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Foreword

This Investment Policy Review of India, *which assesses the development of India's investment environment on the basis of the* Policy Framework for Investment, *forms part of the continuing programme of OECD-India co-operation which led to the holding in October 2004 of the OECD's Global Forum for International Investment back-to-back with the OECD-India Investment Roundtable in New Delhi and continued with the first OECD-India dialogue on investment policies at the April 2005 meeting of the OECD's Investment Committee.*

This Review *is based on the background study that facilitated a review by the Investment Committee of India's investment policies at the Committee's meeting in March 2009. The delegation of the Government of India attending the Review Meeting was led by Shri Ajay Shankar, Secretary to the Government of India, Department of Industrial Policy and Promotion, in the Ministry of Commerce and Industry. An early draft of the report was also discussed at a seminar organised by the Government of India in New Delhi in January 2009.*

The Review *is based on studies prepared by Kenneth Davies, Senior Economist, and Misuzu Otsuka, Economist, in the Investment Division, headed by Pierre Poret, of the OECD's Directorate for Financial and Enterprise Affairs, with input from its Competition and Corporate Affairs Divisions. The report benefited from the views of the Indian authorities, members of the OECD's Investment Committee and consultations with the private sector and other partners.*

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Preface
by Anand Sharma, Minister of Commerce and Industry, Government of India

Global perception about India, its economic might and potential in terms of growth and market size has changed over the last few years. Today, India finds itself among a list of 12 countries with GDP in excess of 1 trillion dollars and growing fastest in the world.

This is an important development not just for India but also, perhaps, for much of the developing world. Till the last decade, there was a view that our democratic processes and pace of economic reforms were responsible for slow growth. However, with the 8.5-10% annual economic growth recorded in India in the last few years, till 2008-09, a clear message has passed that country specific economic models can be pursued in a globalizing world. I would like to believe that the Indian model of economic development has started gaining global credibility and could emerge as one of the biggest ideas of the new millennium. In fact, it would not be an exaggeration to state that India holds important lessons not just for other developing countries round the world but also for developed groupings such as OECD.

We have watched a sea change in the world perception about India. India is now at the center of every international radar, whether it is tracking the global political scene, economic canvas, corporate future or environmental balance. We are aware that the world is closely watching every step that India is taking. India has taken impressive strides in building a policy environment to encourage both domestic and foreign investment and simultaneously facilitate outward investment by the Indian industry. Today, the world has started respecting the fact that steps taken by us in an environment of democracy have unleashed energy and commitment across layers in the private sector, within the central and state governments, and within civil society. The Indian economy has integrated with the world to a great extent but has retained its own dynamics which has enabled the country to chalk out its path of revival from the global downturn that has tremendously hurt large economies all over the world.

As in the rest of the globalised world, Indian society is in transition; yet we can say that transition rules are deeply institutionalised in this country; and long-term political stability can safely be assumed. Today, states managed by different political parties across India are welcoming private investment with open arms. This has allowed the manufacturing sector to become globally competitive. This has also allowed the service sector to discover pricing arbitrage and new growth markets across smaller cities in the country. In the first decade, corporate dynamism changed the business map of the country; in the next decade, I am convinced the same dynamism will change the socio-economic map of the country.

As a broad-based economy is developed across India, sufficient internal strengths are being developed to support India's ambitions to become a developed country, as well as a major world player. The policy reforms being carried out by the government are clearly having a beneficial impact. The most evident of these is the quantum jump in FDI equity inflows into India. Consequent to policy changes and procedural simplifications, FDI equity inflows have registered a phenomenal upswing. FDI inflows have gone up from USD 2.2 billion in 2003-04 to USD 27.3 billion in 2008-09; a thirteen-fold increase during the last 5 years. In this background, it was desirable to subject our Policy to a review by an international body like the OECD, a group of developed economies of the world, which would provide an opportunity to secure international recognition of India's progress in improving the investment environment and support future investment reform plans. I find that the OECD Investment Committee Team has interacted with a cross-section of ministries under the central government and with state governments in carrying out the analysis and research for bringing out this report. I convey my appreciation on the work carried out by the OECD Team members.

I also express my thanks to the OECD Investment Committee for having undertaken the *Investment Policy Review of India* and giving the Indian model of economic development a global perspective and recognition.

Anand Sharma

Preface by Angel Gurría, Secretary-General, OECD

In the past two decades, India has experienced an impressive acceleration in economic growth. An improved policy environment for private sector and foreign investment has played a major part in this positive outcome. Many important changes to address the country's investment needs have been set in motion, but as in many other countries, there are still some important policy challenges.

OECD countries face many of the same challenges and have a long tradition of sharing experience about the policies that work well – or less well. It has been enriching to welcome India as part of our policy dialogue because we have learned much about India's policies and values. We hope that the experience of other countries has been valuable to India as well.

During the recent crisis India's GDP growth has moderated only slightly and foreign direct investment into India has largely remained unaffected. As the world economy recovers, many countries will be trying to draw foreign investment to their economies.

This first OECD *Investment Policy Review of India* examines India's progress in developing an enabling framework to encourage investment. Positive measures include the removal of many licensing requirements and curbs on large enterprises. The *Review* also points to some challenges that remain to be addressed. For example, India may be able to better achieve its objectives through non-discriminatory policies rather than sectoral restrictions on foreign investment. Covering a wide range of related policy areas, the *Review* provides a foundation for continuing co-operative research to support India's investment policy development.

The report is a landmark in the growing co-operation and enhanced engagement between India and the OECD. While the OECD is responsible for its contents, India has participated wholeheartedly in the preparatory work at many levels of government and over the whole period from conception to completion. The spirit of co-operation displayed by India has been a model for international dialogue.

We look forward to further broadening and deepening our co-operation with the government of India in this and many other policy areas.

Angel Gurría

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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.

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Chapter 1

India's Evolving Position in the Global Economy

This chapter charts how India's progress in comprehensive economic reform has contributed to an acceleration in economic growth, noting that further reform is necessary to achieve the government's development goals, such as increasing employment and reducing poverty and inequality. The chapter examines the liberalisation of the regulatory framework for foreign direct investment (FDI) since 1991 and shows how this has led to the country's recent strong performance as both a recipient and a source of FDI. FDI inflows are analysed by motivation, sectoral distribution, geographical source and mode of entry (automatic or approval route). Outflows of FDI are similarly analysed by sector, destination and type (greenfield or M&A), while tracing the evolution of government policy towards outward investment.

1. The setting: Economic reform

Successive reforms since the mid-1980s have had a major beneficial impact on India's economy by reducing state intervention and control over economic activities and moving towards a market-based system, as highlighted by the *OECD Economic Survey of India* (2007). Investment policy has been a major area of economic reform which has greatly contributed to an increase in economic growth potential in India.

India's post-independence economic development

Independent India adopted an industrial strategy of strong state control and import substitution

Upon independence in 1947, India faced great challenges: one of the lowest per capita incomes in the world, a high poverty ratio, a marginal industrial sector representing only 13% of total economic activity,[1] and a low saving rate of around 5% of GDP. To meet these enormous challenges, India embarked on an industrial strategy underpinned by the principles of import substitution and self-sufficiency.

The Industrial Policy Resolution of 1956 assigned the public sector a strategic role in India's economic development while the Second Five-Year Plan (1956-61) emphasised heavy industry. A number of capital-intensive and infrastructure industries were reserved for the public sector. Nationalisation of major commercial banks and textile sector enterprises followed later and state-owned enterprises expanded the scope of their commercial activities even into such sectors as consumer goods and services.

In pursuit of the import substitution strategy, domestic industries were protected from foreign competition *via* high import barriers and restrictive FDI policy. The government further established a comprehensive licensing system with the objective of controlling resource allocation and output distribution according to its Five-Year Plans, which began in 1951. Under the Industries Act of 1951, enterprises were required to obtain licences to establish a new factory/unit, carry on business in an existing unlicensed factory, expand an existing factory's capacity significantly, start a new product line or change location. Import control mechanisms with a licensing system were introduced during the Second Five-Year Plan and were tightened and made more complex from 1960 to 1977. The government's intervention in industrial activities was

also exercised through its controls on the use of foreign exchange, credit allocation and the prices of key commodities.

The government's policy was hostile to foreign enterprises and large private enterprises

The government adopted an unfavourable stance towards foreign enterprises as well as large private domestic enterprises which might have threatened the government's power. The Monopolies and Restrictive Trade Practices (MRTP) Act of 1970 was introduced to deter further expansion of large private enterprises by requiring government prior approval for major decisions by large private enterprises such as expansion, establishment of new units, merger, takeover and appointment of board directors. On the other hand, small-scale enterprises were protected by the government and were given significant benefits. A list of items was exclusively reserved for production by small scale industries (SSI) which have investment in plant, machinery and equipment less than a ceiling set by the government.[2]

The Foreign Exchange Regulation Act (FERA) of 1973 severely restricted the activities of foreign enterprises in India, limiting foreign equity participation to a maximum of 40%. Foreign-owned enterprises which wished to operate in India were burdened with government restrictions in terms of local content, export obligations, use of foreign brand names and technology transfer.

Negative impacts of the government policy had become clear by 1980…

By 1980, the negative consequences of excessive public ownership and control were clear. Many state-owned enterprises with low productivity growth, over-staffed and using obsolete technology, suffered and became a heavy financial burden on public finance. Private enterprises faced substantial administrative costs due to the bureaucratic nature of the licensing process. High protection of the domestic market through restrictive trade and investment policies left an industrial structure that was highly inefficient and also failed to raise the competitiveness of Indian exports. The MRTP Act and the SSI reservation policy have contributed to capacity fragmentation and sub-optimal production scale in many sectors. India's share in world merchandise exports declined from 2% in 1947 to 0.5% in the mid-1980s.

… and partial liberalisation started

In the 1980s, in an attempt to modernise domestic industry and increase India's export earnings, government strategy shifted in favour of liberalisation and openness. For example, about a third of three-digit industries were delicensed in March 1985; the government relaxed import restrictions primarily on intermediate inputs and capital goods,[3] it extended export incentives

through its policy on export-oriented units (EOUs) and export-processing zones (EPZs); and it terminated price control on key intermediate inputs.

These initial steps to policy liberalisation partially explain the acceleration of economic growth in the 1980s. However, the main contributor to economic growth during this period was expansionary fiscal policy. In hindsight, reforms before 1991 were not comprehensive and had a limited impact on the economy. The *OECD Economic Survey of India* (2007) concludes that "*reforms were essentially oriented towards improving the position of domestic producers rather than increasing competition through a generalised opening of the economy*". Eventually, the growing fiscal imbalances of the 1980s spilled over to the external sector, fuelling a large and unsustainable current-account deficit that led to the external payment crisis in 1991.

Economic reform since 1991

Comprehensive economic reform was initiated in 1991

Confronted with an external payments crisis in 1991, India resorted to IMF assistance and committed itself to further economic reforms. Subsequently, the new government introduced a far-reaching set of economic reforms with its New Industrial Policy of 1991, which drastically changed the policy regime by abolishing licensing requirements and opening up publicly-reserved sectors to private enterprise. The government's attitude towards foreign direct investment turned favourable and steps were taken to start the reform of competition policy.

> **Box 1.1. Press Notes**
>
> FDI policy changes are published as "Press Notes" by the Department of Industrial Policy and Promotion (DIPP) of the Ministry of Commerce and Industry. These Press Notes have legal status and together represent current FDI policy in India. The endnotes to this section refer to these Press Notes by number and year of issue, as is normal practice. A fuller explanation of Press Notes appears in Chapter 2 of this *Review*.

Industrial licensing was abolished except in a few cases

Industrial licensing was abolished for all except 18 industries[4] which remained subject to compulsory licensing under the Industries Act of 1951 due to concerns related to national security, public health, public safety and environment. Exemption from licensing was granted to not only new investment projects but also substantial expansion of existing units and manufacturing of new items by existing units. Location decisions for

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investment were also freed from government intervention unless investment was planned within 25 km of 23 highly-populated cities[5] and was in sectors other than the "non-polluting" sectors. Subsequent delicensing has left only 5 sectors subject to compulsory licensing.

Public ownership of industries was reduced substantially

The number of sectors reserved for the public sector was reduced to eight[6] in 1991. As a result of further reviews, only atomic energy and railway transport remain reserved for the state. The government also reviewed its existing portfolio of public investments with a view to shedding loss-making state-owned enterprises deemed to serve little or no public purpose. State-owned enterprises retained after review were granted greater management autonomy and exposed to competition and market discipline by inviting private-sector participation and divesting part of the government's shareholdings.

Policy reform on competition, trade and foreign investment also started

The MRTP Act was amended in 1991 to eliminate the need for prior permission for investment and expansion by MRTP-designated firms. A number of items have been gradually de-reserved from the SSI. The ceiling on investment in plant and machinery for the SSI was raised generally from INR 30 million to INR 50 million under the Micro, Small and Medium Enterprises Act of 2006. The number of items reserved for the SSI decreased from 799 in FY 2001-02[7] down to 21 (see Chapter 5 for competition policy).

India has made a drastic change in trade and foreign investment policy by greatly opening up the domestic market. Quantitative restrictions on imports have been virtually abolished and tariffs reduced. The peak customs duty rate was reduced from 150% in FY 1991-92 to 35% in 2001 and further down to 10% by 2007. Exchange controls were removed on all current-account transactions and India achieved current-account convertibility in 1994 (see Chapter 4 for trade policy).

Both foreign direct investment and portfolio investment have been liberalised. Since 1993, foreign institutional investors have been allowed to purchase shares of listed Indian companies in the Indian stock market. After the introduction in 1991 of automatic approval for FDI projects with up to 51% of foreign equity in 34 specified sectors, FDI has been welcomed in virtually all sectors except lottery and gambling business, retail trade (except single brand retail), atomic energy and a few informal saving schemes; and a number of industries have become open for 100% foreign ownership without government prior approval. As the balance-of-payments situation has improved, the government has gradually relaxed its foreign-exchange-related controls on foreign investors.[8]

Despite gradual reform the financial sector is still dominated by the public sector

Financial-sector reform has progressed much more slowly as government control was stronger, with massive badly-performing loans accumulated in state-owned banks. State-owned banks controlled 90% of bank deposits; credit was subject to mandatory allocation to government priority sectors; interest rates were determined administratively; a large share of bank deposits were absorbed in the government sector through the Statutory Liquidity Ratio requirement; and approval from the RBI was required for any loan projects above a certain threshold as well as for opening of new branches and off-site cash dispensers.

Relaxation of these government controls was started in 1991 along with measures to strengthen the financial regulatory system. The banking sector was opened up for more competition, allowing new private banks – including foreign banks – to enter the market; and interest rates were deregulated, except in four areas.[9] However, in contrast to the industrial sector, the government's presence is still dominant in banking, as the government holds majority shares in most large banks and directly influences various activities of banks (see Chapter 6 for financial-sector developments).

Positive outcomes of the reforms during the past decade

Liberalisation of industry policy in India has led to an acceleration of economic growth and a reduction in poverty. In the post-reform phase India recorded an average economic growth rate of 6.5% per annum which included growth acceleration to 8.9% per annum since FY 2003-04.[10] In tandem, India's poverty rate decreased from 26.1% in 1991 to 21.8% in 2007 (OECD, 2007b). The services sector, led by communications, insurance and information technology services, has outperformed other sectors. Knowledge workers in the software industry increased from 56 000 in FY 1990-91 to over 1 million by FY 2004-05. Exports of products in the IT and ITES sectors have grown at an annual rate of 33.7%[11] since FY 2000-01 (NASSCOM, 2008).

The secular uptrend in economic growth has been supported by robust growth of domestic savings and investment. Gross domestic savings have increased from an average of 21.5% of GDP at the start of reform in FY 1991-92 to almost 37.7% in FY 2007-08. Over the same period, domestic investment rates have increased from 22.1% of GDP to close to 39.1%. The Indian economy has become noticeably more open and globally integrated. The share of combined imports and exports in GDP rose from 13% in FY 1985-86 to 46% in FY 2007-08.

The current Eleventh Five-Year Plan (2007-12) aims to achieve an average GDP growth rate of 9% per year, which consists of sectoral targets of 4% for

agriculture, 10-11% for industry and 9-11% for services. The Plan envisions that this growth target will be achieved in a more inclusive manner which "*yields broad-based benefits and ensures equality of opportunity for all*".

Development challenge

Further reform is necessary to realise faster employment generation and more inclusive growth

The Eleventh Five-Year Plan stresses the importance of faster employment generation and more inclusive growth. For this purpose, further reform is necessary to facilitate entry, expansion and exit of enterprises in the formal sector, as employment has lagged behind the overall expansion of the Indian economy. The organised sector[12] in India has employed a very small share of the total working population.[13] Small-scale enterprises are unlikely to increase in size, as they would lose benefits provided by the government and would have to pay the higher regulatory costs of being in the organised sector.

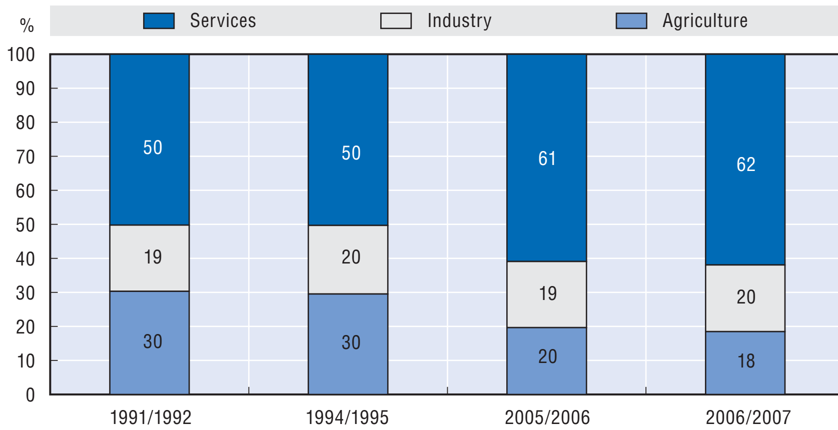
India's labour laws have deterred enterprises from hiring more unskilled workers by making reallocation and retrenchment of employees difficult. The Industrial Disputes Act of 1947 makes it compulsory for enterprises with more than 100 employees[14] to seek permission of the relevant government for retrenchment. The Contract Labour Act 1970 effectively restricts employment of contract labour by empowering the government to order prohibition of employment of contract labour in any establishments with 20 or more workers. As a result, Indian enterprises are unusually small relative to counterparts in other countries and adopt more capital-intensive technology than is warranted by India's resource endowment.

India's industrial structure offers limited employment options for unskilled workers

India's unique business environment has led to the current industrial structure which is characterised by under-representation of the manufacturing sector and a large services sector (see Figures 1.1 and 1.2). While the manufacturing sector has played a large role in economic development in many countries, the manufacturing sector in India has not exhibited a similar dynamism, with only a slight increase recorded over the years. A large pool of labour is still stuck in the agricultural sector, which has a productivity growth rate about one-quarter lower than that of services sector. One reason for this unique industrial structure is believed to be India's pro-labour regulations which have hampered reallocation of resources towards more productive sectors.

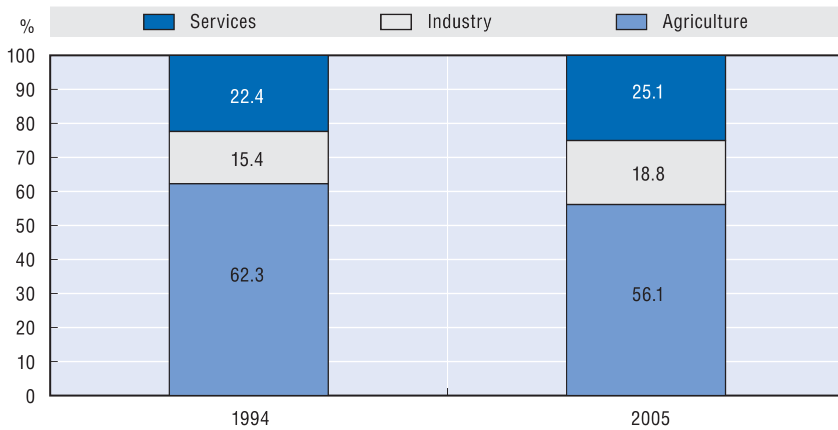
Increasing employment, especially for unskilled workers in non-farm sectors, is crucial for India to sustain rapid and inclusive economic growth. Given India's comparative advantage in its low-cost labour force, the

Figure 1.1. **Change in India's industrial structure – Output**



Source: RBI.

Figure 1.2. **Change in India's industrial structure – Employment**



Source: ADB Key Indicators.

expansion of labour-intensive manufacturing offers a large potential for generating unskilled employment. Due to the regulations restricting enterprise growth, manufacturing establishments in India are extremely small,[15] while a small number of large-sized manufacturing establishments are overly capital-intensive. This indicates that the manufacturing sector has failed to achieve economic scale as well as to exploit the country's most obvious comparative advantage. India expects a declining dependency ratio, which can be a good basis for higher potential growth. However, whether India can turn this opportunity into reality depends on its performance in job creation.

Inequality among states has been increasing in India

Increasing inequality is a serious concern in India. There has been considerable variation in income growth across the country, where states in the North have seen a markedly smaller reduction of poverty than states in the South, West and North-West. Poor states have failed to catch up with rich states (see Chapter 7 on progress and challenges at state level). Investment including foreign direct investment has shown concentration in relatively rich states. While there is a resource transfer mechanism among states and the central government has implemented many schemes to address regional imbalances, each state is seeking to step up its efforts to attract private investment by providing a favourable business environment.

Large infrastructure deficit is a serious bottleneck for sustainable development

Fiscal consolidation during the 1990s was brought about mainly by a decrease in capital expenditure rather than a decrease in current expenditure and an increase in revenues. The fiscal constraints on both the central and the state governments had eroded their capacity to undertake essential public investment. Though the health of public finance has been improved in recent years[16] and public investment has started increasing since FY 2003-04, the historical shortage of public investment in infrastructure to keep up with economic growth has resulted in a large "infrastructure deficit". The Eleventh Five-Year Plan estimated infrastructure financing needs of about USD 500 billion for the Plan period (2007-12)[17] out of which about 70% is to come from public sector sources and 30% from private sector sources. Development of infrastructure, especially in poor states, is critical for realising inclusive growth and reducing inequality in income and social services (see Chapter 6 for infrastructure development).

2. India is an increasingly important destination for FDI

Pre-reform FDI

Independent India sought FDI to complement its capital, foreign currency and technology needs

Private foreign capital had a prominent position in Indian industry prior to independence in 1947: foreign firms, mostly from the United Kingdom, had invested heavily in mining, plantations, trade, infrastructure and manufacturing. Up to the early 1960s, the government attitude remained favourable to FDI as it perceived FDI supplementary to the country's domestic savings, foreign currency reserves and skills. FDI was welcomed as long as the majority stake in projects was owned by Indians. To attract more foreign investment into the country, India offered many incentives and concessions to foreign investors and set up the Indian Investment Centre in 1961 to promote foreign investment in India.

India's import substitution strategy pursued under the Second Five-Year Plan (1956-61) created a protected domestic market and highly profitable opportunities for foreign enterprises. In 1961, the government introduced special incentives for foreign investment in certain sectors, based on its analysis of the resource gap in each sector, including drugs and pharmaceuticals, aluminium, heavy electrical equipment, fertilisers and synthetic rubber. During this period foreign investors were guaranteed free remittance of profits and dividends abroad, fair compensation in the case of expropriation, and national treatment.

The government policy on FDI had turned restrictive since the late 1960s

The government changed its attitude towards FDI as domestic industry developed its technical capacity and remittances of dividends, profits, royalties and technical fees by foreign investors became a significant portion of foreign exchange outflows from India. Screening and approval procedures became stricter and, in 1968, the government set up the Foreign Investment Board to review all FDI projects with foreign ownership of up to 40% and foreign technical collaboration agreements. FDI projects with foreign ownership of more than 40% had to be cleared by a Cabinet Committee. Further restrictions and conditions[18] were imposed on FDI projects and foreign collaboration agreements to limit foreign involvement to high-priority industrial sectors and to cases in which they were expected to bring advanced technologies lacking in India.

In 1973, the Foreign Exchange Regulation Act (FERA) became effective and imposed a requirement to register all foreign-invested enterprises as Indian enterprises and a general ceiling of 40% on foreign equity ownership in Indian enterprises. All enterprises having foreign equity of more than 40% at the time were instructed to dilute foreign shareholdings in due course. Intellectual property rights (IPR) were severely curtailed in 1970 as the revised Patents Act abolished product patents in pharmaceuticals and chemicals and shortened the length of process patents. These measures and the government takeover of private assets in the 1970s[19] prompted a flight of foreign investors from India in the 1970s and negatively affected the quantity and quality of technology transfer. Ironically, the entry barrier created under the FERA effectively shielded some existing foreign enterprises from further international competition and discouraged them from making efforts in technological upgrading and innovation in India beyond the level prevailing among domestic competitors.

Slight liberalisation of FDI restrictions was observed in the mid-1980s

In the mid-1980s, there was a shift in the policy stance towards more competition and less government control. Foreign enterprises setting up 100%

export-oriented units (EOUs) were exempted from the FERA's 40% limit on foreign ownership in projects. Further flexibility in foreign ownership was allowed on a case-by-case basis. Streamlining of administrative procedures and relaxation of rules concerning royalties, technical fees and dividends were also made to encourage technology transfers. This shift in the government attitude towards FDI did not have a large impact, as reform efforts were not comprehensive. Foreign equity inflows remained minimal, as Indian enterprises resorted mainly to foreign debt in tapping international capital markets.

In sum, from independence to 1991 India's policy on FDI was rather restrictive. While India occasionally welcomed foreign investment involving transfer of technological skills, its inward-looking industrial policy and strict capital controls did not provide an environment conducive to foreign investment in India.

Liberalisation of the FDI regime

The New Industrial Policy of 1991 marked a new era of FDI liberalisation

India's FDI regime underwent a major transformation with the New Industrial Policy of July 1991. Automatic approval of up to 51% of foreign ownership was first introduced in 34 priority sectors, including mostly manufacturing industries (such as metallurgical industries, electrical equipment, automobiles, various types of machinery, chemicals, drug and pharmaceuticals and food processing) and a few services sectors (such as the hotel and tourism industry and packaging services for food processing). To encourage exports, majority foreign equity ownership up to 51% was also allowed for trading companies primarily engaged in export activities. Automatic approval was provided for technical collaboration agreements in high priority sectors with certain conditions on royalty payment and in any other sector if such agreements do not require the expenditure of foreign exchange.

Additional liberalisation measures included amendment of the FERA to remove the general ceiling of 40% on foreign ownership in FDI projects; the ban on the use of foreign brand names in the domestic market was lifted;[20] the dividend balancing condition was withdrawn for all foreign investment approvals except for 22 industries in the consumer goods sector;[21] export obligations were relaxed; the terms of technology and royalty agreements were liberalised; and the sectors reserved for the SSI were opened up for foreign investment up to 24% of equity ownership. In 1997, automatic route approval was expanded to 111 high priority sectors with various equity ownership limits between 50% and 100%.

The Foreign Investment Promotion Board (FIPB) was set up to provide single-window clearance for FDI projects which did not fall under automatic approval. In 2000, the FDI regime adopted a negative list approach[22] by

allowing all the sectors/activities which were not on the list to be open for foreign investment without prior government approval. Since then, new sectors such as the defence industry,[23] insurance, real estate,[24] FM radio broadcasting, mass rapid transport systems,[25] print media, tea plantations and single brand retailing[26] have been opened up to foreign investment.

Gradual liberalisation of FDI restrictions continues

The percentages of foreign ownership ceiling on FDI projects have been gradually increased to 100% starting with manufacturing industries. Currently manufacturing, mining and electricity sectors except defence products[27] are open for 100% foreign ownership in FDI projects with prior approval required only for a few sub-sectors which are also subject to a licensing requirement.[28] FDI liberalisation in service sectors has lagged behind that in the manufacturing sector, but is expected to continue steadily. On the other hand, foreign investment in the agricultural sector remains largely restricted (exceptions include floriculture, horticulture, the development of seeds, animal husbandry, aquaculture, cultivation of vegetables and mushrooms under controlled conditions, agriculture-related services and tea plantation – see Chapter 2 for more details).

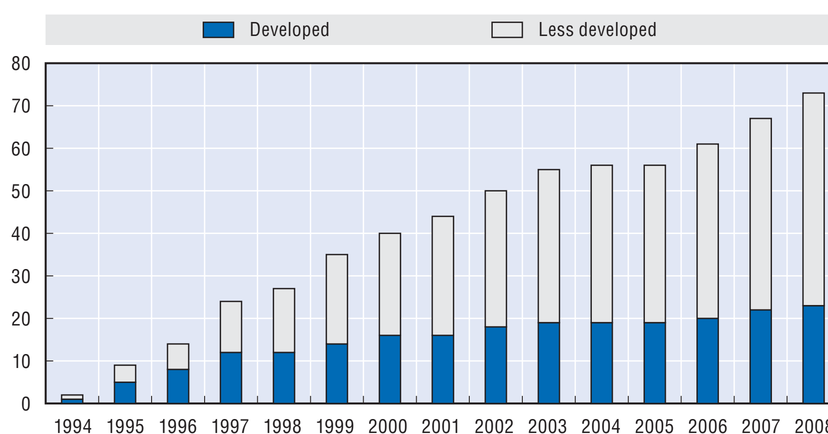
The automatic authorisation procedure was extended in 2004 to cover certain transactions which may lead to changes in ownership.[29] This liberalisation measure applies to those sectors for which new investments already benefited from automatic authorisation and foreign ownership should be within the sectoral caps.[30]

A major rationalisation of FDI policy was announced in 2006, including allowing 100% foreign equity ownership under the automatic route for the distillation and brewing of potable alcohol, manufacture of industrial explosives, manufacture of hazardous chemicals, manufacturing units located within 25 km of the 23 highly populated urban areas (subject to industrial licensing), greenfield airport projects, and cash and carry wholesale trading and export trading.[31]

Many bilateral investment promotion agreements have been concluded by India since the mid-1990s

The government's FDI liberalisation efforts were complemented by bilateral investment promotion agreements (BIPAs) and double taxation avoidance treaties (DTATs)(see Figure 1.3). The BIPAs have offered foreign investors in India strong guarantees in the post-establishment phase on fair and equitable treatment, national treatment, non-expropriation without fair compensation, free remittance of profits and capital, and access to international arbitration. The DTATs have removed tax disadvantages for multinational enterprises operating in India.

Figure 1.3. **Cumulated number of BIPAs concluded by India**



Source: Ministry of Finance, the Government of India.

While liberalisation is likely to continue, national security related concerns may be emerging in India

Although a trend of liberalisation is likely to prevail in the long term, there is an emerging debate in India on whether to introduce a process similar to the United States' CFIUS process to screen FDI projects in the light of national security threats. An initial proposal to create a National Security Exception Act which would have established an additional review process for FDI projects did not materialise, but the discussion on this seems to be continuing. India participates in the Roundtables on Freedom of Investment, National Security and "Strategic Industries" at the OECD where these issues are discussed, measures monitored and best policy practices developed.

India's strong FDI performance

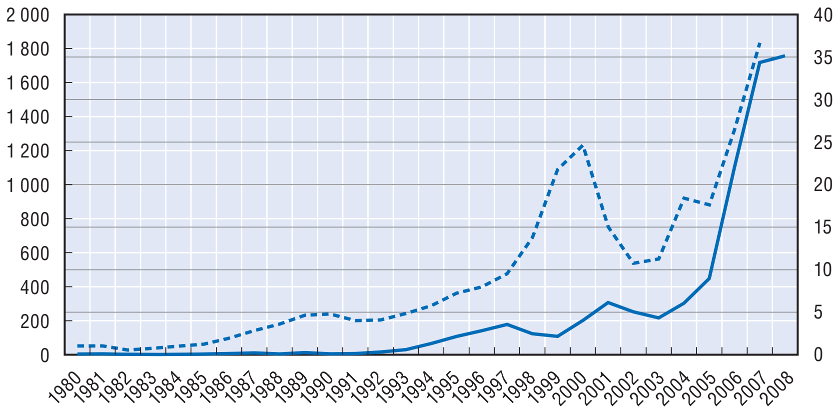
Changes in the overall policy framework since 1991, including FDI liberalisation measures, and robust economic growth have propelled India to become one of major FDI destinations in the world in recent years.

India became the 8th largest recipient of FDI flows among developing economies in 2007

FDI flows into India started to rise in the 1990s and have recently recorded a steep rise, amounting in FY 2006-07 to a level 3.6 times as high as two years before (see Figure 1.4 and Table 1.A1.1). A flow of USD 34.4 billion in FY 2007-08 exceeded the government's initially announced target of USD 25 billion for that fiscal year by a large margin. Even compared with other emerging economies which also have experienced large FDI inflows

Figure 1.4. **India's IFDI flows**

USD billion



Note: A solid line is for India's FDI (measured on the right axis) and a dotted line is for the global FDI flows (measured on the left axis).

Source: RBI.

since 2003, India's performance is outstanding. While FDI inflows both to the whole world and to the developing world almost tripled from 2003 to 2007, FDI inflows to India jumped more than five times during the same period. The recent performance raised India to the 8th position in size of FDI flows among developing economies with 4% of total FDI flows to developing economies, following China (14%); Hong Kong, China (10%); Russia (9%); Brazil (6%); Mexico (4.2%); Saudi Arabia (4.2%); and Singapore (4.1%) in 2007.

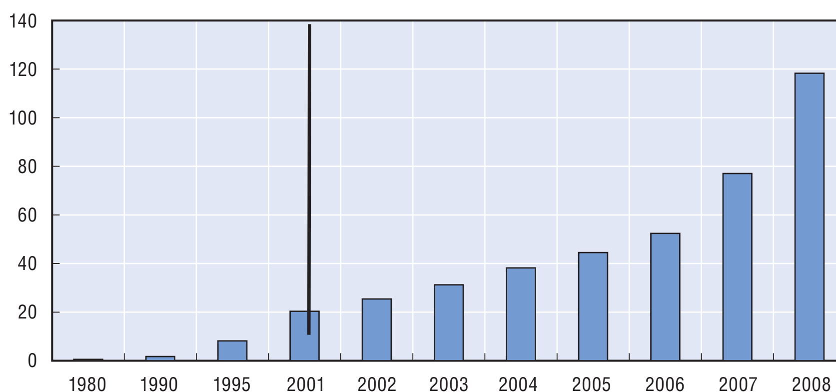
However, FDI still does not play a significant role in capital formation in India

As the emergence of large FDI flows into India is a relatively recent phenomenon, the role of foreign investment in the Indian economy remains modest. FDI in India constituted about 4.7% of gross fixed capital formation over 2004-06 – much lower than the 10.6% found in developing Asia, 12.4% in developing countries and 10.4% in the world as a whole.

Accumulated FDI stock in India reached USD 118.3 billion in March 2008 – eight times the level of a decade earlier (see Figure 1.5 and Table 1.A1.2). Despite the rapid accumulation of FDI stocks since 1991, India was the 35th and 13th largest destination of FDI, measured by stock, in the world as a whole and the developing world respectively. India's FDI stock accounted for 0.5% of total FDI stocks in the world and 1.6% of FDI stock in the developing world. As a ratio to GDP, India's FDI stock rose to 10.4% in FY 2007-08; but this figure is much lower than the average ratio of 27.8% in the world as a whole and 29.2% in the developing world[32] in 2007.

Figure 1.5. **India's IFDI stock**

USD billion



Source: RBI.

To the extent that India experienced a saving-investment gap, foreign investment has contributed to fill this gap, providing finance for the current-account deficit. However India's saving-investment gap has been small relative to its economic size with a peak of 3.2% of GDP reached in FY 1990-91. India's domestic investment has been mostly financed by domestic savings, which have increased in close tandem with domestic investment.

FDI in India is domestic-market seeking rather than export-oriented

Despite the government's intention of promoting export-oriented FDI projects, the main objective of foreign investment in India was domestic-market-seeking and foreign-invested enterprises were characterised by a generally poor export performance, though no less poor than their domestic counterparts. This fact is in stark contrast with East-Asian countries where foreign-invested enterprises account for a significant portion of exports (ADB, 2004).[33]

The recent surge of FDI inflow is for the most part explained by India's recently demonstrated robust economic growth potential which promises an expanding domestic market for foreign as well as domestic enterprises. The quality of FDI projects seems to be improving as India's regulatory reform is engendering competitive conditions and intellectual property rights protection has been strengthened. The export orientation of FDI projects has also increased over time and foreign parents have increasingly transferred technologies to Indian counterparts, as reflected in rising payments of royalties as a ratio to production, especially in the transport equipment and chemical industries.

FDI flows have shifted from the manufacturing sector to the services sector

The sectoral distribution of FDI flows into India has evolved, responding to the gradual liberalisation of FDI restrictions and to the competitiveness and perceived growth potential of each sector. In the early 1990s the manufacturing sector absorbed the largest share of FDI flows into India, including electrical equipment, chemicals, food processing, paper and pulp, and metallurgical industries, which were the most attractive manufacturing sub-sectors. In the 2000s, the largest sub-sector in manufacturing has been electrical equipment and ICT, accounting for 20% of total FDI inflows. This sub-sector consists of the computer software industry, electronics, electronic equipment and computer hardware.

FDI projects in the manufacturing sector typically targeted India's large domestic market which was protected from international competition for a long time. For example, Indian automobile makers enjoyed quantitative import restrictions until 2001. As soon as FDI in the automobile industry was permitted in 1991 (with delicensing following in 1993), foreign automobile makers started to establish joint ventures. Trade liberalisation promoted competition and FDI projects have become more externally-oriented, with the objective of exporting automobiles abroad and/or supplying automobile parts to other countries. As a result, exports of automobiles and automobile parts have increased at a rapid pace during the 2000s.

There was a clear shift in FDI flows from manufacturing to services in the mid-1990s. The share of manufacturing has declined over the 2000s and has been exceeded by that of the services sector since 2006 (see Table 1.A1.3). Within the services sector, the housing and real estate sub-sector and construction sub-sector attracted increasing shares during 2006-07. Financial services have also attracted a significant share, accounting for 9% of total FDI flows in the 2000s (DIPP, 2006).[34] Figure 1.6 shows that the recent surge in FDI is explained by increasing FDI flows into the services sector.

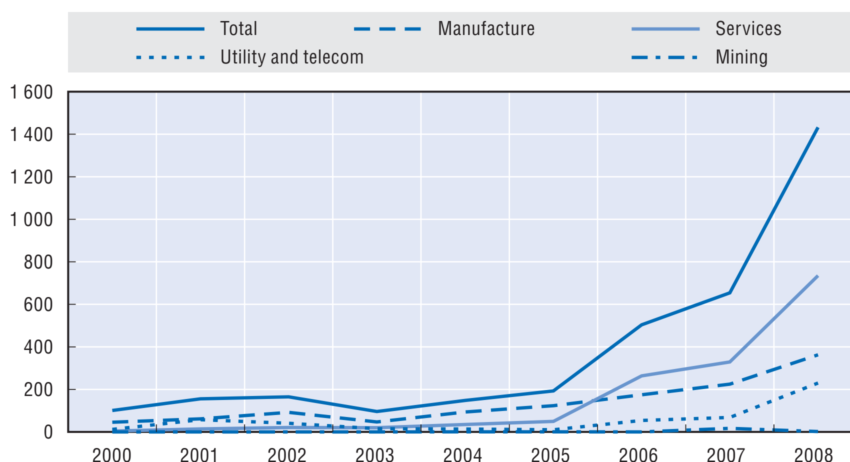
This sectoral shift corresponds to the advance of liberalisation measures, which first opened up the manufacturing sector to FDI and only later the services sector. Since the primary sector (except for petroleum and natural gas, mining and a few agricultural services) has remained largely closed to FDI, the share of the primary sector in total FDI inflows has been minimal.

FDI sources from developing economies have been concentrated in Mauritius and Singapore

FDI to India has originated increasingly from developing economies rather than developed economies during the period from 1991 to 2008 (see Table 1.A1.4). Flows from developing economies have been highly concentrated in just two

Figure 1.6. **India's IFDI by sector**

2000-08, INR billion



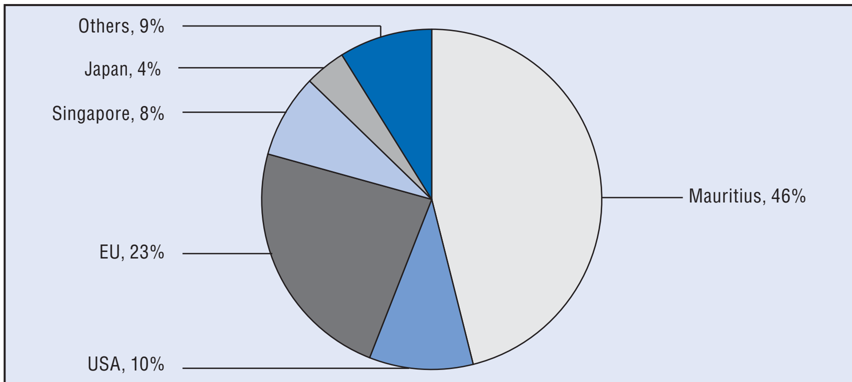
Source: DIPP.

countries: Mauritius and Singapore accounted for 89% of FDI flows to India from developing economies or 54% of total flows from the world during 1991-2008. The preferential tax treaty signed between Mauritius and India has made it attractive for investors to channel funds through Mauritius to India. As is the case with other offshore financial centres, it is hard to determine the original source countries of FDI flows from Mauritius. The Comprehensive Economic Co-operation Agreement signed between India and Singapore in 2005 seems to have boosted FDI flows from Singapore to India during recent years. Sources from developed economies have been more diversified, with the United States being the largest source country (9.9% of total FDI flows to India from 1991-2008) followed by the United Kingdom (7.1%), the Netherlands (5.1%) and Japan (3.9%)(see Figure 1.7).

A share of FDI flows under the government prior-approval route has decreased

There are three major routes recorded by the DIPP for FDI inflows to India: the government's approval route, the RBI's automatic approval route, and inflows through acquisition of existing shares. An increasing number of sectors/activities have been permitted for 100% foreign equity participation under the automatic route. Even if 100% foreign equity ownership is not permitted under the automatic route for all sectors, the ceilings for foreign equity ownership have been gradually relaxed for many of them. Reflecting this policy move, the share of FDI flows under the government's approval route dropped to 64% in 1998 from above 80% in immediately preceding years and

Figure 1.7. **India's IFDI by source country**
1991-2008, percentage of total



Source: DIPP.

has been progressively falling during the 2000s. The share of FDI requiring the government's prior approval accounted for only 10% in 2008 (see Table 1.A1.5).

There is a substantial geographical disparity in performance of attracting FDI flows

A substantial disparity in FDI attraction has emerged among India's states. Several key policy areas which have a critical influence on the investment climate are within the jurisdiction of states rather than the central government, hence, state-level differences in policies translate into divergent investment climates among states. The authorities and academics have expressed concern that liberalisation of FDI policy in the post-reform era has led to a further concentration of FDI projects in the southern and western states, worsening the regional imbalance in the country. Even within a single state, FDI flows have been disproportionally attracted to a few economic centres, leaving rural areas behind. One analysis (Rao and Murthy, 2006)[35] concluded that "*new large manufacturing FDI has tended to choose only very few developed states and its presence in many others was a result of other compelling factors like development in the pre-liberalisation period and the influence of Indian partners*" (see Chapter 7 for a sketch of differences in states' FDI policies and performance).

