Recent FDI reforms

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***Source**: The Hindu*

Manifest pedagogy: Recent FDI reforms and issue of surcharge on FII has bought the limelight back on need fr progressive liberalisation in India. It also brings forward need for faster capital account convertibility. Seeing its relevance for investment and growth, it can be asked in prelims and mains with respect to their impact, reform process and needs vs safeguards.

In news: Reforms have been brought in FDI in various sectors.

Placing it in syllabus: FDI reforms (explicitly mentioned)

Static dimensions:

- FDI vs FII
- FDI reforms post 1991
- FERA to FEMA

Current dimensions:

- Recent FDI reforms
- Impact of FDI reforms on MSMEs

Content: The Centre's recent announcement on Foreign Direct Investment (FDI) norms appears to be one more push to make India a more attractive destination to overseas investors, especially those keen on entering the market for the long haul. The government, clearly concerned by the economic slowdown and persistently weak investment activity, has sought to provide a policy fillip to attract more foreign capital into sectors that it sees as having a multiplier effect, particularly in terms of job creation.

FDI v/s FII:

- **Foreign Direct Investment (FDI)** refers to the investment in which foreign funds are brought into a company based in a different country from the investor company's country.
- In general, the investment is made to gain a long lasting interest in the investee enterprise.
- It is termed as a direct investment because the investor company looks for a substantial amount of management control or influence over the foreign company.
- FDI is considered as one of the primary means of acquiring external assistance.
- A number of ways through which a foreign investor can get controlling ownership is by way of merger or acquisition, by purchasing shares, by participating in a joint venture or by incorporating a wholly owned subsidiary.
- **Foreign Institutional Investors (FII)**, are the companies that invest money in the financial markets in the country based outside the investor country.
- It needs to get itself registered with the securities exchange board of the respective country for making the investment.
- It includes banks, mutual funds, insurance companies, hedge funds, etc.
- FII plays a very crucial role in any country's economy because market trend moves upward when any foreign company invests or buys securities, and similarly, it goes down if it withdraws the investment made by it.

Key Differences Between FDI and FII

-> FDI is the investment made by a company in the company situated outside the country. FII is when investors, most commonly in the form of institutions that invest in the country's financial market.

-> FII is a way to make quick money, the entry and exit to the stock market are very easy. On the other hand, the entry and exit are not easy in FDI.

-> FDI brings long-term capital in the investee company whereas FII may bring long or short term capital in the country.

-> In the case of FDI, there is a transfer of funds, resources, technology, strategies, know-how. Conversely, FII involves the transfer of funds only.

-> FDI increases job opportunities, infrastructural development in the investee country and thus leads to economic growth, which is not in the case of FII.

-> FDI results in an increase in the country's productivity. FII results in an increase in the country's capital.

-> FDI obtains management control in the company. However, FII does not enable such control.

<u>FDI reforms post 1991:</u>

- Till 1990 all the FDI norms were meant to meet domestic requirements.
- It was the **Balance of Payment (BoP) crisis of 1991** that triggered for allowing FDI in India.
- Provision of the **Foreign Exchange Regulation Act (FERA)** were diluted to a great extent in this period.
- India was heavily dependent on foreign exchange in the form of debts in 1970s & 1980s. But the 1991 crisis saw allowing a way to foreign exchange but which was non-debt-creating & long term in nature.
- Now FDI can enter most sectors or activities under the Automatic Approval Route, except for a few sectors where there are additional restrictions on FDI such as equity caps, disinvestment conditions and lock-in periods on investment.
- Such restrictions are present because of the sectoral needs, security and strategic concerns and in the

interest of domestic investment.

Some major reforms in FDI:

⇒ Industrial licensing has been abolished.

⇒ Many sectors open to foreign participation.

⇒ Many sectors were included in the sectors marked for automatic approval of FDI post 2000.

⇒ FERA was changed to **Foreign Exchange Management Act (FEMA)** in 1999 to facilitate foreign exchange management in the capital account.

⇒ RBI introduced an automatic approval channel for 100% foreign equity in priority sectors. The automatic route has been extended to up to 51% foreign equity in priority sectors.

⇒ Abolition of high local content requirements, dividend balancing requirements, and export obligation conditions except for 22 consumer goods. (The conditions on 22 consumer goods were subsequently withdrawn in 2000).

⇒ Major institutions set up to promote and facilitate FDI inflows, such as Foreign Investment Promotion Board (FIPB), Foreign Investment Implementation Authority (FIAA), and Secretariat of Industrial Assistance (SIA).

⇒ Privatisation of public sector.

⇒ Aggressive signing of bilateral investment and double tax avoidance agreements to benefit and assure foreign investors.

=> The law on trademarks and Geographical Indications of Goods passed in 1999 to protect intellectual property rights.

⇒ Fiscal incentives such as tax subsidies and concessions offered by both central and state governments to foreign investment.

⇒ Reforms at the state government level and institutions established to help implement FDI projects.

Major FDI reforms since 2012:

⇒ Allowing 100% FDI ownership in single brand retail trading and upto 51% FDI in multi brand retail.

⇒ Allowing foreign airlines upto 49% FDI.

⇒ Increasing FDI equity from 49% to 74% in certain broadcasting sectors.

⇒ Allow up to 49% FDI in power exchanges.

⇒ Increasing FDI limit from 26% to 49% in the insurance sector.

