Identification of the influential factors of foreign direct investment in the Indian manufacturing sector

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ABSTRACT

There are many factors that may influence Foreign Direct Investment (FDI) in a certain country. The study identifies the influential factors of foreign direct investments with an emphasis on foreign multinational companies in the manufacturing sector of India. It is believed that the growing need for FDI in the global economy is what derives the interest of both foreign investors and host countries in engaging in FDI. In the globalized world economy of the twenty-first century, the world market for foreign investments has become more competitive. FDI is welcomed by countries, especially developing ones. FDI can be an effective contributor not only to economic growth, but it is also important to management skills, technology transfers and a higher standard of living. Therefore, developing countries have made considerable efforts over the past decade to improve their investment climate by offering a wide range of investment incentives. The research highlights incentives attracting foreign investments and discusses the benefits gained from it. The first stage of the thesis is to outline the objectives of the study, with a review of literature relevant to the subject. The second stage is to collect data needed for the research. Finally, the results and discussion are presented together with some recommendations for further research. It is hoped that the outcomes of this research will provide some guidelines that will enable India to become a better place for conducting businesses and a favourable destination for foreign investments.

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ASEAN	Association of South-East Asian Nations
BOI	Board of Investment
BPO	Business Process Outsourcing
CII	Confederation of Indian Industries
CIS	Commonwealth of Independent States
DIPP	Department of Industrial Policy and Promotion
EEC	European Economic Community
EPZ	Export Processing Zone
FDI	Foreign Direct Investment
FTZ	Free Trade Zone
FY	Fiscal Year
FZA	Free Zone Authority
GATT	General Agreement for Trade and Tariff
GDP	Gross Domestic Product
GIC	General Industry Corporation
GNP	Gross National Product
ICOR	Incremental Capital Output Ratio
IIP	Index for Industrial Production
IMF	International Monetary Fund
IT	Information Technology

JBIC	Japan Bank for International Cooperation
JETRO	Japan External Trade Organization
JV	Joint Venture
LAFTA	Latin American Free Trade Area
LDC	Less Developed Country
M&A	Merger and Acquisition
MIDA	Malaysian Industrial Development Authority
MIR	Manufacturing Investment Region
MNC	Multi-National Company
MNE	Multi-National Enterprise
NBER	National Bureau of Economic Research
NCAER	National Council of Applied Economic Research
NRI	Non-Resident Indian
ODI	Overseas Development Institute
OECD	Organization for Economic Co-operation and Development
OLI	Ownership, Location and Internalization
PCPIR	Petroleum, Chemicals and Petrochemicals Investment Region
R&D	Research and Development
RBI	Reserve Bank of India
SEZ	Special Economic Zone
SSI	Small Scale Industry
SWF	Sovereign Wealth Fund
TNC	Trans-National Corporation

UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNCTC	United Nations Centre on Transnational Corporations
US	United States
USA	United States of America
WIPS	World Investment Prospects Survey
WIR	World Investment Report
WOS	Wholly-Owned Subsidiary
WTO	World Trade Organization

Chapter 1

Introduction to Research Area

1.1 Introduction

Foreign Direct Investment (FDI) refers to capital inflows from abroad that invest in the production capacity of the economy and are usually preferred over other forms of external finance because they are non-debt creating, non-volatile and their returns depend on the performance of the projects financed by the investors. FDI also facilitates international trade and transfer of knowledge, skills and technology. (Planning Commission of India, 2002)

It is furthermore described as a source of economic development, modernization, and employment generation, whereby the overall benefits (dependent on the policies of the host government) trigger technology spillovers, assist human capital formation, contribute to international trade integration and particularly exports, help create a more competitive business environment, enhance enterprise development, increase total factor productivity and, more generally, improve the efficiency of resource use. (OECD, 2002)

FDI is widely perceived to help host countries in catching up economically and integrating themselves into the international division of labour. Accordingly, policymakers around the world consider raising the attractiveness to FDI to be a major policy challenge. However, it is still disputed what drives FDI and, in particular, how effective specific policy measures are in attracting FDI.

In an era of increasing world trade and globalization, FDI has grown at phenomenal rate, especially in the past two decades. In the globalized world economy of the twenty-first century, the world market for foreign investments has become more competitive and developing countries are becoming more attractive to foreign investors. Developing countries view foreign investment as vital to prosperity and are changing their policies and regulations to attract it. Developing countries have made considerable efforts over the past decade to improve their investment climate by offering a wide range of government promotional policies. These countries have acknowledged that FDI can be a positive contributor to

economic growth, transfer of technology and management skills, and a higher standard of living.

This research aims to review the potential impact of FDI on developing host countries and identify factors influencing FDI, focusing on the Indian manufacturing sector. In addition to seeking to analyse the implications of the operations of foreign Multi-National Companies (MNCs) in India, the research also seeks to establish the background to the relationships between the influencing factors of FDI.

1.2 Research Objectives

This research aims at identifying factors that influence FDI, reviewing it's impact on developing host countries, and in particular, manufacturing sectors operating in India. After identifying these factors, it is intended to examine the degree of importance of those factors that influence foreign investors. The research goals also include validation of the relationship between these factors and the foreign investing companies and clarifying whether such relationships exist.

The specific objectives of the research are:

- Review impact of FDI on developing host countries.
- Identify and review the factors affecting FDI in order to get a better understanding of the various aspects of FDI such as motivations, determinants and incentives.
- Study FDI worldwide trends and prospects, and their applicability in the case of India's business environment specifics that make it different to the rest of the world.
- Evaluate the investment environment in India and the country's attractiveness to foreign investors, thereby establishing relevance of influencing factors of FDI in Indian manufacturing sector.

1.3 Summary

The research reviews impact of FDI on developing host countries. The study identifies factors influencing FDI by the foreign multinational companies and establishes its relevance within

the manufacturing sector of India. It finds out the importance of various kinds of incentives on altering foreign investors' locational decision. It also attempts to examine how the disincentives or restrictions could deter foreign investment. The study produced some useful insights for both foreign investors and host countries attempting to attract foreign investments. The next two chapters represent the review of the literature for this research.

Chapter 2

Impact of Foreign Direct Investment on Developing Host Countries

2.1 Introduction

Foreign Direct Investment has a major role to play in the economic development of the host country. Over the years, foreign direct investment has helped the economies of the host countries to obtain a launching pad from where they can make further improvements. This trend has manifested itself in the last twenty years. Any form of FDI pumps in a lot of capital knowledge and technological resources into the economy of a country. This helps in taking the particular host economy ahead. The fact that the foreign direct investors have been able to play an important role in relation to the economic development of the recipient countries, these countries have changed their economic stances and have allowed the foreign direct investors to come in and improve their economies.

It has often been observed that the economically developing as well as under-developed countries are dependent on the economically developed countries for financial assistance that would help them to achieve some amount of economical stability. The economically developed countries, on their part, can help these countries financially by investing in these countries. This financial assistance can be channelized into various sectors of the economy. The channelization is normally done on the basis of the requirements of particular sectors.

It has been observed that the FDI has been able to improve the infrastructural condition of a country. There is ample scope for technological development of a country as well. The standard of living of the general public of the host country could be improved as a result of the FDI made. The health sector of many a recipient country has been benefited by the FDI. Thus it may be said that FDI plays an important role in the overall economic and social development of a country.

It has been observed that the private sector companies are not always interested in undertaking activities that help in improving the infrastructure of the country. This is because the gains from these infrastructural activities are made only in the long-term and there are no

short-term benefits as such. This is where the FDI can come in handy. It can also assist in helping economically underdeveloped countries build their own research and development bases that can contribute to the technological development of the country. This is a very crucial contribution as most of these countries are not able to perform these functions on their own. These assistances come in handy, especially in the context of the manufacturing and services sector of the particular country, that are able to enhance their productivity and ultimately advance from an economic point of view.

At times FDI could be provided in the form of technology. Else, the money that comes in a country through the FDI can be utilized to buy or import technology from other countries. This is an indirect way in which FDI plays an important part in the context of economic development. FDI can also be helpful in assisting the host countries to set up mass educational programs that help them to educate the disadvantaged sections of the society. Such assistance is often provided by the non-governmental organizations in the form of subsidies. The developing countries can also tackle a number of healthcare issues with the help of the FDI.

In the globalized world economy of the twenty-first century, the world market for foreign investments has become more competitive. While the debate about the costs and benefits associated with FDI may still be a matter of controversy, countries continue to compete and liberalize their policies in order to attract FDI. Developing countries view FDI as vital to prosperity and are changing their policies and regulations to attract it. These countries have acknowledged that FDI can be a positive contributor to economic growth, transfer of technology and management skills, and a higher standard of living. This chapter provides a thorough analysis of FDI flows and seeks to establish the background to the effects of FDI on host economies.

2.2 General Definitions

2.2.1 The Definition of FDI

The definition of FDI, based on balance of payments transactions between residents and non-residents, refers to investment made by individuals or enterprises that have their centre of

economic interest in an economy other than the economy of their home countries. Under the definition and classification of international accounts presented by the International Monetary Fund (IMF), FDI is the category of international investment in which an entity resident in one economy obtains a lasting interest in an enterprise resident in another. A lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise, and a significant degree of influence by the investor on the management of the enterprise. FDI may be undertaken by individuals as well as business entities. Such investment involves both the initial transaction between the two entities and all subsequent transactions between them and among foreign affiliates. FDI flows comprise two distinct forms, namely equity and non-equity investment. The equity capital flows constitute the foreign direct investor's purchase of shares in an enterprise in a country other than its own. Such flows also include the foreign direct investor's share in reinvested earnings. The equity form of FDI also includes short or long-term intra-company loans and debt transactions between foreign direct investors and the affiliates. The non-equity form of FDI includes investments through such activities as subcontracting, management contracts, turnkey arrangements, franchising, licensing and product sharing.

Flows of FDI comprise capital provided (either directly or through other related enterprises) by a foreign direct investor to an FDI enterprise, or capital received from an FDI enterprise by a foreign direct investor. There are three components of FDI: equity capital, reinvested earnings and intra-company loans. Equity capital is the foreign direct investor's purchase of shares in an enterprise in a country other than its own. Reinvested earnings comprise the direct investor's share (in proportion to direct equity participation) of earnings not distributed as dividends by affiliates or earnings not remitted to the direct investor. Such retained profits by affiliates are reinvested. Intra-company loans or intra-company debt transactions refer to short-term or long-term borrowing and lending of funds between direct investors (parent enterprises) and affiliate enterprises.

Based on above discussion, it can be stated that FDI occurs when an investor based in one country (the home country) acquires an asset in another country (the host country) with the intent to manage that asset. Therefore, the management dimension is what distinguishes FDI from other types of investment.

2.2.2 Multinational Companies

Multi-National Companies (MNCs) or Trans-National Corporations (TNCs), according to the United Nations Conference on Trade and Development (UNCTAD), are incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates. A parent enterprise is defined as an enterprise that controls the assets of other entities in countries other than its home country, usually by owning a certain equity capital stake. An equity capital stake of 10 percent or more of the ordinary shares, or voting power for an incorporated enterprise, or its equivalent for an unincorporated enterprise, is normally considered to be the threshold for the control of assets. A foreign affiliate is an incorporated or unincorporated enterprise in which an investor, who is resident in another economy, owns a stake that permits a lasting interest in the management of that enterprise.

2.2.3 FDI Flows

FDI flows are on a net basis the capital transactions' credits less debits between direct investors and their foreign affiliates. Net decreases in assets (FDI outward) or net increases in liabilities (FDI inward) are recorded as credits (recorded with a positive sign in the balance of payments), while net increases in assets or net decreases in liabilities are recorded as debits (recorded with a negative sign in the balance of payments). Hence, FDI flows with a negative sign indicate that at least one of the three components of FDI mentioned above (equity capital, reinvested earnings or intra-company loans) is negative and is not offset by positive amounts of the remaining components.

2.2.4 FDI Stocks

FDI stocks are the value prices at the time when the investment was made. FDI is estimated for a large number of economies by either cumulating FDI flows over a period of time or adding flows to an FDI stock that has been obtained for a particular year from official national or international sources such as the IMF data series on assets and liabilities of direct investment.

2.3 Liberalization of the FDI Policies

While the debate concerning the costs and benefits of FDI is still unclear, most world economies continue to liberalize their FDI policies in order to attract more foreign investments. Theses countries seem to hold a positive view of the prospects for FDI as a tool that can produce more positive effects than negative. Renewed confidence in the positive benefits of FDI has led many countries that were restricting FDI in the 60s, 70s and 80s to be more open towards FDI in the 90s (Safarian, 1999). The number of countries that changed their investment regimes, according to the UNCTAD, has increased from 35 in 1991 to as many as 71 by the year 2001. The number of regulatory changes introduced by different countries of the world has also increased from 82 in 1991 to 208 in 2001, and most of these regulatory changes were to make FDI more favourable.

The continuation of the liberalization of FDI policies indicates that most countries are keen on attracting foreign operations to their jurisdictions. A possible explanation for this phenomenon is that these countries have acknowledged that FDI can be a positive contributor to economic development and a higher standard of living. It could also be due to persuasion or lobbying by MNCs, but the fact remains that most world economies, at least for the present, are keen to make themselves more attractive destinations for FDI by MNCs.

2.4 Benefits and Costs of FDI

The potential impact of FDI on host countries is a matter of controversy. Some concentrate on the benefits that can be gained from foreign corporations operating in host countries. Such benefits can result from transfer of resources that might be scarce in the host country. There are people who argue that FDI is an important source of private external finance for developing countries, and that the host countries stand to benefit on a number of counts (Mallampally and Sauvant, 1999).

As for the benefits, these are numerous and consist of transferring technology to the host countries, expanding trade, creating jobs and speeding economic development and integration into global markets. FDI allows the 'transfer of technology' (not only defined as scientific processes but also in terms of organizational, marketing and managerial skills),

which has an efficiency enhancing effect on the locally owned firms. Furthermore, an MNC is itself likely to use host country resources more efficiently because of its superior technology. FDI is probably the most important channel through which advanced technology is transferred to developing countries.

On the employment level, recipients of FDI often gain valuable employee training in the course of operating the new businesses, which contributes to human capital development in the host country. MNCs can fill critical management gaps, facilitating employment of local labour and transferring skills to local managers and entrepreneurs. Another benefit is that profits generated by FDI contribute to corporate tax revenues in the host country.

Besides being able to provide the much needed resources leading to accelerated capital formation, FDI also can facilitate transfer of technology, organizational capabilities, management skills, and a higher standard of living. Grosse (1988) suggests that the potential impacts of FDI are broadly positive. He argues that FDI seems to offer net benefits to host countries that cannot obtain such benefits from alternative sources, either because of non-availability or because of higher costs. The proponents of FDI also emphasize its role in accessing international marketing networks. Mallampally and Sauvant (1999) mention some of these FDI benefits: "Not only can FDI add to investible resources and capital formation, but, perhaps more important, it is also a means of transferring production technology, skills, innovative capacity, and organizational and managerial practices between locations, as well as accessing international marketing networks".

On the other hand, there are many who question the appropriateness of FDI as a tool to enhance growth in the host economy. Such views may range from sceptics who cast some doubts about the benefits of FDI in the host country, to those who strongly emphasize the need for further research on the consequences of FDI on the host countries. One of the main reasons behind this view is that it questions the appropriateness of the transfer of resources, especially those related to technology transfer. This view also concentrates on the negative aspects of FDI, such as remittances of profits and fees paid to the mother company.

Furthermore, there are number of examples of problems that can be brought about by FDI. These may include the fact that foreign owners generally expect to take the profits back home with them. Moreover, the sovereignty of companies and national economic polices can be reduced by foreign ownership since FDI is not only a transfer of ownership from domestic to

foreign residents but also a transfer of management and control to the foreign companies over host country firms.

Hanson (2001), in his study on whether policies to promote FDI make economic sense, concludes that: "There clearly is a need for much more research on the consequences of FDI, but the impression from the literature is that countries should be sceptical about claims that promoting FDI will raise their welfare".

The costs and benefits of FDI are the subject of intense debate, as governments try to devise ways to harness MNCs' economic and political power (Grosse, 1988). The levels of positive and negative impacts (costs and benefits) can vary between different countries depending on the host country itself, as well as the investing company, and the interaction between those two. Geographic location, GDP, per capita income, economic environment, investment climate, economic policies and technology base might be some of the influencing factors.

2.5 Impact of FDI on Developing Economies

Developing countries, emerging economies and countries in transition increasingly view FDI as a source of economic development, income growth and employment. The level of importance of FDI to a certain country may depend on the degree of progress and availability of resources in that country. Countries with limited capacities and resources view FDI as a remedy for their constraints. Nevertheless, foreign investors are more attracted to countries with growing economies and various business opportunities because investment requires a foundation that aids in the achievement of investment goals and objectives. The positive aspects of FDI by MNCs are not only capital, which was previously sought by some developing countries, but also other important factors. MNCs can produce a positive impact on employment and tax revenues, and can provide skills, management know-how and access to marketing networks. Therefore, most developing and even developed countries are welcoming FDI and are competing to attract it.

There is a basic assumption in the literature that FDI raises income and social welfare in the host country unless the optimum conditions are significantly distorted by protection, monopoly and externalities (Lall and Streeten, 1977). However, MNCs expand their operations internationally as means of utilizing the advantages they possess and/or

advantages in the targeted host economy to maximize profits worldwide. In the process they shift resources to areas where returns are high and input costs are relatively low. The motives and theories behind FDI by MNCs will be discussed in detail in the next chapter. Generally, MNCs tend to take advantage of market imperfections, casting doubts upon the assumption that FDI is always welfare improving.

The effects of FDI on the host country can be economic, political or social. The economic effects of FDI may include the implications for economic variables such as output, the balance of payments and market structure. The political effects include the issues related to national sovereignty and the possibility that MNCs may jeopardise national independence. The social issues may include the creation of foreign elite in the host country and the cultural effects on the local population, such as customs and tastes. Social issues are more likely to arise when there are significant economic, social, and cultural differences between the investing and host countries.

2.5.1 The Effect of FDI on Growth

One of the most important aspects of FDI is its effect on output, and therefore growth, in the host country. This effect is naturally more important for developing countries, where inward investment is viewed as a means of boosting economic development and growth.

Of the various studies available in the literature, some view FDI as favourable for enhancing growth in developing countries, while others do not support that view. Johnson (1977) points out that FDI brings to the host economy "a package of cheap capital, advanced technology, superior management ability, and superior knowledge of foreign markets". He mentions that developing countries can improve their standard of living through the most important external means, namely the diffusion of technology and the transfer of management expertise from industrial to developing countries. He also claims that managers and workers trained by MNCs can be available for local firms, and the competition introduced by MNCs encourages local firms to aspire to greater efficiency. However, Leahy and Montagna (2000) point out that direct product market competition makes welfare losses more likely because MNCs capture market shares from the indigenous firms.

Grosse (1988) argues that development comes through the use of advanced techniques in production and marketing, training of local labour, and training and encouragement of suppliers and purchasers. He also points out that MNCs are the single most important vehicle for foreign investors, reflecting international transfer of funds, technology, management skills and products. Okamoto (1994) conducted a study on the effect of FDI liberalization policies on the high economic performance of Malaysia. He concluded that the impact of FDI was found to be enormous in the sense that it contributed to the expansion of production and employment, the accumulation of capital stock and the diversification of the industrial structure.

Borenstein et al. (1995) evaluated the effect of FDI on economic growth in a cross-country regression framework, utilizing data on FDI flows from industrial countries to 69 developing countries over two decades. Their results suggest that FDI is an important vehicle for the transfer of technology, contributing relatively more to growth than domestic investment.

On the other hand, Cardoso and Faletto (1979) point out that MNCs introduce a dynamic element into operation in the internal markets of many Latin American countries, and therefore the interests of foreign corporations become compatible to some extent with the prosperity of host economies. Nevertheless, they add that this may incur costs for the host country, including income compression, foreign indebtedness and unemployment, so the net outcome may be "increasing relative misery". They note that FDI did help some Latin American countries achieve partial industrialization, but this was at the expense of economic sovereignty and policy decisions for development.

Lall and Streeten (1977) argue that the domination of a developing economy by an MNC may hinder economic development and growth in the host country for at least three reasons. Firstly, activities by MNCs may lead to a lower rate of accumulation domestically because some of the profits generated by this activity are repatriated rather than invested in the host country. Secondly, the presence of MNCs may lead to some adverse developments, such as a greater incidence of undesirable practices such as derogatory transfer pricing and/or weaken the control over economic policy. Thirdly, the MNC may adversely affect the market structure, making it less competitive.

The effect of FDI on the manufacturing growth of the host country was found to be mixed. Some studies in Latin America suggest a negligible and sometimes negative growth rate, such

as those of Evans (1982). However, Deyo's (1987) and Pattanyak's (1992) studies of Asian countries suggest positive and high manufacturing growth rates.

2.5.2 The Effect of FDI on the Balance of Payments

The balance of payments effect of investment by MNCs is considered to be one of the most important effects of FDI for both home and host countries. The balance of payments can be defined as the total movement of goods, services and financial transactions between one country and the rest of the world or in other words the difference over a period of time between a country's payments to and receipts from abroad. In general, FDI is often blamed for its balance of payments effect when the home country faces a sudden deficit as a result of FDI, whereas the host country faces a deficit as a result of profit repatriation.

A study on the balance of payments effects was conducted by Grosse (1988). He found that these effects are far more complex than the initial inflow of capital from abroad and the remittance of profits to the parent companies. He points out that positive effect on the balance of payments can be achieved if products produced through FDI can be used instead of importing these products or if goods produced locally can be exported. If the foreign company exports its products, some foreign exchange might be gained and in turn can positively affect the balance of payments. Therefore, some host countries target export-oriented MNCs.

A problem could arise for host countries in their balance of payments when the capital outflows are greater than capital inflows resulting from FDI. Foreign operations by MNCs could have a positive effect in the short run, but in the long run negative effects could arise from capital outflows in the form of royalty fees, debt repayments, capital repatriation, etc.

Investment in industries that require high import content for their investment as well as the mechanism of transfer pricing of MNCs seems to have negative effects on the balance of payments of developing countries. Such effect is evident in the manufacturing industries, where the high import content of MNCs is due to the unavailability of local products and materials, the uncompetitiveness of local prices, and inferior quality.

2.5.3 The Effect of FDI on Market Structure

FDI can have an effect on the structure of the market it enters. MNCs may play a role in improving or worsening the competitive features of markets in host economies. Some of the monopolistic or oligopolistic elements may be affected by the foreign operations of MNCs. Caves (1971) argues that the entry of a foreign subsidiary into local markets can force more active rivalry and an improvement in performance in comparison to a domestic entry at the same scale. This is because FDI is thought of as a vehicle for disseminating the transfer of technology, including a higher level of technical efficiency.