The RBI collects FDI flow data at its 16 regional offices. A distribution pattern of FDI flows by the RBI's regional office has demonstrated strong spatial concentration of FDI inflows in India. Two offices at Mumbai and New Delhi have accounted for two-thirds of total FDI flows in India during 2000-08, followed by Bangalore (9.1%), Ahmadabad (8.7%), Chennai (7.3%) and Hyderabad (5.6%) (see Table 1.A1.6). These regional offices cover FDI inflows

into relatively advanced states of India such as Maharashtra, New Delhi, Karnataka, Tamil Nadu, Andhra Pradesh and Gujarat.

The caveat is that the amount of FDI flows recorded at each RBI regional office may not correspond to the amount of FDI projects actually implemented in its respective jurisdiction. A foreign enterprise may transfer funds to a headquarters set up in one state but eventually use the funds for projects in another state. This is especially the case for service sector enterprises, which may have a registered headquarters in one metropolitan area but spread operations across the country. A growing number of foreign investors have set up a holding company from which to make further investments in the country, making the determination of actual FDI destination harder. The RBI only captures fund transfers to headquarters level in India and does not trace use of the funds right down to project level. The concentration of FDI inflows in the two main cities of Mumbai and New Delhi hence may simply reflect the concentration there of many headquarters of foreign-invested enterprises.

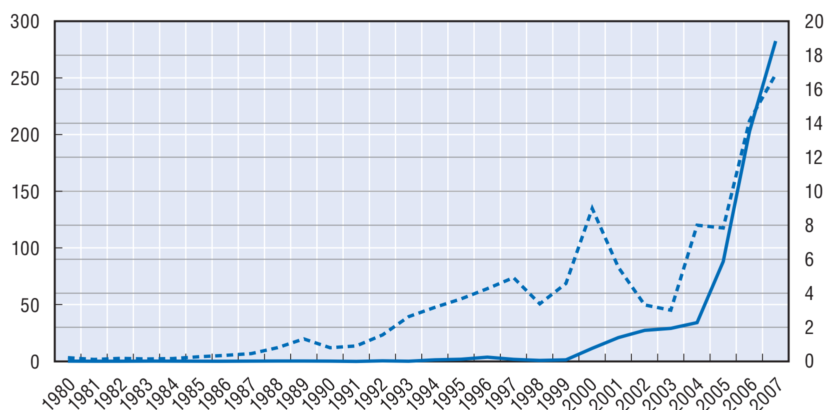
3. India is an increasingly important source of FDI in OECD countries

A surge of outward FDI from India closely followed that of inward FDI into India

In parallel with the development of inward FDI, India's outward foreign direct investment (OFDI) took off in 2000 and has been on a sharp upward trend since then (see Figure 1.8). A unique feature in India is that outward FDI has been tracking inward FDI with a short time lag in contrast with other

Figure 1.8. **India's OFDI flows**

USD billion



Note: The solid line is for India's OFDI flows (measured on the right axis) and the dotted line is for the developing world's OFDI flows (measured on the left axis).

Source: RBI.

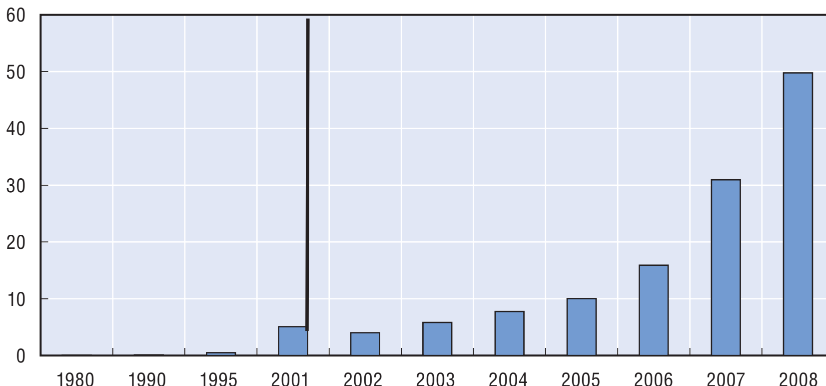
Asian economies which absorbed substantial amounts of inward FDI before starting to invest abroad.

The amount of OFDI from India remained very small until the late 1990s, recording an average of USD 37 million per annum during the 1980s and the 1990s. Since 2000, India's OFDI has surged at an average growth rate of around 60%, reaching USD 18.8 billion in FY 2007-08. While the OFDI figure for 2007 accounts for less than 1% of total OFDI flows from the world, India has risen to 6th position[36] among developing countries as a source of direct investment, providing 4.5% of OFDI flows from the developing world (see Table 1.A1.7). Hence, India's performance is on a par with that of developing countries like Argentina, Brazil, China, Malaysia, Mexico, Singapore and South Africa as a global source of FDI.

Keeping up with the growing OFDI flows, India has been accumulating OFDI stocks since 2000 (see Figure 1.9). As of March 2008, India had invested USD 49.8 billion in FDI stock overseas, which is a notable achievement considering the very low base of USD 3.7 billion in 2000 from which it took off. Although India is catching up quickly in accumulating FDI stock overseas, its share in global OFDI flows was 0.3% in 2008, placing India in the 36th position. Among developing countries, India has gradually increased its presence, becoming the 13th largest country in terms of OFDI stock in 2007 (see Table 1.A1.8).

Figure 1.9. **India's OFDI stock**

USD million



Source: RBI.

Sectoral distribution of India's OFDI flows reflects the evolution of its comparative advantage

Before 1991, the majority of India's OFDI projects were in manufacturing. However, the share of manufacturing OFDI has been declining since 1991

while the share of services sector OFDI has been rising. The sectoral shift in India's OFDI flows has reflected its evolving competitive advantage. Within the services sector, non-financial services including "IT, communication and software" and "media, broadcasting and publishing" have been dominant in overseas investment, though trading has been recently capturing an increasingly significant share of OFDI flows (see Table 1.A1.9). As more Indian firms have entered foreign markets by exporting their goods and services in the course of trade liberalisation, trade-supporting OFDI projects such as the establishment of customer care and service centres have multiplied.

Recently India's overseas investments in natural resources such as oil and gas have been increasing with several mega-deals led by state-owned enterprises. These deals include the acquisition of a 25% state in the Greater Nile Oil Project by the ONGC Videsh Limited in Sudan, a 20% state in the Sakhalin offshore oilfield by the Oil and Natural Gas Corporation Limited in Russia in 2002, and a 50% state in a liquefied natural gas block by the Indian Oil Corporation Limited, in Iran in 2004. Given India's increasing reliance on imports for crucial natural resources such as oil, gas and iron ore, OFDI flows in the natural resources sector are likely to increase.

Destination of India's OFDI flows is increasingly found in developed economies

The geographical pattern of India's OFDI flows has changed from a developing-countries orientation to a preference for developed countries. In the early period (1970-91) developing countries were the major hosts of India's OFDI projects, for example accounting for about 96% of OFDI stock in 1986. Within the developing world, India's OFDI was highly concentrated in South-East Asia and West and East Africa (Pradhan, 2007a).

The strong positive bias towards developing regions in this period was supported by the government's foreign policy of promoting South-South co-operation. It also resulted from the generally low level of technological sophistication of Indian firms, which could not compete in developed countries but had appropriate technologies – relatively simple and labour-intensive – to transfer to other developing regions. Africa attracted the largest amount of OFDI from India in the early 1960s due to historical business links dating from the British colonial era and the significant size of the population of Indian origin in the continent. Later, Asia, especially South-East Asia, replaced Africa as the largest host region for India's OFDI, since Asia had become more attractive with its geographical proximity, growth potential and relatively stable political situation.

Since 1991, India's OFDI has become more geographically diversified and Indian investors have demonstrated a clear preference for developed regions

of the world. The share of OFDI flows in the developed world was about 50.8% during the period FY 2002-03-FY 2007-08,[37] and the share of OFDI stocks in the developed world reached 32.2% in 2006. While the weights of Asia and Africa have declined, Europe and North America have emerged as major host regions of India's OFDI (see Table 1.A1.10). The larger share of OFDI projects in developed countries reflects the following facts: many Indian firms have acquired firm-specific competitive advantages commensurate with those enjoyed by developed-country firms; the rise of services exports to developed countries has led to trade-supporting OFDI projects in these host countries; and the acquisition of strategic assets in the developed countries has become an important strategy for many Indian firms to improve their competitiveness in an increasingly competitive environment.

Within the developing world, India's OFDI has become more widely spread with significant amounts in Latin American and Caribbean countries and CIS regions. OFDI in offshore centres such as the British Virgin Islands, Channel Islands, Cyprus, Hong Kong (China), Mauritius and Singapore has gained importance since 2000. These six economies attracted more than one-third of India's OFDI flows since 1996.

Before 1991, OFDI activities were carried out by a small group of large family-owned business conglomerates which had sufficient internal resources. They expanded their businesses abroad partly because opportunities were limited within the domestic market, where government policy aimed to prevent monopolies and protect small-scale industries.

The government policy was very restrictive for OFDI before 1991

The low level of India's OFDI before the 1991 period is largely a result of the government's restrictive policies on OFDI projects and its strict controls on capital outflows. India's OFDI policy was restrictive because the government was seriously concerned about foreign exchange scarcity within the country given the difficult balance-of-payments situation and minimal foreign exchange reserves. The government issued formal guidelines on OFDI activities for the first time in December 1969. These permitted minority equity participation in turnkey projects involving no cash remittances.

Indian enterprises were allowed to carry out OFDI projects only if they were export-supporting and equity contribution was in the form of exports of India-manufactured plant, machinery, equipment and/or by way of capitalisation of know-how. Indian enterprises were required to repatriate the amount invested abroad in full within a period of five years. Furthermore, Indian investors making minority equity participation in overseas joint ventures were required to provide training facilities to their overseas partners in India.

While the 1978 revision to the OFDI guidelines established an inter-ministerial committee on joint ventures under the Ministry of Commerce and Industry as a focal point for approving, monitoring and evaluating OFDI projects, the administrative burden for Indian enterprises remained onerous. An Indian enterprise had to seek approvals from different agencies, including the Ministry of Commerce and Industry, the Ministry of Finance, the Department of Company Affairs, the Ministry of External Affairs, the Ministry of Law and Justice, the Administrative Ministry, the RBI, the EXIM Bank of India and the Indian Investment Centre.

Although certain relaxations were made[38] in 1978, the government further tightened the approval criteria for OFDI projects by introducing screening of financial credibility and past export performance of Indian enterprises in the 1986 revision to the guidelines. In general, India's inward-oriented industrial policies did not encourage domestic firms to explore export market opportunities. As a result many Indian firms lacked the information and experience required to conduct investment projects abroad and the need to set up trade-supporting infrastructure abroad was not urgently felt by Indian enterprises.

The 1992 guidelines brought a drastic change, liberalising regulations on OFDI flows from India

The 1992 revision to the guidelines marked a drastic change in government policy on OFDI. For the first time it introduced automatic approval of OFDI proposals with equity investment up to USD 2 million in a block of three years, allowed overseas cash transfer[39] towards OFDI projects, and removed the restriction on equity ownership participation. All applications not under the automatic approval route were referred to a special committee under the RBI which included members from the Ministry of Finance, the Ministry of Commerce and Industry, and the Ministry of External Affairs.

India has long imposed a ceiling on OFDI flows as part of its controls on capital outflows. This ceiling was progressively raised several times,[40] and is currently set at up to 400% of net worth of an enterprise without the government prior approval. The relaxation of OFDI restrictions has been consistent with the overall direction towards fuller capital account convertibility. The accumulation of foreign exchange reserves in recent years has also made past concerns about the balance of payments less relevant.

Indian enterprises were given far more flexibility in their OFDI operations: they are now allowed to invest in any business activity, no longer limited to activities in the same core business sector. More financing options[41] have become available for Indian enterprises: Indian banks have expanded their business scope to include loans to overseas JVs and wholly-owned subsidiaries (WOSs) with Indian equity participation as well as to Indian enterprises set up

for acquiring equities of foreign enterprises; external commercial borrowing was also permitted to finance the establishment of Indian JVs and WOSs overseas; and EXIM Bank's overseas investment finance schemes have been expanded to include direct long-term finance to overseas subsidiaries of Indian enterprises, finance for overseas acquisition by Indian enterprises and direct equity participation in overseas ventures with Indian enterprises.

Indian private enterprises took advantage of the more liberal OFDI policy

The government's liberalised policy towards OFDI activities has cleared the stage for Indian enterprises to go abroad. The main driver of India's outward investment boom in the 2000s is, however, the initiative of Indian private enterprises which have developed international competitiveness in the face of intensified domestic competition and opened-up overseas market opportunities. The relaxation on Indian equity ownership of overseas ventures in 1992 allowed Indian enterprises to exploit their firm-specific comparative/technological advantage by establishing majority Indian owned ventures abroad. Indeed, a majority of Indian joint ventures and subsidiaries abroad had Indian equity participation of 80% or more since 1991, compared with the pre-1991 ownership pattern where a majority had Indian equity participation of less than 50% (Pradhan, 2007b).[42]

While the government policy has become substantially encouraging for OFDI activities by Indian enterprises, the government has not provided strong financial incentives to Indian enterprises' investments abroad. It is in stark contrast to the case of China. India's OFDI promotion activities have been so far limited to information provision to potential investors and financing/ guarantee programmes by the EXIM Bank of India and the Export Credit Guarantee Corporation of India.

M&A has become a popular mode of OFDI by Indian enterprises especially in developed economies

OFDI operations to acquire advanced technologies, new products, talents and other strategic assets such as brand names became an important strategy for Indian enterprises with global vision. Mergers and acquisitions (M&As) have become a popular mode of OFDI instead of greenfield investments, pioneered by services sector enterprises, especially in software, then adopted by manufacturing sector enterprises in pharmaceuticals, transport equipment and chemicals. During 2000-06, M&As accounted for more than half (66%) of total OFDI flows from India (Pradhan, 2007b), directed mostly towards developed countries, with the USA being the largest target destination followed by the UK and Germany.

Increasing domestic completion is pushing more Indian enterprises abroad

Since 1991, the total dominance of large family-owned enterprises in OFDI activities has ceased and an increasing number of small- and medium-sized enterprises (SMEs) have joined the rank of overseas investors from India. OFDI approvals by SMEs accounted for 26% of all the approvals in manufacturing sectors and 41% in services by 2001 (UNCTAD, 2007). These SMEs which used to enjoy a high degree of protection from foreign competitors as well as large domestic enterprises lost much of their protective benefits after 1991 through de-reservation for the SSI, reduction in import tariffs and liberalisation of inward FDI, and hence have had to operate in a more competitive environment. This increased competition in the domestic market has pushed many capable SMEs to go abroad to seek survival and expansion.

Notes

1. A figure in FY 1950-51.
2. The ceiling has been set at INR 10 million since 1999. Under the Micro, Small and Medium Enterprises Development (MSMED) Act of 2006, the ceiling is set at INR 100 million for manufacturing enterprises and INR 50 million for services enterprises.
3. In the late 1970s, only 79 products were on the list of items which were allowed for import without a licence. The number of items on the list increased almost twentyfold during the 1980s.
4. These industries were: 1) coal and lignite [deleted in Press Note No. 1 (1998)]; 2) petroleum and its distillation products [deleted in Press Note No. 1 (1998)]; 3) distillation and brewing of alcoholic drinks; 4) sugar [deleted in Press Note No. 12 (1998)]; 5) animal fats and oils [deleted in Press Note No. 11 (1997)]; 6) cigars and cigarettes of tobacco and manufactured tobacco substitutes; 7) asbestos and asbestos-based products [deleted in Press Note No. 11 (1997)]; 8) plywood, decorative veneers, and other wood based products [deleted in Press Note No. 11 (1997)]; 9) raw hides and skins, leather, chamois leather and patent leather [deleted in Press Note No. 4 (1993)]; 10) tanned or dressed fur skins [deleted in Press Note No. 11 (1997)]; 11) motor cars [deleted in Press Note No. 4 (1993)]; 12) paper and newsprint [deleted in Press Note No. 11 (1997)]; 13) electronic aerospace and defence equipment; 14) industrial explosives; 15) hazardous chemicals; 16) drugs and pharmaceuticals [partially delicensed in Press Note No. 4 (1994) and 5 bulk drugs deleted in Press Note No. 3 (1999)]; 17) entertainment electronics [deleted in Press Note No. 5 (1996)]; and 18) white goods [deleted in Press Note No. 4 (1993)].
5. These are 23 cities in India with a population of more than 1 million as of the 1991 Census.
6. These are: 1) arms and ammunition and allied items of defence equipment, defence aircraft and warships [defence industry opened up for 100% Indian private sector participation subject to licensing in Press Note No. 4 (2001)]; 2) atomic energy; 3) coal and lignite [deleted in Press Note No. 1 (1998)]; 4) mineral oils

["petroleum and its distillation" deleted in Press Note No. 1 (1998)]; 5) mining of iron ore, manganese ore, chrome ore, gypsum, sulphur, gold and diamond; 6) mining of copper, lead, zinc, tin, molybdenum and wolfram; 7) minerals specified in the Schedule to the Atomic Energy Order 1953; and 8) railway transport. 5) and 6) were deleted subsequently in Press Note No. 3 (1993).

7. The Indian fiscal year (financial year) runs from 1 April to 31 March. Official statistics generally use the fiscal year rather than the calendar year.
8. The government required that foreign equity brought in by foreign investors only covered capital goods import, and that foreign exchange outflows on account of dividend payments were balanced by export earnings over a period of 7 years from the start of production. These requirements have now been abolished.
9. These are saving deposit accounts, small loans in priority areas, export credits and non-resident transferable rupee deposits.
10. Up to FY 2007-08.
11. The figure is inclusive of IT software and services, engineering services and products and BPO.
12. The organised sector includes all establishments with ten or more workers if using power and those with 20 or more otherwise.
13. In 2005, this share was only 7%.
14. An amendment to the Industrial Disputes Act in 1976 (Chapter V.B) made it compulsory for firms with 300 or more workers to seek the permission of the relevant government for retrenchment. In 1982, this ceiling was even lowered to 100.
15. According to *OECD Economic Survey of India* (2007), about 87% of manufacturing employment is in micro-enterprises with less than 10 employees.
16. The government introduced the FRBM Act of 2003 under which the central government aimed to eliminate the revenue deficit and reduce its fiscal deficit to 3% of GDP by FY 2008-09 and the RBI was prohibited from participating in the primary government securities market since April 2006.
17. It translates to the increase of infrastructure investment from around 5% of GDP in FY 2006-07 up to 9% in FY 2011-12.
18. The permissible range of royalty payments and length of technology transfer agreement with foreign enterprises were specified by sector; the use of Indian consultants rather than foreign consultants whenever available was made mandatory.
19. The government took over assets of companies in insurance sector in 1971 and in petroleum sector between 1974 and 1976.
20. Press Note No. 6 (1992).
21. Press Note No. 12 (1992). 22 specific consumer goods sectors were also exempted from the dividend balancing condition as of Press Note No. 7 (2000).
22. Press Note No. 2 (2000) shifted FDI policy from a positive list to a negative list approach.
23. Press Note No. 4 (2001).
24. FDI in townships was permitted for the first time in 2001 [Press Note No. 4 (2001)]; then, other areas in real estate sector such as housing, built-up infrastructure and construction development projects were opened up for FDI up to 100% foreign ownership under the automatic route in 2005 with certain conditions regarding a

minimum area to be developed, minimum capitalisation, lock-in period of invested capital, schedule to complete projects, etc. [Press Note No. 2 (2005)].

25. Press Note No. 4 (2001).
26. Press Note No. 3 (2006).
27. FDI in defence products is allowed up to 26% of foreign ownership and requires prior approval and licences in manufacturing arms and ammunitions.
28. These include cigar and tobacco, titanium bearing ores and minerals and sectors reserved for small-scale industries in the case of foreign ownership exceeding 24%.
29. Press Note on 29 September 2004.
30. These transactions are: 1) transfer of shares from resident to non-resident other than in the financial services sector; 2) conversion of external commercial borrowing and loans into equity; and 3) increase in foreign equity participation by fresh issue of shares as well as conversion of preference shares into equity capital.
31. Press Note No. 4 (2006).
32. Among major developing economies, FDI stock ratio was 33.6% in South Africa, 24.4% in Brazil, 10.0% in China and 25.2% in Russia in 2007.
33. Foreign-invested enterprises accounts for about 3% of India's exports compared with 50% or more in various East-Asian countries.
34. The figure is the average over 2000-06.
35. Two-thirds of assets by large foreign invested enterprises incorporated after the mid-1991 as of FY 2000-01 were found in two leading states of Maharashtra and Tamil Nadu.
36. It is after Hong Kong, China; Russia; the British Virgin Islands; China; and Korea.
37. This is based on approvals of Indian direct investments in joint ventures and wholly-owned subsidiaries by the RBI.
38. For example, higher Indian ownerships were allowed if the host country government and partners had no objection and cash remittance against OFDI was permitted on a case-by-case basis. Various financing tools became available for Indian firms, including long term loans by Indian investors to overseas joint ventures, foreign currency loans raised abroad, and capitalisation of service fees, royalties and other payments towards OFDI.
39. Out of USD 2 million allowed for OFDI, USD 0.5 million may be in cash. The rest should be in the form of exporting plants, machinery, equipment and know-how.
40. The ceiling was raised (USD 4 million in 1995) to USD 15 million in 1995, USD 50 million in 2000, USD 100 million in 2002, and any amount up to 100% of new worth of an enterprise in 2003 which was then increased to 200% in 2005, 300% in June 2007 and most recently 400% in September 2007.
41. Indian OFDI can be funded by the balances held in Exchange Earners Foreign Currency account, withdrawal of foreign exchange including capitalisation of exports, drawing foreign exchanges from an authorised dealer in India, funds raised through ADR or GDR issues and share swaps.
42. The government policy imposed only minority equity participation for Indian enterprises setting up joint ventures abroad especially to encourage skills and knowledge transfer from India to developing countries.

ANNEX 1.A1

Statistics

Table 1.A1.1. **India's IFDI flows**

USD million

	IFDI flow from India	As a share in IFDI flow to the world (%)	As a share in IFDI flow to developing countries (%)	As a share in GDP (%)	Ranking in the world	Ranking in developing countries
1980s	105	0.1	0.5	0.04		
1990-94	488	0.2	0.6	0.20		
1995-99	2 628	0.5	1.6	0.60		
2000	4 029	0.3	1.4	0.90	36	14
2001	6 130	0.7	2.4	1.30	26	7
2002	5 035	0.9	3.1	1.00	23	6
2003	4 322	0.8	2.2	0.70	26	9
2004	6 051	0.8	1.8	0.90	24	13
2005	8 961	0.8	2.2	1.10	36	15
2006	22 079	1.4	4.2	2.40	18	6
2007	34 362	1.3	3.9	3.00	20	8
2008	33 613					

Sources: RBI, UNCTAD.

Table 1.A1.2. **India's IFDI stocks**

USD million

	IFDI stock in India	As a share in IFDI stock in the world (%)	As a share in IFDI stock in developing countries (%)	As a share in GDP (%)	Ranking in the world	Ranking in developing countries
1980	544	0.1	0.2	0.3		
1990	1 732	0.1	0.3	0.5		
1995	8 166	0.2	0.7	2.3		
2000	20 326	0.3	1.0	4.4	48	24
2001	25 419	0.3	1.1	5.3	44	20
2002	31 221	0.4	1.4	6.2	43	19
2003	38 183	0.4	1.4	6.4	41	17
2004	44 495	0.4	1.5	6.3	41	17
2005	52 369	0.4	1.5	6.5	40	17
2006	77 036	0.4	1.4	8.4	40	15
2007	118 300	0.5	1.6	10.4	35	13

Sources: RBI and UNCTAD.

Table 1.A1.3. **India's IFDI flows by sector**

Per cent

	1991 (August)-1999	2000-03	2004-08
Manufacturing	**64.8**	**57.5**	**35.1**
Cement and gypsum	0.5	2.6	2.2
Chemicals	11.0	4.9	2.5
Drug and pharmaceutical	2.3	2.7	1.9
Electrical equipment including computer software/hardware	12.8	18.3	13.9
Food processing	6.5	4.1	0.6
Metallurgical industries	1.8	1.3	3.8
Services	**13.9**	**13.6**	**50.7**
Services	11.2	9.2	25.1
Trading	1.9	1.4	2.0
Construction	n.a.	n.a.	7.3
Housing and real estate	n.a.	n.a.	7.0
Telecommunications	**11.2**	**15.4**	**7.7**
Power and energy including petroleum and natural gas	**10.1**	**13.5**	**5.7**
Primary (mining)	**0.0**	**0.0**	**0.7**

n.a.: not available.

Source: DIPP.

Table 1.A1.4. **India's IFDI flows by source country**

Per cent

	1991 (August)-1999	2000-03	2004-08	1991 (August)-2008
Developed countries	**56**	**52**	**34**	**39**
Developing countries	**44**	**48**	**66**	**61**
Mauritius	31	41	49.5	46.1
United States	21	13	7.6	9.9
United Kingdom	5	8	7.1	7.1
Singapore	3	2	9.9	7.9
Netherlands	5	7	4.7	5.1
Japan	7	9	2.4	3.9
Germany	6	4	2.8	3.3
France	2	3	1.4	1.8
Korea	5	1	0.6	1.2
Switzerland	2	2	1.0	1.2

Source: DIPP.

Table 1.A1.5. **India's IFDI by route**

Per cent

	1991-99	2000-03	2004	2005	2006	2007	2008
Government approval	77.7	53.1	32.8	26.1	13.8	16.2	9.7
Automatic	8.5	21.6	36.7	35.8	64.0	55.8	71.6
Acquisition of existing shares	17.3	25.4	30.5	38.1	22.2	27.9	18.7

Source: DIPP.

Table 1.A1.6. **India's IFDI by RBI regional office**[1]

Per cent

RBI office	Covered regions	2000-03	2004-08	2000-08
Mumbai	Maharashtra, Dadra and Nagar Haveli, Daman and DIU	31.8	45.9	43.8
New Delhi	Delhi, part of Upand Haryana	37.0	18.1	20.9
Chennai	Tamil Nadu, Pondicherry	9.6	86.9	7.3
Bangalore	Karnataka	9.7	9.0	9.1
Hyderabad	Andhra Pradesh	3.0	6.0	5.6
Ahmadabad	Gujarat	3.8	9.6	8.7
Chandigarh	Chandigarh, Punjab, Haryana, Himachal Pradesh	2.6	0.3	0.7
Kolkata	West Bengal, Sikkim, Andaman and Nicobar Islands	1.0	2.2	2.0
Panaji	Goa	0.8	0.4	0.4
Kochi	Kerala, Lakshadweep	0.6	0.3	0.3
Bhubaneshwar	Orissa	0.0	0.2	0.2
Jaipur	Rajasthan	0.0	0.9	0.8
Bhopal	Madhya Pradesh, Chattisgarh	0.1	0.2	0.2
Kanpur	Uttar Pradesh, Uttranchal	0.0	0.0	0.0
Guwahati	Assam, Arunachal Pradesh, Manipur, Meghalaya, Mizoram, Nagaland, Tripura	0.1	0.1	0.1
Patna	Bihar, Jharkhand	0.0	0.0	0.0

1. The figures consider equity capital components only.

Source: DIPP.

Table 1.A1.7. **India's OFDI flows**

USD million

	OFDI flow from India	As a share in OFDI flow from the world (%)	As a share in OFDI flow from developing countries (%)	As a share in GDP (%)	Ranking in the world	Ranking in developing countries
1980s	4	0.00	0.07	0.00	66	43
1990-94	20	0.01	0.07	0.01	95	69
1995-99	120	0.02	0.19	0.03	52	28
2000	759	0.04	0.37	0.16	40	17
2001	1 391	0.19	1.63	0.29	29	11
2002	1 819	0.31	3.09	0.36	31	12
2003	1 934	0.33	3.37	0.32	28	10
2004	2 274	0.24	1.62	0.32	34	14
2005	5 867	0.34	2.26	0.73	34	14
2006	13 512	0.97	5.44	1.48	21	5
2007	18 835	0.68	4.48	1.65	24	6

Sources: DIPP and UNCTAD.

Table 1.A1.8. **India's OFDI stocks**

USD million

	OFDI stock from India	As a share in OFDI stock from the world (%)	As a share in OFDI stock from developing countries (%)	As a share in GDP (%)	Ranking in the world	Ranking in developing countries
1980	80	0.01	0.11	0.04	46	25
1990	113	0.01	0.09	0.04	64	38
1995	735	0.02	0.15	0.21	60	34
2000	5 083	0.03	0.21	1.10	49	27
2001	4 006	0.04	0.29	0.84	45	23
2002	5 825	0.05	0.43	1.15	44	21
2003	7 759	0.07	0.56	1.29	43	20
2004	10 033	0.08	0.63	1.43	41	18
2005	15 900	0.09	0.69	1.97	41	17
2006	30 946	0.12	0.83	3.38	41	17
2007	46 781	0.19	1.15	4.37	36	13

Sources: RBI and UNCTAD.

Table 1.A1.9. **India's OFDI by sector**

Per cent

	OFDI stocks as of 1980	OFDI stocks as of 1987	OFDI flows during 2003-06	OFDI flows during 2007-08
Manufacturing	93.8	85.4	64.4	30.6
Services	3.9	14.0	31.6	64.1
Non-financial services	3.9	10.0	21.8	32.4
Financial services	0.0	1.2	1.2	0.2
Trading	0.0	2.8	8.6	31.6
Others	2.2	0.6	3.9	5.3

Sources: RBI and Pradhan (2007), Table 4, page 12.

Table 1.A1.10. **India's OFDI by region**

Per cent

	OFDI stock as of 1986	OFDI stock as of 2006
Developed countries	1.6	32.2
Developing countries	96.4	67.8
Asia	58.4	19.9
East Asia	0.1	5.2
South-East Asia	51.1	7.4
South Asia	3.9	1.9
West Asia	3.4	5.4
Africa	35.3	20.4
Europe	3.2	13.5
EU	1.1	12.7
CIS	0.0	17.3
Other Europe	2.1	0.9
Latin America and the Caribbean	0.0	10.4
Caribbean	0.0	9.6
Central America	0.0	0.2
South America	0.0	0.6
Oceania	0.7	3.0
North America	0.4	15.4

Sources: RBI and Pradhan (2007).

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Chapter 2

Investment Policy

This chapter looks at the core elements of India's investment policies. India has made substantial progress in creating a sound environment for all investments, whether small or large, domestic or foreign. The chapter analyses how India's policies have evolved to embrace investment policy principles including transparency, property protection and non-discrimination and suggests further reform in liberalising market restrictions and providing a predictable policy environment for investors. The analysis is structured around the questions set out in the Policy Framework for Investment *(PFI). Each section is preceded by the relevant PFI question, which serves as general context for consideration of main policy areas.*

The following analysis of India's investment policies is structured around the questions set out in the *Policy Framework for Investment* (PFI, see Box 2.1). Each section is preceded by the relevant PFI question, which serves as general context for consideration of main policy areas.

Box 2.1. The *Policy Framework for Investment*

The objective of the *Policy Framework for Investment* is to mobilise private investment that supports economic growth and sustainable development. It thus aims to contribute to the prosperity of countries and their citizens and the fight against poverty.

Drawing on good practices from OECD and non-member economies, the *Framework* proposes guidance in ten policy fields identified in the 2002 United Nations Monterrey Consensus on Financing for Development as critically important for improving the quality of a country's environment for investment. It enables policy makers to ask appropriate questions about their economy, their institutions and their policy settings in order to identify priorities, to develop an effective set of policies and to evaluate progress.

The *Framework* was developed by OECD and non-member participants in a task force established under the aegis of the OECD Investment Committee as part of the OECD Initiative on Investment for Development launched in Johannesburg in November 2003.

The *Framework* was adopted and declassified by the OECD Council, the governing board of the Organisation, and welcomed by ministers at their annual OECD meeting in May 2006. OECD and non-member partners will continue to work together, in co-operation with the World Bank, the United Nations and other interested institutions and with the active engagement of business, labour and other civil society organisations, to support effective use and future development of the *Framework*.

The quality of investment policies directly influences the decisions of all investors, be they small or large, domestic or foreign. Transparency, property protection and non-discrimination are investment policy principles that underpin efforts to create a sound investment environment for all.

1. Legislative and regulatory framework

> What steps has the government taken to ensure that the laws and regulations dealing with investments and investors, including small- and medium-sized enterprises, and their implementation and enforcement are clear, transparent, readily accessible and do not impose unnecessary burdens?
>
> What steps has the government taken towards the progressive establishment of timely, secure and effective methods of ownership registration for land and other forms of property?

India's regulatory framework has gradually become more enabling than restricting for investors. The once formidable administrative burden has been substantially reduced since the announcement of the New Industrial Policy in 1991. This regulatory reform started first at the central level, and then it has been subsequently taken up by state governments, though at various rates of progress and effectiveness.

The comprehensive licensing system has been substantially dismantled since 1991

At the central government level, the Industries (Development and Regulation) Act of 1951 governs India's industrial licensing system. The licensing system allowed the government to regulate investment decisions to a great extent before the industrial reform from 1991.

Currently, only 5 industrial sectors are subject to compulsory licensing; 2 industrial sectors are reserved for the public sector; 21 sectors are reserved for manufacturers in the small-scale industry (SSI) (see Box 2.2); and location decisions of industries are liberalised except for locations within a close distance from 23 highly populated cities.[1] Application for industrial licences is handled by the Secretariat for Industrial Assistances (SIA) under the DIPP which gives approvals generally within 4-6 weeks of filing applications. The SIA regularly publishes application status on the DIPP website.

Instead investors have to submit an Industrial Entrepreneurs' Memorandum at the central level

Investors in the large- and medium-scale sector which are exempted from industrial licensing are required to file an Industrial Entrepreneurs' Memorandum (IEM) with the SIA. The SIA issues acknowledgement of receipt immediately and investors do not need any further approvals from the government. For statistical purposes, investors are required to file information in Part B of IEM at the time of commencement of commercial production and to submit a monthly return to the Industrial Statistical Unit under the DIPP. If an SSI enterprise exceeds the small-scale investment ceiling in plant and

Box 2.2. **Small-scale industries policy in India**

India maintains a policy of encouraging growth of small-scale industries (SSIs) through several promotional measures, the most important of which is reservation of products for exclusive manufacture in the small-scale sector. This reservation policy was initiated in 1967 with 47 items, and was enlarged to over 800 by the late 1970s. Amendment to the Industries Act in 1984 provided a legal backing to this policy by empowering the government to reserve items under the Act. Large- and medium-scale industries are allowed to manufacture these reserved items subject to the condition that they export at least a half of production.

In addition, the government has provided several benefits/privileges to the SSI enterprises including purchase and price preference under public procurement programmes, access to bank credit on priority through the priority sector lending programme, exemptions from some labour laws and preferential tax exemptions.

Since India started its reform of liberalisation, the government policy for the SSI has moved to support competitiveness to infuse more vitality and growth to small-scale enterprises in the face of foreign competition and open market (Government of India, Ministry of Micro, Small and Medium Enterprises, 2007). The reservation policy rather constrains sound growth and discourages capital accumulation of SSIs. As part of liberalisation reforms, the reservation policy has been reviewed on a continuing basis by an Advisory Committee on Reservation constituted under the Industries Act. Through consultation, the list of items reserved for the SSI was reduced to 21 as of October 2008 as follows:

1. pickles and chutneys;
2. bread;
3. mustard oil;
4. ground nut oil;
5. wooden furniture and fixtures;
6. exercise books and registers;
7. PVC pipes and fittings for PVC pipes including conduits up to 110 mm diameters;
8. wax candles;
9. laundry soap;
10. safety matches;
11. fire works;
12. agarbatties;
13. glass bangles;

Box 2.2. **Small-scale industries policy in India** *(cont.)*

14. steal almirah;
15. rolling shutters;
16. steel chairs;
17. steel tables;
18. steel furniture;
19. padlocks;
20. stainless steel utensils; and
21. domestic aluminum utensils.

In 2006, the Micro, Small and Medium Enterprises Act was enacted to facilitate the development of these enterprises as well as to enhance their competitiveness. The Ministry of MSME has drawn up a road map and has been holding detailed consultations with stakeholders to generate consensus on further reducing the reservations list.

A small-scale enterprise is defined as an industrial unit with an investment of less than INR 100 million in plant and machinery for manufacturing units and INR 50 million in equipment for services providing units. Equity from large- and medium-scale enterprises, both domestic and foreign, is permitted in the small-scale sector up to 24%. When equity from another enterprises exceeds the 24% limit, SSI status is lost unless the enterprise undertakes a minimum export obligation of 50% of production. The government decided to remove this equity ownership restriction in the SSI and 100% equity ownership by large- and medium-scale enterprises and foreign enterprises will be permitted in the SSI.*

* Discussion at the OECD-India Seminar in Delhi on 28 January 2009.

machinery by way of natural growth and continues to produce items reserved for the SSI sector, it is required to obtain a Carry on Business Licence from the SIA.

Investors in the micro-, small- or medium-scale sector are required,[2] under the Micro, Small and Medium Enterprises Development Act 2006, to file an Entrepreneurs' Memorandum (EM) with the Joint Director of the respective District Industries Centre at local government level.

Investment projects have to be approved at the state level

At the state level, each state government has developed its own procedure to approve and monitor investment projects in its jurisdiction. Typically, investors are required to obtain approval from different levels of state government administration depending on the size of projects: very large

projects are examined and approved by the State High Level Clearance Committee (SHLCC) headed by the Chief Minister; large- and medium-size projects are examined and approved by the State Level Single Window Clearance Committee (SLSWCC) chaired by the Principal Secretary of the Industries Department or equivalent; and small-size projects are considered and approved by the District Level Single Window Clearance Committee (DLSWCC) chaired by the respective Deputy Commissioner.

To assist and guide investors, many states have established an investment promotion/facilitation agency which provides secretariat services to the state level clearance committee, gives a Combined Application Form (CAF) to investors, coordinates approvals from various state-level departments and authorities on behalf of investors and conducts investment promotional activities.

Efficiency and transparency of investment administration have recently improved at the state level

Clarity and transparency of the investment approval and monitoring procedure have been improved substantially by each state's efforts to streamline administration and promote private sector investment. These efforts include: 1) introduction of a single clearance window or a single contact point for investors; 2) enactment of state laws/rules to specify an administrative procedure, set the timeframe with introduction of a "deemed approval" concept, and delineate the power of administrative authorities; and 3) improvement of communication between the government and investors *via* the website and ICT tools.

Investors are typically invited to attend the committee meetings to present their projects and answer any questions from committee members. States commonly provide enterprises with a right and a mechanism of appealing in case of rejection of proposals by committees. However, the criteria for approving investment proposals are not well documented, which may create an uncertain environment for potential investors.

While all states have been moving towards more efficient and transparent regulatory framework for investment, the progress and effectiveness of their regulatory reforms vary from one state to another. After investment approval is given by the state government, there is still a multitude of licences/clearances/permissions to be obtained and notifications/returns to be submitted during actual setting-up and operation of projects as prescribed under various central and state level acts.

But comparison of regulatory frameworks among states is difficult for potential investors

Comparison of regulatory frameworks among various states is not an easy task for investors. While all the states offer investor information on their websites and/or in the relevant media to varying degrees, there is no one place to look up comparative information on the regulatory frameworks of various states. Since states are empowered to amend major industrial acts and develop detailed implementation procedures, there are substantial differences in regulatory practices among states. For example, different cut-off sizes are set by states to determine which administration (*i.e.* higher state-level, state-level, or district-level) is authorised to approve investment projects;[3] the length of licence under the Factories Act of 1948[4] varies from one to five years; and state-level investment promotion agencies are given different executive powers.

There are various mechanisms for consultations on regulatory issues in India

India has various mechanisms to hold consultations in the course of formulating changes in laws, policies and regulations. The central government or the parliament may from time to time instruct ministries/departments at the central level to review their respective policies, regulations and laws. These reviews are then typically conducted by expert groups constituted by a concerned ministry/department on an *ad hoc* basis. Terms of reference for the expert groups commonly require them to conduct sufficient consultations with stakeholders before making recommendations to the government.

For example, three experts were nominated in 2004 by the Ministry of Finance to constitute the Investment Commission (IC) of India which is mandated to make recommendations to the government of India on policies and procedures to facilitate investment. Its terms of reference include consultations with industrial groups in India and large enterprises abroad, and interactions with the Boards of Directors of potential investing enterprises (see Chapter 3 for a more detailed account of the IC).

Ministries and regulatory authorities themselves frequently carry out public consultations during the process of formulating policies and regulations in India. Many of them post draft regulations and/or consultation papers on their websites to solicit feedback as well as hold meetings with stakeholders. Indian business organisations such as CII, FICCI, and ACCII are well recognised by the government as consultation partners and they are constantly engaged in discussions with the government on policies and regulations concerning businesses. Furthermore, strong participation of the media in publicising and

analysing the contents of new laws and regulations is the norm in India, and hence the government is effectively subject to public opinion.

Land acquisition is subject to local zoning requirements

Both domestic and foreign companies are permitted to rent and/or acquire property for business purposes in India. Location of industrial plants is generally subject to local zoning regulations and must be in delineated industrial zones. If a change in zone is required, for example to convert an agricultural zone to an industrial zone, it may take several months to complete the conversion. Furthermore, India's property market is not transparent as both sellers and buyers tend to declare lower values than in the actual transaction to avoid steep stamp duties of around 5-12% of transaction values, capital gain taxes and income tax clearances.

India's land registration administration is problematic

According to the World Bank's *Doing Business 2009*, India's land registration process is: cumbersome, with a minimum of 6 procedures; inefficient, with an estimated registration time of 45[5] days; and burdensome, with costs of registration measured at 7.5% of the property value. Land title records are disorganised and obsolete: registration records in the registration department are not integrated with land title records in the revenue department and land surveys are not conducted frequently to update maps. Since land is a state-level responsibility, the administration system of land registration and record keeping varies tremendously from state to state.

Most property owners do not have clear titles in India. Under the current system, titles to property are merely presumptive, as the documents of titles[6] are not certified by the state and hence do not have the status of public records recognised by the Evidence Act. Registration of property thus only amounts to a certification of transaction and does not ensure the title of the property. Any prospective buyer who wants to verify the title has to undertake a tedious process of consulting various sources such as past transactions, mortgage deeds, revenue records and encumbrance certificate as there is no centralised property title registry. Only the courts can establish titles, but India's court system is extremely inefficient with many backlogs. The current land registration system has allowed the growing problem of fraud and dispute over land to develop.

The government has initiated programmes to modernise land registration administration

The central government has been aware of the problem and started centrally-sponsored schemes to help states to update and computerise land records.[7] In 2008, the Ministry of Rural Development announced a new

centrally-sponsored scheme, the National Land Records Modernisation Programme[8] to consolidate the two existing schemes and step up the efforts to modernise land record keeping/sharing systems. It is supposed to provide up-to-date land records in a manner more accessible to citizens, reduce fraudulent property deals and land-related litigations/disputes, and bring efficiency in land revenue administration. The government's ultimate goal is to introduce a new comprehensive system in which a single agency will handle land records, document land ownership status and guarantee the correctness of the titles, giving an indefeasible right to property.

