

Foreign Direct Investment Inflows to India since the 1990s -- Issues and Challenges: Comparison with China

1. Introduction

One remarkable feature of the contemporary world has been the proliferation of private capital flow in the form of foreign direct investment (FDI) in developing countries, especially since 1990s. Since the 1980s, multinational corporations (MNCs) have emerged as major actors in the globalization context. Governments around the world— in both advanced and developing countries—have been attracting MNCs to come to the respective countries with their FDI. This phenomenon may be related to the broader context of liberalization in which most developing and transition countries have moved to market-oriented strategies.

Among the developing countries in Asia, India and China are the two major economies that have adopted market oriented economic policies designed to attract FDI inflows. Both these economies are now getting increasingly integrated with the global economy as they open up their markets to international trade and investment inflows. Both countries have enjoyed high positive average GDP growth rate¹ over the last two decades (Table 1) although China substantially exceeds India.

China ventured into the path of liberalization in 1979 (Lemoine, 2000, Huang, 2002) by gradually liberalizing and opening up its economy² (see Table 2 for the checklist of FDI legislation in China). While FDI in 1980 was virtually minimal (about \$ 596 million)³ within a span of 23 years, China's annual FDI inflows are way over \$50

¹ Since 1999, Beijing has maintained a GDP growth above 10 percent. Beginning 2003, the construction projects for the 2008 Olympic Games in Beijing and the demand for higher-grade consumer goods have accelerated of the municipal economy. Between January to June of 2004, the quality of economic growth further improved in Beijing. This can be seen in the fast increase in fiscal revenue and a rise in FDI. During the six months of 2004, Beijing garnered 37.85 billion yuan (\$4.56 billion) in local fiscal income, up 25.3 percent over the same period of last year. Actually \$1.72 billion in foreign capital was used, up 68.1 percent over the same period in 2003. Also, external trade also contributed to the rosy overall economic landscape in China's capital.

“China witnesses double-digit growth”, 17 July, 2004.

http://ads.sify.com/RealMedia/ads/Creatives/sify_html_uploading/citibank_aug_popunder_creative_caller_06aug.html

² Huang (2002) has classified the FDI regime in China into four distinct phases:

1979-1985 – Permitting FDI

1986-1991 – Selectively encouraging FDI

1992-1996 – Substantial FDI liberalization

1997-2000 – Streamlining FDI approvals and World Trade organization (WTO) agreement.

³ Chen, C., Chang, L. & Zhang, Y (1995), “The Role of Foreign Direct Investment in China's Post-1978 Economic Development”, *World Development* 23(4), 691-73.

billion (Table 3)⁴. By the end of 2002, only a year after joining the WTO, China overtook the United States (U.S.) in FDI inflows and became the foremost recipient of FDI inflows in the world. The lead position of China among the destinations of global FDI inflows has also been confirmed by the 2002 A.T. Kearney FDI Confidence Index Survey⁵. China scored 1.99 in a scale from zero to three, while the United States ranked second with 1.89 and India scored 1.05 as per the results. The United States, Britain, Germany and France rounded out the top five, with Brazil falling to 13th place in 2002 from third in 2001. China has also remained the most preferred destination for FDI among the developing nations in the Asia and the Pacific.

China has been able to attract significant sums of FDI inflows by gradually relaxing the FDI regulations (Bajpai and Jian, 1996; Bajpai, Jian and Sachs, 1997). Among others, China has its non-state sector (counterpart of India's private sector) virtually run on free market principles. It has set up large special economic zones (SEZs), encouraged competition among Chinese provinces to attract FDI, offered substantial tax concessions to foreign enterprises, permitted the leasing of land and property, introduced government guarantees for investment and special arrangements regarding retention and repatriation of foreign exchange. This has made possible the acceleration of transfer of technology and modern management skills as well as providing foreign exchange (Chunlai, 1997).

China, in spite of its socialistic philosophy had opened up to MNC investment long before India presumably with a view to securing technological expertise for ultimately starting up sophisticated hardware industries of its own. For more than two decades, foreign capital invested by the MNCs have accelerated the development of China's manufacturing industry. Endowed with the world's largest population, China has virtually become the focal point of global corporations who seek cheap labor as well as the potential of reaching the world's largest market of consumers in an environment of policy preferences given by Chinese government to induce FDI inflows⁶.

⁴ By China's high standards, the financial stake of a foreign company in a Chinese concern must be at least 25 percent to qualify as FDI (Huang, 2002). Even by these standards, China attracts enormous amounts of FDI inflows.

⁵ FDI Confidence Index, A.T. Kearney, Inc. 2002.

⁶ Most of the Top 500 MNCs in the world have been investing in China in recent years. For instance, the foreign share in the market of facsimile and video camera reaches 98% and 99% respectively, while the mobile phone 80%, the computer 75%, the car 70%, and the digital program controlled switch 50%. Now there are 8 large enterprises producing large-sealed integrated circuit in the micro-electricity industry in China, 5 of which are Sino-foreign joint venture, and one of which is exclusively invested by foreign capital. among the 5 enterprises jointly owned, only one is dominated by Chinese enterprise while 4 are dominated by foreign enterprises. In the engineering mechanics industry, there are 126 joint ventures, 36% of which are dominated by foreigners, while 47% of which are dominated by Chinese enterprises, and 17% of which are equally owned.

Yifang, N., Wen, G & Xiaobo, W, (2002) "The Opportunities, Threats and Counter-measures of China's Manufacturing Industry Under the Globalization", School of Management, Zhejiang University, Hangzhou, China.

India has also adopted a similar path of liberalization since 1991⁷ (more than ten years after China's open door policy), by slowly shedding its FDI restrictions and allowing FDI through automatic route barring a few strategic industries of security concern. FDI in India is freely allowed in all sectors, including the services sector, save where the notified sectoral policy does not permit FDI beyond a ceiling. FDI for virtually all items/activities could be brought in through the automatic route under the power vested with the RBI and, for the remaining items/activities, through Government approvals. Annexure 1 provides a comprehensive list of the sector-specific guidelines for FDI for key industries in India.

Until 1991, India relied more on bilateral and multilateral loan agreements with long maturities, and relatively lesser on FDI. FDI inflows was allowed only in designated industries with varying conditionalities imposed upon them regarding the scope and extent of domestic participation in the joint venture agreements such as local content requirements, export obligations, local R & D promotion, etc. India's market-oriented economic reforms undertaken in 1991 were directed towards increased liberalization, privatization and deregulation of the industrial sector, and to re-orient the economy towards global competition by reducing trade barriers, and gradually opening up its capital account. Progressive liberalization of FDI policy by the Government of India in the forms of opening up of new sectors like integrated townships, defense industry, tea plantations etc and the sectoral reforms/deregulation in various sectors including telecom etc. is summarized in Tables 4a and 4b.

China has consistently maintained its highest rank over the decade among the top 10 FDI destinations in developing Asia, exhibiting increasing FDI inflows from around \$14 billion in 1991-93 to more than \$41 billion in 1998-2000, as is evident from Table 5. But, at the same time, it is also evident that while India did not figure out among the top 10 FDI-destinations in 1991-93, it has managed to acquire the eighth position in late 1990s with average annual FDI inflows of \$2.4 billion. FDI inflows to India have risen, albeit marginally, to \$3.45 billion in 2002 from \$3.40 billion in 2001 and to \$ 4.27 billion in 2003⁸, though there was a sharp fall in the global FDI inflows during the same time.

⁷ Following independence, India pursued a development policy based on centralized planning, regulation and control of private enterprise, state ownership, trade protection and limits on the penetration of foreign capital and technology. This regime determined India's economic development until the mid-1980s when there began some movement towards economic liberalization and market orientation. India experienced a crisis in its balance of payments in early 1991, which threatened to destabilize the economy.

In response to this crisis, the Government implemented a program of structural reforms, aimed at stabilizing the economy and promoting reliance on market mechanisms, broadly referred to as 'liberalization'. The main components of the structural reforms program were exchange and trade liberalization; financial sector reforms and control of the budget deficit; inflation and money supply. A great deal of significance was placed on promotion of foreign technology transfers and foreign investment in key areas, as well as, the further development of the private sector.

⁸ As a part of the ongoing effort to make FDI estimation compliant with the IMF norms, the FDI figure in India has risen to US \$5.4 billion in 2002-03. The enhancement of the FDI data is due to incorporation of more items like earnings reinvested by the MNCs operating in India and intra-corporate debt transactions following the revision of the FDI statistics in an effort to comply with the IMF guidelines. More about this is discussed later in this paper. Even this adjusted FDI figure is still significantly low (10.1 percent) in comparison to China.

India's share in the FDI inflows to the developing world has been steadily increasing from 0.92 percent in 2000 to 2.48 percent in 2003.

There has been significant downturn in overall global FDI inflows since 2001. World FDI inflows fell to a low of \$5600 billion in 2003 from a high of \$1388 billion in 2000⁹. Overall world FDI inflows have reduced by 41 per cent in 2001, 17 percent in 2002 and by nearly 18 percent in 2003. Within the developing economies, FDI has certainly played a vital role in the economic progress of most developing countries in Asia. Developing Asia⁹ has shown significant increase in FDI inflows during the last decade. The UNCTAD data presented in Table 5 shows that there has been more than three-fold rise in FDI inflows to this region over 1991-93 to 1998-2000. Following the global pattern, FDI inflows in Asia and the Pacific also showed a downward path since 2001, which got marginally improved in 2003 to \$107 billion from \$95 billion in 2002¹⁰ (Table 3). However, contrary to the general trend in the Asia and the Pacific, among certain other countries¹¹, China and India, registered increased FDI inflows since 2001, which is indicative of their attractiveness for international investment.

However, a healthy increase in FDI inflows in India in a global slowdown cannot detract from the fact that India accounts for an extremely small share of FDI flows. Table 3 demonstrates that compared to the share of Chinese FDI inflows in developing country FDI that stands more than 31 percent in 2003, the corresponding figure for India which is

Source: The Economic Times, 2nd May, 2003.

⁹ This is mainly prompted by a fall in FDI inflows in the developed countries (U.S., central and western Europe). According to an UNCTAD press release in 2003, the decline in FDI flows in 2001-2002 was the most significant downturn of the past three decades. The driving factors were a combination of macroeconomic factors (weak economic growth or slump in economic activity linked to the business cycles in many parts of the world, especially the developed countries, and tumbling stock markets), microeconomic factors (low corporate profits, financial restructuring) and institutional factors (winding down of privatization, loss of confidence in the wake of corporate scandals and the demise of some large corporations).

UNCTAD (2003) "Global FDI Flows Continue to Fall: UNCTAD now forecasts 2004 rebound", UNCTAD/PRESS/PR/2003/85, April 9.

<http://216.239.41.104/search?q=cache:2pBWv0IemcEJ:www.unctad.org/Templates/Download.asp%3Fdocid%3D4022%26lang%3D1%26intItemID%3D2261+world+fdi+fall+2001&hl=en&ie=UTF-8>

⁹ According to the Asian Development Bank, developing Asia constitutes East Asia (People's Republic of China, Hong Kong (China), Republic of Korea, Mongolia, Taipei (China), South-east Asia (Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam, South Asia (Afganistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka), Central Asia (Azerbaijan, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, Uzbekistan) and the Pacific (Cook Islands, Fiji Islands, Kiribati, Republic of the Marshall Islands, Federated States of Micronesia, Nauru, Papua New Guinea, Samoa, Solomon Islands, Democratic Republic of Timor-Leste, Tonga, Tuvalu, Vanuatu).

Source: Asian Development Outlook 2004, Asian Development Bank.

¹⁰ Strong domestic growth, the relocation of efficiency-seeking FDI to competitive locations in the region, higher global corporate spending and oil investment were the key factors behind the performance.

¹¹ The Republic of Korea, Thailand, Vietnam and oil-rich Azerbaijan also experienced higher FDI flows during this period.

around 2.5 percent is very low. In 2003, among the countries in Asia and the Pacific China attracted 50 per cent of the FDI inflows against India's 4 per cent. It is also evident that while the cumulative FDI that India has received in a decade of liberalization (1992-2003) was a total of \$19.92 billion, the corresponding figure for China over the same period was \$312.41 billion, nearly 16 times higher than that of India. The recent data indicates that in 2003, the annual FDI inflows of over \$52.7 billion of China compared with a trivial amount of \$4.3 billion (only about 7% of Chinese FDI inflow) into India¹². China alone attracted over a quarter of total FDI inflows to the developing nations over the decade, thus serving as both an attractive local market and also as an export platform for multinationals. Apart from China, India attracts significantly lower FDI than many other South-East Asian countries, such as South Korea, Thailand and Malaysia. In 2000, China attracted FDI of over \$44 billion, Thailand over \$6 billion and South Korea around \$10.45 billion. The corresponding figure for India was only \$3.4 billion (Global Development Finance, 2001).

Within this otherwise firm conviction about unmatched Chinese superiority in attracting FDI inflows vis-à-vis India, there has occasionally been some skepticism about the actual intensity of the FDI gap between India and China as suggested by the official statistics of the respective countries. A study by the International Finance Corporation (IFC) (Pfeffermann, 2002)¹³ in 2002 has lent added credence to this skepticism by raising doubts on the reported FDI-gap between these two countries. He made the assertion that the difference between the FDI inflows of India and China is not nearly as huge¹⁴ as may be suggested by official figures. He specifically pointed out to the under reporting of FDI by India because of non-conformity of India's method of measuring FDI to the international standards¹⁵ leading to the huge reported discrepancy between the FDI inflows of India and China.

¹² However, it appears that the gap between these two estimates may be exaggerated owing to technical issues in measurement. China includes domestic money coming through Macau, Taiwan and HongKong in calculating its FDI inflows. If that is knocked off, the figures could come down to \$20 billion. The IMF definition of FDI includes as many as twelve different elements-- equity capital, reinvested earnings of foreign companies, inter-company debt transactions, short-term and long-term loans, financial leasing, trade credits, grants, bonds, non-cash acquisition of equity, investment made by foreign venture capital investors, earnings data of indirectly-held FDI enterprises, control premium and non-competition fee. China includes all these in its definition of FDI. China also classifies imported equipment as FDI, while India includes these as imports in its trade data. India, however, does not adopt any other element other than equity capital reported on the basis of issue or transfer of equity or preference shares to foreign direct investors. Reserve Bank of India (RBI) is presently evaluating some modifications in the way that Indian FDI is measured, which could yield somewhat higher estimates for India. This issue is discussed in Bajpai and Dasgupta (2003).

¹³ Pfeffermann, G. (2002), "Paradoxes: China vs. India", paper presented at the Private Sector Development Forum 2002, April 23-24, 2002 - World Bank, Washington, DC.

¹⁴ John Eliot, the economic journalist⁶ who had written a monograph for the Rajiv Gandhi Institute for Contemporary Studies, New Delhi in 1995, had also pointed out to the unreliability of Chinese statistics. He had similarly argued that while China indeed was ahead of India in terms of actual FDI, the margin wasn't nearly as large as was generally assumed. "Round Tripping – FDI", The Financial Express, 5 June 2002.

¹⁵ By 'international standard' we mean the definition of FDI provided by the IMF/OECD.

The study pointed out that adoption of international standards for computation of FDI would raise India's net annual FDI inflows in 2000 from US\$ 2-3 billion as reported in the Reserve Bank of India's (RBI) official balance of payment statistics¹⁶ to about US\$ 8 billion. This would work out to approximately 1.7% of India's GDP and would not be far behind the 2% level achieved by China¹⁷. Thus, with a uniformity in the FDI measuring standard of the two countries in line with the international norm the difference in terms of ratio of adjusted FDI to GDP between India and China could become much smaller, only about 15 percent during 2000.

In cumulative terms, China's FDI levels obviously remain far higher than India's by virtue of the fact that the Chinese reforms have been much more wider and deeper than India's and that the Chinese provinces have been competing much more among themselves to attract FDI relative to the Indian states. Of course, in this context, we are not to lose sight of the fact that China liberalized its trade and investment regime a decade before India did. Yet, the yawning gap between China and India in attracting the non-debt creating FDI flows has indeed been a matter of significant policy concern for India, because in the process India is supposed to be losing a lot of markets and a lot of capital investment to China.

The discrepancies in the relative FDI attracting capabilities of India and China raise some important fundamental questions about the actual FDI potentials of India. Can India possibly emerge as an FDI destination as attractive as China? Which groups of foreign investors should India target in order to attract FDI inflows that match the Chinese inflows both in terms of quantity and quality? What lessons can India possibly derive from Chinese experience and policy adoptions so as to attract these investors? This paper aims at addressing these issues. The answers to these questions and the related issues that emanate in the process will enable us to obtain a blueprint of the prevailing business environment in India. It could also provide us with a direction in which the country needs to proceed in order to become a favored FDI destination in Asia.

The remaining paper is organized as follows. In this introductory section we have already identified the FDI inflows of India and China relative to the global scenario and relative to each other. In the section that follows, we provide a brief analytical framework highlighting the major concepts and ideas that will pervade in this study. Section 3 intends to capture some relative measures of FDI dependency in India and China. Inward FDI dependency ratios give an idea of the attractiveness of an economy to the foreign investors as a potential FDI destination. This in turn determines the perceived quality of investment climate of the host country in terms of competitive advantages and

¹⁶ Statistics on FDI reported earlier by the RBI in the balance of payments included only equity capital and this tended to underestimate the quantum of FDI inflows.

¹⁷ The new figures derived by the IFC for India and China after the cleansing of Indian FDI data have been based on a methodology approved by the IMF to calculate the FDI inflows.
http://dipp.nic.in/anrepo_e/English/chapter5.pdf

government regulations. In this section, the Indian FDI inflow data for the period 2001 onwards will be stated in terms of pre-adjustment statistics. The alignment of Indian FDI inflow statistics to the IMF norms has been accomplished recently by the Indian government. We will assign Section 4 to explore the under-estimation hypothesis of IFC and look into the corrected FDI figures for India after making the necessary adjustments in line with IMF prescriptions. The remaining sections will be devoted to the groundwork analysis of investment climate in India. Investment climate of a country determines the economic and institutional factors that build up the investment attractiveness for the economy. The parameters of investment attractiveness may be different for the MNCs as against the expatriates who invest in their native countries. For a country to expand its FDI inflows, it is necessary to generate appropriate investment climate and to this extent the source of investment matters significantly. This is because the country has to design its investment climate to attract those source countries for FDI inflows. Section 5 will inquire into the source of FDI investors into India. The sectoral allocation of FDI inflows constitutes one dimension of the quality of FDI inflows – whether export oriented or domestic market oriented, whether manufacture or services. Section 6 will present an overview of the sectoral allocation of FDI in India. Finally, in Section 7, we investigate the limitations in the fabric of Indian investment environment in terms of a number of criteria and put forth some policy recommendations that could enable India to attract MNCs into the country and compete successfully with China in attracting FDI inflows. The last section will provide the conclusion. The entire analysis has been performed in comparison to China to the best extent possible.

2. Brief Analytical Framework

What is FDI?

FDI is an important constituent of the globalization efforts of the world economy. FDI flows constitute capital provided by foreign investors, directly or indirectly to enterprises in another economy with an expectation of obtaining profits derived from the capital participation in the management of the enterprise in which they invest. The foreign investors acquire ownership of assets in the host country firms in proportion to their equity holdings. FDI by definition is supposed to reflect a long-term commitment as it involves normally a stake of 10% or more in a host country enterprise, together with managerial control. This is the empirical definition of FDI adopted by many countries to distinguish it from portfolio flows.¹⁸

¹⁸ Portfolio investment includes equity securities, debt securities in the form of bonds and notes, money market instruments, and financial derivatives that include a variety of new financial instruments. However, it should be clear that if any of those instruments complies with the criteria of FDI capital transactions they are considered part of FDI. All other financial transactions not covered in direct investment and portfolio investment are classified in the balance of payments as reserve assets or other investment.

Budget 2003-04, Government of India.

<http://indiabudget.nic.in/es2003-04/chapt2004/chap610.pdf>

World Trade Organization (WTO), Working Group on the Relationship between Trade and Investment, 16 April 2002.

http://trade-info.cec.eu.int/doclib/docs/2004/july/tradoc_111123.pdf

Portfolio investments are also made by foreign investors but their main concern is the appreciation of the value of their capital and the return that it can generate regardless of any long-term relationship consideration or control of the enterprise. Conceptually, the main difference between the FDI and the portfolio investment is in the *lasting interest* expressed by the non-resident direct investor in the resident enterprise of the domestic economy. The *lasting interest* underlines a firm desire on the part of the non-resident investor to be associated with the long-term business activities of the resident enterprise by exerting significant influence on the management of the enterprise. With FDI, a foreign investor has greater risk compared to exporting or licensing, but has considerably more managerial control over the operation.

Role of FDI

The importance of FDI extends beyond the financial capital that flows into the country. In addition, FDI inflows can be a tool for bringing knowledge, managerial skills and capability, product design, quality characteristics, brand names, channels for international marketing of products, etc. and consequent integration into global production chains, which are the foundation of a successful exports strategy (Blomstrom, Kokko and Zejan, 1994; Borensztein, De Gregorio and Lee, 1998; De Mello, 1999; United Nations Conference on Trade and Development (UNCTAD) 1999; Lall, 2000; Organization for Economic Cooperation and Development (OECD) 2002, Lipsey, 1999). FDI could benefit both the domestic industry as well as the consumer, by providing opportunities for technological transfer and upgradation, access to global managerial skills and practices, optimal utilization of human capabilities and natural resources, making industry internationally competitive, opening up export markets, providing backward and forward linkages and access to international quality goods and services and augmenting employment opportunities. For all these reasons, FDI is regarded as an important vehicle for economic development particularly for developing economies. FDI flows are usually preferred over other forms of external finance because they are non-debt creating, non-volatile¹⁹ and their returns depend on the performance of the projects financed by the investors. In a world of increased competition and rapid technological change, their complimentary and catalytic role can be very valuable.

Choice of Location of FDI

Dunning's ownership location internalization (OLI) paradigm indicates the demand side determinants of FDI inflows to the host country in terms of the location advantages that the foreign investor derives by making the FDI. The paradigm shows that

¹⁹ Because of managerial involvement in the case of FDI, the presumption is that the inflow of foreign capital in this form will be more stable than portfolio investments and is less susceptible to sudden reversals in direction due to negative monetary shock or investor panic. FDI, with its much longer-term maturities and manageable debt-service ratios is typically more resilient to short-term economic declines, as its economic relationship with the host country is of a longer-term nature and capital is less easily withdrawn from the engaging enterprise or project. Movement in FDI is therefore a useful gauge of foreign business sentiment about a country's long-term development and its regulatory system. In contrast, portfolio investments are easier to liquidate and following an internal or external shock, investors may quickly withdraw such funds from the host country

under certain conditions it becomes profitable for the investor to produce in the foreign country rather than simply producing the good at home and exporting it to the foreign market. Elements constituting location advantages include resource endowments and also economic and social factors such as market size and structure, prospects for market growth and degree of development, the cultural, legal, political and institutional environment and government legislation and policies of the host country. In terms of the demand-side factors, the host's overall attractiveness to FDI is determined by the location advantages it possesses. Because resource endowments are not evenly distributed among countries and social and economic factors as well as government policies are different among countries, the attractiveness of host countries to FDI is different. Choice of location is motivated by a number of firm-specific variables that categorize FDI into several types, depending on the underlying motivations -- resource-seeking, market-seeking, efficiency-seeking and strategic-asset seeking (Dunning, 1998).

Investing firms make FDI with the goal and expectation of profits through attaining competitive advantage over other firms that could be translated to tangible returns above and beyond their original investment. Given the additional fixed costs involved in operating in a foreign country and with a multitude of potential locations to choose among, entrepreneurs in making the choice of locating the venue for FDI is responsive to the relative incentives offered by different locations. However, in attaining competitive advantage, the investing firms also have to take care of the costs and uncertainties around the returns expected from FDI. These may be the endogenous costs associated with coordination and control, administrative costs etc. and also the exogenous costs arising from the various risks and uncertainties in the business environment of the investing international companies in the destination location.

The choice of location is thus an important strategic factor for the foreign investors in FDI decision because a firm's location influences the distance and closeness of the resources. It also influences the cost of transport and communication to the market. The location also determines the kind of raw materials and knowledge that are available to the firm. Available raw materials and knowledge in turn further defines some of the firm's possibilities to gain competitive advantage. As long as a firm's location cannot be imitated, this might give the firm advantages compared to its competitors. From the knowledge perspective, a location with abundance of technical knowledge might be a contribution for the firm to access labor with the appropriate skills and knowledge.