FDI can have an effect on increasing competition in the host country. Kindleberger (1969) suggests that the main impact of FDI is widening the scope for competition. This is may be due to the fact that MNCs can compete effectively with local rivals and gain a share of the local market. This may lead to reducing monopolistic/oligopolistic distortions, and in turn improve the allocation of resources in the host country.

In order to encourage behaviour conducive to boosting competition in host economies, the Organization for Economic Co-operation and Development (OECD) issued some relevant guidelines for MNCs. According to these guidelines, MNCs should refrain from entering into or carrying out anti-competitive agreements (such as price fixing), conduct their activities in a manner that is consistent with local competition laws, and co-operate with the competition authorities.

2.5.4 The Effect of FDI on Employment and Wages

One of the main motivations to attract FDI by host countries is its potential to create employment opportunities. However, there is still considerable divergence in views among research conducted into the employment effects of FDI. From a general point of view, FDI is capable of increasing employment directly by setting up new facilities, or indirectly by stimulating employment in distribution. However, FDI also can reduce employment through divestment and the closure of production facilities.

There is some evidence to suggest that the effect of FDI on employment is low. In his analysis of the employment effects of MNCs, Vaitsos (1976) provides evidence to indicate

that the overall employment effects of MNCs' activities on their host countries have been relatively small. Meller and Mizala (1982) discovered that US affiliates in seven developing countries were using some labour-saving policies when compared to local firms in the same line of manufacturing. They found that these US affiliates created five percent fewer jobs than their local rivals. Graham and Krugman (1991) also conclude that the net impact of FDI on US employment is approximately zero. On the other hand, a study by the United Nations Centre on Transnational Corporations (UNCTC, 1981) on international automobile firms in India, Morocco and Peru has concluded that FDI can have a substantial and positive indirect effect on employment.

The effect of FDI on wages and salaries is related to the employment issue. Some studies have argued that MNCs pay higher wages than local firms in the same industry (Stewart, (1976); Dunning, (1976)). A possible explanation for this is that foreign firms may offer higher wages to attract qualified people from their jobs. In his study of 500 US affiliates in the UK, Dunning (1976) points out that these affiliates tend to pay above average wages when compared to the yearly wage bill per capita. Feenstra and Hanson (1994) discovered an increase in the relative wages of skilled workers in Mexico during the 1980s. They found that the reason behind wage inequality in Mexico is the increase in the relative demand for skilled labour because capital inflows shifted production towards relatively skill-intensive products. They found that the growth in FDI is positively correlated with the relative demand for skilled labour.

In addition to MNCs' direct employment effects, they might also have an indirect effect on employment through backward linkages with local suppliers or forward linkages with local customers or distributors. These linkages might also have an effect on stimulating trade flows.

2.5.5 The Effect of FDI on Trade Flows

Some concern has been raised in the literature over the effect of FDI on trade flows. There is some evidence to indicate that FDI has a positive effect on trade flows in the host country. Examples of these positive effects on trade flows might take place through linkages with local suppliers (backward linkages) or linkages with local customers or distributors (forward

linkages). Another possible way of enhancing trade flows occurs when subsidiaries import parts and capital equipment from the parent MNC, which is located in the home country. Goldberg and Klein (1998) have shown that FDI directed into developing countries affects their trade flows with industrial countries, even after controlling for the effect of the exchange rate. Hence, it seems that through FDI, MNCs do affect the size and direction of trade flows. In a study of FDI and industrialization in the ASEAN (Association of South-East Asian Nations) countries, Hiemenz (1987) emphasizes the importance of the direct contributions by MNCs to the expansion of manufacturing exports which represents a second area of interest next to technologies.

One of the main issues concerning the relationship between FDI and trade is whether production and sales by MNCs in a foreign market affects trade flows and exports to the same market. FDI may have a positive effect on exports. Production in a foreign country usually requires the import of intermediate products from the home country. If a foreign subsidiary can produce goods more cheaply abroad and export them to the home country, then this obviously means that FDI leads to increasing imports by the home country and increasing exports by the host country. Some empirical studies based on cross-sectional industry and firm level data indicate a positive relationship. Blomstrom et al. (1999) found a predominantly positive relationship, however Pain and Wakelin (1998) considered a time series relationship between manufacturing exports and FDI for eleven countries and found mixed results.

2.5.6 FDI and Technology

The interaction between FDI and technology is considered to be of great importance in the discussion of FDI. The reason for this is that technology can play an important role in economic growth, capital accumulation, production and even changes in the organization of social relations.

Several studies suggest that technology transfer from FDI by MNCs may present important benefits to host countries. Blomstrom (1989) indicates that local firms may become more efficient in the presence of MNCs due to technological spillovers. Kokko (1994) points out that the technology and productivity of local firms may improve as foreign firms enter the market and demonstrate new technologies, provide technical assistance to their local

suppliers and customers, and train workers and managers who may be later employed by local firms. However, Blomstrom (1999) emphasizes the role of the local firms and their policies as an important factor in the technology transfer process.

There are several ways in which technology transfer may be diffused, including technical assistance, training, consultancy, supervision and know-how. As can be understood from the previous discussion, MNCs can play an important role in the transmission of technology.

It is important to consider the mechanisms by which foreign technology is transferred to, and absorbed by, the host country, and how it affects this country's economy. The technology transferred should be appropriate to and relevant to the needs of the host economy, and particular problems in this respect have led to situations where the anticipated positive effects of technology on developing countries have not taken place.

There are examples in the literature where technology transfer has not occurred, as reported in Haddad and Harrison's (1991) study of the FDI effects on the manufacturing industries in Morocco. They suggest that large technology gaps between foreign affiliates and local firms and/or the advanced MNC technology inhibit technology spillovers. Kokko (1994) points out that the occurrence of technology transfer spillovers may be influenced by various host country and industry characteristics. He further suggests that spillovers are negatively related to the complexity of MNC technology, or the technology gap between MNCs and local firms.

Lall and Streeten (1977) point out that FDI may not present the anticipated benefits of technology diffusion due to the appropriateness of technology with respect to the products that are made with the technology transferred, and to the factor endowments of host countries. Lall and Streeten also argue that it is in the nature of MNCs that their products are excessively sophisticated in comparison to the needs of developing countries. Winters (1991) agrees with this argument, stating that MNCs frequently pass on old technologies, which can be too capital-intensive for the local developing economy. Some of the disadvantages that may result are mentioned by Moosa (2002), who lists worsening employment, worsening income inequality, distorting influences on the technology used by other firms, and bias in production towards sophisticated and differentiated products.

Many developing countries have adopted more liberalized policies towards MNCs as a means to encourage FDI. One of their main drivers was the need for new technologies as they realized that multinationals could play a key role in technology diffusion and the production

of technologically advanced products. However, there are still some suspicions that much of the modern technology introduced by MNCs cannot be adapted to suit many developing countries.

2.5.7 FDI and Training

The effect of FDI on training of employees, especially local employees, is a significant matter for both the investing firm and the host country. Foreign firms might consider the cost of training locals, but at the same time they may realize that such expenditure may be important for their investment. Foreign subsidiaries may sometimes choose to rely on expatriate personnel, at least at the beginning of their investment, however they might have a strong incentive to start using more locals due to cost considerations. Sometimes host governments may put pressure on foreign investing firms to use local employees. Moreover, the cost of an expatriate tends to be higher than that of local personnel in developing countries.

It appears to be difficult to quantify the effects of FDI on the training of locals since the combination of local and foreign personnel that foreign firms use is difficult to ascertain. Reuber et al. (1973) conclude that even allowing for the fact that training costs could not be properly identified, costs of training locals are not large enough to make a significant contribution to the improvement of the skills of locals.

2.5.8 FDI and Inter-Industry Linkages

FDI can influence the economy of the host country via inter-industry linkages. To the extent that foreign subsidiaries establish links with local suppliers for locally-produced materials and parts, FDI can help to provide local firms with increased opportunities that in turn affect their employment and income positions. These are called backward linkages. Forward linkages can also be established for distribution purposes.

Affiliates of foreign MNCs can potentially improve development. Linkages with MNCs help local firms to learn new and better production methods. For their part, MNCs often rely on good quality and timely local supplies. Well-developed suppliers can stimulate more investment and help to improve the developmental impact of FDI (Te Velde, 2002). The

debate on FDI and development is extensive. According to Te Velde (2002), linkages form an integral part of the development on two accounts. Firstly, well developed local firms attract more multinationals wanting to exploit these linkages. Secondly, FDI is likely to have more beneficial impact on development with more and better linkages between MNCs and local firms.

Petrochilos (1989) argues that there are dangers of exaggerating the importance of inter-industry linkages for the developing economies since most MNCs operating abroad in the manufacturing sector have incentives to engage in inter-subsidiary transactions that limit the scope for developing strong and extensive ties with local suppliers. Also, for the subsidiary to minimize risk there is the option of takeover of the local supplier.

2.5.9 FDI and Political Considerations

There may be some situations where the foreign investing firms influence the political aspects in the host country. There has been political interference in the affairs of host countries by MNCs acting either in their own interest or at the inducement of their home governments.

Eiteman and Stonehill (1989) analysed the political conflicts between foreign investors and home countries from two view-points. From a legalistic point of view, the host country's views always dominate because it is a sovereign nation that may set whatever rules it wishes for the behaviour of foreign firms operating on its soil. On the other hand, from an economic point of view, the issue is less clear since some types of political interference may draw reprisals from the parent firm, or even from that firm's host government.

Another important issue is the issue of sovereignty and self reliance in host less developed countries. This issue arises from the possibility that MNCs might jeopardise the economic independence of the host country. It was noted by some researchers that foreign investors do not always comply with regulations and local laws of host governments. According to Eiteman, Stonehill and Moffett (1995), the operations of MNCs sometimes interfere with the smooth functioning of policy instruments chosen by the host governments. A report by UNCTC (1992) points out that the general flexibility and power of transnational corporations

are often alleged to undermine the autonomy of host countries in areas like fiscal policy, monetary policy, trade policy, and attempts to organize or control the structure of industry.

2.5.10 FDI and the Environment

Some developing countries may choose to ease their environmental regulations as a means to attract FDI. In spite of the fact the MNCs might contribute to the development in the host country, MNCs, especially those with significant financial, political and negotiating power, can cause damage to the host's environment. Indeed, multinationals in manufacturing and chemicals might cause damage to the environment through waste, emissions and smoke from their operations. In many cases, one of the reasons behind MNCs' locational decisions in developing countries is that these countries have less restricted environmental requirements.

It seems that it is more likely that FDI has a negative impact on the environment in a developing country than it does in a developed country. This is due to the reason that most developing countries have less effective environmental laws. A major motivation for the anti-globalization movement is the environmental damage that may be caused by FDI and the operations of MNCs in developing countries.

There is obviously some concern about the environmental effects of FDI that has prompted the OECD to issue some guidelines for how MNCs should tackle environmental issues. The OECD's guidelines on the environment encourages MNCs to provide information on the potential environmental impact of their activities, consult with the communities directly affected by the environmental policies, and maintain contingency plans for preventing, mitigating and controlling serious environmental damage.

2.6 Summary and Discussion

FDI can play an important role in the development of host economies. The main areas where FDI affects development in the host country include financial resources, technology transfer, employment, skills, export competitiveness, competition and market structure.

The role of international production is increasing as a response to the globalized economy of the twenty-first century. FDI liberalization also increased with an array of favourable changes in regulatory systems. Indeed, countries have increasingly recognized the positive contribution that FDI can make to their economic development through an increase in export capacity, employment generation, creation and application of advanced technologies, industrial upgrading, training of labour and access to international marketing networks.

On the whole, empirical evidence from the literature would suggest that FDI has a beneficial impact on the development of host countries. What appears to be less clear from the literature is the number of such benefits that may occur and if so, what type of policies can be adopted to help maximize such benefits! It is important to realize that FDI does not automatically bring about these benefits, therefore, the appropriate policies must be implemented with it to enhance these potential benefits. Governments aiming at benefiting from FDI as a means to achieve their development objectives will have to adopt policies towards attracting and upgrading FDI, and encouraging linkages between foreign firms and domestic enterprises. More and better linkages between local firms and affiliates of foreign companies can potentially increase the positive impact of FDI. Linkages between firms help to diffuse learning new and better production methods and can help to increase employment. Well developed suppliers and distributors in the host country can stimulate more investment since MNCs often rely on good quality and timely local supplies. These factors can help improve the positive impact of FDI. The next chapter will present a review of the literature on the theories and studies conducted into the various influential factors of FDI, together with review of various investment incentives for foreign investors.

Chapter 3

Factors Influencing Foreign Direct Investment

3.1 Introduction

With its great potential to enhance growth and raise productivity, FDI has caught the attention of many scholars and academics all over the world. There exist a large number of publications providing explanations for the wide range of factors that contribute to the flow of FDI to host economies. For example, Root and Ahmed (1978) identified 44 economic, social and political factors that might affect FDI in the manufacturing sector in developing countries. Multi-National Enterprises (MNEs) are generally motivated by a diverse range of factors which may be company-related, country-related or a combination of these factors. Examples of company-related factors might include ownership advantages, internalization factors, oligopolistic reaction and marketing motives. Country-related factors might include market size, GDP, growth potential, political ability, availability of resource base, availability of an adequate infrastructure and so on.

FDI motives consist of a wide and complicated set of strategic, behavioural and economic motives (Eiteman et al. 1995). The objectives of the MNEs are multiple as each enterprise has some combinations of the various motivations. In this chapter, a review of the main country-related factors (determinants) and the main company-related factors (motives) will be presented, together with a review of the investment incentives and performance requirements that may be imposed on foreign investors by the host nations.

3.2 Motives for FDI

The objectives of the MNEs are multiple and can include a combination of various motivations. The motivating factors for FDI include exploiting ownership advantages, internalization factors, utilizing research and development intensity, economies of scale, and minimizing costs of production and transport. Avoiding trade restrictions, diversification considerations and marketing motives are also considered as examples of motives to FDI.

3.2.1 Strategic Motives

According to Demirag et al. (1994), FDI is essentially a strategic decision which is influenced by political, behavioural and financial factors. Five types of strategic motives for FDI by MNCs were mentioned in the FDI literature. The strategic motives of MNCs are market oriented, resource or raw material seeking oriented, knowledge seeking oriented, efficiency seeking oriented and politically oriented.

3.2.1.1 Market Oriented FDI

Market seeking FDI takes place in large or growing economies when there is a market for the foreign companies' products. They may work in order to fulfil the demand in the host country or export to other foreign markets. MNCs usually familiarize themselves with the business and legal environment of the host country in order to strengthen their position in marketing their product against local producers. Examples of this can be found in the automobile manufacturing companies. At the end of 1980s, market seeking FDI accounted for 45 percent of the global FDI and about 30 percent in developing countries (Dunning, 1993).

3.2.1.2 Resource Seeking Oriented FDI

Resource seeking FDI takes place in any part of the world where resources or raw materials can be acquired for export or for processing and sale in the home or host countries. The acquired resources are either not available in the home country of the MNCs, or are available but can be produced at lower cost in the host country. Root (1994) mentions that raw materials seeking investments increase exports from the host to the home country. Producers of manufactured goods are motivated by this to have access to resources like minerals or raw materials.

3.2.1.3 Knowledge Seeking Oriented FDI

Knowledge seeking FDI takes place in order to expand production abroad, mainly for the purposes of gaining access to managerial ability and technological know-how. There are clear examples of this in the taking over of the US-based electronic companies where the main motive was gaining access to knowledge.

3.2.1.4 Efficiency Seeking Oriented FDI

MNCs are motivated by production efficiency when expanding abroad in order to minimize the cost of production factors. In many cases, companies are motivated by the cheap, skilled, semi-skilled or unskilled labour available in various Less Developed Countries (LDCs). Miller (1993) mentioned an example of low labour costs investment in standardized automotives components where direct labour costs account for only 10 to 15 percent of manufacturing costs and as low as 2 to 3 percent in electronics. An example of this type of investment takes place in various countries that offer various incentives in specialized export processing zones. It can be noted that size of markets is less important than production and transport costs in this case. Another clear example of this type of investment is the labour-intensive production facilities in South-East Asia.

3.2.1.5 Politically Oriented FDI

This type of FDI was mentioned by Eiteman et al. (1995) as political safety seeking investment. This type of investment takes place in countries where the political system is stable and the favourable attitudes and policies towards attracting foreign investors are present. Some countries in the European Union and the United States are generally viewed as politically safe for foreign investment.

3.2.2 Economic Motives

The economic motives behind companies deciding to establish production facilities abroad rather than exporting their products, or licensing overseas entrepreneurs to produce these goods instead are a subject of controversy among scholars. One popular explanation is that foreign firms invest abroad in order to earn higher profits, primarily because of lower labour costs. However, although differences in labour costs influence firms' decisions to invest abroad, there is no evidence that this is generally correct. The majority of FDI still goes to the advanced countries, in particular the United States, where wages are high relative to those in developing countries.

There are several theories that explain the reasons behind the phenomenon of FDI and the expansion of MNCs abroad which will be discussed in the following sections.

3.2.2.1 The Comparative Advantage Theory

The comparative advantage theory focuses on the explanation of trade movement between nations and the support of free trade. A basic pillar for this theory is that FDI should originate in the investing country's comparatively disadvantaged industry or activity, which is potentially a comparatively advantaged industry in the host country. In simpler terms, this theory states that it is beneficial for everyone if every country specializes in producing products that it produces relatively more efficiently, and imports products that are produced relatively more efficiently in other countries. Kojima (1978) argues that FDI and international trade are complementary, leading to a dynamic reorganization in the international division of trade and the associated gains for all countries involved. The theory assumes that some countries produce some goods and services more efficiently than others. Even if this were so, according to Buckley (1992), it might be to the country's advantage to apply all of its skills and resources towards the production of only those goods or services which gave it the greatest payoff and to buy in other products and services which gave a lower payoff. This approach, however, ignores aspirations set by many policy makers for their countries to be self sufficient from domestic productions. The theory was also the target of much criticism because of its perfect market assumptions (such as free trade, perfect competition and no government interference) which can be considered as a limitation, as they ignore economies

of scale, product differentiation and other forms of market failure (US Department of Commerce, 1992). Furthermore, the theory neglects the MNE's ability to internalize functions as a result of its ignorance of market imperfections.

3.2.2.2 Market Imperfections

Hymer (1960) and Kindleberger (1969) argue that product and market imperfections motivate firms to expand abroad. The occurrence of these imperfections can happen naturally or through the interference of companies or governments. For example, a company can create market imperfection through product differentiation. Governments also can create market imperfection by imposing control and restrictions, or by providing investment incentives to foreign investors. According to Buckley (1992), the establishment of overseas subsidiaries is not compatible with perfect competition. The market imperfections include government regulation, barriers to entry, taxes, controls, tariffs, know-how, control of raw materials and marketing and organizational skills.

A number of studies have investigated market imperfections as a motive for FDI. Some of them suggest that imperfections in capital markets are the main cause of FDI, as these make it advantageous, in terms of profit maximization, for the firms to engage in FDI (Bennet, 1999).

It is noteworthy that the advantages that MNCs may have from market imperfections are balanced by disadvantages that arise from the unfamiliarity of the market conditions of the host country, social and business customs, and costs of operating at a distance, such as the costs of travelling and communication.

3.2.2.3 Competitive Advantage

Competitive advantage is very important for MNCs in order to achieve the desired profitability and performance against competitors in the host market. MNCs must have some competitive advantage over their local competitors through the possession of a certain amount of intangible capital in the form of trademarks, patents, marketing or organizational skills (Buckley, 1992). Hymer (1960) suggests that because foreign firms have some

disadvantages when compared with local firms (such as local market knowledge and communications), they must possess some firm-specific competitive advantage if they are to engage in foreign production.

The main competitive advantages are mentioned by Demirag et al. (1994) and Eiteman et al. (1995). They include economies of scale by producing in large quantities to minimize cost, marketing and managerial expertise, superior technology, financial strength, differentiated products. All these factors can contribute in raising the competitive advantage of foreign companies. Multinational firms may indeed have some competitive advantages. These result in competitive gains and must exceed the implementation costs in order to be competitive in international markets.

A number of studies have been carried out by various scholars to study the effect of different competitive advantages on FDI. An example was mentioned by Madura (1995) who points out that multinational corporations that attempt to sell their primary products in new markets may increase their earnings and shareholder wealth due to economies of scale, and Owen (1982) supported that view when he found that US FDI was positively related to a proxy for the plant level of economy of scale.

3.2.2.4 Product Life Cycle Theory

This theory is associated with the work of Vernon (1966) who asserts that products go through different life stages, from birth to maturity to old age and decline. He suggests that FDI is a natural stage of the life cycle of a product, which is first produced and served in the home market, and as the product becomes mature in the home market, competition from other producers becomes stronger and the return on investment decreases. Eventually, MNCs look for new locations to lower the costs and increase profits, and the utilization of foreign markets through exports or other licensing or Joint Ventures (JVs) is inevitable.

The advantages arise in part from the fact that, for many products, there is a production cycle involving several stages, with new technology first being produced and used in the home country and, once standardized, shifted abroad, either because proximity to the final market or lower factor costs make this advantageous.

This theory is considered to be helpful in explaining FDI motives to invest in developing countries. It can be pointed out that the importance of this theory in explaining motives behind FDI has gradually reduced by the narrowing technological and consumption gaps among home and host economies. One of the disadvantages of this theory is that it does not explain why a company has to establish its presence abroad rather than license its technology or products.

3.2.2.5 Oligopolistic Reaction Theory

Oligopolistic reaction takes place when a firm in an oligopolistic industry notices the advantage that another firm might have gained through its FDI, and then follows it with its own FDI (Terpstra and Chow-Ming, 1988). Knickerbocker (1973) points out in his study of 187 US-based MNCs that oligopolistic reaction was positively correlated with the MNCs' FDI activities. Firms working in an oligopolistic market have a tendency to match each others' investment moves in foreign markets in order to maintain their competitive balance among each other (Terpstra and Chow-Ming, 1988). The oligopolistic reaction theory suggests that much of the FDI is explained by the actions of rival firms in oligopolistic industries, however it does not address the issue of whether FDI is more efficient than exporting or licensing for expanding abroad.

3.2.2.6 Internalization Theory

Buckley and Casson (1976) attempted to put together various FDI theories, to construct a more encompassing theory of FDI- an internalization theory. The idea here is that there is transaction costs of various kinds involved in operating through the market mechanism. When such costs are greater than those arising from carrying out activities within the firm (internalizing), establishing an overseas subsidiary will be preferred. Therefore, when the costs of operating are higher than the benefits, there are incentives for the MNC to develop its own internal organizational structure to achieve internal co-ordination of activities.

