



## **G.S. PAPER III – ECONOMIC DEVELOPMENT**

### **INVESTMENT MODELS**

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# 1 Economic Systems

There is hardly any country today which can be called either pure capitalistic economy or socialistic economy. However, for the purpose of categorization we can divide the economic systems into the following types:

## 1.1 Capitalism

Under capitalism, all farms, factories and other means of production are the property of private individuals and firms. They are free to use them with a view to making profit, or not to use them, if it so suits them. The desire for profit is the sole consideration with the property owners in the use of their property. Besides free and unfettered use of their property, everybody is free to take up any line of production he likes and is free to enter into any contract with other fellow citizens for his profit.

Although all modern States do impose certain restrictions on economic freedom in the interest of general welfare, yet even these restrictions leave much latitude to the propertied class to use their property in any manner they like, to start any business they think profitable to themselves and to enter into contracts they think necessary in their interest.

What to produce, how to produce and for whom to produce – all these central problems of economics are settled by the free working of the forces of demand and supply. In the words of Prof. Loucks, “capitalism is a system of economic organization featured by the private ownership and the use for private profit of man-made and nature-made capital”.

### 1.1.1 General Features of Capitalism

- Right of Private Property
- Freedom of Enterprise (it implies three things : (a) freedom of enterprise, (b) freedom of contract, and (c) freedom to use one's property)
- Freedom of Choice by the Consumers
- Profit Motive
- Class Conflict
- Uncoordinated Nature (no conscious regulation or central direction of economic activity required)
- Control with Risks (one who risks his money controls the business)
- Competition
- Importance of Price System (price mechanism facilitates the functioning of capitalism)
- Economic Inequalities

### 1.1.2 Merits of Capitalism

- Automatic Working (does not require any central directing authority)
- Higher Efficiency and Incentive to hard work
- Higher Rate of Capital Formation
- Economic Development and Prosperity
- Optimum Utilization of Resources
- Just and Democratic
- Encouragement to Enterprise and Risk taking
- Adaptability

### 1.1.3 Demerits or Criticism of Capitalism

- Wasteful Competition (cut throat competition does not confer any corresponding social benefit)
- Human Welfare ignored
- Economic Instability and Unemployment
- Property Rights take precedence over Human Rights
- Social Injustice and Economic Inequality

- Misallocation of Resources
- Emergence of Monopolies and concentration of Economic Power
- Malpractices

## 1.2 Socialism

Socialism is an economic organization of society in which the material means of production are owned by the whole community and operated by organs representative of, and responsible to, the community according to a general plan, all members of the community being entitled to benefits from the results of such socialized planned production on the basis of equal rights.

In simple words, socialism implies social ownership of means of production, equality of incomes and opportunity for all. It does not mean that all productive resources should be owned by the State; only the major instruments of production should be under the state control so that economy is run for social benefit rather than private profit.

### 1.2.1 General Features of Socialism

- Social Ownership of Means of Production
- No Private Enterprise
- Economic Equality
- Equality of Opportunity
- Economic Planning
- Social Welfare and Social Security
- Classless Society

### 1.2.2 Merits of Socialism

- Social Justice
- Better Allocation of Resources
- Rapid Economic Growth
- Improving Productive Efficiency
- Social Security and Welfare
- Economic Stability

### 1.2.3 Demerits of Socialism

- Bureaucracy and Red Tapism
- Not Successful in Business
- Misallocation of Resources
- Loss of Consumer's Sovereignty
- Lack of Incentives
- Loss of Economic Freedom
- No economic Equality
- Concentration of Power in the State
- Loss of Personal Liberty

## 1.3 Mixed Economy

A Mixed Economy is neither pure capitalism nor pure socialism but a mixture of the two. It is operated by both private and public enterprise. That is, private enterprise is not permitted to function freely and uncontrolled through price mechanism. On the other hand, the government intervenes to control and regulate private enterprise in several ways. It had been realized that a free functioning of private enterprise results in several types of evils. For instance, it produces trade cycles, i.e. sometimes depression and unemployment and at other times booms and inflationary situation. Besides, free functioning of private enterprise results in extreme inequalities of income and wealth. It is also realized that in countries like India, economic development cannot be achieved at the desired rate of

growth without any active government help and guidance. Hence the government in such countries actively participates in economic activities in order to minimize the evils of unadulterated capitalism and to accelerate economic growth.