Investment Climate

While most developing countries pursue regulations and restrictions on the economic activities of MNCs operating within their territory²⁰, in view of the actual and

²⁰ Till the mid-1980s, FDI inflows were viewed with great wariness in most developing countries worldwide. The scepticism was attributable to the colonial experience of many developing countries and by the view that FDI was a modern form of economic colonialism and exploitation through the capacity of MNCs to influence economic and political affairs. In addition, the local affiliates of MNCs were frequently suspected of engaging in unfair business practices, such as rigged transfer pricing and price fixing through their links with their parent companies.

potential benefits of FDI, they are also increasingly offering incentives to attract FDI as a part of the increasing competition amongst FDI-receiving countries²¹. The strategic importance of the choice of location of FDI in the perception of foreign investors is also creating a competition among the FDI-seeking countries. As a part of the effort, the host countries offer incentive schemes to the foreign investors. These incentives that constitute some of the factors behind competitive advantage may be in terms of lower cost for labor and/or physical resources, secure access to physical resources, proximity to major markets with affluent customers, advantages of integration, improved quality and increased market share. However, the realized level of FDI flowing into different countries indicates that the attractiveness of all countries is not the same.

In general, private investors (domestic or foreign) are guided by their expectation of the potential return and risk of their investment, in choosing among alternative opportunities. In other words, FDI is driven, among other factors, by expected profitability, relative costs/prices, confidence in macroeconomic policy, political stability, the quality of contracting and legal enforcement, e.g., contract law, bankruptcy law, etc. These expectations of the investing foreign firms are shaped by a host of institutional, regulatory and infrastructure-related factors and policies that can be summarized as the 'investment climate' prevailing in the recipient economy.

A pre-condition to FDI inflows is the creation and sustenance of a well-designed business environment. The new institutional economics literature with its emphasis on transaction costs have focused on the creation of an appropriate business environment or "investment climate" for the benefits of FDI²² to be realized by a developing economy (Fields and Pfeffermann, 2003). The quality of the investment climate determines the success of the recipient firms in attracting significant FDI inflows. A favorable

Consequently, most countries regulate and restrict the economic activities of foreign firms operating within their borders. Such regulations often include limitations on foreign equity ownership, local content requirements, local employment requirements, and minimum export requirements. These measures are designed to transfer benefits arising from the presence of foreign firms to the local economy.

²¹ The drying-up of commercial bank lending in the 1980s due to debt crises brought many developing countries in Asia to reform their investment policies to attract more stable forms of foreign capital, and FDI appeared to be an attractive alternative to bank loans as a source of capital inflows. In the process, incentives and subsidies were aggressively offered, particularly to MNCs that supported developing countries' industrial policies. Incentives often include tax concessions, tax holidays, tax credits, accelerated depreciation on plant and machinery, and export subsidies and import entitlements. Such incentives aim to attract FDI and channel foreign firms to desired locations, sectors, and activities.

²² The need for growth in FDI inflows in the developing countries made by the MNCs has assumed significant importance in recent years as a potential source of economic growth and development (Bajpai and Sachs, 2000). It is also viewed as a source of private investment inflows that could be used as a mechanism for alleviating poverty (Fields and Pfeffermann, 2003). Apart from the traditional argument that FDI accelerates economic growth by raising the capital stock of recipient countries, there is also the recent hypothesis that views FDI inflows as a channel of technology transfer through technological diffusion (Markusen, 1995). Access to advanced technologies lead to knowledge spillovers in via imitation, competition, linkages and training (Kinoshita, 1998; Sjolholm, 1999; Saggi 2000).

investment climate implies the existence of no or minimum transaction costs and hence a potentially competitive investment environment.

3. FDI Statistics in India and China

3.1 Certain Indicators of Relative FDI Performance

FDI/GDP Ratio

A good relevant measure of a country's openness to FDI is not the absolute size of FDI but FDI normalized by the size of the host economy which is an indicator of the attractiveness of an economy to draw FDI. Countries vary in their economic and market size and the size of FDI flows ought to be gauged relative to the size of the host economy. The absolute size of FDI flows for the United States in 1990 was much larger than the Chinese FDI but the US economy is roughly seven times as large (on the basis of official foreign exchange conversion). In that sense, the United States was less "dependent" on FDI than China is even though the absolute size of FDI flows into the United States was much greater.

A country with a ratio of FDI to GDP that is greater than unity is reckoned to have received more FDI than that implied by the size of its economy. It indicates that the country may have a comparative advantage in production or better growth prospects reflecting larger market size for the foreign firm. On the other hand, a country that has the ratio value of less than one may be more protectionist and technologically backward, or may possess a political and social regime that is not conducive for investments. Overall, FDI-GDP ratio is an index of the prevailing investment climate in the host economy. Countries with more conducive liberalization policies and measures tend to have larger share of FDI inflows to their GDP.

Table 6 gives a picture of FDI as a percentage of GDP for India and China for some selected years over 1997 through 2001. The share of FDI inflows in GDP has been very small for India not only in comparison to China, but also in absolute terms, remaining less than one over the selected periods compared to China.

Inward FDI Flows as a Percentage of Gross Fixed Capital Formation (GFCF)

A common measure of the relative size of FDI is the "FDI/capital formation ratio," given by the amount of FDI inflows in one year divided by the total fixed asset investments made by foreign and domestic firms in the same year. FDI flows expressed as a percent of GDCF can provide a crude measure of the importance of FDI in an economy's capital formation. The share of inward FDI inflows as a percentage of GFCF measures the relative weight of FDI in total aggregate investment taking place in the host economy. Total investment includes both public and private sector investment in the host country. According to UNCTAD data, China exceeds the world and developing country ratios once from 1992-1998 and then from 2002 onwards. India, on the other hand is consistently much below China (Table 7) improving from 0.4 in 1992 to a ratio of 4 in 2003.

Inward FDI Performance Index

The Inward FDI Performance Index of the UNCTAD is an instrument to compare the relative performance of countries in attracting FDI inflows. This measure ranks countries by the FDI they receive relative to their economic size²³. It is the ratio of a country's share in global inward FDI flows to its share in global GDP. An index value greater than one indicates that the country receives more FDI than its relative economic size given by its relative GDP²⁴, a value below one that it receives less²⁵ (a negative value means that foreign investors disinvest in that period). The exercise is intended to provide policymakers with data on some variables that can be quantified for a large number of countries. The index thus captures the influence on FDI of factors other than market size, assuming that, other things being equal, size is the "base line" for attracting investment. These other factors can be diverse, ranging from the business climate, economic and political stability, the presence of natural resources, infrastructure, skills and technologies, to opportunities for participating in privatization or the effectiveness of FDI promotion²⁶.

²³ The Inward FDI Performance Index is shown for three-year periods to offset annual fluctuations in the data. The indices cover 140 economies for as much of the period as the data permit, however, some economies in transition could not be ranked in the early years for lack of data or because they did not exist as separate countries. The indices exclude tax havens, which for tax rather than productive reasons tend to have massive FDI inflows in relation to their economic size.

Inward FDI Performance Index Methodology, UNCTAD, 2002.

<http://www.unctad.org/Templates/WebFlyer.asp?intItemID=2469&lang=1>

²⁴ A country with an Index value that is greater than unity indicates that the country may have a comparative advantage in production or better growth prospects. This category includes several advanced industrial economies whose FDI performance reflects high incomes and technological strengths (e.g. the United Kingdom) or a location (combined with other favorable factors) within large regional markets like the European Union (Ireland). In other countries, high scores reflect the end of political or economic crises, transition to a market economy or massive privatization.

"Foreign Direct Investments to China and Southeast Asia: Has Asean been Losing Out?" Economic Survey of Singapore, Third Quarter, 2002.

<http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN010347.pdf>

²⁵ A country that has an Index value of less than receive less FDI than would be expected from its size. Such group of countries also vary greatly, due to a range of factors including instability, poor policy design and implementation or competitive weaknesses. Some are very large economies that attract large amounts of FDI, albeit low in relation to GDP (the United States), while others - like Japan - have institutional arrangements that do not encourage foreign participation and thus have traditionally been closed to FDI. Many are simply poor or unable to compete effectively. Others may be more protectionist and technologically backward, or may possess a political and social regime that is not conducive for investments.

"Foreign Direct Investments to China and Southeast Asia: Has Asean been Losing Out?" Economic Survey of Singapore, Third Quarter, 2002.

<http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN010347.pdf>

²⁶ The Inward FDI Performance Index Methodology is given by:

$$IND_i = [(FDI_i)/(FDI_w)] / [(GDP_i)/(GDP_w)]$$

where, IND_i = The Inward FDI Performance Index of the i^{th} country FDI_i = The FDI inflows in the i^{th} country FDI_w = World FDI inflows GDP_i = GDP in the i^{th} country GDP_w = World GDP.

Two facts are immediately evident from Table 8. First, both China and India have indices that are significantly lower than a few other East-Asian economies like Singapore, Malaysia, Philippines, Indonesia and Republic of Korea. Second, India's FDI performance index is much lower, compared to China. China declined in rank from 1988-90 in 1998-2000 (although the index value increased marginally) and then improved just by one point in 2000-02 with a further improvement in index value. However, it could all through maintain an index value above unity, which indicates its comparative advantage and better growth prospects as perceived by foreign investors. The index value for India however remained consistently much below one although it showed a gradual improvement over subsequent periods. This improvement indicates that the policy regime in India must be slowly moving towards a more open economy shedding the protectionist economic policies. However India also shows a deterioration in terms of the ranking of the indices.

Inward FDI Potential Index

The Inward FDI Potential Index²⁷ of the UNCTAD is an instrument to compare the relative potentials of different countries in attracting FDI inflows on the basis of the following selected variables that capture the host of socio-economic factors²⁸ (apart from market size) affecting inward FDI flows. World Investment Report, 2002 admits the difficulty in capturing the socio-economic factors affecting FDI. Nonetheless, it tries to

<http://www.unctad.org/Templates/WebFlyer.asp?intItemID=2469&lang=1>

²⁷ Just as the Inward FDI Performance Index, the Inward FDI Potential Index is also shown for three-year periods to offset annual fluctuations in the data. The indices cover 140 economies for as much of the period as the data permit, however, some economies in transition could not be ranked in the early years for lack of data or because they did not exist as separate countries. The indices exclude tax havens, which for tax rather than productive reasons tend to have massive FDI inflows in relation to their economic size. Inward FDI Potential Index Methodology, UNCTAD, 2002.

<http://www.unctad.org/Templates/WebFlyer.asp?intItemID=2470&lang=1>

²⁸ The factors are: (1) Per capita GDP that indicates the sophistication and breadth of domestic demand (together with some other factors) with the expectation that higher income economies attract relatively more FDI geared to innovative and differentiated products and services. (2) The rate of GDP growth over the previous 10 years, a proxy for expected economic growth. (3) The share of exports in GDP, to capture openness and competitiveness. (4) As an indicator of modern information and communication infrastructure, the average number of telephone lines per 1,000 inhabitants and mobile telephones per 1,000 inhabitants. (5) Per capita Commercial energy use, for the availability of traditional infrastructure. (6) The share of R&D spending in GDP, to capture local technological capabilities. (7) The share of tertiary students in the population, indicating the availability of high-level skills. (8) Country risk, a composite indicator capturing some macroeconomic and other factors that affect the risk perception of investors. The variable is measured in such a way that high values indicate less risk. (9) The world market share in exports of natural resources, to proxy for the availability of resources for extractive FDI. (10) The world market share of imports of parts and components for automobiles and electronic products, to capture participation in the leading TNC integrated production systems. (11) The world market share of exports of services, to seize the importance of FDI in the services sector that accounts for some two thirds of world FDI. (12) The share of world FDI inward stock, a broad indicator of the attractiveness and absorptive capacity for FDI, and the investment climate.

Inward FDI Potential Index Methodology, UNCTAD, 2002.

<http://www.unctad.org/Templates/WebFlyer.asp?int=2470&lang=1>

determine the potential for FDI for each of the 140 selected countries, on the basis of the chosen variables.

Even in Inward FDI Potential Index, India falls much behind China although China itself lags far behind Singapore, Hong Kong and Korea among the East Asian countries. Moreover, comparing absolute FDI inflow data with Table 9, we see that while China attracted FDI inflows more than that of U.S in recent years, it still lags much behind U.S. in the Potential Indices over the years. This confirms the already established fact that in terms of the socio-economic variables, U.S. is much ahead of China.

The comparative performances of India and China in the FDI arena are being studied extensively (Wei, 2000; Srinivasan, 2003; Swamy, 2003; Bajpai & Dasgupta, 2004). Several recent independent global surveys on FDI have also stated the close competition for FDI inflows between these two countries. Annexure 2 provides the findings of some most recent surveys on FDI inflows. While the research and surveys indicate that India is strongly competing with China in the FDI race²⁹, it is practically an established fact that China's track record in attracting FDI is far superior to that of India. The next two sections will identify the nature and extent of FDI discrepancy between India and China and explore to what extent India could overcome the existing discrepancy in FDI inflows that it possesses vis-à-vis China by aligning its FDI statistics in line with the IMF requirements that China already does.

4. FDI Under-Estimation Hypothesis

Under-estimation of FDI activities in terms of undervalued official FDI statistics tends to foster the false idea of low FDI-attractiveness of a country among the foreign investors. If the under-estimation hypothesis is justified then the cumulative FDI inflows in a country serves as low index of FDI potential of a country and India has suffered for long on this account. The time has come therefore, to check the definition of FDI in India, make appropriate alignment with the parameters of the international standard and

²⁹ The FDI Confidence Index Report by A T Kearney, one of the world's biggest business strategy consultants, subscribes to the fact that global investors upgraded India to sixth most attractive FDI destination worldwide in 2003, from fifteenth in 2002. Indian ranking was seventh in 2001, eleventh in 2000, sixth in 1999, seventh in 1998 and fifth in 1998.

The FDI Confidence Index is based on surveys of executives at the world's 1,000 biggest companies, which contributes about 70 per cent of FDI flows and generates \$18 trillion in annual sales.
FDI Confidence Index, A.T. Kearney, Inc. various issues.

³⁰ There is another source of raising equity in international capital markets, through acquisition of shares by Foreign Institutional Investors (FIIs) in Indian offshore market. The Indian offshore market has evolved since 1992 with the rise in demand for Indian equities by FIIs. The Indian Corporate offers their shares in the stock market of developed countries to raise capital. Essentially, it is the use of equity-based instruments like Global Depositary Receipts (GDRs), American Depositary Receipts (ADRs) and other equity-related vehicles that could be traded by non-US firms to raise capital in the US. The share of FDI approved through this route has nearly doubled over 1996-2000 period, compared to initial years of reforms.

find out actually where India stands in FDI-worthiness, vis-a-vis China before India loses any further in the FDI competition to China. Unless India makes serious efforts in evaluating this situation it could harm investor confidence in the country and could further dampen future FDI inflow, given the typical herd behavior of the prospective investors. Thus a meaningful alignment of FDI statistics in India could possibly reduce some gap between the FDI statistics of the two countries.

4.1 Pre-Adjustment Composition of FDI Inflows in India and China

IFC (2002) has pointed out that FDI in India was defined by the RBI in a way that does not conform to the 'international standard' as it did not include several components, which are included in international reporting norms of IMF as stated in Table 10. Compared to the international standard as well as to China, the reporting of FDI inflows in India's balance of payments statistics represented a much narrower coverage of FDI inflows. This was because it was confined only to foreign equity capital reported on the basis of issue/ transfer of equity or preference shares to foreign direct investors. Some of the principal components that India excluded from the IMF definition while estimating actual FDI inflows were:

- Reinvested earnings by foreign companies (which are part of foreign investor profits that are not distributed to shareholders as dividends and are retained and reinvested in the affiliates in the host country).
- Proceeds of foreign equity listings and foreign subordinated loans to domestic subsidiaries as part of inter-company (short and long-term) debt transactions.
- Overseas commercial borrowings (financial leasing, trade credits, grants, bonds) by foreign direct investors in foreign invested firms.
- Equity well over 20 per cent in the form of American Depository Receipts (ADRs) and Global Depository Receipts (GDRs) held by Foreign Institutional Investors (FIIs)³⁰.
- Investment made by international bodies in Indian companies as venture capital funds³¹.
- Grants given by the parent company to the subsidiaries in India³².
- Non-cash acquisition of equity³³, earnings data of indirectly held FDI enterprises, as per IMF definition, which are normally included in other country statistics.

³¹ Venture Capital is placed under Schedule 6 of Foreign Exchange Management Act (FEMA) Regulations 20/2000 dated May 3, 2000, which is not covered by the FC-GPR reporting system.

³² Grants given by the parent company to the subsidiaries in India account as a financial assistance from the parent company to its Indian subsidiary without any repayment obligation.

- Control premium³⁴ / non-competition fee, etc. paid by the foreigners³⁵.
- The investment made by foreign investor/entity on swap basis.
- Foreign currency convertible bonds³⁶.

China, contrary to India, adheres to the IMF/OECD standard of FDI computing (discussed in Annexure 3) and hence the Chinese system of reporting FDI is much more broad-based. China includes all the components prescribed by the IMF in its definition of FDI inflows. It also classifies imported equipment as FDI, while India captures these as imports in its trade data. China's FDI inflow numbers also include a substantial amount of 'round tripping',³⁷

³³ India restricts the definition mainly to hard cash. Unlike other countries, which include non-cash in the form of tangible and intangible components such as technology fee, brand name, etc. under equity capital, the Indian definition of FDI flows does not include non-cash in the form of technology and machinery.

³⁴ 'Control premium' is the premium paid to gain control of a company A by some investor B. It is the additional price paid by a controller in comparison to a non-controller, to acquire the majority status and the consequent privilege of exerting powers of majority ownership to manage the firm. Control premium can be quantified, for instance by estimating the excess earnings or profits that the company A is likely to generate as a result of B gaining control. The maximum premium B would be willing to pay is equal to the estimated excess returns.

Usually a control premium which recognizes not only the value of as control block of shares, but also compensates the minority stockholders for their resulting loss of voting power. Let us suppose that the company A's stock is valued at \$ 50 per share, inclusive of the control premium. If the minority shareholder who does not enjoy such control values the stock at \$ 30 per share, we can say that the minority discount is 40 per cent.

There has been some inflow to the Indian government in the form of control premiums received by the government of India in the recent divestment deals, e.g. \$208.34 million as control premium paid to the Indian government by Suzuki Motor Corporation of Japan against the divestment of equity holdings in the Maruti-Suzuki joint venture. The amount was paid by Suzuki towards shares issued by them on renouncing of rights by the government in the joint venture car company Maruti Udyog Ltd.¹⁸
<http://www.rediff.com/money/2003/feb/11fdi.htm>

³⁵ The reporting format for FDI prescribed under Foreign Exchange Management Act (FEMA) 1999 by RBI does not capture control premium / non-competition fee, etc. paid by the foreigner and as a result the FDI data is underestimated to that extent.

³⁶ In India, foreign currency convertible bonds are included in FDI only when it is converted into equity. Otherwise a foreign currency convertible bond is treated as external commercial borrowings (ECB).

³⁷ The practice of sending capital originating in mainland China to offshore tax havens and then reinvesting the money back to China as 'foreign' investment is popularly known as *round tripping* or *transit FDI* (UNCTAD, 2001). Under this system, mainland-originated money is recycled through a web of companies offshore. According to the 'round tripping' hypothesis, Chinese firms illegally transfer domestic (unaccounted) money to the neighboring countries and then invest it in the mainland as FDI inflows in order to benefit from the preferential treatment given to FDI in terms of taxation, labor policy, etc. Also, in the process, the unaccounted money on their way back into China become accounted for. Since round-tripping is essentially clandestine, accurate data is practically impossible to obtain. Nevertheless, it was

An informal official IFC study "FDI-India and China - A Comparison"³⁸, gave a disintegrated view of FDI inflows in India and China. It showed that China's equity capital of FDI in 2000 was composed of \$6.24 billion of non-cash, \$7.28 billion round tripping, \$16.02 billion of reinvested earnings, \$1.53 billion of other capital and \$7.28 billion of cash out of a total of \$38.35 billion FDI (Table 11). Considering the fact that India's equity capital (cash only) of FDI was \$2.32 billion in 2000, this needs to be compared with China's equity capital cash component of \$7.25 billion for that year.

The comparability of FDI data is an important issue. The nonconformance of India's FDI statistics to international standards has denied the aggregate FDI data for India direct comparability to those of most of the other countries. Especially, the fact that FDI inflows in India are entirely measured on equity investments while ignoring other components implies that FDI inflows into India have been underestimated. This has also created wider gaps between India's official reporting of FDI figures and those of many countries including China (Table 11), which conform to IMF standards. It was however surmised that if India adopts the IMF definition, its annual FDI inflow estimates may rise several-fold.

4.2 Post-Adjustment FDI Inflows Data in India

The RBI in mid-2003 revised the data on FDI from the financial year 2000-01 onwards by adopting a new definition of FDI in accordance with IMF norms. The earlier estimates were based only on equity investment by foreign companies. The revised data on FDI now include all items indicated under *equity capital* (except non-cash acquisitions). The equity capital of unincorporated entities includes the equity capital of foreign banks' branches in India. The new method of accounting also includes "reinvested earnings" and "other capital" as two additional categories of investments made by these foreign companies. While reinvested earnings refer to retained earnings of FDI companies, "other capital" covers inter-corporate debt transactions between related entities. All items under the *reinvested earnings*³⁹ have been included except reinvested earnings of indirectly held direct investment enterprises. Data under 'other capital'⁴⁰ relate to short-term and long-term inter-corporate debt, trade credit (more than 180 days), suppliers' credit (more than 180 days), and financial leasing. The inclusion of re-invested

estimated that in 1992, round-tripping FDI accounted for one-fourth of China's total FDI. According to another estimate, (Huang, 1998) round tripping was responsible for at least 23 percent of China's 1992 inward FDI.

³⁸ Srinivasan, G. (2002), "FDI Computing System Needs Changes", Business Line, India, November 4.

³⁹ Reinvested earnings has been compiled on the basis of information collected from DESACS Survey, CFD database, CMIE database and balance sheets of branches of foreign banks operating in India consisting about 1,700 FDI entities.

⁴⁰ Data on 'other capital' will be obtained from External Commercial borrowings Database. 'Technical Monitoring Group on Foreign Direct Investment: First Action Taken Report', Government of India, June 2003.
http://dipp.nic.in/first_new/atr.pdf

earnings and inter-corporate debt marks a change in the FDI definition in accordance with International Monetary Fund norms.

In this exercise, thus, out of the fourteen items mentioned by the IMF in Table 10, the following *six* items are not included in the revised Indian FDI inflow data. These are (i) non-cash acquisitions⁴¹, (ii) reinvested earnings of indirectly held direct investment enterprises, (iii) short-term trade credit, (iv) financial derivatives, (v) debt securities and (vi) land & buildings⁴². The government is exploring the feasibility of including these items in future. Adjusted⁴³ FDI data for these three years are presented in Table 12. It is evident that, the present coverage is significantly wider than the earlier practice of disseminating FDI data covering the equity capital only.

The earlier estimates were based only on equity investment by foreign companies. The new method of accounting includes “reinvested earnings” and “other capital” as two additional categories of investments made by these foreign companies. As a result, the FDI estimate has shot up. While reinvested earnings refer to retained earnings of FDI companies, “other capital” covers inter-corporate debt transactions between related entities. Short-term and long-term inter-corporate debt, trade credit, suppliers credit, financial leasing have been included in under the “other capital” head.

For the year 2000-01, the FDI into India has been pegged at \$4.03 billion instead of the pre-adjustment data indicating \$2.34 billion. This hike of 72 percent is accounted for by the newly included items -- reinvested earnings (\$1.35 billion), other capital (\$2.8 billion) and the banking capital of \$ 0.06 billion. Similarly, the revised FDI inflow figures for 2001-02 has also been increased by 57 percent. The revised aggregate FDI inflows declined by US 1.47 billion in 2002-03 (24 percent) compared to 2001-02. This

⁴¹ India restricts the definition mainly to hard cash. Unlike other countries, which include non-cash in the form of tangible and intangible components such as provision of capital equipment technology and know-how, brand name, etc. under equity capital, the Indian definition of FDI flows does not include non-cash in the form of technology and machinery. But the non-cash acquisition of equity needs to be integrated in the definition of FDI inflows to India because of its potential to generate direct and spillover benefits similar to those anticipated from FDI in the form of equity flows.

