Foreign Investment Policy during Pre-Reform Period

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Abstract
Foreign capital has significant role for every national economy, regardless of its level of development. For the developed countries it is necessary to support sustainable development. For the developing countries, it is used to increase accumulation and rate of investments to create conditions for more intensive economic growth. Policy towards FDI has undergone a major change since independence (1947). At the time of independence, the government of India followed inward oriented development strategies with restrictive investment regime. Given the importance of FDI in economic development, the government of India started liberalization in mid-1980s and streamlined this process in the early 1990s

Keywords: Foreign Capital, Industrial Policy, Foreign Direct Investment.

Introduction
In the last two decades world has seen an extensive inflow of foreign direct investment into developing countries. Competition developed among the developing countries to attract huge amount of FDI inflows to their countries. Foreign investment contributes a great deal in India’s development. Foreign Investment in India has been the direct outcome of the liberal trade policies undertaken and implemented by successive governments. The government has undertaken various liberal policy decisions to attract foreign investment since independence. The initiatives taken by the government to attract the foreign investors has been divided into four phases.

India’s Industrial Policy can be divided into three periods, namely:
 a) The Industrial Policy during the British Period (Pre-Independence Period)
 b) The Industrial Policy during the period 1948 to 1991 and,
 c) Recent Foreign Investment Policy Measures.

The Pre-Independence Period
India had a self sufficient economy before the advent of the British rule, with various kinds of manufacturing activities, although agriculture was the main source of livelihood. The country was particularly well known in the worldwide market for its handicraft industries in cotton and silk textiles, metal and precious stone works etc. However, the economic policies pursued by the colonial government were basically aimed at the protection and promotion of the economic interests of their home country rather than with the development of the Indian economy. Such policies transformed the country into a net supplier of raw materials and consumer of finished industrial products from Britain.

The British not only exploited India through an exclusive ‘royal monopoly’ but also through a hierarchical monopoly of European businessmen who were in control of external trade and much of the large-scale internal trade in collaboration with few Indian intermediaries, landords and moneylenders. Through suppressing Indians to foster industries and hindering the growth of the Indian capitalist class, they effectively de-industrialised the country which had a very large share of her labour force engaged in secondary industry. The per capita income remained stagnant, perhaps declining over the whole long period whereas unemployment compounded significantly.

During the second half of the nineteenth century, modern industry began to take root in India, in the form of cotton and jute textile mills and iron and steel industry among others. However, the British Government never supported the growth of such industries and imported its own products to serve the market. Therefore, Mahatma Gandhi, with an objective of self sufficiency, protested against English textile imports and demonstrated the need of a society of small-scale agriculture and industry. During this period, the foundation of modern industry in India was laid by number of pioneering private business houses headed by entrepreneurs like Jamshedji Tata, Walchand Hirachand, Lala Sriram, G. D. Birla and others, which in spite of many obstructions imposed and nil investment by the British Government, flourished and managed to earn huge profits.

Industrial Policy after Independence: (1948-1991)
Pandit Jawaharlal Nehru laid the foundations of modern India. It is due to his initiative that India now has a strong and diversified industrial base and is a major industrial nation of the world. The goals and objectives set out for the nation by Pandit Nehru on the eve of Inde-
From the date of independence, the pressure for economic development in India has been immense necessitating policies to meet new challenges, from time to time, it was modified through statement in 1973, 1977 and 1980.

In 1956, capital was scarce and the base of entrepreneurship not strong enough. Hence, the 1956 Industrial Policy Resolution gave primacy to the role of the state to assume a predominant and direct responsibility for industrial development.

The foreign exchange crisis of 1957-58 led to further liberalisation in 1980s and 1990s. These policies outlined the broader economic development priorities and objectives of the government enshrined in the political culture. In fact, the Industrial Policy Resolution of 1948 and 1950 as well as Mr. Nehru’s statement on foreign capital constitute the basis of the government policy on foreign capital till 1991.

Changes in policy frameworks in India dealing with private financial and investment inflows are studied in four phases;

- **A) First Phase: Cautious Welcome Policy (1948-1966)**
  - From the date of independence, the pressure for economic development in India has been immense necessitating a realistic approach towards foreign capital. The Industrial Policy Resolution of 1948 statement on foreign capital acknowledged the need for foreign capital to supplement the domestic savings in financing higher level of investments. The scope of import substitution extended to almost every commodity that could be manufactured in the county. The domestic industry was given a considerable protection in the form of high tariffs and quantitative restrictions on imports. Indian industrial strategy focused on the development of local capability in heavy industries including machinery and manufacturing sectors.