Internalization theory views the MNC as the outcome of a process in which firms attempt to secure rents from their intangible assets in the presence of market imperfections. For

example, earlier theories such as competitive advantage theory and market imperfection theory emphasized the possession of firm-specific advantages leading to market imperfections, however internalization theory focuses on the nature of markets, their weaknesses and limitations, and the organization of firms as a response to market imperfections. These imperfections include government interventions such as price controls, tariffs, etc and uncertainties in external market environment, such as finding suppliers and negotiating contracts, which can lead to significant time lags and transaction costs. Thus, in order to save time and money, MNCs may undertake certain activities and transactions within their organizations rather than the output market.

This theory provides an explanation on the question of why a firm would choose to enter a foreign market through FDI, rather than exploit its ownership advantages by exporting or licensing (franchising) its products. The theory holds that the inherent disadvantages of the firm operating in alien commercial and legal setting are overcome by the opportunity to earn rents on assets already in the firm's possession, accrued through its activities in its home base market (Caves, 1993). Therefore, in order to expand abroad, MNCs must find it advantageous to exploit the assets they possess abroad.

Clegg (1987) provided a study to explain FDI through some empirical testing. He concluded that although internalization theory provides a unifying ground, it is far away from an integrated theoretical account for FDI. Internalization theory recognizes that FDI is an alternative to exports, licensing and JVs. However, there are costs which a firm incurs when FDI is chosen over the alternatives, including search costs, cultural and political costs.

3.2.2.7 Eclectic Paradigm

A further contribution to the theory of the multinational corporation was made by Dunning (1988 and 1995), who proposed the eclectic paradigm because of his dissatisfaction with existing theory of international production. Dunning's eclectic paradigm explains the international strategies of firms engaging in FDI based on the satisfaction of three main conditions.

- The MNC should have a strong "ownership-specific advantages" which are unique to the firm such as technological advantages, economies of scale, patents, know-how, labour

skills, control over markets and trade monopolies, managerial capabilities, etc. If the corporation possesses these ownership-specific advantages, it should internalize its advantages rather than sell or lease them out to other corporations.

- The MNC should have "location advantages" which are associated with the availability of inputs for all firms established in a certain country, such as being closer to consumers or minimizing transportation costs. These circumstances explain, for example, why a firm could undertake production abroad instead of producing for export from the home country.
- The "internalization advantage" explains why firms benefit from organizing their activities on an international scale, within one multinational firm, rather than by acting through the international market. There must be an internalization advantage associated with the MNC, in the sense that the product is better produced by the firm itself than licensed to a foreign firm.

So, the Ownership, Location and Internalization (OLI) theory suggests that in order to compete successfully in a foreign market, a firm must possess some ownership-specific assets over firms from other countries. There should be some location advantages in using the firm's ownership advantage in a foreign location rather than at home and it should be beneficial to internalize those advantages rather than to use the market to pass them to foreign firms.

The concept of ownership advantage is especially important to the eclectic paradigm, not least because it is probably what draws the line with the internalization theory (Rugman and Verbeke, 1981).

One of the main criticisms of the eclectic paradigm is that it includes so many variables that it may lose some operationality. Dunning (1991) partially accepts it, although he sees it as an inevitable consequence of trying to integrate the rather different motivations behind FDI in one general theory.

3.2.3 Behavioural Motives

The behavioural motives for FDI are related to the interaction between foreign investors and the investment environment. These motives arise from the interaction of biases, goals, needs

and commitments of individuals and groups (Aharoni, 1966). These factors are considered to be internal as they are related to the firm and its employees. External factors that affect the firm's decision to expand abroad involve foreign governments and the firm's clients and distributors. Aharoni, in his study of 38 market-seeking US firms, found various factors that encourage FDI. These factors include fear of losing the market, success of competitors in the same business, and strong competition.

3.2.4 Diversification Considerations

There are many studies in the FDI literature that have investigated the effects of international diversification. Cohen (1975) points out that international diversification is an important factor that explains the causes of FDI. Multinationals do diversify by product and region in their attempts to stabilise earnings (Buckley, 1992). Diversification may include the supply of new products, entering new market segments, or imitating products produced by other firms. This approach has a very strong explanatory power in the occurrence of two-way foreign investment and the extent to which foreign investment is different in different industries.

In a survey of chief executives of 193 companies in 15 West European countries, Clegg (1995) has shown that those executives viewed international diversification through FDI as essential for the continued growth for their firms. Another study was conducted by Friedman et al. (1992) to investigate the locational decisions of MNCs in new manufacturing plants in the US. It showed that diversification considerations, among other things, were behind the decision to merge with or acquire another firm.

3.3 Determinants of FDI Location Decisions

Several studies have been carried out to investigate the wide range of determinants of FDI. The previous section highlighted the variables related to the investing company's motives for investment. In this section, factors that are related to the host country's determinants for investment will be discussed, together with brief descriptions of the characteristics and results of some related studies.

3.3.1 Economic Considerations

There are several studies of the economic considerations as determinant factors of investment inflows to host countries. The most significant economic determinant for the attraction of FDI, according to Schnieder and Frey (1985), was a country's level of development as measured by the balance of payments and GNP per capita. Other economic factors as observed by the same study, such as growth of GNP and workers' skill levels, were found to be less important in attracting FDI. Analysis by Caves (1971) showed that factors of production at lower cost or greater efficiency than in the firm's home country are important determinants of FDI. Therefore, economic considerations have a different degree of influence on foreign investment flows. In the following sections, some of the econometric studies on the determinants of FDI will be discussed.

3.3.1.1 Market Characteristics

Foreign investors prefer bigger markets to benefit from large-scale production and fast growing markets because of their promising prospects. A number of studies such as Scaperlanda and Balough (1983), Dunning (1973), Takashi (1975), Nigh (1985) have shown that there is a positive correlation between market size and FDI. In addition, studies by Yamawaki (1991) and Cuelm (1988) highlight a positive relationship between the inflows of FDI and the size and growth rate of the markets. Dunning (1973) argues that the size and growth of the host country is one of the dominant influences on FDI.

On the other hand, Root and Ahmed (1978) found that there is a weak and inconclusive relationship between FDI flows and the size of the market of the host economy. However, their findings were similar to those of Schnieder and Frey (1985), in that there is a statistically significant relationship between FDI flows and market demand as measured by per capita GDP and market growth, as measured by the growth of GDP.

It is accepted that the level of FDI is closely related to the size of the host country's market. This hypothesis was supported by several studies observing US FDI in the European Economic Community (EEC). Bandera and White (1968), for example, found that there is a

significant relationship between US FDI in EEC countries and the GNP of these host countries.

The study of the United States' FDI flows to the EEC and the Latin American Free Trade Area (LAFTA), found that the size of the market was the primary determinant of US FDI in EEC, but the market growth was the primary determinant in the case of LAFTA (Agarwal, 1980). A study by Caves (1982) showed that larger markets and higher levels of economic development attract more FDI because transaction costs are likely to be lower. Both market size and growth of the market of the host country were found to be significant determinants of FDI according to Cuelm (1988). Wheeler and Mody (1992) discovered that market size was a significant determinant of investment flows in their study of international investment location decisions by US firms. Wang (1994) confirmed that there is a positive relationship between FDI and the market size in his study of FDI in Northern Ireland.

Jun and Singh (1996) studied the determinants of FDI in developing countries. They found that market size and growth variables were considered significant in determining foreign investment flows, however, in the case of low FDI countries, the same variables did not appear to be significant.

Several studies of the determinants of FDI have used GNP, GNP per capita, GDP, and the growth of GNP as proxies for the market size of a country. Others have tried to use market demand as measured by the per capita consumption and the growth rate of consumption. Market-related variables are considered as dominant factors for attracting FDI (Agodo, 1978).

It can be noticed that FDI is closely related to the GNP and GNP growth, however the short term changes in the growth of GNP might not have an effect on the FDI location decisions. The market size and/or its growth seem to be very significant determinants of FDI.

3.3.1.2 Balance of Payments and Inflation

There are several studies that examine the balance of payments and inflation as determinants of foreign investment. Different conclusions have been drawn concerning the role of these

factors but in general, most research suggests that there is a significant relationship between inflation rates and FDI in host countries.

Schnieder and Frey (1985) found a significant relationship between inflation rates and FDI. Levis (1979) also found a significant relationship between balance of payments and inflation factors and FDI. It has been suggested that FDI might be deterred by unfavourable current accounts in a country's balance of payments, or by a high rate of inflation.

3.3.2 Tax Factors

The influence of tax-related factors as determinants of the flow of FDI is a debatable issue. According to Bartik (1991), the effect of taxes on the flow of FDI is a complex factor to gauge and interpret. Tax factors such as state and local tax burden are strong deterrents to FDI. Friedman et al. (1992) examined the foreign executives' sensitivity to the tax burden, and their study found that foreign investors were influenced by the local and state taxes and promotional activities undertaken by the state.

A study by Coughlin et al. (1991) revealed that taxes have a negative but statistically insignificant influence on foreign investors, while Root and Ahmed (1978) found that only corporate taxes were found to be a significant determinant of FDI. Surprisingly, they also found that tax incentives failed to attract FDI.

3.3.3 Labour

The availability of labour is considered by many researchers in the field to be an important determinant of FDI. However, there are some contradicting conclusions in the FDI literature concerning the importance of labour costs and wages as a determinant of FDI. Labour costs can play a key role for economies that serve as an export platform, as shown by O'Sullivan (1985), who discovered that the wage rate of the host country was a significant determinant of FDI. Cuelm (1988) identified labour costs as an important determinant of FDI in his study of foreign investment inflows into European countries. He is supported by Jeon (1992) who found a positive relationship between cheap labour and Korean FDI in the manufacturing

industries of LDCs. Kumar (1994) discovered that countries with low average labour wages could be expected to be more successful in attracting export-oriented production. Wang and Swain (1995) discovered that lower wages were statistically insignificant in the case of FDI in Hungary, but were found to be significant in the case of China. A study of FDI in LDCs undertaken by Jun and Singh (1996) found that lower wages were a significant determinant of foreign investment by MNEs. These firms are motivated by the availability of low-cost skilled, semi-skilled or unskilled labour in various LDCs.

On the other hand, a number of studies indicate different conclusions. Wage rates in the host country were found to have limited influence on the FDI location choices by MNEs in the studies by Dunning (1986) and El-Haddad (1988). According to Schnieder and Frey (1985), levels of skills and wages in the host country were found to be a less important determinant of FDI than the per capita GNP and GNP growth.

3.3.4 Availability of Natural Resources

Many scholars have explored the availability of natural resources as a significant determinant of FDI locational choice. Owen (1982) discovered a significant positive relationship between US FDI and the dependence on natural resources of host country. However, El-Haddad (1988) found the availability of raw materials to have a limited importance on FDI. Dunning (1986) also found the desire to gain access to resources such as intangible assets to have limited influence in FDI decisions by Japanese companies in the United Kingdom.

3.3.5 Infrastructure and Services

Good infrastructure, along with good quality of various services at a reasonable cost, is something that foreign investors look for in the location they choose for their investment. Infrastructure services include water, electricity, transportation, waste disposal, sewage services, communication networks, banking and legal services, etc. Wells (1987) found that a good infrastructure is very important in order to attract export-oriented investment. He was supported by Porter (1990), who pointed out the important role that infrastructure plays in attracting FDI. Rolfe and White (1992) found that the quality of the infrastructure is very

important in attracting offshore manufacturing investment, while Hobday (1994), in his study of FDI in Singapore, points out that foreign companies are attracted partly by the efficiency of transportation and communication infrastructure.

In addition, Frank (1980) argues that the availability of infrastructure facilities is an important determinant of FDI, based on interviews with managers of foreign companies. Studies by Little (1980) and Lunduval (1992) on the determinants of FDI in large countries, show a positive relationship between the occurrence of FDI and the availability of primary infrastructures such as roads, motorways, and communication networks. However, Dunning (1993) reports that these factors are rarely considered in studies of the determinants of FDI in various countries. Guisinger (1986) points out the importance of providing government services at less than full cost, in an adequate amount and in the right time. He considers this to be a very important consideration for foreign investors when choosing an investment location.

It is thought that it is more beneficial for countries to choose the kind of incentive that will benefit them and will remain even after the foreign investors leave, building the infrastructure as opposed to tax incentives, for instance.

In a study by the United Nations (UN), it was suggested that the reason for the low inflow of foreign investment into developing countries is that these countries have insufficient infrastructure and poor economic conditions. Insufficient infrastructure such as transportation, power supply, telecommunications, water supply and waste disposal may discourage investment for the production of export goods. The poor state of human resource development is reflected in low literacy and a severe dearth of entrepreneurial capability, managerial expertise or technical skills, which are of vital importance to the FDI, particularly in manufacturers and services (UNCTC, 1990).

3.3.6 Political Stability or Instability

Political considerations have been widely investigated in the FDI literature. Political risk is defined as changes in the operating conditions of foreign enterprises that arise out of political processes, either directly through war, or insurrection, or political violence, or through changes in government policies that affect the ownership and behaviour of the firm. Political

risk can be conceptualized as an event, or a series of events, in the national or international environment, that can affect the physical assets, personnel, and operations of foreign firms (Jodice, 1985). Another explanation was provided by Fatehi-Sedah and Safizadeh (1989) which considers political instability as a negative perception emanating from internal instability, inter-governmental relationships, anticipated or unanticipated government actions, or government discontinuities, all brought about by social, economic, or political imperatives existing in country's internal or relevant external environment.

Many studies have been carried out into the impact of political stability, or conversely, political instability, on the inflows of FDI by MNCs. According to Brewer (1993), political instability in a host country's government results in uncertain investment outcomes. In a study investigating the flow of FDI in 80 LDCs by Schnieder and Frey (1985), it was found that political instability significantly decreases the flow of FDI. El-Haddad (1988) found that political stability ranked among the top determinants of FDI. Political considerations have a profound influence on the multinational corporations (Boddewyn, 1988), and affects the value of a multinational company through change in future cash flow and investors' required return (Butler and Joaquin, 1998).

In a survey conducted by the Overseas Development Institute (ODI) in South Asia and sub-Saharan Africa to measure the political risk in terms of crime level, riots, labour disputes and corruption (Overseas Development Institute, 1997) found that political risk is an important factor restraining foreign investments.

A politically stable environment can give investors the confidence that laws and regulations governing their investment and the market in which they operate will remain stable over the long term. The capital risked in FDI usually requires a long term period in order to generate the expected profits, therefore foreign investors think about not only the current situation, but also the political and economic outlook of the host country.

3.3.7 Geographic Proximity, Cultural and Business Differences

Geographic proximity, and cultural and business differences between the home and a host country may be determinant factors affecting the inflows of FDI. These factors including

differences in language, culture, political regimes, education and levels of development can prevent or disturb the flow of information between firms and markets. (Ohmae, 1995).

It is argued in the FDI literature that when the home country and the host country are closer geographically, they have more chance of sharing similar cultures, although this might not apply in some cases, England and Australia for instance.

Austin (1990) found that the geographic proximity of Mexico and the USA was a determinant factor in the inflows of FDI by lowering transportation costs to compensate for not taking advantage of the lower wage rates available in other countries such as South-East Asia.

The geographic location of a country might play an important part in attracting FDI if the country enjoys a strategic location at the gateway of a major air, land or sea route, or is at the centre of a major market.

Researchers such as Cuelm (1988), Jeon (1992) and Moore (1993) have studied on the distance bewteen the home and host countries resulting from the perception and understanding of cultural and business differences. Cuelm found that the cultural proximity in terms of language between the UK and the US is a determinant factor in FDI inflows between the two countries. He was supported by Jeon, who found cultural differences and geographic proximity to be a significant determinant of Korean FDI flows. Moore also found that geographic distance was a significant determinant of German FDI.

3.3.8 Policies Towards Foreign Companies

Changes in government policies on FDI in the past decade confirm and strengthen the trend towards the liberalization of FDI. Most of the new policies that were adopted by developing countries reduced restrictions to foreign entry, or liberalized operations in industries that were restricted to FDI. Other restrictions that relate to the ownership of land and real estate, and limitations on the number of foreign employees and foreign exchange controls were reduced or removed. Some of the incentive regimes were revised and rationalised, while additional incentives were offered to promote investment in priority industries. As discussed in the previous chapter, the number of countries that changed their investment regimes according to the UNCTAD has increased from a meagre 35 in 1991 to as many as 71 by the year 2001.

The number of regulatory changes introduced by different countries of the world has also increased from 82 in 1991 to 208 in 2001, and most of these regulatory changes were introduced to make FDI more favourable.

Brewer (1993) categorized the various types of government policies towards FDI into five main types. These policies include monetary policies (such as money supply, foreign exchange rates and interest rates), capital controls policies, transfer pricing policies, antitrust or competition policies, and labour relations policies. He concludes that market imperfections can be increased and/or decreased by government policies, even by a single given policy.

Promotion programs, as mentioned in a report by UNCTAD (1995), might involve building an image for the host country within the investment community as an investment location that is favoured by foreign investors. The report also mentioned that an image building program involves advertising in the media, conducting seminars and general investment missions and participating in exhibitions.

3.3.9 Weather of the Host Country

The weather in the host country may be a factor influencing FDI inflows to the host country. This can be important in cross-country studies on locational choices of multinational corporations. In some cases climatic conditions in a country which are conducive to the growth of commodity products, for instance tea in India and coffee in Brazil, might enable an industry based on those products to thrive, and in turn attract FDI (Elizabeth and Veliyath, 1996).

3.4 Investment Incentives

Investment incentives are the promotional or regulatory activities that are adopted by the host government in order to make their location more attractive for foreign investments. In other words, they are the benefits offered by host economies to foreign companies in order to attract more FDI, or retain those already present in a country. The definition of FDI incentives, according to OECD (1983), is that investment incentives are the measures

designed to influence the size, location or industry of a FDI investment project by affecting its relative cost or by altering the risks attached to it through inducements that are not available to comparable domestic investors.

MNCs are mainly attracted by strong economic fundamentals in the host economies. The most important ones are market size and income levels, skill levels in the host economy, the availability of infrastructure and other resources that facilitates efficient specialization of production, trade policies, and political and macro-economic stability. The relative importance of the different fundamentals varies depending on the type and location of investment. For instance, foreigners investing in the United States have been attracted mainly by the large market size, while multinationals investing in Singapore focus mainly on the availability of skilled labour, good infrastructure, and political and economic stability.

An increasing number of host governments provide various forms of investment incentives to encourage foreign-owned companies to invest in their countries. Examples of FDI incentives are tax incentives, guarantees against expropriation, government provision of utilities such as water, power and communication at subsidised prices, reduction/elimination of import duties on inputs, interest rate subsidies, guarantees on loans and coverage for exchange rate risks, wage subsidies, training grants as well as relaxation of legal obligations towards employees.

3.4.1 Types of Investment Incentives

There is a wide variety of FDI incentives, including fiscal incentives such as tax holidays and lower taxes for foreign investors, financial incentives such as grants and preferential loans to MNCs, as well as other incentive measures like market preferences, infrastructure, and sometimes even monopoly rights.

The location of FDI may be influenced by the various incentives offered by governments to attract multinationals. As mentioned earlier, these incentives take a variety of forms. FDI incentives are commonly divided into three categories namely fiscal, financial, and other incentive measures, all of which are financed and/or offered by authorities in the host area. The following tables represent the main types of fiscal, financial and other incentive measures, together with explanations provided by a publication by UNCTAD (1996).

Table 3.1 Main types of fiscal incentives for FDI

Profit-based	Reduction of the standard corporate income-tax rate; tax holidays; allowing losses incurred during the holiday period to be written off against profits earned later (or earlier).
Capital investment-based	Accelerated depreciation; investment and reinvestment allowance.
Labour-based	Reductions in social security contributions; deductions from taxable earnings based on the number of employees or on other labour-related expenditure.
Sales-based	Corporate income-tax reductions based on total sales.
Value-added-based	Corporate income-tax reductions or credits based on the net local content of outputs; granting income-tax credits based on net value earned.
Based on other particular expenses	Corporate income-tax deductions based on, for example, expenditure relating to marketing and promotional activities.
Import-based	Exemption from import duties on capital goods, equipment or raw materials, parts and inputs related to the production process.
Export-based	Output-related, e.g., exemptions from export duties; preferential tax treatment of income from exports; income-tax reduction for special foreign-exchange-earning activities or for manufactured exports; tax credits on domestic sales in return for export performance. Input-related, e.g., duty drawbacks, tax credits for duties paid on imported materials or suppliers; income-tax credits on net local content of exports; deduction of overseas expenditures and capital allowance for export industries.

Source: *UNCTAD, Incentives and Foreign Direct Investment, 1996*

Table 3.2 Main types of financial incentives for FDI

Government grants	A variety of measures (also loosely referred to as "direct subsidies") to cover (part of) capital, production or marketing costs in relation to an investment project.
Government credit at subsidised rates	Subsidised loans; loan guarantees; guaranteed export credits.
Government equity participation	Publicly funded venture capital participating in investments involving high commercial risks.
Government insurance at preferential rates	Usually available to cover certain types of risks such as exchange-rate volatility, currency devaluation, or non-commercial risks such as expropriation and political turmoil (this type of insurance is often provided through an international agency).

Source: *UNCTAD, Incentives and Foreign Direct Investment, 1996*

Table 3.3 Main types of other incentives for FDI

Subsidised dedicated infrastructure	Includes provision, at less-than-commercial prices, of land, buildings, industrial plants, or specific infrastructure such as telecommunications, transportation, electricity and water supply.
Subsidised services	Services offered may include assistance in identifying finance; implementing and managing projects; carrying out pre-investment studies; information on markets, availability of raw materials and supply of infrastructure; advice on production processes and marketing techniques; assistance with training and retaining; technical facilities for developing know-how or improving quality control.
Market preferences	Preferential government contracts; closing the market for further entry; protection from import competition; granting of monopoly rights.
Preferential treatment on foreign exchange	Special exchange rates; special foreign debt-to-equity conversion rates; elimination of exchange risks on foreign loans; concessions of foreign exchange credits for export earnings; special concessions on the repatriation of earnings and capital.

Source: *UNCTAD, Incentives and Foreign Direct Investment, 1996*

Financial incentives include relocation and expatriation support when authorities offer grants to help meet enterprises' additional capital spending and concrete relocation costs. Administrative assistance is practiced when authorities resort to implicit subsidisation, whereby for example, investment promotion agencies take it upon themselves to perform a range of tasks that would otherwise have fallen to the investing enterprises. Examples include preferential treatment by regulatory authorities, whereby administrative impediments, for example the speed of obtaining permissions, are eased.

In developing countries, incentive schemes that are based on tax holidays and other fiscal measures that do not require direct payments of scarce public funds are popular. The other incentive category includes regulatory FDI incentives, which are policies of attracting foreign-owned enterprises by means of offering them derogations from national regulation. Such incentives are almost exclusively granted in connection with targeted strategies, or they are specially negotiated as part of the strategies for luring large individual investment projects. However, many incentives are also applicable when it comes to attracting domestic companies or even in cases where local companies have enough bargaining power to force governments to come up with incentives.

