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FOREIGN DIRECT INVESTMENT IN INDIA

An overview of policies, legal process, trends and impact.

The Indian economic policy post-independence was influenced by the colonial experience and Nehru's exposure to Fabian socialism during his Cambridge years. Policy tended towards protectionism, with a strong emphasis on import substitution, industrialisation, state intervention in labour and financial markets, a large public sector and business regulation.

In 1991, the collapse of the Soviet Union, which was India's major trading partner, and the first Gulf War, which caused a spike in oil prices, triggered a major balance-of-payments crisis for India and India asked for a $1.8-billion bailout loan from the International Monetary Fund, which, in return, demanded reforms.

In response, Prime Minister Narasimha Rao along with his finance minister Dr Manmohan Singh initiated economic liberalisation. The reforms did away with the License Raj and ended many public monopolies, allowing automatic approval of foreign direct investment in many sectors. The slack and struggling economic situation of the country was thus given a long overdue and strong dose of potent economic reform medicine. Since then, the overall direction of liberalisation has remained unchanged, irrespective of the government in command, and the process of dilution of the protectionism of the Indian economy has continued unabated.

Today 100 per cent foreign direct investment (or FDI) is allowed under the 'automatic' route, i.e., without any prior governmental or regulatory approval, in a number of sectors including:

1. Manufacturing of products barring certain exceptions such as items reserved for production in micro and small enterprises;
2. Mining and exploration of metal and non-metal ores including diamond, gold, silver and precious ores but excluding titanium bearing minerals and its ores;
3. Generation and transmission of electric energy produced in hydro electric, coal-/lignite-based thermal, oil-based thermal and gas-based thermal power plants, non-conventional energy generation and distribution, distribution of electric energy to households, industrial, commercial and other users and power trading. It is to be noted that the above do not include generation, transmission and distribution of electricity produced in atomic power plant/atomic energy since private investment in this sector/activity is prohibited and is reserved for the public sector;

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4. Advertising sector;
5. Film industry including film financing, production, distribution, exhibition, marketing and associated activities related to the film industry;
6. Airports: Greenfield projects;
7. Courier services;
8. Health and medical services;
9. Hotels and tourism related industry;
10. Industrial parks—both setting up and already established industrial parks;
11. Construction and maintenance of roads, rail-beds, bridges, tunnels, pipelines, ropeways, runways, waterways and water reservoirs, hydroelectric projects, power plants and industrial plants.

Construction and development of townships, built-up infrastructure, commercial premises, housing, hotels, resorts, hospitals, educational institutions and recreational facilities is allowed subject to strict guidelines. For example, construction and development of serviced housing plots requires a minimum land area of 10 hectares or a minimum built-up area of 50,000 square metres. A minimum capitalisation of $10 million is required for wholly owned subsidiaries and $5 million for joint ventures with Indian partners. The funds have to be brought in within six months of commencement of business.

Persons residing outside India, other than foreign institutional investors (FIIs), can invest in the equity capital of asset reconstruction companies (ARCs) registered with the Reserve Bank of India (RBI) only under the 'government' route (i.e., with prior governmental approval) and FDI is restricted to 49 per cent of the paid-up capital of the ARC. FDI limit in private-sector banks is 74 per cent including investment by FIIs. FDI and portfolio investment in nationalised banks are subject to an overall statutory limit of 20 per cent under the 'government' route.

FDI up to 26 per cent is allowed in the insurance sector under the 'automatic' route.

Foreign investment is permitted up to certain sectoral limits in the broadcasting sector.

FDI is prohibited in the following activities/sectors:

1. Retail trading (except single brand product retailing)
2. Atomic energy
3. Lottery business including government/private lottery, online lotteries, etc.
4. Gambling and betting, including casinos, etc.
5. Business of chit fund
6. Nidhi company
7. Trading in Transferable Development Rights real estate business or construction of farm houses
8. Activities/sectors not opened to private-sector investment

FDI in trusts other than venture capital funds is also not permitted.

Legal process

As mentioned above, depending upon the industry and the amount of foreign investment proposed, FDI may be undertaken under what is referred to as the 'automatic' route or the 'approval' (or 'government') route. Generally speaking, investments which fall within the percentage caps specified for an industry can be made under the 'automatic' route, which means that no prior regulatory approval is needed, although the company is required to make a post-fact filing. For all other investments, the 'approval' route applies, which means that approval of the Foreign Investment Promotion Board (FIPB) is required prior to making the investment. The FIPB approval process typically takes 6 to 8 weeks, and barring exceptional circumstances, is relatively straightforward.

