDI Confidence has risen to 9th in 2016 from 11th in 2015.



In global ease of doing business index India’s position has risen to 130 out of 189 countries in 2016 from 134 in 2015. India has climbed up from 15th in position to 10th position in 2016 as most trusted nation for foreign investment. (UNCTAD, 2016) [12]. Mauritius is India’s top source of investment at 12.8 billion followed by Singapore at 7.1 billion (UNCTAD, 2016) [12]. It has been observed that despite in absolute figures these flows are impressive India share in

global flows is far from satisfactory. It contributes to less than a percent to global flows.

Concluding Remarks

India’s economic reform programme since 1991 has boosted FDI inflows and the country has surpassed its own record of the pre-reform period. It has also performed well in comparison with the growth rate in global inflows of FDI.

Consequently, India's share in global FDI inflows has increased steadily in the post reform period. However, it is important to note that even after two decades of introducing reforms in India, the wide gap between the actual foreign direct investments and approved foreign direct investment exits which need immediate changes in policy. What is now required is a better environment for infrastructure development with an appropriate institutional framework such as a dispute resolution mechanism, independent regulatory authority and special investment law to increase the efficiency of projects with foreign investment. A uniform labour code after an independent review and proper consultation with stakeholders is required.

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