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RESEARCH ARTICLE OPEN ACCESS

FDI in India and Regulatory Environment: Is it really conducive in current Business Scenario?

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ABSTRACT
After the severe financial meltdown, all the economies are trying to revive their economies by bringing stringent reform programs in order to attract more number of Foreign Direct Investment and promote economic growth. India has been the major recipient of FDI, but recently it suffers from low inflow of FDI due to bold economic legislation and tough regulatory environment. Apart from this, there is large gap between approved and actual FDI on account of lack of co-ordination between Union and state governments, as in case of withdrawal of Mittal and undue delay of Posco, result in degradation of India's goodwill to the foreign investors. Through this article, the author has made an attempt to reveal the current regulatory frame work in India vis-à-vis China.
Key Words: Financial meltdown, Foreign Direct Investment, regulatory environment,economic legislation

I. INTRODUCTION

"Investor sentiment is hurt. It is deeply harmed by the fact that there is no stability, certainty and predictability in policy decisions today. As an economy, we have gone into a wait and watch mode so far as FDI is concerned. They are now waiting for the new government to come in. The fear of rollback is always there." Punit Shah, co-head (tax), KPMG.

The investment climate is central to growth and poverty reduction of any economy. Improvingthe opportunities and incentives for firms of all types to invest productively,create jobs, and expand should be a top priority for governments. On account of this, almost all economies of the world have introduced some drastic steps in order to revive their economy after the great financial meltdown in 2008. But, they have to pragmatic in their approach, as itis not just about increasing the volume of investment but also spurring productivityimprovements that are the keys to sustainable growth.

Investors are unlikely to make significant investments unless they areprovided some sense of certainty or predictability in how a host nation willinterpret its FDI laws and whether it will respect the contractual rights andproperty rights inherent in the investment. Absence of a high degree of confidencein the clarity, integrity, and stability of investment rules, investorsmay exaggerate the dangers inherent in a host nation's investment regime,resulting in less investment than would otherwise be provided.

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions withmembers, usually every year. In the context of the 2013 Article IV consultation with India and based on information available at the time of thesediscussions, the staff report of IMF was completed on December 21, 2012 and suggested some structural reforms that building on recent progress is crucial, especially to address supplyconstraints in energy and move the pricing of various natural resources toward a marketbasis. Progress on taxation, land acquisition, and labor market reform, along with 12^{th}Plan goals on infrastructure, skills mismatches and social outcomes, are necessary toreturn to a rapid rate of growth and poverty reduction. Tightening mechanisms to address deteriorating asset quality willpromote healthier banks' balance sheets, but supporting faster growth and reachingBasel III targets will also require capital injections in public banks. In addition, addressingconcentration risks, strengthening creditor rights, and supporting capital marketdevelopment will lay the groundwork for a stronger recovery.

The global economic slowdown from 2008 into 2010 has led many torethink their approach to the liberalization of markets and the courting ofFDI.Some even see the crisis as caused, or at least magnified by, financialglobalization.Yu Yongding, a prominent Chinese economist,recently remarked: "The United States has been a model for China. Nowthat it has created such a big mess, of course we have to think twice." InIndia, concerns over the credit crisis led the Reserve Bank of India (RBI) toreverse course on liberalizing some financial regulations: it will not permitissuance of credit-default swaps, a major contributor to the crisis.

Objectives of the study
- To examine the investment climate in India
- To assess the regulatory environment of India
- To resurrect Indian economy from unnecessary control

II. REVIEW OF LITERATURE

TarunKanti Bose, 2012**,** the study was directed towards detecting the positive and negative sides for the foreign investors while they go for direct investment in India and China. The study found that Chinese economy is suffered by regulatory burden,hindrances in free flow of information, lack of English literacy and so on. Whereas, India suffers from huge sectionof poor and middle class, bureaucracy, power shortage ethnic diversity and so on.

Tim Buthe and Helen V Milner, 2008, have studied 122 developing countries from 1970 to 2000 and by using sample and estimation methods they found that the member nations of WTO and PTA experience greater FDI inflows but the political factors that affect FDI were not understood.

