An Analytical Study on FDI in India and Relevant Political Parameters

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Abstract

This paper attempts to study how **Foreign Direct Investment** (**FDI**) policy of **India** detrmoned by **relevant political parameters, requirements, foreign investments in India**. Apart from being a critical driver of economic growth, Foreign Direct Investment (FDI) has been a major non-debt financial resource for the economic development of India. Foreign companies invest in India to take advantage of relatively lower wages, special investment privileges like tax exemptions, etc. For a country where foreign investment is being made, it also means achieving technical know-how and generating employment.

The Indian Government's favourable policy regime and robust business environment has ensured that foreign capital keeps flowing into the country. The Government has taken many initiatives in recent years such as relaxing FDI norms across sectors such as defence, PSU oil refineries, telecom, power exchanges, and stock exchanges, among others. The study seeks to foster fresh empirical evidence on how FDI is relevant to the foreign trade growth in India under a time-varying parameter model with vector autoregressive specification. The Johansen's cointegration test documents a significant and positive long-run co-movement between FDI and foreign trade in India. The vector error correction model suggests a unidirectional long-run causality from foreign trade to FDI. However, the Granger causality test confirms a bidirectional short-run causal relationship between these variables. Further, the variance decomposition analysis approves strong exogeneity of foreign trade. Again, the impulse response function analysis reveals that the responses generated from a positive shock of foreign trade to FDI and vice versa are small and initially negative and thereafter remain persistently positive at a constant level. The study finally concludes that the absence of long-run causality from FDI to export is the result of much domestic market orientation of foreign investors and less emphasis on the export-oriented sectors in India. While India's flagship 'Make in India' policy is largely guided by an attempt to attract FDI and nurture value chains that begin and end in India, the prime minister's clarion calls of 'Atmanirbhar Bharat'a or 'Vocal for Local' must not be perceived as roadblocks to foreign investments and international trade. The 'Atmanirbhar Bharat' scheme was introduced to increase the resilience of the domestic economy to the elements of uncertainty.

Key words: Make in India, Atmanirbhar Bharat, FDI, PSU, Atmanirbhar Bharat.

Introduction

The World Development Report (World Bank 1987) outlines a crucial observation, that is, while average annual economic growth rate of the Four Asian Tigers, namely Hong Kong, Singapore, South Korea and Taiwan, adopting export-led growth strategy was at 9.5% during the period of 1963–1973, it was only 4.1% in the countries which followed the import-substitution industrialization (ISI) strategy. With the same ISI strategy, India has also witnessed an average economic growth of only around 3.5% (famously known as the Hindu growth rate) during the 1950s to 1980s. In fact, at the time, the approach to solve economic crises like low growth rate, huge Current Account Deficit (CAD) was still inward. Besides, all the efforts undertaken to solve this were through India's own 'resources and ingenuity' (Economic Survey 1991–1992). Of late, the country's policymakers begun to realize the impact of adopting free-market and outward-oriented trade policies considering the remarkable growth attained by the East Asian tigers who became independent concurrently with India. Witnessing the economic success achieved by the East Asian tigers, the neo-classical economists also begun to rely on the doctrine of export-led growth. Notably, the Indian policymakers have learned a lesson on how these economies have utilized the necessary infrastructure and international linkage developed by the colonial government (Gulati 1992) in executing their export-oriented industrialization strategy. In the subsequent period, India, by gradually liberalizing various trading barriers and accepting the idea of export-led economic growth, managed to attain an average annual growth rate of around 5% for the period of 1981 to 1991. Concurrently, the development economists and academicians worldwide like Feder (1982), Krueger (1990) and Trost and Bojnec (2016) have accepted the export-led economic growth hypothesis. However, despite profound effects on the economic growth and foreign trading status witnessed by other emerging and emerged economies, the concept of FDI-led economic growth has still remained ambiguous and vexing for the Indian policymakers until 1993–1994. Although 'swadeshi spirit', an ideology which endorses the use of domestic products, self-dependency and sufficiency, approves domestic competition and even embraces free trading, foreign investment still remains a question (Jhunjhunwala 2002). Therefore, for the Indian government, the inward-FDI liberalization was a stronger challenge than that of foreign trade liberalization.