Awareness among the state governments has been raised regarding the importance of providing a more secure guarantee of property rights. Rajasthan was the first state to introduce a Guaranteed Land Title Act in 2008 which allows freehold landed property ownership.

2. Intellectual property rights

> Has the government implemented laws and regulations for the protection of intellectual property rights and effective enforcement mechanisms? Does the level of protection encourage innovation and investment by domestic and foreign firms? What steps has the government taken to develop strategies, policies and programs to meet the intellectual property needs of SMEs?

India has enacted and updated a number of IPR related laws to meet international standards

India's legal framework for Intellectual Property Right (IPR) protection is generally consistent with international standards. Laws on IPR include the Trade Marks Act of 2007, the Design Act of 2000, the Geographical Indication of Goods Act of 1999, and the Patents Act of 2005 (administered by the DIPP); the Copyright Act of 1995[9] (administered by the Department of Higher Education); the Semi-Conductor Integrated Circuits Layout-Design Act of 2000 (administered by the Department of Information Technology); and the Protection of Plant Varieties and Farmers' Rights Act of 2001 (administered by the Department of Agriculture and Co-operation).

India is a signatory of two major treaties on IPR, the Paris Convention for the Protection of Industrial Property (relating to patents, trademarks, designs, etc.) of 1883 and the Berne Convention for the Protection of Literary and Artistic Works (relating to copyright) of 1886, and has been a member of the Patent Co-operation Treaty since 1998, which facilitates obtaining patents in multiple countries by filing a single application. India is also a member of the World Intellectual Property Organisation (WIPO).

Several amendments were introduced to India's IPR laws after India accepted a commitment to comply with its international obligations as a WTO member by signing the Uruguay Round Agreements in April 1994.[10] For example, the new Trade Marks Act of 1999[11] extended the period of registration from 7 to 10 years, introduced service marks in addition to product marks, provided broader protection for "well-known" trademarks, prohibited the use of another's trademark as a part of corporate name, and streamlined enforcement. The new law is meant to provide increased protection to owners of the global brands in India. The Design Act was passed in 2000 to meet India's obligation under the TRIPS agreement to provide protection for industrial designs.

The Patents Act was strengthened to recognise product patents, but some concerns remain

The previous Patents Act of 1970 came into force in 1972, repealing the Patents and Design Act of 1911. The 1970 Act prohibited product patents on pharmaceuticals, chemicals and food. In these sectors, the Act recognised only a process patent for 5 years[12] from the grant of the patent or for 7 years from application filing whichever was less. It also expanded the use of compulsory licensing[13] of patented pharmaceutical inventions.

As a result, the number of foreign owned patents filings in India had decreased and domestic firms could freely copy pharmaceutical products patented outside India. While a number of MNEs left India or decided not to invest in India, domestic generic drug enterprises flourished as their expertise developed in process chemistry and reverse engineering. However, Indian pharmaceutical firms had not invested in innovative R&D to discover new molecules as they lacked sufficient resources and incentives.

The Patents Act of 1970 has been amended twice, in 2002 and 2005. The currently effective Patents (Amendment) Act of 2005 provides 20-year term patents for all inventions including pharmaceutical products, certain safeguards against "ever-greening" practices, a post-grant opposition procedure for 1 year from the date of publication of grant, and compulsory licensing in certain conditions. While this new Act has substantially strengthened IPR rights in India, concerns remain among MNEs with regards to uncertainty in grant conditions for compulsory licensing,[14] pre-grant opposition provisions, and a scope of patentable inventions.

Data protection is another area of concern for foreign enterprises operating in India. Currently there is no specific Indian law to protect data, while a proposal to amend the Information Technology Act to include a data protection clause is under consideration by the government. Hence, enterprises which

want to protect their data currently resort to making a binding obligation to that effect in their contracts with Indian joint-venture partners.

Capacity of IPR law enforcing institutions is weak in India

The institutional framework for IPR implementation in India mainly consists of the Office of the Controller General of Patents, Designs and Trade Marks (CGPDTM), the Intellectual Property Appellate Board (IPAB) and the Indian court system. The Office of CGPDTM administers the Patent Offices, the Trade Marks Registries and the Geographical Indications Registry. The IPAB, originally established for trademark issues under the Trade Marks Act of 1999, has extended its jurisdiction to patent matters. The IPAB took over the function of hearing appeals on decisions made by the Patent Offices from the Indian High Courts in accordance with the Patents (Amendment) Act of 2002.

Enforcement of IPR laws by the police has been strengthened: special IPR cells have been set up in various states since 2002 to co-ordinate enforcement activities with industries; and the police have increased the number of raids to reveal IPR violations since 2004.[15] However, the actual level of protection is considered problematic despite IPR holders' entitlement to civil and criminal remedies under Indian IPR law. A large quantity of counterfeit products has been found in India's exports; piracy remains a common practice; the judicial system is plagued with a shortage of judges specialised in IPR and operates too slowly to give comfort to IPR holders; and the capacity of patent examiners is not sufficient to handle applications in a timely manner, leading to a substantial backlog.

The number of applications for patents increased 2.5 times from FY 2002-03 to FY 2006-07 while the number of examinations for patents increased at a slower pace (1.5 times) over the same period. In particular, the examination rate has not kept up with the surge of patent applications that came after the full implementation of the new Patents Act in 2005.

The government provides support to the SME sector including IPR awareness raising

The government has for a long time recognised the important role of the SME sector in Indian economy. The Office of the Development Commissioner (MSME)[16] was established in 1954 to promote the SME sector and currently functions under the Ministry of Micro, Small and Medium Enterprises. The Office provides a range of services to SMEs through its nationwide network of offices and service centres, including advice to the government on SME policy, consulting services to SMEs, training and capacity building for SMEs, and provision of economic information to SMEs. In 2000, an IPR Cell was set up at

the Office to increase awareness of IPRs among SMEs by conducting general and industry-specific workshops.[17]

The government provides assistance to SMEs' R&D activities. The Department of Information Technology within the Ministry of Communications and Information Technology has started a scheme to provide financial support[18] to SMEs and technology start-up units for international patent filing to encourage indigenous innovation.

While the government has been taking initiatives to raise awareness of IPR, the response from industry has been slow in most sectors. Use of India's patent system has been so far dominated by foreigners rather than Indian enterprises. Patent applications by Indian enterprises made up only 18% of the total in FY 2006-07.

3. Contract enforcement and dispute settlement

Is the system of contract enforcement effective and widely accessible to all investors? What alternative systems of dispute settlement has the government established to ensure the widest possible scope of protection at a reasonable cost?

India's record on contract enforcement has been generally poor

India has a poor record on contract enforcement. The World Bank's *Doing Business 2009* ranked India 180th (out of 181[19]) with 46 procedures required from filing a case to enforcing the judgement, 1 420 days to complete a court process, and high costs (39.6% of claim) including court costs, enforcement costs and attorney fees. Although the independence of Indian courts is well regarded, the judiciary is extremely slow at processing cases. India has only 13 judges per million, one of the lowest such ratios in the world; and the backlog of pending cases in various levels of courts amounts to about 30 million cases (Government of India, Ministry of Home Affairs, 2003).

Judgements made in foreign courts are enforceable in India

Judgements made in foreign courts are enforceable in India by filing an Execution Decree before an Indian court as long as foreign courts belong to "reciprocating territories"[20] as per the provisions of the Code of Civil Procedure of 1908. If judgements are made by foreign courts in non-reciprocating territories, they are enforceable only after filing a law suit in an Indian court for a judgement.

India has developed a legal framework for alternative dispute resolution

India has been making efforts to promote alternative dispute resolution (ADR), partly to compensate for the delay and backlog in its court system. ADR has a long tradition in India as the first exclusive legislation on arbitration in India, the Arbitration Law, was enacted in 1899.[21] In 1996, the Indian Arbitration and Conciliations Act was enacted to cover international and domestic arbitration comprehensively, limit intervention of courts in arbitral processes to the minimum, treat each arbitral award as a decree of court, introduce the concept of conciliation, and provide a speedy alternative solution to disputes.

The development of institutions supporting ADR has followed that of the legal framework. The Indian Council of Arbitration (ICA),[22] established in 1965, is the apex arbitral organisation at the national level in India. It provides facilities for settlement of both domestic and international commercial disputes by arbitration and maintains a panel of arbitrators including foreign nationals in various fields. The ICA also provides its good offices for the settlement of trade complaints through ADR techniques such as mediation, conciliation, and dispute review; and maintains a list of conciliators and mediators for use by the parties. During FY 2007-08, the ICA received 63 arbitration requests including 10 international ones and settled 35 arbitrations with 559 arbitration cases pending at the end of the fiscal year.

The International Centre of Alternative Dispute Resolution (ICADR)[23] was established in 1995 under the Ministry of Law and Justice for promotion and development of ADR facilities and techniques. The ICADR provides administrative and other support services for holding conciliation, mediation and arbitration proceedings, undertakes education and training in ADR, and promotes ADR methods generally via publications, research, and seminars. Unlike the ICA, the ICADR covers almost all disputes – commercial, civil, labour and family disputes – by using one of the following methods: negotiation, conciliation/mediation, mini-trial or arbitration.

Most recently, in 2001, the Indian Institute of Arbitration and Mediation (IIAM)[24] was established as a non-profit organisation by a group of businessmen and professionals. The IIAM provides facilities for international and domestic commercial arbitration, mediation and conciliation and maintains a panel of arbitrators and mediators.

The government has been promoting the use of ADR by enterprises

The government has been promoting the use of arbitration among state-owned as well as private enterprises. A large number of state-owned enterprises and government departments have previously relied on their own

systems for settlement of disputes by appointing government officials as arbitrators. The Ministry of Commerce and Industry has issued a memorandum to all departments of the government, state-owned enterprises, export promotion councils, commodity boards and apex chambers of commerce and industry recommending that they use the ICA's services and include a relevant clause in commercial contracts.

But India's arbitration process tends to carry the same symptom as its judicial process

Like the Indian judicial process, the Indian arbitration process is prone to delay, as it tends to allow a protracted series of hearings and does not have a mechanism to ensure that arbitration progresses at a reasonable speed. Retired judges of the High Court or Supreme Court are commonly nominated as arbitrators and India does not have a distinct arbitration bar. Hence arbitrations tend to carry the baggage of court practices.

4. Expropriation procedures

> Does the government maintain a policy of timely, adequate, and effective compensation for expropriation also consistent with its obligations under international law? What explicit and well-defined limits on the ability to expropriate has the government established? What independent channels exist for reviewing the exercise of this power or for contesting it?

India's BIPAs provide protection from unfair expropriation or nationalisation

India has signed 75 bilateral investment promotion agreements (BIPAs) which commonly have basic protections related to expropriation.

There were a few international commercial disputes on expropriation in India

There have been a few major commercial disputes in the power sector between the state government and foreign investors including the Dabhol power project in Maharashtra and payment disputes in Tamil Nadu. The Dabhol project reached commercial settlement after several years of negotiation among state-owned financial institutions, the state of Maharashtra, foreign investors, foreign political risk guarantee institution (Overseas Private Investment Corporation), and other foreign lenders.

However, the government commitment to promoting PPPs would reduce the risk of expropriation

Currently there is no investment dispute over expropriation or nationalisation. While a programme of privatisation of state-owned enterprises has stalled since 2004, government policy remains in favour of increasing the role of the private sector in all industrial activities as well as in some public services. Despite past disputes in the infrastructure sector, the government's commitment to, and stated priority placed on, PPPs in infrastructure could reduce the risk of disputes similar to the Dabhol case arising in PPP projects. However, the lack of clear and well-defined limits to expropriation by the state is a concern for investors.

5. The non-discrimination principle

Has the government taken steps to establish non-discrimination as a general principle underpinning laws and regulations governing investment? In the exercise of its right to regulate and to deliver public services, does the government have mechanisms in place to ensure transparency of remaining discriminatory restrictions on international investment and to periodically review their costs against their intended public purpose? Has the government reviewed restrictions affecting the free transfer of capital and profits and their effect on attracting international investment?

The Foreign Exchange Management Act of 1999 regulates foreign investment in India

India's foreign investment framework is generally non-discriminatory, but tends to be more restrictive than in OECD countries (see Box 2.3).

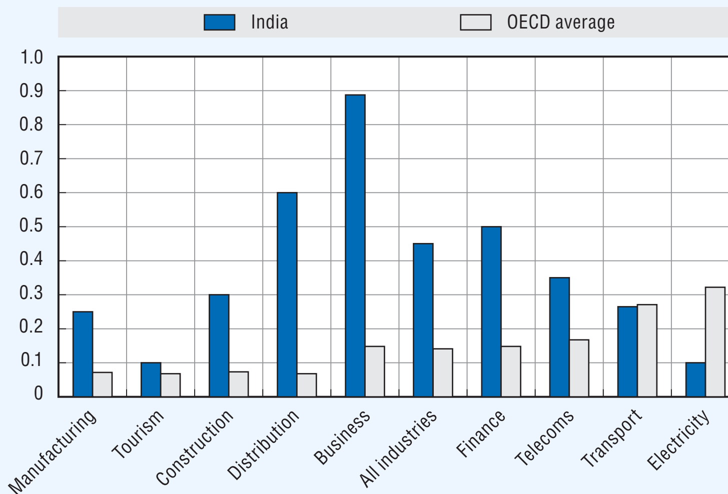
The Foreign Exchange Management Act (FEMA) replaced the Foreign Exchange Regulation Act (FERA) in 1999 and is currently the primary law regulating foreign investment in India, giving the RBI the legal authority to regulate/restrict foreign exchange transactions on capital account including foreign direct investment. Policy changes on FDI may be proposed by any ministry, discussed in inter-ministerial meetings, approved by the Cabinet and finally released as "Press Notes" by the DIPP. These Press Notes are given legality under the FEMA and collectively constitute FDI regulations in India and specify: 1) which sectors are open for foreign direct investment; 2) if allowed, what is the sector-specific ceiling for foreign equity ownership; and 3) when approval for an FDI proposal is required prior to investment or given automatically. All Press Notes are published on the DIPP website and hence readily accessible.

Box 2.3. **FDI regulatory restrictiveness index**

This box presents India's FDI regulatory restrictiveness index, based on the OECD methodology,* and its comparison with other OECD and non-OECD countries. For each sector the index is computed from three underlying indicators measuring: the level of foreign equity ownership permitted, the screening and discriminatory notification requirements, and other restrictions (including nationality and residency requirements for companies' key personnel, domestic content requirements and restrictions on movement of people). The overall index is a weighted average of the sector-specific indices and is expressed on a scale of 0-1 ("0" is the absence of restrictions and "1" is a closed sector for FDI).

There are a number of important qualifications in using the index. In particular, national security related investment measures are not reflected; primary sectors are not covered; and the index takes into account only statutory restrictions and not their actual enforcement. Nonetheless, when combined with other factors beyond statutory restrictions, the index has proven to be one of good predictors of FDI performance (Figure 2.1).

Figure 2.1. **FDI regulatory restrictiveness index**



Source: Investment Division, OECD.

The FDI regulator restrictiveness index covers 9 sectors, among which India records highest FDI restrictiveness scores in business services sectors including legal, accounting and architecture services. India's index mainly reflects sector specific ceiling on equity ownership by foreign enterprises and requirement to obtain the government approval.

Box 2.3. **FDI regulatory restrictiveness index** *(cont.)*

India's sectoral pattern of restrictions is different from that observed in most OECD countries where electricity and transport sectors are the most restricted while distribution and construction are relatively less restrictive. It is due to the fact that India has relaxed foreign equity ownership in the infrastructure services sector to attract private investment into infrastructure.

* OECD (2007), "OECD's Regulatory Restrictiveness Index: Revision and Extension to More Economies and Sectors", *International Investment Perspectives*, Chapter 6.

Several sectors are still closed to FDI

Foreign ownership caps are usually set at one of five levels corresponding to the shareholding level required to make major decisions for enterprises as provided in the Companies Act: 0%, 26%,[25] 49%,[26] 74%,[27] and 100%. The sectors prohibited for foreign investment are: 1) sectors reserved only for the public sector such as atomic energy and rail transport; 2) retail trading except single brand trading; 3) lottery business and gambling; 4) informal money circulation services such as chit fund and Nidhi Company; and 5) trading in Transferable Development Rights (TDR).

Furthermore, the sector-specific FDI policy states that agricultural activities except for a few sub-sectors,[28] plantation activities except for tea plantations, and real estate business except for a few construction development projects[29] are closed to FDI. The current sector-specific FDI policy is summarised in Annex 2.A1. As a result of the government's continuing liberalisation efforts, FDI is allowed up to 100% under the automatic route in practically all manufacturing sectors while the services sector has many restrictions and the agriculture sector remains mostly closed.[30]

Free transfer of funds related to FDI is guaranteed under the law

All foreign investments including remittance of dividends, profits and capital can be freely repatriated after deduction of applicable withholding taxes, except where the policy disallows repatriation for a specified period. Foreign investors apply to the RBI to effect repatriation and remittance of foreign exchange through authorised dealers in India. The only exception is when non-resident Indians (NRIs) choose to invest under non-repatriable schemes.

While there is no limit on the size of remittances in direct connection with foreign direct investments, the RBI maintains certain restrictions on foreign exchange outflows for royalty payments and payments for foreign technology transfers.[31] Royalty payments for the use of trademarks or foreign brand names are allowed up to 1% of domestic sales and 2% of export sales.

The limit for foreign technicians to remit net salaries abroad without the RBI's prior approval[32] is also set by the RBI. These regulations on foreign exchange are periodically reviewed by the RBI.

Various discriminatory conditions imposed on FDI have been removed

India used to impose on foreign investments a local content requirement and an export obligation. Consistent with its WTO-TRIM commitments, India has removed these requirements: dividend-balancing requirements were abolished for foreign investors by 2000;[33] the "indigenisation requirement"[34] in 2001 and the trade balancing requirement[35] in 2002 for foreign investors/importers in the automobile sector. Although government regulations to ban employment of foreign technicians and mangers have been eliminated,[36] hiring and compensating expatriate employees is generally time-consuming due to other regulations related to employment of foreign nationals.

National-security-related strategic sectors may attract additional conditions on FDI

Some national-security-related strategic sectors attract additional conditions to ensure that management control resides with Indian nationals. For example, the defence industry is open to FDI up to 26% equity ownership under the FIPB approval route, but an investor needs to obtain a compulsory industry licence. Application for an FDI project in the defence sector must be made by an Indian company or partnership in which the chief executive officer and a majority of the board directors are resident Indians.[37] Transfer of equity from one foreign investor to another foreign investor is prohibited for the first three-year period and is subject to government prior approval.

The telecommunications sector is regulated by the Department of Telecommunications and the Telecommunication Regulation Authority of India (TRAI) on top of FDI regulations on foreign ownership ceilings and the FIPB approval requirement. As a sensitive sector, FDI in certain telecommunications services[38] attracts security conditions[39] including: 1) that the chief officer in charge of technical network operations and the chief security officer to be resident Indians; 2) that a majority of the Board directors be resident Indian; and 3) security clearance of foreign employees in higher management positions by the Ministry of Home Affairs on an annual basis.

All applications for foreign investments in Indian entities publishing newspapers and periodicals dealing with news and current affairs have to be approved by the Ministry of Information and Broadcasting (MIB) in consultation with the Ministry of Home Affairs and other relevant ministries in addition to the FIPB approval. Foreign ownership[40] is limited to 26% of equity in an Indian publishing media enterprise,[41] of which at least 50% have to be introduced by issue of fresh equity, and at least 51% of the paid up

equity[42] must be held by the largest single Indian shareholder. In addition, at least three-quarters of the Board directors and all key executives and editorial staff must be resident Indians; and all Board directors, regular employees and long-term consultants who are not resident Indian must be cleared by the MIB prior to their engagement.[43]

The "single largest Indian shareholder" concept for Indian media entities was designed to prevent foreign investors from gaining effective control of Indian entities due to fragmented domestic shareholding patterns even if majority foreign ownership is not allowed. The same concept is also applied to some of the broadcasting services[44] regulated by the MIB and the defence industry.

The FDI policy also protects domestic airline operators. Air transport services are open to FDI up to 49% for scheduled flights and 74% for non-scheduled flights under the automatic route.[45] However, a direct or indirect investment stake held by foreign airlines is prohibited[46] as the government feels that domestic airlines are not mature enough to withstand overseas competition. Like telecommunications and print media, air transport services attract the nationality restriction on the Board directors and senior managements: the Chairman and at least three-quarters of the Board directors should be Indian citizens for scheduled air transport services and at least a majority of the Board directors should be Indian citizens for non-scheduled air transport services; senior positions for non-scheduled air transport services, if held by foreign nationals, require security clearance from the Ministry of Home Affairs on an annual basis.

The banking sector has been open to FDI since 1997.[47] Currently, foreign ownership up to 74%[48] is allowed in private Indian banks under the automatic route. However, the RBI continues to regulate foreign (FDI, FII and NRI) entry to the banking sector and approve FDI proposals in banking, separately from the FIPB. In 2005,[49] the RBI issued a road map for foreign bank entry to the Indian banking sector. This is divided into two phases: from March 2005 to March 2009 and from April 2009 onwards. According to the road map, foreign banks can enter the market by establishing a 100% wholly-owned subsidiary (WOS) or a branch, or by acquiring shares of an existing Indian privately-held bank. However, branch expansion is limited to 12 per year; national treatment is not promised before the second phase; and acquisition of Indian banks by foreign banks is permitted only for private sector Indian banks identified by the RBI for restructuring.[50] During the first phase the RBI has not identified such Indian banks for foreign acquisition, and in April 2009 in the middle of the global economic crisis, the RBI decided to postpone the second phase of reform until the global economic conditions become much clearer.

India's FDI regulations are still evolving with frequent changes introduced

India's FDI policy has been going through progressive changes. Though these changes have been consistent in the general direction of deregulation and liberalisation, frequent changes might be considered by foreign businesses as a negative factor contributing to an uncertain policy environment.

The latest Press Notes by the DIPP[51] indicate that India is at the crossroads of liberalising FDI policy further. On the one hand, the government has effectively opened up all sectors further to FDI by revising the method of calculating foreign investment: under the revised method, all investments made by Indian companies which are ultimately owned and controlled by resident Indian citizens are considered as domestic investments and hence are not counted towards the FDI ceiling. On the other hand, the government has imposed a FIPB prior approval requirement on the transfer of ownership or control of Indian companies in all sectors with FDI ceilings from resident Indian citizens to non-resident entities, though many of these sectors with FDI ceilings already required FIPB prior approval.[52]

The FIPB approves FDI projects which are not covered under the automatic route

If prior approval is not required for an FDI project, a foreign investor only needs to inform the RBI within 30 days of receipt of funds or issuance of shares to the foreign investor. When prior approval is required for an FDI project, an FDI proposal has to be sent to the Foreign Investment Promotion Board (FIPB), which is authorised to approve FDI proposals. The FIPB, established under the Ministry of Finance, is an interagency body consisting of: the Secretaries of the Department of Economic Affairs at the Ministry of Finance; the DIPP and the Department of Commerce at the Ministry of Commerce and Industry; the Division of Economic Relations at the Ministry of External Affairs; and the Ministry of Overseas Indian Affairs. In addition, FDI projects over INR 6 billion have to be cleared by the Cabinet Committee of Economic Affairs (CCEA) after receiving FIPB approval.[53]

Prior approval is also required for FDI projects when: proposed foreign equity ownership exceeds the sector-specific ceiling; the foreign investor has an existing joint venture or technology transfer/trademark agreement in the same field; or more than 24% foreign equity is proposed for projects to manufacture items reserved for the SSI. The requirement of prior approval from FIPB for an FDI project when the foreign investor has an existing venture was, however, dropped in 2005 for all new joint ventures formed after 12 January 2005.[54]

The FIPB is expected to follow the Guidelines given in Press Note No. 3 (1997) when it considers FDI proposals. While the Guidelines have improved the predictability of approval and set the time limit[55] in communicating decisions on FDI proposals from the date of submission to the FIPB, they still give substantial flexibility to the FIPB's decision making. The FIPB publishes the application status of FDI proposals, the agenda for the next meeting, and all decisions on approval/disapproval of FDI proposals on its website.[56]

It seems that FIPB disapproval is rare. However, a lack of clear and transparent criteria for approving FDI projects by the FIPB may create a psychological entry barrier for foreign investors. Furthermore, negotiations and informal discussions with government officials out of the formal FIPB approval process may influence the final outcome and may constitute even a pre-selection process (GAO, 2008). Investors are however allowed to file grievances or complaints with the Grievances Officer in the DIPP or to the Business Ombudsman in the Ministry of Commerce and Industry.

Transfer of existing shares in certain sectors are also subject to sector-specific regulations

Not only subscription to newly-issued shares of Indian enterprises by non-residents but also transfer of existing shares of Indian enterprises from residents to non-residents is generally allowed under the automatic route[57] subject to sector-specific FDI regulations.[58] Transfer of existing shares from residents to non-residents continues to require prior approval from the RBI for shares in the finance sector, from the SEBI for cases attracting the SEBI (Substantial Acquisition and Takeover) Regulations, or from the Insurance Regulatory and Development Authority for shares in the insurance sector.

Prices at which foreign investment can be made are regulated by guidelines of the Controller of the Capital Issues, the RBI and the SEBI. If shares are not listed on security markets, prices have to be no less than those determined by the rules prescribed by the Controller of the Capital Issues. If shares are listed on security markets, prices have to be no less than the higher of: 1) the average weekly high and low of the closing prices during the six months preceding the relevant date; or 2) the average weekly high and low of the closing price during the two weeks preceding the relevant date. However, transfer of shares at a price less than instructed above may be possible with prior approval from the RBI.

Foreign investors can choose from several modes of establishing business in India

Foreign investors can start operations either through establishing wholly-owned subsidiaries (WOSs) or joint-ventures incorporated under the

Companies Act of 1956 or acquiring shares or business assets of existing Indian enterprises. Foreign investors can also opt not to incorporate new entities under Indian Law and start operations in India through establishing liaison/representative offices, project offices, or branch offices. However, these foreign establishments in India are limited in their permitted activities[59] and establishment of liaison/representative offices or branch offices requires prior approval from the RBI.

6. Investment promotion and protection agreements

> Are investment policy authorities working with their counterparts in other economies to expand international treaties on the promotion and protection of investment? Has the government reviewed existing international treaties and commitments periodically to determine whether their provisions create a more attractive environment for investment? What measures exist to ensure effective compliance with the country's commitments under its international investment agreements?

India is a founding member of the World Trade Organisation (WTO) and hence is subject to commitments in the Agreement on Trade Related Investment Measures (TRIMs) and the General Agreement on Trade and Services (GATS).

India has signed 75 Bilateral Investment Protection Agreements (BIPAs)…

Since the first agreement signed with the United Kingdom in March 1994, as of June 2008, India has signed 75 Bilateral Investment Protection Agreements (BIPAs) out of which 10 are not yet ratified. It is in negotiation with 26 countries for BIPAs (see Annex 2.A2). Indian BIPAs generally offer strong guarantees in the post-establishment phase on fair and equitable treatment, national treatment, expropriation and free transfers as well as direct access to international arbitration.

… and negotiates on the basis of its own model BIPA

India has its own model BIPA, which is used as the basis for negotiation. Actual agreements signed by India differ noticeably from each other and do not necessarily conform to this model, no doubt because they also take into account the positions of India's negotiating partners. India's model BIPA uses a broad asset-based definition of "investment". It requires the parties to encourage and create favourable conditions for, and fair and equitable treatment to, investors and allow admission of investment in accordance with their laws and policies. It provides for extending national treatment to foreign

investments and MFN treatment to investors. The model BIPA provides that nationalisation or expropriation may only take place according to law, on a non-discriminatory basis, and with fair and equitable compensation. It provides for the free transfer of funds related to investment without unreasonable delay and on a non-discriminatory basis. The model BIPA includes provisions that elaborate dispute resolution mechanisms to resolve disputes between an investor and a host government as well as between the two governments. For settlement of disputes between an investor and a host government, there is provision for prior negotiations to resolve disputes as well as for domestic adjudication, conciliation and international arbitration.

India's approach appears to be evolving beyond its model BIPA

India's approach appears to be evolving beyond this model BIPA. For example, in 2005 India signed a Comprehensive Economic Co-operation Agreement (CECA) with Singapore which combined a preferential trade agreement, an investment agreement and a tax treaty in one package for the first time in the history of India's bilateral agreements. The CECA contains an expanded and more precise definition of "investment" and "investors", and also covers the pre-establishment phase, undertaking of liberalisation commitments and new investment facilitation measures. It also provides stronger guarantees on post-establishment national treatment and stronger investment protection with regard to expropriation and free transfers. On the other hand, it applies public safeguards clauses more widely and adopts broader general exceptions on the lines of GATT Article XX or GATS Article XIV.

The preamble of the India-Singapore CECA states that this agreement "could serve as a template for integration with other countries in the South-East Asian region". Accordingly, India has been in negotiations on CECAs with ASEAN, Indonesia, Japan, Korea, Malaysia and Sri Lanka. However, no CECA has been concluded so far with other countries after Singapore. It remains to be seen whether India's model BIPA would lose relevance and be updated in light of India's willingness to sign CECAs with more countries, especially those outside the South-East Asian region.

7. Ratification of international arbitration instruments

> Has the government ratified and implemented binding international arbitration instruments for the settlement of investment disputes?

India is a signatory to major international conventions on foreign arbitral awards

India is a signatory to the Geneva Convention of 1927 on the Execution of Foreign Arbitral Awards[60] and the New York Convention of 1958 on the Recognition and Enforcement of Foreign Arbitral Awards.[61] As conditions to ratify and enforce these two conventions in the country, India introduced the Arbitration (Protocol and Convention) Act of 1937 and the Foreign Awards (Recognition and Enforcement) Act of 1961. Under these two acts, India is obliged to recognise and enforce commercial arbitration awards given in other signatory countries except in a few cases including where: 1) disputed subjects are not capable for arbitration under Indian laws;[62] or 2) enforcement of awards is contrary to the public policy of India or the fundamental principles of Indian laws, the interests of India, justice or morality.

The above two acts were subsequently absorbed into the Indian Arbitration and Conciliation Act (IACA) of 1996 which applies to both domestic and international arbitration. Since the IACA is based on the UNCITRAL Model law and rules,[63] it adopts harmonised concepts on arbitration and conciliation. Domestic arbitral awards as well as foreign arbitral awards under the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards and under the Geneva Protocol on Arbitration Clauses are enforceable in India in the same manner as a decree of a court. All other foreign arbitrary awards need to be ratified by the courts and a decree passed by them for enforcement in India. A foreign award is also enforceable under the Indian Contract Act as long as the party entered a contract with a valid arbitration agreement in the manner prescribed under the Act and the award was made in accordance with the provisions of the agreement.

India's BIPAs provide arbitration mechanism to settle international disputes

BIPAs which India has entered into commonly include provisions for arbitration mechanism to settle state-to-state and investor-to-state disputes. BIPAs encourage amicable solutions through consultations or negotiations, but also provide for submission of the disputes to the International Centre for Settlement of International Disputes (ICSID) for conciliation and arbitration under the Additional Facility rule of the ICSID or setup of arbitration processes under the UNCITRAL rule.

India has not signed the Convention on the Settlement of Investment Disputes between States and Nationals of Other States of 1965. Once India joins the Convention, India's BIPAs would allow the contracting parties to submit investment disputes to the ICSID for settlement as provided in India's model BIPA.

Other international investment agreements also provide arbitration mechanisms

India is a party to the 1985 Convention establishing the Multilateral Investment Guarantee Agency (MIGA). The Convention defines[64] mechanisms to settle disputes between a member state and the MIGA. Bilaterally India signed an Investment Incentive Agreement with the United States in 1997 with the intent of promoting and protecting investments from the United States into India by facilitating investment support to US investors from the Overseas Private Investment Corporation (OPIC), a designated investment guarantee agency of the US government. The agreement also spells out dispute resolution mechanisms for disputes between two governments which the OPIC may claim arise from acts of the government of India involving questions of liability under public international law.

Notes

1. The cities with population of more than 1 million as per 1991 census are: Greater Mumbai, Kolkata, Delhi, Chennai, Hyderabad, Bangalore, Ahmedabad, Pune, Kanpur, Nagpur, Lucknow, Surat, Jaipur, Kochi, Coimbatore, Vadodara, Indore, Patna, Madurai, Bhopal, Visakhapatnam, Varanasi, and Ludhiana. Licensing requirement is exempted if: 1) the area is designated as an industrial area before 25 July 1991; 2) it is in electronics computer software, printing and any other industry which may be notified as a non-polluting industry; 3) it is to set up administrative and other central offices; or 4) it is a service enterprise.
2. Filing is optional for micro- and small-scale enterprises in both manufacturing and services sectors and for medium-scale enterprises in services sector. Only medium-scale enterprises in manufacturing sector are subject to the compulsory filing requirement.
3. In Karnataka, the cut-off points are set at INR 500 million or more for the State High Level Clearance Committee, at INR 30 million or more for the State Level Single Window Clearance Committee, and below INR 30 million for the District Level Single Window Clearance Committees. On the other hand, in Haryana, the cut-off points are set at INR 300 million or more for the SHLCC, at INR 50 million or more for the SLSWCC, and below INR 50 million for the DLSWCCs.
4. The Factories Act applies to all factories which are engaged in manufacturing with 10 or more employees with the aid of power or with 20 or more employees without the aid of power. The factories under the Act are required to get approval for their building plans, obtain and renew their factory licences, and are subject to inspections.
5. However, it is a significant improvement from 62 days which were recorded for three years before the 2009 survey.
6. The documents to prove titles include: receipt showing a property owner has paid tax related to the property; and sales deed that states that a government authority has witnessed a sale of property.

7. The Computerisation of Land Records scheme started implementation in FY 1987-88 and the Strengthening of Revenue Administration and Updating of Land Records scheme started in FY 1988-89.
8. The total cost of the programme is estimated to be INR 56.560 billion combining the central share and the state shares, and the programme is expected to be completed by the end of the 12th Five-Year Plan (2013-18).
9. India is considering amendments to this Act to extend copyright protection to digital works and Internet-based materials.
10. India was given 10 years (until 1 January 2005) to fully comply with TRIPS.
11. This Act was further amended in 2007 to include provisions required for India to join the Madrid Protocol on international recognition of marks. Signatories to this protocol can avail themselves the benefits of a simple, facilitative and cost-effective system for recognising trademarks across countries.
12. Product patents for goods other than pharmaceuticals, chemicals and food were valid for 14 years.
13. After 3 years of the grant of a process patent, anyone could use the patented process if a royalty was paid.
14. The conditions go beyond the usual national emergency, public health crises and anti-trust situations and extend to the failure to work the inventions in India and the non-availability of the patented invention at a reasonably affordable price.
15. The number of raids had been on the rise in 2005 and 2006. However, there seems to have been a decrease in 2007 as reported in *International Intellectual Property Alliance 2008 Special 301 Report*.
16. It was originally the Office of Development Commissioner (SSI) under the Ministry of Micro, Small and Medium Enterprises, *www.laghu-udyog.com*.
17. *www.wipo.int/sme/en/best_practices/india.htm*.
18. The government reimburses 50% of costs incurred related to international IPR applications.
19. It is before Timor-Leste and after Angola.
20. The reciprocating territories include the United Kingdom; Singapore; Malaysia; New Zealand; Hong Kong, China; Fiji; Bangladesh; United Arab Emirates; Trinidad and Tobago; the Cook Islands; the Trust Territories of Western Samoa; Papua New Guinea; and Aden.
21. It was replaced by the Arbitration Law of 1940.
22. *www.ficci.com/icanet/index.htm*.
23. *www.icadr.org/index.html*.
24. *www.arbitrationindia.org*.
25. Holding more than 25% of shares gives the power of blocking special resolutions and seeking interventions of the Company Law Board.
26. Holding more than a majority of shares gives the power of making resolutions such as appointment of directors, declaration of dividend, and approval of audited financial statements.
27. Holding more than 74% of shares gives the power to authorise certain proposals such as alternation of the Memorandum and Articles of Association of the

company, reduction of capital, issues of shares to persons other than existing shareholders, mergers and amalgamations, variation of the rights of a class of shareholders, and winding up of the company.

28. The allowed agricultural activities are: floriculture, horticulture, development of seeds, animal husbandry, pisciculture, aquaculture and cultivation of vegetables and mushrooms under controlled conditions, and service related to agro and allied sectors.

29. The allowed construction projects are in: housing, commercial premises, resorts, educational institutions, recreational facilities, city and regional level infrastructure and townships.

30. In the agriculture sector, only floriculture, horticulture, development of seeds, animal husbandry, pisciculture, aquaculture and cultivation of vegetables and mushrooms under controlled conditions, and services related to agro and allied sectors are allowed for 100% foreign direct investment under the automatic route. Tea plantation is allowed for FDI up to 100% also, but under the FIPB approval route.

31. Payments for technology transfers or technical collaborations are allowed subject to the limits of lump-sum payments up to USD 2 million and royalty payments up to 5% of domestic sales and 8% of export sales subject to 8% of total sales.

32. The current limit is set at 70% of net salaries.

33. Press Note No. 12 (1992) and Press Note No. 7 (2000).

34. This requirement obliges each car manufacturer to achieve indigenisation, or local content, of a minimum level of 50% by the third year from the date of its first import of cars in the form of completely and semi-knocked down kits, or certain automobile components, and 70% by the fifth year from that date.

35. This requirement obliges each car manufacturer to balance, over the period of the MOU with the government, the value of its imports of components with the value of its exports of cars and components.

36. However, in telecommunication sector, some restrictions to employ foreign nationals at top senior level still exist.

37. Press Note No. 4 (2001) and Press Note No. 2 (2002).

38. Services include: basic and cellular, unified access services, national/international long distance call, V-SAT, public mobile radio trunked services, global mobile personal communications services, other value-added telecommunication services, and internet service.

39. Press Note No. 3 (2007) and Department of Telecommunications (2007), Internet Service Guideline.

40. Including FDI by foreign entities and NRIs and portfolio investments by recognised foreign institutional investors.

41. In 2002, FDI was allowed for the first time in Indian print media dealing with news and current affairs. In 2005, FII and portfolio investments are also allowed in the same sector. In 2009, the government allowed 100% foreign equity ownership in publication of *facsimile* editions of foreign newspapers under the FIPB route while foreign equity participation in publication of Indian editions of foreign magazines dealing with news and current affairs remains limited to 26% [Press Note No. 1 (2009)]. On the other hand, publication of scientific magazines, specialty journals and periodicals is open to 100% foreign equity ownership under the FIPB route.

42. Excluding the equity held by public sector banks and public financial institutions.
43. Ministry of Information and Broadcasting, Press Note (2005).
44. Up-linking a news and current affairs TV channel and FM radio attract the same "single largest Indian shareholder" requirement.
45. NRIs are allowed to own up to 100% of both types of air flight services.
46. Foreign airlines are not allowed to enter directly or indirectly into financial or commercial tie-ups with Indian airlines or any agreements empowering them to have effective control/interference in the management of Indian airlines. Foreign airlines are, however, allowed to participate in the equity of firms operating cargo airlines, helicopter and seaplanes as well as ground handling services, general sales agency, code sharing and interlining agreements.
47. Press Note No. 3 (1997).
48. This is the ceiling for FDI and foreign institutional investment (FII) combined.
49. Dated 28 February, 2005.
50. Acquisition of Indian banks by foreign banks may be allowed for any private sector Indian bank in the second phase (from April 2009) of the road map.
51. Press Note No. 2 and No. 3 (2009).
52. Among sectors with FDI ceiling the sectors which did not require FIPB prior approval before Press note No. 3 (2009) are: air transport services, banking, insurance, and telecommunications.
53. Currently discussions continue to raise this cap to INR 10 billion and limit to projects in a few strategic sectors.
54. In Press Note No. 1 (2005), exemptions were also given in cases of: 1) investments made by Venture Capital Funds registered with the Security and Exchange Board of India (SEBI); 2) if the equity share in the existing joint venture held by either of the parties is less than 3%; 3) if the existing joint venture/collaboration is defunct or sick; and 4) investments in the IT sector.
55. In Press Note No. 5 (1999), this time limit was reduced from the six weeks to 30 days.
56. *http://finmin.nic.in/fipbwebreports/webpage.asp.*
57. Press Note No. 4 (2006).
58. Press Note No. 3 (2009).
59. Branch offices are limited in their activities to representing the parent company, exporting/importing goods, rendering professional or consultancy services, carrying on research, promoting technical or financial collaboration, information technology and software services, technical support and foreign airlines/shipping companies. Liaison offices are limited to representing the parent company/group companies, promoting export from/to India, promoting technical/financial collaboration between parent/group companies and companies in India, gathering information for the parent company and acting as a communication channel between the parent company and Indian companies; and all expenses of liaison offices have to be met by inward remittance from non-residents. Project offices are set up specifically to execute large projects such as construction, civil engineering and infrastructure projects.

60. Chapter II of the IACA contains provisions related to the Geneva Convention in Sections 53-60.

61. Chapter II of the IACA contains provisions related to the New York Convention on enforcement of foreign awards in Sections 44-52.

62. Under the Indian Law, issues which cannot be settled by arbitrations are: matters of public rights; proceedings under the Foreign Exchange Management Act (FEMA) which are quasi-criminal in nature; validity of intellectual property rights granted by statutory authorities; taxation matters beyond the will of the parties; winding up under the Companies Act of 1956; and disputes involving insolvency proceedings.

63. United Nations Commission on International Trade Law prepared a Model Law on International Commercial Arbitration in 1985.

64. Article 57 (Chapter IX) and Annex II of the Convention establishing the MIGA.

ANNEX 2.A1

Sector Specific FDI Policy

Sector	FDI ownership cap	Entry route	Other conditions
Agriculture sector Except sectors mentioned below, FDI is not allowed.			
Floriculture, horticulture, development of seeds, animal husbandry, pisciculture, aquaculture, cultivation of vegetables and mushrooms under controlled conditions and services related to agro and allied sectors	100%	Automatic	
Tea sector including tea plantation	100%	FIPB	Subject to the conditions such as divestment of 26% equity in favour of Indian partners/Indian public within 5 years and prior approval of the state government in case of any changes in future land use.
Mining sector FDI in mining substances listed by the Department of Atomic Energy is not allowed.			
Mining of diamonds and precious stones, gold, silver and minerals	100%	Automatic	Prior approval requirement for new proposals in cases foreign investor has or had any previous joint venture or technology transfer/trademark arrangement in the same field is not applied to this sector (declaration from the applicant that he/she has no existing joint venture for the same area and/or the particular mineral is sufficient). Subject to Mines and Minerals Act of 1957.
Coal and lignite (mining only for captive consumption by power projects; iron, steel and cement production; and other eligible activities permitted under the Coal Mines Act of 1973)	100%	Automatic	Subject to Coal Mines Act of 1973.