⁴² Fixed assets like land and buildings that is included in gross fixed capital formation are not brought under FDI inflows in India presumably because the government has FDI restrictions in certain types of real estate development like construction of modern office buildings, shopping malls, condominium buildings etc. 100 percent FDI inflows by NRIs and overseas corporate bodies (OCBs) on prior government approval may be permitted for projects such as the development of integrated townships, including housing, commercial premises, resorts, and hotels. However, the FDI guidelines stipulate that the foreign company should develop a minimum area of 100 acres of land in integrated townships to 20 acres with 3 years lock-in period as such a vast expanse may not be available in urban areas. In most cities, such a large acquisition is just not possible. Even if the foreign companies go for suburbs and smaller towns, providing external infrastructure would pose severe problems. It is expected that FDI inflows in India will start including real estate in its net only after relaxation of restrictions in real estate laws.

India Country Commercial Guide FY 2004: Investment Climate
http://64.233.161.104/search?q=cache:FS3_mOH4MPQJ:strategis.ic.gc.ca/epic/internet/inimr-ri.nsf/fr/gr121660f.html+debt+securities+fdi+india+2004&hl=en&ie=UTF-8s

⁴³ The adjusted figures on FDI are provisional. Finer data on FDI are expected to be compiled disseminated when reporting system is stabilized to capture data on trade credit, venture capital, financial derivatives etc.

was principally due to a sharp drop in fresh equity inflows, which might be indicative of a commensurate decline in fresh investment projects. Yet, compared to the pre-revision data, there has been a rise of the amount of about 73%.

The reinvested earnings and equity capital of unincorporated bodies are stipulated to be included in FDI data on an annual basis, as these data are available from the balance sheets of the FDI companies. Moreover, every year these data would become available with a time lag of one year. For instance, data for 2002-03 will be available by June 2004. Consequently, for these items, advance estimates will be incorporated in the balance of payment data until firm data become available with a time lag of one year. For 2002-03, the data on reinvested earnings are estimated as the average of 2000-01 and 2001-02. In the future as well, there will be a regular one-year lag in the reporting of reinvested earnings. "Other capital" could be captured on a quarterly basis and would be reported together with quarterly dissemination of the balance of payment statistics.

4.3 Observations

The alignment of Indian FDI reporting system in line with the international reporting practices has been a matured policy approach by the Indian government. On the one hand, it would render data precise and comparable not only between India and China but also with other economies that follows the same FDI measurement pattern. Moreover, this was expected to substantially improve the Indian FDI inflow figures in global standards with a refurbished data. This whole exercise also seemed to be a mandatory requirement considering that India is also a subscriber to the IMF's Special Data Dissemination Standard (SDDS) established in 1996⁴⁴.

Reinvested earnings

The inclusion of reinvested earnings is a major step in this regard. As Table 12 reveals, it is reinvested earnings that occupies the major share of the post-adjustment FDI inflows data and hence its inclusion has added value to the composition of FDI inflows to India. It was imperative that reinvested earnings, which are part of foreign investor profits that are not distributed to shareholders as dividends and are reinvested in the affiliates in the host country, are shown as inflow of FDI. Reinvested earnings have so far only been reported by companies on a sporadic and voluntary basis. Since India has had foreign companies for decades and many of them have reinvested heavily over the years, quantifying this would boost the stock of FDI considerably. If the retained earnings from all these are cumulated, then the current returns on the stock of retained earnings would have to be added to the returns on measured FDI. Added together, these total returns would be high relative to the stock of measured FDI.

However, even the flow of reinvested earnings in recent years can increase since several multinational companies (MNCs) have been reinvesting their profits in India and this is not being captured as FDI, a practice China adopts. Citigroup, for example, has

⁴⁴ Report on the Survey of Implementation of Methodological Standards for Direct Investment, IMF and OECD Directorate for Financial, Fiscal and Enterprise Affairs, March 2000.
<http://siadipp.nic.in/new/fdipress03.htm>

reinvested significant earnings in its Indian business over a sustained period--funds that are not captured in the FDI reporting. Its Citibank unit in India has retained earnings of about \$350 million was not captured in FDI reporting. The recent reinvestment of more than \$ 400 million in India by Citibank alone was not captured in FDI reporting⁴⁵. Similarly, the purchase of around \$300 million in non-equity form of direct investment capital by Fiat, the Italian automobile company, to compensate for the losses sustained by its Indian subsidiary was also not reflected in Indian FDI figures. Also, Coke and Pepsi have recently invested \$1.3 billion in India.

From a technical point of view, it is well recognized that it is quite difficult to capture 'reinvested earnings' through the reporting arrangements for foreign exchange transactions. This is mainly because such transactions do not actually take place and thus have to be imputed in the balance of payments statistics. However, the understatement of the total and reinvested earnings can be prevented by the inclusion of statistics regarding the indirect ownership in subsidiaries, associates and branches, etc. The reinvested earnings could also be captured through appropriately designed surveys by government authorities. The reporting system must be made legally mandatory for the companies through modification of the Foreign Exchange Management Act (FEMA) and the Industrial Development and Regulation (IDR) Act. Data on reinvested earnings with regard to 3,000 major companies have been included in revised FDI figures for 2002-03. A process to collect the data from a total of over 10,000 companies are on, while this has not been accounted in the 2002-03 figures. The areas that still need to be explored for FDI calculations are investment by MNCs for establishment of branch offices, and money flowing to a subsidiary from its parent corporation as grants.

Methodologically, reinvested earnings as an offsetting entry (with opposite sign) could also be notionally shown as dividends paid out under direct investment income in current account and as inflow of FDI. From a technical point of view, it is well recognized that it is quite difficult to capture 'reinvested earnings' through the reporting arrangements for foreign exchange transactions, mainly because such transactions do not take place though it have to be imputed in the balance of payments statistics.

The data on reinvested earnings are available with a lag since such data are collected from annual surveys on FDI companies. The latest available survey on 'Finances of Foreign Direct Investment Companies' relating to 1999-2000 was published in May 2001 issue of RBI Bulletin. In view of the lag in availability of reinvested earnings data, the direct investment transactions data disseminated in the balance of payments statistics for the first time do not include reinvested earnings. The inclusion of reinvested earnings also necessitates adjustment in other items of balance of payments in addition to changes in the inflow of FDI⁴⁶.

⁴⁵ 'India's FDI Inflows Set to 'Jump' Massively', *The Indian Express*, November 15, 2002.

⁴⁶ "Report of the Committee on Compilation of Foreign Direct Investment in India", October 2002, Government of India.
http://dipp.nic.in/first_new/fdi.pdf

Inter-company Debt Transactions

‘Other capital’ transactions between direct investors and direct investment enterprises, pass through the banking channel. There exists, however, the problem of identifying and isolating mutual borrowing and lending of funds among direct investors and direct investment enterprises. Recognizing the above-mentioned constraints, greater reliance needs to be placed on collection of such data through direct investors’ survey. The proper coverage of such transactions in India depends, therefore, upon the availability of information through the survey. The data on inward FDI for India did not include ‘direct investment in other capital’ till the revised data from 2000-2001. Revision has been made in 2003. Till then, the data regarding inter-company debt transactions were included under External Commercial Borrowings of the balance of payments.

Incorporation of Project Costs

One may think that evaluating project costs versus equity investment for India would theoretically be very useful in comparing India’s FDI flows with those of other economies in Asia. While till now, India reported FDI approvals on equity only, while southeast and east Asian countries take project costs which are usually higher than the value of foreign equity by three to four times, the differences are even more exaggerated.

Project costs include equity investment plus inter-company borrowings (including contributions by domestic partners, if any), imports of machinery and so on. However, machinery import by the subsidiary from the foreign investor is a legitimate trade transaction and is accounted for in the current account of the balance of payments. With inter-company borrowings recently coming into the fold of FDI statistics, project costs have duly been taken care of in India.

Conflicting situations may arise when we need to distinguish between direct import of machinery by the subsidiary firm from the foreign investor vis-à-vis using the equity of the foreign investor to import machinery of equivalent value from some source including the investor itself. In that case, India should take an unambiguous and transparent policy position – imports should be reckoned in the trade account, while equity in the FDI account.

Banking Capital of the Branches of Foreign Banks

Since foreign banks operating in India are branches of foreign banks, they are unincorporated bodies in India. Therefore, FDI inflows with respect to branches of foreign banks were not captured under the previous system that only captured FDI inflows in the form of equity investment in corporate entities. FDI inflows in the form of equity capital of branches of foreign banks have been captured by increment in equity capital during the year. This information has been obtained from balance sheets of individual banks. The bank deposits of the non-resident Indians (NRIs)⁴⁷ constitute a significant share of the equity capital of unincorporated entities. This is in the form of

⁴⁷ Nonresident Indians are defined as those who possess an Indian passport or whose father or paternal grandfather was a citizen of India.

acquisition of shares by NRIs in various Indian entities like software and bio-tech firms. Also, shorter term credit constitute a component.

Implication for Balance of Payments

The major change that has taken place in the balance of payments after the inclusion of the new items under the new definition of FDI inflows is with regard to the inclusion of reinvested earnings under investment income (as paid out dividends) in the current account⁴⁸. Methodologically, reinvested earnings as an offsetting entry (with opposite sign) could also be notionally shown as dividends paid out under direct investment income in current account and as inflow of FDI. From a technical point of view, it is well recognized that it is quite difficult to capture 'reinvested earnings' through the reporting arrangements for foreign exchange transactions, mainly because such transactions do not take place though it have to be imputed in the balance of payments statistics.

Following the above methodology, appropriate changes have been made in the current and capital account transactions of the balance of payments. The current account surplus during 2001-02, which amounted to US \$ 1.4 billion, has been revised to a surplus of US \$ 0.8 billion. Furthermore, the current account deficit during 2000-01 has increased from US \$ 2.6 billion to US \$ 3.6 billion. This is mainly on account of adjustment of reinvested earnings as a contra entry in the investment income. The other major change is the reduction in errors and omissions in both the years. In net terms, the *errors and omissions* have been revised from US \$ (-) 0.59 billion to US \$ (-) 0.57 billion during 2000-01 and from US \$ 0.86 billion to US \$ 0.40 billion during 2001-02⁴⁹.

⁴⁸ At the company level, reinvested earnings can be defined as the positive or negative difference between a company's profit and the distributed dividends. At the macroeconomic level, reinvested earnings are measured as a balance between reinvested earnings on domestic direct investment abroad on the one hand and on foreign direct investment on the other hand. According to the IMF Fifth Balance of Payments Manual, transactions may be imputed and entries may be made in the balance of payments accounts in some cases when no actual flows occur. The reinvested earnings are the typical example of such a flow as the earnings, whether distributed in the form of income dividends or reinvested in the enterprise, are included in the balance of payments. Reinvested earnings are included in the balance of payments within the double-entry bookkeeping principle. First, reinvested earnings are included in the financial account as the part of the foreign direct investment to reflect the direct investor's increased investment in the foreign subsidiary or branch. Second, reinvested earnings of a foreign direct investment enterprise are also recorded as a liability within net income receipts in the current account to represent the direct investor investment income on equity. The surplus of reinvested earnings in domestic economy has positive impact on the financial account due to increasing net direct investment, though the impact on net income receipts within the current account is of equal amount, but with reverse sign. Thus, reinvested earnings increase the inflow of the foreign direct investment, while they also increase the deficit of the current account. In this respect, the impact of the reinvested earnings on the balance of payments is neutral as its positive impact on the financial account is offset by its negative impact on the current account. in the IMF Balance of Payments Methodology

⁴⁹ The detailed balance of payments data revised as per above have been released in a separate RBI press note on June 30, 2003.

The data on reinvested earnings are available with a lag since such data are collected from annual surveys on FDI companies. The latest available survey on 'Finances of Foreign Direct Investment Companies' relating to 1999-2000 was published in May 2001 issue of RBI Bulletin. In view of the lag in availability of reinvested earnings data, the direct investment transactions data disseminated in the balance of payments statistics for the first time do not include reinvested earnings. The inclusion of reinvested earnings also necessitates adjustment in other items of balance of payments in addition to changes in the inflow of FDI⁵⁰.

'Other Capital' reported as part of FDI inflow has been carved out from the figure reported under external commercial borrowings by the same amount. Thus, on this count too, there has been some change in the composition of Indian balance of payment since 2000-01. However, because this is just a repositioning of a balance of payment item from one head to another, there is supposed to be no commensurate change in the balance of payment accounts for this movement.

According to RBI, in terms of standard practice of balance of payments compilation⁵¹, the above revision of FDI data is not expected to affect India's overall balance of payments position for the 2001-02 and 2002-03, that is, the accretion to foreign exchange reserves would not undergo any change. In general, the foreign exchange reserves in India have been on an increasing trend since 1991 to early 2004. Much of it is attributable to the strong increase in capital inflows in the form of bank deposits of expatriate Indians, foreign institutional investors' (FII) funds in the stock market, outstanding commercial borrowings, suppliers' credit and all short term loans.⁵²

In fact, whether FDI adds to net inflow of foreign exchange or leads to a drain of foreign exchange depends on the corporate policies of dividend remittances and import intensity of manufacture. FDI units, particularly in the automobile sector, tend to tie their manufacturing process to imports of components. Hence, the higher exports may not

⁵⁰ "Report of the Committee on Compilation of Foreign Direct Investment in India", October 2002, Government of India.
http://dipp.nic.in/first_new/fdi.pdf

⁵¹ "Overall balance shows \$17b surplus in 02-03", The Hindu, July 1, 2003.

⁵² India has the sixth largest forex reserve in the world, ahead of U.S., Germany, France, to name a few. This rise in foreign exchange reserves is partly attributable to the capital inflows in the form of bank deposits of non-resident Indians (NRIs), foreign institutional investors' (FII) funds in the stock market, outstanding commercial borrowings, suppliers' credit and all short term loans. The FII funds were negligible in 2002, but they exploded in the second half of the year 2003. The rise in secondary market prices of shares was caused mostly by steep fall in interest rates on bank deposits. The FII portfolio investment which crossed \$ 10 billion in 2003 was clearly aimed at reaping huge gain out of rising prices of shares in secondary markets. But while doing so, it causes an appreciation of the rupee. The NRI deposits in Indian accounts are also aimed at taking advantage of the appreciation of the rupee. Another major factor, in fact the single largest factor driving the accretion in foreign exchange reserves in the year 2002-03 was banking capital. Banks borrowed abroad at low interest rates and lent at home at higher interest rates.

translate into equally high foreign exchange earnings, unless the investor sets up local units to produce components.

The RBI has in December 2003 (RBI Bulletin, 2003) published a study of FDI companies in India for the year 2001-02. It has pointed out the high intensity of imports to exports of the automobile-related industry. It is perhaps explained by the presence of CBU (completely built-up units) in the industry. The existence of a high ratio of imports to exports in wholesale and retail trade should also be explicable in terms of India acting as a re-export hub. But the figures need some explanation. The relatively low figures in computer and related sectors are perhaps because of value addition.

FDI inflows can also contribute to foreign exchange earnings if there is favorable export intensity of sales of FDI units. The study does not also convey any significant information in favor of FDI as an export enhancer. The surmise regarding re-export explaining the high import-export ratio for wholesale and retail trade also stands discredited by the low export sale ratio. How far FDI inflows can add to net inflow of foreign exchange or leads to a drain of foreign exchange is a potential area of research.

Resulting Change in FDI Inflows in India

At the end of the adjustment exercise it is now time to check whether the gap between the post-adjustment FDI inflows in India with the Chinese inward FDI flows have reduced significantly. Comparing Table 7 with Table 12, we observe with dismay that even after the increase in FDI inflows to India corresponding to the alignment, the Indian FDI inflows are still much lower than the Chinese counterpart. Indian inward FDI flows was around 38 percent of Chinese figures in 2000-01, 53 percent in 2001-02 and once again 38 percent in 2002-2003. Overall, Indian FDI is less than half of FDI inflows in China. However, there is a documented evidence (Harrold & Lall, 1993; Gunter, 1996; Sicular, 1998; Huang, 1998, 2002; Tseng and Zebregs, 2002) of the possibility that the Chinese FDI may be over estimated due to round tripping⁵³ of FDI inflows into China.

Clandestine round tripping of FDI inflows in China is common knowledge but given its surreptitious nature, accurate data on round tripping is practically impossible to obtain. Nevertheless, different economists and institutions have presented various estimates of round tripping over years (Lardy, 1995; Huang, 1998; IFC, 2002; Subramanian, 2002; Wu, Yeo and Puah, 2002; Bhaskaran 2003). Even if we take the most recent estimate of the IFC (2002) which claims that as large as around 50 per cent of Chinese FDI inflows is the result of round tripping, then post-adjustment Chinese FDI figures become \$ 10.36 billion in 2000, \$ 23.44 billion in 2001 and \$ 26.37 billion in

⁵³ The practice of sending capital originating in mainland China to offshore tax havens and then reinvesting the money back to China as 'foreign' investment is popularly known as *round tripping* or *transit FDI* (UNCTAD, 2001). Under this system, mainland-originated money is recycled through a web of companies offshore. According to the 'round tripping' hypothesis, Chinese firms illegally transfer domestic (unaccounted) money to the neighboring countries and then invest it in the mainland as FDI inflows in order to benefit from the preferential treatment given to FDI in terms of taxation, labor policy, etc.

2002⁵⁴. Comparing the Chinese figures with Indian FDI figures post alignment, it is immediately observed that Chinese FDI inflows is 2.6 times larger than that of India in 2000-01, 3.8 times larger than that of India in 2001-02 and nearly 5.7 times larger than that of India in 2002-03. In other words, the gap between Indian and Chinese FDI inflows is consistently rising over the last 3 years.

Given the above revisions, can one conclude that India's efforts in attracting FDI inflows during the last decade have succeeded? Unfortunately, the answer continues to be negative. FDI into India is only about one per cent of its GDP. During the last few years, FDI into developing countries has been above \$200 billion a year. Hence, even with the upward revision of data, India's share is only 2-3 per cent of FDI into developing countries. Countries like China, Mexico and Brazil continue to attract far more FDI.

5. Foreign Investors in China and India

An important point that is usually overlooked in comparing the Indian and Chinese FDI is that there is an intrinsic difference between the source of FDI inflows between India and China. While a substantial portion of the FDI to China comes from overseas Chinese who are businessmen and are shifting manufacturing operations to main-land China, a significant percentage of inward FDI inflows to India comes from the MNCs. This section will evaluate the relative contributions of the MNCs in the two countries vis-à-vis the expatriate population. The purpose of this exercise is to identify the potential FDI investors for India for an appropriate designing of the investment climate in the economy. India can attract FDI inflows by creating for itself a conducive investment climate (Bajpai and Sachs, 2000). Perhaps, then, India can possibly withstand Chinese competition in the market for FDI inflows and achieve the benefits that FDI inflows bring in.

5.1 The Case of China

Disaggregation of Expatriate Contribution vis-à-vis MNC Participation in Chinese FDI Inflows

Chinese government, through a decree passed on 18th August 1990, provides for special rules and regulations to encourage investments by overseas Chinese. The government has thus pursued an active policy to attract investments by the Non-resident Chinese (NRCs). This shows that China has maintained its links with the Chinese abroad, both culturally and economically⁵⁵.

⁵⁴ Indian FDI inflow figures are presented not in terms of calendar years as in China but in terms of financial years covering 1 April of one year to 31 March of the next. Thus we compare Indian financial years 2000-01, 20001-02 and 2002-03 with Chinese years 2000, 2001 and 2002.

⁵⁵ CII News, Confederation of Indian Industry (CII), Press Releases: January, 2003
<http://216.239.57.100/search?q=cache:kImcg6FdnGMC:www.ciionline.org/news/pressrel/2003/Jan/8Jan5.htm+nri+fdi+state+sector+india&hl=en&ie=UTF-8>.

It is evident from Table 13 that approximately over two thirds of China's FDI inflows have been consistently made by the overseas Chinese Diaspora in the 1990s and consequently less than one-third has come from non-Chinese sources. Expatriate investment in China has essentially been a process of relocation of export oriented simple labor-intensive manufactures from the neighboring expatriate settlements into China. This process has been facilitated by China's low wages coupled with rapid growth of manufactured exports globally.

Since 1994, the proportion of FDI flows from non-Chinese sources has increased, but, in spite of this, even now the FDI flows from overseas Chinese sources are very large. The huge FDI made by the Chinese Diaspora could be explained in terms of the following factors⁵⁶.

- ◆ A substantial portion of the FDI to China comes from overseas Chinese living in an arc of Pacific Rim, especially Taiwan, Macao, Hong Kong and Singapore. This Chinese diaspora pioneered export-led growth with labor-intensive manufacture (e.g. toys, wigs and textile assembly lines) in Taiwan, Hong Kong and Singapore, and, once wages there rose sharply, it re-located these manufacturing operations to mainland China⁵⁷ when the economy was opening up in the 1980s taking with it the huge volumes of FDI that the country is now known for. This possibly explains, at least partially the present Chinese export machinery centering on the manufacture and shipping of light manufactured goods.
- ◆ The overseas Chinese have acquired a strong interest in investing in China because of the benefits that they derive in way of making FDI in China. These economies had begun to switch over from the manufacturing to the services sector just when China liberalized its economy in 1979. They got incentives from China that encouraged them to shift their manufacturing industries lock, stock and barrel to the coastal provinces of China. Some of these benefits were in the form of Special Economic Zones (SEZs), tax holidays, hassle-free bureaucratic clearances, cheap labor, knowledge of country and its policies, local partners, reasonably good infrastructure, overall government promotion of such FDI for the huge Chinese market as well as the huge export market that China has come to capture over time. This movement also brought with them their overseas markets and customers together with their equipment, knowledge and expertise. The very same industries manufacturing goods such as textiles, toys, sports goods, leather articles etc continued to cater to the same

⁵⁶ Raman, B (2003), "NRIs and the Elusive Indian Miracle", South Asia Analysis Group, Paper No. 576, January.
<http://www.saag.org/papers6/paper576.html>

⁵⁷ Chinese government, through a decree passed on 18th August 1990, provides for special rules and regulations to encourage investments by overseas Chinese. The government has thus pursued an active policy to attract investments by the Non-resident Chinese (NRCs). This shows that China has maintained its links with the Chinese abroad, both culturally and economically.
CII News, Confederation of Indian Industry (CII), Press Releases: January, 2003
<http://216.239.57.100/search?q=cache:kImcg6FdnGMC:www.ciionline.org/news/pressrel/2003/Jan/8Jan5.htm+nri+fdi+state+sector+india&hl=en&ie=UTF-8>.

markets and customers abroad, but from factories in China and not in Hong Kong or Taiwan⁵⁸. The huge market for its exports of consumer articles in the USA, Japan etc was not created by China after 1979. It was inherited by it from Hong Kong and Taiwan and further expanded.

- ◆ The overseas Chinese business class of South East Asia was in the lead of the pre-1997 economic miracle in those countries. Part of the profits earned by it was diverted to China as FDI flows.
- ◆ During the Communist regime in China, personal possession was declared illegal. Some citizens surrendered their possessions to the Communist Government; others kept them hoarded. After 1979, taking advantage of the liberal economic atmosphere, these hoarders sent their wealth (gold, jewelry and other items) clandestinely to their relatives abroad, who converted the wealth into cash which returned to China as FDI flows. So long as the money came back as productive investment, the Chinese authorities did not object to the inflow.