  During this period, foreign investments were in the form of technical collaboration and hence the import of technical know-how and the technocrats were mainly considered in supplementing Indian capital and for securing scientific, technical and industrial knowledge and capital equipment. It was encouraged on mutually advantageous terms though the majority local ownership was preferred. Foreign investors were assured of no restrictions on the remittance of profits.

  The foreign exchange crisis of 1957-58 led to further globalisation in the Government's attitude towards FDI. In a bid to attract foreign investments to finance foreign exchange components of projects, a host of incentives and concessions were extended. In 1961, the Government issued a list of industries where foreign investments were to be welcomed. These included some of the industries reserved for the public sector, such as drugs and aluminum. The protection given to local manufacturers acted as an important advantage encouraging market-seeking FDI's. A large number of foreign enterprises serving Indian market through exports started establishing manufacturing affiliates in India. This was the period in which MNCs started showing real interest in India. Because of this, in 1948 and 1964 the flow of FDI into India had more than doubled.

  **B) Second Phase: Selective and Restrictive Policy (1967-79)**
  - Towards the end of the third Annual Plan in the late sixties, there was an acute pressure on the external payments. Conservation of foreign exchange had become an objective of its policy. Accordingly, a restrictive regime was imposed leading to the culmination in the enactment of the Foreign Exchange Regulation Act (FERA) 1973. This policy brought in a highly regulated policy with regard to the management of foreign capital. As per section 29 of the FERA, all branches of foreign companies and joint stock companies in India in which non-resident interest was more than 40 percent had to obtain fresh permission to carry on business and comply with Reserve Bank of India directives on foreign participation in the capital structure, borrowings, foreign exchange payments due to repatriation of capital, etc. Further, a process of intimidations was introduced in which these...
companies were required to dilute their non-resident shareholdings to the levels prescribed by the Reserve Bank, which was generally at 40 percent within two years. However, companies involved in export and manufacturing activities involving sophisticated technology and skills were exempted from this dilution clause. These companies were allowed foreign share holding up to 74 percent. During the seventies, further tightening of the regulatory regime was reflected in the Janata Government's Industrial Policy Statement 1977, prohibiting foreign collaboration in certain industries, since it was perceived that indigenous technology in these industries had sufficiently developed.

The Janata Government's Industrial Policy Statement compelled the provisions of FERA to be rigorously enforced in the consumer goods industries. The foreign firms were asked to carry forward the process of Indianisation. Their production capacities were also to be frozen at the existing levels. During two years of the Janata Governments rule, two major decisions regarding multinational companies were taken and were advertised heavily;

1. First, the Coca-Cola Company was asked to wind-up its operations.
2. Secondly, the government asked the International Business Machines (IBM) to dilute their equity to 40 percent so as to conform to FERA guidelines. Since the IBM did not agree, it was also asked to role back its operations in India.

The restrictions placed on FDI during the second phase led to stagnation of its inflows. A massive reorganisation took place in the pattern of FDI in the country during this period e.g., liquidation in FDI stock in non-manufacturing sector largely due to take over by the government of certain activities of General Insurance Companies in 1971 and of Petroleum sector between 1974-1976. On the other hand, all fresh inflows of the FDI were directed to the manufacturing sectors. As a result, the share of the FDI in manufacturing sector went up to 40.5 percent in 1964 and up to 86.9 percent in 1980. Within the manufacturing sector, maximum amount of FDI inflows was directed to technology-oriented industries such as pharmaceuticals and chemicals, machinery and machine tools and electrical goods. These three sectors accounted for nearly 58 percent of total FDI into India in manufacturing units to 41 percent in 1964. The FDI gave importance to technology-intensive products at the expense of traditional consumer's goods industries such as food and beverages, textiles and other chemical products.


Towards the end of the seventies, India's failure to boost the volume and proportion of its exports in the background of the second oil price hike began to worry the policy makers and led to the realisation that international competitiveness of Indian goods has suffered from growing technological obsolescence and inferior quality, limited range and high cost, due to the protected local market. Another limiting factor for Indian manufacturing exports was that the marketing channels in the industrialised countries were dominated by MNCs.