Promotional activities by the host country are also an important factor for countries that are trying to attract foreign investments. These promotional activities include advertising locally

or internationally, establishing representative offices in countries that have the potential of providing FDI, investment delegations, investment conferences and seminars, and providing various kinds of services to potential investors. In a study by Friedman et al. (1992), a coefficient of promotion was found to be a positive and significant factor for enticing foreign companies to conduct foreign investment activities.

3.4.1.1 Subsidies

Examples of subsidies that are provided by the host countries are subsidised infrastructure, including the provision of energy (fuel, power, water, etc), transportation and telecommunication at lower costs, and subsidised purchase/rental of land, buildings, and industrial plants. Subsidies might also include a subsidised exchange rate, export subsidies, capital subsidies, loan subsidies, subsidised buildings and subsidised services. Subsidised services may include assistance in implementing and managing projects, carrying out pre-investment studies, information on markets, availability of raw materials, advice on production processes and marketing techniques, assistance with training, technical facilities for developing know-how or improving quality control. Job training subsidies, particularly when investment is sought in activities that are new to the host economy, are offered for investors that are faced with a shortfall of qualified labour. In these cases, authorities offer to alleviate this shortfall through supported education programs.

3.4.1.2 Tax Incentives

Tax incentives can be defined as any incentives that reduce the tax burden of enterprises in order to induce them to invest in particular projects or sectors, and are exceptions to the general tax regime. Tax incentives would include, for example, reduced tax rates on profits, tax holidays, accounting rules that allow accelerated depreciation and loss carry forwards for tax purposes, and reduced tariffs on imported equipment, components, and raw materials, or increased tariffs to protect the domestic market for import substituting investment projects.

Because tax incentives are intended to encourage investment in certain sectors or geographic areas, they are rarely provided without conditions attached. Very often countries design

special incentive regimes that detail the tax benefits as well as the key restrictions. For instance, these regimes may require that a facility be established in a certain region or regions, have a certain turnover, require the transfer of technology from abroad, or employ a certain number of individuals. For example, China offers foreign investors a tax refund of up to 40 percent on profits that are reinvested to increase the capital of the firm or to launch another firm. The profits must be reinvested for at least five years. If the reinvested amounts are withdrawn within five years, the firm has to pay the taxes. Similarly, India offers a tax exemption on profits of firms engaged in tourism or travel.

The impact of tax policies on the volume and location of FDI has for long been an area of interest of scholars in the field of international business and economics, however the findings have been less than conclusive (Milward and Newman, 1989). Agodo (1978), in his study of 33 United States companies that have 46 manufacturing investments in 20 African countries, discovered that tax concessions were insignificant as a determinant of FDI in his statistical regression analysis. Rolfe and White (1992) found only a slightly significant relationship between the presence of a fifteen year tax holiday and the attractiveness of a country as a site for FDI. On the other hand, Woodward and Rolfe (1993) conclude that tax holidays and free zones would increase the probability of a country receiving foreign investments.

Examples of tax-related incentives might include granting tax reductions, granting tax holidays, corporate income-tax reductions, exemption from income tax, and exemption from sales tax, tax credits and preferential tax treatment.

3.4.1.3 Streamlining of Policies

Streamlining of policies can be an important influencing factor in foreign investment activities as it involves reducing bureaucracy and red tape, easing entrance procedures, simplifying administrative procedures, and the availability of one agency to deal with and coordinate between ministries and entities that are involved in investments.

An example of streamlining of policies is the Malaysian Industrial Development Authority (MIDA) and the Thai Board of Investment (BOI), wherein both established a centre through which investors can obtain approval and make arrangements for all their investment needs (Wells and Wint, 1990).

3.4.1.4 Services and Infrastructure

Infrastructure developments are one of the preferred ways of increasing the attractiveness of a host country. These are made through providing physical infrastructure (roads, railways, harbours, airports) or communication tailored to meet the needs of the investors. Infrastructure facilities, when provided at reasonable price, together with good means of transportation, can be an important factor for attracting foreign investments. Countries should choose the types of incentives that help to develop the country, and which remain even after the foreign investors leave, meaning infrastructure development as opposed to tax breaks, for example.

Governments providing accommodation of a high standard to expatriates, adequate industrial estates and export processing zones may succeed in attracting foreign investors. Investment incentive programs and the duty-free entry of components in free trade zones may further induce manufacturers in the developed world to move operations to LDCs (Woodward and Rolfe, 1993). Moreover, a very important factor in attracting foreign investments is the provision of good quality services such as energy (petrol, diesel, etc.), telecommunications, power supply, water supply, public security, banking services, freight, sewage services, fire department, financial market services, health services, media, information services, waste removal and insurance. Availability of advanced supporting systems including consulting, accounting and maintenance is regarded as very important by numerous investors. Furthermore, the availability of technical resources such as laboratories, information systems, standards and quality control can be a considerable attraction for foreign investors.

3.4.1.5 Government Agreements and Guarantees

The government of the host country can enter into agreements with other foreign governments in order to facilitate foreign trade and make it easier for foreign investors to invest by solving financial and managerial problems. These agreements include common market and regional economic agreements, and can act as an important attracting factor for FDI. Multiple tax treaties and double taxation agreements are also important attracting factors for FDI.

Government guarantees for investments are commitments made by the government to back a private investment and to back a third-party lender if investment is lost for political or other reasons (Lubetzky, 1994). Examples of guarantees that a host country might offer to foreign investors are guarantees against expropriation, guarantees of stable tax rates, guarantees of stability of laws and regulations, and sometimes, guarantees of protection against competition through disallowing new investments in the same industry.

3.4.2 Importance of FDI Incentives

The views on the importance of FDI incentives have begun to change over the past decade. As a factor in attracting FDI, incentives were considered by many economists as secondary to more fundamental determinants, such as market size, access to raw materials, availability of skilled labour and political and economic stability. This perspective of host country characteristics assumed that investment incentives were seen as relatively minor determinants of FDI decisions. While they might move the investment decision in favour of one of several investment locations that have similar investment determinants, the effects were considered to be limited. It appears that this view has changed and that incentives are becoming a more important determinant of international investment decisions. One indication is the proliferation of investment incentives across the world.

Studies on the impact of various investment incentives provided by the host countries on the investment decisions were a subject of controversy and did not provide conclusions concerning the effectiveness of the incentives. A study by Contractor (1990) concluded that FDI policy changes appear to have very weak influence on investment flows. Shepherd, Silberstone and Strange (1985) surveyed the UK's overseas investors and found that incentives in host countries have a negligible effect on FDI decisions. Hill and Lindsey (1987) found the host country's incentives to have a limited influence on the FDI decisions in the Philippines. On the other hand, a study by Guisinger (1986) discovered that incentives were effective in affecting the decisions of FDI. El-Haddad (1988) found tax incentives to exert a high degree of influence on FDI decisions.

3.4.3 Effects of Incentive Systems

As host governments struggle to attract FDI in order to enhance their growth and development, it is still not certain whether these investments will have positive effects on the host countries. Increasing the amounts of investment does not necessarily lead to positive net profits or to achieving the development goals of the host country. Incentive-based competition risks a race between countries to offer more incentives and ease their regulatory measures, as countries feel obliged to keep up with one another. This scenario may increase the risk of making the costs of incentives exceed the expected benefit return to society.

Incentives may be offered to compensate for deficiencies and distortions in a host country's business environment (e.g. poor infrastructure and bureaucracy). This is one of the main rationales for setting up Free Trade Zones (FTZs) or Export Processing Zones (EPZs). Investment incentives would be cost effective as they can work to offset existing risks and disincentives since they act as direct subsidies for the targeted enterprises (Lubetzky, 1994). Hence, it is possible that FDI incentives are effective in the sense that they influence FDI flows. However, it is not obvious whether they are also efficient in the sense that the benefits to the host country are as large as the costs for providing the incentives.

A study by UNCTC (1992) suggests that the goal of an incentive system should be the achievement of the country's development goals rather than increasing investments. It was also mentioned in the same study by UNCTC that incentives might influence some foreign investors' decisions to locate in a certain country, but other existing investors could ask for the privileges offered to new investors and therefore, the benefits that arise from increased investments by the new investors must be offset by the costs of providing incentives to retain existing investors.

The main argument against incentives is related to the costs involved. These include the opportunity costs of granting incentives instead of using the same resources for improving the infrastructure or educating the workforce. While remedying one failure, an incentive may create others. It is also difficult to assess whether an incentive has been welfare-enhancing.

3.4.4 Competition Among Countries to Attract FDI

While some countries have attracted large FDI flows, others have been less successful, even though they have liberalized FDI regimes. Intensified competition for FDI has led many organizations to look for benchmarks of policies in attracting FDI, and as such, countries are almost forced to be more open towards FDI. According to Blomstrom and Kokko (2003), designing efficient incentive programs is a complex task, and the competition between host governments trying to attract FDI adds to the challenge, as it tends to shift profits and welfare from the host countries to foreign multinationals. Some solutions for this problem were suggested by coordinating multi-lateral policies for FDI incentive by setting the rules and boundaries, in the same way as GATT/WTO has defined the rules for international trade policy. A second-best solution may be to consider the investment incentive packages as part of the country's overall industrial policy, and to make support programs available to all investors, foreign as well as local. The strongest theoretical motive for incentives to inward FDI is spillovers of foreign technology and skills to local industry, which is not an automatic consequence of foreign investment. Potential spillover benefits are realized only if local firms have the ability and motivation to invest in absorbing foreign technologies and skills. To motivate subsidisation of foreign investment, it is necessary to support learning and investment in local firms as well through training and research and development. Moreover, the country's industrial policies in general can cause significant effects on FDI. By enhancing the modern infrastructure and by improving other fundamentals for economic growth including the supply of human capital, a country does not only become a more attractive site for multi-national firms, but it also increases the likelihood of benefits through spillover from the foreign participation.

3.4.5 Government Intervention Policies

The effects of FDI on a host country's economy, in particular its growth and development prospects, are of special interest to developing countries. Concerns in this respect have sometimes led to government intervention. Several other strategic and socio-economic considerations have also regularly figured in host government intervention processes, such as employment effects, technology transfer, and environmental and cultural effects. Host

government policies in this respect emerge from the specific mix of political and economic circumstances characterizing particular countries.

Many government interventions to promote development may cause constraints rather than help growth and welfare. The most successful developing countries in recent economic history are the newly industrializing Asian economies that intervened intensively in markets to build up their competitive capabilities. Their experience suggests that there is a significant role for government in providing the collective goods needed for sustained development. A study conducted by the UNCTC (1992) suggests that the issue is not whether governments should intervene, but how should they intervene.

Regarding the issue of competition among governments (national or local) to attract FDI, some problems may be created as a result of this competition. When governments compete to attract FDI there is a tendency to overbid, and the subsidies may very well surpass the level of the benefits, with welfare losses as a result. These problems may be particularly severe if the incentives discriminate against local firms and cause losses of local market shares and employment.

3.5 Performance Requirements or Restrictions

The regulation of entry and establishment of MNCs may take the form of controls or restrictions over the admission and establishment of foreign investors, and limitations on foreign ownership and control. These requirements and controls are imposed by host countries in order to maximize the potential benefits to their country.

Examples of these performance requirements might include restricting foreign ownership, price controls, corporate tax charges, limitations on numbers of foreign employees, tariff duties, fees, income taxes, limitations on the size of the venture, local content requirements, local management requirements, minimum export requirements, local labour requirements, location restrictions, production capacity control, transfer prices control, foreign exchange balancing requirements, technology sharing requirements, financial and information disclosure requirements and labour training requirements. In some cases, host countries control the remittances of profits and the repatriation of capital on order to encourage reinvestments of profits.

Performance requirements "accelerate and redirect the rents generated by incentive policies, and act as turbochargers for incentive instruments" (Guisinger, 1986). However, performance requirements have been criticised because they might affect the location of production and consequent trade flows of goods, services, technology and capital among markets (UNCTC, 1992). It was mentioned in a report by UNCTC (1992) that some countries impose regulations on export-oriented investments concerning hiring local personnel in spite of the fact that local personnel may not be available at the required level of experience and productivity. Besides the market distortions that the performance requirements may cause, many scholars have criticised such performance requirements as a deterring factor for FDI, as they might affect the gains that foreign investors aspire to when investing in a certain country.

3.6 Summary and Discussion

The factors influencing FDI appear to be diverse in the context of the firm, industry and country-specific factors, and therefore the decision of MNCs to expand internationally can also be found to vary in terms of these factors. FDI can play an important role in raising a country's technological level, creating new employment, and promoting economic growth. Many countries therefore actively try to attract foreign investors in order to promote their economic development.

The preceding discussion on theories and issues related to FDI has highlighted some of the influential factors. A large amount of literature exists from studies conducted by many scholars in the field on the reasons behind FDI by MNCs. There might be other factors other than the ones cited in the literature that could have an effect on FDI, as the factors affecting FDI appear to be diverse in the context of the firm, industry-related factors and country-related factors, however the findings from the various studies on FDI were found to have some consistency with theories of FDI. It is difficult to generalize these findings or draw general conclusions since each study involves a different methodology, with different magnitudes and qualities of the available data. Nevertheless, these studies provide some support to the theorization of FDI, especially in the context of internalization and the eclectic paradigm frameworks.

The study of the determinants of FDI and their effect on the locational decisions of MNCs has proved to be a significant area of study in the FDI. The results were found to be multiple, with some contradictory conclusions. Some studies have emphasized the role of tax and labour factors as significant determinants of foreign investment decisions, while others claim that tax and labour have limited influence on FDI decisions. The determinant FDI factors that are related to host countries include the size and growth of the economy, balance of payments, taxation policy, labour and government policies towards foreign investors. Most of the studies have observed the market size and market growth of the host country as significant FDI determinants. A general guideline may be that in choosing a foreign location, MNCs, besides market related factors, look for a good infrastructure and services at relatively low cost, and with easy access to international transportation and communication networks.

Governments, especially those experiencing economic deficiencies, offer investment incentives in order to attract FDI in order to achieve their development goals. The various incentives that host governments offer to attract foreign investments have been discussed in this chapter, together with the performance requirements that host governments may impose on foreign investors. There is a controversy over the effectiveness of investment incentives as a tool to attract FDI. Some studies have concluded that incentives have limited influence on investment flows, while others have found incentives to be a significant influencing factor for FDI. The literature suggests that the goal of an incentive system should be the achievement of the country's development goals, rather than increasing investments. The next chapter discusses worldwide trends and prospects for FDI.

Chapter 4

Foreign Direct Investment: Global Trend

4.1 Introduction

Flow of foreign direct investment has grown at a rapid rate over recent past. Higher flows of FDI over the world always reflect a better economic environment in the presence of economic reforms and investment-oriented policies.

Global flow of FDI reached at a record level of US$ 1306 billion in the year 2006, a 38% increase compared to year before, largely fuelled by cross border Mergers and Acquisitions (M&As).

Most of the developing and least developed countries worldwide equally participated in the process of direct investment activities.

- FDI inflows to Latin American and Caribbean region increased by 11 percent on an average in comparison to previous year.
- In African region FDI inflows made a record in the year 2006.
- Flow of FDI to South, East and South East Asia and Oceania maintained an upward trend.
- Both Turkey and oil rich Gulf States continued to attract maximum FDI inflows.
- United States Economy, being world's largest economy also attracted larger FDI inflows from Euro Zone and Japan.

Over recent years most of the countries over the world have made their business environment investment friendly for absorbing global opportunities by attracting more investable funds to the country. This chapter present worldwide trends in FDI and prospects that lie ahead. Moreover, it is intended to assess where India stands in relation to the rest of the world.

4.2 Worldwide Trend in Foreign Direct Investment Flows

FDI has been growing since the early 1980s. FDI activities have been undertaken by MNCs in order to control assets and manage production activities abroad.

After a decade of strong and steady growth, global flows of FDI fell sharply in 2001, following the historical boom during the period 1999-2000, shrinking by a half in 2001. This was the first drop in inflows since 1991, and the largest decline in at least three decades, according to the World Investment Report (UNCTAD, 2002). The volume of FDI inflows reached about US$ 534 billion in 2002, as against US$ 735 billion in 2001, and is equivalent to about a third of the US$ 1492 billion peak in 2000. Behind this decline was the slowdown in the world economy, which reduced world demand due to the global economic recess and a weakening of business confidence, both of which were accentuated by the events of September 11 in the United States, and both contributed to a sharp reduction of the cross-border M&As that take place predominantly between industrialized countries.

Global FDI inflows rose in 2007 by 30% to reach an all-time high of US$ 1833 billion, according to the World Investment Report (UNCTAD, 2008). The 2007 flows surpassed the previous record set in 2000 by some US$ 400 billion (figure 4.1), despite the global financial and credit crisis that began in the second half of 2007.

The upward trend in 2007 was apparent in nearly all regions and sub-regions of the world, and in all three economic groupings: developed countries, developing countries, and the transition economies of South-East Europe and the Commonwealth of Independent States (CIS) (table 4.1).

The stock of FDI worldwide reached US$ 15 trillion. This represents the significant scale of the activities of around 79000 TNCs worldwide that own about 790000 foreign affiliates. The sales, value added and exports of these affiliates are estimated to have increased by 21%, 19%, and 15% respectively, in 2007 (table 4.2).

FDI inflows to developed countries amounted to US$ 1248 billion. The United States remained the largest recipient country, followed by the United Kingdom, France, Canada, and the Netherlands (figure 4.2). FDI inflows to developing countries reached their highest level ever (US$ 500 billion), a 21% increase over 2006. While South Asia, East Asia, South-East Asia, and Oceania accounted for half of all FDI into developing countries, Latin America and the Caribbean recorded the largest increase (36%). Inflows to West Asia have been growing in recent years and have exceeded those to Africa since 2004. All the same, investment in Africa also reached a historic high. In addition, the LDCs attracted US$ 13 billion worth of FDI in 2007, which is also a record.

FDI outflows from developed countries grew even faster than their inflows, exceeding them by US$ 445 billion in 2007. The United States maintained its position as the largest single source country of FDI (figure 4.2). Developing countries also continued to gain in importance as sources of FDI, with outflows peaking at US$ 253 billion, mainly as a result of the outward expansion of Asian TNCs. Among developing and transition economies, the three largest recipients of FDI from developing countries were China, Hong Kong (China), and the Russian Federation (figure 4.2).

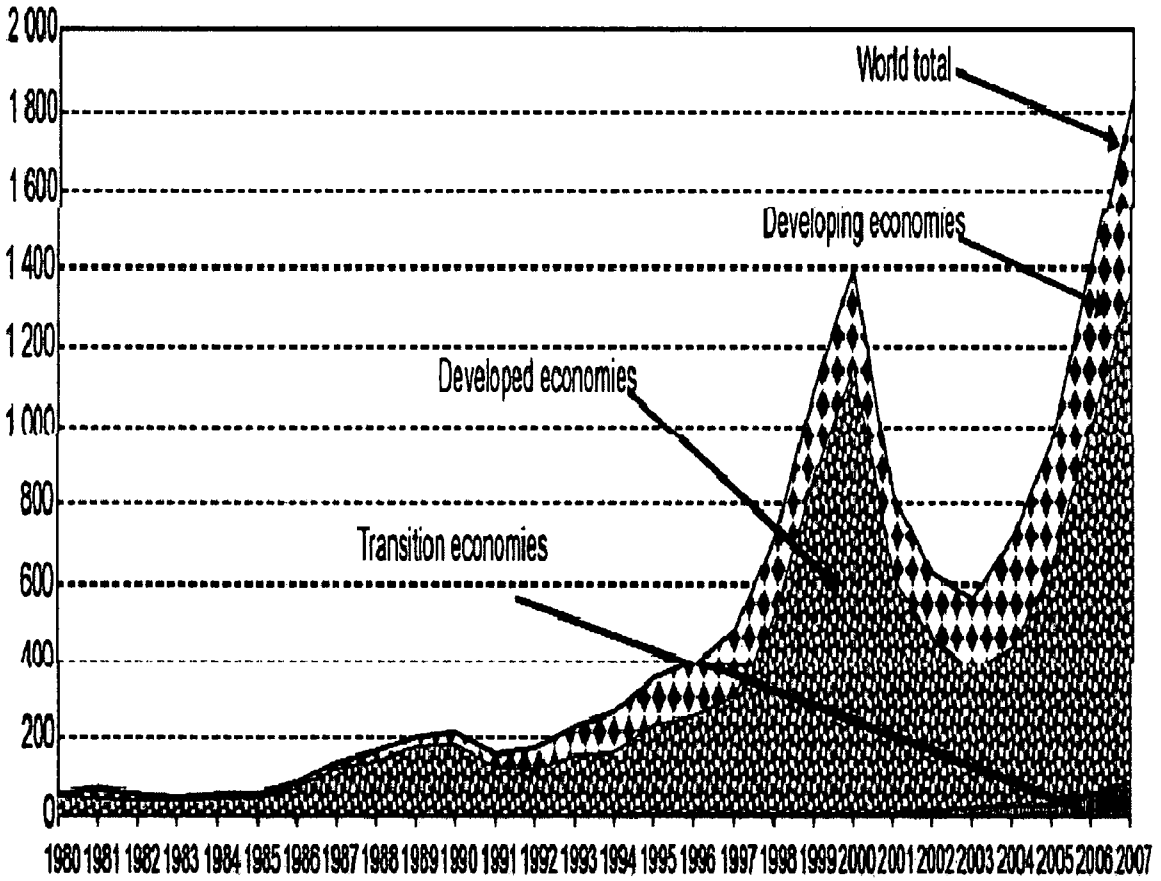
Unprecedented levels of cross-border M&As, reflecting a continuing trend in consolidation of companies, contributed substantially to the global surge in FDI. In 2007, the value of such transactions amounted to US$ 1637 billion which is 21% higher than the previous record set in 2000. Cross-border M&As involving private equity funds almost doubled, to US$ 461 billion, another record, accounting for over one quarter of the value of such transactions worldwide. A new feature of global FDI is the emergence of Sovereign Wealth Funds (SWFs) as direct investors. While the amounts invested by SWFs in the form of FDI remain relatively small, they have been growing in recent years.

The sub-prime mortgage crisis that began in the United States in 2007 has affected financial markets and created liquidity problems in many countries, leading to higher credit costs. However, the capacity of firms to invest abroad appears to have been less affected in 2007 as a whole. The sharp weakening of the dollar helped to stimulate FDI to the United States. The overall policy trend also remains one of greater openness to FDI. UNCTAD's annual survey of changes in national laws and regulations that may influence the entry and operations of TNCs suggests that policymakers are continuing to make the investment climates in their countries more attractive to TNCs. In 2007, of the almost 100 policy changes identified by UNCTAD as having potential bearing on FDI, 74 aimed at making host-country environments more favourable to FDI, despite growing concerns and political debate over rising protectionism.