In the Indian economy, both the public and private sector are in operation, though the share of public sector has been progressively declining since 1991, when India began the economic reforms. The foundations of the mixed economy in India were laid by the Industrial Policy Resolution of 1948 which was modified by the Industrial Policy Resolution of 1956. According to these resolutions, the various industries were divided between the two sectors, viz. the private sector and the public sector. The responsibility for the development of several basic, heavy and strategic industries was assigned to the State and the development of the rest of the industries was left to the private sector. Even the private sector was sought to be controlled and influenced by the Government of India by means of direct controls or through appropriate fiscal and monetary policies.

### 1.3.1 General Features of Mixed Economy

- Co-existence of the Public and Private Sectors
- Role of Price System and Government Directives
- Government Regulation and Control of Private Sector
- Consumer's Sovereignty Protected
- Government Protection of Labour
- Reduction of Economic Inequalities
- Control of Monopoly

## 2 Economic Development

Though Economic Development has been defined differently from Economic Growth and Economic Progress by some, however, for our purposes here we can consider these terms as denoting the same. Thus we can base our definition of economic development on per capita income. Accordingly we can say that it denotes an increase in per capita income of the country at constant prices. A higher per capita would mean that people are better off and enjoy a higher standard of living and to raise the level of living of the people is the main objective of economic development. But the increase in national income must be maintained for a long time. A temporary or short-lived increase will not connote real economic growth. This improvement in income helps and in turn is facilitated by larger savings, increased capital formation and technological development.

### 2.1 Rostow's Stages of Economic Development

Rostow lays stress on the efficacy of free trade and free market capitalism. He has divided the historical process of economic growth into the following stages:

#### 2.1.1 Traditional Society

- Subsistence economy
- Limited technology

#### 2.1.2 Preconditions to "Take off" - Preparatory Stage

- A change in society's attitude towards science, risk-taking and profit-earning
- The adaptability of the labour force
- Political Sovereignty
- Development of a centralized tax system and financial institutions; and
- The construction of certain economic and social overheads like rail-roads and educational institutions

### 2.1.3 The “Take off” Stage

- The economy transforms itself in such a way that economic growth subsequently takes place more or less automatically
- The rate of investment increases in such a way that real output per capita rises and this initial increase carries with it radical changes in the techniques of production and the disposition of income flows which perpetuate the new scale of investment and thereby the rising trend in per capita output
- It implies three things
  - The proportion of investment to national income outstrips the likely population increase
  - The period must be relatively short so that it should show the characteristics of an economic revolution
  - It must culminate in self sustaining and self generating economic growth

### 2.1.4 Drive to Maturity - Period of Self Sustained Growth

- Rates of saving and investment are of such magnitude that economic development becomes automatic
- Overall capital per head increases as the economy matures
- The structure of the economy changes increasingly
- The initial key industries which sparked the take-off decelerate as diminishing returns set in. But the average rate of growth is maintained by a succession of rapidly growing sectors

### 2.1.5 Age of Mass Consumption

- Industrial base dominates
- Widespread consumption of high value consumer goods

## 3 Models used in the Planning Process

### 3.1 Harrod – Domar Growth Model

Harrod and Domar analyzed the dynamic nature of investment and demand and showed how variations in capital and in demand were responsible for instability in economic growth.

The main determinants of economic growth are: natural resources, technological progress, population growth etc. These determinants of economic growth influence the rate of growth by influencing two important factors:

- The rate of Investment
- Capital-output Ratio

Hence the rate of economic growth in a country depends on the rate of investment and capital-output ratio. Harrod and Domar arrived at the following relation:

$$\text{Growth Rate} = \text{Investment} * (1/\text{Capital-Output Ratio})$$

#### 3.1.1 Relevance of Harrod-Domar Model for Developing Countries

Harrod-Domar model was formulated primarily to protect the developed countries from chronic unemployment and they were not meant to provide guidelines to the developing economies in their economic development. Since they were formulated primarily for the developed countries they were based on high propensity to save and a correct estimate of the capital-output ratio, which should remain fixed over time. On the other hand, the main problems of the under-developed countries is to raise their propensity to save because it is generally low in these countries. Nor is it possible to assume a fixed value of the capital-output ratio. This ratio happens to be very

high in these countries. Thus the two important bases of the Harrod-Domar model are non-existent in the case of developing economies.

Further, the nature of unemployment problem in developing countries is different from that in the developed countries. It is cyclical unemployment due to deficiency of demand in the developed economies and disguised in developing economies. In developed economies, unemployment can be removed by raising the level of investment so that aggregate demand increases which was not keeping pace with the growth of productive capacity. In the developing economies, there is unemployment because available productive capacity is inadequate to employ fully the existing labour force. Thus in such countries, the purpose of investment is to raise productive capacity rather than aggregate demand and fully utilize the existing idle capacity.