Entry strategies. In India, the preferred mode of business is through a limited liability company, although recent legislative changes have allowed the formation of limited liability partnerships as well. Large-scale business activity is usually conducted through a project company. The project company can be a wholly-owned subsidiary of the foreign investor in sectors where 100 per cent FDI is permitted; alternatively, the project company can be a joint venture between the foreign investor and Indian counterparty (counterparties).

Incorporating a company in India is a fairly straightforward process (although occasionally time-consuming). Investment in the project company can be through simple equity or other equity-linked instruments.

A number of foreign investors elect to route their investments into India through either Mauritius or Cyprus in order to take advantage of the benefits available under the double taxation avoidance treaties which India has with these countries.

Exit. The process of repatriation of capital invested and income earned on it is simple. Companies with direct foreign investment, established on the basis of repatriation,

are allowed to repatriate dividends, net of taxes. The equity invested can also be repatriated, should the investor decide to do so. Dividends, capital gains, royalties and fees can be repatriated easily. In case of an exit decision, the overseas promoter can repatriate his share after discharging tax and other obligations. He can also disinvest his share either to his Indian partner, to another company or to the public. If an exit is contemplated through the public markets in India, careful consideration has to be given to the public offering guidelines of the Securities and Exchange Board of India, which is the country's primary securities market regulator.

Trends

Foreign investment into India has been steadily increasing with increased liberalisation. According to data released by the Department of Industrial Policy and Promotion (DIPP), the cumulative amount of FDI from August 1991 to April 2010 stood at $134,642 million.

During the period April 1, 2009 to March 31, 2010 (FY 2009-10), the services sector comprising financial and non-financial services attracted $4.4-billion FDI, constituting 21 per cent of the total FDI into India during this period, while construction activities including roadways and highways attracted the second largest amount of FDI worth $2.9 billion during the same period. Housing and real estate was the third largest sector attracting FDI worth $2.8 billion followed by telecommunications, which garnered $2.5 billion during the same period. The automotive industry received FDI worth $1.2 billion, while power attracted FDI worth $1.4 billion.

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Impact

Foreign direct investment is widely acknowledged to benefit developing countries, not only by supplementing domestic investment but also in terms of employment creation, transfer of technology, increased domestic competition and other positive externalities.

FDI is preferred over other forms of external finance because it is non-debt creating, non-volatile and its returns depend on the performance of the projects financed. FDI also facilitates international trade and transfer of knowledge and skills.

Numerous studies of different developing countries have concluded that FDI triggers technology spillovers, assists human capital formation, contributes to international trade integration, and particularly exports, and helps create a more competitive business environment, enhances enterprise development, increases total factor productivity and more generally, improves the efficiency of resources use.

From the foregoing sections of this article, it is clear that our policies and legal procedures encourage foreign investment. The question that arises is whether these policies and laws (along with macroeconomic factors) have successfully created a favourable investing environment.

In its report on world investment prospects titled *World Investment Prospects Survey 2009-11*, the United Nations Conference on Trade and Development has ranked India third in global foreign direct investments in 2009. According to this report, India will continue to be among the top five attractive destinations for international investors during 2010-11.

The 2009 survey of the Japan Bank for International Cooperation (formerly The Export-Import Bank of Japan) released in November 2009, conducted among Japanese investors, continues to rank India as the second most promising country for overseas business operations, after China.

A report released in February 2010 by Leeds University Business School, commissioned by UK Trade & Investment, ranks India among the top three countries where British companies can do better business during 2012-14.

Thus despite the common perception that various hurdles exist to prevent the smooth flow of foreign investment into India, the reality is that it has never been easier or more attractive to invest in India. ■

The author is the founder and managing partner of Juris Legal & Financial Services—a specialised boutique law firm based in New Delhi. He is an expert in domestic and cross-border mergers and acquisitions, restructuring, financing, project development, commercial contracts and general corporate advisory. His team delivers advice to Indian and foreign entities on Indian company laws, real estate transactions, intellectual property, foreign investments and private equity transactions