The Chinese official statistical database does not provide a disaggregated FDI statistics that would directly project the relative contribution by the Non-Resident Chinese (NRC) population in the country. However, based on the fact that a large proportion of NRCs residing in Hong Kong, Macao, Singapore and Taiwan make FDI to mainland China, we will make the assumption that, in broad terms, -- any FDI originating from these countries will constitute expatriate FDI and mainland Chinese funds routed through local financial agents - roundtripping. While it is very likely that the entire FDI from these economies to China may not be totally from the NRCs, but a very large part of it actually is. Given that we're simply trying, in broad terms, to segregate FDI by NRCs and the MNCs, this procedure will enable us to get at least a rough idea of the amount of FDI by the NRCs in China. Accordingly, we have computed the FDI contribution of Hong Kong, Macao, Singapore and Taiwan to mainland China over 1992 to 2001 in Table 14. It is evident that the share of OECD countries and with it the share of MNCs in Chinese FDI inflows has been rising over the 1990s while the share of Singapore, Macao, Taiwan and Hong Kong (supposedly the NRC contribution) is falling. NRC contribution, which was nearly 80.5% of the total Chinese inflows in 1992, has gradually decreased over the 1990s, being on an average about 60.56% over the decade. But nonetheless, even in 2001, more than 47% of FDI inflows to China came from these four countries⁵⁹.

⁵⁸ The Indian policy of small scale industry product reservation meant that India virtually gave up the market for many products to China.

⁵⁹ There is a controversy among economists regarding the volume of expatriate contribution derived from Singapore. They opine that unlike Hong Kong, Macao and Taiwan, FDI from Singapore cannot be claimed to be from expatriate sources because of the substantial MNC activity in Singapore. That is why, we have also calculated the percentage contribution of NRCs to the Chinese FDI excluding Singapore in Table 3. It is interesting to note that while the percentage contribution to FDI excluding Singapore in 1992 was slightly lower (79.37) than that including it, this figure showed significant difference over the decade and in 2001, it was 42.7%, that is much lower than the FDI contribution including Singapore. This implies, one that Singapore's contribution to Chinese FDI inflows increased over the decade and two, there is a need for undertaking a separate study for exploring the actual ratio of expatriate and MNC contribution to Chinese FDI inflows from Singapore. We intend to do that in a subsequent research. Right now, we will assume

MNC Participation in FDI Inflows to China

For more than two decades, foreign capital invested by the MNCs have accelerated the development of China's manufacturing industry. Endowed with the world's largest population, China has virtually become the focal point of global corporations who seek cheap labor as well as the potential of reaching the world's largest market of consumers in an environment of policy preferences given by Chinese government to induce FDI inflows⁶⁰.

While foreign investments into China have mainly been from Hong Kong and Taiwan, MNCs from the developed nations have, of late, emerged as significant investors. Even such Latin American countries as Cayman Islands have become key pushers of FDI into China. In 2001, 23 per cent of the increase in FDI was by Japanese investors alone (Majumder, 2003).

5.2 The Case of India

Disaggregation of Expatriate Contribution vis-à-vis MNC Participation in Chinese FDI Inflows

As a stark contrast to the Chinese experience, the Indian diaspora did not follow the similar route in spite of gradual attempts by the government to simplify the regulations involving NRI investments into the country⁶¹. This explains the very low NRI

that the contribution to FDI from Hongkong, Macao, Singapore and Taiwan is an index of NRC participation in Chinese FDI inflows.

⁶⁰ Most of the Top 500 MNCs in the world have been investing in China in recent years. For instance, the foreign share in the market of facsimile and video camera reaches 98% and 99% respectively, while the mobile phone 80%, the computer 75%, the car 70%, and the digital program controlled switch 50%. Now there are 8 large enterprises producing large-sealed integrated circuit in the micro-electricity industry in China, 5 of which are Sino-foreign joint venture, and one of which is exclusively invested by foreign capital. among the 5 enterprises jointly owned, only one is dominated by Chinese enterprise while 4 are dominated by foreign enterprises. In the engineering mechanics industry, there are 126 joint ventures, 36% of which are dominated by foreigners, while 47% of which are dominated by Chinese enterprises, and 17% of which are equally owned.

Yifang, N., Wen, G & Xiaobo, W, (2002) "The Opportunities, Threats and Counter-measures of China's Manufacturing Industry Under the Globalization", School of Management, Zhejiang University, Hangzhou, China.

⁶¹ NRIs are observed to be an important source of FDI in India. The government of India has been offering high interest to attract foreign investors since 1991. NRI investment are a part of both FDI and portfolio investments and since economic reforms, large portion of NRI investment was attracted under the portfolio scheme. The NRIs were targeted as a specific group with special incentives, including high interest rates and low tax rates. Further, NRI investments were attracted through the announcement of various NRI-schemes by the Reserve Bank of India. However, the share of NRI investment in total FDI approvals has been declining, particularly in the later years of reforms.

In general, the NRIs can avail themselves of the general policy and facilities for FDI as available to foreign companies. In addition, the Government, in the course of economic liberalization, has extended some concessions especially for NRIs and Overseas Corporate Bodies (OCBs) predominantly owned by the NRIs. These include:

investment in India (Guha and Ray, 2002; Bajpai and Dasgupta, 2002). The official statistics on FDI data in India clearly identifies the dichotomy in the source of FDI inflows in terms of expatriate and non-expatriate route that can be assumed to reflect the MNC contribution to the FDI inflows. This can be seen in Table 15⁶².

Table 15⁶³ reflects the diversity in the sources of FDI data in India over 1991-92 to 2000-01. The actual total FDI in India is composed of those sanctioned by RBI's automatic approval route for equity holding up to 51%, those through the discretionary approval route of the Secretariat for Industrial Assistance (SIA)/Foreign Investment Promotion Board (FIPB) for larger projects with equity holding greater than 51%, NRI investments and also the acquisition of shares (since 1996). It is evident from the table that over the ten years following liberalization, the FDI inflows from NRI sources was on an average, around 13.8% as compared to an average of nearly 78% from non-NRI

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- ❑ Prior approval by RBI for bringing in FDI/NRI/OCB investment and issue of shares to foreign investors after FIPB/Government approval is done away with.
 - ❑ While no foreign investment is permitted in the real estate sector, NRIs/OCBs are permitted in the real estate and housing sectors up to 100 per cent.
 - ❑ NRI/OCB investment in domestic airlines sector is permitted up to 100 per cent while foreign investment is limited up to only 40 per cent;
 - ❑ NRI/OCBs are permitted to invest up to 40 per cent in the banking sector whereas foreign equity other than investment by multilateral financial institutions is permitted only up to 20 per cent:
 - ❑ while foreign equity and OCB equity is limited up to 24 per cent in the case of SSI units, NRIs can invest beyond 24 per cent in such units in the first instance provided they do not have a stake in any other industrial undertaking; and
 - ❑ NRI/OCB can invest up to 100 per cent in a large number of sectors, which include mining, plantation, manufacture of food products, transport equipment, electric generation and transmission etc.
 - ❑ NRIs and OCBs are allowed to invest in up to 5 per cent equity in listed companies. Aggregate investment limit raised from 5 to 10 per cent.
 - ❑ NRIs/OCBs are allowed to acquire shares of Indian companies and mutual funds listed on an exchange in India and to invest directly in Indian firms.
 - ❑ NRIs may also own 100 percent of Indian firms, including those considered high priority sectors, without permission from the RBI.
 - ❑ NRIs can repatriate capital and dividends but it depends on the percentage of NRI ownership and the sector in which the investment has been made.

<http://meadev.nic.in/clinton/factsheets/fact-fdi.htm>,

India News, published by the Press, Information and Culture Wing, Embassy of India:

[http://www.indiagov.org/inews/January\(2\)99/nri.htm](http://www.indiagov.org/inews/January(2)99/nri.htm)

Competing for Global FDI: Opportunities and Challenges for the Indian Economy”, Sadhana Srivastava and Rahul Sen

⁶² The Government of India also provides another account of FDI inflows in its annual publication of *Economic Survey*. The difference between this account and the one provided by the RBI is that the *Economic Survey* classifies ADR/GDR inflows as FDI while the RBI account records them under foreign portfolio investment.

⁶³ FDI statistics in India are monitored and published by two official sources: (a) Reserve Bank of India (RBI), and (b) Secretariat for Industrial Assistance (SIA) in the Ministry of Commerce and Industry. The finance and external affairs ministries also play their part from time to time. The RBI presents balance of payment statement in the RBI Bulletin and its Annual Report on monthly and annual basis, respectively. SIA reports FDI inflows on both approval and actual basis in its monthly SIA's Newsletter and SIA Statistics.

sources. Thus, expatriate investment has been very small portion of aggregate FDI in India, in spite of gradual attempts by the government to simplify the regulations involving investments by the NRIs into the country. This reflects that given the present scenario, the expatriate Indians do not seem to form a large segment of the target investors in India, unlike in China. The proportion of FDI into India flowing from the non-NRI sources has been on an average, steadily rising since 1992, reaching 97 percent in 2001. Also, on an average, FDI inflows into India from non-NRI sources have been around 5.8 times that from NRI sources. This figure is an indication of the growing interest of MNCs in India.

It is observed that an important source of FDI in India is through Non-Resident Indians (NRIs). The government of India has been offering high interest to attract foreign investors since 1991. NRI investment are a part of both FDI and portfolio investments and since economic reforms, large portion of NRI investment was attracted under the portfolio scheme. The NRIs were targeted as a specific group with special incentives, including high interest rates and low tax rates. Further, NRI investments were attracted through the announcement of various NRI-schemes by the Reserve Bank of India. However, the share of NRI investment in total FDI approvals has been declining, particularly in the later years of reforms.

MNC Participation in FDI Inflows to India

MNC participation in FDI Inflows to India is an old phenomenon that got largely waned out with the Monopolistic and Restrictive Trade practices Act (MRTP) Act and Foreign Exchange Regulation Act (FERA) in the 1970s. However, since liberalization, repealing of MRTP and delicensing⁶⁴, more and more MNCs are operative in the Indian economy (see Table 16). Some of them may have been attracted to make FDI in India with the opening up of the economy. Many others were already functioning in the economy with minority shareholdings in the joint ventures. A large number of these companies have increased their holdings to 51% or more with the liberalization (Dasgupta, 1999).

However, MNC participation in Indian FDI stands remarkably low as compared to China. This is evident from the fact that the multinationals from the Western world as

⁶⁴ Prior to 1991 investment decisions were subject to Government directives. Progressive deregulation and decontrol came into being since 1991³. Industrial license is now required only for industries under compulsory licensing where licensing continues purely on public health, safety and security considerations. Manufacturer of items reserved exclusively for Small-Scale Sector and the project is to be located around large cities. No industrial license is required for remaining items.

Industries exempted from licensing are now required to file only the relevant information in the prescribed Industrial Entrepreneurs Memorandum (IEMs) with the Secretariat for Industrial Assistance (SIA) with no requirement of further approvals. At the State level, serious efforts for simplifying the rules and procedures for setting up and operating industrial units have been made. A 'single window' system is now in existence in most of the States for granting approval for setting up industrial units.

well as Japan and some Asian countries have poured in more than \$300 billion⁶⁵ into China over the 1990s as compared to around \$15 billion into India⁶⁶.

5.3 Comparison of MNC versus Expatriate Contribution to FDI inflows between India and China

Because of lack of a similar data-base in India and China that categorically shows the FDI inflows coming from the expatriate sources as distinct from those coming from non-expatriate sources, no direct comparison of MNC versus non-resident contribution to FDI inflows between India and China is possible. As such, we have chosen to address this issue in an alternative way.

We have selected a number of source countries from across the continents (excluding, Singapore, Hong Kong, Macao and Taiwan) that make significant FDI in both China and India and we have categorized the FDI inflows from these countries as MNC investment inflows as distinct from expatriate investment inflows. On the basis of this assumption which we consider to be valid in the absence of disaggregated data, we have compared their respective FDI contribution in the two countries. These fourteen countries are Japan, Republic of Korea, Mauritius, Virgin Islands, United Kingdom, Federal Republic of Germany, France, Italy, Netherlands, Sweden, Switzerland, United States, Australia and Canada. Tables 14 and 17 show the country-wise FDI inflow in China and India⁶⁷ respectively.

Table 18, computed on the basis of the previous two tables reflects a number of facts. First, while the FDI contribution of the aforesaid countries to China during the 1990s was only 14.91%, that to India is slightly greater than 67%. This is an indicator of the relatively greater MNC participation in the FDI inflows of India as compared to China. This corroborates our finding in the last row of Table 4a where on the basis of a 1991-2001 FDI data, we showed that the participation of MNCs in the Indian FDI inflows over this period was around 77%⁶⁸.

However, while in terms of percentages to total FDI inflows, country-wise FDI to India exceeds China, yet the individual contribution of these countries to China is much higher than that flowing to India. This is evident from the last column of Table 8 where

⁶⁵ This figure is obtained in Table 14, by adding FDI inflows to China over 1992 to 2001 from Japan, Republic of Korea, Mauritius, Virgin Islands, United Kingdom, Federal Republic of Germany, France, Italy, Netherlands, Sweden, Switzerland, United States, Australia and Canada.

⁶⁶ This figure is obtained in Table 15, by subtracting NRI contribution from the total official FDI inflows to India over the 1990s.

⁶⁷ Although substantial FDI inflows have taken place from Singapore to India over 1992-2000 (\$1858.91 million) and such FDI is rightfully of the MNC variety, yet to maintain parity with the Chinese scenario we have not included it in the MNC contribution to FDI inflows in India.

⁶⁸ The figures do not match exactly because of differences in the data sources. However the largeness of the two figures indicate a similarity of the results and hence it may be concluded that MNC participation in Indian FDI inflows over the 1990s has been substantial.

we have measured the China-India ratio of FDI inflows according to source countries. On an aggregate, FDI inflows to China from the stated source countries are more than three times that to India. The FDI inflow to India exceeds China only from Mauritius. The special role of Mauritius here is likely to be the consequence of the special tax treatment (Double Taxation Treaty) accorded in India to investments routed through Mauritius.

We have ranked the fourteen countries making MNC investment in China and India respectively in Table 18. In terms of the country-wise breakup of FDI inflows, the most important FDI-making countries to India are U.S. (23.89 percent), followed by Mauritius (10.25 percent), and UK (7.52 percent). The corresponding figures for China are US (rank 1 with 3.88 percent) followed by Japan (3.51 percent) and the Virgin Islands (1.88 percent).

The simple correlation coefficient between the ranks comes out to be around 0.28. This means that there is very little consistency among the relevant ranks of the two countries in terms of source country FDI. The little bit of consistency that is perceived is that while US is the forerunner in FDI in both India and China -- France, Netherlands and Sweden take the eighth, ninth and fourteenth positions in both the host countries. There is lack of consistency in the ranks among the other ten countries of which some amount of similarity in ranks has been observed for Korea, Germany and Switzerland. Extreme difference is found for Mauritius and Virgin Islands, which have been alleged for round-tripping of FDI in India and China respectively.

It is to be noted that Chinese FDI data till 1996 comprised 'other' investment elements as well. These 'other' elements included value of equipment supplied by foreign businesses in transactions of compensation trade, processing and assembly and value of equipment supplied in financial leasing transactions. Thus, there is no direct comparability of FDI statistics between China and India till 1996. Moreover, country-wise FDI data for China shows the actual utilization data while the Indian counterpart is available only for the approval statistics. In spite of these dissimilarities we have no option but to study the available data in the absence of alternative comparable FDI statistics for India and China. The year-wise approved FDI for India is visibly much less than the actually used FDI in China. Given the wide discrepancy between annual actual and approved FDI in India as disclosed by official reports, one can just imagine the actual FDI that really gets flowed into India from these foreign countries. Thus, the actual MNC participation to FDI in India is presumably much lower as compared to that in China. However, compared to expatriate investment in India, the MNCs are major players in the market for FDI inflows.

6. Sectors attracting FDI Inflows in India and China

The sectoral breakdown of FDI inflows in India over 1992 to 2002 is shown in Table 19. In the early years of the 1990s, FDI was heavily concentrated in manufacturing activities, as a legacy of the pre-reform years which was due to import-substituting industrialization that encouraged tariff-jumping investments to capture the protected domestic market (Munjal and Pohit, 2001). However, the trend has clearly changed in the

latter 1990s towards an increase in foreign investment in the tertiary sector that encompasses mainly services⁶⁹ activities. The service sector attracted a significant share of the FDI in 2002 (38 per cent of the total FDI, leaving 61 per cent for the manufacturing sector). Within the manufacturing sector, FDI in the chemicals, finance, food and dairy products and the pharmaceutical sector have shown a remarkable decline since the mid-1990s. FDI in engineering industries displayed a downward trend but still could retain an 8 per cent share in 2001-02. FDI was rarely available for infrastructure projects. On the whole, manufacturing sector still contributes the major share of FDI inflows (61 per cent in 2002) although the share of the service sector is on the rise. It gives us the impression that FDI is flowing into areas in India where skilled labor is a major input.

The SIA data on sectoral allocation of FDI provides a more detailed breakdown of FDI inflows compared to the RBI data. In terms of the industries where FDI has flown into India, Table 20 shows that the most important sectors are telecom⁷⁰, electrical equipment including computer software, energy, and the transportation industry⁷¹. These four sectors accounted for roughly 47 percent of FDI inflows. So far as approval is concerned, energy (power and oil refineries), telecom, electrical equipment including computer software and electronics are the sectors that have attracted highest FDI approval indicating the priorities of development and growth of these sectors in the government psyche. The service sector includes the Information and Communication technology (ICT) sector (comprising of telecommunication, computer software, consulting services, etc), as well as power generation, and hotel and tourism. The share of services sector (including all the above) in total FDI inflows was about 47 per cent during 1991-2004 (Table 20). The ranking of the actual FDI inflows in Table 20 also indicate a clear shift towards the tertiary sector in the post-liberalization regime in India. Thus, there seems to be a match between the areas where Indian government has been inviting FDI (visible from the approval data) and the sectors which could in reality attract the foreign investors as shown by actual FDI inflows.

It has been evident from Table 21 that FDI inflows in manufacturing has maintained the lead position in China since 1999, the different categories of which are not explicit from the data source. It can be presumed that manufacturing includes all low technology as well as technology-intensive production sectors. Real estate has been upgraded from a fifth position in 1999 to a second rank since the next year. The FDI inflows in electric power, gas and water supply has been gradually deteriorating from

⁶⁹ FDI in India is gradually entering into the finance and service sectors and will be continuing to do so with the emerging trend of US companies outsourcing their routine services to India.

⁷⁰ It has been revealed in the FDI Confidence Index, 2002 by A.T. Kearney, that telecom and utilities investors consider India as their 25th most attractive investment destination. This is probably stimulated by new policies and regulations, including allowing telecom service providers to carry forward losses and unabsorbed depreciation, measures that facilitated the merger of Birla Tata AT&T and BPL Communications in June 2002.

⁷¹ In the 1990s, with software and telecom fever gripping India, FDI flows were largely into these two sectors.

1999. Social services have been figuring out as a vital area in the FDI portfolio of foreign investors in China while wholesale and retail trade has been improving from an insignificant FDI-driving sector to the sector that could ranked fifth in attracting FDI inflows in 2001.

There is a remarkable difference in the expanse of the areas of foreign investments in India and China. FDI in China is rather extensive, being diffused over agriculture (farming, forestry, animal husbandry and fishery), mining, manufacturing and significantly into the tertiary sector. Moreover, social-welfare related sectors like education and healthcare and wholesale and retail trade that have not yet been targeted in India as sectors competent for attracting FDI inflows, have contributed to FDI in China. Labeled as the cheapest workshop in the world, China attracts FDI mainly into the manufacturing sector, which accounts for over 70 percent of the approvals; the service sector accounts for less than 1 per cent of the inflows, which is not so in India. India attracts more than 30% of the FDI inflows in the service sector over the 1990s (see Table 20). China has, since 1998, stepped up its efforts to encourage foreign investments into technology development and innovation. Several incentives, such as import duty exemption for equipment and technology brought into China by foreign-invested research companies, tax breaks for incomes obtained from transfer of technology, and business tax exemption to foreign enterprises transferring advanced technology, are luring foreign investors to China. Telecommunications in China is yet to be opened up to foreign investors and in computer software India has the lead compared to China.

Sectors with public relevance like media, radio, television etc. have also drawn FDI inflows. Manufacturing and real estate are the two sectors that have attracted the most FDI over the three years. Some sectors that indicate very small FDI (less than 0.5 percent), have been recorded zero in the table. But what is important is that even these sectors (such as geological prospecting and water conservancy, healthcare, sports & social welfare, education, culture & arts, radio, film & television, and scientific research & polytechnical services) have captured the attention of foreign investors and are capable of attracting higher FDI in the future. It is interesting to note that banking and insurance has not been able to attract 1% of the total FDI inflows in China, primarily due to the lack of reform in China's financial sector.

7. Possible Directions of Improvement in FDI Inflows for India

The paper indicates that FDI has been playing an increasingly important role in the Indian economy since the reforms were undertaken a decade ago. Since the initiation of economic reforms by the Indian government in 1991 (ten years after China's open door policy), attracting FDI has been an important area. However, India continues to be at the lower end with respect to the global competition for FDI, in spite of opening up of significant market opportunities. The previous Government had targeted FDI of \$10 billion by 1997 but, even as late as 2003, less than half of the target has been achieved. India would need to overcome both domestic as well as external economic challenges to take advantage of these opportunities.

The likely strategies that policymakers would need to adopt in the light of these challenges therefore, have to be multi-pronged, with focus on both the domestic as well as the global market. In order to be competitive with China, India needs to give greater orientation towards export-driven FDI in manufacturing. For this, India needs to have focussed development of export processing zones and SEZs comparable in size and intensity with those of China. It also needs to provide appropriate incentives in the form of good infrastructure and tax reliefs to the investors so as to attract quality FDI inflows. Another major point that is to be noted for India is that it should reduce the procedural hassles at the implementation stage of FDI. This is a bureaucratic problem and it needs to be taken care of at the institutional level. Finally, India should gear up its overall business environment conditions so as to attract the FDI inflows that could have been routed towards India but parks elsewhere because of certain unfavorable elements in the investment climate fabric of India. In particular, India would need to focus on certain strategies in order to improve its quality of FDI and correspondingly its global competitiveness, growth prospects, and the attractiveness to FDI inflows. These are as follows:

1. Adopt an Export –Oriented FDI Policy

It is well-recognized that export-oriented FDI is an important means of expanding manufactured exports for developing countries, as it helps improve the quality and competitiveness of manufacturing industries. It is well documented that in the 1970s and 1980s, FDI played a crucial role in the rapid export growth achieved by East Asia's newly industrialized economies.

Export-orientation in China

China has been successful in attracting huge export oriented FDI inflows in recent years. Table 22 shows that over the late 1990s till 2001, the share of foreign funded enterprises in Chinese exports have consistently remained over 40% during this period and has exceeded 50% in 2001. China has pushed up the MNC share in exports from 17 per cent in 1991 to over 45 per cent in 1999 to around 50 per cent in 2001 as compared to a mere 3 per cent of exports by MNC affiliates in India.

China invited in foreign direct investors to provide the capital and the expertise to achieve export competitiveness in a wide range of sectors, including electronics, apparel, plastic toys, stuffed animals, ceramics, and many other labor-intensive sectors. In each sector, the key was to link foreign investor capital and expertise with a large and low-cost Chinese labor force. The foreign investors brought in the product design, specialized machine tools and capital goods, key intermediate products, and knowledge of world marketing channels. The Chinese assured these foreign investors certain key conditions for profitability, such as low taxes, reliable infrastructure, physical security, adequate power, decent logistics for the import and export of goods, and so forth.

Table 23 exhibits the official breakup of Chinese exports into primary and manufacturing commodities over the 1990s through 2001. It is remarkable to note that Chinese official export data does not give any category of service in its data-base. This

confirms that the contribution of services in China's exports is negligible. We observe that the manufactured exports as a percentage of total exports have always demonstrated a rising trend reaching around 90% in 2001. Within the manufacturing exports, about 57% was by the chemicals, light & textile industrial products, machinery and transport equipment, minerals and metallurgical products, rubber products etc. over 1991-2001 (see Table 18). Presumably, a substantial percentage of these exports especially in the mechanical and electrical products sector was contributed by the MNCs⁷².

Export-Orientation in India

Focus of FDI in India is mainly on sectors such as infrastructure, power, capital goods and food processing, none of which fall under export-oriented units. Only one-fourth of total approvals were directed towards major exporting sectors like textiles, chemicals & pharmaceuticals, leather goods, transport, metallurgical industries and food processing industries. Of India's export basket of software products and services, gems and jewelry, minerals, and agricultural products, FDI is allowed only in software products. India needs a larger export market for manufactured goods where FDI could flow in. For example, the handicraft sector has consistently made the largest contribution to exports over the 1990s. But since this sector falls under the reserved small-scale category, FDI is practically non-existent in this area.