Looking at the theoretical and empirical perspective we observe that Harrison (1996) in general perspective views FDI to stimulate exports from domestic sectors through industrial linkage or spill-over effects which further instigates high-demand stimulus for domestic enterprises and results in export promotion. FDI is also believed to enhance export-oriented productivity which further improves export performance (Jana et al. 2017 and Sahu and Pandey 2018). There is a widely accepted view that FDI promotes exports of the host country by augmenting domestic capital for exports, enabling the transfer of technology and production of new products, facilitating access to new and large foreign markets, and providing training for the local workforce to enhance technical and managerial skills (Zhang 2005). However, the outflow of FDI from the home country to the host country largely depends on how strong collaboration the two countries establish with

each other to ensure better information flow and coordination relating to the execution of investment projects (Rasiah et al. 2010). According to Narula and Dunning (2000), outward FDI is also much driven by three factors, i.e., efficiency seeking, market seeking and resource seeking from the part of the home country.

Again coming to the Indian perspective we observe that, as of now, economic growth through free trading and allowing inward foreign investment has become an integral part of India's national economic policy. Now, for the Indian government the liberalization of inward FDI policies has two broad objectives: to supplement its export promotion efforts and to promote its economic growth.

To sum up, unlike most of the emerged and emerging market economies, the perception toward FDI-led economic growth reasonably remains susceptive for India. This might be the reason why the economic policies of India pertaining to FDI could not become smooth. Lack of confidence, suspicion and great caution always prevail among the development economists and policymakers over the actual impact of FDI on the Indian economy. In this backdrop, the motivation behind this empirical investigation is routed to the felt need of some fresh empirical insights especially in the context of an emerging economy like Indian where the nexus between FDI and foreign trade is yet not anonymously established. There is a genuine lack of empirical evidence and an economic model that can exhibit the actual channel of linkage between these two macro-economic variables. In India, where the policymakers are in a way much concerned about export-led economic growth through liberalized foreign trade, establishing Special Economic Zones (SEZs), Export Processing Zones (EPZs) and in other way are gradually dismantling economic restrictions and consequently deregulating or liberalizing inward foreign investment, an empirical inquiry on the overall economic benefits of inward FDI especially in export promotion is worthwhile to carry out.

Objective:

This paper intends to explore and analyze the level of **foreign direct investment** across **India** that varies widely due to **political parameters** and dynamics of the states.

FDI in India political parameters

For last couple of decades, the understanding of the empirical relationship between the extent of foreign capital inflow especially in the form of FDI and the economic wellbeing of a country in many forms like growth in domestic production, industrial growth, employment generation and foreign trade especially export promotion has really been a core interest for the academicians and economic analysts in India and abroad. The theoretical postulations highlighting the importance of the above-mentioned issues are highly controversial and conflicting and different empirical investigations also identify the ambiguous relationship between these macroeconomic variables. However, the association between these variables is largely country-specific.

Moreover, a number of studies have been done during the last few decades to establish the validity of the nexus between FDI and foreign trade promotion. Besides, there is empirical evidence that suggests the presence of a bidirection relationship between FDI and export in various developed and developing economies. Andersen and Hainaut (1998) indicate that there exists a bidirectional causal link, i.e., exports stimulate FDI inflows and FDI inflows promote exports for the USA, Japan and Germany. Pfaffermayar (1996) conducts a study on Austrian FDI and exports and obtain positive significant causation in both directions. Again, a strong bidirectional FDI–export relation in China is reported by Liu et al. (2002). Other empirical studies like Pacheco-Lopez (2005) in the context of Mexico, Zhang and Felmingham (2001) in the People Republic China, and Keho (2015) on sub-Saharan African countries document a bidirectional causal link between FDI and foreign trade in the form of export.

Putting India into perspective, the studies on the relation between FDI and export is very limited in number and the findings of the literature are providing mixed evidence. Prasanna (2010) advocates inward FDI to have a significant contribution toward magnifying the export performance of India between 1991–1992 and 2006–2007. Similarly, Barua (2013) argues that FDI in India may complement local developmental efforts by boosting export competitiveness and acts as a vehicle for accelerating the pace of export. On the contrary, in a contemporary study, Dash and Sharma (2011) find a unidirectional causality between FDI and export where it runs from the later to the former. Again, Sultan (2013) finds a similar result as observed by Dash and Sharma (2011) applying Johansen cointegration method and VECM. However, Chakraborty et al. (2016) observe FDI inflows to be non-contributive to exports, while reverse relation is true, underlining the fact that FDI inflows in the country may mostly be targeting the growing domestic sectors, rather than utilizing domestic resources for reaching the global market. Other studies like Sharma (2000) and Singh and Tandon (2015) cannot establish any significant statistical association between the variables.

