

Executive Summary

India has made tremendous progress in building a policy environment to encourage investment. As a result, the country's economy is growing more rapidly and FDI inflows have accelerated impressively. However, investment remains insufficient to meet India's needs, particularly in infrastructure. Current efforts to strengthen and liberalise the regulatory framework for investment need to be intensified and India's well-developed economic legislation implemented at an accelerated pace both at national level and right across India's states and union territories.

India has made tremendous progress in promoting investment

India has made impressive strides in building a policy environment to encourage both domestic and foreign investment, in particular to attract foreign direct investment (FDI) and facilitate outward investment, as evidenced in this study. This progress is an integral part of the market-oriented reforms which have since 1991 set the scene for a shift to a consistently higher rate of real annual GDP growth than the country has experienced in its recent history.

The "licence raj" has been largely dismantled. Restrictions on large-scale investment have been greatly relaxed. Many sectors formerly reserved to the public sector have been opened up to private enterprise. Import substitution and protectionism have been replaced by an open trade regime. Sectoral restrictions on FDI have been progressively removed and foreign ownership ceilings steadily raised. FDI approval procedures have been greatly liberalised. Foreign exchange restrictions related to investment have been relaxed. Experimental economic zones such as the Special Economic Zones have been established to test investment liberalisation measures.

At the same time, other elements of the business environment that have an impact on investment have improved. The legal framework for intellectual property rights (IPR) protection has been greatly developed in the past two decades and enforcement has been strengthened. A non-discriminatory Competition Act is being gradually put into effect. India's tax system now treats foreign-owned companies on a par with domestic firms. The corporate

governance framework has improved, taking advantage of international norms. The government is striving to increase investment in human capital.

These reforms are expected to last. India has a history of democracy and the rule of law which provides a firm basis for the development of a sound legislative and regulatory environment for investment, incorporating good practices from other jurisdictions, generally on the basis of internationally-recognised standards.

As a result, India's FDI inflows have accelerated sharply in recent years (until the current economic crisis). FDI inflows have grown from relatively insignificant levels in the early 1990s to magnitudes now greater than most developing countries. These inflows have begun to play an important role in providing employment, diversifying consumer choice and adding competitive stimulus to domestic investment.

India's outward investment, which has grown apace with its inward investment during the 2000s, is also contributing to India's role as a major player in the world economy. Indian companies are active in M&As in OECD countries as well as greenfield investment in developing countries. This role is also evidenced by India's increasingly active investment treaty practice.

To meet India's investment needs, remaining challenges need to be addressed

India needs more investment, especially in infrastructure and manufacturing

However, India's investment needs remain massive, especially in view of the country's inadequate infrastructure, which imposes restraints both on improvements in living conditions and on productivity growth. Also, while India's exports of services, including those of the IT sector, are highly successful, and the country has continued to export labour services, its export manufacturing is far below potential, given India's resource endowment, particularly its vast labour force. This is a reflection of the under-representation of the manufacturing sector in the economy as a whole.

At the same time, the growth rate of employment has lagged behind the overall economic growth rate and obstacles remain to the expansion of activity and therefore employment in the formal sector. More investment can promote employment growth and so help raise the incomes of India's poorest families.

Investment restrictions may be holding back productivity growth

Although the policy framework for FDI in India has been greatly liberalised since 1991, it remains restrictive in comparison with a majority of OECD countries, as shown by the OECD's FDI Restrictiveness Index. Many of the current FDI restrictions in place apply to relatively low-productivity sectors where growth could be accelerated by the enhanced productivity that would benefit from increased foreign investment, for example in banking, insurance and especially retail distribution, where the influx of FDI could help raise incomes in the agricultural sector while increasing choice and lowering living costs for consumers.

Implementation gaps need to be narrowed to reduce regional income disparities...

While both economic growth and investment have been impressive since 1991, regional inequalities have not only persisted but have generally been aggravated as a result of economic reform. This trend needs to be reversed if the government is to reach its goal of achieving pro-poor growth and reducing inequality. Poorer and slower-growth states may begin to catch up with their richer neighbours by accelerating implementation of policies adopted at the central level to promote investment. For example, while the central government has reduced the number of approvals needed for new investment, there remains a need to streamline administrative procedures at the state level.

... and improve the nationwide investment environment

At the same time, there appears to be some potential for narrowing implementation gaps at the central level. For example, while great progress has been made in IPR protection, the capacity of the judicial system to handle such cases in a timely manner remains insufficient, and although a Competition Law was passed in 2002, the resulting Competition Commission only became operational in mid-2009.

Improvements in FDI statistics can support effective regional analysis and informed policy decisions

Current official statistics provide much detail on the origin and application of FDI in India and improvements continue to be implemented. However, there is still no consistent reporting and publication of FDI inflows to the states and union territories. As detailed in this report, FDI inflows are recorded at 16 Reserve Bank of India (RBI) regional offices, but there is no record of the final destination. The FDI inflows to each state are therefore not effectively recorded by the RBI. Many states keep their own records of FDI inflows, but there is no guarantee that the methodology used is consistent across states, and some states may not have the capacity to maintain a regular reporting system for FDI inflows, so the available data for cross-state comparisons are likely to be incomplete and of variable quality.

Policy options to address these challenges

The government of India may wish to consider policy options to address these challenges, including:

- Further relaxing restrictions on inward FDI where public interest objectives can be achieved by non-discriminatory means, including foreign ownership ceilings in sectors such as banking, insurance and retail trade, and regularly reviewing remaining FDI restrictions to ascertain that their costs do not outweigh their expected benefits.
- Developing a system of comparable FDI statistics for states and union territories as a basis for cross-state monitoring of FDI performance.
- Conducting a study into the design of mechanisms that can be employed by central government to induce states to streamline investment approval procedures.
- Conducting a study and/or establishing an inter-state forum to evaluate the costs and benefits of investment incentives, their transparency and their impact on other states, using the OECD's *Checklist for Foreign Direct Investment Incentive Policies* as a reference.
- Strengthening implementation of measures to enhance corporate transparency and responsibility to align India more closely with internationally-recognised standards and practices.