Recommendations for India

Perhaps with the opening up of the small-scale industries, MNCs could be attracted and export-oriented FDI could get a significant boost. Also, comparing Table 24 (machinery and transport equipment in China) with Table 25 (engineering figures in India), we observe that India lags very much behind China in the export of machinery and electronics goods. This can be mitigated if India adopts competent incentive measures like tax break to attract FDI from the MNCs in these capital-intensive industries.

2 Generate and Expand SEZs in India

Export-oriented industries can be fostered through the creation of different types of special economic zones (SEZs). Virtually all of the East and South-east Asian countries have utilized export-processing zones (EPZs) or other SEZs to help attract foreign investment and to initiate the process of manufacturing export-led growth. These zones have attempted to carve out a geographical zone in which export-businesses can conduct profitable export-oriented activities, exempt from costly regulations, tax laws, and labor standards that apply more generally within the country. More generally, the relatively successful industrial policies have had a few common characteristics. First, they have aimed to promote exports, rather than to protect the domestic market; second, they have provided subsidies on the basis of successful performance (for example, the growth of exports) rather than to cover losses; and third, they have been temporary rather than permanent subsidies (for example, a five-year tax holiday for new export firms).

SEZs in China

⁷² It is documented that in the export of mechanical and electrical products, the share of foreign-invested firms rose from 43.7 per cent in 1996 to 52.4 per cent in 1999.

At the center of China's strategy to attract investors' and to develop China as a major platform for labor-intensive manufacturing exports were the SEZs in which favorable export conditions were assured. The urban export-oriented enterprises in China were encouraged by the designation of a growing number of SEZs, coastal⁷³ open cities and economic and technological development zones, all designed to encourage manufacturing exports. These SEZs, along China's coastline, were designed to give foreign investors and domestic enterprises favorable conditions for rapid export promotion. All key aspects of the export environment were secured. Exporters, for example, were allowed to import intermediate products and capital goods duty free. They were given generous tax holidays. The exporters were assured decent physical infrastructure, often through the provision of land, power, physical security, and transport to the ports, within specially created industrial parks. China has demonstrated through its own experience that creation of SEZs attract substantial FDI for the export sector.

In 1980, the Chinese authorities set up Shenzhen SEZ, the first of its kind in the country. Today, China has five SEZs. Of these, four — Shenzhen, Xiamen, Shantou and Zhuhai — were founded 20 years back and the fifth, Hainan, was set up in 1988. All the five SEZs had unique locations. Shenzhen (near Hong Kong), Shantou (a major home of overseas Chinese) and Zhuhai (near Macao) are in the Guangdong province. The other SEZ, Xiamen, in the Fujian province, is nearer Taiwan. The last was set up in the Hainan Islands in 1988 promoting the island to the Province status. Setting up these zones close to internationally reputed commercial destinations was basically for easier access to foreign investments, modern technology and managerial expertise. The strategic locations of these SEZs perhaps explain the alacrity FDI by the expatriate Chinese since the 1980s.

The locational advantage of these SEZs attracted foreign investors that spurred FDI in China — with Hong Kong accounting for about 60 percent of the total inflows. Initially, the majority of foreign investors were NRCs from Hong Kong who were engaged in trading. Later, MNCs started investing in technology-oriented sectors even as China liberalized its foreign investment policy further to attract modern technology. The Guangdong province, which has the largest number of SEZs, became the most attractive foreign investment destination. In 2001, over 25 percent of China's FDI flowed into Guangdong.

These SEZs, along China's coastline, were designed to give foreign investors and domestic enterprises favorable conditions for rapid export promotion. The SEZs were given extra-territorial rights to function as a foreign land for all financial purposes, despite being a part of the country. All key aspects of the export environment were secured. Exporters, for example, were allowed to import intermediate products and

⁷³ In the early years of the reforms beginning in 1979, China began coastal development policy, resulting a marked shift in term so of producing for export. Coastal, urban-based industry can serve both the internal market and the international market, and can more readily make logistical links with foreign suppliers and customers than can interior-based enterprises. New export-oriented units are therefore heavily concentrated on the coast. Manufacturers in interior regions can of course service the domestic market, particularly in consumer goods such as processed foods, but the potential for rapid growth based on the internal market tends to be more limited than the growth based on exports to the world market.

capital goods duty free. They were given generous tax holidays. Another important aspect was the attention paid to infrastructure. The exporters were assured decent physical infrastructure, often through the provision of land, power, physical security, and transport to the ports, within specially created industrial parks. The quality of infrastructure ensures that there is no stoppage of work, no delays and no loss due to bottlenecks. All the SEZs, which China has developed, are on virgin land where there was no trade or commerce earlier. This has helped in devising the right quantum of infrastructure required to sustain a defined quantum of population. This ensures that there is no unnecessary load on the infrastructure, as the population grows unbounded. These special areas also received various kinds of favorable tax and regulatory treatment, such as tax holidays, and duty-free access to imported inputs and capital goods needed for export production. Thus, the SEZs and other special areas were akin to the EPZs that had been used in other parts of Asia as of their initial export-led growth. Most joint ventures and wholly owned foreign companies operating in China qualify for corporate tax holidays and reductions because they are engaged in production, are located in a special incentive zone or are technologically advanced or export oriented.

The Chinese SEZs are very large in magnitude, and in addition to export processing they promote activities such as commerce, tourism, housing, agriculture and industrial production. These zones are in direct competition with each other at both the domestic and the international level. They are typically marked by minimum bureaucracy, best infrastructure, generous tax holidays for manufacturing units, unlimited duty free imports of raw, intermediate and final goods as well as capital goods.

SEZs in India

India also had similar models of EPZ and Export Oriented Units (EOU). EPZs are located at various places including Cochin, Falta (near Calcutta), Kandla, Chennai, Noida, Santacruz (Mumbai), Vishakhapatnam and Surat. A unit could be set up in these zones subject to availability of space. Incentives provided to attract investment in these areas were 'zero import duty', a 'special 10 years income tax rebate' and also the existence of no restriction on the quantity of domestic sales.

But these eight special zones failed to achieve the export targets⁷⁴. One of the reasons posited for the failure is the poor quality of infrastructure of these special zones. In April 2000, the government of India introduced a new SEZ scheme in the Export & Import Policy, that would substitute some of the existing EPZs and provide an internationally competitive and regulation and hassle free environment⁷⁵ for export production and also generate an FDI base. The Exim Policy 2000 (chapter 9 para 30) defined the SEZ as a specifically delineated, duty free enclave deemed to be foreign

⁷⁴ The eight EPZs in India have contributed a meager Rs85.52bn in exports (4.3% of country's exports) in 2001. That one of the reason for failure was the poor quality of infrastructure and other facilities is evident from the fact that the government invests only Rs170mn annually in the seven of the government-owned EOUs.

⁷⁵ SEZs are areas where export production can take place free from plethora of rules and regulations governing imports and exports. The objective is to bypass the bureaucratic hurdles, high tax levels and the inherent problem of poor infrastructure.

territory for the purpose of trade operations and duties and tariffs. Units may be set up in SEZ for manufacture of goods and rendering of services. All the import/export operations of the SEZ units will be on self-certification basis. The units in the Zone have to be a net foreign exchange earner but they shall not be subjected to any pre-determined value addition or minimum export performance requirements.

The setting up of an SEZ unit was made open to any private, public, joint sector or state government. There would be no customs and excise duties, automatic approval for all items barring select ones on the negative list. Up to 75% of the earnings of the company units in SEZs could be retained in foreign exchange. The infrastructure and management in these zones were envisaged to be provided by the private promoters to ensure quality and the proper pricing of services. The units within SEZs are planned to be declared as public utility services so that sudden strikes can be ruled out. All supplies going into the SEZs from the domestic markets will be duty-free, whereas in reverse the domestic sector will have to pay the equivalent amount of taxes as applicable in similar imports.

Units operating in these zones have full flexibility of operations and can import duty free capital goods and raw material. The movement of goods to and fro between ports and SEZ are unrestricted. The units in SEZ have to export the entire production. The Government has converted EPZs located at Kandla and Surat (Gujarat), Cochin (Kerala), Santa Cruz (Mumbai-Maharashtra), Falta (West Bengal), Madras (Tamil Nadu), Visakhapatnam (Andhra Pradesh) and Noida (Uttar Pradesh) into operational SEZs. SEZs are approved for establishment at Kanpur and Bhadohi (Uttar Pradesh), Indore (Madhya Pradesh), Kulpi (West Bengal), Paradeep and Gopalpur (Orissa), Positra (Gujarat), Dronagiri (Andhra Pradesh), Kakinara (Kerala) and Nanguneri (Tamil Nadu).

India versus China

India, like China, is also offering a host of incentives to boost FDI at the SEZs such as duty-free imports, tax holidays, freedom from customs procedures, etc. In the Exim Policy 2002-07 as well as in the 2002 Budget, a comprehensive policy package was drawn up for attracting foreign investments in SEZs involving fiscal concessions, export incentives etc., for both the SEZ developers as well as the SEZ units. Units operating in these trade zones will be provided with lot more incentives and given more flexibility in their operations. Not only will the government provide them the necessary infrastructure but they would be able to import raw materials duty-free and would also be able to access those from the domestic tariff area (DTA) without payment of terminal excise duty. Within the SEZ, no permission would be required for inter-unit sales or transfer of goods.

However, share of SEZs in total exports in 2001 was 10.5% in China whereas the corresponding figure for India in 2001-2002 was 4.4% (Majumder, S. (2003). Hence, the question that remains is whether the generous offering of incentives is by itself enough to ensure greater investment flows. In other words, merely switching from EPZs to SEZs, without undertaking the required structural changes, can success of SEZs be guaranteed in India. First, it should be remembered that conceptually, EPZs and SEZs are different in size — while the former is an industrial estate, the latter is an industrial township. In

China, each SEZ is well over 1,000 hectares, the minimum recommended area. In India, the EPZs converted into SEZs are not even a third of the recommended size. Among the converted SEZs, the one in Noida is the largest but extends only 310 hectares. The Santa Cruz Electronics Export Processing Zone (SEEPZ), the first SEZ in India, is only 93 hectares.

Another ingredient of infrastructure is the availability of power at competitive rate. Apart from cheap power (the price of power is around 4 to 6 cents per unit), there is no power failure in China, as in India. Moreover, the concept of minimum demand (minimum amount paid whether or not power is used) for power is nonexistent in China, as in India. Also, bank interest is less than 4 percent in China as against about 14 per cent in India⁷⁶.

Commensurate with their size, the scope of SEZs are much wider and their linkages with the domestic economy stronger. SEZs provide supportive infrastructure such as housing, ports, roads and telecommunication and, as a result, have a wider industrial base. Compared to EPZs, SEZs give more in terms of exports, industrial growth, investments, both domestic and foreign, and employment generation. Hence, undertaking the required structural changes in terms of supportive infrastructure becomes mandatory to ensure success of SEZs. The conversion of EPZs into SEZs can be successful if SEZs are carved out with the recommended size and dedicated infrastructure to provide uninterrupted supply and no blockages. With such small areas of SEZs in India, the requisite infrastructure and services required of an SEZ cannot be created nor multiple economic activities undertaken.

Strong domestic market is another important aspect for SEZ success. In China, about 50 percent of SEZ sales are to the domestic market. Though India has a large domestic market, it has failed to project this to lure SEZ investors because of the policy restriction to sales in the domestic market. While in China the thrust of SEZs has been to attract FDI and modern technology, in India the emphasis has been on exports.

Decentralization of power was also a major reason for SEZ success in China. Provincial and local authorities were made partners and stakeholders, by delegating to them powers to approve foreign investment. The SEZ authorities in China can approve foreign investment proposals up to \$30 million. In India, until recently, only State governments are allowed to set up SEZs⁷⁷ and the powers for foreign investment approvals are vested with the Development Commissioners, who are the representatives of the Central Government.

The flexible labor laws with the hire-and-fire policy in SEZs has been one of the biggest attractions for foreign investors in China. The new labor law consists of 107

⁷⁶ Business Line, September 16, 2002
<http://216.239.51.104/search?q=cache:cnol84bxgncJ:www.thehindubusinessline.com/bline/2002/09/16/stories/2002091600160900.htm+export+oriented+FDI+india+china&hl=en&ie=UTF-8>

⁷⁷ As per the 2000 EXIM policy of India, SEZs can be set-up by private sector, joint sector as well.

articles, but none of these is more than one paragraph. All jobs are on labor contract basis, which stand terminated upon the expiry of the terms, which can be fixed/flexible or for a specific job. In contrast, the labor policy in India is worker, rather than investment, oriented. SEZs have been declared as public utilities under the Industrial Disputes Act but that may not may not suffice to quell the image of labor unrest in the country.

In China, the major responsibility for the SEZs rests with local and provincial governments, whereas in India, the responsibilities remain heavily with the central government at New Delhi. Under those circumstances, many state governments were actually averse to the idea of EPZs in their state. It should be noted, however, that since the year 2000, India has begun to put in place SEZs, similar to those in China, and the federal and state governments are engaged in the process of attempting to reform critical issues, such as labor laws, land laws, and the federal government has also been pruning the long list of items on the small-scale product reservation list.

India too experimented with special zones, mainly EPZs, but one has to say that India's approach, at least until the early to mid 1990s to export zones, as engines for attracting foreign investors, has been one of relative neglect rather than support. While China's 15 special zones proved to be very successful in boosting exports and creating large-scale employment, India's main export processing zones, or EPZs (Kandla, Santacruz, Noida, Madras, Cochin and Falta), managed to do very little, drawing only 1.16 percent of total exports and generating employment only for 95,000 workers as against 30 million in China over 2000 through 2003 (Table 26).

In sum, India's EPZs have not performed as well as China's SEZs for many reasons, including:

1. limited scale and overcrowding of the EPZs
2. insufficient logistical links with airports and seaports
3. poor infrastructure in areas surrounding the zones (e.g. unpaved roads and poor physical security)
4. government ambivalence and red-tape regarding inward FDI
5. unclear incentive packages governing inward investment, and
6. lack of interest and authority of state and local governments, and the private sector, compared with the central government, in the design, set-up, and functioning of the zones.

Recommendations for India

The SEZs in India could be fostered as SEZs as investment-friendly areas so as to increase the rate of FDI into high technology manufacturing. They could also create manufacturing facilities that would serve as supply partners to renowned global firms, whose brand names and global reach will give easy access to world markets for parts and products made in Indian SEZs. India-based manufacturers should receive assistance to become part of the supply chain for renowned US or other Western firms locating in the SEZs. This would require excellence in cost, quality and an ability to provide in-time delivery. SEZs should boast modern physical infrastructure and access to India's skilled

workforce. These Zones must operate on a new set of industrial, trade, tariff and labor policies that would make investment in these zones more attractive than in China or other competing nations in Asia.

The policies and procedures for investment and various clearances must be simplified and made as transparent as possible. The government agencies that operate in these zones should recruit employees with appropriate education and experience of interacting with foreigners or foreign businesses. The success of these zones would depend on their coastal location, world-class infrastructure in high-speed highways, access to suppliers, housing, education, health, transport (air and sea), water, power, information technology and telecommunications. A coastal access would reduce the dependence of manufacturers in the zone on India's slow-moving highways. The central government should function in conjunction with the subnational governments and the private sector in designing, installing and implementation of the SEZs.

3. Eliminate Procedural Delays in Clearance and Implementation of FDI

Since the initiation of economic reforms by the Indian government in 1991 (ten years after China's open door policy), attracting FDI has been an important area. The previous Government had targeted FDI of \$10 billion by 1997 but, even as late as 2003, less than half of the target has been achieved. The consistent difference between the approved and actual FDI inflows in India is an indication of the prevailing dissatisfactory investment climate in the perception of the FDI investors. This is reflected in Table 20 where we have shown the sector wise FDI approval figures and the actual inflows over 1991 through March 2004. Maximum inflows as a percentage of approvals are slightly over 50 per cent in transportation industry followed by 47 per cent in electrical equipment that includes computer software and electronics.

China is today the largest FDI destination. But the paradox is that its investment climate is not liberal in all directions. For example, China's FDI policy is still relatively restricted in terms of FDI forms, foreign ownership shares, access to certain activities and performance requirements. China's laws and regulations unambiguously stipulate that foreign investors can choose from among three different forms to invest in China — contractual joint ventures; equity joint ventures; and wholly foreign-owned enterprises. A comprehensive study by the OECD titled *China in the World Economy* in 2002 has said that despite China's continued priority of luring FDI with advanced technology, there remain restrictions on the organizational forms of FDI entry⁷⁸. There are 31 industries that do not allow the establishment of wholly foreign-owned enterprises, and 32 sectors in which the Chinese partners must hold majority share-holdings or a dominant position⁷⁹.

⁷⁸ China's industrial guidance on FDI has four categories — encouraged (agricultural new technologies, new or advanced technologies which can improve the quality of products, conserve energy and raw materials etc and so forth); permitted (FDI that is not under the categories of encouraged, restricted and prohibited); restricted; and prohibited.

⁷⁹ Industries where Chinese partners must have majority shares include coal-mining, design and manufacture of civil aeroplanes, construction and management of oil and gas delivery pipelines, as well as oil depots and oil wharves, printing and publishing, development and production of grain, cotton and

In spite of these stringent restrictions in FDI into China, one reason why China receives huge FDI is because its approval process is fast and efficient. Project status, be it a 'yes' or 'no', is known within a couple of months. On the other hand, the reason for the huge gap between approved FDI and the actual flow in India lies in the delays, inefficiencies, complexities, obfuscation, overlapping jurisdictions and excessive governance. All this may frustrate the foreign investor prompting the investor to exit mid-way in the project implementation stage and park the money elsewhere. To be specific, out of the three stages of a project — general approval, clearance and implementation — the delays faced by foreign investors are not at the stage of FDI approval *per se*, but *vis-à-vis* clearance and at the State level — as projects reach the crucial implementation stage. Hence, the regime does not work the way it is supposed to despite being liberal on paper (see Table 4a).

Apart from these delays there are also complexities and delays in the time spent by plant managers dealing with government officials, days to clear imported inputs through customs in 2001, time to clear imported inputs through customs, customs clearing time, etc. The relative magnitudes of these items of regulatory burdens and mis-governance are provided in Table 27. On all counts, India seems to be behind China in governance.

For foreign investors therefore, bureaucracy and red-tapism at different levels are biggest transaction costs in making FDI to India. Further, the federal structure with many of the clearances vested in State-level authorities, leads to procedural delays. Environmental and legal clearances take up too much time. More important, the limited credibility of regulatory systems, and multiple and conflicting roles of agencies and government affect foreign investors more than their domestic counterparts because the latter know how the system works.

4. Improve the Investment Climate

Table 27 summarizes the different major factors determining the investment climate of India towards the beginning of this decade and compares them with that of China. Apart from the items covered by the table, there are certain other lacuna in the institutional structure of India that requires attention. One major problem in India is that there is a lack of harmonization of government policies in India. Two events, which occurred in 1995, illustrate this lack of coordination and often-contradictory government policy and damaged India as an investor-friendly country. First, Enron's project with the Maharashtra State government was scrapped after it had been approved by the government. Furthermore, Kentucky Fried Chicken's license in New Delhi, India's capital city was revoked as the company was accused of using ingredients that were harmful.

China has augmented its efforts to improve its investment climate since 1998 when it stepped up its efforts to encourage foreign investments in technology development and innovation and initiated a transformation from low to hi-tech industries.

oilseeds, domestic commerce, foreign trade, medical institutions and repairs, designing and manufacturing of special, high-performance ships, and ships at or above 35,000 tonnes.

Basic features that help attract FDI to China, besides a stable political structure, include lower commodity and utility prices⁸⁰, lower indirect taxes (14 per cent as against 25-30 per cent in India), lower import duties on raw materials⁸¹ (13 per cent as against 24 per cent), higher labor productivity (1.6 to 5 times in different segments) and low capital investment requirements⁸². It is widely claimed that China's competitiveness is because of low wages. This is true when compared to those in Japan or the US — where it is 25 times more. But vis-à-vis India, the wages are not that low — at \$1,000 per annum on an average, it is only slightly lower than that in India. But with much higher labor productivity, China enjoys the low-wage windfall.

China is today the largest FDI destination. But the paradox is that its investment climate is not liberal in all directions. For example, China's FDI policy is still relatively restricted in terms of FDI forms, foreign ownership shares, access to certain activities⁸³ and performance requirements. China's laws and regulations unambiguously stipulate that foreign investors can choose from among three different forms to invest in China — contractual joint ventures; equity joint ventures; and wholly foreign-owned enterprises. A comprehensive study by the OECD titled *China in the World Economy* in 2002 has said that despite China's continued priority of luring FDI with advanced technology, there

⁸⁰ The CII-McKinsey study, supported by the DIPP, notes that subsidies, marginal pricing and poor cost accounting drive lower domestic prices in China. But it hastens to note that lower domestic prices are based on sustainable economic factors. The factors for lower prices include lower indirect taxes, lower import duties, higher labor productivity, lower capital costs and lower margins. Citing a case, the report said the Chinese price for a three-blade, 48-inch ceiling fan is 32 percent lower than the Indian price. Lower indirect taxes in China account for almost half (14.5 percent of the Indian price) of the total price difference. Higher labor productivity further decreases prices by 5 per cent, while lower raw material prices in China account for another 4 percent and lower capital costs for 2.5 percent of the Indian retail price. The remainder of the price difference of close to seven percent of the retail price is the result of such other factors as margins, capital productivity and difference in specifications between the Indian and the Chinese product, e.g. the use of steel rather than aluminium blades in Chinese fans.

⁸¹ The CII-McKinsey study found the average incidence of import duties in China is 17 percent, and the trade-weighted average about 13 percent — almost half of India's trade-weighted level of 24 percent. Import duties on several key raw materials, such as plastics and aluminium, are much higher in India than in China. Higher import duties on raw materials result in higher prices of inputs, as most domestic players resort to import parity pricing. China has a flat 17 percent VAT rate (about 14 percent of the retail price), while India's indirect taxes range from 25 percent to 30 percent of the retail price for most manufactured products.

⁸² Nair, G.K. (2003), "Does the economy really need FDI?" Business Line, Jan. 12. <http://216.239.51.104/search?q=cache:V5eW56h1TYIJ:www.thehindubusinessline.com/bline/2003/01/13/stories/2003011300951300.htm+state+government+india+fdi&hl=en&ie=UTF-8>

⁸³ China maintains numerous restrictions on FDI. Proposed FDI projects are classified into four categories according to the Catalogue Guiding Foreign Investment in Industry: prohibited, restricted, permitted, and encouraged. The prohibited category understandably contains items that are off-limits in most countries on grounds of national security. It also includes sectors—for example, production of bodiless lacquerware or enamel products—in which the presumed intention of protecting traditional techniques could be better fulfilled by means other than obstructing financial inflows. "Towards a Rule-Based Policy Framework", The China Business Review, 2003.

remain restrictions on the organizational forms of FDI entry⁸⁴. There are 31 industries that do not allow the establishment of wholly foreign-owned enterprises, and 32 sectors in which the Chinese partners must hold majority share-holdings or a dominant position⁸⁵. Presumably, the factors that contribute to China's number one position in attracting FDI inflows, include its populous market, continued economic growth, stable political situation, sound investment environment, WTO membership, etc. However, China offers super-national treatment to foreign firms by offering the following incentive scheme:

- ◆ Foreign enterprises transferring advanced technology to China are exempt from both business and income taxes.
- ◆ Income tax rate is 15% in Economic Zones, Hi-tech Industrial Zones, Economic and Technological Development Zones.
- ◆ The enterprise income tax rate is 24% in the coastal opening areas and provincial capital cities.
- ◆ Income tax exemption is given to the foreign invested enterprises for the first 2 years after making profits and income tax reduction by half in the following 3 years.
- ◆ For foreign invested hi-tech enterprises the income tax is exempted in the first 2 years after making profits and income tax is reduced by half in the following 6 years.
- ◆ In addition to the above mentioned preferential income tax policies, the export-oriented enterprises enjoy income tax reduction by half so long as the volume of its annual exports accounts for more than 70% of the general sales of the enterprises.
- ◆ Foreign invested enterprises are exempted from business tax in technological transfer and if the foreign invested enterprises purchase domestically made equipment within the volume of total investment, they enjoy a refund of value added tax on domestically made equipment.
- ◆ Moreover, the imported equipment for foreign or domestic-invested projects that are encouraged and supported by the state is exempted from import-stage value added tariff.
- ◆ Foreign invested firms that increase their technology funding by more than 10 percent over the previous year are eligible to deduct 50 percent of the funds actually spent on technological development from their income-tax dues.
- ◆ Further, the technology, equipment, spares and components imported into China by the foreign invested research and development (R&D) centers for upgrading enterprises considered high-priority by the state are exempt from import duty.