The slowdown and financial turmoil in the world economy have led to liquidity crisis in money and debt markets in many developed countries. As a result, M&A activity has begun to slow markedly. In the first half of 2008, the value of M&A transactions was 29% lower than in the second half of 2007. UNCTAD estimates that, overall, FDI flows in 2008 will be about US$ 1600 billion, representing a 10% decline from 2007. This estimate is based on available data for 75 countries relating to FDI flows for the first quarter of 2008. Meanwhile,

FDI flows to developing countries are likely to remain fairly stable. World Investment Prospects Survey 2008–2010 (UNCTAD, 2008) indicates a lower level of optimism than was expressed in the previous survey, and more caution in TNCs' investment expenditure plans than in 2007.

Figure 4.1 FDI inflows, global and by groups of economies, 1980-2007
(Billions of US dollars)



Source: *UNCTAD, World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge.*

Table 4.1 FDI flows, by region and selected countries, 2005-2007
(Billions of US dollars and per cent)

Region/economy	FDI inflows			FDI outflows		
	2005	2006	2007	2005	2006	2007
Developed economies	611.3	940.9	1 247.6	748.9	1 087.2	1 692.1
Europe	505.5	599.3	848.5	689.8	736.9	1 216.5
European Union	498.4	562.4	804.3	609.3	640.5	1 142.2
Japan	2.6	- 6.5	22.5	45.8	50.3	73.5
United States	104.8	236.7	232.8	15.4	221.7	313.8
Other developed countries	- 1.7	111.3	143.7	- 2.1	78.4	88.3
Developing economies	316.4	413.0	490.7	117.6	212.3	253.1
Africa	29.5	45.8	53.0	2.3	7.8	6.1
Latin America and the Caribbean	76.4	92.9	126.3	35.8	63.3	52.3
Asia and Oceania	210.6	274.3	320.5	79.5	141.1	194.8
Asia	210.0	272.9	319.3	79.4	141.1	194.7
West Asia	42.6	64.0	71.5	12.3	23.2	44.2
East Asia	116.2	131.9	156.7	49.8	82.3	102.9
China	72.4	72.7	83.5	12.3	21.2	22.5
South Asia	12.1	25.8	30.6	3.5	13.4	14.2
South-East Asia	39.1	51.2	60.5	13.8	22.2	33.5
Oceania	0.5	1.4	1.2	0.1	0.0	0.1
Transition economies (South-East Europe and CIS)	31.0	57.2	85.9	14.3	23.7	51.2
South-East Europe	4.8	10.0	11.9	0.3	0.4	1.4
CIS	26.1	47.2	74.0	14.0	23.3	49.9
World	958.7	1 411.0	1 833.3	880.8	1 323.2	1 996.5
Memorandum: percentage share in world FDI flows						
Developed economies	63.8	66.7	68.1	85.0	82.2	84.8
Developing economies	33.0	29.3	27.3	13.3	16.0	12.7
Transition economies (South-East Europe and CIS)	3.2	4.1	4.7	1.6	1.8	2.6

Source: *UNCTAD, World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge.*

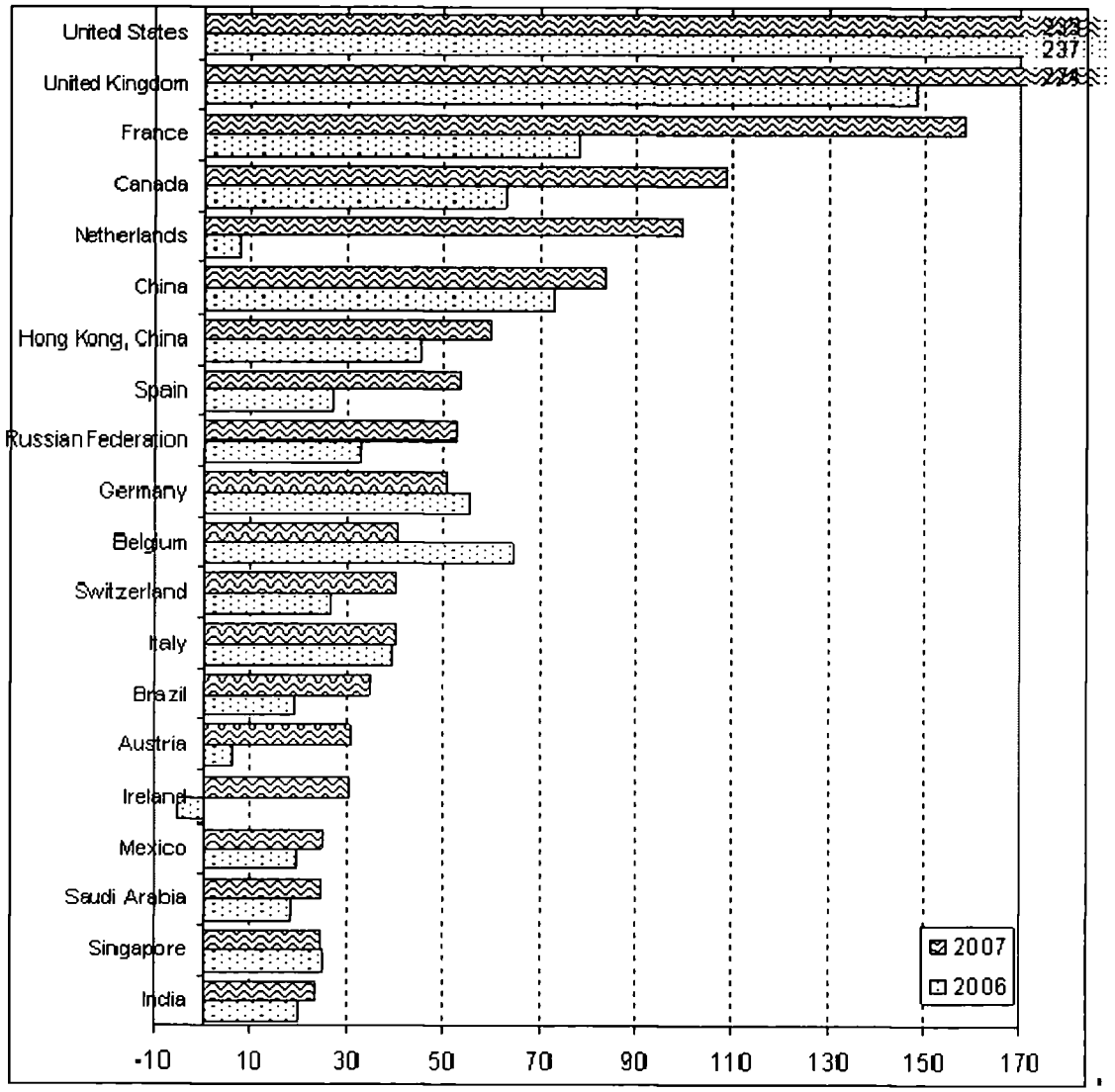
Table 4.2 Selected indicators of FDI and international production, 1982, 1990, 2006 and 2007

Item	Value at current prices (billions of US dollars)			
	1982	1990	2 006	2 007
FDI inflows	58	207	1 411	1 833
FDI outflows	27	239	1 323	1 997
FDI inward stock	789	1 941	12 470	15 211
FDI outward stock	579	1 785	12 756	15 602
Income on inward FDI	44	74	950	1 128
Income on outward FDI	46	120	1 038	1 220
Cross-border M&As	..	200	1 118	1 637
Sales of foreign affiliates	2 741	6 126	25 844	31 197
Gross product of foreign affiliates	676	1 501	5 049	6 029
Total assets of foreign affiliates	2 206	6 036	55 818	68 716
Exports of foreign affiliates	688	1 523	4 950	5 714
Employment of foreign affiliates (thousands)	21 524	25 103	70 003	81 615
Memorandum				
GDP (in current prices)	12 083	22 163	48 925	54 568
Gross fixed capital formation	2 798	5 102	10 922	12 356
Royalties and licence fees receipts	9	29	142	164
Exports of goods and non-factor services	2 395	4 417	14 848	17 138

Source: *UNCTAD, World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge.*

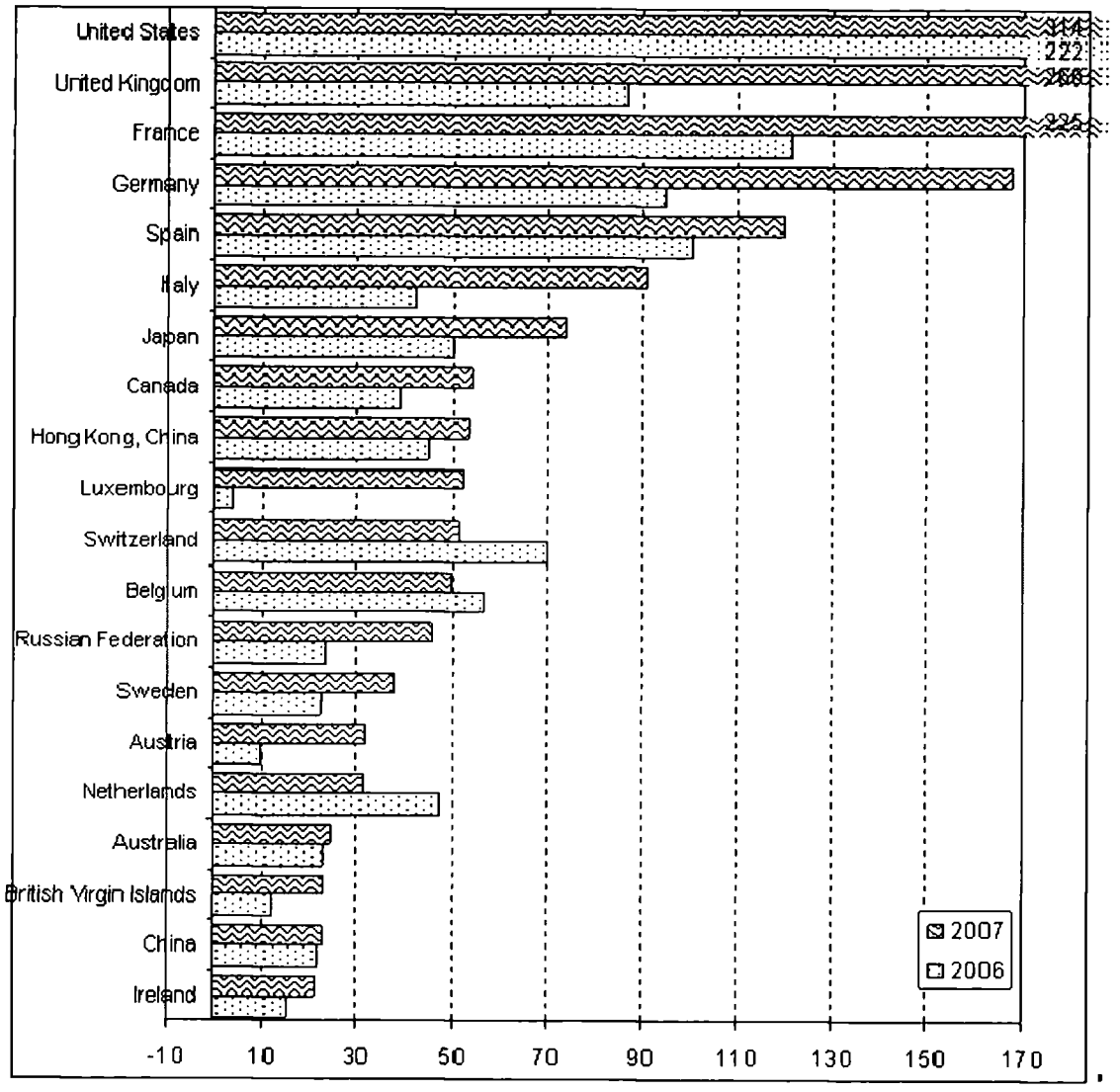
Figure 4.2 Global FDI flows, top 20 economies, 2006-2007
(Billions of US dollars)

4.2a FDI inflows



Source: *UNCTAD, World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge.*

4.2b FDI outflows

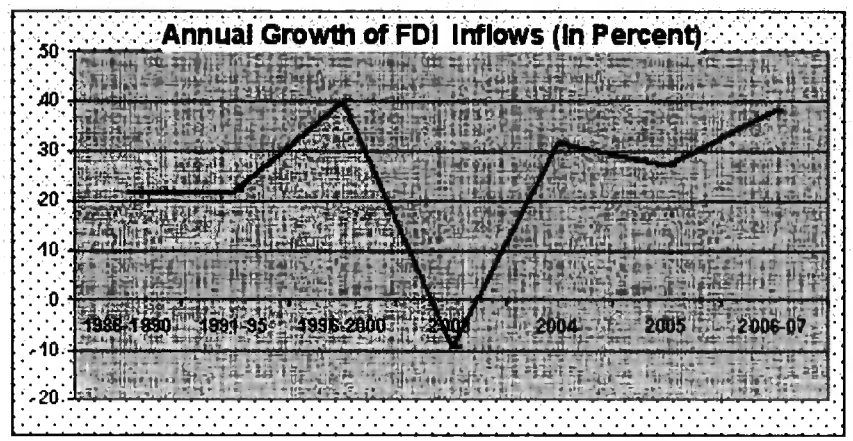


Source: *UNCTAD, World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge.*

The following diagram shows the annual Growth of FDI inflows over the world:

Figure 4.3 Annual Growth of FDI Inflows (1986-2007)

(In Percent)



***Source**: Economy Watch*

A higher inflow of FDI to a country largely generates employment in the nation. FDI in manufacturing sector creates more employment opportunities than to any other sectors.

For the year 2006, countries such as Luxembourg, Hong Kong China, Suriname, Iceland and Singapore ranked in the top of Inward performance Index Ranking of the UNCTAD.

Over recent years most of the countries over the world have made their business environment investment friendly for absorbing global opportunities by attracting more investable funds to the country.

4.3 Private Equity Funds

While FDI by private equity funds set a record level in 2007, it's now on a decline. Cross-border M&A activity of such funds almost doubled in 2007. Private equity investors are buying larger and also publicly listed companies. In the first half of leveraged buyout transactions slowed down, raising doubts over their sustainability in FDI activity.

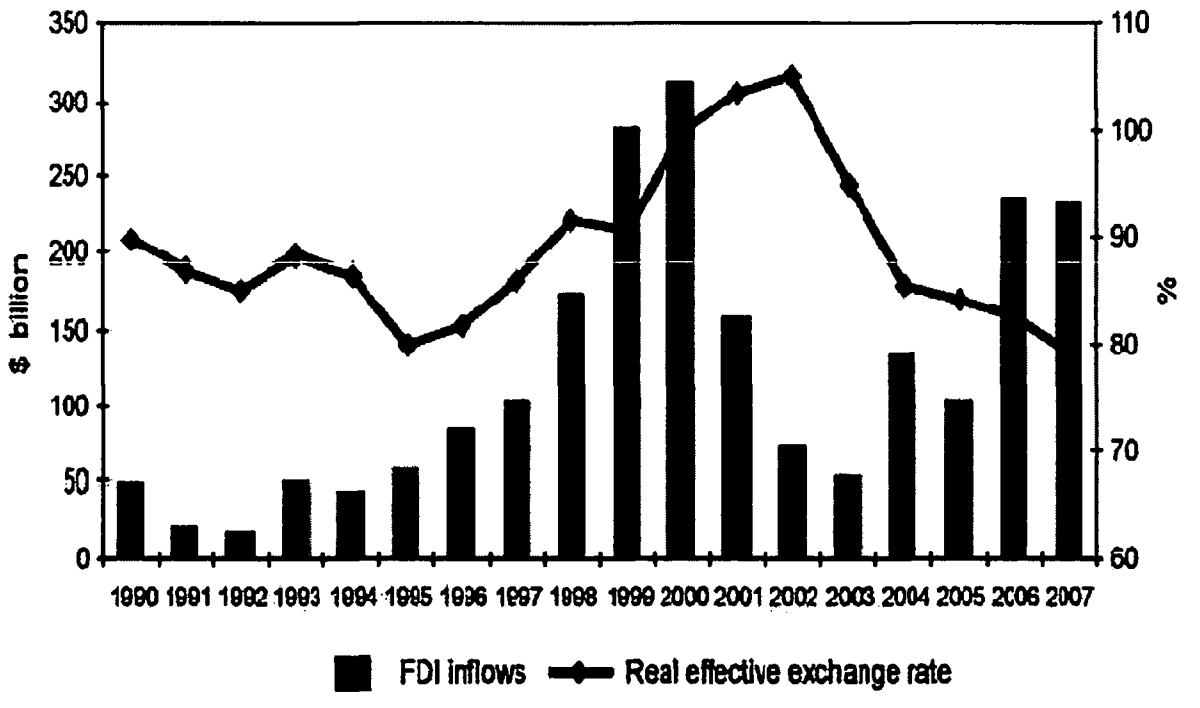
4.4 Sovereign Wealth Funds

Sovereign Wealth Funds are emerging as new actors on the FDI scene. The amount invested by SWF in FDI is small relative to their total assets (0.2% in 2007). 79% of total amount invested in FDI took place in the last three years. Three quarters of FDI by SWF has been in developed countries.

4.5 Global Financial and Monetary Developments affect FDI

The sharp weakening of the dollar helped to stimulate FDI to the United States (figure 4.4). There's been limited impact of global financial crisis on FDI flows in 2007, but is likely to have some negative impact in 2008 (figure 4.5).

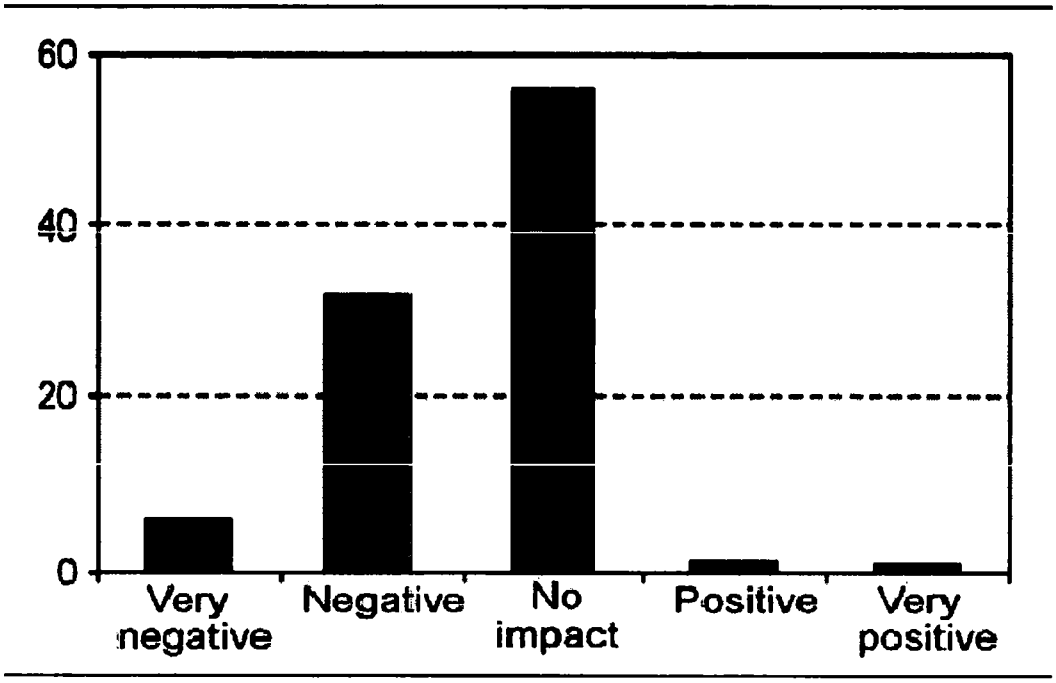
Figure 4.4 FDI inflows and the real effective exchange rate of the United States dollar (1990-2007)



Source: UNCTAD, World Investment Report 2008

Figure 4.5 Impact of financial instability on FDI flows 2008-2010

(Percent of responses to the UNCTAD survey)



***Source**: World Investment Prospects Survey 2008-2010*

4.6 Policy Changes

Most policy changes continue to favour FDI, but restrictions also need to be taken into account. 98 policy changes were introduced in 2007, 74 of which were favourable to FDI.

New measures to attract FDI were adopted such as:

- Establishment of special economic zones (e.g. India)
- Lowering of corporate income tax (e.g. Iceland, Colombia, Bulgaria)
- New promotional measures (e.g. invest in America initiative)

As in 2006, there were some restrictions imposed on extractive industries such as:

- New sectoral or ownership restrictions (Bolivia, Brazil, Ecuador, Venezuela, Kazakhstan)
- Stricter regulations related to national security (United States, Russian Federation, Germany)

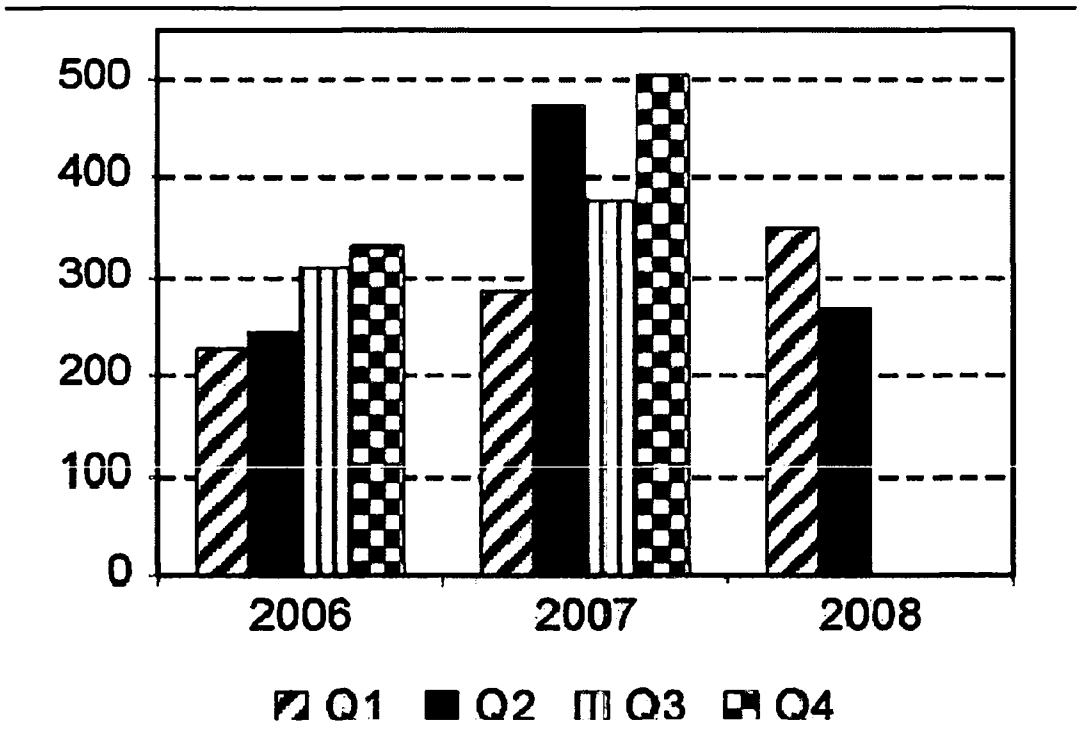
4.7 Prospects

FDI flows are poised to decline in 2008, but a rising trend is expected in the medium term.