Thus the peculiar conditions prevailing in the developing countries e.g. disguised unemployment, low propensity to save and low productive capacity makes the Harrod-Domar model inapplicable to them. Also, this model assumes no government intervention, fixed prices and no institutional changes. All these assumptions too make it inappropriate.

However, we should not reject this model wholesale and emphasize their inapplicability to developing economies. With slight modifications and reinterpretation they can be made to furnish suitable guidelines even for the developing economies. In some cases, it is only a question of changing the emphasis. For instance, Domar's model recognizes the capacity creating role of investment. But it is intended to increase effective demand in developed countries, while in developing countries, the capacity creating role of investment is to be seen as a means of overcoming the problem of unemployment. Hence, to make the model applicable to the developing countries, it has to be suitably reinterpreted.

### 3.2 Lewis Model of Economic Development with Unlimited Labour Supply

Lewis presented a theory of economic development with the use of unlimited supply of labour. The supply of labour in under developed countries is generally such that an unlimited supply is available at the subsistence wage. This unlimited supply of labour is drawn from surplus agricultural labour, casual labour, domestic servants, women in households etc.

Lewis model is not based on disguised unemployment but on other conditions, viz.:

- The wage rate in the industrial sector is above the subsistence sector by a small but fixed margin
- The investment in the industrial sector is not large relative to population growth
- The cost of training of the skilled workers is constant

In his model, Lewis analyses the process of economic development in terms of inter-sectoral relationships in a dual economy composed of a 'Capitalist' (manufacturing, mining etc.) Sector and a 'Subsistence Sector' or the Self-Employment sector. In an overpopulated country the capitalist sector draws labour from the subsistence sector of which there is an almost unlimited supply. The wage in the capitalist sector depends on what labour gets/earns in the subsistence sector and is a bit higher so as to attract labour. Hence at this wage, the capitalist sector can have as much labour as it requires. Subsistence wage, in turn, is governed by the conventional view of the minimum required for subsistence or by the average product per worker in subsistence agriculture.

Lewis points out that the process of economic growth must come to an end when:

- No surplus labour is left
- Population declines
- Food prices rise pushing up wages; and
- Workers press for higher wages



### 3.2.1 Relevance of Lewis Model for India

Nehru's approach was based on the Lewis model. The basic idea was that India has an agriculture sector with a huge amount of surplus labour. If the surplus labourers are taken away from the agriculture sector, it will not affect output in that sector. The industrial sector has positive productivity for the labourers. If this sector is promoted, it will generate profit. If this profit is invested in machines and tools, the capital per worker will increase and this in turn, will boost profits. This profit is reinvested again and the process moves on. So, this will increase capital formation at a fast rate. Thus, the basic understanding has been that agriculture is not likely to bring about a turnaround, whereas continuous investment of profit generated by the industrial sector in industries will start a self-sustaining growth process.

### 3.3 Mahalanobis Strategy of Economic Growth

There has been a lot of controversy in our country on the appropriate strategy to be adopted for planned economic development. There was no clear strategy in the First Five-Year Plan. But when the second plan was being formulated Prof. P.C Mahalanobis prepared a growth model in which he showed that to achieve a self-sustained growth quickly in the country, it would be essential to devote a major part of the development outlay to building basic heavy industry, e.g. of capital goods industry like steel and the engineering industry for making different types of machines, the multipurpose river valley projects for irrigation and power.

According to Prof. Mahalanobis, the rate of real capital formation in a country like India did not depend merely on savings in the form of money but it depends on the capacity for making capital goods. He argued that even if the rate of savings was substantially raised and it was desired to accelerate economic growth and capital formation by investing it in the consumer goods industries, it would be futile. The reason is that the capital goods required for the consumer goods industries are not produced in the country in sufficient quantities.

Thus, Prof. Mahalanobis was of the view that if large investment is not made in the heavy basic and capital goods industry, the country will forever remain dependent on foreign countries for the imports of steel and capital goods like machinery for economic development and real capital formation. Since it is not possible for India to earn sufficient foreign exchange for the purpose by increasing exports, the capital goods cannot be imported in sufficient owing to foreign exchange constraints. The result will be that the rate of economic growth and the rate of real capital formation in the country will be slow indeed. Thus according to him, to achieve rapid economic growth and self-reliance, it would be necessary to give a high priority to basic and capital goods industries in the development strategy of a plan.