⇒ Allowing 49% FDI in several sectors such as petroleum and natural gas, commodity and stock exchanges, power exchanges, asset reconstruction, single brand retail and telecommunications.

=> Foreign investment up to 49% in these industries may be made under the automatic route which does not require approval from the RBI or the Indian government

⇒ Sectors such as asset reconstruction and telecommunications are eligible for 100% FDI upon approval by the FIPB.

⇒ The defence sector will also be eligible for greater FDI under the recent changes. For present it is 26%. But 100 equity is also allowed if the project are likely to result in access to modern and state of the art technology.

=> FDI in the insurance sector capped at 49 per cent under the automatic route.

In 2018:

⇒ 100% FDI under automatic route for Single Brand Retail

Trading.

=> 100% FDI under automatic route in Construction Development.

=> Foreign airlines allowed to invest up to 49% under approval route in Air India.

FERA to FEMA:

- **Foreign Exchange Regulation Act (FERA)**, was introduced in the year 1973.
- The act came into force, to regulate foreign payments, securities, currency import and export and purchase of fixed assets by foreigners.
- The act was promulgated in India when the position of foreign reserves wasn't satisfactory.
- It **aimed at conserving foreign exchange and its optimum utilisation** in the development of the economy.
- As the act applied to the whole country, all the citizens of the country, inside or outside India were covered under this act.
- The act extended to branches and agencies of the Indian multinationals operating outside the country, which is owned or controlled by the person who is a resident of India.
- **Foreign Exchange Management Act (FEMA)**, was promulgated in the year 1999, to repeal and replace the FERA (Based on Tarapore committee recommendation).
- The act applies to the whole country and to all branches and agencies of the body corporate operating outside India, whose owner or controller is an Indian resident and also any violation committed by the person covered under the Act, outside India.
- The main objective of the act is **to facilitate foreign trade payments and to encourage systematic development and maintenance of forex market** in the country.
- There are a total of seven chapters contained in the act which are divided into 49 sections, out of which 12

sections deal with the operational part while the remaining 37 sections cover penalties, contravention, appeals, adjudication and so on.

- Violation of FERA was a non-compoundable offence in the eyes of law. In contrast **violation of FEMA is a compoundable offence** and the charges can be removed.
- Citizenship of a person was the basis for determining residential status of a person in FERA, whereas in FEMA the person’s stay in India should not be less than six months.

Recent FDI reforms:

The Union cabinet recently cleared changes in FDI regulations, including easing rules for overseas single-brand stores and permitting FDI through the automatic route in contract manufacturing and all areas of coal mining.

These reforms are part of India’s strategy to become part of the global supply chain amid its disruption due to the US-China trade war.

- **In single-brand retail**, the government allowed companies to **conduct online retail trading** prior to opening of physical stores, subject to the condition that brick-and-mortar stores come up within two years from the date it starts online operations.
- Now online sales would lead to creation of jobs in logistics, digital payments, customer care, training and product skilling.
- To provide greater flexibility and ease of operations to foreign **single-brand retail entities with more than 51% FDI**, the cabinet decided that all procurements made from India by the entity for that **single brand shall be counted towards local sourcing of 30%**, irrespective of whether the goods procured are sold in India or

exported.

- Further, the current cap of considering exports for five years only was removed, to give an impetus to exports.
- The cabinet allowed **100% FDI in contract manufacturing**, allowing large foreign electronics and pharmaceutical companies to directly invest in local or foreign contract manufacturers. This will give a big boost to the government’s Make in India policy.
- So far, 100% FDI under the automatic route was allowed for coal processing plants as well as for coal mining for captive consumption by power projects, iron and steel and cement units.
- Now **100% FDI under the automatic route for coal mining as well as sale and export of coal** is allowed.
- This is expected to end the monopoly enjoyed so far by Coal India Ltd (CIL), which is often considered lacking capability to mine the coalfields.

Impact of FDI reforms on MSMEs:

- The recent FDI announcements made would help promote Make in India initiatives, MSMEs, and budding entrepreneurs, according to the Department for Promotion of Industry and Internal Trade (DPIIT).

However a Parliamentary panel set up in 2018 had warned that FDI policy for retail may not have beneficial impact on MSMEs and had suggested that a regulatory authority be set up to safeguard the interests of domestic players in the sector. It was of the view that not enough safeguards have been provided to insulate the SME sector from sudden changes in trade policy.

The committee was of the opinion that FDI in retail may not benefit the retail sector unless designing, packaging, bar coding, skill development are improved upon and integrated into supply chain. It also said that the implementation of policy provisions should be closely monitored through an institutional mechanism in the initial years, and not left to self-certification.

The committee suggested that the auditor should specifically certify adherence to the 30 per cent sourcing norm and it must be mentioned in the audited report of the companies which would invest under FDI in retail scheme. It recommended that MSME ministry should conduct regular survey of MSMEs to monitor sickness/takeover/mergers and other trends.

The committee has opined that continued dominance of big foreign retail giants and their direct dealings with farmers by giving attractive prices in the beginning will cripple mandis and markets which form part of rural economy. Once such mandis are eliminated the big foreign retail giants would manipulate prices and farmers would be forced to sell their products at allow price dictated by them. It called upon national board on MSME to take up the issue of impact of FTAs, trade policy and FDI on the sector.