Sector	FDI ownership cap	Entry route	Other conditions
Titanium bearing minerals and ores (only three activities – mining and mineral separation, value addition, and integrated activities of these two – are allowed)	100%	FIPB	Subject to sectoral regulations and the Mines and Minerals Act of 1957. Value addition facilities should be set up within India along with transfer of technology. Disposal of tailings during the mineral separation should be carried out as per regulations by the Atomic Energy Regulatory Board.
Manufacturing sector			
Alcohol distillation and brewing	100%	Automatic	Industrial licence required from the SIA under the DIPP and licence required from the state where a unit is built.
Defence production (only in arms and ammunition and allied items of defence equipment, defence aircraft and warships)	26%	FIPB	Industrial licence required from the SIA under the DIPP. Subject to guidelines on FDI in production of arms and ammunition by the DIPP.
Cigars and cigarettes	100%	FIPB	Industrial licence required from the SIA under the DIPP.
Hazardous chemicals (hydrocyanic acid and its derivatives; phosgene and its derivatives; and isocyanates and diisocyantes of hydrocarbon)	100%	Automatic	Industrial licence required from the SIA under the DIPP.
Industrial explosives	100%	Automatic	Industrial licence required from the SIA under the DIPP.
Drugs and pharmaceuticals including those involving use of recombinant DNA technology	100%	Automatic	
Infrastructure sector Real estate business is not allowed for FDI			
Airports			
a) Greenfield projects	100%	Automatic	Subject to sectoral regulations notified by the Ministry of Civil Aviation.
b) Existing projects	100%	Automatic below 74% FIPB beyond 74%	
Construction development projects (housing, commercial premises, resorts, educational institutions, recreational facilities, city and regional level infrastructure, and townships)	100%	Automatic	Subject to conditions including: 1) minimum capitalisation requirement; 2) time limit to bring in funds; 3) minimum area to be developed; 4) no repatriation of investment capital for the first 3 years without prior government approval; and 5) minimum 50% development within 5 years from obtaining all statutory clearances (these conditions do not apply for hotels and hospitals and for NRI investment).

Sector	FDI ownership cap	Entry route	Other conditions
SEZ and FTWZ	100%	Automatic	Subject to SEZ Act of 2005 and the Foreign Trade Policy. The state governments are required to sponsor the project, and also acquire the land for the developer.
Industrial parks and units in industrial parks	100%	Automatic	Exempt from the conditions applied to construction development projects if: 1) it comprises of a minimum of 10 units and no single unit occupies more than 50% of the allocable area; and 2) the minimum % of the area allocated for industrial activity is no less than 66% of the total allocable area.
Power including generation, transmission, distribution and power trading	100%	Automatic	Subject to the Electricity Act of 2003.
Satellites (establishment and operation)	74%	FIPB	Subject to sectoral regulations by the Department of Spaces.
Services sector			
Banking sector – private banks			
(only for those identified by the RBI for restructuring)	74% including FDI, FII and NRI investment	Automatic	Subject to various sectoral regulations by the RBI such as 10% ceiling on voting rights of a single shareholder, 5% general ceiling on equity holding by each bank, prior approval by the RBI on disinvestment by foreign investors and sales though private arrangement by NRIs.
Insurance	26%	Automatic	Subject to licence regulation by the Insurance Regulatory and Development Authority.
Credit information companies	49% including FDI and FII (24% for FII within this limit on listed CICs)	FIPB	Subject to the CIC Act of 2005 including: 1) 10% equity ceiling, directly and indirectly, on a single entity; 2) reporting requirement to the RBI for acquisition in excess of 1%; and 3) no representation on the Board for investing FIIs.
Commodity exchange	49% including FDI and FII (23% for FII and 26% for FDI within this limit)	FIPB	FII purchase is restricted to the secondary market only. A single foreign investor or entity should not hold more than 5% of the equity in these companies.

Sector	FDI ownership cap	Entry route	Other conditions
Non-banking financial companies *a)* Merchant banking *b)* Underwriting *c)* Portfolio management services *d)* Investment advisory services *e)* Financial consultancy *f)* Stock broking *g)* Asset management *h)* Venture capital *i)* Custodial services *j)* Factoring *k)* Credit rating agencies *l)* Leasing and finance *m)* Housing finance *n)* Foreign exchange broking *o)* Credit card business *p)* Money changing business *q)* Micro credit *r)* Rural credit	100%	Automatic	Subject to conditions such as: 1) minimum capitalisation; 2) upfront FDI requirement for larger projects; 3) NBFCs with no more than 74% foreign ownership to set up subsidiaries for other NBFC activities; and 4) compliance with the RBI guidelines.
Broadcasting			
a) FM radio	20% including FDI and FII	FIPB	Subject to licence regulation by the MIB.
b) Cable network	49% including FDI and FII		Subject to Cable Television Network Rules of 1994.
c) Direct to home	49% including FDI and FII (20% for FDI within this limit)	FIPB	Subject to guidelines by the MIB.
d) Setting up hardware facilities such as up-linking hubs and teleports	49% including FDI and FII	FIPB	Subject to guidelines for up-linking from India by the MIB.
e) Up-linking a non-news and current affairs TV channel	100%	FIPB	
f) Up-linking a news and current affairs TV channel	26% including FDI and FII	FIPB	

Sector	FDI ownership cap	Entry route	Other conditions
Print media			
a) Newspaper and periodicals publishing with news and current affairs			Subject to guidelines by the MIB.
a.1) publication of facsimile edition of foreign newspapers	100%	FIPB	
a.*2)* publication of Indian edition of foreign magazines dealing with news and current affairs	26% including NRIs/ PIOs/FII	FIPB	
b) Publishing of scientific magazines, specialty journals and periodicals	100%	FIPB	
Civil aviation services			
a) Scheduled air flights	49% for FDI, 100% for NRI investment	Automatic	Foreign airlines are not allowed for direct and indirect equity participation.
b) Non-scheduled air flights, chartered airlines and cargo airlines	74% for FDI, 100% for NRI investment	Automatic	Foreign airlines are not allowed for direct and indirect equity participation for non-scheduled flights and chartered airlines; but allowed for cargo airlines.
c) Helicopter services and seaplane services requiring DGCA approval	100%	Automatic	
d) Ground handling services	74% for FDI, 100% for NRI investment	Automatic	Subject to sectoral regulations and security clearance.
e) Maintenance and repair services, flight training, and technical training	100%	Automatic	
Investing companies in infrastructure and services sector (except telecommunication sector)	49%	FIPB	If management is with Indian resident, investment by these companies in infrastructure and services sector does not count for the sectoral limits if any.
Asset reconstruction	49%	FIPB	If any individual investment exceeds 10% of the equity, compliance with Section 3 (3f) of Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act of 2002 is required.
Telecommunications			
a) Basic and cellular, unified access services, national and international long distance calls, V-SAT, public mobile radio trunked services, global mobile personal communications services, and other value added telecom services	74% including FDI and FII	Automatic up to 49%, FIPB beyond 49%	Subject to licence and security regulations by the DOT.
b) ISP with gateways, radio paging, end-to-end bandwidth	74%	Automatic up to 49%, FIPB beyond 49%	

Sector	FDI ownership cap	Entry route	Other conditions
c) ISP without gateway; infrastructure provider of dark fibre, right of way, duct space, tower; and electronic mail and voice mail services	100%	Automatic up to 49%, FIPB beyond 49%	Subject to the condition of divesting 26% of equity in favour of Indian public in 5 years if the companies are listed in other parts of the world. Subject to licence and security regulations by the DOT.
Trade			
FDI not allowed in retail trail except single brand retail			
a) Wholesale and cash and carry trading	100%	Automatic	
b) Trading for exports	100%	Automatic	
c) Trading of items sourced from SSI	100%	FIPB	
d) Test marketing of items for which a company has approval for manufacturing	100%	FIPB	A test marketing facility should be used for 2 years, and investment in setting up manufacturing facilities should commence simultaneously with test marketing.
e) Single brand retail	51%	FIPB	
Courier services (Except distribution of letters which are exclusively reserved for the government).	100%	FIPB	
Petroleum and natural gas sector			
a) Refining	49% in case of PSUs, 100% in case of private entities	FIPB in case of PSUs, Automatic in case of private entities	No divestment or dilution of domestic equity in the existing PSUs. Subject to regulations by the Ministry of Petroleum and Natural Gas.
b) Other than refining (market study and formulation, financing, setting up infrastructure for marketing, trading and marketing)	100%	Automatic	
c) Oil exploration	100%	Automatic	Subject to the policy of the government on private participation in exploration for oil and the discovered fields of national oil companies.

ANNEX 2.A2

Bilateral Investment Treaties Concluded

Partner country	Date of signature	Date of entry into force
Argentina	20 August 1999	12 August 2002
Armenia	23 May 2003	30 May 2006
Australia	26 February 1999	4 May 2000
Austria	8 November 1999	1 March 2001
Bahrain	13 January 2004	5 December 2007
Bangladesh	9 February 2009	
Belarus	26 November 2002	23 November 2003
Belgium and Luxembourg	31 October 1997	8 January 2001
Bosnia and Herzegovina	12 September 2006	14 February 2008
Brunei Darussalam	22 May 2008	
Bulgaria	29 October 1998	23 September 1999
China	21 November 2006	1 August 2007
Croatia	4 May 2001	19 January 2002
Cyprus	9 April 2002	12 January 2004
Czech Republic	11 October 1996	6 February 1998
Denmark	6 September 1995	28 August 1996
Djibouti	19 May 2003	
Egypt	9 April 1997	22 November 2000
Ethiopia	5 July 2007	
Finland	7 November 2002	9 April 2003
France	2 September 1997	17 May 2000
Germany	10 July 1995	13 July 1998
Ghana	5 August 2002	
Greece	26 April 2007	12 April 2008
Hungary	3 November 2003	2 January 2006
Iceland	29 June 2007	
Indonesia	10 February 1999	22 January 2004
Israel	29 January 1996	18 February 1997
Italy	23 November 1995	26 May 1998
Jordan	1 December 2006	
Kazakhstan	9 December 1996	26 July 2001
Korea	26 February 1996	7 May 1996

Partner country	Date of signature	Date of entry into force
Kuwait	27 November 2001	28 June 2003
Kyrgyzstan	16 May 1997	12 May 2000
Laos	9 November 2000	5 January 2003
Libya	26 May 2007	
Macedonia	17 March 2008	17 October 2008
Malaysia	1 August 1995	12 April 1997
Mauritius	4 September 1998	20 June 2000
Mexico	21 May 2007	23 February 2008
Mongolia	3 January 2001	29 April 2002
Morocco	13 February 1999	22 February 2001
Mozambique	19 February 2009	
Myanmar	24 June 2008	
Netherlands	6 November 1995	1 December 1996
Oman	2 April 1997	13 October 2000
Philippines	28 January 2000	29 January 2001
Poland	7 October 1996	31 December 1997
Portugal	28 June 2000	19 July 2002
Qatar	7 April 1999	15 December 1999
Romania	17 November 1997	9 December 1999
Russia	23 December 1994	5 August 1996
Saudi Arabia	25 January 2006	20 May 2008
Senegal	3 July 2008	
Serbia and Montenegro	31 January 2003	
Slovak Republic	25 September 2006	16 June 2007
Spain	30 September 1997	16 October 1998
Sri Lanka	22 January 1997	13 February 1998
Sudan	22 October 2003	
Sweden	4 July 2000	1 April 2001
Switzerland	4 April 1997	16 February 2000
Syria Arab Republic	18 June 2008	22 January 2009
Chinese Taipei	17 October 2002	25 February 2005
Tajikistan	13 December 1995	14 November 2003
Thailand	10 July 2000	13 July 2001
Trinidad and Tobago	12 March 2007	7 September 2007
Turkey	17 September 1998	18 October 2007
Turkmenistan	20 September 1995	27 February 2006
Ukraine	1 December 2001	12 August 2003
United Kingdom	14 March 1994	6 January 1995
Uruguay	11 February 2008	
Uzbekistan	18 May 1999	28 July 2000
Viet Nam	8 March 1997	1 December 1999
Yemen	1 October 2002	10 February 2004
Zimbabwe	10 February 1999	

Source: Ministry of Finance, the Government of India.

ANNEX 2.A3

Trade and Economic Co-operation Agreements

Signed agreements		
Bangkok Agreement	Signed in 1975; effective since 1976	
India – Bangladesh BTA	Signed in 1980	
India – Maldives BTA	Signed in 1981	
Global System of Trade Preferences	Signed in 1988; effective since 1989	
SAARC RTA (SAPTA)	Signed in 1993	
India – Sri Lanka FTA	Signed in 1998; effective since 2006	CEPA under negotiation
India – Thailand FTA Framework Agreement	Signed in 2003; effective partially since 2004	
India – ASEAN Framework Agreement on CECA	Signed in 2003	
India – Afghanistan PTA	Signed in 2003; effective since 2003	
South Asian FTA (SAFTA)	Signed in 2004; effective since 2006	
India – MERCOSUR PTA	Signed in 2005; not yet effective	
Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Co-operation (BIMSTEC) FTA Framework Agreement	Signed in 2004; FTA under negotiation	
India – Gulf Co-operation Council Framework Agreement	Signed in 2004; FTA under negotiation	
Asia Pacific Trade Agreement (APTA)	Signed in 2005; effective since 1976	Replacing Bangkok Agreement
India – Singapore CECA	Signed in 2005; effective since 2005	
India – Bhutan FTA	Signed in 2006; effective since 2006	
India – Chile PTA	Signed in 2006; effective since 2007	
India – Nepal Treaty of Trade	Signed in 2007; effective since 2007	
Agreements under negotiation		
India – ASEAN CECA	Under negotiation	
India – Mauritius CECPA	Under negotiation	
India – Korea CEPA	Under negotiation	
India – Japan EPA/CEPA	Under negotiation	
India – Israel PTA	Under negotiation	
India – EU Trade and Investment Agreement	Under negotiation	
India – Southern African Customs Union (SACU) PTA	Under negotiation	
India – China RTA	Joint Task Force set up to study the feasibility of RTA	
India – Brazil – South Africa CECA	Joint Task Force set up to study the feasibility of CECA	
India – Indonesia CECA	Joint Study Group for set up to examine the feasibility of CECA	
India – Malaysia CECA	Under negotiation	
India – Russia CECA	Joint Task Force set up to study the feasibility of CECA	
India – Sri Lanka CEPA	Under negotiation	

Note: BTA = Bilateral Trade Agreement; CECA = Comprehensive Economic Co-operation Agreement; CEPA = Comprehensive Economic Partnership Agreement; EPA = Economic Partnership Agreement; FTA = Free Trade Agreement; PTA = Preferential Trade Agreement; SAARC = South Asia Association for Regional Co-operation.
Source: Ministry of Commerce and Industry.

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Chapter 3

Investment Promotion and Facilitation

Investment promotion and facilitation play an increasingly important role in India's economic reforms. This chapter introduces various investment promotion agencies (IPAs) at the national and state levels which have been set up by the government, in some cases in partnership with the private sector. Investment incentives offered by the government are reviewed, together with progress in attracting investment through the establishment of special economic zones (SEZs). The analysis is structured around the questions set out in the Policy Framework for Investment *(PFI). Each section is preceded by the relevant PFI question, which serves as general context for consideration of main policy areas.*

Investment promotion and facilitation measures, including incentives, can be effective instruments to attract investment provided they aim to correct for market failures and are developed in a way that can leverage the strong points of a country's investment environment.

1. Investment promotion strategy

> Does the government have a strategy for developing a sound, broad-based business environment and within this strategy, what role is given to investment promotion and facilitation measures?

For more than a decade, successive governments of India have stood by the principles of the New Industrial Policy of 1991, which pledged to pursue a sound policy framework encompassing encouragement of entrepreneurship, development of indigenous technology, bringing in new technology, dismantling of the excessive regulatory system, development of the capital markets and increasing competitiveness. Investment promotion and facilitation measures have been adopted, though incrementally, in this overall economic reform agenda.

The Department of Industrial Policy and Promotion administers and facilitates investment in India

At the central government level, the Department of Industrial Policy and Promotion (DIPP), established in 1995, is responsible for the formulation and administration of overall industrial policy in India, covering both domestic and foreign direct investment. The strategy and the role of the DIPP have evolved from regulation and control of industries to facilitation and promotion of industrial investment and development as consistent with the overall policy direction. The DIPP's primary functions include: 1) formulation and implementation of industrial policy and strategies with a view to making Indian industry internationally competitive; 2) monitoring and stimulation of industrial growth in general and performance of industries specifically assigned to it; 3) formulation of FDI policy and promotion and facilitation of FDI in India; 4) formulation and administration of policies/rules relating to intellectual property rights in the fields of patents, trademarks, industrial designs and geographical indications; 5) international co-operation and

negotiation of international investment agreements; and 6) compilation of statistics on industrial production and FDI.

The DIPP operates with the objective of attaining international competitiveness and transforming India into a major player in the global arena. It focuses on the deregulation of industry, allowing it more freedom and flexibility in responding to market conditions. Although the DIPP's objectives are consistent with the development of a sound, broad-based business environment, the DIPP seems to spend much time formulating and implementing specific industrial schemes,[1] administering the Industries (Development and Regulation) Act of 1951, and monitoring industrial growth and production by receiving the Industrial Entrepreneurs' Memorandum (IEM),[2] Letters of Intent, and industrial production returns. Policy advocacy to improve the investment environment, based on interaction with domestic and foreign investors, is not taken up actively by the DIPP but is delegated to other institutions. Despite its efforts to transform its role, the DIPP may not have shaken off its image of regulating and licensing industry activities.

2. Investment promotion agencies

> Has the government established an investment promotion agency (IPA)? To what extent has the structure, mission, and legal status of the IPA been informed by and benchmarked against international good practices?

Five agencies share the responsibility of promoting foreign direct investment at the central level

India does not yet have a unique agency with a specific mandate to promote foreign investment. The functions of promotion and facilitation of investment are shared among various government agents and departments, government-established commissions and business associations. However, the DIPP is in the process of incorporating a company in association with the Federation of Indian Chambers of Commerce and Industry (FICCI), one of the main national business representative organisations, which will have a clear mandate and a separate budget for carrying out investment promotion activities.

At the central level, five agencies are mainly in charge of promoting and facilitating foreign direct investment: the FIPB, the DIPP, the Investment Commission (IC), the Indian Brand Equity Foundation (IBEF), and the Ministry of External Affairs.

FIPB is a single approval window for FDI projects

The FIPB under the Ministry of Finance approves FDI projects which do not fall under the RBI's automatic route. Though the FIPB was established to

facilitate foreign direct investment by providing a single approval window, it is really a regulatory body and does not undertake any major investment promotion activities. Nonetheless, the FIPB has been exercising its role of clarifying, implementing and enforcing FDI policy. As an inter-ministerial body, the FIPB has saved foreign investors from having to approach various sector ministries separately for licences and approvals.

DIPP is effectively the main IPA at the central level

The DIPP assumes the main function of investment promotion and facilitation and is effectively the main IPA at the central level. Within the DIPP, the Investment Promotion Cell was created in 1996 to assume an investment promotion role. It was later merged with the International Co-operation Division to become the Investment Promotion and International Co-operation (IP&IC) Cell. The IP&IC Cell is responsible for disseminating information on the investment climate and investment opportunities in India, facilitating investment, and compiling sectoral policies, strategies and guidelines for the infrastructure sector.

The Cell is expected to conduct various investment promotion events such as: Destination India events at home and abroad; publishing promotional materials; maintaining the DIPP website where investors can find information on industrial and FDI policy and procedures, projects on offer, various forms and status of applications submitted to the DIPP; and assisting state governments as well as business organisations in undertaking investment promotion activities. Activities of the IP&IC are of a general nature in the area of pre-investment services and do not include investor targeting and professional consulting services for potential investors. Guidance to both existing and prospective investors with the objective of facilitating the various approvals and clearances is provided *via* online guidance services on the DIPP website; this system has been in existence since 2001.

Another unit within the DIPP, the Foreign Investment Implementation Authority (FIIA),[3] was set up in 1999 to assist foreign investors in implementing projects after approval. The FIIA provides foreign investors with a one-stop aftercare service by assisting them to obtain state-level clearances and to solve operational problems. It meets with various government agencies in finding solutions to investors' problems. The FIIA is assisted by a Fast Track Committee (FTC) set up for each sector which is headed by the lead sector ministry and includes representatives from all agencies, including those at the state level, concerned with implementation of a particular project. FTCs are also responsible for identifying and suggesting simplification of existing procedures at the central and state level. Senior officers of the DIPP have been identified as nodal officers responsible for specific states to follow up FDI projects and to bring to the notice of the FIIA any difficulties in implementation.

The government set up the Investment Commission as an advisory body on investment policy

A three-person Investment Commission (IC)[4] was set up by the Ministry of Finance in December 2004 to make recommendations to the government of India on policies and procedures to facilitate investment, recommend projects and investment proposals that should be fast tracked and promote India as an investment destination. The IC consists of a chairman and two other members who meet once a week and have discussion with government officials on a quarterly basis. Since the IC members represent the private business sector, they provide recommendations and advice on government policy from a business practitioner's point of view.

The IC has: prepared an Investment Handbook and a website to promote India as an investment destination; interacted with Indian business associations, foreign embassies and foreign investor groups; and made consolidated recommendations to the government in its IC report 2006 (Investment Commission, 2006). Its members and staff are highly qualified, with private-sector backgrounds. The IC's authority is well regarded by the government officials and its recommendations have been taken up by the government agencies. The IC's mandate and capacity are however limited to general-level promotion of India as an investment destination, advice to the government on investment policy and facilitation of very large investment projects.

IBEF is a PPP project to promote India's image as an investment destination

There are also several public-private-partnership initiatives to disseminate information on investment policy and opportunities and to promote India's image as an investment destination. For example, the India Brand Equity Foundation (IBEF)[5] is a PPP project between the Ministry of Commerce and Industry and the Confederation of Indian Industry (CII) set up to build positive economic perceptions of India globally. The IBEF is a one-stop resource centre for global investors, international policy-makers and world media, providing updated, accurate and comprehensive information on the Indian economy.

The CII also has another PPP project, the Overseas Indian Facilitation Centre,[6] with the Ministry of Overseas Indian Affairs. The centre was set up to assist and facilitate the engagement of overseas Indians with the Indian economy, especially to facilitate FDI by overseas Indians.

The Ministry of External Affairs also conducts investment promotional activities

The Investment and Technology Promotion Division under the Ministry of External Affairs conducts broad-based investment promotional activities by

disseminating information on India's economic conditions, policies and opportunities,[7] and participates in discussions with the FIPB, the RBI, and the Board of Trade on liberalisation of the economy and simplification of administrative procedures. The division has close co-operation with FICCI in publishing materials and maintaining its website[8] and interacts with other business associations, Export Promotion Councils, and the DIPP. However, the division has other responsibilities and its investment promotion activities are generally limited to image building and pre-investment services of general nature.

State governments have their own investment promotion and facilitation agencies

State governments have set up a single window clearance system to handle various approvals/clearances required for investment projects, both domestic and foreign. Typically, the Directorate of Industries is the nodal agency for guiding new investors and acts as a single clearance window for investors. While mechanisms of a single window clearance system are more or less the same across states, differences in capacities, public governance and political factors result in diversity in effectiveness of the system. For example, the time taken for obtaining investment approvals varies widely from state to state.

In addition to a single window clearance system, several states have set up state-level IPAs with the aim of promoting both domestic and foreign investment into the states (see Table 3.1). The level of services offered by these state-level IPAs varies widely. While general information services for investors are provided by all, some state-level IPAs can handle various business applications on the e-governance platform, facilitate communications between government offices and investors, offer consulting services for investors, organise investment promotion events, and even provide financing and implement state industrial subsidy schemes.

Table 3.1. **State-level IPA**

State	IPA	Parent ministry	Single Window Clearance Act	Homepage
Andhra Pradesh	Commissariat of Industries; AP Invest	Department of Industries	Single Window Clearance Act 2002	*www.apinvest.co.in*
Bihar	Industries Department	Single Window Clearance Act 2006		
Chhattisgarh	A cell under Department of Commerce and Industries	Industrial Investment Promotion Act 2002		
Gujarat	Industrial Extension Bureau	Industries and Mines Department	None	*www.indextb.com/index.html*
Haryana	Investment Promotion Centre		Industrial Promotion Act 2005	*www.haryanainvest.org*
Karnataka	Karnataka Udyog Mitra	Department of Commerce and Industries	Industries Facilitation Act 2002	*www.kumbangalore.com*
Kerala	Kerala State Industrial Development Corporation, Ltd.			*www.ksidc.org/default.htm*
Maharashtra	Department of Industries, Energy and Labour			
Madhya Pradesh	M.P. Trade and Investment Facilitation Corporation, Ltd.		M.P. Investment Facilitation Act 2008	*www.mptrifac.org/default.htm*
Orissa	Industrial Promotion and Investment Corporation of Orissa, Ltd.	Department of Industry	Orissa Industries (Facilitation) Act 2004	*www.ipicolorissa.com/default.htm*
	Orissa Investment and Export Promotion Office	Office of Resident Commissioner		*www.oiepo.teamorissa.org*
Rajasthan	Bureau of Investment Promotion		None	*www.investrajasthan.com/index.php*
Tamil Nadu	GUIDANCE bureau	Industries Department	None	
Uttar Pradesh	Udyong Bandhu	Infrastructure and Industrial Development Department	None	*http://udyogbandhu.up.nic.in*
West Bengal	WB Industrial Development Corporation	Commerce and Industries Department	None	*www.wbidc.com*

Source: Various state-level governments.

3. Performance of IPAs

> Is IPA adequately funded and is its performance in terms of attracting investment regularly reviewed? What indicators have been established for monitoring the performance of the agency?

Assessment of relationships between budgetary inputs and performance outcomes for IPAs is difficult

Since IPA activities are shared among different government offices at central and state level, and these government offices typically conduct other activities not related to investment promotion, it is hard to assess the relationships between inputs (financial resources) and outputs (performance in attracting investment) for each IPA or the whole of IPAs.

Although a separate cell exists for investment promotion within the DIPP, the IP&IC Cell does not have a distinctive face as an IPA for the country. Some of the functions normally undertaken by IPAs in other countries are shared with other parts of the DIPP (such as the FIIA), other governmental departments/ committees and Indian business associations. As both belong to the same department, the IP&IC Cell and the FIIA do not have independent budgets. It is not possible to extract the actual costs of financing IPA activities within the DIPP except for specific schemes.[9]

Staff working in the IP&IC Cell and the FIIA report to the Joint Secretary of the DIPP who in turn reports to the Secretary, the DIPP and ultimately to the Minister of Commerce and Industry. Currently there are about 11 and 3 staff working for the IP&IC Cell and the FIIA respectively. Given the size of the economy, this staffing is not likely to be sufficient for these bodies to conduct all India's IPA activities unaided. However, the DIPP has actively collaborated with Indian business associations such as CII, FICCI and ASSOCHAM, and may co-finance investment promotion activities with them.

Review of various IPAs' activities to maximise the effectiveness may be useful

India has too many IPAs or agents conducting IPA services. There is not enough interaction and co-operation among them, resulting in an overlap of functions and mandates and an inefficient use of resources. The state-level IPA activities are conducted in various forms with diverse capacities and resources. The DIPP may provide some financial assistance to states' investment promotional activities, but does not offer guidance, monitoring and evaluation to states.

It seems that much has been spent on IPA activities, but that these are fragmented among different agents, rendering assessment of IPA

performance difficult. Networking and benchmarking of performances among different state-level IPAs is non-existent. The government may wish to consolidate IPA activities at the central level and conduct a comparative study of state-level IPAs with a view to optimising financial resources and establishing monitoring indicators.

4. Rationalising administrative procedures

> How has the government sought to streamline administrative procedures to quicken and to reduce the cost of establishing a new investment? In its capacity as a facilitator for investors, does the IPA take full advantage of information on the problems encountered from established investors?

The government has been incrementally removing administrative burdens on investors by reducing the number of approvals required for new investment, making government decisions faster and more transparent, and introducing a single window system of approval where possible.

Most administrative burdens are found at state level

The need to streamline administrative procedures for investment projects lies rather at the state level since most approvals are sought at state, not central, level. After obtaining approval at the central level under either the FIPB route or the RBI's automatic route, an investor is usually required to follow a series of procedures with various government departments including: 1) incorporation of a company with Registrar of Companies; 2) submitting an Industrial Entrepreneurs' Memorandum (IEM) or a Letter of Intent (LOI) and obtaining an industrial licence if necessary; 3) obtaining allotment of land; 4) obtaining permission for land use if a project is located outside an industrial zone; 5) obtaining a no-objection-certificate and permission under the Water and Air Pollution Control Acts from the State Pollution Control Board; 6) obtaining an approval of construction activity and building plan; 7) application for utility services such as water, electricity and sewerage; 8) obtaining factory and boiler clearance and a boiler inspection certificate; 9) registration with tax authorities at both central and state levels; 10) obtaining a code number for export and import if necessary; and 11) other approvals required on a case-by-case basis at the state level. All these steps except three (*i.e.* 1, 2 and 9) are at the state level.

To simplify the many requirements for setting up a business at the state level, Indian state governments have initiated reforms to their administrative procedures to improve the investment climate. However, there are still wide differences between states in the costs and time involved in starting investment projects. While some states have outlined a clear commitment to

administrative reform in their industrial policy statements, have enacted the Single Window Clearance Act, and have set the time limit on each approval step with a provision for deemed approval, some states have lagged behind.

ICT tools are increasingly used to improve government administration

At the central level, a National e-Governance Plan was adopted in 2006 to improve the efficiency and transparency of government services by applying ICT tools (also see Chapter 6). Under the Plan, the DIPP has started an e-Biz project to create a government-to-business (G2B) interface as a one-stop shop for convenient and efficient government services offered to foreign and domestic investors, businesses and industries. In the pilot phase, the DIPP plans to include 25 services[10] in three states under the e-Biz project. These efforts are useful but are not a substitute for more fundamental reforms to simplify administrative procedures.

5. Dialogue with investors

> To what extent does the IPA promote and maintain dialogue mechanisms with investors? Does the government consult with the IPA on matters having an impact on investment?

DIPP has a regular mechanism to interact with individual investors and business associations

The central-level IPAs have continuous interactions with investors, both domestic and foreign. The DIPP has a bulletin board and chat room service though its website where DIPP officers answer investors' questions. Foreign investors can also avail themselves of investment facilitation services *via* the FIIA under the DIPP. Although these services at the DIPP are valuable, the capacity of the DIPP for answering questions and providing guidance is rather limited.

On the other hand, the DIPP has traditionally a good working relationship with apex Indian business organisations such as CII, FICCI and ASSOCHAM. These Indian business associations all make policy advocacy to governments, organise seminars/conferences on policy issues inviting government officials, and conduct and publish relevant research. The influence of these business associations seems to be significant in investment policy areas due to their long-term relationships with governmental departments. The DIPP has regular interactions with foreign investors at bilateral, regional, and international meetings as well as at individual meetings and seems to take a relatively pro-business stance.

The IC is mandated to consult businesses in India and abroad

Since its inception in 2004, the IC has actively interacted with both the government and investors. The IC's terms of reference states that "*the IC will*

seek meetings and visit with industrial groups/houses in India and with large companies abroad, particularly in sectors where there is a dire need for investment but adequate investment has not flowed so far" and that "*the IC will interact closely with the Boards of Directors of potential investing companies*". Accordingly, the IC has met business delegations from major FDI source countries, international and domestic investors, and industry bodies and associations.

The IC has: highlighted specific issues in carrying out several large investment proposals and suggested solutions to relevant government agencies; made recommendations to the government to address large investing companies' concerns; and identified investors to be targeted for new or further investment. The IC's unique position with the government (*i.e.* the IC is given operational autonomy but enjoys the government's overall support) and the high respect accorded by both government and business seem to have made the IC an effective communicator between the two sides.

State government has a single contact point for investors but its role is limited

At the state level, most state governments have nominated one government agency as a single contact point for existing and potential investors. As mandated by state governments, these state-level IPAs interact with investors on a daily basis. However, most state-level IPAs do not have a mandate or the capacity to play the role of policy advocate to the government on behalf of investors. They are at the lower level of state government administration and may be perceived by investors as another manifestation of administrative red tape.

6. Investment incentives

> What mechanisms has the government established for the evaluation of the costs and benefits of investment incentives, their appropriate duration, their transparency, and their impact on the economic interests of other countries?

Most incentives to attract foreign direct investment (as well as domestic investment) are offered by the central government with a view to promoting export-oriented investment projects. They include central government schemes of Special Economic Zones (SEZs), Export-Oriented Units (EOUs), Bio-Technology Parks (BTPs), Electronic Hardware Technology Parks (EHTPs) and Software Technology Parks (STPs).

India has refined its schemes to encourage export-oriented investments

India introduced an incentive scheme in Export-Processing Zones (EPZs) as early as 1965.[11] However, the EPZ model was not successful due to burdensome administrative procedures, poor infrastructure, and instability in fiscal

incentives. The EOU programme followed in 1980, offering the same investment incentives as the EPZ model but with more flexible location choice. Sector-specific investment zones such as the STP, the EHTP and the BTP schemes were introduced later.

Learning from the lessons of the EPZ experiences and the successes in STPs and EHTPs, the SEZ model was adopted in 2000 to remove administrative burdens on investors, provide quality infrastructure and support investors with an attractive package of fiscal incentives. The objectives of SEZs are not only to promote exports, but also to attract investment in the manufacturing sector. To provide policy certainty to the SEZ scheme, the government further enacted the SEZ Act in 2005 and published the SEZ Rules in 2006. Many states have responded positively by establishing enabling laws to facilitate SEZs at state level. In many cases, state-owned development corporations are engaged in developing SEZs on their own as well as in partnership with private-sector enterprises. Before the Act, there were only 19 SEZs in India. Between enactment and end-2007, 558 SEZs were given formal or in-principle approval by the Board of Approval.

The SEZ Act encouraged the private sector to play a more active role in developing SEZs. The legislation allows domestic and foreign enterprises from both public and private sectors or in public-private-partnerships to set up an SEZ as well as an SEZ unit. SEZ developers are provided with financial incentives including: a 10-year tax holiday on revenues; exemption from service tax, central sales tax and dividend distribution tax; and duty free import access to goods. SEZ units are also provided with: a 5-year tax holiday on export income;[12] exemption from central and state sales tax and service tax; duty free import access to goods; public utility status;[13] and more relaxed access to external commercial borrowing. Although the policy is designed to encourage exports from the SEZs, requirements for exports and foreign exchange earnings[14] are – unlike in the case of EPZs – flexible enough for manufacturers to set up SEZ units for domestic sale as well as for exports. FDI regulations are also relaxed to encourage foreign investors to develop SEZs or set up SEZ units.[15]

Administrative burdens have been significantly removed for both SEZ developers and SEZ units. Applications for SEZs are processed through a single-window application procedure and the time limit for approval is set by the SEZ Act. Manufacturers wanting to establish a unit in an SEZ can apply to a zone-level approval committee of the SEZ headed by a Development Commissioner who is a single point contact for various government clearances. For SEZ units, the powers under the Industrial Disputes Act and other labour-related Acts are delegated to the Development Commissioner.

Positive response to the SEZ policy has been recorded

The new SEZ policy has already had some success in increasing exports, generating employment, and attracting investment. A growing number of SEZs is privately owned, developed and operated. As of January 2009, the government

had approved 568 SEZs formally or 144 in principle, of which 315 had been notified.[16] India's SEZs together: exported USD 16.6 billion, accounting for 10.4% of total exports in FY 2007-08;[17] employed 349 203 persons directly as of end-June 2008; and attracted total investment of INR 693 billion with FDI accounting for 8% by March 2008. The most active state in establishing SEZs is Maharashtra, where the state industrial development corporation[18] is actively engaged in SEZ projects. Andhra Pradesh, Tamil Nadu, Karnataka, Haryana and Gujarat follow Maharashtra and these six states together account for 73% of the total number of approved SEZs.

Review of the SEZ policy is ongoing at various levels

The central government has set up mechanisms to review implementation of SEZ policy on a regular basis. The Empowered Group of Ministers, headed by the Minister of Commerce and Industry, was set up to evaluate the rules and regulations on SEZs in 2006. They have recommended several amendments to these regulations. As a regular policy review mechanism, a department-specific Parliamentary Standing Committee on Commerce at the Rajya Sabha Secretariat is responsible for reviewing overall activities of the Ministry of Commerce and Industry. They submitted a report on functioning of SEZs with several recommendations to amend the current SEZ regulations in 2007. Moreover, the Department of Commerce commissioned a study (CUTS International, 2006) on potential costs and benefits of SEZs in India to be used for their own evaluation and review process.

Land acquisition related to development of SEZs has been the most contentious area of review; there have been several protests against SEZs' land acquisitions. While the law imposes minimum size limits and minimum processing areas for each type of SEZs, recently the government also introduced a 5 000 ha universal cap on sizes of SEZs in response to these protests.[19] On the other hand, it is argued that the small size of SEZs is a concern for the effectiveness of SEZs in fully exploiting scale economies as the average size of Indian SEZs is much smaller than that of Chinese SEZs (Kowalski and Dihel, 2009). The issue of tax revenue losses[20] due to SEZs has been debated within the government. The main question is whether tax concessions offered to SEZs are justified *vis-à-vis* the perceived benefits. Since the literature indicates that the overall benefits of SEZs are likely to be limited, the government should continue to reassess the effectiveness and the cost of its SEZ policy against the intended objectives.

India's investment incentives are targeted at specific sectors and backward regions

India does not have specific incentives targeted only at foreign investors. Investment incentives are available for both domestic and foreign investors. Investment incentives at the central government level are designed to promote investment in specific sectors (*e.g.* infrastructure), support the

development of "backward" regions and special category states such as the north-eastern states, Sikkim, Jammu and Kashmir, Uttarakhand and Himachal Pradesh, and encourage exports; and take the form of preferential tax treatment and investment subsidies.[21]

The government has been aware that infrastructure is a key constraint on the sustainability of economic growth and that the investment needs for infrastructure, estimated at USD 500 billion[22] for the 11th Five-Year Plan period, will have to be financed partly by the private sector. Thus, infrastructure sector projects in telecommunications, power, and transport are incentivised with various tax exemptions and holidays.

States offer their own investment incentives without inter-state corporation

Indian states also give a number of investment incentives specified in their respective industrial policies. State-level incentives typically include: tax concessions, exemptions or discounts on utility charges, exemption from registration fee and stamp duty, capital subsidies to new investments in backward districts, small-scale entrepreneurs, women entrepreneurs, and scheduled caste and tribal entrepreneurs. As there is no co-ordination mechanism for state-level investment incentives and investment promotion activities, there is strong competition among the states for investment. An inter-state forum to evaluate impacts of state-level investment incentives on other states' investment environment, for example using the *OECD Checklist for FDI Incentives Policies* (see Box 3.1), may be useful.

Box 3.1. ***OECD Checklist for FDI Incentives Policies***

Use of FDI incentives has been popular at both national and sub-national levels. While incentives competition may in some cases contribute to efficiency in the allocation of FDI, there are important risks that these benefits come at an excessive cost to the domestic as well as international community. Such risks may include distorting impacts on domestic resource allocation, unjustifiable budgetary cost, waste of economic resources, and violation of commitments under international agreements. Since investment incentives often have effects beyond the jurisdiction that offers them, co-operation among different jurisdictions/authorities is crucial.

Given a complex matrix of potential benefits as well as costs and risks of investment incentives, the OECD has developed a list of the most important policy choices in designing FDI incentives. The list is formulated as a set of questions in six broad categories for policy makers to consider when embarking on a policy of offering FDI incentives.

Box 3.1. ***OECD Checklist for FDI Incentives Policies*** *(cont.)*

The six categories are:

- The desirability and appropriateness of offering FDI incentives.
- Frameworks for policy design and implementation.
- The appropriateness of the choice of strategies and policy tools.
- The design and management of individual programmes.
- Transparency of procedures (*i.e.* evaluation, monitoring and follow-up).
- Assessing the extra-jurisdictional consequences of FDI incentive strategies.

The checklist is designed for incentives offered discriminatingly to FDI. However, many questions in the list are also relevant in cases for a sub-national level incentive policy to attract investment to the respective locality. Incentive competition is likely to be more intense among jurisdictions within the same region or those sharing a similar environment. In India, state governments aggressively compete to attract investment by offering various incentives to businesses that decide to locate in their respective localities. The checklist may be useful for policy makers at the sub-national level in formulating incentive packages and for those at the central level in reviewing and co-ordinating various incentives offered at the sub-national level.

7. Measures to promote investment linkages and SMEs

What steps has the government taken to promote investment linkages between business, especially between foreign affiliate and local enterprises? What measures has the government put in place to address the specific investment obstacles faced by SMEs?

India shifted its measures to promote vertical linkages between foreign and domestic investors

The government has recognised the importance of promoting linkages between foreign enterprises and local enterprises which would enhance positive spillover effects from FDI on the local economy. To realise this benefit, the government's FDI policy used to allow only joint ventures by limiting foreign ownership in projects; and India formerly imposed local content requirements on foreign investors in the automobile sector to promote vertical linkages. These measures not only discouraged overall FDI flows into the country but also hindered productivity growth of the restricted sectors. These regulations on foreign ownership and local content requirements have

now been substantially removed and the government uses a more broad-based approach to enhance the capacity of local enterprises and the local labour force so that local economies can maximise benefits from FDI.

State-level IPAs have not been capable of matching foreign and local businesses' interests

A few state-level IPAs can provide business partner matching and directory services to foreign investors. However, no IPA in India has established a comprehensive programme to foster linkages between foreign and local enterprises. Their current strategy to promote partnership between local and non-local enterprises is to organise an investment fair where interested investors can attend to meet potential local partners. The services of partner matching and searching may be valuable especially for local SMEs looking to expand their business and upgrade their process by tying up with foreign partners.

India has traditionally protected the SME sector, but this has produced unintended negative effects

India has a long tradition of protecting the SSI sector with various forms of support programmes. However, some of the SSI protection measures might entail an unintended consequence: hampering growth of the SSI sector. For example, the equity ownership limit imposed on medium-to-large domestic investors and foreign investors might have constrained SSIs from raising further capital and benefiting from backward and forward linkages with these domestic and foreign investors.

8. International and regional investment promotion initiative

> Has the government made use of international and regional initiatives aimed at building investment promotion expertise, such as those offered by the World Bank and other intergovernmental organisations? Has the IPA joined regional and international networks?

Three Indian institutions are members of the World Association of Investment Promotion Agencies (WAIPA): the DIPP, the IBEF and the Rajasthan Bureau of Investment Promotion. Rajasthan is the only state in India which has worked with the WAIPA as a member and was also assisted by UNCTAD's Advisory Services on Investment and Training in 1998 in developing an action plan for investment in integrated industrial parks. Over years, several Indian institutions,[23] both governmental and non-governmental, have participated in annual conferences of the WAIPA. Bihar, India's poorest state, has been assisted by FIAS in improving its investment climate.

While there have been several cases where Indian IPAs have participated in international fora and used assistance from international organisations on

investment promotion, their interactions with international and regional initiatives have been *ad hoc* rather than consistent and continuous. This is probably because Indian IPAs at the central level do not have a clear-cut identity as an IPA and most Indian IPAs at the state level have not developed a strategy to train their staff and hone their expertise.