### 3.4 Planning Model adopted in India

The second five year was based on the Nehru-Mahalanobis strategy of development, which guided the planning practice for more than three decades until the end of the Seventh Five Year Plan. The draft outline of this plan was based on the Mahalanobis Model which was viewed as a variant of the Soviet Planning model and the Lewis model. The basic elements of this strategy can be summed up as:

- Raising the rate of investment since the rate of development is dependent on the rate of investment. It involved stepping up domestic and foreign savings also
- Rapid growth of the productive capacity of the economy by directing public investment toward development of industries. Simultaneously, promotion of labour-intensive small and cottage industries
- Import substitution for self-reliance
- An elaborate system of controls and industrial licensing
- Predominance of public sector in capital goods industries

### 3.4.1 Relevance of Planning in India:

Though Planning has been one of the basic pillars of the Indian state's approach to development since Independence, however in recent times the relevance of planning is much debated. One argument is that planning has failed to achieve its goals. The second argument is that planning has become irrelevant owing to globalization and liberalization. However, planning based on the Mahalanobis framework was fine during the first three plans. The problems that surfaced later were not due to planning but are the product of lack of appropriate planning and mismanagement by the government. Planning does not become irrelevant due to internationalization of capital. In a liberalized economy, the nature of planning changes corresponding to the changes in the nature of state intervention but it does not become irrelevant. Public investment will continue to have a major role in social sectors and rural economic infrastructure and the prioritization of the investment has to be properly planned. The role of planning in our federal system is to coordinate the activities of all levels in the government – center, states and local level – and that of the market and civil society actors. In this way, it has to evolve a shared commitment to national goals among all actors in the society. Further the inherent exclusionary tendencies of the market can only be limited by the State through proper planning. To make Planning successful, the country has to follow a more decentralized and participatory planning. The poor are to be placed in our economic planning. To remove regional disparities there is need for regional planning, town and country planning. It also needs to be made contemporary and comprehensive by including not only the conventional issues but also the emerging areas, like critical environmental issues.

## 4 Infrastructure Investment Models

### 4.1 Financing of Infrastructure

The relationship between infrastructure development and economic growth is well established in the literature. While infrastructure development facilitates economic growth; economic growth increases demand for more infrastructure. Thus, development of adequate and quality infrastructure is a necessary, if not sufficient; condition to maintain growth momentum in any economy. However, infrastructure development is an arduous job for any country as it involves huge investments, long gestation periods, procedural delays and returns spread over a long period of time. These unique features of infrastructure development raise some issues which are specific to the financing of infrastructure.

To support the high economic growth, the investment requirements in the infrastructure sector is estimated to be around 41 lakh crore (revised to Rs 45 lakh crore in the Approach paper for the Twelfth Plan) during the Twelfth plan period. Let us look at the broad pattern of financing of infrastructure in our country before highlighting some of the issues involved in it.

- According to the Planning Commission, during the first three years of Eleventh Five Year Plan, funds from the Central Government budget financed around 45 per cent of the total investment in infrastructure.
- The remaining 55 per cent was divided between debt financing (41 per cent) and equity financing (14 per cent).
- It is noteworthy that within the debt financing, commercial banks alone financed around 21 per cent and another 10 per cent was financed by the NBFCs.
- Notably other sources of financing, such as, External Commercial Borrowings (ECBs), equity, FDI and insurance companies financed less than 10 per cent of the total infrastructure investment each.

#### 4.1.1 Issues in Infrastructure Financing

- **Funding Gap** - Funding Gap is the most important issue that we face on this front. The slowdown in the economy has further aggravated this funding gap in the infrastructure sector. More recently, in the context of Eurozone debt crisis, accessing external resources by way of ECBs could also become difficult and this would also accentuate the funding gap.