- Slowdown in economic growth as a result of financial and credit crisis
- Decline in corporate profits
- Annualized global FDI flows for 2008 are estimated to be around US$ 1600 billion, about 10% lower than in 2007 (based on 75 countries)
- Cross-border M&As for the first half of 2008 fell 29% compared to the second half of 2007
- FDI flows to developing countries in 2008 remain resilient, FDI in natural resources is expected to pick up further

Figure 4.6 Value of cross-border M&As, 2006-2008, by quarter

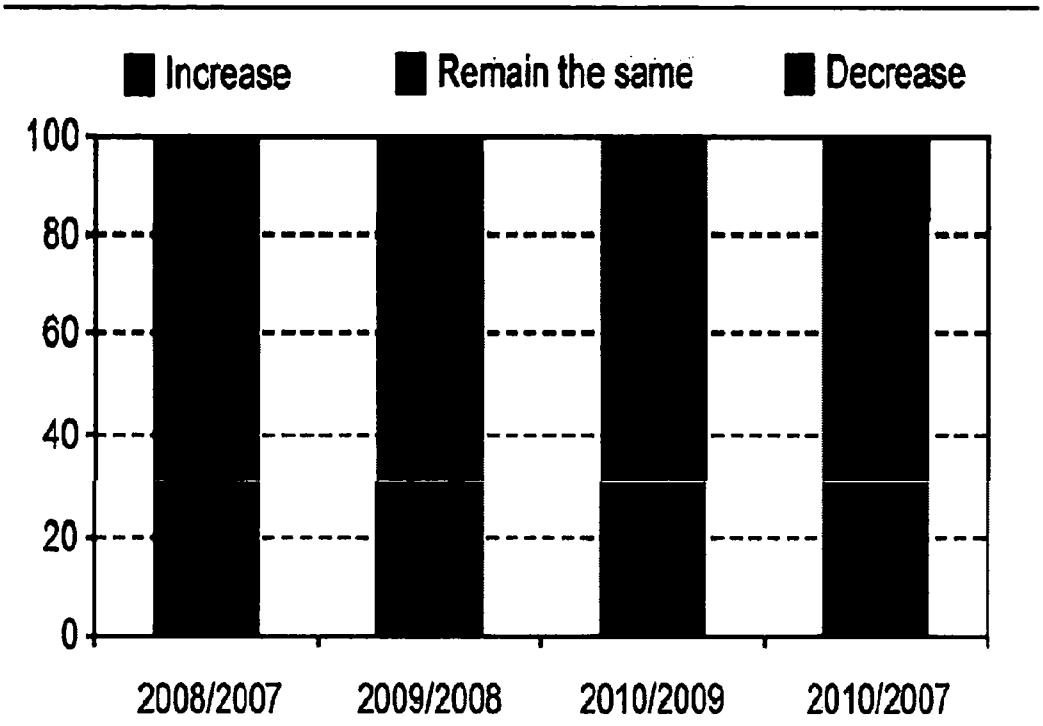
(Billions of US dollars)



Source: UNCTAD, World Investment Report 2008

Figure 4.7 Prospects for global FDI flows over the next three years

(Percent of responses to the UNCTAD survey)



***Source**: World Investment Prospects Survey 2008-2010*

4.8 FDI in India

India has continually sought to attract FDI from the world's major investors. In 1998 and 1999, the Indian national government announced a number of reforms designed to encourage FDI and present a favourable scenario for investors.

India has been rated as the fourth most attractive investment destination in the world, according to a global survey conducted by Ernst and Young in June 2008. India was behind China, Central Europe and Western Europe in terms of prospects of alternative business locations. With 30 percent votes, India emerged ahead of the US and Russia, which received 21 percent votes each. (Economic Times, 2008)

According to a report by the National Council of Applied Economic Research (NCAER), "In the first nine months of 2007-08, the net capital flows rose to US$ 83 billion from US$ 30 billion the country received during the corresponding period of the previous year." The funds coming in as FDI or external commercial borrowing, had also upped portfolio funds, as between FY 2004 and FY 2008, the reserves increased by more than US$ 150 billion. The influx of foreign funds during the period was sufficient to finance the current account deficit. (Financial Express, 2008)

As per the global survey of corporate investment plans carried out by KPMG International, released in June 2008, India will see the largest overall growth in its share of foreign investment, and it is likely to become the world leader for investment in manufacturing. Its share of international corporate investment is likely to increase by 8 percent to 18 percent over the next five years, helping it rise to the fourth, from the seventh position, in the investment league table, pushing Germany, France and the UK behind. (Economic Times, 2008)

4.9 Summary and Discussion

Over recent years most of the countries over the world have made their business environment investment friendly for absorbing global opportunities by attracting more investable funds to the country. Global FDI inflows rose in 2007 by 30 percent to reach an all-time high of US$ 1833 billion, according to the World Investment Report (UNCTAD, 2008). The 2007 flows surpassed the previous record set in 2000 by about US$ 400 billion, despite the global financial and credit crisis that began in the second half of 2007.

The sharp weakening of the dollar helped stimulate FDI to the US. There has been limited impact of global financial crisis on FDI flows in 2007, but will likely have a negative impact in 2008.

Most policy changes continue to favour FDI. Measures like establishment of Special Economic Zones (SEZs), lowering of corporate income tax and new promotional measures were adopted to attract FDI.

Global FDI flows look poised to decline in 2008, but a rising trend is expected in the medium term. However, FDI flows to developing countries in 2008 will remain resilient. India will see the largest overall growth in its share of foreign investment, and it is likely to become the world leader for investment in manufacturing. The next chapter discusses investment environment in India and country's attractiveness to foreign investors, focusing mainly on the manufacturing sector.

Chapter 5

Foreign Direct Investment: Destination India

5.1 Introduction

Since the launch of economic reforms in 1991 by Dr Manmohan Singh, the then Finance Minister of India, foreign direct investment has been touted as the magic wand that will transform under-developed India into an advanced nation with a modern infrastructure. Every government that has followed has dutifully talked of taking steps to encourage and expand FDI.

FDI plays an important role in the long-term economic development of a country not only as a source of capital but also for enhancing competitiveness of the domestic economy through transfer of technology, strengthening infrastructure, raising productivity and generating new employment opportunities. FDI also has an important role in enhancing exports. FDI is a developmental tool. The policy of the Government of India strives to maximize the developmental impact and spin-offs of FDI. While the Government encourages, and indeed, welcomes FDI in all the sectors where it is permitted, it is especially looking for large FDI inflows in the development of infrastructure, technological upgradation of Indian industry through Greenfield investments in manufacturing, and in projects having the potential for creating employment opportunities on a large scale. India invited investments in setting up SEZs and establishing manufacturing units therein.

India tops the world ranking in terms of financial attractiveness, people and skills availability and business environment. The liberal investment regime, rapid growth of the economy, strong macro economic fundamentals, progressive de-licensing of sectors and the ease in doing business has attracted global corporations to invest in India.

Consequent to policy changes and procedural simplifications, FDI equity inflows have registered a phenomenal upswing. FDI inflows have recorded over five-fold increase in the last three years, from US$ 2.2 billion in 2003-04 to US$ 15.7 billion in 2006-07. Simultaneously, FDI share in India's GDP has increased from 0.77 percent to 2.31 percent.

Significantly, FDI has come to play an increasing role in the economic growth of the country. The share of FDI in total investment has more than doubled from 2.55 percent in 2003-04 to 6.42 percent in 2006-07. (Department of Commerce, 2008)

According to the AT Kearney FDI Confidence Index 2007 (table 5.1), India continues to be the second most preferred destination for attracting global FDI inflows, a position it has held since 2005.

Table 5.1 FDI Confidence Index, 2007

Country	Rating	Ranking
China	2.21	1
India	**2.09**	**2**
United States	1.86	3
United Kingdom	1.81	4
Hong Kong SAR	1.78	5
Singapore	1.75	7
Germany	1.70	10
Australia	1.68	11
France	1.67	13
Canada	1.65	14
Japan	1.63	15
Malaysia	1.62	16
Indonesia	1.58	21
Korea	1.57	24

Note: *Ratings are calculated on a scale of zero to three, where zero represents a highly unattractive market and three represents a highly attractive market.*

Source: *FDI Confidence Index, A.T. Kearney, December 2007.*

Similarly, World Investment Report (UNCTAD, 2005) considers India the second most attractive investment destination among the TNCs.

Clearly, India is in the reckoning and the figures appear to be improving by the day. FDI equity inflows which totalled US$ 5.5 billion in 2005-06 grew by almost three times to US$ 15.7 billion in 2006-07 (table 5.6).

This huge inflow of FDI has in turn reversed the past trend, with FDI inflows overtaking the portfolio investment inflows by almost US$ 5.6 billion in 2006-07, according to a report by Reserve Bank of India (RBI) on International Investment Position. FDI inflow continues

apace in the new fiscal with total FDI during April-February 2007-08 recording a growth rate of 70 percent to US$ 20.1 billion from US$ 11.88 billion in the corresponding period last year, taking the cumulative FDI inflows during August 1991 to February 2007 to US$ 73.64 billion. In fact, the US$ 5.67 FDI inflows recorded in February 2008 was the highest-ever during any month since 1991 and more than the entire annual inflows from 1991-92 to 2004-05.

This surge in FDI is likely to further boost India's attraction as an investment destination. Already, India recorded a higher change in Investor outlook than China in the latest FDI Confidence Index of AT Kearney, implying bridging the gap between the two countries in terms of investment attractiveness. Also, India has emerged as the preferred investment destination for European investors, ahead of even china. This chapter cites FDI inflows in fast expanding Indian economy and discusses country's attractiveness to foreign investors. It also intends to establish relevance of factors influencing FDI in the Indian manufacturing sector, together with government initiatives to accelerate rapid growth in this area.

5.2 FDI - India

5.2.1 India - Favoured Destination

India ranks number one in the world in terms of financial attractiveness, people and skills availability and business environment. This is revealed in AT Kearney's 2007 Global Services Location Index (table 5.2). Country's financial stability in the current environment of financial turbulence and a possible unwinding of macro imbalances sends clear message to the prospective foreign investors about India's position as an expanding investment destination.

Table 5.2 FDI Global Services Location Index, 2007

Rank	Country	Financial attractiveness	People and skills availability	Business environment	Total score
1	India	3.22	2.34	1.44	7.00
2	China	2.93	2.25	1.38	6.56
3	Malaysia	2.84	1.26	2.02	6.12
4	Thailand	3.19	1.21	1.62	6.02
5	Brazil	2.64	1.38	1.47	5.89
6	Indonesia	3.29	1.47	1.06	5.82
7	Chile	2.65	1.18	1.93	5.76
8	Philippines	3.26	1.23	1.26	5.75
9	Bulgaria	3.16	1.04	1.56	5.75
10	Mexico	2.63	1.48	1.61	5.73
11	Singapore	1.65	1.51	2.53	5.68
12	Slovakia	2.79	1.04	1.79	5.62
13	Egypt	3.22	1.14	1.25	5.61
14	Jordan	3.09	0.98	1.54	5.60
15	Estonia	2.44	0.96	2.20	5.60
16	Czech Republic	2.43	1.10	2.05	5.57
17	Latvia	2.64	0.91	2.00	5.56
18	Poland	2.59	1.17	1.79	5.54
19	Vietnam	3.33	0.99	1.22	5.54
20	United Arab Emirates	2.73	0.88	1.92	5.53
21	United States (tier two)	0.48	2.34	2.29	5.51
22	Uruguay	2.95	0.98	1.54	5.47
23	Argentina	2.91	1.30	1.26	5.47
24	Hungary	2.54	0.95	1.98	5.47
25	Mauritius	2.84	1.04	1.56	5.44
26	Tunisia	3.03	0.90	1.50	5.43
27	Ghana	3.27	0.90	1.25	5.42
28	Lithuania	2.80	0.83	1.98	5.42
29	Sri Lanka	3.18	0.96	1.22	5.36
30	Pakistan	3.23	1.00	1.11	5.34
31	South Africa	2.62	1.18	1.60	5.30
32	Jamaica	2.83	0.98	1.49	5.29
33	Romania	2.88	0.87	1.53	5.28
34	Costa Rica	3.09	0.88	1.36	5.22
35	Canada	0.77	2.09	2.30	5.16
36	Morocco	2.92	0.90	1.33	5.14
37	Russia	2.61	1.38	1.16	5.14
38	Israel	1.97	1.27	1.86	5.10
39	Senegal	3.19	0.82	1.05	5.06
40	Germany (tier two)	0.46	2.10	2.40	5.05
41	Panama	2.88	0.76	1.40	5.02
42	United Kingdom (tier two)	0.50	2.16	2.35	5.01
43	Spain	1.18	1.71	2.06	4.95
44	New Zealand	1.53	1.12	2.25	4.91
45	Australia	0.89	1.69	2.31	4.89
46	Portugal	1.59	1.14	2.11	4.84
47	Ukraine	2.76	0.98	1.09	4.83
48	France (tier two)	0.45	2.07	2.27	4.79
49	Turkey	2.06	1.31	1.41	4.78
50	Ireland	0.40	1.54	2.29	4.13

***Note**: The weight distribution for the three categories is 40:30:30. Financial attractiveness is rated on a scale of 0 to 4, and the categories for people and skills availability and business environment are on a scale of 0 to 3.*

***Source**: FDI Global Services Location Index, A.T. Kearney, 2007*

"India's external sector has displayed considerable strength and resilience since the reforms in 1991. Despite several domestic as well as global political events and supply shocks in food and fuel, India partners with the global economy fully on the trade and current account while there is progressive liberalization of the capital account, consistent with the progress in reforms in the real, fiscal and financial sectors". (Reddy, 2008)

"The strong macro economic fundamentals, growing size of the economy and improving investment climate has attracted global corporation to invest in India. A major outcome of the

economic reforms process aimed at opening up the economy and embracing globalization has led to tremendous increase in FDI inflows into India". (CII, 2008)

5.2.2 FDI Inflow - Government Initiatives

The sweeping economic reforms undertaken by the government aimed at opening up the economy and embracing globalization have been instrumental in the surge in FDI inflows.

- Restructuring the Foreign Investment Promotion Board.
- Establishment of the Indian Investment Commission to act as a one-stop shop between the investor and the bureaucracy.
- Expanding the number of industries for which 100 percent FDI is allowed through the automatic route.
- Progressively raising the FDI cap in other sectors like telecom, aviation, banking, petroleum and media sectors among others.
- Removal of the investment cap in the Small Scale Industries (SSI) sector.

With government planning further liberalization measures across a broad range of sectors and continued investor interest, the inflow of FDI into India is likely to further accelerate.

5.2.3 FDI Inflows

Branding India as a 'safe and stable' investment destination amid global financial turmoil, country's Commerce and Industry minister Kamal Nath expects despite the global financial meltdown, FDI inflows into India during the Fiscal Year (FY) 2008-09 will close at US$ 35 billion signifying over US$ 11 billion invested in the previous financial year (note: India's fiscal year is April to March). (Economic Times, 2008)

In 2007-08, reinvested earnings of foreign firms in India stood at US$ 5.5 billion. Global firms have routed most of the investment through tax havens like Mauritius and Singapore during 2007-08, while Japanese firms have invested more money in India. Lot of investment is expected to flow into petroleum, manufacturing and electronic hardware sectors.

Table 5.3 CUMULATIVE FDI EQUITY INFLOWS (2000-2008)		
	In Rs Crore	In US$ Million
Cumulative amount of FDI inflows (From April 2000 to July 2008)	382167	91,534
Amount of FDI inflows during 2008-09 (From April to July 2008)	51440	12,320
Cumulative amount of FDI Inflows (Up to July2008)	321540	74,829
SOURCE: DIPP, Federal Ministry of Commerce and Industry, Government of India 1 Crore = 10 Million		

The infrastructure sector that offers massive potential to attract FDI witnessed marked increase in FDI inflows during this five-year period. The extant policy for most of the infrastructure sectors permits FDI up to 100 percent on the automatic route. From US$ 1902 million in fiscal 2001-02 the foreign investment in India's infrastructure sector increased to US$ 2179 million in 2006-07. But fiscal 2007-08 witnessed significant increase in the FDI inflows in the infrastructure attracting US$ 4095 million in first nine months. From 2000-01 to December 2007, total FDI in India's infrastructure sector stood at US$ 10575 million (table 5.4).

Table 5.4 Year Wise FDI inflows into Infrastructure sector during April 2000 to December 2007 (In US$ million)	
YEAR	AMOUNT
2000-01	292.37
2001-02	1902.26
2002-03	347.33
2003-04	388.37
2004-05	456.00
2005-06	914.04
2006-07	2179.39
2007-08 (Up to December 2007)	4095.80
TOTAL	10575.56
SOURCE: Federal Ministry of Commerce and Industry, Government of India	

Policymakers estimate that to sustain high growth rate India will need massive investment in the five-year period to March 2012, including US$ 500 billion in infrastructure, to sustain high growth rates. India raised FDI limits in petroleum refinery, aviation,

commodity exchanges, credit information companies and mining of some precious metals to attract more capital and boost growth in those sectors. The Congress-led UPA government has raised FDI limits in insurance to 49 percent. However, the retail trade is yet to be opened further. The government is having a close look at FDI rules in order to make India more attractive as FDI destination.

Table 5.5 FDI Equity Inflows (April 2007- July 2008)

MONTHS	In Rs crore	In US$ Million
April 2007	6927	1643
May 2007	8642	2120
June 2007	5048	1238
July 2007	2849	705
August 2007	3394	831
September 2007	2876	713
October 2007	8008	2027
November 2007	7353	1864
December 2007	6146	1558
January 2008	6960	1767
February 2008	22529	5670
March 2008	17932	4443
April, 2008	15005	3749
May 2008	16563	3932
June 2008	10244	2392
July 2008	9627	2247
Year 2008 (Up to July 2008)	98860	24200
Year 2007 (Up to July 2007)	51969	12162
YOY Growth (%)	(+) 90	(+) 99

SOURCE: DIPP, Federal Ministry of Commerce and Industry, Government of India
1 Crore = 10 Million

In FDI equity investments Mauritius tops the list of first ten investing countries followed by US, UK, Singapore, Netherlands, Japan, Germany, France, Cyprus and UAE. Between April 2000 and July 2008 FDI inflows from Mauritius stood at US$ 30.18 billion followed by US$ 5.80 billion from Singapore; US$ 5.47 billion from the US; US$ 4.83 billion from

the UK; US$ 3.12 billion from the Netherlands; US$ 2.26 billion from Japan; US$ 1.83 billion from Germany; US$ 1.41 billion from Cyprus; and US$ 1.02 billion from France (table 5.6)

Table 5.6 Top ten investing (FDI Equity) countries (In Rs. crore)

COUNTRY	2005-06	2006-07	2007-08	2008-09 (from April-July, 2008)	Cumulative (From April 2000 to July 2008)	% with total (inflows in terms of rupees)
Mauritius	11441 (2570)	28759 (6363)	44483 (11096)	18999 (4547)	129372 (30182)	43.49%
USA	2210 (502)	3861 (856)	4377 (1089)	3944 (944)	23901 (5477)	8.03%
UK	1164 (266)	8389 (1878)	4690 (1176)	1984 (469)	21048 (4832)	7.08%
Singapore	1218 (275)	2662 (578)	12319 (3073)	6088 (1452)	24213 (5809)	8.14%
Netherlands	340 (76)	2905 (644)	2780 (695)	1779 (417)	13701 (3122)	4.61%
Japan	925 (208)	382 (85)	3336 (815)	589 (139)	9925 (2265)	3.34%
Germany	1345 (303)	540 (120)	2075 (514)	1227 (291)	7966 (1834)	2.68%
France	82 (18)	528 (117)	583 (145)	1098 (262)	4482 (1023)	1.51%
Cyprus	310 (70)	266 (58)	3385 (834)	1817 (433)	5884 (1418)	1.98%
UAE	219 (49)	1174 (260)	1039 (258)	669 (161)	3541 (824)	1.19%
Total FDI inflows*	24613 (5546)	70630 (15726)	98664 (24579)	51440 (12320)	321524 (74829)	-

SOURCE: DIPP, Federal Ministry of Commerce and Industry, Government of India
Figures in bracket are in US$ million
1 Crore = 10 Million

The average FDI inflow per year during the 9th Plan was US$ 3.2 billion and during the 10th Plan it increased manifold to stand at US$ 16.33 billion the annual average being US$ 6.16 billion. The top five sectors attracting FDI in fiscal 2007-08 included Services sector, Housing & Real Estate, Construction, Petroleum & Natural Gas and Computer Software & Hardware (table 5.7).

Table 5.7 Sectors attracting highest FDI Equity Inflows (In Rs crore)

SECTOR	2005-06	2006-07	2007-08	2008-09 (April-July)	Cumulative (Apr.2000-July 2008)	% of total inflows*
Services (Financial & non-financial)	2399 (543)	21047 (4664)	26589 (6615)	6684 (1602)	62381 (14659)	20.97%
Computer Software & Hardware	6172 (1375)	11786 (2614)	(1410)	4642 (1092)	36809 (8370)	12.37%
Telecommunications	2776 (624)	2155 (478)	5103 (1261)	1295 (315)	18043 (4157)	6.065
Construction	667 (151)	4424 (985)	6989 (1743)	6224 (1483)	19606 (4646)	6.59%
Automobile	630 (143)	1254 (276)	2697 (675)	1792 (441)	11648 (2678)	3.92%
Housing and Real estate	171 (38)	2121 (467)	8749 (2179)	5480 (1315)	16642 (4026)	5.59%
Power	386 (87)	713 (157)	3875 (967)	2124 (520)	11754 (2725)	3.95%
Metallurgical	6540 (147)	7866 (173)	4686 (1177)	3208 (766)	10556 (2528)	3.55%
Chemicals (Other than fertilizers)	1731 (390)	930 (205)	920 (229)	1261 (301)	7401 (1686)	2.49%
Petroleum & Natural Gas	64 (14)	401 (89)	5729 (1427)	263 (62)	8509 (2043)	2.86%

Figures in bracket are in US$ million
* In terms of Rs.

SOURCE: DIPP, Federal Ministry of Commerce and Industry, Government of India
1 Crore = 10 Million

Of the total FDI amounting to US$ 56450 million in first 11 months of fiscal 2007-08, direct investment stood at US$ 25455 million. Of this, equity investment accounts for the major share with US$ 20636 million. Portfolio investments totalled US$ 30995 million (table 5.8).