9. Information exchange networks

> To what extent has the government taken advantage of information exchange networks for promoting investment?

Recently India started a programme of setting up a technical information, promotion and matchmaking centre for industrial subcontracting with assistance of UNIDO. The UNIDO Subcontracting and Partnership Exchanges of India (SPX India)[24] was launched in 2007 with the Ministry of Micro, Small and Medium Enterprises (MSME) as a local government partner. It is also supported by Indian business associations such as the CII, the Automobile Component Manufacturers Association of India, the Indian Shoe Federation, and the Indian Finished Leather Manufacturers and Exporters Association, and SME financiers such as the Small Industry Development Bank of India and the Indian Venture Capital and Private Equity Association. Currently, SPX India focuses on auto components, leather and footwear manufacturing sectors with a target to profile 1 000 Indian manufacturers in these three sectors by the end of 2008. Chennai, Pune and the National Capital Region have established their own local SPXs. Indian IPAs may take advantage of the SPX India programme in their promotional activities.

Notes

1. Major industrial schemes implemented by the DIPP include: modernisation of patent offices, strengthening and enhancing the capabilities of trademark offices, scheme for salt workers, an integrated leather development programme, a transport subsidy, a growth centre, a package for special category states for Jammu and Kashmir, Uttaranchal and Himachal Pradesh, a package for North-East States, an E-Biz project, international cooperation and joint ventures, an industrial infrastructure up-gradation scheme, and a survey of boilers.
2. The system of IEM was introduced to replace the licensing system for delicensed goods and services. To set up a unit to manufacture or expanding production of delicensed goods, an entrepreneur has to submit an IEM to the Secretariat of Industrial Assistance (SIA) under the DIPP for the record.
3. *http://siadipp.nic.in/sia/fiia.htm*.
4. *www.investmentcommission.in/index.html*.
5. *www.ibef.org*.
6. *www.oifc.in/index.aspx*.

7. The division annually publishes "India-Dynamic Business Partner: Investor Friendly Destination" which presents a comprehensive picture of India's economic growth, sectoral developments, social and legal background and potential business and investment opportunities.
8. *www.indiainbusiness.nic.in.*
9. The scheme implemented by the IP&IC Cell had a budget of INR 90 million and INR 140 million for FY 2007-08 and FY 2008-09, respectively.
10. They include 14 central government services, 8 state government services and 3 local body services.
11. The first EPZ in India was Kandla EPZ in Gujarat established in 1965 with improved infrastructure and tax holidays.
12. 50% for the second 5-year period, and 50% of re-invested export profit for the third 5-year period.
13. Public utility status under the Industrial Disputes Act provides certain protection for enterprises from disruptive strikes by requiring workers to give advance notice.
14. SEZ units are allowed to sell their goods in the domestic tariff area as long as they are a net foreign exchange earner for five years.
15. Foreign ownership limits are eliminated for SEZ units in manufacturing sector and all FDI projects in SEZ units are placed under the automatic approval route.
16. *http://sezindia.nic.in/HTMLS/approved-sez.htm*. The number of notified SEZs is as of May 2009.
17. The export share from SEZs was merely 4.7% in FY 2003-04.
18. *www.midcindia.org/midcWebsite/default.aspx.*
19. The government also introduced a new Relief Rehabilitation Policy in 2007 which is expected to safeguard land owners from developers' exploitation.
20. The Ministry of Finance estimated that the revenue losses from SEZs could be over USD 25 billion for FY 2007-10.
21. Units set up in the backward states can enjoy a 100% income tax and exercise duty exemption for 10 years, a transport subsidy for the transfer of raw materials and finished products, and an investment subsidy.
22. The Planning Commission's estimate made in September 2007 as the infrastructure investment required to achieve annual growth of 9%.
23. Indian institutions which participated in annual conferences of the WAIPA include: the Centre for Trade and Investment, the DIPP, the FICCI, the CUTS, the Ministry of Chemicals and Fertiliser, the Rajasthan Bureau of Investment, the Export-Import Bank of India, and the Asian and Pacific Centre for Transfer of Technology.
24. *http://spxindia.org/index.htm.*

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Chapter 4

Trade Policy

This chapter reviews India's trade policy, which has resulted in a rapid transition from one of the most closed large economies of the world to a much more open one. It explains how India's international trade agreements have complemented efforts to expand markets and reduce the cost of trading goods and services across borders. The chapter also examines India's process of formulating trade policies and tariffs, the establishment of consultation mechanisms, and implementation challenges. The analysis is structured around the questions set out in the Policy Framework for Investment *(PFI). Each section is preceded by the relevant PFI question, which serves as general context for consideration of main policy areas.*

India's exports increased by more than 400% between 2000 and 2007, the value of exports reaching USD 250 billion in FY 2007-08.[1] This expansion brought India's market share in world exports up to 1.4% in 2007. Export growth was driven by services exports including software, business, financial and communication services as the service share in total exports increased from 22% in the late 1990s to 36.7% in 2007. During the same period, India's imports also increased by four times to USD 286 billion in FY 2007-08. Import growth was led by strong domestic demand, especially for energy and infrastructure. Hence, India's integration with the global economy has increased substantially over the past decade, the share of trade in GDP increasing from 27% in 2000 to 46% in 2007. India's fast transition from one of the most closed large economies of the world to a relatively more open one is only surpassed by China (Kowalski and Dihel, 2009).

1. Cross-border trade procedures

What recent efforts has the government undertaken to reduce the compliance costs of customs, regulatory and administrative procedures at the border?

India is committed to greater simplification in cross-border trade procedures

India's current Foreign Trade Policy (2004-09) promises the government's commitment to work towards greater simplification, standardisation and harmonisation of trade documents based on international best practices. The government has been developing an automated, electronic environment[2] for filing, retrieval and verification of trade documents which links all government offices involved in trade transactions together with exporters and importers. The electronic data interface (EDI) allows trading agents to file customs documents and licence applications online and enables government offices to share trade administrative information simultaneously. After the launch of the first pilot project at Delhi Customs House in FY 1994-95, the Indian Custom EDI System[3] is currently operational at 23 sites throughout India, providing electronic transaction tools for customs clearances. Introduction of EDI has established a single window for customers and has reduced transaction costs at the border by eliminating multiple manual verifications.

In addition to development of the trade-supporting electronic interface, the procedures in trade transactions across borders have been streamlined: the trade and customs classifications have been harmonised; the number of duty rates has been reduced; document requirements have been reduced by 30% from 2007 to 2008;[4] a risk-based management inspection system was introduced at customs in 2005, allowing customs staff to focus on cargos with a higher risk of faulty declaration; and an electronic database managed by the Directorate General of Valuation has facilitated speedy customs valuation since 2002.

The ease in trading across borders has greatly increased compared to other developing countries…

As a result, costs and time taken for cross-border trade have been reduced, improving India's rank in this category to 90th position in the 2009 World Bank's *Doing Business Survey* – an improvement from 142nd in 2007. Among low-income countries, India was top-ranked in the Logistics Performance Index 2007 (World Bank, 2007), which measures seven critical factors of trade logistics performance: efficiency of cross-border trade clearances, quality of logistics infrastructure, ease of arranging international shipments, competence of local logistic industry, ability to track international shipments, domestic logistics costs and travel time of shipments.

… but there is still scope for improvement to reduce transaction costs for business at borders

However, customs clearances are still more time-consuming in India than the OECD average and there is still scope for improvement of cross-border trade transactions (World Bank, 2004a). Furthermore, India has adopted an extremely complex system of customs duty exemptions and other preferential arrangements through various export promotion schemes which have undermined the government's efforts to simplify customs clearance.

2. Predictability of trade policy

What steps has the government taken to reduce trade policy uncertainty and to increase trade policy predictability for investors? Are investors and other interested parties consulted on planned changes to trade policy?

Trade policy is formulated for a five-year period in consultations with stakeholders

Trade policy formulation and implementation are the responsibility of the Department of Commerce under the Ministry of Commerce and Industry. The Foreign Trade Policy (FTP) is announced for a five-year period, along with annual reviews, by the Department of Commerce. The FTP is then

implemented by the Directorate General of Foreign Trade (DGFT)[5] which is an attached office under the Department of Commerce and has a network of 34 regional offices. A draft of the FTP is widely consulted with other key ministries, the RBI, state governments, industry and farmers' associations, trade bodies, research and academic institutions, and other stakeholders.

Regular consultations are held between the government and businesses on trade policy

The Board of Trade (BOT), set up to provide an effective mechanism to maintain a continuous dialogue with trade and industry, has been advising the government on trade policy measures. Currently the BOT is headed by Chairman of the Aditya Birla Group and has 39 members selected from ministries, banks, large private enterprises, Indian business associations, and export promotion councils. The government maintains regular dialogue with industry through Indian business associations and may also set up *ad hoc* groups of experts to solicit advice on specific trade policy issues.

India's tariff structure is very complex

Import tariffs are set separately from the FTP mentioned above as tariff formulation is a responsibility of Central Board of Exercise and Customs under the Department of Revenue in the Ministry of Finance. A new tariff policy including the peak rate of tariffs[6] is announced every year in India's annual budget by the Ministry of Finance; however, the applied tariff rates are frequently changed on an *ad hoc* basis *via* notifications by the Ministry of Finance after approval by the Parliament throughout the year.

Complicating the actual tariff structure, these announced tariffs are exempted or reimbursed under various trade incentive schemes which are adopted in the FTP and its annual supplements to the FTP by the Ministry of Commerce and Industry.[7] As of 2008, there were 655 types of duty exemptions serving different purposes.

India had an overall tariff bound rate of 48.6%[8] in 2007. However, the actually applied tariff rate is much lower than the bound rate for most tariff lines, resulting in a wide gap between the two rates. This large gap may create uncertainty for importers as it gives the government a room to raise the actual tariffs substantially (WTO, 2007).

India also has consultation mechanisms for tariffs

Consultation on tariffs is undertaken in various channels. The Tariff Commission of India,[9] set up in 1997, has provided expert recommendations on tariff levels and structures. The ministry regularly conducts stakeholder consultations on changes in policy and regulations. For example, during the negotiation of regional trade agreements (RTAs), finalisation of the items on which tariffs would be liberalised is done with stakeholder consultation.

3. International trade agreements

> How actively is the government increasing investment opportunities through market expanding international trade agreements and through the implementation of its WTO commitments?

India has complied with multilateral agreements to liberalise its trade policy

India is a founding member both of the General Agreement on Tariffs and Trade (GATT) in 1945 and of its successor, the WTO, in 1995. In the Uruguay Round negotiations (1986-94), India agreed to reduce tariffs on a large number of products covering 65% of total tariff lines and eliminate quantitative restrictions on all commodities except for about 600 items. In 2001 and 2002, India further removed quantitative restrictions on textiles and another 1 429 items which had been protected for balance of payments reasons as required by its WTO commitments.[10] Subsequent review of remaining quantitative restrictions has further narrowed the list of restricted items to those necessitated on account of security, health, safety, environment and public morals in accordance with Articles XX and XXI of the GATT.

During the Doha Round negotiations since 2001, India has maintained a firm position to safeguard the interest of low-income farmers in rural areas, gain substantial market access for India's service providers and allow sufficient flexibility to address the sensitivities and developmental concerns of developing countries. India's stance in services trade negotiations at the WTO has shifted from a very defensive one to a pro-liberalisation position as India's comparative advantage in the services sector has resulted in massive expansion in its services exports. India's submissions of commitments in services to the WTO increased considerably after 2001 and India has shown more willingness to liberalise new services sectors.

India has concluded a number of regional trade and investment agreements

Although India advocates a multilateral trade regime on WTO principles and was in the past cautious about adopting a regional approach, India today recognises the role of regional trade agreements given the slow pace of progress in the WTO negotiation and the proliferation of RTAs across the world. India has concluded or been in various stages of negotiations of a number of regional trade and investment agreements (see Annex 2.A3).

India's first concluded regional trade agreement was the Bangkok Agreement in 1975 which brought tariff concessions among 7 member countries (Bangladesh, India, Korea, Laos, Philippines, Sri Lanka and Thailand)

based on the principle of the Global System of Trade Preferences among Developing Countries. China's accession to the Bangkok Agreement led to the signing of the Asia-Pacific Trade Agreement (APTA) in 2005, extending agreements to institutional organisation and dispute resolution mechanism. The APTA had held three rounds of trade negotiations by the end of 2008[11] and aims to extend negotiations into other areas such as non-tariff measures, trade facilitation, services and investment in the near future.

In the South Asia region, the South Asian Association for Regional Co-operation (SAARC), created by seven South Asian countries[12] in 1983, was one of the first international organisations in Asia to develop economic co-operation in various areas. Tariff liberalisation among the SAARC member countries led to the launch of the SAARC Preferential Trade Agreement (SAPTA) signed in 1993, and the South Asia Free Trade Area (SAFTA) effective since 2006, however it has not been very effective due to political difficulties between India and Pakistan, lack of commitment to reduce non-tariff barriers (NTBs) and remaining market access restrictions through trade restriction quotas and rules of origin. The SAFTA covers only trade in goods, not in services, and tariff reduction in goods has been very slow. Given the difficulties in advancing regional trade liberalisation via the SAARC, India has developed bilateral trade agreements with individual countries in South Asia, including Afghanistan, Bangladesh, Bhutan, Nepal and Sri Lanka.

The Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Co-operation (BIMSTEC)[13] was established in 1997 to advance sub-regional co-operation in the areas of trade, investment, and technological exchange. It was visualised as a bridging link between the two major regional economic groupings, namely the ASEAN and the SAARC, and serves India's "Look East" strategy. Since the signing of the Framework Agreement in 2004, the BIMSTEC has entered a new phase of co-operation toward establishing an FTA in goods, services and investment. However, negotiations on the BIMSTEC FTA have not progressed so far except for goods.

In spite of many regional agreements, India's trade integration in South Asia has been slow

These regional trade agreements have a potential to make the South Asia region more attractive to investors as they can ensure easier market access within the region and encourage imports of intermediate/capital goods from other member countries. However, their scope has been limited and implementation has been slow. India continues to shield sensitive sectors such as those employing marginal farmers, artisans and fishermen, and highly labour-intensive sectors from foreign competition. Unlike China, which has successfully inserted itself into the regional production chain, India is not highly integrated with other economies in the region in terms of trade linkages.

India is seeking regional co-operation in a larger area of economic policy beyond South Asia

Outside the South Asia region, India's interest in trade liberalisation has become more prominent with economies in East and South-East Asia. India signed a Framework Agreement on Comprehensive Economic Co-operation with ASEAN in 2003 and several bilateral trade agreements with East-Asian countries including a Comprehensive Economic Co-operation Agreement (CECA) with Singapore in 2005 and a Framework Agreement for establishing an FTA with Thailand in 2003. The India-Singapore CECA was the first signed by India that covered not only goods, but also services and investment.[14]

Understanding that the mere easing of border trade barriers *via* tariff liberalisation may not bring mutual economic gains unless behind-the-border barriers and distortionary domestic regulations are addressed, India seems now to prefer a more comprehensive approach in negotiating international trade and investment agreements.

4. Trade policy distortions in investment

> How are trade policies that favour investment in some industries and discourage it in others reviewed with a view to reducing the costs associated with these distortions?

In the pre-reform period, India had one of the most restrictive trade regimes in Asia. Trade policy moved towards liberalisation since the mid-1980s as the government's development strategy gradually shifted from import substitution to export-led growth. Nonetheless, the trade-weighted average tariff was high at around 87%; 92% of internationally tradable domestic production was sheltered behind quantitative import restrictions in the late 1980s.

A drastic change in trade policy was triggered by the balance-of-payments crisis in 1991 when a structural adjustment programme including major trade policy reform[15] was agreed with the IMF. Most of the reform was implemented over the Eighth Five-Year Plan (1992-97) period. The peak tariff[16] was reduced from about 400% to 150% in July 1991, and further down to 40% by FY 1997-98.[17] The average tariff fell from more than 80% in 1991 to around 30% in 1997 and continues to fall as the government aims to reduce its tariff level to ASEAN level on non-agricultural products by 2009.[18] India also reduced the use of non-tariff barriers significantly as the coverage of NTBs on imports declined from over 90% in FY 1988-89 to below 25% in FY 1999-2000.

Under the pre-reform trade regime, imports of manufactured consumer goods were completely banned and imports of most items were only allowed

with import licences. India switched its import regime from a positive to negative list approach in 1992 when all 26 import licensing lists were abolished except for a negative list. Since then delicensing has continued by moving more items from the banned or restricted list to an Open General Licence (OGL) list. While the government maintains control of imports of a few products through canalisation,[19] the share of imports subject to such canalisation decreased substantially from 67% in FY 1980-81 to 27% in FY 1986-87.

However, India's trade regime is still relatively restrictive, affecting the types of FDI projects

Despite progress in trade liberalisation, India's trade regime is still much more restrictive than those of other large emerging economies.[20] The restrictive trade regime has provided a high level of effective market protection for Indian manufacturers, giving them an incentive to produce for the domestic market rather than export markets.

The high production cost structure has made India less attractive as a base for export production, especially the production of labour-intensive exports, and has attracted FDI projects much more oriented to the protected domestic market. The relatively high import tariffs have an especially damaging effect on the competitiveness and the productivity of Indian manufacturing as a disproportionate proportion of India's imports are used as intermediate inputs by domestic manufacturers rather than sold for final consumption (Kowalski, 2008).

A complex system of tariff exemption schemes has been developed with a risk of creating distortions

To offset the high cost burden of imported intermediate and capital goods, the government has adopted an extremely complex system of duty exemption, duty reimbursement and import credit programmes which are meant to give incentives to exporting enterprises. For example, the Foreign Trade Policy (2004-09) included: four tariff neutralisation schemes[21] to exempt exporters from customs and other duties on imports used for producing exports; the Export Promotion Capital Goods scheme[22] to allow import of capital goods at a reduced tariff rate in exchange for an export obligation; the Served from India scheme to entitle service providers to duty credits equivalent to 10% of free foreign exchange earned during preceding financial year; and the Industrial Park schemes to permit duty free access to import.

However, the selective incentives to neutralise the high import tariff burden and other business transaction costs are no more effective in enhancing efficiency and productivity of the Indian economy than would be a policy of removing the actual bias itself and liberalising trade in a

non-discriminatory manner. The specific duty exemption schemes may impose high transaction costs and delays on exporters who try to obtain licences for these schemes, negating financial benefits from the schemes.

5. Cost of imported inputs

> To what extent do trade policies raise the cost of inputs of goods and services, thereby discouraging investment in industries that depend upon sourcing at competitive world prices?

Trade liberalisation started with imports of capital and intermediate goods

Since the government realised that the higher costs of imported inputs and capital goods had been translated to the higher production cost of manufacturing, India's tariff reform started first with capital and intermediate goods before being extended to final goods. Trade liberalisation for capital and intermediate goods was also relatively easy since there were not many domestic manufactures in these industries. Import licensing requirement was lifted for all capital and intermediate goods in 1991 while delicensing for consumption goods was only undertaken 10 years later. Capital and intermediate goods were moved onto the OGL list much earlier than consumption goods and enjoyed larger tariff reduction. Furthermore, to offset the tax incidences on exports, the government has introduced a number of specific incentives to allow export manufacturers to have cheaper access to imported capital goods and inputs.

Better access to imports of capital and intermediate goods benefited India's economy

India's trade reforms have contributed to the expansion of imports into India as well as a reduction in the unit price of import substitutes. Consistent with the trade policy favouring imports of capital and intermediate goods, the overall increase in imports was dominated by an increase in imports of intermediate goods rather than of final goods during the 1990s. Availability of a wider range of imported intermediate goods at lower prices led to a reduction of the marginal cost of production for many manufacturers in India, which in turn boosted domestic production of final manufactured goods. Benefits from trade reform also took the form of the introduction of new products using cheaper and newly imported inputs as a wider variety of accessible intermediate imports relaxed technological constraints for Indian manufacturers (Goldberg *et al.*, 2008).

6. Measures to avoid a negative effect on investment

> If a country's trade policy has a negative effect on developing country exports, what alternative means of accomplishing public policy objectives has the government considered, taking into account the dampening effect that such a restrictive trade policy also has on investment?

India has advocated a trade regime which allows developing countries preferential access to developed country markets and flexibility in international commitments to trade liberalisation. By adhering to the principle that least developed countries (LDCs) should be provided integrated development assistance, including enhanced market access, for their exportable products, India had offered preferential tariff concessions to imports from LDCs in the framework of RTAs and FTAs.

In line with the decision[23] taken at the WTO Hong Kong Ministerial Meeting in 2005 to provide duty-free quota free market access to LDCs, India announced the Duty Free Tariff Preference Scheme for all LDCs[24] in 2008 which grants preferential tariffs except for 326 items (6% of total tariff lines) on the exclusion list.

Notes

1. The figures are from World Bank's World Development Indicators. The amount includes goods and services exports.
2. Electronic Database Interface (EDI) is included in India's National e-Governance Plan.
3. *http://ices.nic.in/ICES/Home.aspx*.
4. According to the World Bank's *Doing Business India 2009*, the number of documents required for export and import fell from 27 and 15 respectively in the 2007 publication to 17 and 9 in the 2009 publication.
5. *www.dgft.gov.in*.
6. The "peak rate" announced for FY 2007-08 was 10% for non-agricultural goods except for new and second hand cars/two wheelers, natural rubber, fish, mixture of odoriferous substances, textile fabrics and garments; and there was no change announced for FY 2008-09.
7. Due to these customs exemptions, the average tariff rate based on duty collection is about 10% compared with the average statutory tariff rate of 15.8% in FY 2006-07.
8. Arithmetic mean of bound rates in FY 2006-07.
9. *http://tc.nic.in/default.htm*.

10. Quantitative restrictions on imports of manufactured consumer goods and agricultural products were finally removed in 2001 because of a ruling by a WTO dispute panel on a complaint brought by the United States.
11. The fourth round of trade negotiations started in October 2007.
12. Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. Afghanistan joined the SAARC in 2007.
13. Members are: Bangladesh, India, Sri Lanka, Thailand, Myanmar, Bhutan and Nepal.
14. In the area of investment, the CECA stipulated investment protection clauses and provided Singapore's investment in India with an exemption from capital gains tax. For services, commitments made by India on financial services go beyond its GATS commitments.
15. The trade reform package included rationalisation of tariffs, removal of quantitative restrictions on imported inputs and capital goods for export production, and abolition of the public sector monopoly on all imports except a few products.
16. This peak rate is applicable to all manufactured and mineral products except alcoholic beverages and automobiles.
17. Further reduced to 30% in 2002. The peak rate tariff announced in the FY 2008-09 Budget is 10%.
18. The MFN applied simple average tariff was 14.5% in FY 2007-08, down from 32% in FY 2001-02, while the import-weighted tariff average was 7.8%.
19. Commodity imports such as petroleum products, some pharmaceuticals, some chemical products and bulk grains must be channelled through public sector companies.
20. Kowalski and Dihel (2009) pointed out that the trade-weighted average tariffs of 62% in agriculture and 9% in manufacturing increased costs of production in India.
21. Advance Authorisation, Duty Free Import Authorisation, Duty Entitlement Passbook, and Duty Drawback schemes.
22. The export obligation is equivalent to 8 times the amount of duty saved over an 8-year period. The reduced duty rate of 5% was further reduced to 3% in the 2008 annual supplement to the Foreign Trade Policy.
23. This decision requires all developed country members and developing country members declaring themselves in a position to do so to provide duty free quota free market access for all products originating from LDCs by 2008 or no later than the start of the implementation period. Developing country members such as India were permitted to phase in their commitments and can enjoy appropriate flexibility in coverage.
24. They consist of 50 LDC members.

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Chapter 5

Competition Policy

India has enacted a Competition Act to replace the outdated Monopolies and Restrictive Trade Practices Act. This chapter examines the new Act and points out challenges ahead for the recently established Competition Commission of India. The analysis is structured around the questions set out in the Policy Framework for Investment *(PFI). Each section is preceded by the relevant PFI question, which serves as general context for consideration of main policy areas.*

Competition policy favours innovation and contributes to conditions conducive to new investment. Sound competition policy also helps to transmit the wider benefits of investment to society.

1. Competition legal framework

> Are the competition laws and their application clear, transparent, and non-discriminatory? What measures do the competition authorities use (*e.g.* publishing decisions and explanations on the approach used to enforce the laws) to help investors understand and comply with the competition laws and to communicate changes in the laws and regulations?

Competition regulation has lagged behind economic reform, but is now catching up

The economic reforms of recent decades have been largely focused on the gradual dismantling of entry barriers in more and more sectors as policies have moved away from central planning and the protection of small producers towards a more market-driven economy. These reforms have allowed increasing scope for the entry of domestic private entrepreneurs and foreign investors in sectors previously reserved for state-owned enterprises and small firms. The licensing of industrial activity has been largely eliminated. While there is still scope for further reform, for example by resuming the stalled privatisation programme and relaxing remaining restrictions on foreign investment, it is clear that the reforms already enacted have transformed India's economy by allowing far greater competition, resulting in higher GDP growth rates. The law and enforcement structure for dealing with constraints on competition have lagged behind this transformation and are now in the process of rapid catch-up.

The Competition Act 2002 replaces an outdated Monopolies and Restrictive Trade Practices Act

The first enactment dealing with competition issues in India was the Monopolies and Restrictive Trade Practices (MRTP) Act 1969, which came into force on 1 June 1970.[1] The MRTP Act was designed to ensure that the operation of the economic system does not result in the concentration of economic power to the common detriment and to prohibit such monopolistic and restrictive trade practices that are prejudicial to public interest. The MRTP Commission was established for the purposes of this Act. By an amendment

in 1991 the state-owned enterprises, with a few exceptions, were also brought under the purview of the Act. The agreements relating to restrictive trade practices, listed in Section 33 of the Act, must be registered, but agreements that are expressly authorised by any other law or have the approval of central government or to which the government is a party are exempted from such registration. The deeming of a restrictive trade practice to be prejudicial to the public interest is hedged about with a number of exceptional circumstances under which it may not be applied, for example that the resulting removal of the restriction may adversely affect employment or exports (Section 38). The provisions relating to unfair trade practices were brought under the purview of the Act by an amendment in 1984 with a view to protecting consumers against false or misleading advertisements or other similar unfair trade practices.

The MRTP Act was found to be insufficient to meet the new policy aim of building a competitive market economy with a steadily growing private sector. New legislation was needed to promote competition at a time when private enterprises were growing in power and government monopolies were being dismantled. While the MRTP Act covered restrictive practices, it did not cover abuse of dominance, which has become an increasing concern. The role of the MRTP Commission was restricted to dealing with cases referred to it, and there was no provision for the Commission to play an active role in promoting competition by educating the public and reviewing government policies and enactments to ensure that they enhance, and not restrict, competition. While the Act did confer powers, including powers of inquiry, on the MRTP Commission, the financial penalties which backed up these powers were eroded by inflation. The MRTP Act stands repealed from 1 September 2009. The MRTP Commission will continue to hear cases filed before that date for a further two years.

In 1999, the government decided to shift the focus of competition policy from curbing monopolies to promoting competition by appointing a committee to suggest a modern competition law. Pursuant to the recommendations of this committee, the Competition Act 2002 was enacted on 13 January 2003. A number of detailed amendments and addenda were provided by the Competition (Amendment) Act 2007. These amendments include a provision of setting up a Competition Appellate Tribunal, which will be a committed body to deal with the appeals against the decisions/orders of the Competition Commission of India and to deal with compensation claims arising out of the decision of the Commission and Arbitration Tribunal.

The Competition Act 2002 prohibits anticompetitive agreements and abuse of dominant position, and also provides for the regulation of mergers and acquisitions to prevent adverse effects on competition. It provides for the creation of the Competition Commission, with clearly specified composition and powers, to administer the law, and sets out detailed provisions on procedures and penalties.

The Competition Act is non-discriminatory

All economic entities are covered by the Competition Act 2002, including private enterprises and government bodies, both central and local, except where they are in discharge of sovereign functions. The word "person" is defined in the Act to include: an individual; a Hindu undivided family; a company; a firm; an association of persons, whether incorporated or not, in India or outside India; any corporation established under any central, state or provincial act or a government company; any corporate body incorporated outside India; a co-operative society; a local authority; every artificial judicial person not falling into the preceding categories. The word "enterprise" includes government bodies acting as economic units, as opposed to carrying out sovereign functions.

The Competition Commission is intended to be expert and independent

The Competition Commission consists of a chairperson and not less than two and more than six other members. These are all appointed by the central government on the recommendation of a selection committee headed by the Chief Justice of India or his nominee and including the Secretary in the Ministry of Corporate Affairs, the Secretary in the Ministry of Law and Justice and two experts in a relevant academic subject.

All members of the Commission hold office for a term of five years and are eligible for re-appointment. Members of the Commission can be removed from office by the central government on the recommendation after an enquiry made by the Supreme Court following an inquiry initiated after a reference made to the Court by the central government. The structure of the Commission is not further specified in the Act, however, these are to be prescribed by rules to be made under the Act.

The Commission is funded by grants from the central government. These are placed in a Competition Fund, which is administered by a committee of members of the Commission chosen by the Chairperson. The Commission must maintain proper accounts for audit by the Comptroller and Auditor-General of India, and must also prepare annual reports giving a true and full account of its activities to the central government for presentation to each House of Parliament.

Prohibition of anticompetitive agreements

Section 3 of the Act states that no enterprise or association of enterprises or person or association of persons shall enter into any agreement in respect of production, supply, distribution, storage, acquisition or control of goods or provision of services which causes or is likely to cause an appreciable adverse

effect on competition within India. Any agreement that contravenes this provision is considered void.

Agreements presumed to have an appreciable adverse effect on competition are those horizontal agreements which: directly or indirectly determine purchase or sales price; limit or control production, supply, markets, technical development, investment or the provision of services; share the market or source of production or provision of services by allocating geographical area or market, or type of goods or services, or number of customers; directly or indirectly result in bid rigging or collusive bidding.

Other forms of horizontal agreements are prohibited if they cause or are likely to cause an appreciable adverse effect on competition. Similar is the case with vertical agreements, including: *tie-in arrangements*, which require a purchaser to purchase other goods as a condition of purchase; *exclusive supply agreements*, which restrict the purchaser from dealing with other sellers; *exclusive distribution agreements*, restricting output or supply of goods and services or allocating any area or market for the disposal and sale of goods; *refusals to deal*, which restrict the persons or classes of persons to whom goods are sold; and *resale price maintenance*, *i.e.* forcing retailers to charge set prices.

Exceptions to prohibition include the imposition of reasonable conditions necessary to protect intellectual property rights specified in the Act. Agreements relating to the production, supply, distribution or control of goods or provision of services for export are also exempted.

Prohibition of abuse of dominant position

Section 4 of the Competition Act 2002 states that no enterprise or group shall abuse its dominant position. Dominant position is defined in the Act as a position of strength enjoyed by an enterprise in the relevant market in India which enables it to operate independently of competitive forces there or affect its competitors or consumers there in its favour. Abuse of dominant position includes: directly or indirectly imposing an unfair or discriminatory condition or price (including predatory price) in the purchase or sale of goods or services; limiting or restricting the production of goods or the provision of services or market therefore, or technical or scientific development relating to goods or services to the prejudice of consumers; or denying market access in any manner; making contracts dependent on the acceptance of unrelated supplementary obligations; or using a dominant position in one market to enter into, or protect, another market.

The regulation of combinations

Combinations covered by the Competition Act 2002 include mergers and acquisitions involving large enterprises, *e.g.* acquisitions in which the acquirer and the enterprise being acquired have joint assets of over 10 billion rupees or turnover of more than 30 billion rupees in India, or, in India and abroad, assets

of over USD 500 million, including at least 5 billion rupees in India, or turnover of over USD 1.5 billion, including at least 15 billion rupees in India. When one or more enterprises involved in the combination belong to a group, the threshold is four times higher. Another category of combinations that is covered involves the acquisition of control by a person over an enterprise when the person already has direct or indirect control over another enterprise producing, distributing or trading similar or substitutable goods or services, also subject to minimum size criteria.

Combinations causing or likely to cause an appreciable adverse effect on competition within the relevant market in India are void.

Notice must be given to the Competition Commission of any such combination within thirty days of the approval of a merger proposal by the boards of directors concerned or the execution of any agreement for acquisition. The combination can come into effect after two hundred and ten days from the date of such notice or when the Commission approves it, whichever is earlier.

If the Commission considers that a combination has caused, or is likely to cause an appreciable adverse effect on competition, it may issue a notice calling on the parties to respond within thirty days of receipt of the notice to explain why an investigation should not be conducted. Within seven days of receiving a reply to this notice the Commission can, if not persuaded otherwise, direct the parties to publish details of the combination within ten working days, and may then invite any person or member of the public who might be affected by the combination to file written objections to it within fifteen working days from publication of these details. After receiving the written objections, within 15 days, the Commission may call for such additional or other information as it may deem fit from the parties. The additional or other information may be furnished by the parties within 15 days. After receipt of all information, the Commission must then make a judgment within forty-five working days.

The Commission may, after such consideration, decide to: 1) approve the combination; 2) direct it not to take effect; or 3) propose appropriate modification to eliminate any appreciable adverse effect on competition. In case 3), the parties must carry out the modification within the period specified by the Commission, or the combination is deemed to have an appreciable adverse effect on competition and will be dealt with accordingly. If the parties submit an amendment that is accepted by the Commission, the combination will be approved; if unacceptable, the Commission may propose a modification that the parties then have thirty working days to accept.

2. Resources of the competition authorities

> Do the competition authorities have adequate resources, political support and independence to implement effectively competition laws?

The Competition Commission has powers of enforcement and inquiry…

The Competition Commission is empowered to take strong remedial actions to deal with anticompetitive agreements and abuse of dominant position. During the course of an inquiry, it can pass an interim order restraining a party from continuing with such an agreement or abuse for the duration of the inquiry. It can impose a penalty of up to 10% of the average turnover of an enterprise for the three preceding financial years. In the case of a cartel, the Commission can impose on each member a penalty of up to three times the profit or up to 10% of turnover, whichever is higher, for each year of the continuation of such an agreement. After the inquiry, the Commission may issue a cease and desist order directing a delinquent enterprise to discontinue and not to re-enter an anticompetitive agreement or abuse its dominant position. The Commission may also direct that an enterprise enjoying a dominant position be divided.

The Competition Commission also has powers of inquiry, supported by penalties for non-compliance with its procedures, including the power to: order compensation for loss or damage incurred by contravention of its orders; a fine of 100 000 rupees per day for failure to comply with its directions; a penalty of up to 1% of total turnover or assets, whichever is higher, for failing to furnish information on a combination; a fine of from 500 000 to 10 million rupees for knowingly making a false statement or omitting any material particular.

… with no automatic exemptions…

Unlike the MRTP Act, the Competition Act 2002 does not grant automatic exemptions to government-related bodies. The central government does, though, have the power to grant specific exemptions on grounds of: security of the state or public interest; international treaty, agreement or convention obligation; the performance by an enterprise of a sovereign function on behalf of the central government or a state government.

… but a limited competition advocacy role

Section 49 of the Competition Act 2002 gives the Competition Commission a role in competition advocacy which its predecessor, the MRTP Commission, did not have. Both central and state governments may refer policies and laws on competition or any other matter to the Commission for its opinion on the possible effect. The Commission must then give its opinion within 60 days of such a reference.

However, no obligation is imposed on any government body to make a reference to the Commission, and the Commission's opinion is non-binding. Nor does the Act empower the Commission to take the initiative in selecting for its review policies or laws which might affect competition.

Section 49 also enjoins the Commission to take suitable measures for the promotion of competition, creating awareness and imparting training about competition issues. The Commission has accordingly established a website *www.cci.gov.in,* on which can be found details of its competition promotion and education activities, including: four workshops on competition policy and law it organised in New Delhi and Mumbai in 2006-08; 24 articles explaining competition law published by the Commission in major newspapers; and 76 presentations on competition law and related topics. The Commission has published a series of seven advocacy booklets outlining the Commission's activities, including its competition compliance programme for enterprises, and explaining key concepts in the Competition Act 2002, including abuse of dominance, bid-rigging, cartels and intellectual property rights. The Commission has informed the OECD[2] that it is intensively engaging stakeholders, has organised over 100 workshops and seminars, and has a network of nodal government departments at the state level. Nodal officers have been appointed by 28 states and union territories. Five states have also constituted state-level Competition Advisory Committees with representation from various stakeholders.

3. Anticompetitive practices of incumbent enterprises

> To what extent, and how, have the competition authorities addressed anticompetitive practices by incumbent enterprises, including state-owned enterprises, that inhibit investment?

The Competition Commission started work in 2009

All seven members of the Competition Commission were appointed in 2009. However, the number of support staff remains far short of the original target, as is clear from a comparison of the existing and proposed organograms on the Commission's website (*www.cci.gov.in*).

The Monopolies and Restrictive Trade Practices (MRTP) Act remains temporarily in force

Under Section 66 of the Competition Act 2002, the Monopolies and Restrictive Trade Practices (MRTP) Act stands repealed and the Monopolies and Restrictive Trade Practices Commission (MRTPC) stands dissolved, but may continue for two years from the commencement of the Competition Act with effect from 1 September 2009 to deal with all cases lodged before commencement under the provisions of the MRTP Act. The backlog of cases will thus be handled by the MRTPC until 2011.

4. Capacity of the competition authorities

> Do the competition authorities have the capacity to evaluate the impact of other policies on the ability of investors to enter the market? What channels of communication and co-operation have been established between competition authorities and other relevant government agencies?

The extent to which the competition authorities have the capacity to evaluate the impact of other policies on the ability of investors to enter the market remains to be determined. The relationship of the Competition Commission with sector-specific independent regulators is not well-defined and the consequent overlapping of regulatory jurisdictions may cause uncertainty for businesses. While the Commission has not yet established channels of communication with other government agencies, it has provided its opinions on several pieces of draft legislation, such as the draft Postal (Amendment) Bill 2006, draft Carriage by Road Bill 2005, draft Shipping Trade Practices Bill 2006 and the Warehousing (Development and Regulation) Bill 2005.

5. Costs and benefits analysis of industrial policies

> Does the competition authority periodically evaluate the costs and benefits of industrial policies and take into consideration their impact on the investment environment?

The Competition Authority has not yet started its work, so it has no record of evaluating the costs and benefits of industrial policies or their impact on the investment environment. However, under its advocacy mandate, the Commission looks at the economic policies of the government from the perspective of competition. There is provision for central and state governments to refer issues to the Commission for comment. The Commission is expected to give its views, which are advisory, not mandatory, within 60 days.

6. Monitoring of privatisations

> What is the role of the competition authorities in case of privatisations? Have competition considerations having a bearing on investment opportunities, such as not permitting market exclusivity clauses, been adequately addressed?

The Commission has no explicit role in monitoring industrial policy or privatisations. Like the MRTP Act, the Competition Act 2002 does not specify a role for the Commission in monitoring privatisations or in evaluating the costs and benefits of industrial policies. Whether such a role will develop remains to be determined once the Commission has started work.

7. International co-operation

> To what extent are competition authorities working with their counterparts in other countries to co-operate on international competition issues, such as cross-border mergers and acquisitions, bearing on the investment environment?

The Commission has powers to inquire into an anticompetitive agreement or abuse of dominant position taking place outside India, if it has, or is likely to have, an appreciable adverse effect on competition in India. Such inquiries may be facilitated by agreements with other countries. The Competition Commission is empowered under Section 18 of the Competition Act 2002 to enter into any memorandum or arrangement with any agency of any foreign country, provided that this has received prior central government approval and is for the purpose of discharging the Commission's duties under the Act. This is a distinct improvement on the MRTP Act, which contained no provision for international co-operation on competition.

The Commission reports that it has not yet signed agreements with other competition authorities, but has the mandate to enter into memorandums of understanding to cover its needs.[3] The provisions on external co-operation for enforcement have not yet been used because the Commission has not yet started enforcement work.

Notes

1. A full text of the MRTP Act is on the Ministry of Corporate Affairs website, *www.mca.gov.in*.
2. During the OECD research mission to New Delhi, 4 July 2008.
3. OECD research mission to New Delhi, 4 July 2008.

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Chapter 6

Other Aspects of the *Policy Framework for Investment*

This chapter examines enabling factors in India's investment environment, including tax policy, corporate governance, policies for promoting responsible business conduct, human resource development, infrastructure and financial sector development, and public governance. It highlights related measures taken by the government of India, such as the e-governance programme to enhance efficiency and transparency in corporate and public governance and public-private partnership (PPP) initiatives to develop the country's infrastructure. The analysis is structured around the questions set out in the Policy Framework for Investment *(PFI). Each section is preceded by the relevant PFI question, which serves as general context for consideration of main policy areas.*

1. Tax policy

To fulfil their functions, all governments require taxation revenue. However, the level of the tax burden and the design of tax policy, including how it is administered, directly influence business costs and returns on investment. Sound tax policy enables governments to achieve public policy objectives while also supporting a favourable investment environment.

Resident and non-resident companies are taxed at different corporate tax rates…

A company is said to be resident in India in any previous year if it is an Indian company, *i.e.* if it is registered in India, or if, during that year, the control and management of its affairs is situated wholly in India (1961 Act, Chapter II, Section 6). An enterprise that is wholly or partly foreign-owned is therefore taxed in exactly the same way as a domestically-owned enterprise as long as it meets one or both of these residency requirements and is thus a "domestic" company. For such companies, the corporation tax rate, levied on all income, regardless of source location, is 30% plus a 3% education cess, totalling 30.9%, for taxable income up to 10 million rupees, and 30% plus a 10% surcharge and 3% education cess, totalling 33.99%, where taxable income exceeds 10 million rupees.[1]

Foreign companies are defined as those whose control and management are situated outside India. Corporation tax is only levied on their income in India, at 40% plus 3% education cess, totalling 41.2%, for taxable income up to 10 million rupees, and 40% plus 2.5% surcharge and 3% education cess, totalling 42.23%, where taxable income exceeds 10 million rupees. Foreign investors can avoid these higher rates of tax by establishing companies that are registered and/or controlled and managed in India.

… and states provide tax incentives to attract both domestic and foreign investment

India's states, who compete with each other fiercely for investment, provide several tax incentives to attract investment, both domestic and foreign. These include: tax concessions, electricity charge exemptions, and exemptions from registration fees and stamp duty. The availability of a plethora of tax incentives at many levels may be less than wholly transparent, as it can create confusion among potential investors. Incentives are especially

prevalent in the Special Economic Zones (SEZs), where they include: exemption from customs and excise duties; excise duty drawbacks; exemption from service tax, securities transaction tax and taxes on the sale or purchase of goods other than newspapers; income tax concessions; and a sales tax holiday for a set period.

The central government is working toward preventing wasteful tax competition among states. The *OECD Checklist for FDI Incentive Policies* (2003a) provides a list of issues for central/local government dialogues.

2. Corporate governance

The degree to which corporations observe basic principles of sound corporate governance is a determinant of investment decisions, influencing the confidence of investors, the cost of capital, the overall functioning of financial markets and ultimately the development of more sustainable sources of financing.