Market size

According to the Department for Promotion of Industry and Internal Trade (DPIIT), FDI equity inflow in India stood at US$ 521.47 billion between April 2000 and December 2019, indicating that the government's efforts to improve ease of doing business and relaxing FDI norms have yield results.

FDI equity inflows in India stood at US$ 51.47 billion in 2019-21 (between April 2019 and December 2019). Data for 2019-21 indicates that the computer software and hardware sector attracted the highest FDI equity inflows of US$ 24.39 billion, followed by the construction (infrastructure) activities (US$ 7.15 billion), service sector (US$ 3.86 billion) and trading (US$ 2.14 billion).

In 2019-21 (between April 2019 and December 2019), India received the highest FDI equity inflows from Singapore (US$ 15.72 billion), followed by the US (US$ 12.83 billion), the UAE (US$ 3.92 billion), Mauritius (US$ 3.48 billion), Cayman Islands (US$ 2.53 billion), the Netherlands (US$ 2.44 billion) and the UK (US$ 1.83 billion).

In 2019-21 (between April 2019 and December 2019), Gujarat received the highest FDI equity inflows of US$ 21.24 billion, followed by Maharashtra (US$ 13.64 billion), Karnataka (US$ 6.37 billion) and Delhi (US$ 4.22 billion).

Investments/ Developments

Some of the significant FDI announcements made recently are as follows:

- In the first nine months of FY21, total FDI inflows amounted to US$ 67.54 billion, a 22% YoY increase.
- In February 2019, Amazon announced to start manufacturing electronic devices in India from 2019
- In January 2019, Amazon partnered with Startup India, Sequoia Capital India and Fireside Ventures to launch an accelerator programme to support early-stage start-ups take their brands to international markets and boost domestic exports.
- In November 2019, Rs. 2,480 crore (US$ 337.53 million) foreign direct investment (FDI) in ATC Telecom Infra Pvt Ltd. was approved by the Union Cabinet.
- In November 2019, Amazon Web Services (AWS) announced to invest US$ 2.77 billion (Rs. 20,761 crore) in Telangana to set up multiple data centres; this is the largest FDI in the history of the state.
- Since April 2019, the government has received over 120 foreign direct investment (FDI) proposals worth ~Rs. 12,000 crore (US$ 1.63 billion) from China. Between April 2000 and September 2019, India received US$ 2.43 billion FDI from China.
- According to the Reserve Bank of India (RBI), India's Outward Foreign Direct Investments (OFDIs) in equity, loan and guaranteed issue stood at ~US$ 1.85 billion in February 2019 vs. US$ 1.19 billion in January 2019.

Government Initiatives

In March 2019, the parliament approved a bill to increase foreign direct investment (FDI) in the insurance sector from 49% to 74%.

In March 2019, Mr. Shripad Naik, the Minister of State for Defence, stated that a total of 44 Indian companies, including public sector units, have received approvals related to FDI for joint production of defence items with foreign organisations.

In December 2019, the government of Uttar Pradesh agreed to provide Samsung Display Noida Private Limited with special incentives to set up a mobile and IT display product manufacturing unit. Under the Central Government's scheme for promotion of manufacturing electronic components and semiconductors (SPECS), Samsung will also receive a financial incentive of Rs. 460 crore (US$ 62.61 million). This project will develop a global export hub in Uttar Pradesh and will help the state attract more foreign direct investments (FDI).

In December 2019, changes in the guidelines for the provision of Direct-to-Home (DTH) services have been approved by the Union Cabinet, enabling 100% FDI in the DTH broadcasting services market.

Key Findings

• Developing nations in Asia, such as India, are some of the largest recipients of foreign investment in the world, and there is intense competition for FDI in the region. India recorded US$ 49 billion in FDI in 2019, a 16-percent increase from the previous year. This accounted for 80 percent of FDI flowing into South Asia in 2019.