Table 5.8 India: Foreign Investment Inflows (Fiscal 2007-08)
(In US$ Million)

SEGMENT	MONTH											
	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	Apr. to Feb
A. Direct Investment (I+II+III)	**1643**	**2120**	**1238**	**705**	**831**	**713**	**2027**	**1864**	**1558**	**1767**	**5670**	**25455**
1. Equity (a+b+c+d+e)	1643	2120	1238	705	831	713	2027	1864	1558	1767	5670	20636
a. Govt. (SIA/FIPB)	76	847	177	177	76	117	95	82	127	221	259	2254
b. RBI	699	1050	912	515	512	201	1710	965	1385	884	4704	13537
c. NRI	-	-	-	-	-	-	-	-	-	-	-	-
d. Acquisition of shares.	868	223	149	13	243	395	222	817	46	662	707	4345
e. Equity capital of unincorporated bodies#	-	-	-	-	-	-	-	-	-	-	-	500
Reinvested earnings+	-	-	-	-	-	-	-	-	-	-	-	4476
Other capital ++	-	-	-	-	-	-	-	-	-	-	-	343
B. Portfolio Investment (a+b+c)	**1974**	**1852**	**3664**	**6713**	**-2875**	**7081**	**9564**	**-107**	**5294**	**6739**	**-8904**	**30995**
a. GDRs/ADRs##	11	5	300	2028	448	1	2731	158	2708	249	87	8726
b. FIIs**	1963	1847	3279	4685	-3323	7057	6833	-265	2396	6490	-8991	21971
c. Offshore funds & others	-	-	85	-	-	23	-	-	190	-	-	298
Total (A+B)	**3617**	**3972**	**4902**	**7418**	**-2044**	**7794**	**11591**	**1757**	**6852**	**8506**	**-3234**	**56450**

* : Relates to acquisition of shares of Indian companies by non-residents under Section 6 of FEMA, 1999. Data on such acquisitions have been included as part of FDI since January 1996.
** : Represents inflow of funds (net) by Foreign Institutional Investors (FIIs).
# : Figures for equity capital of unincorporated bodies for 2006-07 and 2007-08 (April-December) are estimates.
# # : Represents the amount raised by Indian Corporates through Global Depository Receipts (GDRs) and American Depository Receipts (ADRs).
+ : Data for 2006-07 and 2007-08 are estimated as average of previous two years.
++: Data pertain to inter company debt transactions of FDI entities.
‡ : Include swap of shares of US $ 3.1 billion.

SOURCE: Reserve Bank of India

In recent times, TNCs from many developing and transition economies have become very important investors in developed as well as less-developed countries either through M&A route or through Greenfield investments. According to a report by RBI (2008), TNCs from economies like China, Brazil, India, Russia and South Africa have emerged as global leaders in manufacturing and services sectors.

Table 5.9 India: Foreign Investment Inflows (1995-2007)
(In US$ Million)

SEGMENT	YEAR											
	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
A. Direct Investment (I+II+III)	2144	2821	3557	2462	2155	4029	6130	5035	4322	6051	8961	22079
1. Equity (a+b+c+d+e)	2144	2821	3557	2462	2155	2400	4095	2764	2229	3778	5975	16482
a. Govt. (SIA/FIPB)	1249	1922	2754	1821	1410	1456	2221	919	928	1062	1126	2156
b. RBI	169	135	202	179	171	454	767	739	534	1258	2233	7151
c. NRI	715	639	241	62	84	67	35	-	-	-	-	-
d. Acquisition of shares.	11	125	360	400	490	362	881	916	735	930	2181	6278‡
e. Equity capital of unincorporated bodies#	-	-	-	-	-	61	191	190	32	528	435	897
Reinvested earnings+	-	-	-	-	-	1350	1645	1833	1460	1904	2760	5091
Other capital ++	-	-	-	-	-	279	390	438	633	369	226	506
B. Portfolio Investment (a+b+c)	2748	3312	1828	-61	3026	2760	2021	979	11377	9315	12492	7003
a. GDRs/ADRs##	683	1366	645	270	768	831	477	600	459	613	2552	3776
b. FIIs**	2009	1926	979	-390	2135	1847	1505	377	10918	8686	9926	3225
c. Offshore funds & others	56	20	204	59	123	82	39	2	-	16	14	2
Total (A+B)	4892	6133	5385	2401	5181	6789	8151	6014	15699	15366	21453	29082

* : Relates to acquisition of shares of Indian companies by non-residents under Section 6 of FEMA, 1999. Data on such acquisitions have been included as part of FDI since January 1996.
** : Represents inflow of funds (net) by Foreign Institutional Investors (FIIs).
# : Figures for equity capital of unincorporated bodies for 2006-07 and 2007-08 (April-December) are estimates.
: Represents the amount raised by Indian Corporates through Global Depository Receipts (GDRs) and American Depository Receipts (ADRs).
+ : Data for 2006-07 and 2007-08 are estimated as average of previous two years.
++: Data pertain to inter company debt transactions of FDI entities.
‡ : Include swap of shares of US $ 3.1 billion.

SOURCE: Reserve Bank of India

5.2.4 India's Outward Foreign Direct Investment

As an outcome of liberalization policies, India's outward FDI witnessed an unprecedented rise in recent period. India's overseas investments, which began with information technology and related services sectors, has over the years spread to wider areas like manufacturing and financial and non-financial areas. The World Investment Report (UNCTAD, 2007) revealed that global outward FDI amounted to US$ 1216 billion in 2006 (table 5.10) registering significant growth in last 17 years from US$ 230 billion in 1990.

Table 5.10 OUTWARD FOREIGN DIRECT INVESTMENT: WORLD & DEVELOPING COUNTRIES (2004-2006) (In US$ Billion*)

	2004	2005	2006
A. World outward FDI flows	**877**	**837**	**1216**
Outward FDI flows from developing economies.	117	116	174
Of which			
South Africa	1.4	0.9	6.7
Brazil	9.8	2.5	28.2
China	5.5	12.3	16.1
Korea	4.7	4.3	7.1
India	**2.2**	**2.5**	**9.7**
Singapore	8.1	5.0	8.6
Russian Federation	13.8	12.8	18.0
B. World outward FDI stock	**10325**	**10579**	**12474**
C. Income on outward direct investment	607	845	972
D. Cross border M&As	381	716	880
E. Total asset of foreign affiliates	42807	42637	51187
F. Exports of foreign affiliates	3733	4197	4707
G. Employment of foreign affiliates ('000)	59458	63770	72627
* Value at current prices			
SOURCE: UNCTAD, World Investment Reports (2006 & 2007)			

A report by RBI (2008) suggests that number of proposals approved for outward FDI from India in JVs and Wholly-Owned Subsidiaries (WOSs) increased from 1214 in 2003-04 to 1817 in 2006-07. The amount for approved proposals increased from US$ 1466 million in 2003-04 to US$ 15060 million in 2006-07 (table 5.11).

Table 5.11 APPROVED PROPOSALS (2003-2007) (In US$ Million)

Year	No. of proposals	Amount of approved proposals			
		Equity	Loan	Guarantee	Total
2003-04	1214	822.40	229.90	413.83	1466.13
2004-05	1281	2010.03	384.39	409.91	2804.33
2005-06	1395	1887.78	629.74	337.32	2854.84
2006-07	1817	11244.96	1475.28	2339.76	15060.00
Apr.-Dec. 2007	1595	11324.99	1331.77	5780.50	18437.26
Apr.-Dec. 2006	1268	4594.09	1270.70	2079.75	7944.54

SOURCE: Reserve Bank of India report, April 2008

The amount of outward FDI from India on account of JVs/WOSs, according to the report by RBI (2008), increased from US$ 1495 million in 2003-04 to US$ 12880 million in 2006-07 (table 5.12). Equity accounted for 90 percent of the total investments and the remaining 10 percent by way of loans in 2006-07.

Table 5.12 ACTUAL OUTFLOWS (2003-2008) (In US$ Million)

Year	Equity*	Loan	Guarantee Invoked	Total
2003-04	1234.25	260.93	-	1495.18
2004-05	1365.59	402.79	-	1768.38
2005-06	3858.46	1008.10	3.00	4869.56
2006-07	11599.01	1281.07	-	12880.08
2007-08 (April-December)	9096.50	1017.72	-	10114.22
2006-07 (April-December)	8097.27	876.07	-	8973.34

*** The equity data do not include equity of individuals and banks. Figures are provisional**

SOURCE: Reserve Bank of India report, April 2008

Inflows from India's outward FDI are in the form of dividend, royalty, license fee, brand fee, technical know-how fee, repayment of loans etc. During 2006-07 total inflows from outward FDI amounted to US$ 295 million (table 5.13).

Table 5.13 INFLOWS FROM INDIA'S OUTWARD FDI (2006-2008) (In US$ Million)

Year	Dividend	Others@	Total
2006-07	21.96	272.75	294.71
2007-08 (April-December)	29.41	307.68	337.09
2006-07 (April-December)	20.15	274.33	294.48
@ Others include dividend, royalty, licence fee, brand fee, technical know-how fee, repayment of loan, etc.			
SOURCE: Reserve Bank of India report, April 2008			

The sectoral pattern of outward FDI is led by manufacturing during first nine months of fiscal 2007-08 with US$ 7634 million followed by non-financial services at US$ 1678 million (table 5.14).

Table 5.14 SECTORAL PATTERN OF OUTWARD FDI DURING APRIL-DECEMBER 2007
(In US$ Million)

Sector	Month									Total Approvals
	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec	
Trading	54.22	28.25	46.74	40.57	-	24.17	114.98	311.55	-	620.48
Manufacturing	149.10	549.00	4122.00	495.40	219.52	1339.11	256.93	345.09	157.78	7634.00
Non Financial Services	66.79	234.20	61.20	23.63	364.91	420.61	139.50	248.07	118.78	1677.71
Others	52.47	396.90	883.30	172.60	67.20	77.67	4554.26	596.99	879.84	7681.09
Financial	-	-	-	-	-	-	7.00	25.46	-	32.46
Total	322.60	1208.00	5113.00	732.20	651.63	1861.56	5072.67	1527.16	1156.40	17645.74
SOURCE: Reserve Bank of India report, April 2008										

The country's outward FDIs rose by 29.6 percent to US$ 17.4 billion in 2007-08, backed by India's Inc large-scale acquisitions, growing appetite for an overseas presence and the hunt for energy assests. The outward FDI in 2006-07 was US$ 13.45 billion.

Outward investment refers to investment by Indian entities and partnership firms in JVs and WOSs abroad. The manufacturing sector led the investments, with a 43 percent share, followed by the non-financial services (11 percent) and trading (4 percent). The manufacturing sector saw proposals in electronic equipment, fertilisers, agricultural and allied products and gems and jewellery.

5.2.5 Sector-wise FDI Inflows

A large portion of the FDI flows into skill intensive and high value-added services industries, particularly financial services and information technology. Service sector and computer software and hardware industry together account for about 35.49 percent of the total FDI into India between April 2000 to December 2007.

After the IT boom, a manufacturing revolution has been well underway in the Indian economy, spurred on by the increasing presence of multinationals, scaling up of operations by the domestic companies and expanding domestic market

India dominates the global service industry in terms of attracting FDI with its unbeatable mix of low costs, deep technical and language skills, mature vendors and supportive government policies. India top ranked on AT Kearney's 2007 Global Services Location Index, emerging as the most preferred destination in terms of financial attractiveness, people and skills availability and business environment.

Global investors have also shown increasing interest in other sectors as well. Particular amongst them have been telecommunication, energy, construction, automobiles, electrical equipment among others. For example, all the five leading global telecom companies have made significant investment in India. Similarly, leading automobile companies have set up their manufacturing base in India.

Table 5.15 Sector-wise FDI Inflows (from April 2000 to July 2008)			
SECTOR	**AMOUNT OF FDI INFLOWS**		**PERCENT OF TOTAL FDI INFLOWS (In terms of Rs)**
	In Rs Million	**In US$ Million**	
Services Sector	623808.97	14659.48	20.97
Computer Software & hardware	368091.46	8369.51	12.37
Telecommunications	180426.68	4156.92	6.06
Construction Activities	196092.19	4646.26	6.59
Automobile	116479.17	2677.52	3.92
Housing & Real estate	166417.79	40262.8	5.59
Power	117536.59	2725.31	3.95
Chemicals (Other than Fertilizers)	74008.90	1685.91	2.49
Ports	62154.33	1528.25	2.09
Metallurgical industries	105562.25	2528.04	3.55
Electrical Equipments	51143.69	1187.93	1.72
Cement & Gypsum Products	68804.72	1577.41	2.31
Petroleum & Natural Gas	85089.26	2043.44	2.86
Trading	58053	1388.76	1.95
Consultancy Services	41242.49	950.40	1.39
Hotel and Tourism	44768.54	1049	1.50
Food Processing Industries	31853.51	706.73	1.07
Electronics	32333.63	715.54	1.09
Misc. Mechanical & Engineering industries	25527.50	590.33	0.86
Information & Broadcasting (Incl. Print media)	38238.17	909.61	1.29
Mining	20814.21	514.57	0.70
Textiles (Incl. Dyed, Printed)	24134.07	557.38	0.81
Sea Transport	17059.88	390.26	0.57
Hospital & Diagnostic Centres	25481.17	608.56	0.86
Fermentation Industries	26778.09	637.58	0.90
Machine Tools	9627.04	219.52	0.32

Air Transport (Incl. air freight)	9043.64	209.84	0.30
Ceramics	9929.15	234.61	0.33
Rubber Goods	8354.47	183.17	0.28
Agriculture Services	7778.15	185.11	0.26
Industrial Machinery	11739.04	275.02	0.39
Paper & Pulp	9640.58	227.37	0.32
Diamond & Gold Ornaments	7735.65	178.37	0.26
Agricultural Machinery	6626.94	147.85	0.22
Earth Moving Machinery	5661.09	132.41	0.19
Commercial, Office & Household Equipments	5791.40	132.59	0.19
Glass	5628.13	125.32	0.19
Printing of Books (Incl. Litho printing industry)	5609.27	126.43	0.19
Soaps, Cosmetics and Toilet Preparations	4809.40	110.66	0.16
Medical & Surgical Appliances	5208.93	116.50	0.18
Education	4789.79	112.01	0.16
Fertilizers	4279.74	96.54	0.14
Photographic raw Film & Paper	2580.20	63.90	0.09
Railway related components	3067.95	70.67	0.10
Vegetable oils and Vanaspati	2163.30	49.25	0.07
Sugar	1728.24	39.35	0.06
Tea & Coffee (Processing & warehousing coffee & rubber)	2360.81	55.19	0.08
Leather, Leathergoods & Piackers	1570.26	35.70	0.05
Non-conventional energy	3243.16	78.11	0.11
Industrial instruments	599.87	13.60	0.02
Scientific instruments	475.84	10.81	0.02
Glue and Gelatine	385.80	8.44	0.01
Boilers & steam generating plants	238.67	5.40	0.01
Dye-Stuffs	350.28	8.35	0.01
Retail Trading (Single brand)	814.79	19.47	0.03
Coal Production	614.10	15.42	0.02

Coir	50.17	1.12	0.00
Timber products	78.81	1.85	0.00
Prime Mover (Other than electrical generators	17.24	0.41	0.00
Defence Industries	2.37	0.05	0.00
Mathematical, Surveying & drawing instruments	50.35	1.27	0.00
Misc. Industries	170046	3944.06	5.75
Sub Total	**2974981.14**	**69444.96**	100.00
Stock Swapped (from 2002 to 2008)	**145466.35**	**3391.09**	5.24
Advance of Inflows (from 1999 to 2004)	**89622.22**	**1962.82**	
RBI's NRI Schemes	**5330.60**	**121.33**	
Grand Total	**3215400.31**	**74830.18**	
Sector wise FDI inflows data reclassified, as per segregations of data from April 2000 onwards			
SOURCE: DIPP, Federal Ministry of Commerce and Industry, Government of India			

Table 5.16 INDIA: SECTOR SPECIFIC POLICY FOR FOREIGN DIRECT INVESTMENT

Sector/Activity	FDI Cap/Equity	Entry Route	Other Conditions
Airports			
(a) Greenfield projects	**100%**	Automatic	Subject to sectoral regulations notified by Ministry of Civil Aviation
(b) Existing projects	**100%**	FIPB beyond 74%	Subject to sectoral regulations notified by Ministry of Civil Aviation
Construction Development projects including housing, commercial premises, resorts, educational institutions, recreational facilities, city and regional level infrastructure, townships	**100%**	Automatic	Subject to conditions notified vide Press Note 2 (2005 Series) including a minimum capitalization of US$ 10 million for wholly owned subsidiaries and US$ 5 million for joint venture. The funds would have to be brought within six months of commencement of business of the Company
Petroleum & Natural Gas			
(a) Other than Refining and including market study and formulation; investment/financing; setting up infrastructure for marketing in Petroleum & Natural Gas sector)	**100%**	Automatic	Subject to sectoral regulations issued by Ministry of Petroleum and Natural Gas; and in the case of actual trading and marketing of petroleum products, divestment of 26% equity in favour of India partner/public within 5 years.
(b) Refining	**26%** in case of PSUs **100%** in case of Private companies	FIPB Automatic	Subject to sectoral policy
Telecommunication			
(a) Basic and cellular; Unified Access Services, National/International Long Distance, V-Sat, Public Mobile Radio Trunked Services (PMRTS), Global Mobile Personal Communications Services (GMPCS) and other value added telecom services	**74%** (including FDI, FII, NRI, FCCBs, ADRs, GDRs, convertible preference shares, and proportionate foreign equity in Indian promoters/investing Company	Automatic upto 49% FIPB beyond 49%	Subject to guidelines notified in the PN 5/2005 Series
(b) ISP with gateways, radio-paging, end-to-end bandwidth	**74%**	Automatic up to 49% FIPB beyond 49%	Subject to licensing and security requirements notified by the Department of Telecommunication
(c) ISP without gateway, infrastructure provider providing dark fibre, electronic mail and voice mail	**100%**	Automatic up to 49% FIPB beyond 49%	Subject to the condition that such companies shall divest 26% of their equity in favour of Indian public in 5 years, if these companies are listed in other parts of the world. Also subject to licensing and security requirements, where required.
(d) Manufacture of telecom equipment	**100%**	Automatic	Subject to sectoral requirements
Power including generation (Except Atomic energy); regulations transmission, distribution and Power Trading			Subject to provisions of the Electricity Act 2003
Ports	100%	Automatic	Subject to sectoral regulations
Roads & Highways	100%	Automatic	Subject to sectoral regulations
Shipping	100%	Automatic	Subject to sectoral regulations

SOURCE: DIPP, Federal Ministry of Commerce and Industry, Government of India

5.2.6 Country-wise FDI Inflows

The country wise figures for 2000-01 to July 2008 reveal Mauritius in the leading position accounting for over 43 percent of total FDI inflows into India. The US and UK is far behind it with around 8 percent and 7 percent respectively (table 5.17).

It is to be noted that Mauritius pre-eminence has been due to its stature as a tax haven and most volume of FDI inflows through Mauritius has been from the USA.

Table 5.17 Country wise FDI inflows (April 2000 to July 2008)

COUNTRY	Amount of FDI Inflows		% to total FDI Inflows (In terms of Rs)
	(In Rs. million)	(In US$ million)	
Mauritius	1293722.44	30181.82	43.49
USA	239014.87	5476.65	8.03
UK	210483.37	4831.97	7.08
Singapore	242127.12	5808.50	8.14
Netherlands	137007.59	3121.90	4.61
Japan	99246.67	2264.61	3.34
Germany	79656.37	1834.18	2.68
Cyprus	58840.42	1418.22	1.98
France	44819.59	1022.85	1.51
Switzerland	32305.16	739.42	1.09
UAE	35413.68	824.25	1.19
Cayman Island	26847.01	652.40	0.90
Bermuda	20938.97	467.29	0.70
Sweden	20186.62	461.28	0.68
Korea (South)	17642.73	403.94	0.59
British Virginia	15299.78	359.17	0.51
Italy	24149.07	574.12	0.81
Hong Kong	14180.23	332.86	0.48
Spain	10940.31	257.24	0.37
Malaysia	6882.53	155.43	0.23
Canada	8772.93	204.95	0.29
Denmark	5286.76	119.05	0.18
Belgium	8179.64	184.42	0.27
Australia	8876.69	200.74	0.30
Austria	1113.81	24.61	0.04
South Africa	3384.80	74.78	0.11
Luxembourg	4451.12	102.05	0.15
Russia	2699.37	59.88	0.09
Ireland	3032.07	72.50	0.10
Oman	2565.08	60.44	0.09

Finland	2304.01	53.21	0.08
Thailand	1827.28	42.68	0.06
West Indies	2228.72	51.75	0.07
Indonesia	1562.42	33.94	0.05
Norway	1312.58	30.54	0.04
Bahrain	1087.12	24.94	0.04
Nevis	1115.51	25.58	0.04
Ice Land	808.63	18.56	0.03
Gibraltar	811.51	18.98	0.03
Morocco	699.77	15.21	0.03
Panama	733.66	16.95	0.03
Saudi Arabia	690.71	15.97	0.02
Taiwan	807.66	19.21	0.03
Liberia	578.42	13.09	0.02
Bahamas	630.96	14.24	0.02
Kenya	506.76	10.97	0.02
Slovenia	390.74	8.24	0.01
Sri Lanka	462.35	10.81	0.02
Myanmar	357.49	8.96	0.01
Israel	935.44	22.50	0.03
Kuwait	318.86	6.93	0.01
Portugal	344.02	8.46	0.01
Malta	289.19	6.55	0.01
Kazakhstan	281.05	7.07	0.01
British Isles	306.42	7.05	0.01
Channel Island	342.15	7.86	0.01
New Zealand	555.81	13.55	0.02
Isle of Man	228.08	5.25	0.01
Tunisia	198.40	4.31	0.01
Liechtenstein	193.42	4.23	0.01
Slovakia	189.83	4.40	0.01
Belorussia	474.07	11.66	0.02
China	190.75	4.35	0.01
Korea (North)	157.04	3.50	0.01
Nigeria	165.83	3.64	0.01
Fiji Islands	144.15	3.23	0.01
Maldives	136.97	3.08	0.00
Uruguay	154.09	3.48	0.01
Ghana	135.61	3.08	0.00
Chile	205.87	4.70	0.01
Scotland	119.05	2.69	0.00
Poland	85.64	1.88	0.00
Virgin Islands	63.02	1.43	0.00
St. Vincent	62.30	1.38	0.00
Yemen	64.33	1.61	0.00
Seychelles	88.28	2.10	0.00
Cuba	47.32	1.04	0.00

Brazil	68.72	1.68	0.00
Columbia	41.24	0.94	0.00
Uganda	35.24	0.81	0.00
Ukraine	31.07	0.69	0.00
Philippines	29.43	0.67	0.00
Czech Republic	713.15	16.62	0.02
Aruba	19.65	0.43	0.00
Croatia	18.44	0.42	0.00
Greece	15.31	0.36	0.00
Yugoslavia	11.31	0.24	0.00
Lebanon	11.11	0.24	0.00
Jamaica	10.00	0.20	0.00
Estonia	7.50	0.15	0.00
Hungary	6.75	0.16	0.00
Vanuatu	6.55	0.14	0.00
Bulgaria	6.43	0.14	0.00
Tanzania	22.51	0.55	0.00
Vietnam	5.08	0.11	0.00
Qatar	4.80	0.10	0.00
Zambia	4.64	0.10	0.00
Turkey	34.75	0.81	0.00
Nepal	8.39	0.20	0.00
Jordon	3.19	0.07	0.00
Egypt	3.01	0.04	0.00
Libya	2.55	0.06	0.00
Latvia	2.50	0.02	0.00
Mexico	2.55	0.06	0.00
Peru	2.01	0.00	0.00
Iran	1.68	0.00	3.55
West Africa	4.56	0.11	0.00
Georgia	0.10	0.00	0.00
Coast Rica	0.10	0.00	0.00
Afghanistan	0.09	0.00	0.00
East Africa	0.06	0.00	0.00
Romania	0.05	0.00	0.00
Djibouti	0.01	0.00	0.00
Venezuela	0.00	0.00	0.00
NRI	134190.35	3229.47	4.51
Un-indicated country	135311.33	3290.90	4.55
FIIs	2.46	0.06	0.00
Sub. Total	**297497995**	**6944494**	**100.00**
Stock Swapped (From 2002-2008)	145466.35	3301.07	-
Advance of Inflows (From 2000-2004)	89622.22	1962.82	-
RBI's NRI Schemes	5330.60	**121.33**	-
GRAND TOTAL	**3215399.12**	**74830.16**	
SOURCE: DIPP, Federal Ministry of Commerce and Industry, Government of India			

5.2.7 Key Investments - Foreign Multinational Companies

The surging economy has resulted in India emerging as the fastest growing market for many global majors like HSBC, Dell among others. This has resulted in many companies lining up aggressive investment plans for the Indian market.