> What steps have been taken to ensure the basis for a corporate governance framework that promotes overall economic performance and transparent and efficient markets? Has this been translated into a coherent and consistent regulatory framework, backed by effective enforcement?
>
> How does the corporate governance framework ensure the equitable treatment of shareholders?
>
> What are the procedures and institutional structures for legal redress in cases of violation of shareholder rights? Do they function as a credible deterrent to such violations? What measures are in place to monitor and prevent corporate insiders and controlling owners from extracting private benefits?
>
> What procedures and institutions are in place to ensure that shareholders have the ability to influence significantly the company?
>
> By what standards and procedures do companies meet the market demand for timely, reliable and relevant disclosure, including information about the company's ownership and control structure?
>
> How does the corporate governance framework ensure the board plays a central role in the strategic guidance of the company, the effective monitoring of management, and that the board is accountable to the company and its shareholders? Does the framework also recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises?

What has been done, and what more should be done in terms of voluntary initiatives and training to encourage and develop a good corporate governance culture in the private sector?

Has a review been undertaken of the national corporate governance system against the OECD Principles of Corporate Governance? Has the result of that review been made public?

How is the ownership function of state-owned enterprises (SOEs) structured to ensure a level playing field, competitive market conditions, and independent regulation? What are the processes in place to ensure the state does not interfere in day-to-day management of SOEs and that board members may effectively carry out their role of strategic oversight, rather than serve as a conduit for undue political pressure? How are SOEs effectively held accountable to the government, the public, and to other shareholders (if any)?

The government of India states that the legal framework for corporate governance in India is entirely contained in the Companies Act 1956, supplemented by the Securities and Exchange Board of India (SEBI) Act 1992.[2] A new Companies Bill introduced in October 2008 is pending approval by Parliament. This is planned to put more emphasis on self-regulation and on strengthening the role of shareholders.

The Ministry of Corporate Affairs has established a National Foundation for Corporate Governance (NFCG) to promote the development of good corporate governance practices. The mission of the NFCG, in partnership with the Confederation of Indian Industry (CII), the Institute of Company Secretaries of India (ICSI) and the Institute of Chartered Accountants of India (ICAI), is: to foster a culture for promoting good governance, voluntary compliance and facilitate effective participation of different stakeholders; to create a framework of best practices, structure, processes and ethics; and to make a significant difference to the Indian Corporate Sector by raising the standard of corporate governance in India towards achieving stability and growth.[3] The Ministry and the Confederation of Indian Industry (CII) have also established the Institute for Corporate Affairs.

To increase transparency in this area, the government has established the MCA21 Programme, under which it moved in September 2006 from publishing company information in a public registry to putting all such information online in a "virtual registry". This is part of the National e-Governance Plan which was approved in 2006 by the government and the MCA21 was evaluated as one of the most effective in the government's impact assessment report (see above, section on public governance). All information about a company is now disclosed by means of 62 "e-forms". By the 2012-13 financial year, all shareholders will be able to participate in real time in company meetings online.[4]

India's corporate governance framework has been assessed twice (in 2000 and 2004) by the World Bank under the *Reports on Observance of Standards and Codes (ROSC) for Corporate Governance* (World Bank, 2004c). Therefore, the World Bank assessment is considerably out of date. However, as it uses the OECD Principles of Corporate Governance as the benchmark, it still provides a helpful reference. The OECD has not conducted its own review of India's corporate governance framework, although under the OECD's enhanced engagement programme with India, some type of corporate governance review could be explored.

The OECD's work with India on corporate governance primarily takes place through regional initiatives, notably the Asian Roundtables on Corporate Governance. Since 1999, the Roundtable has been meeting annually to assist decision makers in their efforts to improve corporate governance. It also serves as a regional hub for exchanging experiences and advancing the corporate governance reform agenda[5] India has contributed to developing and has endorsed recommendations in the *Asian White Paper on Corporate Governance* (OECD, 2003b) and provided information on implementing these recommendations (OECD, 2006) as well as updates on its corporate governance framework (OECD, 2007a).

Shareholders' rights are generally observed, but there is no shareholder activism

The World Bank has found that shareholders' rights are generally observed (World Bank, 2004c). Secure methods of ownership registration are in place, in the form of two electronic depositories. Shares are freely transferable. Relevant corporate information is provided to shareholders, including annual, half-yearly and quarterly statements, the company's memorandum and articles of association, and minutes of the annual general meeting (AGM). An AGM must be held each year. Shareholders have the right to participate in general meetings, which alone may decide on fundamental corporate decisions. Directors are normally proposed by the board and elected by shareholders, and shareholders may also propose candidates (though they seldom do). The AGM approves payment of dividends, which must be done within thirty days.

While shareholder rights are clearly defined in the Companies Act 1956, these rights are not always fully exercised. Investor representatives state that shareholder activism is practically non-existent in India (International Institute of Finance, 2006). The World Bank found that institutional investors do not appear to exercise their voting rights in a transparent manner. The three largest institutional investors, all government owned, instead exert influence through directors nominated to the board of their portfolio companies. The Bank has recommended that regulators should consider introducing an obligation that institutional investors acting in a fiduciary

capacity adopt and disclose their corporate governance and voting policy (World Bank, 2004c).

Legal redress is available to shareholders, subject to the laws' delays

The Companies Act 1956 stipulates that shareholders may apply to the Company Law Board (CLB) for redress in cases of mismanagement or oppression by majority shareholders. The CLB has strong powers and its decisions may be appealed to the high and supreme courts. Any shareholder may apply for the winding up of a company. Investors can also apply to the Securities Exchange Board of India (SEBI) for redress. SEBI can disbar company directors and delist companies or pass a judicial order. Class action suits are available, for example in mergers where shareholders were not satisfied by the proposed share-swap ratio, but, as is commonly observed in India, "prolonged delays are the norm in court proceedings" (World Bank, 2004c).

Insider trading and abusive self-dealing is prohibited by the SEBI (Prohibition of Insider Trading) Regulation 1992, and in 1995 SEBI directed the stock exchanges to set up surveillance departments to detect these practices. However, practical difficulties persist in implementation.

Senior management must disclose to the board all material financial and commercial transactions in which they have a personal interest which may conflict with company interests. Directors must disclose share dealings above a certain threshold to the exchanges and this information is publicly disseminated. Directors, officers and designated employees must hold their shares for 30 days before they can trade them. However, abusive related party transactions remain a concern. For the controlling shareholders and insiders, such as managers, these transactions can become the mechanism for extracting private benefits at the cost of other shareholders. The existing legal and regulatory provisions need a review to check abusive transactions (Batra, 2008).

Companies must prepare and send an annual report to shareholders, the stock exchange, the Department of Company Affairs (DCA) and the Registrar. The report must contain full financial information, including balance sheet, profit and loss account, auditor opinion and a cash flow statement. Share ownership must be disclosed by investor category and by tranches of ownership; disclosure does not extend to the level of ultimate beneficiary and the structure of business groups. The corporate governance section of the report includes summary information on directors, directors' emoluments, and senior management remuneration (World Bank, 2004c).

The World Bank cites market analysts as judging that the quality of disclosure has improved in recent years, but suggests that the stock exchanges' human resources are insufficient to ensure compliance, forcing heavy reliance on auditors. It suggests that SEBI needs to co-operate more

closely with the exchanges to monitor and enforce compliance with disclosure rules, and that the division of responsibilities between the exchanges, SEBI and DCA should be clarified to avoid unintentional regulatory overlap (World Bank, 2004c).

In February 2006, the Indian Ministry of Company Affairs together with the OECD organised the 2006 Policy Dialogue on Corporate Governance in India. The conference, which was co-hosted by The National Foundation for Corporate Governance, The Confederation of Indian Industry, and The Institute of Company Secretaries of India, addressed the issues of:

- The role of the board in dealing with related party transactions.
- The role of institutional investors in dealing with non-controlling shareholders.
- Developments on compliance with international accounting and auditing standards.
- Corporate governance of state-owned enterprises, including the OECD *Guidelines on Corporate Governance of State-Owned Enterprises*.
- Corporate governance and capital markets.
- Insolvency and corporate governance.

India is moving in the direction of strengthening its corporate governance framework in part because it seeks to attract more foreign capital. The Securities and Exchange Board of India (SEBI) in October 2004 instructed all listed companies to implement a revision of Clause 49 of the standard listing agreement a company signs with the exchange on which it is listed. The revised Clause 49 is intended to improve the corporate governance of all listed companies by: increasing the number of independent directors on boards to at least 50%, establishing and maintaining internal controls, requiring all companies to submit quarterly compliance reports to the stock exchange, and ensuring that all audit committee members are financially literate.[6] All listed companies were to comply with Clause 49 by a deadline finally extended to 31 December 2005; it remains to be determined if all have now done so.

In 2007, the government started to test a set of experimental guidelines on corporate governance for central state enterprises (see Box 6.1).

Worries over the effectiveness of the current regulatory framework have arisen following the resignation of the chairman of Satyam Computer Services, Ltd., after he admitted serious computer fraud. Satyam, previously a reputable company with operations in many countries, was understood to have good auditors and a good corporate governance framework – it had even been awarded an international award for excellence in corporate governance.[7] The revelation that the founder of the company had falsified assets over a number of years without detection indicates a need for tighter regulatory oversight.

Box 6.1. *Guidelines on Corporate Governance for Central Public Sector Enterprises**

In 2007, the Ministry of Heavy Industries and Public Enterprises of the government of India published a set of experimental *Guidelines on Corporate Governance for Central Public Sector Enterprises* to be tested over a one-year period and then improved in the light of experience gained during the experimental phase.

The government's aim in developing these Guidelines was the promotion of a "strong and effective public sector" which will be encouraged to enter the capital market and also the need for "public accountability of the public sector management regarding its duties and responsibilities".

The Guidelines were formulated through a consultation process with stakeholders, keeping in view relevant laws, rules and instructions. They have also been developed in the context of India's participation in the OECD's Asia Network on Corporate Governance of State-Owned Enterprises, which has developed Asia-specific recommendations, using the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* as a reference.

Issues covered by the Guidelines include:

- The composition of boards of directors.
- Setting up audit committees.
- Roles and powers of audit committees.
- Issues relating to subsidiary companies.
- Disclosures.
- Accounting standards.
- Risk management.
- Compliance.
- Schedules of implementation.

The Guidelines are voluntary, but strongly encouraged by the government, for example by the requirement that compliance with the Guidelines be reflected in the Directors' Report, Annual Report and Chairman's speech at the Annual General Meeting. The Ministry of Heavy Industries and Public Enterprises also grades central public sector enterprises on the basis of such compliance.

* Available at the Ministry's website, *www.dpe.nic.in*.

The government of India is encouraged to strengthen implementation of all measures designed to enhance corporate governance so that, by aligning itself more closely with internationally-recognised standards and practices, it can further develop a business environment conducive to foreign investment.

3. Policies for promoting responsible business conduct

Public policies promoting recognised concepts and principles for responsible business conduct (RBC), such as those recommended in the *OECD Guidelines for Multinational Enterprises*, help attract investments that contribute to sustainable development. Such policies include: providing an enabling environment which clearly defines respective roles of government and business; promoting dialogue on norms for business conduct; supporting private initiatives for RBC; and participating in international co-operation in support of RBC.

RBC entails above all compliance with laws such as those on respecting human rights, environmental protection, labour relations and financial accountability, even where these laws are poorly enforced, and also responding to societal expectations communicated by channels other than the law, *e.g.* intergovernmental organisations, within the workplace, by local communities and trade unions, *via* the press. Private voluntary initiatives addressing this latter aspect of RBC are often referred to as CSR (corporate social responsibility).

How does the government make clear for investors the distinction between its own role and responsibilities and those ascribed to the business sector? Does it actively assume its responsibilities (*e.g.* by effectively enforcing laws on respecting human rights, environmental protection, labour relations and financial accountability?

What steps does the government take to promote communication on expected responsible business conduct to investors? How does the government endeavour to protect the rights framework that underpins effective communication?

Does the government ensure that an adequate framework is in place to support the financial and non-financial disclosure that companies make about their business activities? Is this framework flexible enough to allow scope for innovation, for tailoring practices to the needs of investors and their stakeholders?

How can the government support companies' efforts to comply with the law?

How does the government through partnership (*e.g.* by participating in the development of standards that lower costs of adopting responsible business policies) and through promotion (*e.g.* by improving the information on responsible business practices to customers and the public) help to strengthen the business case for responsible business conduct?

Does the government participate in inter-governmental co-operation in order to promote international concepts and principles for responsible business conduct, such as the *OECD Guidelines for Multinational Enterprises*, the ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policies and the United Nations Global Compact?

Governments are co-operating with each other and with other actors to strengthen the international legal and policy framework in which business is conducted. Landmarks in the development of this framework include the adoption in 1948 of the Universal Declaration of Human Rights and, more recently, such instruments as the ILO Declaration on Fundamental Principles and Rights at Work, the Rio Declaration on Environment and Development and Agenda 21.

India was one of the main drafters of the 1948 Universal Declaration of Human Rights. India has supported major United Nations conventions, including the International Covenant on Civil and Political Rights and the International Covenant on Economic, Social and Cultural Rights, acceding to both in 1979. In 1992, India acceded to the Convention on the Rights of the Child. India ratified the International Convention on the Elimination of All Forms of Racial Discrimination in 1967 and the Convention on the Elimination of All Forms of Discrimination against Women in 1980, though it only came into force in 1993. India has so far not taken action on the International Convention on the Protection of the Rights of All Migrant Workers and Members of Their Families.[8] India has ratified 4 of the 5 core ILO conventions: C29 and C105 on the elimination of all forms of compulsory labour, and C100 and C111 on the elimination of discrimination in respect of employment and occupation. India is an active member of the Commission on Sustainable Development set up after the Rio Conference to monitor implementation of Agenda 21. It signed and ratified the Kyoto Protocol in 2002. India is party to a number of international environmental protection conventions, including the Vienna Convention for the Protection of the Ozone Layer, the Convention on Conservation of Bio-diversity, the Montreal Protocol on Substances that Deplete the Ozone Layer and the International Convention for Combating Desertification.

Initiatives to ensure responsible business conduct in India have come mainly from business itself over the past century, and more recently also from

NGOs. The government has developed a regulatory framework to secure respect for human rights, core labour standards and financial accountability on the part of companies. However, implementation remains a major challenge.

As in many OECD countries, several well-established companies have a long history of commitment to making positive contributions to society, starting with philanthropy and then incorporating responsible business conduct norms in their normal operations.

India is one of the most active countries in the field of RBC in Asia (OECD, 2005). India has a number of companies with long traditions of philanthropic and community programmes. A recent paper argues that corporate philanthropy is shifting towards Corporate Social Investment (which is a more strategic approach to philanthropy involving the building of stronger relationships with stakeholders).

A number of leading companies are also actively managing their environmental impacts and this is evidenced by some major Indian companies producing detailed sustainability reports and exercising leadership within the broader Indian business community.

A 2001 survey by the Centre for Social Markets (CSM) asked (mainly large) Indian companies to list the main factors driving changed attitudes to social and environmental responsibility. The most frequently cited factors were (listed in order of magnitude): increasing awareness, reputation, rising domestic standards, rising international standards, commercial pressure and domestic regulation, with public opinion and community group pressure relatively low on the scale.

For example, the Council for Fair Business Practices (CFBP) was established to promote consumer interests in 1966. From 1970 onward, business leaders have stressed social responsibility also as a way of protecting the autonomy of the business sector in the face of demands for government intervention to tackle social ills, as well as for restoring their prestige. In a 1981 survey of senior executives at companies in and near Delhi, 98% of respondents considered that CSR was relevant to business. A study conducted in 2004 using a sample of 536 companies across India found that the largest driver of CSR was philanthropy (64%), followed by image building (42%), employee morale (30%) and ethics (30%) (Sood and Arora, 2006).

The two main India-wide business associations have established specialised bodies to promote responsible business conduct (see Box 6.2).

A 2009 review of environmental, social and governance practices in 40 large emerging market economies conducted by the Sustainable Investment Research Analysis Network (SIRAN) in partnership with the Ethical Investment Research Service (EIRIS) included four major Indian enterprises (Reliance Industries, ICICI Bank, Infosys Technologies and the

Box 6.2. **Focus of Indian national business associations on promoting responsible business conduct**

The two major associations grouping Indian business are the Confederation of Indian Industry (CII) and the Federation of Indian Chambers of Commerce and Industry (FICCI). Both organisations promote responsible business conduct as a core element of their work. Each set up a specialised body for this purpose in 1995.

Confederation of Indian Industry (CII)[1]

The CII set up a Social Development Council in 1995 to ensure that the benefits and opportunities emerging out of the economic reforms and industrial growth are made available to all, to facilitate Indian industry's responses to the needs of a developing India, and to build-up strong partnerships across the sectors for better Governance, Accountability and Empowerment.

The CII states that its social development role is to be an advocate, catalyst, facilitator and partner for enhanced corporate leadership and engagement, working in sync with the National priorities and aligning with global codes and benchmarks.

The CII's focus areas are HIV/AIDS, social infrastructure, women's empowerment and Corporate Social Responsibility (CSR), though it states that no single element is predominant.

The CII maintains partnerships with over 120 NGOs nationwide to pursue initiatives in integrated development, including health, education, livelihoods, diversity management, skill development and water. It also employs a team of development experts to provide specialised services to help companies plan and implement development initiatives.

CII's Social Development Division works with central and state governments, multilateral and bilateral agencies and civil society organisations on various innovative projects and programmes throughout the country. It also strives to promote multi-stakeholder dialogue and evolve a common understanding of good corporate citizenship through initiatives such as the CII-UNDP India Partnership Forum. CII is a member of the UN Global Compact.

Federation of Indian Chambers of Commerce and Industry (FICCI)[2]

FICCI in 1995 established a Socio-Economic Development Foundation (FICCI-SEDF) to promote CSR among FICCI members. FICCI states that FICCI-SEDF has successfully influenced its members' participation in various social welfare programmes. In 1999, FICCI-SEDF instituted India's first Corporate Social Responsiveness Award to encourage companies to promote "business with conscience".

Box 6.2. **Focus of Indian national business associations on promoting responsible business conduct** *(cont.)*

FICCI-SEDF's advocacy has developed beyond the promotion of charity and external philanthropy. It encourages enterprises to institute socially responsible practices "within their own fold", so that they may themselves benefit from "a happier and healthier workforce, increased efficiency, higher productivity and conservation of their most valuable resources – their human resources", producing a win-win situation for companies, staff and the national economy.

FICCI-SEDF has organised seminars, workshops and orientation programmes on socially relevant themes jointly with UNFPA, ILO, UNICEF and UNDP, as well as with Indian government ministries and NGOs. Training is provided for company managers and trade union leaders.

Social and CSR issues covered by FICCI-SEDF's advocacy include: population moderation, child labour, gender-based issues in the workplace, labour welfare, HIV/AIDS, empowerment of disabled persons, assistance to disabled defence personnel and their families, and the timely mobilisation of corporate resources at times of national disasters.

1. CII website: *www.cii.in*.
2. FICCI-SEDF website: *www.ficci-sedf.org*.

Housing Development Finance Corporation) (SIRAN and EIRIS, 2009).The findings of this study show average performance by the four enterprises compared to other large developing economies in environmental/climate change, human/labour rights and antibribery areas, and better than average performance in the area of corporate transparency and disclosure.

State-owned enterprises: The government appears to have decided to limit itself to a participatory, not a leading, role in private-sector initiatives to promote responsible business conduct (RBC). At the same time, it seeks to pursue an RBC-based business strategy in some government-owned enterprises. For example, the Rural Electrification Corporation, Ltd. (a government of India enterprise) has adopted a CSR policy involving recognition of the company's "social responsibilities to all stakeholders" including consumers, shareholders, employees, local community and society at large (see Box 6.3).

Export customers: Consumer pressure to demonstrate that businesses are acting responsibility comes from outside India in the form of the requirements of major international brands communicated to suppliers and subcontractors in India. Such pressure along supply chains is largely limited to ethical labour practices, mainly in the garments, sports goods, carpets and toys sectors (Sood and Arora, 2006).

Box 6.3. **Corporate responsibility programme of the Rural Electrification Corporation, Ltd.***

Policy statement

The REC's mission is "to facilitate availability of electricity for accelerated growth and for enrichment of quality of life of rural and urban population and to act as a competitive, client-friendly and development-oriented organisation for financing and promoting projects covering power generation, power conservation, power transmission and power distribution network in the country".

Its corporate social responsibility policy is "to remain a responsible corporate entity mindful of its social responsibilities to all stakeholders including consumers, shareholders, employees, local community and society at large".

REC's approach to implementing this policy is oriented to "identify and formulate projects in response to felt societal needs in diverse areas and to implement them with full involvement and commitment in a time-bound manner".

REC promises to strive consistently for opportunities to meet the expectations of its stakeholders by pursuing sustainable development, in particular by:

1. Facilitating demonstration of commercially viable rural electricity delivery models with appropriate intervention and support on a selective basis such that they can be replicated elsewhere.
2. Promoting rural enterprise and livelihood including skill development and training.
3. Providing support to common facility centres/production centres in rural areas.
4. Promoting and developing rural technologies for micro-enterprise promotion.
5. Making sustained efforts for environmental preservation.
6. Promoting sports and games.
7. Promoting the development and well-being of employees and their families.
8. Undertaking relevant community development programmes.
9. Supporting initiatives of vocational, technical and higher education to the most disadvantaged and marginalised section of society.
10. Participating in national/local initiatives to provide relief/rehabilitation in times of natural disasters.

Box 6.3. **Corporate responsibility programme of the Rural Electrification Corporation, Ltd.*** *(cont.)*

REC specifies a list of mandatory CSR activities which includes offering employment to "backward classes" and the disabled, and providing social security and healthcare facilities.

Optional CSR activities include: rural industry promotion; educational support activities; health check-ups, immunisation and health awareness campaigns; promotion of sports and the arts; scholarships; community plantation and forestry programmes; natural disaster rehabilitation; projects promoting ecological balance and preventing environmental degradation; supplementing government development programmes; offering employment to deprived sections of society; adoption and maintenance of places of public/cultural heritage sites.

* REC website, http://*recindia.nic.in*.

4. Human resource development

Human resource development is a prerequisite needed to identify and to seize investment opportunities, yet many countries under-invest in human resource development due in part to a range of market failures. Policies that develop and maintain a skilled, adaptable and healthy population, and ensure the full and productive deployment of human resources, thus support a favourable investment environment.

Has the government established a coherent and comprehensive human resource development (HRD) policy framework consistent with its broader development and investment strategy and its implementation capacity? Is the HRD framework periodically reviewed to ensure that it is responsive to new economic developments and engages the main stakeholders?

What steps has the government taken to increase participation in basic schooling and to improve the quality of instruction so as to leverage human resource assets to attract and to seize investment opportunities?

The government of India is striving to universalise basic education, overcome illiteracy and narrow the gap in educational achievement between males and females. Literacy has been increasing steadily in recent years, but remains far from universal (Government of India, 2007). The 2001 census showed 304 million people to be illiterate, a reduction of 25 million from

329 million in 1991, but still unacceptably high in terms of human capital requirements at a time of rapid economic development and in terms of basic human development.

Primary education is now widespread, with the gap between girls and boys narrowing. However, the Millennium Development Goals indicator for primary enrolment, the net enrolment ratio (NER),[9] is estimated at only 81.9% in 2004-05, indicating that the government has some way to go to reach its goal of elementary education for all (Government of India, 2007). The NER varies markedly between India's states. This is largely because education has in practice been a responsibility of state governments, which started with varying levels of provision and have applied different policies, partly because of differences in the availability of finance.

Is the economic incentive sufficient to encourage individuals to invest in higher education and life-long learning, supporting the improvement in the investment environment that flows from better human resources? What measures are being taken to ensure the full benefit of a country's investment in its own human resources accrues, including the attraction of nationals who have completed their studies abroad? What mechanisms exist to promote closer co-operation between education institutions and business and to anticipate future labour force skill requirements?

To what extent does the government promote training programmes and has it adopted practices that evaluate their effectiveness and their impact on the investment environment? What mechanisms are used to encourage businesses to offer training to employees and to play a larger role in co-financing training?

A 2008 World Bank study observed that the Indian government has a clear vision regarding the vocational education and training system, which it is keen to reform (World Bank Human Development Unit, 2008).

Does the government have a coherent strategy to tackle the spread of pandemic diseases and procedures to evaluate public health expenditures aimed at improving public health outcomes and, through inter-linkages, the investment environment?

The government is striving to tackle the spread of pandemic diseases

The government has developed integrated strategies to control major pandemic diseases, notably HIV/AIDS, malaria and TB.

India is suffering from an AIDS epidemic. Some 5.7 million people were reported to be living with HIV in India in 2006, representing two-thirds of total HIV cases in Asia. The government is committed to implementing a comprehensive multi-sectoral National AIDS Control Programme (NACP) to combat HIV/AIDS. The situation is monitored by the National AIDS Control Organisation (NACO) through an annual surveillance mechanism established in 1992, which has expanded to cover most districts and is concentrated in antenatal clinics and high risk sites that include those dealing with injecting drug users, female sex workers, men having sex with men and STD clinic attendees.

About 95% of India's population lives in areas where malaria is endemic. The Directorate of National Vector Borne Disease Control Programme (NVBDCP) has framed technical guidelines and policies to control malaria. Indicators have been developed at national level to ensure uniformity in data collection. Passive surveillance is carried out by treatment centres.

India is the world's greatest sufferer from TB. In 2005, 1.8 million TB cases, 0.8 million of them infectious, were estimated to have occurred in India, out of the global annual incidence of 8.9 million. Some 370 000 people die of TB in India each year. A Revised National Tuberculosis Control Programme (RNTCP) was established in 1997 by the government of India, the World Health Organisation (WHO) and the Swedish International Development Agency on the basis of an existing national programme and incorporating elements of the internationally-recommended directly observed treatment, short courses strategy for TB control. The RNTCP expanded during its first phase from covering 18 million people in 1998 to total national population coverage by March 2006. Phase II (2006-11) is aimed at achieving the TB-related Millennium Development Goal up to 2015 of a detection of at least 70% and a cure rate of at least 85% in new TB patients.

5. Infrastructure and financial sector development

Sound infrastructure development policies ensure scarce resources are channelled to the most promising projects and address bottlenecks limiting private investment. Effective financial sector policies facilitate enterprises and entrepreneurs to realise their investment ideas within a stable environment.

What processes does the government use to evaluate its infrastructure investment needs? Does the national government work in co-operation with local and regional governments to establish infrastructure investment

priorities? Does the government have clear guidelines and transparent procedures for the disbursement of public monies funding infrastructure projects? Are the regulatory agencies that oversee infrastructure investment and the operations of enterprises with infrastructure investments independent from undue political interference?

What measures has the government adopted to uphold the principle of transparency and procedural fairness for all investors bidding for infrastructure contracts, to protect investors' rights from unilateral changes to contract terms and conditions? What steps have been taken to attract investors to supply infrastructure at fair and reasonable prices, to ensure that investor-state contracts serve the public interest and to maintain public support for private involvement in infrastructure?

In the telecommunications sector, does the government assess market access for potential investors and the extent of competition among operators? Does the government evaluate whether telecommunication pricing policies are competitive, favouring investment in industries that depend on reliable and affordable telecommunications?

Has the government developed a strategy to ensure reliable access to electricity services by users, and economic incentives to invest in and supply electricity? What programmes exist to ensure on a least-cost basis access to electricity services by a wide range of users? Are these programmes time-bound and based upon clear performance targets?

What processes are followed to inform decisions on the development of new transport facilities, as well as the maintenance of existing investment in transport infrastructure? Are the requirements for all modes of transport regularly reviewed, taking into consideration investor needs and the links between different modes of transport infrastructure?

Has the government evaluated the investment needs in water required to support its development goals? To what extent is the private sector involved in water management, supply and infrastructure financing?

The infrastructure challenge

India needs to accelerate infrastructure construction to meet the basic needs of its people and to support the continuation of rapid economic growth. Despite the efforts of successive governments, much of the population still lacks access to basic facilities, including water, energy, transport and telecommunications. At the same time the rapid GDP growth achieved by recent reforms is unsustainable without the removal of infrastructure bottlenecks. Such bottlenecks may motivate a diversion of both foreign and domestic investment away from India because they constitute obstacles to the realisation of investments and also threaten to slow domestic market growth.

Infrastructure development can therefore exert a strong positive influence on Indian economy and society. Constructing infrastructure adds employment opportunities, raises incomes and wages, and thus reduces poverty.[10] By extending the connectivity of networks of basic services throughout the population, it also diminishes inequality and promotes solidarity. New infrastructure is needed to meet development targets, including the Millennium Development Goals (MDGs). Once commissioned, infrastructure contributes to positive externalities of firms, reducing costs and increasing productivity. Investment in infrastructure adds more than its own value to total investment, as it improves the overall business environment and hence promotes more investment in other sectors (see, for example, Dutta *et al.*, 2007).

India needs to upgrade its water supply and sanitation systems

The proportion of households with tap water varies from 28.5% in Bihar to 91.7% in Gujarat and in Maharashtra (Zérah, 2006). The supply of water in most cities is unreliable and intermittent and urban water quality is low (Zérah, 2006). Sanitation provision is inadequate throughout India. Sewerage system provision ranges from 0.2% in Bihar to 50.3% in Punjab. Existing irrigation capacity is only 64% of potential and is largely ageing infrastructure. Silting of large dams reduces the area under irrigation and lowers dam life. Urbanisation is beginning to harm irrigation, while unregulated growth of groundwater irrigation has led to over-extraction, causing diversion of drinking water and a lowering of water quality (Oza, 2007).

The energy challenge needs to be met

The number of people without access to electricity has fallen, but was still an estimated 412 million in 2005, largely in rural areas. Some 668 million people relied on wood, dung and agricultural residues for cooking and heating in 2005, causing an estimated 400 000 premature deaths each year (IEA, 2007). Power shortages and fluctuations in voltage and frequency result from insufficient investment in new capacity and the poor performance of existing equipment. Unreliable power is particularly damaging for power-intensive and continuous-process industries. Distribution in India is the weakest part of the power-supply chain. Electricity losses from theft and technical factors average 32%-35% of total generation (IEA, 2007).

"Power for all by 2012"

The National Electricity Policy envisages "Power for all by 2012" and per capita availability of power to be increased to over 1 000 units by 2011-12. To meet these targets, additional capacity of 82 500 MW is being added during the current 11th Five-Year Plan period. Of this, 52 905 MW is to be generated from new thermal power stations, mostly coal-fired, 16 553 MW will be from

hydropower and 3 380 MW from nuclear power stations. In addition to expanding transmission capabilities to cope with increased output, the focus of the 11th Plan programme is to form a National Power Grid to enable optimal exploitation of unevenly distributed generation resources to provide a reliable transmission system. A major challenge is to upgrade distribution to provide a quality service to consumers while reducing technical and commercial losses, including from pilferage (Government of India, Ministry of Power, 2007).

Roads and public transport systems need to be expanded and upgraded

Rural road connectivity is a major element in rural development, enlarging markets and providing access to services, and therefore generating increased agricultural productivity, non-agricultural productivity and non-farm employment opportunities. About 1 million kilometres of rural roads are estimated to be below required technical standards. However, government figures show that by 2000, almost all villages with populations over 1 500 were connected to the road system, as were 86% of villages with 1 000-1 500 people, but only 43% of villages with less than 1 000 people (Mohapatra and Chandrasekhar, 2007). In urban areas the main transport problem is congestion. While the population in the six major metropolitan areas increased 1.89 times in 1981-2001, the number of registered vehicles went up 7.75 times. As a result of space and resource constraints, the urban road system has not kept pace with the increase in vehicles. Feasible solutions are likely to include urban public transport systems (Agarwal, 2006).

The advent of the mobile phone has allowed a rapid increase in urban telephone density, but the number of rural phone subscribers has lagged far behind. This is because of a lack of hard infrastructure, not low demand.

The structure of government policy making for infrastructure development[11]

Infrastructure policy is led by a Committee on Infrastructure and the PPP Cell in the DEA

A Committee on Infrastructure (COI) headed by the Prime Minister was set up in August 2004. Its remit is to ensure the time-bound creation of world-class infrastructure and delivery of services and at the same time develop structures that maximise the role of public-private partnerships (PPPs). The COI is serviced by the Planning Commission.

The Department of Economic Affairs (DEA) has taken major initiatives on PPPs including capacity building and policy formulation. To provide greater focus in mainstreaming PPPs at both central and state levels, a PPP Cell has been constituted in the DEA. It is envisaged that some 8.5 trillion rupees will be spent on infrastructure investment up to 2012 (see Tables 6.1 and 6.2)

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Table 6.1. **Infrastructure investment indication of the government of India**

Sector	Investment (billion rupees)	To be made by
National highways	2 200	2012
Airports	400	2010
Ports	500	2012
Energy	5 400	2012

Source: Chawla, Ashok (2006).

Table 6.2. **Sectoral distribution of PPP projects based on contract value**

In rupees

Sector	No. of projects	Number of projects by contract value				Value of contracts (in billion rupees)
		< 1 billion	1-2.5 billion	2.51-5 billion	> 5 billion	
Airports	5	–	–	1	4	191.11
Ports	38	3	5	6	24	604.87
Railways	3	–	1	2		10.07
Roads	170	74	20	51	25	470.91
Urban development	5	3		1	1	18.79
Total	**221**	**80**	**26**	**61**	**54**	**1 295.75**

Sources: PPP Cell, Department of Economic Affairs; online *PPP Database*.

The government has identified six major constraints in developing PPPs:

1. Policy and regulatory gaps, especially in relation to specific sectoral policies and regulations.
2. Inadequate availability of long-term finance (*i.e.* with a tenor of 10 years or more), both equity and debt.
3. Inadequate capacity in public institutions and public officials to manage PPPs.
4. Inadequate capacity in the private sector to manage PPPs, both in the form of developer/investor and in technical human resources.
5. An inadequate "shelf" of bankable infrastructure projects that can be submitted for bids by the private sector.
6. Inadequate advocacy to create a greater acceptance of PPPs by the public.

To address these constraints, the government has taken steps to create an enabling framework for PPPs. Progressively more sectors have been opened to private and foreign investment; levy of user charges is being promoted; regulatory institutions are being set up and strengthened; and infrastructure projects are encouraged with fiscal incentives.

Standardised contractual documents are being prepared. These include sector-specific model concession agreements, which will lay down standard terms relating to risk allocation, contingent liabilities and guarantees, as well as

service quality and performance standards, and standardised bidding documents such as a model request for qualifications and a model request for proposals.

The PPP approval mechanism at the central government level has been streamlined by setting up a Public Private Partnership Appraisal Committee (PPPAC). A website devoted exclusively to PPPs, *www.pppindia.com*, has been launched to serve as a virtual market place for PPP projects and an online database on PPP projects is being developed to provide comprehensive information on the current status of infrastructure PPPs.

The government has adopted a range of measures to finance infrastructure PPP projects

To address the financing needs of infrastructure PPP projects, the government has established the India Infrastructure Finance Company Limited (IIFCL) to provide long-tenor debt to infrastructure projects.

The government has also launched a scheme for financial support to PPPs to provide viability-gap funding (VGF, see Box 6.4) to PPP projects that would otherwise not be financially viable. The government sees such funding not as a subsidy, but as representing a saving, since the alternative would be for the government to pay the entire cost of such projects.

Box 6.4. **Viability Gap Funding (VGF)**

In July 2005, the Infrastructure Section of the Department of Economic Affairs of the Ministry of Finance set out updated details of a scheme to support infrastructure PPPs.

Public funding to bridge the "viability gap": In this document, the government recognises the need for PPPs to effect large investments in physical infrastructure that can not be undertaken by public financing alone, but notes that infrastructure projects may not always be financially viable because of long gestation periods and limited financial returns. The government therefore offers funding to bridge the "viability gap" of infrastructure PPPs.

PPP projects eligible for Viability Gap Funding (VGF) are limited to: 1) roads and bridges, railways, seaports, airports and inland waterways; 2) power; 3) urban transport, water supply, sewerage, solid waste management and other physical infrastructure in urban areas; 4) infrastructure projects in Special Economic Zones; and 5) international convention centres and other tourism infrastructure projects. All projects should provide a service against payment of a pre-determined tariff or user charge, which may not be increased to eliminate or reduce the viability gap. The project must be implemented, *i.e.* constructed, maintained and operated during the project term, by an entity with at least 40% private equity. All VGF

Box 6.4. **Viability Gap Funding (VGF)** *(cont.)*

projects must be vetted/endorsed by the concerned line ministries and have received government approval at the appropriate level.

20% + 20%: Total Viability Gap Funding is limited to 20% of the total project cost, while the government or statutory entity that owns the project may provide additional grants out of its own budget up to another 20% of the total project cost. Thus the maximum effective public funding of a qualifying PPP infrastructure project is 40%, comprising 20% from the central government in the form of VGF and another 20% from the state government or other public owner of the project.

VGF limits: For speedy appraisal, an empowered institution and an empowered committee is set up. Viability Gap Funding up to 1 billion rupees for each project will be sanctioned by the empowered institution and up to 2 billion rupees by the empowered committee. VGF over 2 billion rupees is sanctioned by the empowered committee with the approval of the Finance Minister. These limits are likely to be revised upwards (Chawla, 2006).

Capital grant: Viability Gap Funding is normally in the form of a capital grant at the stage of project construction.

Competitive bidding: The private sector company is selected through a transparent and open competitive bidding process (see Table 6.3 for sectoral distribution of PPP projects based on contract award method). The criterion for bidding is the amount of Viability Gap Funding required by the company for implementing the project where all other parameters are comparable.

Table 6.3. **Sectoral distribution of PPP projects based on contract award method**

Sector	No. of projects	Number of projects by contract award method			Value of contracts (in billion rupees)
		Domestic competitive bidding	International competitive bidding	Negotiated MoU	
Airports	4		4	–	188.08
Ports	28	4	12	12	574.33
Railways	3	1		2	10.07
Roads	164	123	36	5	457.37
Urban development	2	1	1	–	5.25
Total	**201**	**129**	**53**	**19**	**1 235.10**

Sources: PPP Cell, Department of Economic Affairs; online *PPP Database*.

Multilateral agencies such as the Asian Development Bank (ADB) have been permitted to raise rupee bonds and carry out currency swaps to provide long-term debt to PPP projects. The government is also encouraging the

establishment of dedicated infrastructure funds to increase the flow of equity investment, for example the India Infrastructure Finance Initiative facilitated by the Ministry of Finance, which is deploying some USD 5 billion in capital for infrastructure projects. This is structured as a venture capital fund, with approximately USD 2 billion in equity capital and USD 3 billion in long-term debt financing with maturities exceeding ten years.

To finance quality project development activities at both state and central levels, a set of *Guidelines for the India Infrastructure Project Development Fund* (IIPDF) has been developed. The IIPDF, with an initial budgetary outlay of 1 billion rupees, will be a revolving fund, replenished through fees earned from successful bid projects, although it may also be supplemented in subsequent years by the government budget. The IIPDF will ordinarily assist up to 75% of project development expenses in the form of an interest-free loan. On successful completion of the bidding process, the project development expenditure will be recovered from the successful bidder.

Initial steps have also been taken to use India's foreign exchange reserves for infrastructure construction. IIFCL has set up an offshore special-purpose vehicle (SPV) for this purpose. The Reserve Bank of India (RBI) has given approval "in principle" to invest up to USD 5 billion in the securities of this SPV and these will be fully guaranteed by the government of India.

The government is building capacity at central and state levels

To meet the capacity-building requirements of public institutions and officials so that they can prepare a pipeline of credible, bankable projects that can be offered to the private sector through a competitive bidding process and also to enable them to manage the PPP process, state governments and central ministries are being provided with technical assistance in the form of in-house PPP, financial/risk experts, management information system (MIS) experts and access to a panel of legal firms. State governments and central ministries are assisted by a panel of transaction advisers through whom consultants are hired, by the preparation of a PPP user manual, and the provision of training programmes for public officials on PPPs, risk assessment and exposure to pre-bid grading of projects. To intensify and deepen the capacity building of public officials at state and municipal level, a curriculum for training at state administrative institutes and a "Training of Trainers" programme are being developed. As the reach of PPPs is extended across sectors, private sector capacity to manage these projects over their 20-30 year life-cycle will also need to be enhanced. These initiatives are being supported by the ADB and the World Bank.

Three examples are given below of states using PPPs to develop infrastructure: Tamil Nadu (Box 6.5), Uttar Pradesh (Box 6.6) and Maharashtra (Box 6.8).

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Box 6.5. **Tamil Nadu**

Tamil Nadu is the most urbanised state in India. Its urban areas are home to 43% of the state's population and produce over 70% of its GDP. The government is keen to develop infrastructure both because it recognises that current infrastructure is insufficient to provide quality services for citizens and because it considers economic growth to be organically linked to infrastructure development. It sees public-private partnerships (PPPs) as leveraging its scarce budgetary resources, while allowing ownership of underlying public assets to remain in government hands. PPPs can bring in management practices from the private sector. While capping government liabilities, PPPs enable the government to share the up-side risk of projects. The Tamil Nadu government wishes to attract private partners by offering policy and statutory support, handholding to resolve bottlenecks such as land acquisition, clearances and approvals, by offering some financial assistance and by enhancing lender confidence and hence enabling mobilisation of cheaper funds.

The government of Tamil Nadu has identified five sectors as suitable for PPPs:

- Water supply and sewerage.
- Road infrastructure (roads, bridges and flyovers).
- Improvement of urban infrastructure.
- Port infrastructure.
- Computer literacy in school education.

Four organisations have been established by the Tamil Nadu government to organise PPP projects:

- The Tamil Nadu Water Investment Company (TWIC), formed by the government of Tamil Nadu together with a leading Indian infrastructure company, Infrastructure Leasing and Financial Services, Ltd. (IL&FS), for the purpose of developing water projects, has established the New Tirupur Area Development Corporation Ltd. (NTADCL) as a special purpose vehicle to supply industrial and drinking water under the Tirupur Water and Sanitation Project. Tirupur, a major knitwear export centre, lacks quality infrastructure: domestic water supply is limited to a few hours on alternate days; industries do not have access to piped water supply; and ground water in the region has been depleted. NTADCL has a 30-year exclusive build-own-operate-transfer (BOOT) concession granted by the government of Tamil Nadu and Tirupur Municipality, with investment costs recovered through index-linked composite water and sewerage charges. The project scope involves water supply of 185 million litres per day to an urban population of 346 551 and a rural/semi-urban population of 400 266, and to 730 industrial units, plus sewerage covering the sanitation needs of 60% of Tirupur's households. Private-sector participation includes major Indian and OECD-based infrastructure construction company.

Box 6.5. **Tamil Nadu** *(cont.)*

- The Tamil Nadu Road Development Company (TNRDC) is a 50:50 joint venture between the Tamil Nadu Industrial Development Corporation (TIDCO) and IL&FS. TIDCO, was incorporated as a Limited Company in 1965 to identify and promote the establishment of large and medium scale industries in Tamil Nadu in association with the private sector. TNRDC is currently engaged in the East Coast Road Project.
- The Tamil Nadu Urban Development Fund (TNUDF) involves a number of major infrastructure companies.
- Ennore Port Special Economic Zone.