⁸⁴ China's industrial guidance on FDI has four categories — encouraged (agricultural new technologies, new or advanced technologies which can improve the quality of products, conserve energy and raw materials etc and so forth); permitted (FDI that is not under the categories of encouraged, restricted and prohibited); restricted; and prohibited.

⁸⁵ Industries where Chinese partners must have majority shares include coal-mining, design and manufacture of civil aeroplanes, construction and management of oil and gas delivery pipelines, as well as oil depots and oil wharves, printing and publishing, development and production of grain, cotton and oilseeds, domestic commerce, foreign trade, medical institutions and repairs, designing and manufacturing of special, high-performance ships, and ships at or above 35,000 tonnes.

After ten years of economic reforms with not much tangible results in terms of FDI growth the government of India has now taken active policy measures to attract FDI inflows both at the state and the central level (Table 28). The government of India had also set up a Steering Committee on FDI, which addressed its concern regarding improvement in the different aspects of investment climate to attract FDI inflows (Table 29).

8. Conclusion

At the end of the exercise it transpires that in order to have a high and sustained quality FDI inflow and consequently high economic growth rate, India should focus on the export-oriented manufacturing sector so as to be competitive with China. To make this happen, India should take trade liberalization measures by reducing average tariff and complement it with export promoting measures as China has done. India should also adopt policies to boost its exports of FDI generating services like software because of its competitive advantage in intellectual capital, skilled labor and a pool of workforce with knowledge of English.

Moreover, it needs to build a sound investment climate in order to achieve high growth rates. This involves a review of its institutions, policies, and regulations. The role of subnational government in attracting FDI inflows should also be clearly defined (Bajpai and Dasgupta, 2003). With a highly bureaucratic and corrupt local government or with an inefficient infrastructure and financial services, investing firms will not be rendered reliable services. Such conditions will make it difficult to persuade entrepreneurs to invest in potential export opportunities, since their returns will be low and uncertain. Apart from the national level investment climate factors, the other factors in terms of customs reliability, infrastructure, and financial services are also important to attract export-oriented FDI inflows into India and thus raise the share of foreign-invested firms.

A study by the World Bank (Dollar, 2003) has estimated the probability that a firm will export and the probability that the firm is foreign to see how much investment climate influenced the number of foreign firms in a country. Based on these models, there is a clear relationship between investment climate indicators and international integration: exporting and foreign investment are much more common in locations where hassles and delays are low. The study controls for a number of geographic factors such as distance from major markets, distance from ports, and population of the city. Moreover, the study takes into account country dummies. That is, it accounts for the fact that there may be other conditions in China (political stability, culture, size) that make it particularly attractive to foreign investors and traders. Based on these results it seems all the more imperative that India needs to focus on the details of the investment climate so as to attract MNCs into India. At the same time an improvement in the business environment could also induce the FDI-seeking expatriate Indians to perceive India as a desirable FDI destination. This way, India could presumably acquire the potential to compete with China and other FDI-recipient economies in Asia in becoming a favorable FDI recipient country in the Asia and the Pacific.

TABLES

Table 1
GDP Growth -1980 to 2003

Economy	Rank	Average
China	1	9.5
Singapore	2	6.7
Korea, Rep.	3	6.7
Vietnam	4	6.5
Taiwan	5	6.5
Oman	6	6.5
Malaysia	7	6.2
Thailand	8	6.0
India	9	5.7
Indonesia	10	5.3

Source: Virmani, A. (2004), 'Development of World Economy and Global Governance', Indian Council for Research on International Economic Relations (ICRIER), September 30.
<http://www.hss.de/downloads/virmani.PDF>

Table 2
A Checklist of Landmark Legislation of FDI Policy in China

Year	Legislation
1979	Equity Joint Venture Law
1983	Regulation for the implementation of the law of the People's Republic of China on Chinese-foreign Equity Joint Ventures
1986	Wholly Foreign Owned Subsidiaries (WFOS) Law
1986	Provision for the FDI Encouragement
1986	Constitutional Status of Foreign Invested Enterprises in Chinese Civil Law
1987	Interim Provisions on Guiding FDI
1988	Delegation on Approval of selected FDI Projects to more Local Governments
1988	Laws of Cooperative Joint Ventures
1990	Revision of Equity Joint Venture Law
1990	Rules for Implementation of WFOS Law
1991	Income Tax Law and its Rules for Implementation
1992	Trade Union Law
1993	Company Law
1993	Provisions Regulations of Value-added Tax, Consumption Tax, Business Tax and Enterprise Income Tax
1994	Law on Certified Public Accountants
1994	Law of the People's Republic of China on Protection of Taiwan Compatriots' Investment
1994, 1997	Provisions for Foreign Exchange Controls
1995	Insurance Law
1995	Law of Commercial Bank
1995	Detailed rules for implementation of Cooperative Joint Venture Law
1995, 1997	Provisions on Guiding Foreign Investment Direction
1996	Further delegation For Approving FDI to Local Government
2000	Industrial Catalogue for Foreign Investment in the Central and Western Regions
2001	Revision of Equity Joint Venture Law
2001	Revision of regulation for the implementation of the law of the People's Republic of China on Chinese-foreign Equity Joint Ventures
2001	Rules for Implementation of WOS Law
2002	Provisions on Guiding Foreign Investment Direction

Source: Chen, J., & Song, Y. (2003), 'FDI in China: Institutional Evolution and its Impact on Different Sources'. Proceedings of the 15th Annual Conference of the Association for Chinese Economics Studies Australia (ACESA).

Table 3
FDI Inflows, by Host Region and Economy, 1992 – 2003

(US \$ Billion)

Host Region/ Economy	1992-97 (Annual Average)	1998	1999	2000	2001	2002	2003
HWorld	310.88	690.90	1086.75	1387.95	817.57	678.75	559.58
HDeveloped Countries	180.75	472.54	828.35	1107.99	571.48	489.91	366.57
HDeveloped Countries as a Percentage of World	58.14	68.40	76.22	79.83	69.90	72.18	65.51
HDeveloping Economies	118.60	194.05	231.88	252.46	219.72	157.61	172.03
HDeveloping Economies as a Percentage of World	38.15	28.09	21.34	18.19	26.87	23.22	30.74
HAsia and the Pacific	74.49	102.45	112.88	146.19	111.97	94.47	107.28
HAsia and the Pacific as a Percentage of World	23.96	14.83	10.39	10.53	13.70	13.92	19.17
HChina	32.80	45.46	40.32	40.71	46.88	52.74	53.50
HShare of China in Developing Countries	27.65	23.42	17.39	16.12	21.34	33.46	31.10
HIndia*	1.68	2.63	2.17	2.32	3.40	3.45	4.27
HShare of India in Developing Countries	1.42	1.36	0.93	0.92	1.55	2.19	2.48

H

Source: UNCTAD (2004) World Investment Report.

http://www.unctad.org/en/docs/wir2004_en.pdf

Note: The Indian FDI inflow figures show the data prior to the adjustment of FDI inflow statistics in line with IMF standards.

Table 4a
Some Measures of Liberalization of FDI Inflows to India

Measures for the Rise in FDI Inflows after 1991	
H	Opening up of new sectors (integrated townships, defense industry, tea plantations, etc.).
H	Removal of FDI caps in most sectors, including advertising, airports, private sector oil refining, drugs and pharmaceuticals, etc.
H	Greater degree of automaticity for investment.
H	Liberalization of foreign exchange regulations by way of simplification of procedures for making inward and outward remittances.
H	Policy to allow foreign companies to set up wholly owned subsidiaries in India enabling foreign companies to convert their joint ventures into wholly owned subsidiaries ¹
H	Sectoral reforms, especially in sectors such as telecom, information technology and automobiles making these sectors attractive destination for FDI.
H	Public sector disinvestment emerging as an important means to promote FDI.
	Liberal policy towards Foreign Venture Capital Investment (FVCI) giving an impetus to investment in technology and infrastructure projects.
	Various investment facilitation measures such as facility for electronic filing of applications, online chat facility with the applicants, online status on registration/ disposal of applications, dedicated e-mail facility for investment related queries, etc., contributing substantially to improving investors' confidence.
	An inter-ministerial Committee set up by the Government in 2001 to examine the extant procedures for investment approvals and implementation of projects, and suggest measures to simplify and expedite the process for both public and private investment ³ .
	The activation of the Foreign Investment Implementation Authority (FIIA) that is supposed to meet at regular intervals to review and resolve investment-related problems ⁴ .

Note:

1. The percentage of FDI through merger and acquisition route has increased to around 30 per cent (from around 10 per cent in 1999), which is still much lower than the global percentage of 70-80 per cent.
2. On an average, about 2,000 responses in a year are given to investors and potential investors.
- 5 The committee has submitted Part I of its report to the Government, which is under examination. A sub-Group of the Committee is specifically looking into simplification of procedures relating to private investment. The sub-Group will submit its report shortly.
- 6 A recent study conducted by FICCI, FIIA acknowledges that it has emerged as a problem-solving platform.

Table 4b
Period wise Liberalization of FDI Inflows to India

Period	Liberalization Policies of FDI Inflows
Pre-1991	Allowed selectively up to 40%
1991	Up to 51% under 'Automatic Route' for 35 Priority Sectors
1997	Up to 74/51/50% in 111 Sectors under 'Automatic Route' & 100% in some sectors
2000	Up to 100% under 'Automatic Route' in all sectors except a small negative list
Post 2000	More sectors opened; Equity caps raised; Conditions relaxed; Foreign Exchange Management

Table 5
Top 10 Destinations for FDI in Developing Asia, 1991-1993 and 1998-2000

1991-1993			1998-2000		
Rank	Host Economy	Average Annual Total FDI Inflows (US \$ billion)	Rank	Host economy	Average Annual Total FDI Inflows (US \$ billion)
1	People's Republic of China	14.3	1	People's Republic of China	41.6
2	Malaysia	5.0	2	Hong Kong, China	33.8
3	Hong Kong, China	3.9	3	Singapore	11.1
4	Singapore	3.9	4	Korea	8.0
5	Thailand	2.0	5	Thailand	5.6
6	Indonesia	1.8	6	Malaysia	3.5
7	Taipei, China	1.0	7	Taipei, China	2.7
8	Philippines	0.9	8	India	2.4
9	Korea	0.8	9	Philippines	1.6
10	Kazakhstan	0.7	10	Vietnam	1.5
	Total Developing Asia	35.4		Total Developing Asia	111.6

Source: UNCTAD, FDI database, available: http://r0.unctad.org/en/subsites/dite/fdistats_files/fdistats.htm.

Table 6
FDI inflows and GDP figures in India and China, selected years

	1997	2000	2001	2002
India – FDI (\$ billion)	3.6	2.3	3.4	3.4
India – GDP (current \$ billion)	409.7	457.0	477.6	510.2
India – FDI/GDP (%)	0.88	0.51	0.71	0.67
China – FDI (\$ billion)	44.2	40.8	46.8	52.7
China – GDP (current \$ billion)	898.2	1100.0	1200.0	1237.1
China – FDI/GDP (%)	4.9	3.7	3.9	4.3

Source: World Development Indicators database, April 2003, World Bank.

Table 7
Inward FDI Flows as a Percentage of Gross Fixed Capital Formation by Host Region and Economy, 1992-2003

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
World	3.0	4.2	4.7	5.4	6.0	7.6	10.6	16.0	19.8	12.0	10.1	7.5
Developing Countries	3.8	6.4	8.6	8.0	9.2	11.6	12.3	14.7	14.9	13.1	9.9	10.0
Asia and the Pacific	3.2	6.8	8.2	7.8	8.4	9.7	10.6	11.3	13.3	10.2	8.3	9.3
India	0.4	0.9	1.4	2.4	2.9	4.0	2.9	2.2	2.3	3.2	3.0	4.0
China	7.3	12.2	17.3	15.4	14.9	14.9	13.6	11.3	10.3	10.5	11.5	12.4

Source: World Investment Report, United Nations, various issues.

Table 8
Inward FDI Performance Index of Some Selected Countries

	1988-90		1998-2000		2000-02	
	Rank	Index	Rank	Index	Rank	Index
China	46	1.033	51	1.198	50	1.331
Hong Kong	3	5.292	2	6.033	2	6.508
India	98	0.066	119	0.155	121	0.215
Indonesia	56	0.794	137	-0.570	121	-0.528
Republic of Korea	81	0.369	91	0.587	107	0.330
Malaysia	4	4.355	49	1.248	70	0.923
Pakistan	72	0.493	114	0.216	116	0.278
Philippines	30	1.689	87	0.641	90	0.618
Singapore	1	13.599	7	3.737	6	4.755
Thailand	17	2.562	44	1.375	80	0.753
United States	41	1.115	78	0.805	92	0.589

Source: UNCTAD, World Investment Report, various issues.

Table 9
Inward FDI Potential Index of Some Selected 140 Countries

	1988-90		1998-2000		2000-02	
	Rank	Index	Rank	Index	Rank	Index
China	45	0.176	42	0.255	39	0.273
Hong Kong	17	0.355	13	0.426	12	0.413
India	72	0.120	91	0.156	89	0.159
Indonesia	42	0.177	85	0.161	82	0.163
Republic of Korea	20	0.312	17	0.410	18	0.387
Malaysia	38	0.205	32	0.302	32	0.292
Pakistan	92	0.095	129	0.103	128	0.104
Philippines	76	0.110	69	0.193	57	0.212
Singapore	13	0.402	2	0.500	4	0.465
Thailand	40	0.182	53	0.225	54	0.215
United States	1	0.727	1	0.706	1	0.659

Source: UNCTAD, World Investment Report, various issues.

Note: The indices are measured on a scale of 0 (minimum potential) to 1 (maximum potential).

Table 10
Existing Definitional Similarities and Difference of FDI of China and India with the IMF Format

IMF	China	India
<p><i>A. Equity capital</i></p> <p>1. Equity capital in unincorporated entities; 2. Non-cash acquisition against technology transfer, plant and machinery, goodwill, business development and similar considerations; 3. Control premium; 4. Non-competition fees.</p>	<p>Equity capital</p> <p>1. Equity capital of unincorporated entities; 2. Non-cash acquisition against technology transfer, plant and machinery, goodwill, business development and similar considerations; 3. Control premium; 4. Non-competition fees.</p>	<p>Equity capital reported on the basis of issue/ transfer of equity or preference shares to foreign direct investors</p>
<p><i>B. Reinvested Earnings</i></p> <p>5. Reinvested earnings of incorporated entities; 6. Reinvested earnings of unincorporated entities; 7. Reinvested earnings of indirectly held direct investment enterprises.</p>	<p><i>B. Reinvested Earnings</i></p> <p>1. Reinvested earnings of incorporated entities; 2. Reinvested earnings of unincorporated entities; 3. Reinvested earnings of indirectly held direct investment enterprises.</p>	<p>NA</p>
<p><i>C. 'Other capital'</i></p> <p>8. Short-term and long-term inter-corporate borrowings; 9. Trade credit; 10. Suppliers credit; 11. Financial leasing; 12. Financial derivatives; 13. Debt securities; 14. Land and buildings .</p>	<p><i>C. 'Other capital'</i></p> <p>1. Short-term and long-term inter-corporate borrowings; 2. Trade credit; 3. Suppliers credit; 4. Financial leasing; 5. Financial derivatives; 6. Debt securities; and 7. Land and buildings.</p>	<p>NA</p>
	<p>Round-tripping of capital</p>	<p>NA</p>

Table 11
Components of FDI -- China vis-à-vis India

Components of FDI	2000 (U.S. \$ billion)		Percentage of Total	
	China	India	China	India
Non-Cash	6.24	NI	16.27	--
Round-Tripping	7.28		18.98	--
Cash (Equity)	7.28	2.32	18.98	100.00
Reinvested Earnings	16.02		41.77	--
Other capital	1.53		4.00	--
Total	38.35*	2.32	100.00	100.00

Source: Financial Express, India, November 15, 2002

Note: NI – not included

Note: * indicates that the FDI figure for China is different from the number in Table 1. This is presumably because of the difference in data sources.

Table 11

FDI Definition Pursued in Some Select Countries

FDI Definition	Pursued by Asian Countries	Pursued by other Countries
FDI data with the break up of equity capital, reinvested earnings and other capital as per the BPM5	China, Hong Kong and Japan	Germany, Mexico, USA, UK, Russia, Australia, France and Switzerland
No FDI data under the reinvested earning category	Indonesia, Republic of Korea and Thailand	South Africa, Belgium-Luxemburg, Brazil, Euro area and New Zealand
No FDI data under the other capital category	Pakistan	Chile
No FDI data under the reinvested earnings and other capital category	India	Singapore and Mauritius
No FDI data under the equity capital category		Canada

Source: Reporting Format of Balance of Payments Year Book 2001

Table 12
Component-wise Revised FDI Inflows to India

(\$ US Million)

	Item/Year	2000-01	2001-02	2002-03
1.	Revised FDI to India (a+b+c)	4029	6131	4660
2.	Pre-revision FDI Data Published by RBI (Equity Capital Invested by Foreign Companies)	2342	3905	2574
3.	Additional Components captured by TMG on Account of Revision (a)+(b)+(c)	1687	2226	2086
	(a)Banking Capital of the Branches of Foreign Banks	58	190	NA
	(b) Reinvested Earnings {(i)+(ii)+(iii)}	1350	1646	NA
	(i) Corporate Sector – Compiled through Survey	605	749	NA
	(ii) Corporate Sector – Compiled through Balance Sheet information obtained from CMIE* & other sources	389	436	NA
	(iii) Branches of Foreign Banks	356	461	NA
	(c)Other Capital (Inter-Company Debt Transactions)	279	390	NA
	Adjustment (%)	72.0	57.0	72.6

Source: Table is composed from information in the 'Technical Monitoring Group on Foreign Direct Investment: First Action Taken Report', Government of India, June 2003.

http://dipp.nic.in/first_new/atr.pdf

Table 13
FDI (NRC Actuals)

(U.S. \$ million)

Year	NRC	FDI	NRC/FDI (%)
1991	2.96	4.15	71.3
1992	8.76	10.90	80.3
1993	2100	25.30	82.9
1994	23.56	30.21	78.0
1995	23.79	33.00	72.1
1996	24.94	35.99	69.3
1997	25.30	38.94	65.0

Source: China Statistical Handbook, 1998

Table 14
Countrywise FDI (and other) Actually Used in China, 1992-2001

(US \$million)

	1992	1993	1994	1995	1996
Total FDI (& other)	11291.62	27770.87	33945.84	37805.69	421351.60
Hong Kong	7706.12	17444.93	19822.68	20185.11	201851.60
Macao	202.82	587.56	509.44	439.82	606.28
Singapore	125.93	491.80	1179.61	1860.61	2247.16
Taiwan	1053.35	3139.13	3391.34	3165.16	3482.02
Total	9088.22	21663.46	24903.07	25650.70	208187.06
% of total FDI (& other)	80.49	78.00	74.35	67.85	49.41
Japan	748.27	1361.37	2086.16	3212.47	3692.14
Korea, Republic	120.25	381.49	726.12	1047.10	1504.16
Mauritius	0.11	0.19	1.19	1.0010	0.22
Virgin Islands	4.00	13.92	128.27	303.76	537.61
UK	38.50	220.51	688.84	915.20	1301.93
Federal Republic of Germany	91.28	62.48	264.12	390.53	518.87
France	46.92	141.51	193.40	287.02	424.65
Italy	26.66	99.89	206.16	270.20	169.44
Netherlands	28.41	84.00	111.05	114.11	125.17
Sweden	10.01	22.91	24.18	24.04	56.69
Switzerland	29.44	46.88	71.60	79.38	214.41
US	519.44	2067.85	2490.80	3083.73	3444.17
Australia	35.05	110.34	188.26	232.99	194.06
Canada	59.07	136.88	216.05	257.04	337.97

Source: China Statistical Yearbook, various issues.

Note: Chinese FDI data till 1996 comprised 'other' investment elements as well. These 'other' elements include value of equipment supplied by foreign businesses in transactions of compensation trade, processing and assembly and value of equipment supplied in financial leasing transactions.

Table 14 (contd.)
Countrywise FDI Actually Used in China, 1992-2001

(US \$million)

	1997	1998	1999	2000	2001
Total FDI	45257.04	45462.75	40318.71	40714.81	46877.59
Hong Kong	20632.00	18508.36	16363.05	15499.98	16717.30
Macao	394.55	421.57	308.64	347.28	321.12
Singapore	2606.41	3403.97	2642.49	2172.20	2143.55
Taiwan	3289.39	2915.21	2598.70	2296.58	2979.94
Total	26922.90	25249.11	21912.88	20316.04	22161.91
% of total FDI	59.49	55.54	54.35	49.90	47.28
Japan	4326.47	3400.36	2973.08	2915.85	4348.42
Korea, Republic	2142.38	1803.20	1274.73	1489.61	2151.78
Mauritius	45.86	100.50	170.25	264.79	305.63
Virgin Islands	1717.17	4031.34	2658.96	3832.89	5042.34
UK	1857.56	1174.86	1044.49	1164.05	1051.66
Federal Republic of Germany	992.63	736.73	1373.26	1041.49	1212.92
France	474.65	714.89	884.29	853.16	532.46
Italy	215.04	274.57	187.44	209.51	219.98
Netherlands	413.80	718.82	541.68	789.48	776.11
Sweden	42.84	133.42	155.80	159.24	84.39
Switzerland	215.67	228.82	247.09	194.03	205.44
US	3239.15	3898.44	4215.86	4383.89	4433.42
Australia	313.74	271.97	263.31	308.88	335.60
Canada	344.12	316.52	314.42	279.78	441.30

Source: China Statistical Yearbook, various issues.

Table 15
Foreign Investment Inflows in India (1991-92 – 2000-01)

(US \$ million)

	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-2001	Average
A. Direct Investment	130	320	590	1310	2140	2820	3560	1660	2160	2340	1703
a. RBI automatic route		40	90	170	170	140	200	180	1410	1460	428.89
b. SIA/FIPB route	70	220	280	700	1250	1920	2750	1020	170	450	883
c. Acquisition of shares					10	130	360	400	490	360	291.67
d. NRI	60	60	220	440	710	630	250	60	90	70	259
d/A (%)	46.15	18.75	37.29	33.59	33.18	22.34	7.02	3.61	4.17	2.99	13.81
a+b+c	70	260	370	870	1430	2190	3310	1600	2070	2270	1444
(a+b+c)/A (%)	53.85	81.25	62.71	66.41	66.82	77.66	92.98	96.39	95.83	97.01	77.56

Source: Constructed from Reserve Bank of India, *Report on Currency and Finance*, various issues and RBI Annual Report, various issues.

Note: The average for the first four rows have been computed using arithmetic mean and that of the fifth row has been calculated with the help of geometric mean.