The realisation of these factors made the Government to deal with the situation by:
1. Putting emphasis on the modernisation of plants and equipments through liberalised imports of capital goods and technology.
2. Exposing the Indian industry to compete by gradually reducing the import restriction and tariffs.
3. Assigning a greater role to MNCs in the promotion of manufactured exports by encouraging them to set up Export-Oriented Units.

This strategy has been reflected in policy announcements made in the 1980s. The Industrial Policy Statement of 1980 and 1982, for instance, announced a globalisation of industrial licensing approvals, a host of incentives and exemptions from foreign equity restrictions under FERA to 100 per cent Export Oriented Units. The Government of India decided to set up four more Export Processing Zones (EPZs) in addition to the two existing ones, to attract MNCs to set up export oriented units. The trade policies in this period gradually liberalised the import of raw materials and capital goods by expanding the list of items on Open General License (OGL). Tariffs on import of capital goods were also abolished. Import of designs and drawings and capital goods were permitted under a liberalised technical development scheme.

The globalised industrial and trade policies were accompanied by increasingly receptive attitude towards FDI and foreign collaborations. The rules concerning payment of royalties and lump sum technical fees were also relaxed. A degree of flexibility was introduced in the policy concerning foreign equity participation and exceptions from the general ceiling. Forty percent of foreign equity was allowed on the merits of individual investment proposals. The procedure for onward remittances of royalty, technical fees, dividends etc, was streamlined. A fast channel was set up in 1988 for expediting the clearances of FDI proposals from major investing countries like Japan, US and UK. The focus of the policies during this period was on strengthening the international competitiveness of Indian enterprises by
exposing them to increased international and domestic competition.


In the financial year 1990 - 91, India entered into a period of severe Balance of Payments (BOP) crisis and political uncertainty. A rapid increase in India's external debts coupled with the political uncertainties led the international credit rating agencies to lower India's rating both for short and long-term borrowings. This made the borrowing in international commercial markets difficult for India and also led to outflow of foreign currency deposits kept in India by the NRIs. This situation was made worse by the Gulf War, as it led to rise in petroleum prices and caused virtual stoppage of remittances from Indian workers in Gulf countries.

These incidents brought the country almost to the verge of default in respect of external payments liability, which would only be averted by borrowing from IMF made under by arrangement and certain emergency measures taken by the government to restrict imports. In June 1991, the new government initiated a programme of macroeconomic stabilisation measures and structural adjustments supported by the IMF and the World Bank. As part of this programme, a New Industrial Policy (NIP) was announced on 24th July 1991 in the Parliament, which started the process of full-scale globalisation and intensified the process of integration of Indian Economy with the global economy.

The NIP and other policy initiatives liberalised the industrial policy regime in the country with reference to foreign investments beyond regulation. Some of the changes initiated during this period were as follows:

a) Abolition of the industrial approval system in all the industries except for 18 strategic or environmentally sensitive industries.

b) FDI proposals need not necessarily, have to be accompanied by technology transfer agreement.

c) Trading companies engaged primarily in export activities are also allowed upto 51 percent foreign equity.

d) To attract MNCs into many sector, 100 percent foreign equity was also permitted in power generation.

e) A new package for 100 percent Export-Oriented Units and companies in Export Processing Zones was announced.

f) A Foreign Investment Promotion Board (FIBS) authorised to provide a single window clearance board had been setup in the Prime Minister's office to invite and facilitate investments in India by international companies.

g) The existing companies are also allowed to raise foreign equity levels up to 51 Per cent for proposed expansion in priority industries.

h) New businesses in the fields like mining, banking, telecommunication, highways constructions and management were throw open to private, including foreign owned companies.

Investments in shares of foreign companies were permitted up to 51 percent for automatic approvals and this limit was raised to 74 percent in January 1997 in case of foreign investors. The government also permitted 100 percent foreign equity in high technologies and export-oriented foreign companies.

Conclusion

Capital formation is an important determinant of economic growth. While domestic investments add to the capital stock in an economy, FDI plays a complementary role in overall capital formation and in filling the gap between domestic savings and investment. FDI develops the economy at both micro and macro level. At the macro-level, FDI is a non-debt-creating source of additional external finances. FDI plays a vital role in molding the structure of the economy. FDI as a strategic component of investment is needed by India for its sustained economic growth and development. In India, the role of FDI plays a special significance after liberalisation of the economy.

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