Box 6.6. **Uttar Pradesh**

A huge state like Uttar Pradesh requires enormous investments to match international standards of infrastructure facilities. It is not possible for the government to make investments of such volumes from its own resources. Therefore, the state government considers it necessary to invite/encourage private participation on a large scale for expediting the development of top grade infrastructure facilities. Similarly, government expenditure on non-profitable activities will have to be compulsorily reduced; accordingly disinvestment/privatisation of a few public-sector enterprises is also required.

Guidelines were formulated in June 2007 to ensure implementation of such activities in a transparent and competitive manner and to maintain uniformity in selection of developer for infrastructure projects under private partnership

and selection of private investor in the disinvestment/privatisation process. Likewise, guidelines have also been laid down for selection of reputed/renowned consultant/advisor in a transparent and competitive method in order to avail expert consultancy services in the selection process of private developer and private investor for disinvestment/privatisation.

The Uttar Pradesh State government has accorded high priority to industrial development. The government has established a separate "Infrastructure Development Department" to ensure proper execution and implementation of policies and schemes for the development of industry and to attract optimum industrial investment along with providing basic infrastructure facilities for industrial growth, encouraging mega projects and their proper monitoring.

Five crucial areas have been specified/identified for infrastructure development:

- Empowerment of farmers.
- Development of the power sector.

Box 6.6. **Uttar Pradesh** *(cont.)*

- Urban rejuvenation.
- High quality transport system.
- World-class road infrastructure.

Several ambitious projects are coming to Uttar Pradesh under the PPP policy laid out for the development of infrastructure with maximum involvement of assistance from private investors, including:

The Ganga Expressway – a pioneer project of the Uttar Pradesh State government to be developed under PPP Policy from Greater Noida to Ballia. Under this project, an access-controlled eight-lane expressway will be constructed along the left bank of river Ganga in compliance with environment policy and all provisions stipulated in required approvals through public-private partnership. This project will greatly help in controlling floods and spurring the industrial growth in the districts along the route as well as cutting down drastically the travel time between eastern and western borders of the state. It will encourage tourism, industrial development and commercial activities in the State. This expressway will provide facility to the farmers from distant locations to transport their crops, especially perishable crops, to Delhi and other agro-markets in short time. Flood affected land will be better utilised.

Infrastructure development will stimulate growth of economic and industrial resources as well, which will open vast avenues of employment generation.

Hence, the Ganga Expressway is not only a road project but also a means to development of an industrial corridor as well, which will boost the industrial and economic progress.

This endeavour is the biggest project under public-private partnership incurring no expenditure on government funds.

Therefore, the probability of harm to/wastage of farmland/agricultural land and livelihood problem of farmers and labourers arising due to this project is ruled out, rather development of widespread opportunities of employment will benefit the farmer and non-agriculture population of the area and economic as well as integrated development will accrue from this project. Besides, this project will provide the much needed impetus to the industrial, economic and commercial development of the whole state. Expressway will be open to fast speed/moving vehicles only; however, there is a provision for construction of service roads for bicycles, two-wheelers, tractors etc. for their free and uninterrupted traffic under this project. State government has formulated a special scheme for providing adequate compensation to the persons whose land is acquired/used for this project. This compensation will be provided by the developer.

Box 6.6. **Uttar Pradesh** *(cont.)*

The following projects are also being implemented under the state PPP Policy:

a) Urban rejuvenation: Facilities for uninterrupted, fast and smooth traffic is being developed in cities like Lucknow, Kanpur and Agra, etc. Besides, the development of public amenities and modernisation is also provisioned through public-private partnership.

b) Development of the power sector: The following power projects are being set up in the state under public-private partnership:

- Karchhana, Allahabad 1 320 MW.
- Bara, Allahabad 1 980 MW.
- Roza, Shahjahanpur 600 MW.
- Meja, Allahabad 1 320 MW.
- Anpara-C (expansion) 1 000 MW.
- Srinagar 300 MW.
- Obra (expansion) 1 000 MW.

c) High quality transport system: To ensure an excellent transport system, routes for traffic of buses have been allowed to be opened under public-private partnership. At present, arrangements are being made to manage the transport system by the private sector on all the 475 national highways.

d) World-class road infrastructure: Including the Ganga Expressway, the following road projects are also being implemented through public-private partnership:

- Noida Toll Bridge *Functional*.
- Yamuna Expressway *Under construction*.
- Ganga Expressway *MoU signed*.
- Other Expressways, viz.:
  - Ghaziabad-Saharanpur to Mohand;
  - Jhansi-Kanpur-Lucknow-Gorakhpur to Kushinagar;
  - Agra-Kanpur and Bijnore-Moradabad to Fatehgarh;
  - Lucknow-Barabanki-Nanpara link;
  - Narora to Hardwar (10 km before in border of U.P.) *Under planning*.
- State Highways *Under planning*.

Besides these projects railway over/under bridges are also being developed through public-private partnership.

Box 6.6. **Uttar Pradesh** *(cont.)*

e) Development of the aviation sector: An international airport and aviation hub are proposed to be built under public-private partnership at Jewar, Greater Noida. Besides, the construction of new air-strips at Moradabad, Azamgarhand Chitrakoot as well as the extension of air-strips at Meerut, Faizabad, Sultanpur, Shravasti and Kushinagar is also being done through public-private partnership. Five aviation academies at Aligarh and one each at Kushinagar, Sultanpur and Faizabad are being set up under public-private partnership.

f) Development of the service sector: In order to promote service sector in the state, it is proposed to establish Manyawar Shri Kanshiramji Super Speciality Hospital and Manyawar Shri Kanshiramji International Convention Centre under public-private partnership.

Table 6.4. **Forthcoming PPP projects in Uttar Pradesh (estimated)**

Projects	INR billion	USD billion
Ganga Expressway	300.0	7.50
Network of More Expressways	470.0	11.75
Power Generation	250.0	6.25
Upgrading Road Network	35.0	0.90
Urban Regeneration Initiative	120.0	3.00
Technical Skill Upgrading	17.0	0.43
Public Transport Initiative	18.0	0.45
Public Health Services Initiative	11.5	0.26
Tourism Initiatives – Buddhist Circuit	30.0	0.75
Natud-Gangoh International Airport	20.0	0.50
Taj International Airport	40.0	1.00
Total	**1 311.5**	**32.79**

Source: The state government of Uttar Pradesh.

Achievements:

- Noida Toll Bridge *Functional*.
- Yamuna Expressway *Under construction*.
- Ganga Expressway *MoU signed on 23.3.08*.

The most successful PPPs have been in road construction

The central government and some state governments have successfully used PPPs in road development, where toll income is proving attractive to the private sector. As part of the National Highways Development Project (NHDP), 66 projects with a value of about USD 6 billion have been implemented *via* BOT, including 42 toll projects and 22 annuity projects. These formed only 10% of road projects in the first two phases of the NHDP, but their success has convinced the government to implement all subsequent NHDP projects *via*

BOT, applying Viability Gap Funding (VGF) grants of up to 40% of the project cost. The government also approved a new Model Concession Agreement (MCA) allowing for grant funding and government guarantees. In the event, VGF grants averaged only 8% of project cost in those projects which opted for VGF support (Government of India, Ministry of Finance, 2007a). The World Bank recorded 63 road PPPs (out of a total of 76 PPPs in all sectors) in 2006, of which 54 were build-operate-transfer (BOT) projects, eight annuity-type projects and one lease arrangement. The majority of private partners were Indian, with four road PPPs arranged with Malaysian companies and one with a US and a Philippines company. Another 13 road PPPs, all but one (yet to be finalised) BOTs, are in the pipeline (World Bank, 2006a).

PPPs are planned in the railway sector

The Railways Ministry's current five-year plan for modernising India's railways envisages that 40% of the 3 trillion rupees investment will be generated through PPPs (Government of India, Ministry of Finance, 2007a). In 2006, two relatively modest railway PPP projects were in operation, both BOTs. However, another 14 were reported to be in preparation (World Bank, 2006a).

The private sector is building ports

There has been substantial private investment in ports, especially in container terminals and in captive and dedicated facilities. While capacity has expanded and efficiency increased, large-scale additional investment is necessary to keep pace with the country's rapid trade growth and bring berth productivity up to global benchmarks. The government recognises that the current regulatory framework, which limits its role to that of regulating tariffs on a cost-plus basis, which is incompatible with a revenue-sharing model, needs to be expanded so that a more effective model for awarding concessions can be established (Government of India, Ministry of Finance, 2007a). Of the eight port PPPs in existence in 2006, four were in the form of international competitive bidding (ICB) contracts with major international operators in the sector, one was the result of a limited tender with another such operator, and three were negotiated with Indian firms. All eight were build-operate-transfer (BOT) projects. Another 12 BOT PPP port projects are in the pipeline (World Bank, 2006a).

Airports

Although airport investment was only opened to foreign investors on a national scale under the draft policy on Airport Infrastructure in December 1997, private participation effectively started with the partial financing by Gulf-based non-resident Indians (NRIs) of the expansion of Cochin Airport, in the state of Kerala, from 1994 to 1999 (Varkkey and Raghuram, 2002). The second airport PPP is the Rajiv Gandhi International

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Airport, popularly known as Shamshabad Airport, 63% of which is owned by the GMR Group and 11% by Malaysian Airport Holding Berhad, while the government of Andhra Pradesh and Airports Authority of India each hold 13%. Both airports are build-operate-own (BOO) projects. A third BOO PPP project, Bangalore International Airport, is in the pipeline (World Bank, 2006a).

PPP experience in power distribution is mixed

PPPs are not yet implemented in power generation. Electricity distribution PPPs are at an early stage of development. A distribution joint venture between the government and the private sector in Orissa and Delhi is reported as having experienced "mixed results", though one of the privatised distribution companies has managed to reduce its losses significantly. Maharashtra has signed the country's first 10-year distribution franchisee pilot contract with an Indian private company for the textile hub area of Bhiwandi Circle. The franchisee has exclusive rights to supply power, which it purchases at pre-determined prices from the government-owned state-wide distribution company. It appears likely, though, that PPPs in electricity distribution will develop only gradually because of the risk perception related to measurement of operational parameters, regulatory risk, information risk and political risk. Designing an equitable risk allocation framework is therefore necessary for the success of PPPs in the sector (Government of India, Ministry of Finance, 2007a).

Urban infrastructure PPPs are developing

The World Bank noted 11 PPPs in 2006, including 6 solid waste management projects, two water supply schemes, one sewerage project, one compost plant and one bus terminal upgrading. The form of PPP varies in the sector, 7 of the projects being build-operate-transfer (BOT), three of them affermage[12] and one build-operate-own (BOO). Another 12, one of them affermage the rest BOTs, are in preparation (World Bank, 2006a).

States vary in PPP use

Apart from 16 road PPPs arranged by the National Highways Authority of India (NHAI) and four container terminals organised by the Ministry of Shipping, Road Transport and Highways (MoSRTH), the majority of PPP projects noted by the World Bank in 2006 were local government, *i.e.* the public partner was a state or municipal government (World Bank, 2006a).

The only PPPs are for road construction in the cases of Madhya Pradesh (21 projects) and Maharashtra (14 projects). Both states are planning urban infrastructure projects and Maharashtra also has three port projects in the pipeline. Gujarat has a variety of PPP projects, three of them in ports, another

three in roads and two in railways. Gujarat also holds the national record for the number of PPP projects abandoned – 9 in total, six of them in ports and three in roads. Tamil Nadu has four road and three urban infrastructure PPPs. Other states and union territories with PPPs include: Delhi (2), Karnataka (4), Kerala (3), Punjab (1), Uttar Pradesh (2) and West Bengal (1). States without previously awarded PPPs that are planning to start some include Andhra Pradesh (two ports and a road PPP) and Orissa (three ports and four road projects), while existing PPP states have more in the pipeline: Gujarat (4), Karnataka (9), Kerala (2), Madhya Pradesh (1), Maharashtra (7), Punjab (2), Tamil Nadu (1), Uttar Pradesh (1) and West Bengal (2) (World Bank, 2006a).

The government is working with international bodies to improve the PPP framework

These numbers show that PPPs are still only at an experimental stage in India. A massive expansion of PPP use may take place once investors are satisfied that there is an adequate institutional framework to support such projects. A number of studies and meetings to identify and propose solutions to the problems pointed out that best current PPPs have been conducted by the Indian government, on its own or in association with international bodies including the World Bank and the ADB.

Studies point to the patchy nature of the regulatory framework across states, which explains the variation in use of PPPs noted above. There is, states the World Bank, "considerable diversity in both the strength of policy and legal frameworks in place, and the level of transactions capacities and experiences" (World Bank, 2006a). The Bank makes several proposals for improved use of PPPs (Box 6.7).

There are also shortcomings common to all states. PPPs are generally used to supplement public sector funding rather than to provide a more efficient service for consumers. There is still inadequate capacity within the administration for handling PPPs.

Box 6.7. **World Bank proposals***

In its 2006 study *Building Capacities for Public-Private Partnerships in India*, the World Bank suggested that:

- PPPs be used to improve the efficiency and quality of service delivery, including in projects where the government remains the purchaser of services, not just in situations where large capital investments are required and where user fees can be used to defray much of the costs.
- State governments and national agencies can lower perceptions of political and regulatory risks involved in PPPs by developing a track record of bringing well-conceptualised PPPs to the market and honouring contractual commitments, particularly where state governments or state enterprises are not financially strong.
- Governments should seek to streamline slow and fragmented approval processes, which increase risks and increase overall cost to bidders, and hence the cost to taxpayers and consumers.
- The public sector should develop better capacities to identify possible PPPs, develop bankable contracts and bid them out, then monitor their performance and costs.

* The World Bank (2006a).

Box 6.8. **Maharashtra PPPs**

The government of the state of Maharashtra supports public-private partnerships (PPPs) as a means of helping relieve its financial burden and also securing efficiency gains. It promotes PPPs at local level through awareness and capacity building programmes, in association with multilateral bodies, notably the ADB.

Roads

Viability Gap Funding is used for PPPs in constructing 1 200 kilometres of 4-lane highways and other roads, including trans-harbour links, in Maharashtra, with 20% from the central government and up to 20% from the Maharashtra state government, and the private sector providing the remaining 60%. The state government considers itself as a supporter, rather than a driver, of PPPs in the sector. Private companies recover their investment by levying pre-set tolls for 25-30 years.

Ports

So far, 43 sites have been identified for port development. Traditionally, ports have been constructed by signing a memorandum of understanding

Box 6.8. **Maharashtra PPPs** *(cont.)*

between the investor and the state, with a concession of 25-30%, recovering the investment by means of fixed wharfage charges. The state government considers that this process has not been transparent, so it is now switching to PPPs *via* a bidding process.

Urban infrastructure

The first corridor of a new metro rail system, involving construction of 15 kilometres of track, has been awarded to a private contractor with Viability Gap Funding provided by both central and state governments. The second corridor, 38 kilometres long, will also be constructed by PPP, as will associated roads, bridges and stations.

Civil aviation

The Multi-Modal International Passenger and Cargo Hub Airport at Nagpur is a PPP project aimed at upgrading and expanding the existing airport at Nagpur, which is in the geographical centre of India and has five national highways passing through it. The Maharashtra government is in the process of acquiring land and funding for a further three airports for which PPPs have been approved. The state's new airports are being constructed by a special purpose vehicle, initially 100% state-owned, with 74% eventually divested. Another 12 airports are in the planning stage.

Tourism and entertainment

PPPs are being used in the modernisation of Taraporevala Aquarium, with four companies so far having submitted bids. A museum is being created by PPP on a decommissioned aircraft carrier, the INS Vikrant, in dock in Mumbai.

Water supply and irrigation

Several pilot PPP water supply projects are in process, including five irrigation projects that remain incomplete as a result of resource inadequacies – the International Finance Corporation (IFC) is conducting a study to develop a feasible model for completing them. Private operators will recover investment from an irrigation cess and also from associated tourism facilities and hydroelectric power generation charges.

Electricity supply and distribution

PPPs are considered difficult to apply in electricity transmission because of the size of investment involved, so the state government involves the private sector by contracting out construction of transmission lines. Private-sector franchises are proposed for electricity distribution.

What process does the government use to evaluate the capacity of the financial sector, including the quality of its regulatory framework, to support effectively enterprise development? What steps has the government taken to remove obstacles, including restrictions on participation by foreign institutions, to private investment in the development of the financial sector?

What laws and regulations are in place to protect the rights of borrowers and creditors and are these rights adequately balanced? Is a registry system in place to support the use of property as collateral and to expand business access to external sources of credit? What data protection and credit reporting laws have been enacted to facilitate the flow of information and improve financial sector stability, thereby enhancing the investment environment?

Before financial market liberalisation began in earnest in 1991, state-owned banks controlled 90% of bank deposits and channelled a high proportion of funds to the government, interest rates were administratively determined, credit was allocated on the basis of government policy and RBI approval was required for individual loans above a certain threshold (OECD, 2007b).

Foreign ownership restrictions persist in the financial sector, as detailed in Chapter 2.

Data protection legislation is understood to be in the drafting process, partly in response to external criticisms of the lack of protection of data transiting India via offshore call centres.

The Credit Information Bureau (India) Limited (CIBIL), was incorporated in 2000. It is India's first Credit Information Bureau, set up by the government of India and the Reserve Bank of India to improve the functionality and stability of the Indian financial system by containing NPAs while improving credit grantors' portfolio quality.

CIBIL was initially promoted by the State Bank of India (SBI), India's largest bank, the Housing Development Finance Corporation (HDFC), India's largest housing finance company, Dun and Bradstreet Information Services India Private Limited (D&B), and TransUnion International Inc. (TransUnion). Shareholding has since been diversified and now includes various financial institutions.

CIBIL provides a centralised database for sharing information and a credit bureau dealing with commercial and consumer credit information. The aim of CIBIL's Commercial Credit Bureau is to minimise instances of concurrent and serial defaults by providing credit information pertaining to non-individual borrowers such as public limited companies, private limited companies, partnership firm proprietorships.

The objective of CIBIL's Consumer Credit Bureau is to minimise defaults and maximise credit penetration and portfolio quality, by providing comprehensive credit information pertaining to individual borrowers. The Bureau collects credit information from its members. As of 2006, 126 credit grantors had accepted membership and committed to give data. Data sharing is based on the Principle of Reciprocity, which means that only members who have submitted all their credit data, may access Credit Information Reports from CIBIL for use in the loan approval process.

6. Public governance

Regulatory quality and public sector integrity are two dimensions of public governance that critically matter for the confidence and decisions of all investors and for reaping the development benefits of investment. While there is no single model for good public governance, there are commonly accepted standards of public governance to assist governments in assuming their roles effectively.

> Has the government established and implemented a coherent and comprehensive regulatory reform framework, consistent with its broader development and investment strategy?
>
> What mechanisms are in place for managing and co-ordinating regulatory reform across different levels of government to ensure consistent and transparent application of regulations and clear standards for regulatory quality?

India's regulatory reform has evolved in line with its economic reform. At the start of the New Industrial Policy in 1991, liberalisation and privatisation prompted deregulation. As a result, the costs of entry and exit have fallen, gradually engendering competition and contributing to higher productivity and economic growth.

The "second generation" of regulatory reform followed a realisation that the past reform had failed to generate sufficient private sector participation in areas such as infrastructure and utilities. As deregulation alone was insufficient for active private sector participation in these sectors, the government has developed a new regulatory framework to ensure a fair and competitive market for private enterprises in sectors formerly characterised by monopolistic conditions and the dominance of state-owned enterprises. Regulators were set up in many sectors including the Telecommunication Regulatory Authority of India (TRAI),[13] the Securities Exchange Board of India (SEBI),[14] the Central/State Electricity Regulatory Commissions,[15] the Directorate General of Hydrocarbons[16] for oil and natural gas exploration, the Insurance Regulatory and Development Authority,[17] the Director General of

Civil Aviation,[18] the Tariff Authority for Major Ports, the RBI for financial sector, the National Pharmaceutical Pricing Authority,[19] the Petroleum and Natural Gas Regulatory Board for downstream petroleum and natural gas activities, and the Central Ground Water Authority for ground water development.[20] A new competition law[21] was passed in 2002 to ensure a competitive environment for both private and public enterprises in all sectors.

India is still at an early stage of developing a modern regulatory regime. Sector-specific regulations have evolved separately, producing an uneven regulatory environment where there is substantial difference in objectives, structures and procedures among sector-specific regulators (Government of India, Planning Commission, 2008). These new regulators are not perceived as independent from political pressures due to the conflict of interests between regulators and the regulated enterprises, large SOEs with close ties to sectoral ministries. Many regulators are not fully functional, with many vacant posts, high staff turnover and limited powers.

India's performance in public governance, reflected in various investment climate indices (*e.g.* time and cost required to set up a business, perceived over-staffing rate, time to declare a firm bankrupt, manager's time spent dealing with government officials, and a number of inspector visits), is still weak in international comparison. Divergence among states is wide. Certain regulatory reforms have not been implemented though widely recommended. For example, reform of labour regulations,[22] which impair flexibility in major employment decisions such as hiring, firing and reallocation, has not started at the central level, or the small-scale industry (SSI) reservation, which, though relaxed, remains in place.

India has yet to develop a coherent and comprehensive regulatory reform framework. Co-ordination of regulatory frameworks among sectors has been insufficient. Some sectors, such as higher education, are still burdened by micro-regulation while others, such as healthcare, lack effective regulations to ensure quality standards and protect consumers from anticompetitive practices. Potential judicial overlaps between sectoral regulators and the new Competition Commission have not been resolved. Given the complex, long-entrenched institutional structure developed to implement regulations in India, regulatory reform is inevitably a time-consuming process involving various government agents at both central and local level. The current Five-Year Plan includes an improvement in the quality of public governance, including economic regulation. It sets up principles such as separation of powers, democratic accountability of regulators, federal principle, and participatory regulatory process in guiding India's future regulatory reforms. While these regulatory principles are clear and sound, a mechanism to apply these principles has not been established.

To what extent are regulatory impact assessments used to evaluate the consequences of economic regulations on the investment environment? Are the results of these assessments made public on a timely basis?

Regulatory impact assessments are not used in a systematic manner in India. Nonetheless, assessment may be initiated as sector ministries or the Planning Commission perceive the needs for such assessment. For example the Planning Commission prepared a report on approach to regulation of infrastructure in 2008, based on the understanding that infrastructure development in India would require mobilisation of much more private sector resources and expertises than before and regulatory reform should be designed to create an investor-friendly environment supportive for such private sector mobilisation.

To what extent are the administrative burdens on investors measured and quantified? What government procedures exist to identify and to reduce unnecessary administrative burdens, including those on investors? How widely are information and communication technologies used to promote administrative simplification, quality services, transparency and accountability?

The government does not have a systematic programme to identify and measure the administrative burdens on investors. However, the government interacts regularly with Indian business associations which make proposals to the government on reducing administrative burdens on business. If the government decides to act on such proposals, it first constitutes an *ad hoc* commission or expert group to solicit recommendations. For example, it set up the second Administrative Reforms Commission (ARC)[23] in 2005 to suggest measures to make government administrations more responsive, accountable and efficient at all levels. The DIPP has also commissioned several studies on administrative and other burdens hampering investment projects.

External institutions have found India's administration to be burdensome. For example, the World Bank's *Doing Business* survey (2009) ranks India low in categories whose ranks are highly affected by administrative efficiency such as dealing with construction permits (136th out of 181), registering property (105th), and paying taxes (169th).

The government has started to apply information and communication technologies (ICT) to re-engineer the government interface with businesses and citizens and make its processes more transparent and objective. After a

decade of implementing individual e-governance initiatives at various levels, the government started a holistic approach towards e-governance initiatives nationwide by announcing a National e-Governance Plan (NeGP)[24] in 2006. The NeGP aims to make all government services accessible to citizens in an efficient, transparent and reliable manner through ICT. It currently consists of 9 central-level programmes, 11 state-level programmes and 7 integrated programmes. For example, MCA21 Project by the Ministry of Company Affairs aims to improve the speed and certainty in the delivery of MCA services such as filing of documents, registration of companies and corporate information access through an electronic portal. The e-Trade Project of the Ministry of Commerce and Industry introduces electronic delivery services by government agents handling imports and exports. A Central Board of Excise and Customs Project enables taxpayers to access information and make online transactions through the internet. The DIPP's e-Biz project provides comprehensive G2B services to all the business entities in an efficient, transparent and reliable manner. In parallel, the government has been providing support infrastructure for e-governance and capacity building programmes to government staff at state and local levels.

The NeGP has a programme management unit under the Department of Information Technology to facilitate and monitor project implementation, provide capacity building, conduct research and create awareness of the NeGP. An impact evaluation study of the NeGP (Department of Information Technology, 2008) reported several benefits brought by the Plan such as time saving by users and reduced payment of bribes.

To what extent have international anti-corruption and integrity standards been implemented in national legislation and regulations? Do penal, administrative and civil law provisions provide an effective legislative and regulatory framework for fighting corruption, including bribe solicitation and extortion as well as promoting integrity, thereby reducing uncertainty and improving business conditions for all investors?

The Prevention of Corruption Act 1988 is the main law for fighting corruption. It criminalises corruption in the form of active and passive bribery, extortion, bribery of a public official and abuse of office. Under the Act, any public servant taking gratification is liable for punishment with a fine and imprisonment, which may extend up to 7 years. An institutional framework to implement the Act has been developed.

Recently India took a major step towards transparency with the enactment of the Right to Information Act of 2005. The Act is intended to give

citizens better access to government records by mandating public authorities to provide information within a prescribed timeframe and thus increase transparency of public administration. The Central Information Commission was established in 2005 to implement the Act and most states also set up State Information Commissions.

The government has endeavoured to increase transparency and confidence in procurement and contract management by government departments and state-owned enterprises. The Central Vigilance Commission (CVC)[25] recommended adoption of integrity pacts in all government procurement activities in its circulars in 2007 and 2008. An Integrity Pact commits procuring agents and bidders to a level playing field and no illegal payments over the entire procurement process. The Ministry of Defence has adopted integrity pacts in all defence procurement above a certain size since 2006 and several state-owned enterprises have also signed integrity pacts.[26]

Though India has a legal framework to fight corruption, implementation is incomplete and corruption remains a major problem. Transparency International's Corruption Perception Index for 2008 ranks India at 85th position out of 180 alongside Albania, Madagascar, Montenegro, Panama, Senegal and Serbia. This rank is markedly worse than its 72nd position in 2007.

Do institutions and procedures ensure transparent, effective and consistent application and enforcement of laws and regulations on anti-corruption, including bribe solicitation and extortion and integrity in the public services? Have standards of conduct by public officials been established and made transparent? What measures are used to assist public officials and to ensure the expected standards are met? Are civil society organisation and the media free to scrutinise the conduct of public officials' duties? Are whistle blower protections in place?

India has developed an institutional framework to implement laws and regulations against corruption. At the central level, the CVC and the Central Bureau of Investigation (CBI)[27] are the two prime institutions responsible for implementing anti-corruption laws and regulations. The CVC, first set up in 1964, was given a statutory status and guaranteed operational independence under the CVC Act of 2003. The CVC advises the government on the integrity of public administration servants, monitors corrupt practices in violation of the Prevention of Corruption Act and handles complaints on corruption cases. The CBI, set up in 1963, is an investigating agency under the Ministry of Personnel, Public Grievances and Pensions. The CBI derives its power to investigate offences from the Delhi Special Police Establishment Act

of 1946. The Anti-Corruption Division of the CBI investigates all corruption cases allegedly committed by public servants of the central government and its state owned enterprises. The CVC has a supervisory power over the CBI with respect to the investigation of corruption cases.

All ministries/departments at the central government level have a Vigilance Division headed by a Chief Vigilance Officer (CVO) for internal checks on misbehaviour and corruption. CVOs work for the integrity of their respective internal staff and communicate with the CVC and the CBI. The Comptroller and Auditor-General of India (CAG), a supreme audit authority in charge of ensuring the accountability of public expenditure, also checks on corrupt behaviour in its regular financial audit of governmental bodies. Although the CAG can reveal financial irregularities in audit reports of various governmental offices, it does not have power and means to enforce compliance with its proposals.

At the state level, the State Vigilance Commission/Commissioner, the Anti-Corruption Bureau and/or the Lokayukta are set up as anti-corruption agencies. The State Vigilance Commission (SVC) and the Anti-Corruption Bureau are state-level equivalents of the CVC and the CBI. The Lokayukta is given a higher authority to deal with corruption of top public servants which tend to escape investigation of the SVC and the Anti-Corruption Bureau. There is no standard institutional set-up for anti-corruption at state level; and functions, power and resources of these state-level anti-corruption agents are highly diverse.

Although this institutional framework is in place, its effectiveness in implementing anti-corruption regulations remains weak. The conviction rate of investigating agencies is low and there is a large backlog of pending cases. Despite a legally mandated independent status, these institutions are still perceived to be struggling under political pressures and have failed to convince the public of their ability to convict high ranking officials against corruption. However, the Supreme and High Courts and the Election Committee have recently proved more active in prosecuting malpractices.

The code of conduct for public servants is provided in the Central Civil Services (Conduct) Rules 1964 and corresponding state-level rules. These rules are continuously updated to include additional behavioural codes, reflecting expectations of society. India is considering introducing a Public Services Bill whose draft is available on the website of the Ministry of Personnel, Public Grievances and Pensions. The Bill is intended to consolidate regulations on public servants and includes a Public Service Code and a Public Service Management Code laying down specific duties and responsibilities.

In 2004, the government passed a resolution on Public Interest Disclosures and Protection of Informers which strengthens whistleblowers protection. This designates the CVC as the authority to protect whistleblowers

and act on their complaints. The CVC can take action against those who leak names of whistleblowers and can request police assistance in investigation. Despite these improvements, cases of harassment of whistleblowers are still reported. A Public Interest Disclosure (Protection of Informers) Bill drafted by the Law Commission in 2001 is pending for approval.

> Do review mechanisms exist to assess the performance of laws and regulations on anti-corruption and integrity?

The Planning Commission reviews existing conditions of public governance including corruption committed by public servants and makes suggestions for improvement as part of its comprehensive exercise in the formulation of five-year plans. The 11th Five-Year Plan (2007-11) acknowledges that "corruption in public services has assumed serious dimension" and that "in the last few decades, its scale, growth and spread have significantly increased". To remove corruption, the Plan proposes: an increase in power of the CVC and SVCs; strengthening the CAG's watchdog role; tackling corruption in public utilities and municipal services; a thorough and systematic review of all legislations to minimise discretionary decision making; formulating a code of conduct to regulate relations between government and private enterprises; and the development of self-policing arrangements.

The Law Commission of India regularly reviews Indian laws and proposes amendments or legal reform measures to the government. While its coverage is universal and not limited to anti-corruption laws, the Commission submitted a report recommending adoption of the Public Interest Disclosure Bill in 2001. This report was initiated by a CVC request to draft a law which would encourage disclosure of corrupt practices on the part of public servants and protect whistleblowers from victimisation.

In 2005, the government established the second Administrative Reform Commission under the Ministry of Personnel, Public Grievances and Pensions. This is expected to make recommendations on public administration reform. According to its terms of reference, the Commission was to consider ethics in governance along with 12 other issues. In its 4th report on ethics in governance in 2007, it recommended measures to strengthen vigilance to eliminate corruption, address systematic deficiencies discouraging punishment of the corrupt, and combat corruption and arbitrary decision making.

India is a member of the ADB/OECD Anti-Corruption Initiative for Asia and the Pacific.[28] This Initiative was launched in 1999 to curb corruption to counter its negative effects on political stability, welfare, economic development, and international trade and investment. It is currently

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> Is the government a party to international initiatives aimed at fighting corruption and improving public sector integrity? What mechanisms are in place to ensure timely and effective implementation of anti-corruption conventions? Do these mechanisms monitor the application and enforcement of the anti-corruption laws implementing the conventions?

supported by 28 governments in the region and India joined the Initiative in 2001 by endorsing the ADB/OECD Anti-Corruption Action Plan for Asia and the Pacific. Since then India has been represented in the Steering Group *via* the Ministry of Personnel, Public Grievances and Pension and has been committed to implement its priority reform programmes[29] under the Action Plan.

India signed the United Nations Convention against Corruption in 2005. While the UN Convention provides for international co-operation in combating corruption cases, it also obligates member states to implement domestic measures that meet common standards. It is yet to be ratified as the government is preparing implementing legislation.

India is not among the 38 countries which have ratified the OECD Anti-Bribery Convention. The OECD Convention was signed in 1997 as a multilateral commitment to fight corruption in international business transactions. Signatory countries are required to adopt national legislation making it a crime to bribe foreign public officials, imposing dissuasive sanctions and providing mutual legal assistance. Surveillance on compliance to the OECD Convention is carried out by the OECD Working Group on Bribery to ensure that signatory countries strengthen and enforce their anti-bribery laws.

Notes

1. The rates cited in this and the next paragraph are those in the Finance Act 2007. These were left unchanged in the 2008-09 budget. See *www.excise.gov.in*.
2. Interview with Ministry of Corporate Affairs, 3 July 2008.
3. NFCG website, *www.nfcgindia.org*.
4. Interview with Ministry of Corporate Affairs, 3 July 2008.
5. The participating Asian economies include: Bangladesh, China, Hong Kong (China), India, Indonesia, Korea, Malaysia, Pakistan, the Philippines, Singapore, Chinese Taipei, Thailand and Viet Nam.
6. The circular containing the revised Clause 49 is on the SEBI website, *http://web.sebi.gov.in*.
7. The Golden Peacock Global Award for Excellence in Corporate Governance for 2008 was awarded to Satyam by The World Council for Corporate Governance (WCFCG) in September 2008.
8. United Nations website, *www.un.org*.

9. The Net Enrolment Ratio (NER) is defined as the proportion of students of official school age of 6-11 years enrolled in grades I-V to the population of children of age group 6-11 years.
10. Infrastructure provision can also reduce or remove the hidden costs of poor infrastructure. For example, where a village has no water supply, girls may spend several hours a day fetching water. Studies in Africa have shown that school attendance increased significantly when water systems were improved [Kalra and Shekhar (2006)].
11. This section is largely based on a written briefing from the PPP Cell of the Department of Economic Affairs provided during the OECD research mission in July 2008.
12. An affermage arrangement is one in which operator is responsible for operating and maintaining the infrastructure facility but is not required to make any large investment. Unlike a leasing arrangement, in which the operator retains revenue collected from users and makes a specified lease fee payment to the contracting authority, the operator and the contracting authority in an affermage arrangement share the revenue from users.
13. *www.trai.gov.in*.
14. *www.sebi.gov.in*.
15. *www.cercind.gov.in*.
16. *www.dghindia.org*.
17. *www.irdaindia.org*.
18. *www.dgca.nic.in*.
19. *www.nppaindia.nic.in*.
20. More sectoral regulators, including a Water Regulatory Authority, a Broadcasting Regulatory Authority, an Airports Economic Regulatory Authority and a Post Regulatory Authority, are under consideration.
21. The Competition Act 2002 (amended in 2007).
22. They are embodied in the Industrial Disputes Act 1947, the Industrial Employment Act 1946 and the Contract Labour (Abolition and Regulation) Act 1970.
23. *http://arc.gov.in/index.htm*.
24. *http://mit.gov.in/default.aspx?id=144*.
25. *www.cvc.nic.in*.
26. The ONGC was the first enterprise in India to sign an MOU with the Transparency International Indian and the CVC in 2006 to adopt integrity pact in its procurement and contract practices.
27. *www.cbi.gov.in/default.php*.
28. *www.oecd.org/pages/0,3417,en_34982156_34982385_1_1_1_1_1,00.html*.
29. India proposed its priority project at the second Steering Group meeting in 2002 to review existing conduct rules specified for public servants and conduct training of officials performing the vigilance function in ministries/departments and public sector enterprises.

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Chapter 7

Progress and Challenges at State Level

This chapter examines variations in economic growth across states during the reform period and explores possible links with policies towards investment, including foreign direct investment (FDI). The evidence indicates that economic policy reforms are a necessary condition for investment attraction, along with investment in human capital. Maharashtra is cited as an example of successful reform and investment promotion. The chapter ends with tentative suggestions for improving the investment performance of India's states.

1. Introduction

India has a federal system of government. Its constitution specifies a division of powers between central and state governments (see Box 7.1). Variations in economic performance between states may thus arise both from the application of different policies in policy areas which are the prerogative of state governments and from the mediation of state governments of varying political denominations in the implementation of national policies, not least because the division of powers includes a large element of overlapping jurisdiction, as set out in the "concurrent list".

This chapter examines variations in economic growth across states during the reform period and explores possible links with investment, including foreign direct investment (FDI). The evidence indicates that economic policy reforms are a necessary condition for investment promotion, along with investment in human capital. Maharashtra is cited as an example of successful reform and investment promotion. The chapter ends with tentative suggestions for improving the investment performance of states.

Box 7.1. **Division of powers between central and state governments**

In India's federal system, states have more autonomy than union territories

India has a federal political system uniting 28 states[1] and 7 union territories.[2]

States have a relatively high degree of autonomy. The executive power of the state is vested in a governor (Article 154) appointed by the federal president (Article 155). The governor is aided and advised by a council of ministers led by a chief minister (Article 163); after being appointed by the governor, the chief minister recommends other ministers for approval by the governor (Article 164). The council of ministers is collectively responsible to the state's legislative assembly [Article 164(2)], which is bicameral in Bihar, Maharashtra, Karnataka and Uttar Pradesh, and unicameral in other states (Article 168). Each state also has a high court (Article 214), consisting of a chief justice and other justices appointed by the president of India (Article 217), which tops a system of district courts.

Union territories have less autonomy than states. They are administered by the president, acting through an administrator (Article 239), with the exception

Box 7.1. **Division of powers between central and state governments** *(cont.)*

of Pondicherry, which may have a legislature and council of ministers (Article 239A). The National Capital Territory of Delhi is administered by a lieutenant governor appointed by the president (Article 239AA).

Central and state legislative powers are set out in three lists

Part XI of the Constitution of India sets out in detail the relations between the union (*i.e.* the central government) and the states. The national parliament has exclusive power to make laws with respect to policy areas in a list appended to the Constitution known as the "union list". Similarly, those areas exclusively covered by laws made in state legislatures are in a "state list". Overlapping areas of policy in which both the centre and the states may enact laws are enumerated in a "concurrent list" (Article 246). The national parliament has residuary power to legislate in areas not covered by the state and concurrent lists (Article 248) and may legislate on items in the state list if a proclamation of emergency is in operation (Article 250). If any provision of a law made by a state legislature contravenes a law made by parliament, the latter prevails and the state law is void (Article 254).

The **Union List** includes the usual prerogatives of central governments in both unitary and federal jurisdictions: defence, foreign affairs, citizenship, passports and visas (Seventh Schedule, List I, Articles 1-21), as well as currency, foreign exchange, foreign loans, postal services, central banking and all lotteries, whether at central or state level (Seventh Schedule, List I, Articles 36-40). In the area of transport, the central government is empowered to legislate for railways, national highways, inland shipping on designated national waterways, major ports, airways and airports. Also in the Union List are telecommunications and broadcasting "and other like forms of communication" (Seventh Schedule, List I, Article 31).

The **States List** covers a wide area of local facilities, such as local roads, bridges, ferries and municipal tramways, but also whole sectors for which the rationale for allocating them exclusively to state control is not self-evident. While gas and gas works are strictly a state prerogative, electricity is in the **Concurrent List**, so may be legislated on by central and state governments. Agriculture and fisheries are in the State List (except fishing outside territorial waters, which is in the Union List), but forests are in the **Concurrent List**.

1. The state of Jammu and Kashmir, which is disputed territory, is defined as not being one of India's states by Article 152 of the Indian state constitution.
2. Constitution of India, First Schedule. Article numbers in brackets in this box refer to the Constitution.

2. Evaluating the investment environment in India's states

Economic growth in the reform period has varied between states...

States have shared unevenly in the faster growth produced by economic reform in the 1990s. Most of the research papers that have examined whether per capita income levels have been converging or diverging between India's states following the economic reforms of 1991 have found a tendency towards divergence (Sachs, Bajpai and Ramjah, 2002).[1]

A comparison of gross state domestic product (GSDP) growth rates in the ten years up to 1991 and the subsequent ten-year period shows a significant disparity between states (see Table 7.1). For example, in Bihar, one of India's poorest states, it expanded at an annual average rate of only 2.88% in the second period, while GSDP in Gujarat, one of the richer states, increased at an annual average rate of 8.15%. Poorer states typically recorded lower growth rates than richer states in the reform period. Furthermore, poorer states experienced a deceleration in growth, while the GSDP of richer states tended to accelerate at that time. Combined GSDP growth rates rose between the two periods from 5.24% to 5.90%, but GSDP growth in Bihar fell from 4.66% to 2.88% and in Uttar Pradesh from 4.95% to 5.89%, while in Maharashtra GSDP growth increased from 6.02% to 8.01%, in Tamil Nadu from 5.38% to 6.02% and in Gujarat from 5.08% to 8.15%. As a result, some inter-regional inequalities widened in the 1990s, though the picture is complicated by a deceleration in growth in two richer states, Punjab and Haryana (Ahluwalia, 2001).

Table 7.1. **Factors associated with per capita growth of real GSDP (1991-2001)**

	GSDP per capita in 1997/98 in rupees	Growth in per capita GSDP 1980-98	Coastal access (% of population within 100 km of coast)	Major port city	Number of export-oriented units 1991-2001	FDI per capita 1991-2001	Rate of urbanisation in 1991
Bihar	1 261	1.0	0		7	89	13.17
Maharashtra	5 690	4.5	34	Mumbai	563	4 716	38.73
Tamil Nadu	3 454	4.3	65	Chennai	547	3 587	34.00
Uttar Pradesh	2 023	2.0	0		206	253	34.20
West Bangal	3 308	3.3	43	Kolkata	98	1 050	27.39

Source: Sachs, Bhajpai and Ramiah (2002).

... partly because of differences in investment rates...

Investment is a key factor affecting differences between GSDP growth rates. In particular, a highly significant positive correlation has been found between the rate of private investment and state GSDP growth rates, explaining almost a third in the variation in growth between states. By

contrast, public investment expenditure and state economic plans have been found to be unrelated to GSDP growth of states (Ahluwalia, 2001). Another important explanatory variable is urbanisation as of 1991, which is consistent with the process of urban-led growth which has characterised the period since 1991 (by contrast with "green revolution" led growth in earlier decades, which favoured states like Rajasthan) (Sachs, Bajpai and Ramjah, 2002).

… including differences in FDI inflows

Another determinant of GSDP growth appears to be foreign direct investment (FDI). The state with the highest recorded FDI per capita in 1991-2001 was the state with the highest GSDP growth, Maharashtra, with 4 716 rupees. Bihar, with only 89 rupees per capita FDI, is the lowest recipient of the 14 states studied, and the state with the slowest GSDP growth. States with higher FDI also tend to be those near the sea, with major ports, and home to more export-oriented units (Sachs, Bajpai and Ramjah, 2002).

Studies indicate a link between investment attraction and economic reforms…

A 1999 study demonstrated a clear link between a state's reform orientation and its economic performance, including FDI attraction and FDI attractiveness. The study identified a group of "reform-oriented states" (Andhra Pradesh, Gujarat, Karnataka, Maharashtra and Tamil Nadu), a second group of "intermediate reformers" (Haryana, Orissa and West Bengal) and a larger group of "lagging reformers" (Assam, Bihar, Kerala, Madhya Pradesh, Punjab, Rajasthan and Uttar Pradesh). Reform-oriented states were shown to have experienced higher GSDP growth rates after 1991 (Bajpai and Sachs, 1999). At the same time, other explanatory variables have to be taken into account, including coastal access – the richer and faster-growing states tend also to be western coastal states which contain major port cities, facilitating the growth of export-oriented industries.