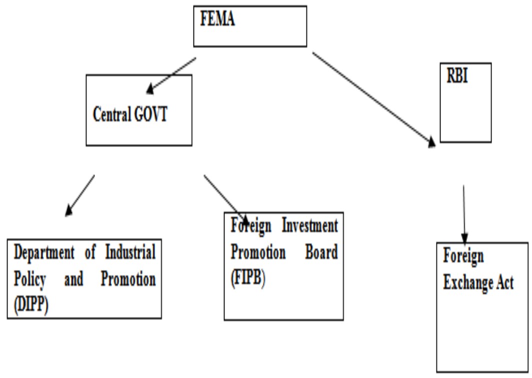
SapnaHooda (2011) finds that India needs a business environment which is conducive to the needs of business. The study suggests that as foreign investors don't look for fiscal concessions or special incentives but they are more of a mind in having access to a consolidated document that specified official procedures, rules and regulations, clearance, and opportunities in India. In fact, this can be achieved only if India implements its second generation reforms in totality and in right direction. Then no doubt the third generation economic reforms make India not only favorable FDI destination in the world but also set an example to the rest of the world.

NIRUPAM BAJPAI AND NANDITA DASGUPTA, 2004, in their paper tried to find out the existing accounting gap in FDI statistics between India and China and to explore the reason behind low growth of FDI in India and to examine whether changes in the present laws are required to bring India's FDI in conformity to the IMF. The study recommended that the collection of data should in accordance with the international definition of FDI recommended by IMF.

PriyankaSahni(2012) attempted to examine the determinants of FDI in India by taking time series data for the period 1992-93 to 2008-09. She applied Ordinary Least Square (OLS) method for this purpose and the empirical results indicated that GDP, inflation and Trade Openness are important factors in attracting FDI inflows in India during post-reform period whereas Foreign Exchange Reserves are not important factors in explaining FDI inflows in India.

Major Government Agencies deals with FDI in India
- **DIPP**-It comes under the Ministry of Commerce & Industry,makes policy, Co-ordinates with industry bodies and SIA to provide investor guidance, process applications. It publishes Annual consolidated FDI policy, Press Notes, Press Releases & Discussion papers.
- **FIPB-** It is the Secretarial body and Administrative body chaired by Secretary, Dept. of Economic Affairs, and Ministry of Finance that clears FDI proposals. It also provides clarifications and Publishes meeting details of the approved cases.
- **Foreign Exchange Department-** It comes under the direct supervision of RBI set up under the RBI Act, 1934 and derives its power from Section 5 (current account transactions) & 6 (capital account transactions) of the FEMA, though all Regulations like FDI & ODI are notifications of the RBI under the FEMA.

Fig1- Foreign Exchange Regulatory framework



India's Investment Regime

A. The Legal and Regulatory Environment of India- It has undergone a process of market liberalization, spurned ironically in part from witnessing rapid economic growth in China and the other Asian tigers. FDI in India is governed by a number of laws, foremost of which is the Foreign Exchange Management Act of 1999 (FEMA) for all FDI and the Takeover Code of the Stock Exchange Board of India (SEBI) for foreign M&A activity. Acting under FEMA, the RBI issued a set of regulations which outline an "automatic route" through which foreign investors may be granted automatic approval for investment. Like China, India restricts foreign investment in certain sectors of the economy. The FEMA Regulations altogether prohibit foreign investment via the automatic route in some sectors like banking and atomic energy. In others, like telecommunications, pharmaceuticals, and mining, the FEMA Regulations cap the percentage of investment in a company. Schedule I, & 2 allows for the automatic issuance of shares or convertible debt to foreign investors, provided that the company is not engaged in any restricted activity, does not require an industrial license per the Industries Act of 1951, and the issuance is not done "with a view to acquiring existing shares of any Indian company."The Industries Act of 1951 requires certain licenses to operate in certain industrial sectors. Recently this Act has been updated with the goal of liberalizing foreign investment in part by reducing the list of industries for which licensing is required. Where FDI cannot be made via the automatic route, approval must be granted from the Foreign Investment Promotion Board (FIPB).Recently, most FDI has required FIPB approval. In addition to the need for approval for restricted industries, and industries requiring a license to operate, government approval is also required in instances where the foreign investor has already made an existing investment in the same economic sector. Importantly, FDI approval in India is centered almost entirely on the national level. Locally mandated approval, registration, or licensing requirements are not coordinated through national level offices, thus investors must conduct separate negotiations at the local level should such approvals be required.