- **Fiscal Burden** - We have already seen that almost half of the total investment in the infrastructure sector was done by the Government through budget allocations. Here the point to be noted is that Government funds have competing demands, such as, education, health, employment generation, among others.
- **Asset-Liability Mismatch of Commercial Banks** - After the budgetary support, next in line for financing infrastructure were funds from the commercial banking sector. However, it is a well known fact that these are institutions that primarily leverage on short-term liabilities and, as such, their ability to extend long-term loans to the infrastructure sector is limited. This is because, by doing so they get into serious asset-liability mismatches.
- **Takeout financing** - Takeout financing offers a window to the banks to free their balance sheet from exposure to infrastructure loans, lend to new projects and also enable better management of the asset liability position. In other words, takeout financing enables financing longer term projects with medium term funds. However, due to several factors the mechanism has not really emerged as a game-changer. One plausible reason is that the model does not envisage equitable distribution of risks and benefits. One of the oft repeated arguments is that banks assume credit and liquidity risk since the inception of the project but once the project is economically viable, taking out of the loan results in loss of opportunity of earning returns on seasoned loans.
- **Investment Obligations of Insurance and Pension Funds** - From the point of view of asset-liability mismatches, insurance and pension funds are one of the best suited institutions to invest in the infrastructure sector. This is because, in contrast to the commercial banking sector, these institutions leverage on long-term liabilities. However, they are constrained by their obligation to invest a substantial portion of their funds in Government securities. Of course, in a way, this facilitates the financing of gross fiscal deficit of the Central Government and hence enables the Central Government to make more investments. However, this limits the direct investment of these institutions in the infrastructure sector
- **Need for an Efficient and Vibrant Corporate Bond Market** - An active corporate bond market can facilitate long-term funding for the infrastructure sector. However, despite the various initiatives taken by the Reserve Bank, Securities & Exchange Board of India and Government of India, the corporate bond market is still a long way to go in providing adequate financing to the infrastructure sector in India.
- **Developing Municipal Bond Market for Financing Urban Infrastructure** -For large scale financing urban infrastructure which is assuming critical importance in the context of rapid urbanization, conventional fiscal transfers to the urban local bodies or municipalities from governments are no longer considered sufficient. There have been some earnest experimentations by these bodies to tap unconventional methods of financing such as public private partnerships, utilizing urban assets more productively, accessing carbon credits, etc. but then these do not address the financing needs. One possible way of addressing the problem is developing a municipal bond market.
- **Insufficiency of User Charges** - It is a well known fact that a large part of the infrastructure sector in India (especially irrigation, water supply, urban sanitation, and state road transport) is not amenable to commercialization for various reasons, such as, regulatory, political and legal constraints in the real sector. Due to this, Government is not in a position to levy sufficient user charges on these services. The insufficiency of user charges on infrastructure projects negatively affect the servicing of the infrastructure loans. Generally, such loans are taken on a non-recourse basis and are highly dependent on cash flows. Hence, levy and collection of appropriate user charges becomes essential for financial viability of the projects.
- **Legal and Procedural Issues** - Infrastructure development involves long gestation periods, and also many legal and procedural issues. The problems related to infrastructure development range from those relating to land acquisition for the infrastructure project to environmental clearances for the project. Many a times there are legal issues involved in it and these increase procedural delays. The added uncertainty due to these factors affects the risk appetite of investors as well as banks to extend funds for the development of infrastructure.