… and between economic reforms and FDI performance

As pointed out in Chapter 1, a precise breakdown of FDI by state is not possible because inflows recorded by the RBI at its regional centres do not include the location of actual investments. However, the partial data that have been collected indicate that states which have made progress in economic reforms have tended to be more successful in attracting both domestic and foreign investment. One study that compares the shares in total approved FDI in 1991-2004 for which locational details are known shows that much of this has accrued to states which have made progress in reforming their investment environments, with Maharashtra, Delhi, Tamil Nadu and Karnataka at the head of the list (Rao and Murthy, 2006; see also Table 7.2).

Table 7.2. **Distribution of approved FDI (1991-2004) for which location details are known**

State	Share (%)
Maharashtra	23.63
Delhi	13.29
Tamil Nadu	11.59
Karnataka	11.16
Gujarat	8.71
Andhra Pradesh	6.35
Madhya Pradesh	4.58
West Bengal	4.31
Orissa	3.80
Uttar Pradesh	2.33
Haryana	1.79
Rajasthan	1.40
Punjab	1.12
Kerala	0.72
Himachal Pradesh	0.54

Source: Rao and Murthy (2006).

However, implementation of reforms appears to be a necessary, but not a sufficient, condition for FDI attraction. The influence of other factors is indicated by the relatively weak FDI performance of Andhra Pradesh, which, along with Tamil Nadu, is one of the two most reform-oriented states (Bajpai and Sachs, 1999). Both Andhra Pradesh and Gujarat, which also experienced only moderate benefit in terms of FDI inflows from their reform orientation, are coastal states, so they do not suffer the constraints experienced by landlocked states like Bihar and Uttar Pradesh.

Those states that appear to have attracted the least FDI tend to be poorer states with slow growth, where growth has often also decelerated while it has accelerated in the rest of the country. These states also tend to fare less well as measured by human development indicators, although there have been marked improvements in recent years.[2] Examples include Bihar, with a literacy rate in 2001 of only 47%, well below the national average rate of 64.84%, and an infant mortality rate at the same time of 67, or Uttar Pradesh, with a literacy rate of 56.27% and infant mortality of 85.

Conversely, strong investment in human capital appears to pay off in terms of encouraging growth and attracting domestic and foreign investment. Instances include Maharashtra, with a literacy rate of 76.88% in 2001, also Delhi (81.67%) and Tamil Nadu (73.45%). A major exception is Kerala, which had the highest literacy rate (90.86%) and by far the lowest infant mortality rate (16%) of highly-populated states in the 2001 census, but is not noted for having investor-friendly policies.

Measuring states' economic reform progress is complex

Differences between the economic policies of India's states are not as clear as differences between economic policies of nation states. Constitutional constraints on state power (see Box 6.5 above) ensure that national policies enacted by the central government are enacted in all states, though there may be differences in commitment to these policies at state level and hence in the speed and effectiveness of implementation.

To the extent that states are run by parties and leaders of different political persuasion from each other and from those at the central government level, there may be differences not only in commitment to national policies but also differences of policy between them in areas that are state prerogatives. At independence, most states were run by the same party, Congress, as the central government; in recent decades, Congress has no longer had a firm grip on central power or on the states, which are run by diverse parties and groups. At the same time, international political and economic changes have influenced the thinking of almost all players, and a broad consensus in favour of economic reform is emerging, albeit tempered by interest-group politics.

An objective comparison of states' reform progress should be based on the actions of state governments, not simply on their political character, which is, at best, only a summary indicator of likely attitudes to economic reform. For example, it is not surprising that Kerala and West Bengal, which have been dominated for many years by communist parties, are less keen to change laws and regulations that protect the rights of workers. Both states, however, have started to embrace the free market and welcome private, including foreign, investment.

A state's application of sectoral policies may only be a weak indicator of reform commitments, as it is also likely to reflect the stage of economic development. Bihar, for example, implements such policies only in agriculture and the sugar industry. By contrast, Maharashtra has a wide range of policies covering primary, secondary and tertiary industries. Tamil Nadu's and West Bengal's sectoral policies are mainly aimed at developing "sunrise" industries (biotech and IT)(see Table 7.3).

Product market regulation varies across states

The *OECD Economic Survey of India* found a wide variation in product market regulation across states, as shown in Figure 7.1 (OECD, 2007b).

Table 7.3. **Sectoral policies by state**

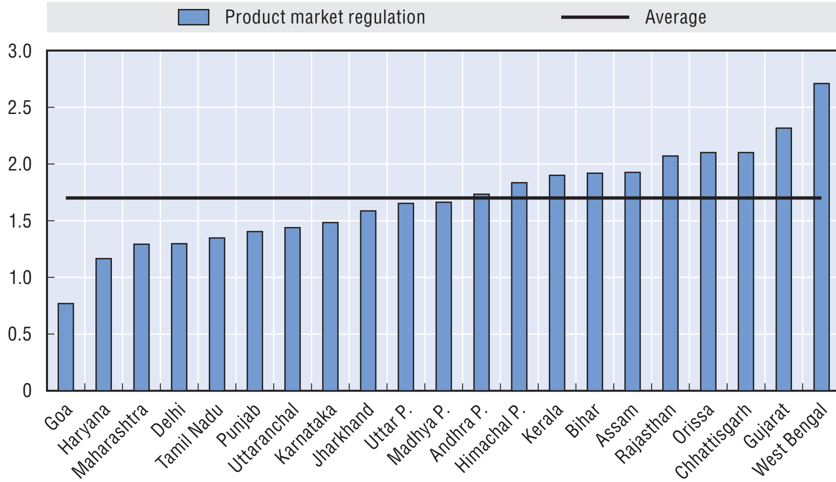
Sector	Bihar	Maharashtra	Tamil Nadu	Uttar Pradesh	West Bangal
Agriculture	Agriculture policy 2006	Key thrust sector			
Automobiles/ components		Key thrust sector			
Biotech		Key thrust sector	Biotech policy	Biotech policy 2004	Biotechnology policy
Chemicals/ petrochemicals		Key thrust sector			
Engineering		Key thrust sector			
Film industry				Film industry policy 1999	
Financial services		Key thrust sector			
Food processing				Policy for food processing industry 2004-09	
IT		Key thrust sector	IT policy	IT policy 2004-09	IT policy 2003
ITES		Key thrust sector	ITES policy		
Media and entertainment		Key thrust sector			
Minerals				Mineral policy	Mineral policy
Pharmaceuticals		Key thrust sector			
Power				Power policy 2003-09	
Sugar	Policy for sugar industry			Sugar policy 2004	
Textiles		Key thrust sector		Textile policy	
Tourism			Tourism policy	Tourism policy/hotel policy 2006	

Sources: India Brand Equity Foundation; state governments.

According to the *Survey*, some of the variation in economic performance between states appears to be related to differences in product market regulation, and a negative relationship has been established between the location of FDI and product market restrictions, as indicated in Figure 7.2.

Figure 7.1. **Indicators of product market regulation by state**[1]

The indicator score runs from 0-6, representing the least to most restrictive regulatory regime

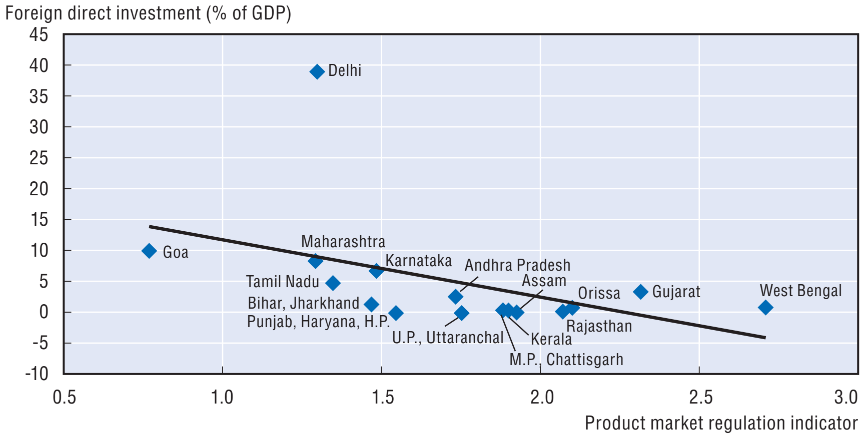


1. The high-level PMR indicators for Indian states have been modified to better reflect the ways in which state governments influence the regulatory environment, they are not directly comparable with the national indicators.

Source: Conway (2007).

Figure 7.2. **Product market regulation and foreign direct investment by state**[1]

The indicator score runs from 0-6, representing the least to most restrictive regulatory regime



1. Foreign direct investment is measured as cumulative inflows over the period 2000 to 2006 as a share of annual average state GDP.

3. Maharashtra's performance

Maharashtra's reforms, together with its favourable location, have enabled it to become one of the richest states, having enjoyed the highest per

capita GSDP growth rates (see Box 7.2). Favourable regional factors include the possession of a major entry port in Mumbai, developed manufacturing industry, a skilled labour force and major tourist attractions.

Box 7.2. **Maharashtra: Basic background***

Territory: Maharashtra is India's third largest state. Its land area is 308 000 km^2, nearly 10% of India, divided into 35 districts. The state capital, Mumbai, is India's largest city.

People: The population is 97 million, 9% of India's total, making it the second most populous state in the country. It is also young, with 67% of its people below the age of 34. There is a high rate of net immigration. The literacy rate is relatively high for India at 77%.

Economy: Maharashtra is the richest state. It produces 13% of India's GDP and its per capita GDP is 44% above the national average. Real annual GSDP growth in the most recent year, 2006-07, was 9.4%. The largest sector is services, which contribute 61% of GSDP, with industry at 26%. The state produces 42% of the country's exports. Maharashtra contributes some 40% of India's tax revenues.

Infrastructure: There are two large and several smaller seaports in Maharashtra. The Jawaharlal Nehru Port (JNPT) opposite Mumbai is the largest container port in India, handling 56% of the country's container traffic; the older port of Mumbai Harbour handles a larger tonnage. The state's four major international and domestic airports, which include the country's busiest airport, Mumbai, carry 34% of India's international passenger and cargo traffic. Some 11% of India's road mileage and 9% of its rail network are in Maharashtra. Installed electricity generation capacity in Maharashtra is 15 210 MW, 10 000 MW of which is from publicly-owned power stations; the rest is provided mainly by two private providers, Tata (since 1968) and Reliance (since the 1990s). The state has 10 billion m^2 of live water storage capacity. With Mumbai as the landing site for India's undersea cable, Maharashtra has reliable, cost-effective telecommunications. Maharashtra has over 229 public industrial parks (including parks specialising in such sectors as chemicals and IT) spread over 130 000 acres.

* Information provided by the government of Maharashtra during the OECD research mission on 7 July 2008.

Total factor productivity is relatively high in Maharashtra. Compared to factories in other parts of India, factories in Maharashtra produce 37% more output and 51% more value-added with only 16% more capital and 2% more labour.[3]

In the period 1991-2001, Maharashtra was home to the largest number of export-oriented units (EOUs), 563, representing 15.3% of the national total. However, in terms of EOU per million of population, Maharashtra, at 5.8, is half-way down the league table, which is topped by Haryana (9.8) (Sachs, Bajpai and Ramiah, 2002).

In 1995-96, Maharashtra came below only Karnataka in value of software exports, both total and per capita (Sachs, Bajpai and Ramiah, 2002).

In 1991-2001, FDI approvals for Maharashtra totalled 456.3 billion rupees, the highest of any state. Tamil Nadu came second, with 222.8 billion rupees and Karnataka third with 208.2 billion rupees. By contrast, West Bengal registered FDI approvals of 84.2 billion rupees, Uttar Pradesh 42.1 billion rupees and Bihar a mere 7.4 billion rupees (Sachs, Bajpai and Ramiah, 2002). By mid-2008, a total of 4 009 approvals with a value of USD 18 billion had been granted for FDI projects in Maharashtra, the highest in India.[4]

With an annual student capacity of 244 000, Maharashtra has a disproportionate (to population) share of higher education institution, with 12% of India's universities, 13% of its engineering education institutions, 17% of its medical colleges, and 19% of its management training facilities.[5]

The government of Maharashtra is planning to achieve at least 10% annual growth in manufacturing and 12% annual growth in services. It intends to develop Maharashtra as "Asia's most competitive manufacturing and services hub" and put Mumbai among the top five financial centres in the world, while retaining Maharashtra's position as India's best investment destination.[6] It expects this growth to generate two million additional jobs by 2010 (Government of Maharashtra, Department of Industries, Energy and Labour, 2006).

Of Maharashtra's 141 Special Economic Zones (SEZs), 98 have been given central government approval and 43 of these – the "easier" ones, including IT SEZs – have been finally notified. Maharashtra, the first state to frame SEZ policy in 2001, has prepared draft legislation for state dispensation of SEZs. Fiscal incentives are applied in the SEZs without legislation. At the moment, these incentives include duty and octroi waivers and VAT (formerly sales tax) refunding for units. The government will probably extend these incentives also to developers. The SEZs were originally export-oriented, so the government started by concentrating them along the coast, but a number of them, especially in the IT sector, are now located far inland, for example the MIHAN[7] SEZ project in Nagpur at the eastern end of the state, near the geographical centre of India.[8]

The Maharashtra Industrial Development Corporation (MIDC) organises projects with the private sector, with the MIDC providing land (see Box 7.3). The MIDC is also making some effort to co-opt other sectors of society which might otherwise be opposed to land acquisition for non-farming purposes. For

Box 7.3. **The Maharashtra Industrial Development Corporation (MIDC)**

The Maharashtra Industrial Development Corporation (MIDC), a government of Maharashtra undertaking, is the largest and oldest industrial development corporation in India. MIDC undertakes land acquisition to make it available for industrial development by providing infrastructure, including water, power, roads, telecommunications, gas, effluent treatment plants, sewerage and hazardous waste management plants.

MIDC offers a number of services to investors *via* its "one-stop shop", including clearances, development permissions, customised packages for mega-projects, cheap land on 95-year leases and the encouragement of industrial clusters.

MIDC manages and owns 12 airports/landing strips and 2 425 km of roads and provides inland container depots. It has allotted land for 10 power projects for 3 500 MW generation, including five biomass-based projects. It is acquiring land for a further two power projects generating 2 000 MW. It plans to put two power SEZ projects totalling 1 250 MW into PPP mode. It plans to make gas available to all major industrial areas and SEZs within three years.

MIDC is developing 22 out of 141 SEZs in Maharashtra. Five other SEZs are being developed as joint ventures between MIDC and private partners and another nine are being developed by private developers. Expected investment in infrastructure in SEZs is USD 22 billion. The Zones are expected to employ 5.5 million people.

instance, in Pune the MIDC has promoted two companies with NGOs and local farmers as shareholders.[9]

Labour reforms are in prospect

The government of Maharashtra lays strong emphasis on labour reforms to create a conducive and smooth working environment. It has already amended central government acts and exempted some state acts for units operating in SEZs and Designated Areas, in particular to reduce the number of regulatory inspections.

A number of shops, establishments and factories now operate the Self Certification Cum Consolidated Annual Return Scheme. The Industrial Disputes Act 1947 has been amended to exempt industries or companies from having to give prior notice for varying the service conditions of workers.

The Maharashtra government is now considering more changes in labour regulations,[10] including:

- Allowing employment of contract workers with a provision that the workers will be employed for at least 200 days a year.
- Increasing working hours from 48 to 60 hours.
- Allowing workers to be laid off on condition of payment of adequate compensation.
- Allowing female workers to work night shifts and 12-hour shifts.
- Amending the Industrial Disputes Act 1947 to provide flexibility to units exposed to fluctuating market conditions and in technology.
- Conducting annual joint inspections, preparing a schedule of inspections in advance, and permitting other inspections only on written, signed, verifiable complaint and after obtaining authorisation from the Head of Department.
- Permitting compliance certificates to be signed by an authorised signatory.
- Initiating prosecution or imposing of penalties only after sanction by the Head of Department after giving the entrepreneur a hearing.
- Compiling and publishing a compendium of all laws under which inspections are stipulated.
- Greater participation by industry, associations and government.
- Extending the exemption from some state labour laws from SEZs and Designated Areas to other districts.

A Single Window Clearance for business start-ups is being prepared

The Maharashtra government realises that it is necessary to streamline and simplify the process for granting licences and permissions to reduce transaction costs for business start-ups. It is therefore setting up committees to prepare provision of Single Window Clearance.

A Common Application Form (CAF) will be developed for every applicant seeking to set up an industrial unit, covering clearances for: allotment of MIDC land; water and electricity connections; small-scale unit and VAT registrations; building plan approval; pollution control and health and safety approvals; and any other approval required under central legislation (Government of Maharashtra, Department of Industries, Energy and Labour, 2006).

Maharashtra is developing computer software for processing applications online.

Maharashtra is promoting FDI

To retain its position as the leading destination for FDI in India, Maharashtra has set up a Separate Cell to facilitate FDI and a High-level

Committee to accord fast track clearances for proposals involving FDI. This Cell will function as a single point of contact for all enquiries from foreign investors, including supplying information on permissions, procedures, central government and Reserve Bank of India (RBI) guidelines (Government of Maharashtra, Department of Industries, Energy and Labour, 2006).

Investment incentives

A number of specific local incentives are available to promote industrial development.[11] These include:

- An industrial promotion subsidy linked to fixed capital investment to promote new industrial projects and additional investments in existing projects.
- Additional industrial promotion subsidies for small-scale industry (SSI) units in industrial clusters and industrial parks notified by the state government and in agro-industries, textiles, automobiles and automobile components, electronic products, pharmaceuticals, gems and jewellery, IT, IT-enabled services and biotechnology.
- Employment-based incentives for new units in the ten districts in Maharashtra lowest on the Human Development Index that employ at least 75% local persons.
- Customised incentives for mega-projects, *i.e.* with investment of over 5 billion rupees or generating employment for more than 1 000 persons in specified areas, or investment of over 2.5 billion rupees or generating employment for more than 500 persons in the rest of the state. Industrial projects in the 10 lowest Human Development Index districts with investment of more than 1 billion rupees or generating employment for more than 250 persons also qualify for customised incentives.
- A 5% subsidy on interest paid to banks on term loans for acquiring fixed capital assets for new SSI units in textiles, hosiery, knitwear and readymade garments.
- A 15-year exemption from payment of electricity duty for eligible new units in areas with little or no industry, and a 10-year exemption from payment of electricity duty in the rest of the state for 100% export-oriented units, IT and bio-technology units.
- Exemption from stamp duty up to 31 March 2011.
- An exemption from payment of non-agricultural assessment charges for units in MIDC areas and Co-operative Industrial Estates.
- A refund of royalty paid on purchase of minerals from mine owners within Maharashtra for five years from commencement of production for new and expanded eligible units in the Vidarbha region.

- Refund of octroi duty in the form of a grant limited to 100% of admissible fixed capital investment of the eligible unit for a period varying according to location from 5 to 15 years (longer in areas with less industry).
- A 100% exemption on octroi payable on raw materials used by units in Municipal Corporation areas for manufacture of products to be exported outside those areas.
- An increase in the amount available to unemployed educated youths to start their own ventures under the Seed Money Scheme from 1 million rupees to 2.5 million rupees and a lowering of the interest rate from 14% to 6%.
- Special incentives to promote SMEs, including a 5% capital equipment subsidy for upgraded technology, a 50% subsidy on quality certification expenses, a 25% subsidy on cleaner production measures and a 50% subsidy on patent registration expenses.

Cluster development is encouraged

Maharashtra is encouraging cluster development by developing infrastructure based on the needs of specific industries, providing optimum utilities and common facilities, attracting appropriate talent and segregating labour-intensive industries from highly automated units. The MIDC has announced that it will reserve spaces within its areas for specific industries and their ancillaries. It will also earmark land exclusively for small- and medium-scale industrial units in and around large industrial projects to promote linkages between projects of different sizes (Government of Maharashtra, Department of Industries, Energy and Labour, 2006).

4. Uttar Pradesh

In 1980, Uttar Pradesh became the first state to set up a single window for investors, entitled the "Friend of Industry". This facility has, however, not lived up to expectations, as it remains unable to over-ride other departments and statutes, so its function is still that of a "friend" to investors. The situation is now changing, as over-riding authority has been agreed by 11 departments and agreement is being awaited from the one remaining department.[12] The state's investment promotion and facilitation system is implemented by the Department of Industrial Developments (see Box 7.4). A new policy to promote investment in industrial and services sectors was introduced in 2004 (see Box 7.5).

Box 7.4. **Uttar Pradesh Investment Promotion and Facilitation System**

The Department of Industrial Development of the state government of Uttar Pradesh has been chosen to be the key implementing agency of the state's investment promotion strategy.

Investment promotion

Participating in international conventions and seminars.

Using international level events regularly held in India, such as the International Trade Fair and Pravasi Bhartiya Divas.

Organising, assisting and sponsoring expositions, seminars, conferences, workshops and trade fairs at state level.

Investment facilitation

Monitoring of problem-solving mechanisms at different levels of government, from the grass-roots to the highest level of the government according to the level of difficulty of the problem.

Holding Quarterly High Power Committee meetings, chaired by the Chief Minister or the Authority nominated by the Chief Minister at the State Secretariat in Lucknow.

Organising weekly meetings at the state level with provision for co-ordination between different departments and entrepreneurs for easy and swift mitigation of barriers to growth and investment.

Convening regular monthly problem-solving sessions at district and division levels for on-the-spot resolution of problems of investors, under the chairmanship of the most powerful authority of the district level, *i.e.* District Magistrate and at the division level, Divisional Commissioner, with Officers of Industries Department assisting as Secretariat. Investors have direct access to these authorities/forums.

Investment environment reforms

Formulating and implementing a strategy for simplifying processes and procedures, including remedying of infrastructural deficiencies, and structural and bureaucratic impediments.

Various web-based e-initiatives are in pipeline to facilitate investment in Uttar Pradesh irrespective of the location of the investors.

A paradigm shift in approach is imperative so that the impact of proposed well-structured and systematic business regulatory reforms reach investors/entrepreneurs in a transparent and efficient manner to enable them to understand and realise the full potential of opportunities and plan their strategy accordingly. This will not only improve the actual investment environment but will also help in assisting the general perception.

Box 7.4. **Uttar Pradesh Investment Promotion and Facilitation System** *(cont.)*

These reforms broadly include policy making, monitoring, implementation, feedback and industry specific problem-solving mechanisms at all levels of government. The state government of Uttar Pradesh has finalised a proposal for the engagement of consultants for a reasonable period for a sustained and comprehensive effort to identify and analyse current impediments and develop a practical approach to solve these problems. The state government of Uttar Praadesh has already framed the Terms-of-Reference based on various parameters including those prescribed by the World Bank. The scope of these consultancy services will also include assistance in implantation of policy changes. Feedback from entrepreneurs and investors is as important as policy formulation and implementation, therefore engaged consultants will also be vested with the responsibility of getting third party objective feedback, so that the govt. gets an independent view of the actual impact of reforms at ground-level. Under these systematic reforms a Policy Steering Committee will be constituted under the Chairmanship of IIDC at the govt. level with E.D., Udyog Bandhu as its Member Secretary. In an effort to assimilate diversified views in policy evolution with mature economic sense, govt. has taken the bold step of including three persons of repute from the industrialist's community and two academicians as member of this Steering Committee. The Policy Steering Committee and consultants engaged as stated above will be supplementing in this strategy formulation and implementation exercise.

Source: Information provided by the state government of Uttar Pradesh.

Box 7.5. **Uttar Pradesh Industrial and Service Sector Investment Policy, 2004**

The Industrial and Service Sector Investment Policy, 2004, was approved by the Cabinet of the state government of Uttar Pradesh on 19 February 2004. The Highlights of new policy are as follows:

Infrastructure

1. Creation of the Industrial Infrastructure Development Fund (IIDF) with a Budgetary Provision of 500 million rupees.
2. Establishment of the Industrial Infrastructure Development Authority (IIDA) to manage IIDF, which will have the right to collect user-charges and raise capital and will become self-sustaining through professional project planning and implementation.

Box 7.5. **Uttar Pradesh Industrial and Service Sector Investment Policy, 2004** *(cont.)*

3. Creation of world class infrastructure through private partnership, including transshipment centres, integrated transport and trade centres, exhibition halls, trade centres, container depots, way-side facilities and display centres.
4. Maintenance of Industrial Estates by a Co-operative Society of Entrepreneurs. The Society will receive 60% of taxes collected by the local authority and may be granted financial assistance as and when necessary.

Power and energy

5. Uninterrupted power supplies for 24 hours to Industrial Areas. IT/BT/Food Processing/Agro-based industries involving investment of more than 100 million rupees and other industries involving investment of more than 500 million rupees will be supplied electricity through dedicated feeders.
6. Feeders having 75% or more industrial load will be deemed as industrial feeders and will be exempted from power cuts.
7. Dedicated feeders built at the cost of industries shall not be tapped for any other purpose, except where such industry consents to tapping of such feeders for another industrial unit.
8. Captive and co-generation to be promoted.
9. Natural gas to be promoted as an alternative source of energy.

Fiscal assistance for infrastructure projects

10. Financial assistance for investment in infrastructure projects:
    - 10.1. Industrial estates for IT/BT units are eligible for 50% of investment or 25 million rupees, whichever is less.
    - 10.2. Other industrial estates are eligible for 20% of investment or 25 million rupees, whichever is less.
    - 10.3. Call centre hubs having covered area of not less than 10 000 m^2 are eligible for 50% of investment or 5 million rupees, whichever is less.
    - 10.4. Convention halls, multimedia centres, exhibition grounds and business/trade centres having recreational facilities and having:
        - 10.4.1. Covered area of not less than 5 000 m^2 but less than 10 000 m^2 are eligible for 50% of investment or 5 million rupees, whichever is less.
        - 10.4.2. Covered area of not less than 10 000 m^2 are eligible for 50% of investment or 10 million rupees, whichever is less.
    - 10.5. Common facilities in industrial clusters, which are recommended by industrial associations are eligible for 50% of investment or 20 million rupees per cluster, whichever is less.

Box 7.5. **Uttar Pradesh Industrial and Service Sector Investment Policy, 2004** *(cont.)*

10.6. Laboratories for quality control and research and development for products of small-scale industries are eligible for 50% of investment or 10 million rupees, whichever is less.

10.7. Case by case approval by Cabinet on the recommendations of the high-powered committee under the chairmanship of Chief Secretary.

Stamp duty and registration charges on land

11. 100% exemption from payment of stamp duty on:

11.1. New small-scale units in 24 districts of Poorvanchal and 7 districts of Bundelkhand.

11.2. Infrastructure projects.

11.3. IT/BT, and food processing units and call centres.

11.4. Service sector projects as enumerated below:

11.4.1. Multi-facility hospitals with specified facilities and having at least 100 beds.

11.4.2. Super-specialty hospitals with specified facilities.

11.4.3. Hospitals at block headquarters with specified facilities and having at least 50 beds.

11.4.4. Hospitals in rural areas other than a block headquarters with specified facilities and having at least 30 beds.

11.4.5. IT/Technical education institutes at block headquarters teaching a syllabus approved by the state government for this purpose and having at least 75 students/apprentices.

11.4.6. Medical and dental colleges, other educational institutions, multiplexed cinema halls, shopping malls and entertainment centres investment in building and machinery in which is not less than 1 million rupees.

12. 50% rebate on stamp duty on all industrial projects not covered under paragraph 11.

13. Facility of registration of all industrial projects at the concessional rate of 2 rupees per thousand, subject to a maximum of 5 000 rupees. This facility is also available on service sector projects listed in Paragraph 11.4.

Fiscal incentives – Service sector

14. Service sector projects listed in Paragraph 11.4 will also be eligible for:

14.1. Exemption from acquisition charges if land for the project is acquired by the state government.

14.2. Exemption from entry tax on plant and machinery used for the establishment of the project.

Box 7.5. **Uttar Pradesh Industrial and Service Sector Investment Policy, 2004** *(cont.)*

14.3. Exemption from electricity duty for 10 years from the date of establishment.

14.4. Exemption from development charges and levied by the development authority/local authority.

14.5. Exemption from house-tax, water and sewage tax and all other taxes/charges levied by the development authority/local authority for five years from the date of establishment.

Incentives for new investment in the state

15. Incentives for new investment in the state.

15.1. 10% capital subsidy on investment in new small-scale units in 24 districts of Poorvanchal and 7 districts of Bundelkhand, subject to a maximum of 500 000 rupees.

15.2. Units of women and SC/ST entrepreneurs in such areas to get 15% capital subsidy subject to a maximum of 750 000 rupees.

15.3. 5% interest subsidy to new small-scale units for five years subject to a maximum of 250 000 rupees per annum.

15.4. Concessional rate of 2% of CST instead of 4%.

15.5. Power bill subsidy equivalent to trade-tax paid on raw materials.

15.6. Exemption from entry tax on plant and machinery used in establishment of new units.

15.7. First new units in every district with an investment of at least 1 million rupees in the case of IT/BT/food-processing units and 2.5 million rupees in the case of other units identified as pioneer units. Pioneer units will get interest-free loans under the Industrial Investment Promotion Scheme (IIPS) for 15 years instead of 10 years.

15.8. New industrial units employing more than 50% or 500 women and 25% or more SC/ST employees will be entitled to addition 20% of interest-free loans under IIPS.

15.9. All new industrial units will be exempted from payment of electricity duty for 10 years. Pioneer units will be exempted for 15 years.

15.10. Projects having investment of more than 5 billion rupees will be considered on a case-by-case basis for providing incentives.

Incentives for existing units

16. Incentives for existing units

16.1. Stamp duties on business transactions to be rationalised to 2 rupees per thousand for:

16.1.1. Agreements relating to the deposit of title deeds for pawn or pledge, from the existing rate of 5 rupees per thousand.

Box 7.5. **Uttar Pradesh Industrial and Service Sector Investment Policy, 2004** *(cont.)*

16.1.2. Bank guarantees, subject to a maximum of 10 000 rupees, from the existing rate of 5 rupees per thousand, subject to a maximum of 10 000 rupees.

16.1.3. Conveyancing of movable property belonging to the industry, from the existing rate of 20 rupees per thousand.

16.1.4. Mortgage deeds in which possession is not transferred, from the existing rate of 70 rupees per thousand.

16.1.5. Collateral security, from the existing rate of 10 rupees per thousand.

16.2. Rates of interest on arrears of declared trade tax and assessed trade tax to be reduced to 14% and 12% respectively from the existing rates of 24% and 18% respectively.

16.3. Reimbursement of 50% of expenditure incurred on registration of patents and other intellectual property rights, subject to a maximum of 500 000 rupees.

16.4. Interest rates of state financial institutions to be brought at par with bank/market rates.

16.5. Reimbursement to small-scale units of expenditure incurred on:

16.5.1. Obtaining quality certification, 50% of expenditure subject to a maximum of 200 000 rupees.

16.5.2. Market and technical studies and study of production skills, 90% of expenditure subject to a maximum of 50 000 rupees.

16.6. Incentives to existing small-scale units under the Uttar Pradesh Small Industries Technical Upgradation Scheme:

16.6.1. 50% cent subsidy, subject to a maximum of 250 000 rupees for purchase/import of technical know-how from government-recognised institutions.

16.6.2. 50% capital subsidy, subject to a maximum of 200 000 rupees for purchase of additional machinery for increasing production.

16.6.3. 5% interest subsidy for five years, subject to a maximum of 50 000 rupees per annum, on loans from banks/financial institutions for purchase of machinery mentioned in Paragraph 16.6.2.

16.7. Purchase of diesel for captive power plants permitted against form 3-B.

16.8. Identification of trade fares and exhibitions will be made at the beginning of the year and participating industrialists shall be chosen through a transparent process at least 6 months before the event. The Uttar Pradesh state government will bear 50% of transport and space rental expenditure.

Box 7.5. **Uttar Pradesh Industrial and Service Sector Investment Policy, 2004** *(cont.)*

Deregulation and simplification

17. Deregulation and simplification measures
    - 17.1. An Act will be passed for effective implementation of the Single Window Clearance System.
    - 17.2. A system of self-certification and third-party certification will be introduced.
    - 17.3. Only one combined inspection of industries will occur each year.
    - 17.4. Small-scale units having less than 25 employees will be exempted from labour laws.
    - 17.5. Entrepreneurs and traders having turnover up to 300 000 rupees will be exempted from trade-tax registration.
    - 17.6. Automatic approval of industrial building plans on submission except for a restricted list of highly-polluting industries.
    - 17.7. Compulsion of giving employment to land-holder in lieu of acquired land removed.
    - 17.8. In case of recovery of dues:
        - 17.8.1. Stamp duty will be charged on the actual auction amount.
        - 17.8.2. Recovery charges will be charged only on the actual amount recovered/amount of OTS.
    - 17.9. Local truck cartels will be broken up.
    - 17.10. The Uttar Pradesh Shops and Establishments Act, 1962, will be amended to take into account the needs of Call Centres, Multiplexes, Shopping Complexes and other services facilities which stay open for 24 hours.

Other matters

18. Chief Industrial Development Officers will be appointed in selected industrial districts.
19. A task force will be set up under the chairmanship of the Industrial Development Commissioner for inquiry into complaints of harassment by officials.
20. A fast-track system for redress of grievances on security issues will be established. An IG Police officer will be deputed on a whole-time basis in the office of DG Police to look into the security needs of entrepreneurs.
21. An Entrepreneurs/Trader Security Forum will be created at district level under the Chairpersonship of the District Magistrate.
22. There will be a meeting of Udyog Bandhu at Chief Minister level every three months.

Box 7.5. **Uttar Pradesh Industrial and Service Sector Investment Policy, 2004** *(cont.)*

23. A Human Resource Development Fund will be created to provide assistance to participating companies for training and development of employees. Participating companies to contribute ½% to 1% of their wage bill according to the number of employees. The Uttar Pradesh state government will contribute twice such amount. Participating companies will be entitled to draw three times their contribution.
24. An Uttar Pradesh Small Industrial Units Rehabilitation Board will be created. An act to be passed for effective implementation of the Rehabilitation Board.
25. A Rehabilitation Fund of 5 million rupees will be established for funding 50% of consultancy charges for making rehabilitation packages.

5. Conclusions

The variation in levels of reform commitment and in investment attraction suggests that more experience sharing between states on the application of investor-friendly policies would be beneficial. To overcome states' understandable reticence to share information with other states competing for investment, the central government can explain beneficial externalities accruing to neighbouring states from improvements in a state's business climate. It can also further strengthen arrangements for inter-state experience sharing.

Lack of success in investment attraction indicates a possible need for more capacity building at state government level. Where this is not already the case, a mechanism should be established to facilitate regular feedback from each state's investment promotion agency to relevant state government departments to help frame investor-friendly policies. Such feedback should include reactions of domestic and foreign investors to existing policies and to proposed policy changes, as well as positive suggestions for policy development from investors.

Standardised and reliable FDI inflow data for all states and union territories should be compiled and published to facilitate meaningful research into the effectiveness of states' policies in attracting investment from abroad.

Notes

1. Most studies focus on the 14 most populated states and omit Himalayan states and union territories, including Delhi.

2. See Chapter 2, Section 8, from which the statistics in this paragraph and the next paragraph are taken.
3. Interview with government of Maharashtra, 7 July 2008.
4. Interview with government of Maharashtra, 7 July 2008.
5. Interview with government of Maharashtra, 7 July 2008.
6. Interview with government of Maharashtra, 7 July 2008.
7. MIHAN stands for Multi-Modal International Hub Airport at Nagpur.
8. Interview with government of Maharashtra, 7 July 2008.
9. Interview with government of Maharashtra, 7 July 2008.
10. This list is in government of Maharashtra, Department of Industries, Energy and Labour (2006).
11. This list is adapted from that in government of Maharashtra, Department of Industries, Energy and Labour (2006).
12. Discussion with representative of Uttar Pradesh state government at 28 March 2009 seminar in New Delhi.

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Glossary

ADB	Asian Development Bank
ADR	Alternative Dispute Resolution
AGM	Annual General Meeting
AIDS	Acquired Immune Deficiency Syndrome
APO	Asian Productivity Organisation
APTA	Asia Pacific Trade Agreement
ARC	Administrative Reforms Commission
ASEAN	Association of South-East Asian Nations
ASSOCHAM	Associated Chambers of Commerce and Industry of India
BIMSEC	Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Co-operation
BIPA	Bilateral Investment Promotion Agreement
BIT	Bilateral Investment Treaty
BOO	Build Operate Own
BOOT	Build Own Operate Transfer
BOT	Board of Trade
BOT	Build Operate Transfer
BTP	Bio-Technology Park
CAF	Common Application Form
CAG	Comptroller and Auditor General of India
CBI	Central Bureau of Investigation
CCEA	Cabinet Committee of Economic Affairs
CCI	Competition Commission of India
CECA	Comprehensive Economic Co-operation Agreement
CFBP	Council for Fair Business Practices
CFIUS	Committee on Foreign Investment in the United States
CGPDTM	Controller General of Patent, Designs and Trade Marks
CIBIL	Credit Information Bureau India Limited
CIC	Credit Information Company
CII	Confederation of Indian Industry
CIR	Credit Information Report
CIS	Commonwealth of Independent States
CLB	Company Law Board
COI	Committee of Infrastructure

CSR	Corporate Social Responsibility
CVC	Central Vigilance Commission
CVO	Chief Vigilance Officer
DCA	Department of Company Affairs
DEA	Department of Economic Affairs
DGCA	Director General Civil Aviation
DGFT	Director General Foreign Trade
DIPP	Department of Industry Policy and Promotion
DOT	Department of Telecommunication
DTAT	Double Taxation Avoidance Treaty
EHTP	Electric Hardware Technology Park
EM	Entrepreneurs' Memorandum
EOU	Export-Oriented Unit
EPZ	Export-Processing Zone
FDI	Foreign Direct Investment
FEMA	Foreign Exchange Management Act
FERA	Foreign Exchange Regulation Act
FIAS	Foreign Investment Advisory Service
FICCI	Federation of Indian Chambers of Commerce and Industry
FII	Foreign Institutional Investment
FIIA	Foreign Investment Implementation Authority
FIPB	Foreign Investment Promotion Board
FRBM	Fiscal Responsibility and Budget Management
FTA	Free Trade Agreement
FTC	Fast Track Committee
FTP	Foreign Trade Policy
FTWZ	Free Trade Warehousing Zone
FY	Fiscal Year
GATS	General Agreement on Trade and Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GSDP	Gross State Domestic Product
G2B	Government to Business
HDFC	Housing Development Finance Corporation
HIV	Human Immunodeficiency Virus
IACA	Indian Arbitration and Conciliation Act
IBEF	Indian Brand Equity Foundation
IC	Investment Commission
ICA	Indian Council of Arbitration
ICADR	International Centre of Alternative Dispute Resolution
ICAI	Institute of Chartered Accountants of India
ICB	International Competitive Bidding

ICSI	Institute of Company Secretaries of India
ICSID	International Centre for Settlement of International Disputes
ICT	Information and Communication Technology
IEM	Industrial Entrepreneurs' Memorandum
IFC	International Finance Corporation
IFDI	Inward Foreign Direct Investment
IIAM	Indian Institute of Arbitration and Mediation
IIFCL	India Infrastructure Finance Company Limited
IL&FS	Infrastructure Leasing and Financial Services Limited
ILO	International Labour Organisation
IMF	International Monetary Fund
IPA	Investment Promotion Agency
IPAB	Intellectual Property Appellate Board
IP&IC	Investment Promotion and International Co-operation
IPR	Intellectual Property Right
ISP	Internet Service Provider
IT	Information Technology
ITES	Information Technology Enabled Services
JV	Joint Venture
LDC	Least Developed Country
M&A	Merger and Acquisition
MCA	Model Concession Agreement
MDG	Millennium Development Goal
MFA	Most Favoured Nation
MIB	Ministry of Information and Broadcasting
MIDC	Maharashtra Industrial Development Corporation
MIGA	Multilateral Investment Guarantee Agency
MIS	Management Information System
MNE	Multinational Enterprise
MoSRTH	Ministry of Shipping, Road Transport and Highways
MOU	Memorandum of Understanding
MRTP	Monopolies and Restrictive Trade Practices
MRTPC	Monopolies and Restrictive Trade Practices Commission
MSME	Micro, Small and Medium Enterprise
NACO	National AIDS Control Organisation
NACP	National AIDS Control Programme
NBFC	Non-Banking Financial Company
NeGP	National e-Governance Plan
NER	Net Enrolment Ratio
NFCG	National Foundation for Corporate Governance
NGO	Non-Governmental Organisation
NHAI	National Highways Authority of India

NHDP	National Highways Development Project
NPA	Non-Performing Asset
NSEA	National Security Exception Act
NRI	Non-Resident Indian
NTADCL	New Tirupur Area Development Corporation Limited
NTB	Non-Tariff Barrier
NVBDCP	National Vector Bourne Disease Control Programme
OFDI	Outward Foreign Direct Investment
OGL	Open General Licence
ONGC	Oil and Natural Gas Corporation
OPIC	Overseas Private Investment Corporation
PFI	Policy Framework for Investment
PPP	Public-Private Partnership
PPPAC	Public-Private Partnership Appraisal Committee
R&D	Research and Development
RBC	Responsible Business Conduct
RBI	Reserve Bank of India
REC	Rural Electrification Corporation
RNTCP	Revised National Tuberculosis Control Programme
ROSC	Reports on Observance of Standards and Codes
RTA	Regional Trade Agreement
SAARC	South Asia Association for Regional Co-operation
SAFTA	SAARC Free Trade Area
SAPTA	SAARC Preferential Trade Agreement
SBI	State Bank of India
SEBI	Security Exchange Board of India
SEZ	Special Economic Zone
SIA	Secretariat for Industrial Assistance
SME	Small and Medium Enterprise
SOE	State-Owned Enterprise
SPV	Special Purpose Vehicle
SPX	Subcontracting and Partnership Exchanges
SSA	Sarva Shiksha Abhiyan
SSI	Small-Scale Industry
SVC	State Vigilance Commission
TB	Tuberculosis
TDR	Transferable Development Right
TIDCO	Tamil Nadu Industrial Development Corporation
TNRDC	Tamil Nadu Road Development Company
TNUDF	Tamil Nadu Urban Development Fund
TRAI	Telecommunication Regulation Authority of India
TRIM	Trade-Related Investment Measure

TRIP	Trade-Related Aspects of Intellectual Property Rights
TWIC	Tamil Nadu Water Investment Company
UNDP	United Nations Development Programme
UNFPA	United Nations Population Fund
UNICEF	United Nations Children's Emergency Fund
UNIDO	United Nations Industrial Development Organisation
VAT	Value Added Tax
VGF	Viability Gap Funding
WAIPA	World Association of Investment Promotion Agencies
WHO	World Health Organisation
WIPO	World Intellectual Property Organisation
WOS	Wholly Owned Subsidiary
WTO	World Trade Organisation

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