• Analysis of sub-national FDI flows indicate the emergence of two categories of states: Those that have received uniform (i.e. low volatility) and high volumes of FDI between 2005-06 and 2018-19 are called 'better performing' states; another group that received low volumes of FDI, with high fluctuations (i.e. high volatility) in yearly inflows, are the 'poor performing' states.

• The 'poor performing' states in India with high FDI volatility are Bihar, Madhya Pradesh, Rajasthan, Jharkhand and Uttar Pradesh. The 'better performing' states with low FDI volatility are Delhi, Gujarat, Maharashtra, Tamil Nadu, Karnataka and Andhra Pradesh.

• Ease of Doing Business (EoDB) conditions should be improved to attract more FDI into the regions. For Indian states, this study estimates that a one-percent increase in the EoDB score leads to a 6.32-percent increase in FDI inflow.

• Better performance on the SDGs parameters improves aspects of EoDB, and enables a congenial investment climate. Estimates for the Indian states suggest that a one-percent increase in SDG scores translates into a 0.80-percent increase in EoDB parameters and a 6.77-percent increase in FDI inflows.

• The 'poor performing' states must establish SEZs with favourable conditions, while the 'better performing' states should also focus on the holistic sustainability concerns in accordance with environmental, social and governance (ESG) considerations.

• Current literature suggests that FDI contributes to domestic capital formation. Competition for FDI among Indian states, employing the driving principles of SDGs, will not only ensure long-term economic growth, but also lead to equitable distribution of the gains from FDI.

Road ahead

India is expected to attract foreign direct investments (FDI) of US$ 120-160 billion per year by 2025, according to CII and EY report. Over the past 10 years, the country witnessed a 6.8% rise in GDP with FDI increasing to GDP at 1.8%.

In terms of attractiveness, investors ranked India #3; ~80% investors have plans to invest in India in the next 2-3 years, while ~25% reported investments worth >US$ 500 million, the Economic Times reported. Through this scheme, the government aims to boost domestic production and make India a 'self-reliant' nation; funds worth INR 20 trillion have been disbursed for this purpose. FDI is crucial for economic development, modernisation, and employment generation; it contributes to technology transfer, human capital formation, entrepreneurship, and efficiency of resource management. Espousing the spirit of 'competitive federalism', the Indian states have engaged in competition for FDI amongst themselves. States that have been successful in attracting higher FDI have enjoyed greater benefits from its positive spillovers. This study maps the regional distribution of FDI inflows into India between 2005-06 and 2018-19. Data on FDI inflows are collected by the Reserve Bank of India (RBI) at its various regional offices, each of which often caters to more than one State or Union Territory. This dataset has been decomposed into its state-wise components by employing an appropriate statistical technique. Using this dataset estimated by the authors, the analysis outlines the subnational trends in FDI inflow. It reviews India's policies on Special Economic Zones (SEZs), land, labour and industry to determine their role in governing the Ease of Doing Business environment, which in turn influences FDI inflow into the domestic economy.

Conclusion

Foreign Direct Investment (FDI) is crucial for economic development, modernisation, and employment generation; it contributes to technology transfer, human capital formation, entrepreneurship, and efficiency of resource management.1,2 Developing countries like India have therefore sought to attract greater FDI. The World Investment Report of 20193 found that FDI in developed countries have fluctuated over the period from 2007 to 2018: after a steep fall following the 2008 financial crisis, it recovered to pre-crisis levels in 2015, only to decline once again thereafter. Meanwhile, FDI in developing economies, including India, has remained stable. Indeed, estimates for 2018 suggest that FDI in developing economies was higher that year than in developed economies, accounting for 54 percent of global FDI inflow.

Developing countries are more attractive to transnational corporations5 for various reasons, one of which is the presence of cheap, skilled and unskilled labour. In other words, there are opportunities that could help in cost reduction in terms of labour—India's huge inexpensive labour force, comprised by the largest working age population in the world, is one of the reasons why foreign investors find India attractive.6 Moreover, land and other infrastructure are also cheaper; there is promise of emerging large markets; and there exist 'created' assets such as communications infrastructure, marketing networks, and innovative technology that all help companies become more competitive

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