Table 16
Some MNCs operating in India

Infrastructure	Consumer Durables	Consumer Non-durables	Services	Others
Alcatel	Aiwa	3M	ABN Amro	ABB
Alstom	Akai	Avon	Alliance Capital	Caltex
AT&T	Bosch	Bayer	American Express	Castrol
BT	Canon	Cargill	Arthur Henderson	Compaq
Bell Canada	Casio	Coca-Cola	ANZ	Cummins
Bechtel	Electrolux	Colgate	Bank of America	Daewoo
British Gas	Ericsson	Henkel	BCG	Daimler Chrysler
Cogentrix	Gillette	Hoechst	Citicorp	Du Pont
Deutsche Telecom	Hoover	ICI	Deutsche Bank	Fiat
Enron	LG	IDV	Dresdner Bank	Ford
Fujitsu	Levi Strauss	Johnson & Johnson	HSBC	General Motors
General Electric	Matsushita	Kellog	ING Barings	Hewlett Packard
Hutchison	Nokia	Nestle	Jardine Fleming	Honda
Itochu	Philips	Novartis	KPMG	Hyundai
Mission Energy	Samsung	PepsiCo	McKinsey & Co.	IBM
Mitsubishi	Sansui	Procter & Gamble	Merrill Lynch	Microsoft
Motorola	Sanyo	Revlon	Morgan Stanley	Mobil
Nynex	Sony	Reckitt & Colman	Standard Chartered	Oracle
Shell	Timex	Sara Lee	UBS	Siemens
Sumitomo	Whirlpool	Seagram		Suzuki
Telstra	Xerox	Smithkline Beecham		Toyota
Total		Unilever		Volvo
US West				

Table 17
Countrywise FDI Approval in India, 1992-2000

(US \$million)

	1992	1993	1994	1995	1996
Annual Re-dollar exchange rate (\$1=Rs. ...)	30.649	31.366	31.399	33.45	35.5
Total FDI	1268.41	2824.50	4518.36	9597.96	10182.20
Hong Kong	18.62	28.04	52.48	121.72	143.07
Macao					
Singapore	19.65	21.28	84.56	79.37	279.17
Taiwan	5.87	3.19	3.25	1.16	21.93
Japan	199.10	82.07	127.68	452.69	419.23
Korea, Republic	12.86	9.35	34.03	93.93	907.30
Mauritius	0	40.52	170.30	540.63	657.47
Virgin Islands	0.17	1.47	1.16	1.95	10.55
UK	38.39	198.54	413.76	515.95	429.46
Federal Republic of Germany	28.15	56.09	181.33	400.45	433.21
France	9.67	41.16	28.58	125.67	470.90
Italy	29.16	37.41	124.51	137.62	39.12
Netherlands	31.58	102.55	65.91	288.93	295.41
Sweden	15.79	0.20	3.71	150.15	150.15
Switzerland	225.05	136.07	15.38	92.52	45.00
US	401.81	1103.70	1110.89	2108.93	1987.15
Australia	25.33	9.42	123.71	449.69	235.05
Canada	0.25	8.69	13.40	410.60	55.36

Source: <http://www.economywatch.com/database/foreigninvestment2.htm>

Note: Annual Re-dollar exchange rate is quoted from Economic Survey of India 2001-02, Government of India, p. S-76.

The annual FDI inflow data to India from Macao is not available presumably because of the absence of FDI inflows.

Table 17 (contd.)

Countrywise FDI Approval in India, 1992-2000

(US \$million)

	1997	1998	1999	2000 *
Annual Re-dollar exchange rate (\$1=Rs. ...)	37.165	42.071	43.333	45.684
Total FDI	14769.63	7324.17	6546.17	34.18
Hong Kong	69.57	56.58	10.19	6.95
Macao				
Singapore	86.04	204.87	177.08	15.41
Taiwan	0.36	0.85	1.72	1.12
Japan	512.94	304.92	296.04	37.36
Korea, Republic	526.30	87.56	842.07	5.61
Mauritius	2705.74	752.52	877.63	105.05
Virgin Islands	4.93	2.33	6.67	0
UK	1208.32	760.82	683.78	42.77
Federal Republic of Germany	580.07	202.93	263.76	35.32
France	191.96	122.07	334.30	3.66
Italy	321.54	66.16	406.04	1.8
Netherlands	234.24	117.96	145.90	14.76
Sweden	29.33	51.21	63.22	16.35
Switzerland	132.83	67.75	67.20	10.86
US	2705.74	3225.46	821.99	165.38
Australia	116.15	626.97	149.76	5.17
Canada	103.39	75.03	8.50	18.47

Source: <http://www.economywatch.com/database/foreigninvestment2.htm>

Note: * upto 03/31/2000

Note: Annual Re-dollar exchange rate is quoted from Economic Survey of India 2001-02, Government of India, p. S-76.

The annual FDI inflow data to India from Macao is not available presumably because of the absence of FDI inflows.

Table 18
Country-wise Average FDI Inflow in India and China, 1992-2000

(US \$million)

	China	Rank	India	Rank	China: Times Larger
Total FDI	78213.21		6340.62		12.33
Total FDI from the relevant countries	11664.52		4270.07		2.73
Percent Country-wise FDI to total FDI	14.91		67.34		
Japan	2746.24	2	270.23	5	10.16
Korea, Republic	1165.45	5	279.89	4	4.16
Mauritius	64.90	15	649.98	2	0.10
Virgin Islands	1469.77	4	3.25	15	452.24
UK	933.99	6	476.87	3	1.96
Federal Republic of Germany	607.93	7	242.37	6	2.51
France	446.72	8	147.55	8	3.03
Italy	184.32	12	129.26	10	1.43
Netherlands	325.17	9	144.14	9	2.26
Sweden	69.90	14	53.35	14	1.31
Switzerland	147.48	13	88.07	12	1.68
US	3038.15	1	1514.56	1	2.01
Australia	213.18	11	193.47	7	1.10
Canada	251.32	10	77.08	13	3.26

Source: Computed from China Statistical Yearbook, various issues and <http://www.economywatch.com/database/foreigninvestment2.htm>

Table 19
Sectoral Distribution of FDI in India

Sector/ Industry	(Percentage of total)									
	1992- 93	1993- 94	1994- 95	1995- 96	1996- 97	1997- 98	1998- 99	1999- 2000	2000- 01	2001- 02 P
1.Chemicals & Allied Products	17	18	16	9	15	9	19	8	7	2
2.Enginee- ring	25	8	15	18	35	20	21	21	14	8
3.Domestic Appliances	6	1	12	0	1	2	0	0	0	0
4.Electro- nics & Electrical Equipment	12	14	6	9	7	22	11	11	11	22
5.Food & Dairy Products	10	11	7	6	12	4	1	8	4	2
6.Com- puters	3	2	1	4	3	5	5	6	16	12
7.Pharma- ceuticals	1	12	1	4	2	1	1	3	3	2
8.Others	25	19	19	24	14	22	13	35	30	13
Manufac- turing (1-8)	98	85	78	74	88	84	73	92	86	61
Finance	1	10	11	19	11	5	9	1	2	1
Services	1	5	11	7	1	11	18	7	12	38
Total	100	100	100	100	100	100	100	100	100	100

P: Provisional

Source: Computed on the basis of RBI Annual Reports, various issues.

Table 20
Sectors Attracting Highest FDI Approvals with Inflows in India over January 1991 through March 2004

(US \$ million)

Sector	Amount of FDI Approved	Percentage of Total FDI approved	Amount of FDI inflows	Percentage of total FDI inflows (Ranks)	Inflows as percent of approvals
Energy					
(i) Power	11.90	14.95			
(ii) Oil Refinery	9.09	11.67			
Total (i+ii)	20.99	26.62	2.32	10.2 (4)	9.7
Telecommunications (Radio Paging, Cellular mobile, Basic Telephone Services)	15.43	19.61	2.56	11.17 (3)	18.71
Electrical Equipment (including computer software & electronics)	7.29	9.94	3.32	14.5 (1)	47.92
Transportation Industry	5.73	7.51	2.78	11.99 (2)	52.43
Services Sector (Financial & Non-financial)	5.12	6.59	2.04	8.47 (5)	42.23
Metallurgical Industries	4.27	5.31	0.31	1.43(8)	8.07
Chemicals (excluding fertilizers)	3.73	4.48	1.49	5.93(6)	43.48
Food Processing Industries	2.77	3.29	1.09	4.53 (7)	45.18
Hotel & Tourism	1.45	1.78	2.14	0.87 (10)	17.24
Textiles	1.02	1.20	0.31	1.21 (9)	33.07

Source: SIA (FDI Data Cell), Department of Industrial Policy & Promotion (DIPP), Ministry of Commerce & Industry.

Table 21
Sectoral Distribution of Actually Used FDI in China

Sector/ Industry	(Percentage of total)		
	1999 (Rank)	2000 (Rank)	2001 (Rank)
Agriculture	2	2	2
Mining & Quarrying	1	1	2
Manufacturing	56 (1)	63 (1)	66 (1)
Electric Power, Gas, Water Production & Supply	9 (2)	6 (3)	5 (4)
Construction	2	2	2
Geological Prospecting & Water Conservancy	0	0	0
Transport, Storage, Post & Telecom Services	4 (4)	3	2
Wholesale & Retail Trade & Catering Services	2	2	3 (5)
Banking & Insurance	0	0	0
Real Estate Management	3 (5)	11 (2)	11 (2)
Social Services	6 (3)	5 (4)	6 (3)
Healthcare, Sports & Social Welfare	0	0	0
Education, Culture & Arts, Radio, Film & Television	0	0	0
Scientific Research & Polytechnical Services	0	0	0
Other Sectors	2	4 (5)	2
National Total	100	100	100

Note: Figures have been rounded to the nearest whole number. 0 percentage implies percentages less than 0.5. When the individual percentages fall short of the national total, it signifies that this discrepancy is the rounding-up error attributable to the rounding up at each sectoral level.

Source: Computed on the basis of Chinese Statistical Yearbook, various issues.

Table 22
Value of Export Goods of Foreign Funded Enterprises in China from 1998 through 2001

(\$100 million)

Year	Value of Export Goods of Foreign Funded Enterprises (a)	Total Value of Exports (b)	a as percent of b
1998	809.6189	1837.09	44.07
1999	886.2766	1949.31	45.47
2000	1194.4121	2492.03	47.93
2001	1332.3506	2661.55	50.06

Source: Computed on the basis of Chinese Statistical Yearbook, various issues.

Table 23
Value of Exports of Commodities in China over 1991 to 2001 (Customs Statistics)

(\$100 million)

Year	Primary Goods	Manufactured Goods	Total Value of Exports	Manufactured Exports as a Percent of Total exports
1991	161.45	556.98	718.43	77.53
1992	170.04	679.36	849.40	79.98
1993	166.66	750.78	917.44	81.83
1994	197.08	1012.98	1210.06	83.71
1995	214.85	1272.95	1487.80	85.56
1996	219.25	1291.23	1510.48	85.49
1997	239.53	1588.39	1827.92	86.90
1998	204.89	1632.20	1837.09	88.85
1999	199.41	1749.90	1949.31	89.77
2000	254.60	2237.43	2492.03	89.78
2001	263.53	2398.02	2661.55	90.10

Source: China Statistical Yearbook, various issues.

Table 24
Value of Manufacturing Exports by Categories in China over 1991 to 2001 (Customs Statistics)
(\$100 million)

Year	Manufactured Goods	Chemicals & Related Products	Light & Textile Industrial Products, Rubber Products, Minerals Metalurgical Products	Machinery & Transport Equipment	Miscellaneous Products	Products not Other-wise Stated
1991	556.98	38.18	144.56	71.49	166.20	136.55
1992	679.36	43.48	161.35	132.19	342.34	
1993	750.78	46.23	163.92	152.82	387.81	
1994	1012.98	62.36	232.18	218.95	499.37	0.12
1995	1272.95	90.94	322.40	314.07	545.48	0.06
1996	1291.23	88.77	284.98	353.12	564.24	0.12
1997	1588.39	102.27	344.32	437.09	704.67	0.04
1998	1632.20	103.21	324.77	502.17	702.00	0.05
1999	1749.90	103.73	332.62	588.36	725.10	0.09
2000	2237.43	120.98	425.46	826.00	862.78	2.21
2001	2398.02	133.54	438.23	949.18	871.23	5.84
1991-2001	15170.22	933.69	3174.79	4545.44	6371.22	145.08

Source: China Statistical Yearbook, various issues.

Table 25
Exports of India over 1991-92 to 2001-02

(\$ million)

Commodity	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-20	2000-01	2001-02
I. Primary Products	4132.2	3873.5	4915.7	5214.4	7256.9	8035.1	7687.3	6927.9	6524.2	7126.2	7065.2
II. Manufactured Goods	13148.4	14038.8	16656.7	20404.4	23747.0	24613.4	26546.6	25791.5	29714.4	34335.2	33127.8
1. Leather and Manufactures	1268.8	1277.5	1299.5	1610.6	1752.2	1605.8	1656.7	1660.7	1590.2	1944.4	1905.5
2. Chemicals and Allied Products	1479.3	1228.7	1477.8	1955.5	2359	2690.3	3169.9	2906.2	3409	4034.1	4039.7
a) Drugs, Pharmaceutical and Fine Chemicals	628.8	529.3	640.7	800.1	1019	1223	1458.2	1487	1668.5	1917	2044.6
b) Others	850.5	699.3	837.1	1155.4	1340	1467.3	1711.7	1419.2	1740.5	2117.2	1995.1
3. Plastic and Linoleum Products	112.1	149.4	335.9	478.3	585.4	539.4	514.3	471.7	603.8	915.2	970.7
4. Rubber, Glass, Paints, Enamels and Products	269.8	395.5	523.6	619.1	642	670.7	696.8	613.5	679.6	936.5	974
5. Engineering Goods	2253.1	2480.8	3038.1	3508	4391	4962.7	5336.2	4463.9	5152.1	6818.6	6873.4
6. Readymade Garments	2199.2	2393	2586.2	3281.9	3675.6	3753.3	3876.2	4364.9	4765.1	5568.9	4987.4
7. Textile Yarn, Fabrics, Made-ups, etc.,	1804.6	1900.9	2140.2	3044.6	3523	4056.8	4355.3	3724.7	4188.7	4888.5	4416.8
a) Cotton Yarn, Fabrics, Made-ups, etc.,	1299.3	1350.5	1537.1	2233.8	2576.6	3121.7	3264.3	2771.9	3089.6	3460.7	3031
b) Natural Silk Yarn, Fabrics, Made-ups, etc.,	142	138.6	127.2	136.2	133.2	128.8	176.4	178.2	237.7	306.9	274.6
c) Others	363.2	411.8	475.9	674.6	813.2	806.3	914.6	774.6	861.4	1120.9	1111.2
8. Jute Manufactures	158.5	122.6	124	150.6	185.7	155.4	186.8	138.2	125.7	151.2	127.9
9. Coir and Manufactures	28.5	31.2	41.4	55	62.9	61	68.6	75.2	46.1	48.3	61.6
10. Handicrafts	3386.9	3783.1	4768.1	5328.2	6129.2	5664.7	6282	6971.7	8669.6	8492.4	8222.9
a) Gems and Jewellery	2738.2	3071.7	3995.8	4500.4	5274.8	4752.7	5345.5	5929.3	7502.3	7384	7305.7
b) Carpets (Handmade excl. Silk)	407.4	434.8	453.8	441.5	420.4	436.3	410.6	409.3	498.6	446.9	369.3
c) Works of Art (excl. Floor Coverings)	241.5	276.6	318.5	386.3	433.9	475.7	525.9	633.1	668.6	661.5	547.9
11. Sports Goods	31.5	35	44.5	65.8	73.7	78.1	80.8	73.2	67	64.6	68.2
12. Others	156.1	241.1	277.4	306.8	367.4	375.2	322.9	327.4	417.6	472.3	479.7
III. Petroleum Products	414.7	476.2	397.8	416.9	453.7	481.8	352.8	89.4	38.9	1869.7	2085.9
IV. Others	170.1	148.7	268.1	294.8	583.4	339.4	419.8	409.9	544.9	1229.2	1547.8
Total Exports	17865.4	18537.2	22238.3	26330.5	31794.9	33469.7	35006.4	33218.7	36822.4	44560.3	43826.7

Source: Computed on the basis of RBI Annual Reports, various issues.

Table 26
Economic Performance of the SEZs in China and India over 2000 to 2003

Countries	No. of EPZs	Other Types of Zone	Total Employment (2000 - 2003)	Investment (US \$ billion)	Main Investing Countries	No. of Firms	Main Sectors	Zone Exports (US \$ billion)	Zone Ex-port as % of Total Ex-port
China	15	5 SEZs, 15 coastal zones, 32 ETDZ, 53 national hi-tech industrial development zones	30,000,000	4356	USA Germany France Switzerland, Netherlands, Canada	456,892	High-tech export oriented industry, IT industry, pharmaceutical industries	16.34	88 of merchandise
India	7	NA	95,000		NA	680	High tech jewelry, gems, pharmaceutical industry, leather, textiles, food processing, other	0.51	1.16 of total

Source: ILO database on export processing zones, International Labor Office, Geneva, 2003.
<http://www.ilo.org/public/english/dialogue/sector/themes/epz/epz-db.pdf>

Table 27
Comparative Statistics of India and China indicating Investment Climate
(1999 & 2000)

Factors of Investment Climate	Unit	India	China
Market Size			
Population in 2000	Billion	1,276	1,029
FDI-GDP ratio in 1999	Percent	0.5	3.9
Trade-GDP ratio in 1999	Percent		41
GDP in 2000	Billion \$	1121	440
Per capita GDP growth over 1990-1999	Percent	3.3	8
Per capita GDP (measured at purchasing power parity) in 2000	\$	2800	4200
Average annual GDP growth in 1990s	Percent	6	
Infrastructure			
Freight as a percent of traffic units	Percent	5	79
Sea Freight in 2000	Million tons	922.37 (17 ports)	251.73 (12 ports)
Transportation costs associated with shipping a container of textiles to the United States	Percent greater than in China	35% higher than in China	
Share of firms with own power generators	Percent	69	30
Growth of number of fixed telephone lines between 1997 and 1999	Percent	140	300
Roads in 2000	Million km	1.7	3.0
Paved roads	Percent of total	56	88
Railways in 2000	'000 km	61.0	81.5
Power Generation	Billion KW	1166	417
Number of telephone lines in largest city	Per 1000 people	131	294
People Per Telephone		12	46
Internet Connections in 2000	Millions	35	3
Cost of Shipping	Percent	8.5	5.4
Number of personal computers	Per 1000 people	3	12
Regulatory burden			
Time spent by plant managers dealing with government officials	Percent	16	9
Days to clear imported inputs through customs in 2001	Number	10.6	7.8
Longest number of days to clear imported inputs through customs over the 1990s		21.0	9.2
Governance			
Customs clearance time	Days	21	12
Frequency of making irregular payments to officials	Percent	90	

Table 27 (contd.)
Comparative Statistics of India and China indicating Investment Climate
(1999 & 2000)

Factors of Investment Climate	Unit	India	China
Entry and Exit			
Number of permits to start a firm	Number	10	6
Median number of days to start a firm	Number	90	30
Restrictions on the hiring and firing of workers	Rank out of 75 countries*	75	23
Finance			
Capital coming from bank loans relative to firms	Rank	Higher	Lower
Differences in the reliance on bank loans	Percent	35	18
Savings	Percent of GDP	39	22
Inflation	Percent	1.3	4.0
Interest rate on Loans	Percent	12.3	5.9
Corporate Tax	Percent	15	36.5
Indirect Taxes	Percent	14	25-30
Import Duties on Raw Materials	Percent	13	24
Average tariff rate in the 1990s	Percent	30	15
Double Taxation		No	Yes

*Global Competitiveness Report, 2002

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Table 28
Incentive Schemes To Invite FDI Inflows to India

Central Government investment incentives	<ul style="list-style-type: none"> • 100 per cent profit deduction for developing, maintaining and operating infrastructure facilities • Tax exemption of 100 per cent on export profits for ten years • Deduction in respect of certain inter-corporate dividends to the extent of dividend declared • Various capital subsidy schemes and fiscal incentives for expansion in the north-eastern region • Tax deduction of 100 per cent of profits for 5 years and 50 per cent for next two years for undertakings in Special Economic Zones (SEZs).
State Government investment incentives	<ul style="list-style-type: none"> • Single window approval system for setting up industrial units • Electricity duty, registration fee and stamp duty exemptions • Reservation of plots for NRIs, EOUs and Foreign Investment Projects • Rebate on land cost, tax concessions and octroi refunds • Interest rate and fixed capital subsidy.

Source: Constructed from Economic Budget, 2004-05, Government of India.

Table 28
Incentive Schemes Proposed by the Steering Committee To Invite FDI Inflows to India

- Increase the FDI in the petroleum sector, including refining, marketing and exploration along with banking and financial services to 100 per cent. (Currently, there is a cap of 26 per cent for FDI in oil refining, 74 per cent in oil marketing and 51 per cent in petroleum production.)
- Increase the FDI in the banking and financial services to 100 per cent. (Currently, there is a cap of 49 per cent in banking and financial services)
- Throw open the real estate sector to 100 per cent FDI (Currently, there is a ban on FDI in real estate).
- Open up Indian skies to foreign airlines together with a hike in FDI cap in civil aviation from 40 to 49 per cent and airports from 74 per cent to 100 per cent.
- Increase FDI limit in basic and mobile telephony to 74 per cent. (Currently, there is a cap of 49 per cent for basic and mobile telephony)
- Increase FDI limit in insurance to 49 per cent. (Currently, there is a cap of 26 per cent in insurance).
- Allow automatic entry routes for FDI in all the above sectors with the exception of few sectors in which the caps remain.
- Remove the current barriers relating to exit conditions.
- Expedite decontrol and delicensing in the power, urban infrastructure and real estate sectors.
- Empower the Foreign Investment Promotion Board (FIPB) to grant initial Central level registrations and approvals where possible, with a view to speeding up the process of project implementation.
- Change the Government's Rules of Business to empower the Foreign Investment Implementation Authority to expedite the processing of administrative and policy approvals.
- Transform the Foreign Investment Promotion Council (FIPC) into a primary arm of the Government for promoting FDI in India, with the Department of Industrial Policy and Promotion (DIPP) continuing to act as its Secretariat.
- Develop the special economic zones as the most competitive destination for export-related FDI in the world by simplifying applicable rules, laws and administrative procedures and reducing red tape to the levels found in China.
- Focus on accelerated/immediate implementation of reforms in the country, as a whole, and not on tax sops.
- States should enact special investment laws relating to infrastructure to expedite all investments in infrastructure sectors and remove hurdles to production in this critical sector.
- The Government should consider enactment of a Foreign Investment Promotion Law to incorporate and integrate aspects relevant to promotion of FDI.

Source: Report of the N.K. Singh Steering Committee on Foreign Direct Investment, Government of India, 2002.

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ANNEXURE 1
Sector-Specific Guidelines for Foreign Direct Investment (FDI) for key industries in India

Industry	Specifications
Advertising and films	100 percent FDI with automatic approval is allowed, but certain conditions apply in film industry.
Agriculture	No FDI is permitted in farming or seed business, nor may foreigners, NRIs, or OCBs own farmland. FDI up to 100 percent is permitted in tea plantations, but proposals require prior government approval. There is compulsory divestment of 26 percent equity of the company in favor of an Indian partner or the Indian public within five years.
Airport Infrastructure	FDI is allowed up to 100 percent. Approvals for up to 74 percent are automatic. For ground-handling business at the airports, foreign companies can form joint ventures with the three state-owned companies to an FDI limit of 49 percent, on a case-by-case approval basis.
Alcoholic beverages	No FDI limit is applicable but prior government approval is required.
Atomic energy	FDI is limited to 74 percent for mining and mineral separation, integration, and value addition in mining and mineral separation. FDI beyond 74 percent is approved on a case-to-case basis. There are no automatic approvals.
Automobiles	In 2002, the GOI abolished FDI caps as well as local content requirements and export obligations for the industry 100 percent FDI allowed with automatic approval.
Banking	FDI is limited to 49 percent for private banks, and 20 percent for state-owned banks. The foreign portfolio investment caps are equal to the FDI caps, and are additive for private banks and cumulative for public sector banks. Foreign banks in India have the option to operate as branches of their parent banks or as subsidiaries. A regulatory rule change in 2003 allows foreign shareholders of banking companies to exercise their voting rights in accordance with their shareholding level; earlier, the law restricted voting rights to a maximum of 10 percent.