B. M&A Regulation- M&A is the primary means for FDI in India. Until 2006, bothFIPB and the RBI had to grant approval in cases where there were attemptsto acquire control of a domestic company. The required approvals werea major obstacle for foreign M&A activity, especially for hostile takeovers. Since 2006, only RBI approval is needed, although all FEMArestrictions regarding restricted and limited economic sectors still apply.India's antitrust regime was just recently promulgated and a numberof its key provisions have yet to come into force. In 2007, the Competition(Amendment) Act of 2007 was enacted, replacing and amending legislation from 1969 and 2002. The Competition Act requires theCompetition Commission of India to notify and approve certain transactions.Like China, the full effect of the legislation is yet to be seen.

World Economic Prospects to 2011: Economist Intelligence Unit

According to the EIU, FDI into India has been sub-par and will continue to be sobecause its business environment is rather poor. The report states: "FDI inflows are setto increase substantially during the forecast period, but will still remain well belowpotential because of persistent business environment problems."

Business Environment Rankings	**Score out of 10**	**Rank (out of 82)**	**Score (out of 10)**	**Rank (out of 82)**
	2002-06	**2002-06**	**2007-11**	**2007-11**
Overall score and ranks	5.27	62	6.37	54
Political environment	5.2	50	5.7	50
Political stability	5.5	55	6.3	49
Political effectiveness	4.9	45	5.2	46
Macroeconomic environment	7.5	39	7.5	44
Market opportunities	7.6	10	7.7	9
Policy towards private enterprise & competition	5	51	6	50
Policy towards foreign Investment	5.1	66	6.9	49
Foreign trade & exchange controls	3.7	76	6.4	68
Taxes	5.1	60	6.3	42
Financing	4.8	59	6.6	48
Labour market	5.6	64	6.2	56
Infrastructure	3.3	76	4.5	72

Note: The numbers for 2007-11 are forecasts based on trend.
Source: Economist Intelligence Unit. 2007. "World Investment Prospects to 2011".

The rankings for both time periods are fairly awful and the only reasonableranking, like before, is for the 'market opportunities' factor. Apart from infrastructure andlabour market, India ranks low in terms of policy towards private enterprise andcompetition, taxes as well as external trade and exchange controls.What is certainly of concern is the forecast for the period 2007-11. While India'sranking does go up by a few notches to 54 from 62, it is still in the bottom half. Whatagain emerges is that infrastructure is the biggest problem in terms of businessenvironment ranking; it is ranked at 72 of 82. When writing about India's potential to getinward FDI, the report says that "India's potential to attract increased FDI inflows is vast, although poor infrastructure, excessive bureaucracy and interdepartmental wranglingwill slow the pace of opening in many sectors."

FDI Regulatory Restrictiveness Index

The FDI Regulatory Restrictiveness Index (FDI Index) measures statutory restrictions on foreign direct investment in 57 countries, including all OECD and G20 countries, and covers 22 sectors. The FDI Index is currently available for 6 years: 1997, 2003, 2006, 2010, 2011 and 2012.

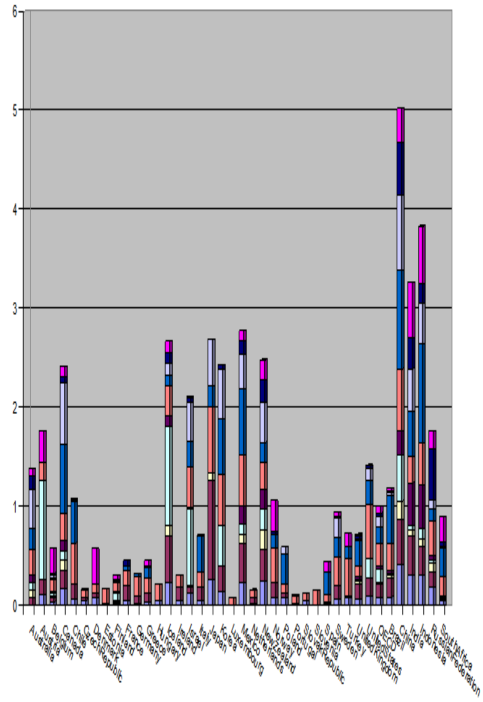
Measuring FDI restrictiveness

The FDI Index gauges the restrictiveness of a country's FDI rules by looking at the four main types of restrictions on FDI:

- Foreign equity limitations
- Screening or approval mechanisms
- Restrictions on the employment of foreigners as key personnel
- Operational restrictions, e.g. restrictions on branching and on capital repatriation or on land ownership

Business surveys show that India figures high amongst the countries where companies wish to invest. However, a major obstacle to direct foreign investment in India is still not impressive. Apart from the relatively high duties on imports and high barriers to doing business, India remains a country with one of the most restrictive FDI regimes as shown by the OECD FDI Regulatory Restrictiveness Index.