- Arcelor Mittal, the world's largest steel producer, plans to invest US$ 20 billion for building two 12 million-tonne steel plants.
- Vodafone, the world's second-biggest mobile firm, plans to spend US$ 2 billion a year on capital expenditure.
- DailmerChrysler India Pvt Ltd, makers of Mercedes-Benz cars, has decided to set up a new plant in Pune.
- Nokia plans to invest US$ 170 million to ramp up its production unit in Chennai.
- US-based hotel chain Hampshire Hotels and Resorts LLC plans to develop 25 hotels at an investment of US$ 1.26 billion.
- Israeli mall developer Plaza Center NV will invest US$ 1.22 billion over the next five-seven years to set up 50 malls in India.
- Teva Pharmaceutical Industries, the world's largest manufacturer of generics, plans to invest over US$ 1 billion.
- US-based aircraft engine manufacturer, Pratt and Whitney, plans to invest about US$ 30 million in the infotech and spare parts manufacturing sector.

In fact, the advantage of setting up a base in India is turning a host of companies like Ford, Suzuki, Cisco, Mercer and LSG Sky Chefs among others to make India as a hub for their global operations.

5.3 FDI - Manufacturing Sector

5.3.1 India - Manufacturing Powerhouse

After the IT boom, a manufacturing revolution has been well underway in the Indian economy, spurred on by the increasing presence of multinationals, scaling up of operations

by the domestic companies and expanding domestic market. The sector has been averaging 9 percent in the last four years (2004-08), with a record 12.3 percent in 2006-07.

India's manufacturing base, which is the fourth-largest among emerging economies, is among the fastest growing and has seen more investments as a proportion of gross domestic product than any other country except China. India has all the required skills in process, product, and capital engineering, owing to its long manufacturing history and higher-education system. Consequently, manufacturers from across the world are transforming India into a potential manufacturing powerhouse.

Every major company has India on its radar screen and the number of companies spanning diverse industries and planning to make India their global hub for host of operations has only been increasing by the day.

Cummins is making India its manufacturing hub for newly developed line of generator sets, Samsung plans to make its manufacturing plant in Chennai its global hub, Ford is making India its manufacturing hub for engine manufacturing, Suzuki and Hyundai are making India the manufacturing and exports hub for small cars. In fact, all the top five telecom manufacturers have set up manufacturing facility in India.

5.3.2 India Advantage

India's vast domestic market and availability of low-cost workers with advanced technical skills has been instrumental in attracting the ever expanding number of multinationals who are setting up their manufacturing base in the country.

The sheer size of the Indian market has obvious appeal. The rapid growth of the Indian economy is likely to make India the fifth largest consumer market in the world by 2025 from twelfth in 2005, says a study by McKinsey Global Institute. Aggregate Indian consumer spending is likewise estimated to more than quadruple to US$ 1.77 trillion by 2025, on the back of a ten fold increase in middle class population and three fold jump in household income. (Business Standard, 2007)

Along with this India offers abundant engineering and technical manpower, producing annually about 400,000 graduate engineers. Significantly, the technical workforce is likely to

cross the two million mark this year, with the transition from one million to two million happening in just about three years.

5.3.3 Top of the Value-Chain

With such a large technical workforce, high skill-sectors account for almost 40 percent of the manufacturing output in India. Taking advantage of this fact, several multinationals operating in skill-intensive industries requiring advanced technical expertise have set up their shop in India. For example, ABB, Honeywell, and Siemens in electrical and electronic products; Cummins, DaimlerChrysler, and Toyota Motor in auto components and engineering; and Degussa as well as Rohm and Hass in specialty chemicals have all set up their manufacturing base in India.

As the next wave of outsourcing in manufacturing expected to take place in just these kinds of industries, India is likely to become primary sourcing and manufacturing base. Already just over half of all offshore manufacturing by US companies involves skill-intensive sectors, and that figure could rise to 70 percent by 2015 opening up huge opportunities.

5.3.4 Global Manufacturing Exports Hub

'Made in India could become the next big manufacturing exports story', says a report by McKinsey (2005). India, with its proven track record in the skill-intensive industries and the global trend to manufacture and source products in low cost countries, is poised to emerge as one of the leading hub for manufactured exports.

Already a host of companies are making India their global manufacturing exports hub for their global operations. The list includes companies like Nissan Motor Co, Suzuki Motor Corp, Fiat, Anest Iwata, Hyundai and Nokia, among others.

Manufacturing contributes about two-thirds of the total exports of the country. It is estimated that manufacturing exports could increase from US$ 40 billion in 2002 to US$ 300 billion in 2015, simultaneously increasing its share in world manufacturing trade from 0.8 percent to 3.5 percent.

5.3.5 Going Global

Indian manufacturers, with the tremendous expertise gained in the domestic market, are spreading their wings to reach out to global markets. Indian corporates have been busy taking aggressive steps through both acquisitions and Greenfield investments abroad. All these initiatives are likely to boost brand India in the global arena.

Bharat Forge after multiple acquisitions has emerged as the world's second-largest manufacturer of axle beams, crankshafts, and other forged auto components. Similarly, Tata Steel after the acquisition of Corus has become the fifth largest steel producer in the world. Suzlon is the world's largest Wind Turbine Generator manufacturer. Ranbaxy Laboratories, India's largest pharmaceutical company, manufactures generic drugs in 11 countries, distributes and markets them directly in 49 countries, and counts on foreign markets for 80 percent of its revenue.

Additionally, a group of Indian companies are also becoming a vital link in the global supply chain. Sundram Fasteners makes generator caps for General Motors. Moser Baer has established itself as a global manufacturer of data storage media such as DVDs and CDs.

5.3.6 Manufacturing Excellence

Indian companies are also becoming renowned for their adherence to global quality standards. Already, India is amongst the countries with the highest tally for 2007 with total TPM Excellence Awards (conferred by the Japan Institute of Plant Maintenance) winners standing at 111. It can also proudly claim to have 15 Deming award-winning companies (amongst the highest tallies worldwide outside Japan) and one Japan Quality Medal winner. The industry has also been on the path of continuously increasing its productivity levels. For example, an Economic Times survey of 200 companies (arranged in terms of value of output) finds that the Incremental Capital Output Ratio (ICOR), that measures the output generating capacity of incremental capital, has improved from 0.62 in 2005-06 to 0.59 in 2006-07. (Economic Times, 2007)

5.3.7 Manufacturing Growth - Government Initiatives

The Government has taken several initiatives to accelerate growth in this sector and improve competitiveness of Indian industry in general and manufacturing in particular:

- Implementation of technology upgradation schemes for various sectors such as small scale industries, textiles, food processing among others.
- Implementation of industrial infrastructure upgradation programs on cluster basis.
- Easier access to inputs at competitive prices and rationalisation and reduction in duty rates.
- Encouragement to foreign technology collaborations and liberalization of FDI in manufacturing activities.
- Launch of "Visionary Leadership in Manufacturing" program to generate 300 visionary leaders in manufacturing in the next three years.
- Implementation of Special Economic Zones Act.
- Starting the construction of Delhi-Mumbai Industrial Corridor in cooperation with Japan External Trade Organization (JETRO).

To further encourage manufacturing growth, the Government plans to set up Manufacturing Investment Regions (MIRs) on the lines of Petroleum Chemicals and Petrochemical Investment Regions (PCPIRs).

5.3.8 India - Hub for World Manufacturing Industry

Leading Non-Resident Indian (NRI) industrialist Lord Swraj Paul, Chairman of the Caparo Group, foresees India becoming a hub for world manufacturing industry in the near future and says his US$ 1.5 billion Caparo Group remains very positive about the country. According to him India is changing very fast and has started enjoying globalization and the benefits from it. It is to be noted that the Group built the first factory in India in 1994, and currently have 16 facilities in operation, with another 16 being built which will be ready by 2009. (Financial Express, 2007)

According to a response of more than 340 of the world's largest international manufacturing companies (from Europe, Americas and Asia Pacific) in a study by global consultancy major Cap Gemini, India could challenge the position of China as the world's backyard for manufacturing in the next three to five years. It says companies are planning to offshore manufacturing activities primarily to India, that will surpass its IT and BPO activities, and the country is expected to become the number one outsourced manufacturing destination due to its competitive advantage over China. (Times of India, 2007)

Emerging economies like India and China have the largest market share of offshoring activities. India is diversifying from its stronghold in the IT and BPO segment to the manufacturing segment, which is currently dominated by China. It needs to be highlighted that India has to make significant investments for improving its infrastructure to cater to the increased demand of manufacturing and supply chain operations. The Indian government is eager to attract foreign manufacturing activities, but it will need to make significant investments to harvest this potential.

5.4 Summary and Discussion

India, among the global investors, is believed to be a good investment despite political uncertainty, bureaucratic difficulties, shortages of power and infrastructural deficiencies. India presents a vast potential for overseas investment and is actively encouraging the entrance of foreign players into the market. No company, of any size, aspiring to be a global player can, for long ignore this country with the world's second fastest growing economy. And the number of companies, spanning diverse industries, planning to make India their global hub for host of operations has only been increasing by the day.

Success in India will depend on the correct estimation of the country's potential, underestimation of its complexity or overestimation of its possibilities can lead to failure. For those who take the time and look to India as an opportunity for long-term growth, not short-term profit, the trip will be well worth the effort.

Top three motivating factors for FDI investors' entry in to India are:

- Market Size
- Highly skilled manpower
- Low cost of infrastructure and operation

Investors of FDI have rated India's attractiveness as an export platform as 'medium to high'. India's attractiveness as an off-shoring destination has been rated as 'high' by the FDI Investors. FDI investors have rated India as a highly attractive destination in terms of availability of skilled IT/BPO workforce.

The Government has taken several initiatives to accelerate growth in this sector and improve competitiveness of Indian industry in general and manufacturing in particular.

India is poised to challenge the position of China as the world's backyard for manufacturing in the next three to five years. Companies are planning to offshore manufacturing activities primarily to India, that will surpass its IT and BPO activities.

Reflecting this optimism in the country's potential, India has emerged as the top most promising destination for long-term Japanese overseas business for the first time in a survey by Japan Bank for International Cooperation (JBIC).

With such a surging interest of global manufacturers in Indian market, India is expected to become the hub for world manufacturing industry.

India is poised to attract FDI of US$ 40 billion in fiscal 2008-09 with overseas investors focusing big on the manufacturing sector in world's second fastest growing economy. India received US$ 20 billion FDI between January and June in the calendar year 2008 and US$ 10 billion in the first quarter of the current fiscal. Going by this, achieving US$ 40 billion in 2008-09 does not seem unrealistic. It may be noted that the target for the fiscal is set at US$ 35 billion while the inflows in 2007-08 were US$ 25 billion.

Though India is witnessing slight moderation in production growth, the country has emerged among the preferred destinations for the overseas investors. Automobiles and construction equipment segments are attracting increased interest among investors.

The Index for Industrial Production (IIP) growth had dropped to 5.4 percent in June this fiscal from 8.9 per cent a year ago. For the April-June period as well, the IIP rose by 5.2 percent against 10.3 percent in the same period last year. Within IIP, manufacturing expanded by 5.9 percent in June against 9.7 per cent in the same month last year. For the first quarter, the segment grew by 5.6 percent, compared to 11.1 percent in the corresponding period in 2007-08.

Though the growth outlook for 2008-09 has been lowered to sub-eight percent by different agencies, India remains among the fastest expanding economies.

A decade and a half ago the prospect of India becoming a major player in the global economy seemed a distant dream, only a theoretical possibility. During this period there has been a sea of change not only in the world's perception about India's future, but in the perception of Indians about themselves. The world has acknowledged the arrival of India. They no longer discuss the future of India; they say the future is India.

Chapter 6

Discussion and Conclusions

Foreign Direct Investment plays an important role in the world economy, especially in economic liberalization, intensified competition and the transfer of technology. The present study was intended to gain an essential understanding of the impact of FDI in developing host countries and factors influencing FDI, including determinants, motives and investment incentives. In addition, it seeks to review the relevance and impact of the FDI influencing factors in the context of India, with focus being the manufacturing sector, witnessing the fastest growth in the world.

FDI is perceived to be able to produce a positive impact on employment and tax revenues, and provide externalities in the form of the transfer of technology, management know-how and access to international marketing networks. Therefore, India and other developing countries that have similar circumstances are in need of conducting research on this area. The business prospects of traders and investors may be significantly improved through understanding the various unique aspects of the region in general. In a world that is becoming a global village, and experiencing the increasing pressure of the world global economy, all economies of the world, regardless of their type and direction, have to find their location within a wider global context and formulate policy on this basis.

Host governments can benefit from an understanding of what motivates foreign investors to invest abroad, and what investors look for when choosing a host country in which to establish their investment operations. Not only can host governments attract the desired level of FDI by foreign firms, but they can also retain existing firms. Providing the right types of incentives and obtaining the right balance between the costs of providing incentives and the benefits of enhancing development and growth in the host country is an important issue in this process.

A critique of the potential effects of FDI on host economies was presented in chapter two of this study. The areas where FDI could affect development in host countries include financial resources, technology transfer, employment, skills, export competitiveness, competition and market structure.

The main effects of FDI on the host country include social, cultural, economic, political and environmental effects. Views regarding the costs and benefits of FDI were found to vary in the literature, with some researchers focusing on the positive effects and others emphasizing the negative effects. The positive effects or spillovers may also include an increase in export capacity, creation and application of advanced technologies, industrial upgrading, training of labour and access to international marketing networks. On the other hand, FDI may cause some damage to the balance of payments of host countries through the remittance of profits, evading taxation or distorting transfer prices. Economic and political sovereignty, conflicts with policies in the host countries, socio-cultural impacts and impacts on the environment are other examples of negative FDI effects.

The costs and benefits of FDI may vary depending on some host country characteristics such as market size, political and economic stability, availability of labour, geographic location and so on. The foreign investing company may also cause an FDI impact through utilizing its intangible assets and the competitive advantage over local firms. In general, host countries continue to compete in attracting foreign firms, which indicates the realization that FDI can produce a beneficial impact on the development of host countries.

FDI decisions appear to be diverse in the context of the firm, industry and country specific factors, and therefore the decision of MNCs to establish FDI activities was found to vary across these factors. A large amount of literature exists from studies conducted by many scholars in the field on the motives behind FDI by foreign companies. The objectives of the foreign multinational firms are multiple and can include a combination of various motivations. The motivating factors for FDI include exploiting ownership advantages, internalization factors, utilizing research and development intensity, scale economies and minimizing costs of production and transport. Other examples of FDI motives include avoiding trade restrictions, diversification considerations and marketing motives. FDI is governed by a complex set of strategic, behavioural and economic factors.

Moreover, behavioural motives include the interaction between the foreign multinational company and the external environment (such as governments, distributors and clients) and internal environment (such as personal biases, goals and needs). There are several theories that explain the reasons behind the phenomenon of FDI and the expansion of multinational companies abroad. Some theories take a financial perspective and relate the investment by MNCs to maximizing profits and reducing risk through international diversification of their

investment. Other theories, such as the product life cycle theory, view the firm's expansion as a stage in the evolution of its products. On the other hand, a number of theoretical view-points, such as internalization theory and the market imperfection theory, focus on the market imperfection aspects as a reason for FDI by MNCs. The monopolistic advantage theory also focuses on market imperfections and regards FDI as a means through which firms attempt to extend profitability through their monopolistic advantages. The OLI or eclectic paradigm explains the international strategies of firms through the simultaneous presence of ownership specific advantages, location specific advantages and internalization advantages.

Some studies have emphasized the role of tax and labour factors as a significant determinant of foreign investment decisions, while others claim that tax and labour have limited influence on FDI decisions. Some of the FDI determinant factors that are related to the host country, such as size and growth of the economy, balance of payments, taxes, labour and government policies towards foreign investors were discussed. Most of the studies have observed the market size and market growth of the host country as significant FDI determinants. A general guideline may be that in choosing a foreign location, foreign investors look for a good infrastructure at relatively low cost, and easy access to international transportation and communication networks.

Governments strive to attract FDI as a means of helping them achieve their development goals. They try to offer investment incentives in order to correct their economic deficiencies and attract FDI. The various incentives that host governments may offer to attract foreign investments were discussed, together with the performance requirements that host governments may impose on foreign investors. There is a controversy over the effectiveness of investment incentives as a tool to attract FDI. Some studies have concluded that incentives have limited influence on investment flows, while others have found incentives to be a significant influencing factor of FDI. The findings from the literature suggest that the goal of an incentive system should be the achievement of the country's development goals rather that increasing investments.

Over recent years most of the countries over the world have made their business environment investment friendly for absorbing global opportunities by attracting more investable funds to the country.

India has been rated as the fourth most attractive investment destination in the world. In the first nine months of 2007-08, the net capital flows rose to US$ 83 billion from US$ 30 billion

the country received during the corresponding period of the previous year. India is expected to see the largest overall growth in its share of foreign investment, and it is likely to become the world leader for investment in manufacturing. Its share of international corporate investment is likely to increase by 8 percent to 18 percent over the next five years, helping it rise to the fourth, from the seventh position, in the investment league table, pushing Germany, France and the UK behind.

Most policy changes continue to favour FDI. Measures like establishment of special economic zones, lowering of corporate income tax and new promotional measures are being adopted to attract FDI.

FDI plays an important role in the long-term economic development of a country not only as a source of capital but also for enhancing competitiveness of the domestic economy through transfer of technology, strengthening infrastructure, raising productivity and generating new employment opportunities. FDI also has an important role in enhancing exports. The policy of the Government of India strives to maximize the developmental impact and spin-offs of FDI. While the Government encourages, and indeed, welcomes FDI in all the sectors where it is permitted, it is especially looking for large FDI inflows in the development of infrastructure, technological upgradation of Indian industry through Greenfield investments in manufacturing, and in projects having the potential for creating employment opportunities on a large scale. India invited investments in setting up SEZs and establishing manufacturing units therein.

India ranks number one in the world in terms of financial attractiveness, people and skills availability and business environment. The liberal investment regime, rapid growth of the economy, strong macro economic fundamentals, progressive de-licensing of sectors and the ease in doing business has attracted global corporations to invest in India. Consequent to policy changes and procedural simplifications, FDI equity inflows have registered a phenomenal upswing.

FDI flows are likely to decline in 2008, but a rising trend is to be expected in the medium term. However, FDI flows to developing countries in 2008 look resilient. India will see the largest overall growth in its share of foreign investment, and it is likely to become the world leader for investment in manufacturing. India, among the global investors, is believed to be a good investment despite political uncertainty, bureaucratic difficulties, shortages of power

and infrastructural deficiencies. India presents a vast potential for overseas investment and is actively encouraging the entrance of foreign players into the market. No company, of any size, aspiring to be a global player can, for long ignore this country with the world's second fastest growing economy. Furthermore the number of companies, spanning diverse industries, planning to make India their global hub for host of operations has only been increasing by the day.

Although India is witnessing slight moderation in production growth, the country has emerged among the preferred destinations for the overseas investors. Automobiles and construction equipment segments are attracting increased interest among investors. Though the growth outlook for 2008-09 has been lowered to sub-eight percent by different agencies, India remains among the fastest expanding economies.

Success in India will depend on the correct estimation of the country's potential, underestimation of its complexity or overestimation of its possibilities can lead to failure. For those who take the time and look to India as an opportunity for long-term growth, not short-term profit,the trip will be well worth the effort. Top three motivating factors for FDI investors' entry in to India are market size, highly skilled manpower and low cost of infrastructure and operation. The Government has taken several initiatives to accelerate growth in this sector and improve competitiveness of Indian industry in general and manufacturing in particular.

India is well poised to overtake China as the world's backyard for manufacturing in the next three to five years. MNCs are planning to offshore manufacturing activities primarily to India, that is expected to surpass its IT and BPO activities. With such a surging interest of global manufacturers in Indian market, India is destined to become the hub for world manufacturing industry.

Chapter 7

Future Work

This can be considered a useful study of foreign direct investment in a developing country, such as India. The study has attempted to achieve its aims and produced significant implications for theory and practice. Naturally, as with any other research, questions have to be raised for further study. Such questions may provide opportunities for future research that can be conducted, not only in the context of India, but also in many similar contexts.

Furthermore, this study has addressed numerous issues related to Foreign Direct Investment and India's investment environment. However, it is impossible for a single piece of work to cover all related issues, considering the time limit of this research. The following remarks may suggest potential directions for further work.

Given the intended exploratory nature of this research, further empirical research in the Indian context would present a more conclusive view. A study may be conducted to cover all economic sectors in the country, such as the services or financial sectors, rather than just the manufacturing sector.

Similar studies may be conducted in the context of other countries in order to examine the impact of FDI and the effects of the various FDI factors in attracting and/or deterring foreign operations, and comparing these aspects across different economies. This would clarify the picture of the overall impact of FDI on the economies under examination, and would suggest possible ways of coordination and integration to maximize the benefits of FDI.

Finally, this research, with its analysis, findings, discussions and recommendations can represent a very useful guide for future researchers especially in the context of India.

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