ANNEXURE 1 (Contd.)
Sector-Specific Guidelines for Foreign Direct Investment (FDI) for key industries in India

Industry	Specifications
Broadcasting	FDI is limited to 20 percent in FM terrestrial broadcasting with prior government approval, but NRIs and OCBs may hold as much as 49 percent. In direct-to-home broadcasting and uplinking hubs foreign investment from all sources is limited to 49 percent (with a maximum FDI component of 20%) with prior government approval. In satellite broadcasting, FDI is limited to 49 percent with prior government approvals. TV channels, irrespective of the ownership or management control, have to uplink from India provided they comply with the broadcast code. FDI is limited to 26 percent (including portfolio investment) in news channels uplinking from India. Entertainment channels face no FDI limit
Cable Network	FDI is limited to 49 percent (inclusive of both FDI and portfolio) of paid up share capital.
Cigars/cigarettes of tobacco	There is no FDI limit but prior government approval is required.
Civil Aviation (domestic airlines)	FDI is limited to 40 percent for foreign non-aviation companies. No foreign airline company may make either a direct or indirect investment in an Indian domestic airline. NRIs and OCBs may own 100 percent of a domestic airline. In 2001, the GOI offered to offload 26 percent of India's state-run international airlines - Air India - to foreign investors including foreign airlines. There has been no movement on
Coal/Lignite	FDI is allowed up to 100 percent in coal processing plant/power projects, but limited to 74 percent for exploration and mining for captive consumption. Proposals for up to 50 percent FDI in private sector companies are approved automatically. FDI is limited to 49 percent in state-owned units.
Construction	Construction and maintenance of roads, highways, vehicular bridges, tunnels, ports and harbors is allowed 100 percent FDI with automatic approval, up to a ceiling of \$345 million. FDI is limited to 74 percent with automatic approval for construction and maintenance of waterways, rail beds, hydroelectric projects, power plants and industrial plants. FDI is not allowed in housing or office construction.
Defense and strategic industries	FDI is limited to 26 percent, subject to a license from the Defense Ministry. There are no automatic approvals.

ANNEXURE 1 (Contd.)
Sector-Specific Guidelines for Foreign Direct Investment (FDI) for key industries in India

Industry	Specifications
Drugs/Pharmaceuticals	FDI is allowed up to 100 percent for bulk drugs. Automatic approval is granted irrespective of the FDI limit, provided the activity does not attract compulsory licensing or use recombinant DNA technology; otherwise, an approval from the FIPB is required.
E-commerce	FDI up to 100 percent is allowed in business-to-business e-commerce with the condition that foreign investors divest at least 26 percent to the Indian public within 5 years. FDI is limited to 49 percent under the automatic approval route. No FDI is allowed in retail e-commerce.
Food Processing	FDI is limited to 51 percent with automatic approval for most products with the exception of malted foods, alcoholic beverages including beer, and in a protected category reserved for “small scale industries” where foreign equity ownership up to 24 percent is allowed. Higher FDI is allowed on case-to-case basis on prior approval basis. However, 100 percent FDI is allowed with automatic approval to NRI or OCBs. FDI up to 74 percent is allowed with automatic approval for cold storage facilities.
Hotels, Tourism and Restaurants	100 percent FDI is allowed with automatic approval
Housing/Real Estate	No FDI is permitted in retail housing business. NRIs and OCBs may invest up to 100 percent. FDI up to 100 percent on prior government approval is permitted for projects such as the development of integrated townships, including housing, commercial premises, resorts, and hotels.
Information Technology	100 percent FDI is allowed with automatic approval in software and electronics except aerospace and defense.
Insurance	FDI is limited to 26 percent in the insurance business and insurance brokering. Approval is automatic.
Manufacturing	100 percent FDI is allowed in manufacturing with automatic approval in textiles, paper, basic chemicals, rubber, plastic, non-metallic mineral products, metal products, ship/boat building, machinery and equipment. FDI is limited to 24 percent in a protected category reserved for “small scale industries”. The manufacture or production of 550 goods or services is restricted by law to small-scale enterprises with a capital investment of less than \$206,000. Higher percentages of foreign equity may be approved if the company exports 50 percent or more of its product.

ANNEXURE 1 (Contd.)
Sector-Specific Guidelines for Foreign Direct Investment (FDI) for key industries in India

Industry	Specifications
Mining	FDI is limited to 74 percent with automatic approval for diamond and precious stone mining. 100 percent FDI is allowed with automatic approval for exploration and mining metallurgy, and processing of gold, silver and other minerals.
Non-Banking Financial Companies (Merchant banking, underwriting, portfolio management, financial consulting, stock-brokerage, asset management, venture capital, credit rating, housing finance, leasing & finance, credit card business, foreign exchange brokerage, factoring and custodial services, investment advisory services)	FDI is allowed up to 100 percent with automatic approval. Capital norms are as follows: if FDI is less than 51 percent, \$500,000 needs to be provided upfront; if FDI is between 51 percent and 75 percent, \$5.0 million must be brought in up front; and if FDI exceeds 75 percent, \$50 million is needed, out of which \$7.5 million must be fronted, the balance due in two years. Approvals may not be used to undertake holding company operations pertaining to downstream investments.
Petroleum	Approval must be obtained from the FIPB for all activities other than oil-refining in the private sector: Discovered small fields 100 percent Unincorporated joint venture 60 percent Incorporated joint venture 51 percent Refining with domestic private 100 percent Refining with public company 26 percent Petroleum product/pipeline 51 percent Marketing and marketing infrastructure 74 percent LNG Pipeline 100 percent Exploration 100 percent
Pollution Control	FDI up to 100 percent is allowed with automatic approval for equipment manufacture and for consulting and management services.
Ports and harbors	FDI up to 100 percent with automatic approval is allowed in construction and manufacturing of ports and harbors.
Postal/courier services	FDI up to 100 percent is permitted in courier services with prior government approval. FDI in letter delivery is not allowed.
Power	FDI up to 100 percent is permitted with automatic approval.
Print Media	In 2002, the GOI opened up the sector to foreign investment, with a 26 percent equity cap for news publications and a 74 percent cap for non-news publications.
Professional services	FDI is limited to 51 percent in most consulting and professional services with automatic approval. Legal services are not open to foreign investment.
Railways	FDI is not allowed in rail services.
Retailing	FDI is not allowed in retail business.

ANNEXURE 1 (Contd.)
Sector-Specific Guidelines for Foreign Direct Investment (FDI) for key industries in India

Industry	Specifications
Roads, highways, and Mass Rapid Transport systems	FDI up to 100 percent is allowed with automatic approval
Satellites	FDI is limited to 49 percent for establishment and operation of satellites.
Shipping	FDI is limited to 74 percent with automatic approval for water transport services.
Telecommunications	Basic and cellular services including: National and International 49 percent Long Distance 49 percent Equipment manufacturing 100 percent Global Mobile Personal Communication 49 percent Radio paging, Internet service 74 percent providers with gateways and GOI approval needed end-to-end bandwidth for FDI above 49 percent ISP without international gateways, 100 percent; GOI approval voice-mail and e-mail for FDI above 49 percent
Trading	FDI is not allowed in retail business. FDI is limited to 51 percent under the automatic route primarily for export activities. 100 percent FDI may be approved through the FIPB for activities like bulk imports with export warehouse sales, as well as cash and carry wholesale trading.
Venture Capital	FDI is allowed up to 100 percent in venture capital funds (VCF) and venture capital companies (VCC) subject to Securities and Exchange Board of India (SEBI) regulations and sector specific FDI limits. VCFs and VCCs may own up to 40 percent of unlisted Indian companies. Investment in a single company by a VCF or VCC may not exceed five percent of the paid up corpus of a domestic VCF or VCC. The automatic route is not available.

Source: U.S. Department of Commerce (2003) "India Country Commercial Guide FY 2004: Investment Climate", prepared by Hayden Wetzel, November 3 (expires on November 1, 2005)
http://216.239.41.104/search?q=cache:FS3_mOH4MPQJ:strategis.ic.gc.ca/epic/internet/inimr-ri.nsf/fr/gr121660f.html+fdi+actual+approval+india+2004&hl=en&ie=UTF-8

ANNEXURE 2

Some Recent Global Surveys on FDI Inflows into India and China

Survey	Methodology	Findings	Source
Business Environment Survey 2003 of the Commonwealth Business Council	Review of commonwealth countries' performance in mobilizing investment covering 31 countries	China continues to attract the lion's share of new investment and presents stiff competition to many emerging markets in terms of its attractive domestic market potential and low manufacturing costs. India is continuing to grow strongly, and "is narrowing the growth gap with China."	http://www.thehindubusinessline.com/2004/05/02/stories/2004050201210500.htm
UNCTAD's Worldwide Survey 2004	The survey polled 335 top transnational corporations (TNCs) from developed countries, developing economies and Central and Eastern Europe, some 24% of which responded. The respondent companies together control total assets of \$1.9 trillion, of which 38% (\$725 billion) is foreign assets.	China is considered the top magnet for FDI flows, far ahead of other countries. India ranks second, although it has yet to become a major FDI recipient in the region.	UNCTAD/PRESS/PR/2004/012 03/06/04 http://64.233.161.104/search?q=cache:H6DxmX1z64kJ:www.factbook.net/FDI_strategies.htm+fdi+china+india+survey+2004&hl=en
Joint UNCTAD-Corporate Location Survey, 2004 of international location experts	The survey was based on the responses of 87 experts from different regions. The experts were individuals working for consultancies and other service providers that play a key advisory role for TNCs in their locational decision-making processes. The survey gave no figures for investment flows, but said volumes were seen improving after three poor years between 2001 and 2003.	China and India take the top positions as attractive destinations for FDI in the near future, with Thailand in third place. In the manufacturing sector, improved prospects are expected for motor vehicles and other transport equipment, machinery and equipment, chemicals and, to a lesser extent, electrical and electronic products, publishing and media services. In the services sector, banking and insurance, business services, tourism, transport, computer-related services, retail and wholesale trade will take the lead in attracting FDI in the years to come, experts believe. Asia-Pacific garners the most optimism of all regions in terms of its future FDI prospects. For both the short and medium term, 88% of the experts expect further improvement in those prospects, with the remaining 12% anticipating that they will remain the same. Not a single expert predicted any downturn in the region's prospects.	Prospects for FDI Flows, Transnational Corporation Strategies and Promotion Policies: 2004–2007 Global Investment Prospects Assessment (GIPA) Research Note 1: Results of a survey of location experts UNCTAD/PRESS/PR/2004/005 14/04/04 http://www.unctad.org/Templates/webflyer.asp?docid=4720&intItemID=1634&lang=1

ANNEXURE 3

IMF and OECD Definitions of FDI Inflows and Related Concepts

FDI statistics are part of the balance of payments statistics collated and presented according to the guidelines stated in IMF Balance of Payments Manual, Fifth Edition, 1993 (BPM5) and OECD Benchmark Definition of Foreign Direct Investment (Benchmark), Third Edition¹, 1999.

1 IMF Definition of FDI

According to the IMF BPM5, paragraph 359, FDI is the category of international investment that reflects the objective of a resident entity in one economy (“direct investor” or parent enterprise) obtaining a ‘lasting interest’ in an enterprise resident in another economy (“direct investment enterprise”). The two criteria incorporated in the notion of “lasting interest” are:

- the existence of a long-term relationship between the direct investor and the enterprise and,
- the significant degree of influence that gives the direct investor an effective voice in the management of the enterprise.

The concept of lasting interest is not defined by IMF in terms of a specific time frame, and the more pertinent criterion adopted is that of the degree of ownership in an enterprise. A direct investment relationship is established when the direct investor has acquired 10 percent or more of the ordinary shares or voting power of an enterprise abroad. Thus, the IMF threshold is 10% ownership of the ordinary shares or voting power or the equivalent for unincorporated enterprises (p 93)². Direct investment comprises not only the initial transaction establishing the FDI relationship between the direct investor and the direct investment enterprise but all subsequent capital transactions between them and among affiliated enterprises resident in different economies³.

¹ The OECD Benchmark Definition of Foreign Direct Investment provides operational guidelines on how FDI activity should be measured according to internationally agreed standards. The initial version of the Benchmark Definition (in 1983) and its subsequent revisions were prepared under the supervision of the Investment Committee (formerly the Committee on International Investment and Multinational Enterprises). The Council recommendation of July 1995, which endorsed the third edition, also included a recommendation that Member countries continue to take steps to bring their statistical methodology into line with the Benchmark Definition.

In 2003, FDI experts of the OECD Workshop on International Investment Statistics agreed that the timing was appropriate to revise the Benchmark Definition. The OECD is currently undertaking a revision of the Benchmark Definition of Foreign Direct Investment.

http://216.239.41.104/search?q=cache:IPcN9Qmh4fUJ:www.oecd.org/document/33/0,2340,en_2649_2011_85_33742497_119656_1_1_1,00.html+oecd+benchmark+definition+FDI+2003&hl=en
http://www.oecd.org/statisticsdata/0,2643,en_2649_34863_1_119656_1_1_1,00.html

² The OECD also recommends to follow the 10 per cent numerical guideline of ownership of ordinary shares or voting stock to determine the existence of a direct investment relationship.

³ Direct investment transactions are discussed in subsection 3.

According to the above criteria, Direct Investment enterprises are those in which the foreign direct investor owns an amount of shares or voting power that allows him to participate effectively in the management of the enterprise or in its control. The IMF BPM5 (paragraph 364) explains that “most direct investment enterprises are either (i) branches or (ii) subsidiaries that are a rather small proportion of the universe”.

According to IMF, there are a number of popular misconceptions about what FDI is (IMF, 2003):

- FDI does not necessarily imply control of the enterprise, as only a 10 percent ownership is required to establish a direct investment relationship.
- FDI does not comprise a “10 percent ownership” (or more) by a group of “unrelated” investors domiciled in the same foreign country—FDI involves only one investor or a “related group” of investors.
- FDI is not based on the nationality or citizenship of the direct investor—FDI is based on residency.
- Borrowings from unrelated parties abroad that are guaranteed by direct investors are not FDI.

There could be cases in which a foreign investor controls a company even owning a rather small amount of shares or when an investor owns a significant amount of shares but does not have an effective voice in the management of the enterprise. However, control is considered to be one of the features of FDI according to the UNCTAD definition (UNCTAD, World Investment Report, 2002).

The IMF definition of FDI (Table 10) includes as many as twelve different elements, namely: equity capital, reinvested earnings of foreign companies, inter-company debt transactions including short-term and long-term loans, overseas commercial borrowings (financial leasing, trade credits, grants, bonds), non-cash acquisition of equity, investment made by foreign venture capital investors, earnings data of indirectly-held FDI enterprises, control premium, non-competition fee and so on.

FDI flows are recorded on a net basis (capital account credits less debits between direct investors and their foreign affiliates) in the balance of payments accounts. The liabilities represent the source of funding, which covers loans, capital and reserves and the profits brought forward. The assets represent the use of funds that involves the act of investment by the company to acquire plant and machinery, real estate, etc.

FDI, defined in accordance with IMF guidelines, can take the form of green-field investment in a new establishment or merger and acquisition of an existing local enterprise. Undistributed profits of the subsidiary figure in FDI accounts, even though they may not strictly be used for investments. FDI flows with a negative sign indicate that at least one of three components of FDI (equity capital, reinvested earnings or inter-company loans) is negative and is not offset by positive amounts of the other components. These are indications of disinvestment.

The IMF definition of FDI is based on source of capital funds from the point of view of the subsidiary in the host country, but not on the *use* of funds. In other words, these guidelines don't necessarily interpret investments in the sense of leading to immediate addition to productive assets like plant, machinery or capital stock. This is for the following reasons.

- First, recorded inflows of new equity or debt into the host country may be destined for the purpose of buying up an existing firm or merging with one. Though counted as FDI in the statistics, this does not necessarily represent any immediate addition to plant and machinery or stocks.
- Second, the profits of a subsidiary in a host country, whether these are repatriated or not, are notionally regarded as an outflow in the current account of the host country's balance of payments. At the same time, that portion of undistributed profits (i.e. profits which are not distributed to shareholders as dividends) which remain in the host country is regarded as an inflow of FDI from the home country to the host country and recorded as a notional inflow on the capital account of the host country's balance of payments. However, a subsidiary in a host country may use undistributed profits to buy financial assets or loan them to another enterprise for any use whatsoever and there will therefore have been no net addition to capital stock or inventories of the subsidiary or of the nation. Furthermore, a subsidiary firm may earn no profits whatsoever in a particular year but borrow funds in the host country in order to invest in plant and machinery or to finance an increase in stocks. Such an act of investment is not, however, recorded in the FDI statistics, due to the fact that it is not recorded as a balance of payments transaction.

2 OECD Definition of FDI

FDI reflects the objective of obtaining a lasting interest by a resident entity in one economy (direct investor) in an entity resident in an economy other than that of the investor (direct investment enterprise). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise.

The concept of Direct Investment includes the capital funds received by the direct investment enterprises from the direct investor. Direct investment involves both the initial transaction establishing the relationship between the investor and the enterprise and all subsequent capital transactions between them and among affiliated enterprises, both incorporated and unincorporated⁴. Direct investment enterprises often represent units in a multinational operation, the overall profitability of which depends on the advantage to be gained by deploying the various resources available to the investors in units located in different economies. Direct investors are thereby in a position to derive benefits in addition to the investment income that may accrue on the capital that they invest (e.g., the opportunity to earn management fees or other sorts on income). Such extra benefits are

⁴ IMF, Balance of Payments Manual, fifth edition, 1993, p 86.

likely to be derived from the investors' associations with the enterprises over considerable period of time.

The OECD like the IMF also recommends the 10 per cent numerical guideline of ownership of ordinary shares or voting stock to determine the existence of a direct investment relationship. If the criteria are met, then the concept of FDI includes the following organizational bodies:

- ◆ subsidiaries (in which the non-resident investor owns more than 50 per cent);
- ◆ associates (in which the non-resident investor owns between 10 and 50 per cent), and;
- ◆ branches (unincorporated enterprises, wholly or jointly owned by the non-resident investor).

It is evident from the above analysis that there is a large degree of commonality between the IMF and OECD definitions of FDI. The IMF definition is adopted by most countries and also by United Nations Council for Trade and Development (UNCTAD) for reporting FDI data in its annual publication entitled 'World Investment Report'⁵. The BPM5 and the Benchmark recommend that FDI statistics be compiled as part of balance of payments and international investment position statistics. Consequently, countries are expected to collect and disseminate FDI data according to the standard components presented in the BPM5.

3 Components of FDI according to the Standard Statistical Requirements (IMF-OECD)

Countries are expected to compile and disseminate FDI data according to the standard components of balance of payments. These components of Direct Investment are (a) direct investment income, (b) direct investment transactions and (c) direct investment position. The direct investment income component is divided into two categories for (i) income on equity and (ii) income on debt. Direct investment transactions are sub-classified into (i) equity, (ii) reinvested earnings (iii) other capital associated with various inter-company debt transactions and (iv) financial derivatives. This division and subdivision of Direct Investment is illustrated in Figure 1.

Equity capital constitutes the value of the MNC's investment in the purchase of shares of an enterprise in a foreign country. Equity capital consists of non-cash, which again is in the form of tangible and intangible components such as technology fee, brand name etc. It comprises equity in branches, all shares in subsidiaries and associates (except

⁵ The World Investment Report 2002 defines FDI as 'an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the FDI enterprise, affiliate enterprise or foreign affiliate. FDI implies that the investor exerts a significant degree of influence on the management of the enterprise resident in the other economy. Such investment involves both the initial transaction between the two entities and all subsequent transactions between them and among foreign affiliates, both incorporated and unincorporated. Individuals as well as business entities may undertake FDI.

non-participating preferred shares that are treated as debt securities and included under direct investment in other capital category) and other capital contributions. An equity capital stake of 10 per cent or more of the ordinary shares or voting power in an incorporated enterprise, or its equivalent in an unincorporated enterprise, is normally considered as a threshold for the control of assets. If a shareholding of 10 per cent or more is acquired eventually by a non-resident who entered initially through the portfolio route but holds investment aggregating over 10 per cent through the purchase of additional shares in subsequent transactions, those additional shares should be regarded as a part of FDI.

Reinvested earnings of foreign companies consists of direct investor's share (in proportion to direct equity participation) of earnings not distributed as dividends by subsidiaries or associates, and earnings of branches not remitted to the direct investor. Such retained profits by affiliates are reinvested. Because undistributed (reinvested) earnings result in additions to direct investors' equity in subsidiaries and branches, these earnings are included as direct investment capital transactions in amounts equal to the corresponding entries recorded under direct investment income. According to IMF guidelines, these reinvested earnings are a part of FDI inflows, and should be recorded as inflow on the capital account of host country's balance of payments.

Other direct investment capital (or inter-company debt transactions) covers the short and long-term borrowing and lending of funds – including debt securities and supplier's credits – between direct investors and subsidiaries, branches, and associates⁶. It also includes short-term and long-term loans, financial leasing, trade credits, grants, bonds, non-cash acquisition of equity, investment made by foreign venture capital investors, earnings data of indirectly held FDI enterprises and control premium, non-competition fee, and so on.

In sum, direct investment capital transactions include those operations that create or liquidate investments as well as those that serve to maintain, expand or reduce investments.

3.4 Inter-Country Variations in FDI Reporting

Inter-country variations in FDI occur with respect to definition methodology, compilation, reporting system and source or coverage⁷. Although the IMF definition has been accepted by most countries and also by UNCTAD for reporting FDI data, yet there are also considerable inter-country variations in defining and measuring FDI, since every country does not follow IMF guidelines (Table A2.1). In general, the IMF guidelines are followed closely by most industrial countries but not completely by many developing countries since several elements in the IMF's definition of FDI do not strictly fall under

⁶ BPM5, paragraph 370, p 95.

⁷ For a detailed coverage of these inter-country variations of FDI, consult "Report of the Committee on Compilation of Foreign Direct Investment in India", October 2002, Government of India. http://dipp.nic.in/first_new/fdi.pdf

the purview of what should constitute FDI and perhaps also, in the case of certain countries, due to difficulties in compilation of data on certain elements.

Table A2.1
FDI Definition Pursued in Some Select Countries

FDI Definition	Pursued by Asian Countries	Pursued by other Countries
FDI data with the break up of equity capital, reinvested earnings and other capital as per the BPM5	China, Hong Kong and Japan	Germany, Mexico, USA, UK, Russia, Australia, France and Switzerland
No FDI data under the reinvested earning category	Indonesia, Republic of Korea and Thailand	South Africa, Belgium-Luxemburg, Brazil, Euro area and New Zealand
No FDI data under the other capital category	Pakistan	Chile
No FDI data under the reinvested earnings and other capital category	India	Singapore and Mauritius
No FDI data under the equity capital category		Canada

Source: Reporting Format of Balance of Payments Year Book 2001

Not all countries use the 10 percent threshold for defining FDI. Although the 10 percent criterion is specified for defining direct investment in the balance of payments, some countries choose other criterion. There are countries that require 50 per cent foreign equity for management control to be exercised, and management control is regarded as a pre-requisite to the non-resident managing the asset. Other countries accept management control with 20 per cent foreign equity. Data on inward FDI in China are based on information collected from foreign-funded enterprises, which are resident enterprises with an aggregate of 25 percent or more of their equity funded by non-residents. In Malaysia, FDI data are collected through a survey of a limited number of companies, and foreign controlled companies are those in which non-residents hold more than 50 percent of the equity capital. India also adopts the 10 percent rule (individual FII limit is 10 per cent and classified as portfolio investment).

Apart from definitional differences, variations also lie with respect to the institutional practices followed in select countries. In most of the countries (including China and India) the central bank compiles and disseminates the FDI data with few exceptions, where FDI data are compiled and disseminated by governments and other agencies (Table A2.2). Inter-country differences also exist in terms of source of information on FDI. In some countries, data on FDI are obtained from annual sample surveys/ reports filed by the recipient entities. In some other countries, data on direct investment are derived from semi-annual reports provided by FDI enterprises. In others, FDI data are compiled on the basis of information obtained from International Transactions Reporting System (ITRS), bank reports and non-bank debt surveys (Table A2.3).

Table A2.2
Compilation of FDI Data in Some Select Countries

FDI data are compiled and disseminated by	Asian Countries	Other Countries
The central bank	China, India, Indonesia, Republic of Korea, Thailand, Mauritius, Philippines, Pakistan	Germany, Mexico, South Africa, Russia, Belgium-Luxemburg, Brazil, Chile, France, Euro area, Switzerland
Government	Singapore, Hong Kong	USA, UK,
The Ministry of Finance (the central bank is entrusted with the actual preparation of statistics (including data collection))	Pakistan	

Source: Reporting Format of Balance of Payments Year Book 2001

Table A2.3
Source of FDI Data in Some Select Countries

FDI data are obtained from	Asian Countries	Other Countries
Annual sample surveys/ reports filed by the recipient entities	Hong Kong	South Africa, Russia, Belgium-Luxemburg, Chile and USA
Semi-annual reports provided by FDI enterprises	Indonesia	USA, UK,
Information obtained from International Transactions Reporting System (ITRS), bank reports and nonbank debt surveys	Thailand	

Source: Reporting Format of Balance of Payments Year Book 2001