Fig-2 OECD FDI Regulatory Restrictiveness Index-2011



http://www.oecd.org/investment/fdiindex.htm

The total FDI index is derived from taking different sectors like primary, manufacturing, electricity, distribution, transport, media, communications, financial and business services. The figure shows that Luxembourg is having the best scope for FDI and rated number one in the regulatory index followed by Portugal. India placed in the third position after China and Indonesia.

India and China: a comparative analysis

Both India and China have successfully courted tremendous volumesof FDI inflows. Yet both nations fail to maximize their use and attractionof FDI. There are several steps that each nation could take toimprove their FDI attraction and usage. Some proposed reforms wouldchange the investment regime itself, while others would have a major indirectimpact on FDI.First, India would do well to consider incorporating several aspects ofChina's FDI regime as a component of future reform. For example, Indiamay benefit from emulating China's policy of explicitly signaling a commitmentto FDI by promulgating a separate body of law that is relativelyclear and tailored to foreign investors.

India's statutory governance of FDI is comparatively more convoluted andmore antiquated than China's, and therefore, it is less conducive toattracting, processing, and retaining FDI inflows. In addition, China usesdistinct legal vehicles that prove more transparent and more comprehensiblefor foreign investors than India's outdated legislation. While China is the preferred destination for FDI, India is seen as far stronger in observing the rule of law and controlling corruption. Thus, a state can largely disregardthe rule of law in other areas of society and still attract foreigninvestment so long as the state provides clarity and transparency andobserves the rule of law where foreign investments are concerned. Investors may be more confident in China's commitment to attracting FDI than in India's efforts. First, investors may view China as morelikely than democratic India to maintain consistent policy goals and objectivesbecause of China's long-term communist leadership. Or alternatively,investors may have more confidence in a single-party regime to putinto effect liberalizing reforms beneficial to investors, which, in an opendemocracy, may be too politically costly to enact.

Second, China has explicitly and actively sought to reform its investmentregime to court foreign investment in a way that signals a deep commitmentto attracting and maintaining high levels of foreign investment. The sustainability of this commitment to foreign investment may be furtheredby the single-party autocratic rule of China. Because there is lessof a threat of political change in China, there may be a perception that thegovernment is less likely to make an about-face and curtail investment rights. China's FDI laws were formed with the specific intention ofattracting foreign investments and were tailored to that end, beginning withthe promulgation of the EJV law following Deng Xiaoping's "open door policy" of 1979. Soon thereafter, the Chinese constitution was amendedto more explicitly allow for foreign investment. India has largely failed to signal an explicit commitment to attracting foreign investment, increasing the perception that such investment is a lowpriority of the Indian government, thus making any governing laws moresubject to change.

III. CONCLUSION AND RECOMMENDATION:

India should re-evaluate industry specific FDI restrictions.Some restrictions may make sense, considering political andsocial differences. But as one anonymous commentator points out, the specifics ofsome restrictions suggest a lack of careful deliberation: "Why, for example,does India permit 100% FDI in the manufacture of hazardous chemicalsand industrial explosives, but 74% in telecoms, 26% in insurance and none at all in supermarkets?" Next, India should work to simplify and integratelocal FDI approval into a national scheme or reduce the need toseek local approval altogether by offering more "automatic route" approvals. Because a single party does not govern India, India may suffermore than China from infighting between local and national approval agencies.However, the benefits from a vertically integrated approval process appear to outweigh their costs. Additionally, India should include mechanisms that impede temporary or quick regulatory change. InsulatingFDI legislation from political whims in a nation that is perceived asrelatively unstable may have an important impact on the sentiments ofinvestors concerned with changing political winds.

Recent moves by the Commerceand Industry Minister, Anand Sharma, suggest that India is well on its way in this direction. India should follow China and provide clear guidanceto investors about who make the relevant decisions as well as how and onwhat basis those decisions are made. While both nations suffer fromprolonged bureaucratic processes, India has the most to gain by reducingbureaucracy and increasing investment simplicity.

Finally, India should continue to reduce trade and FDI barriers, especially in goods and services sectors with strong links to the manufacturing sector. Further simplify and improve the transparency of the trade and investment regimes, as well as rationalize the export regime, including export restrictions.

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