#### 4.1.2 Measures taken by the Government

- **Public-Private Partnership Projects in Infrastructure** - As Government faces a tight budget constraint in the context of a rule based fiscal policy framework, it was important to encourage the private sector to invest more in the infrastructure sector. Resultantly, the Government started encouraging Public-Private Partnership (PPP) projects in the infrastructure sector. PPP mechanism provides built in credit enhancement for improving project viability by way of buyback guarantee, escrow arrangement, substitution rights for the lenders, etc. Government has taken several initiatives, especially to standardize the documents and process for structuring and award of PPP projects. This has improved transparency in relation to the issues involved in setting up PPP projects.
- **Viability Gap Funding** Viability gap funding was introduced in 2006, which provides Central Government grants up to 20 per cent of the total capital cost to PPP projects undertaken by any central ministry, state government, statutory entity, or local body. The scheme aimed at providing upfront capital grant to PPP projects to enable financing of commercially unviable projects. The level of grant is the net present value of the gap between the project cost and estimated revenue generation over the concession period based on a user fee that was to be levied in a pre-determined manner.
- **Foreign Direct Investment and Infrastructure Development** - To facilitate infrastructure financing 100 per cent FDI is allowed under the automatic route in some of the sectors such as mining, power, civil aviation sector, construction and development projects, industrial parks, petroleum and natural gas sector, telecommunications and special economic zones. Further, FDI is also allowed through the Government approval route in some sectors such as civil aviation sector, Petroleum and Natural Gas sector – refining PSU companies; Telecommunications etc
- **Setting up of India Infrastructure Finance Company Limited (IIFCL)** - Another major development was the setting up of IIFCL by the Central Government for providing long-term loans to the infrastructure projects. IIFCL is involved both in direct lending to project companies and refinancing of banks and other financial institutions. IIFCL can provide funds to the infrastructure project up to 20 per cent of the total project cost as long-term debt
- **Setting up of Infrastructure Debt Funds** - Reserve Bank of India and the Securities and Exchange Board of India (SEBI) notified detailed guidelines for setting up of IDFs which can either be a mutual fund (trusts) (IDF-MF) or an NBFC (companies) (IDF-NBFC). The Scheduled commercial banks are allowed to act as sponsors to IDF-MFs and IDF-NBFCs with prior approval from RBI subject to certain terms and conditions. Further, to attract off-shore funds into IDFs, Government of India is contemplating the reduction of withholding tax on interest payments on the borrowings by the IDFs from 20 per cent to 5 per cent. Income of the IDFs is also expected to be exempt from income tax. The IDF-NBFC can raise resources through issue of either rupee or dollar denominated bonds of minimum five year maturity. IDFs are expected to channelize funds from insurance companies, pension funds and other long term sources into infrastructure sector. This will provide an alternative source of foreign currency funds for the infrastructure projects.
- **Tapping the retail investor base through Infrastructure Bonds** - To provide further impetus to infrastructure financing, Government of India has permitted IFCI, IDFC, LIC and infrastructure finance firms to issue long-term infrastructure bonds providing for tax benefit of up to Rs.20,000 in the year of investment, under the Income Tax Act. The tax-free status has been granted by the government to these bonds issued only by designated financial institutions. By introduction of such instruments, the retail base can be tapped for raising funds for infrastructure projects.
- **Use of Foreign Exchange Reserves for Infrastructure Development** - Although use of reserves for such purposes does not meet the criterion of reserve management objectives, a special and limited window has been created. Accordingly, IIFC (UK) Ltd. was incorporated in London and was set up in April 2008. Under this scheme, RBI invests, in tranches, up to an aggregate amount of USD 5 billion in fully government guaranteed foreign currency denominated bonds issued by this overseas Special Purpose Vehicles (SPV) of the IIFCL. The funds, thus raised, are to be utilized by the company for on-lending to the Indian companies implementing infrastructure projects in India and/or to co-finance the ECBs of such projects for capital expenditure outside India without creating any monetary impact.

- **Introduction of Credit Default Swaps** - Further, the introduction of Credit Default Swaps (CDS) would help banks to manage exposures while increasing credit penetration, and lending to infrastructure and large firms without being constrained by the extant regulatory prescriptions in respect of single borrower gross exposure limits.
- **Liberalisation & Rationalization of ECB policies** - Corporates implementing infrastructure projects were eligible to avail of ECB up to USD 500 million in a financial year under the automatic route. This limit has been raised to USD 750 million. Infrastructure Finance Companies (IFCs) i.e., Non Banking Financial Companies (NBFCs) categorized as IFCs by the Reserve Bank, are permitted to avail of ECBs, including the outstanding ECBs, up to 50 per cent of their owned funds, for on-lending to the infrastructure sector as defined under the ECB policy, subject to their complying with certain conditions

#### 4.1.3 What more needs to be done?

- **Making the Infrastructure Project Commercially Viable** - This is the first and foremost thing we should do for financing infrastructure in a sustainable manner. As mentioned earlier infrastructure projects involve huge financing requirements, most of which are met by banks and other financial institutions directly and indirectly. Thus, it is very important to make the project commercially viable to ensure regular servicing of the loan. This will lead to sustainable development of infrastructure without jeopardizing the soundness of the financial sector. Project appraisal and follow-up capabilities of many banks, particularly public sector banks, also need focused attention and upgradation so that project viability can be properly evaluated and risk mitigants provided where needed.
- **Greater Participation of State Governments** - In a federal country like India, participation and support of the State governments is essential for developing high quality infrastructure. The State governments' support in maintenance of law and order, land acquisition, rehabilitation and settlement of displaced persons, shifting of utilities, and obtaining environmental clearances are necessary for the projects undertaken by the Central Government or the private sector. It is satisfying to know that many State governments have also initiated several PPP projects for improving infrastructure.
- **Improving efficiency of the Corporate Bond Market** - Vibrant corporate bond market will reduce the dependence on the banking sector for funds. Further, coordinated regulatory initiatives could be considered in the areas involving standardization of stamp duties on corporate bonds across the states, encouraging public issuance and bringing in institutional investors in a big way. It is also important to broad base the investor base by bringing in new classes of institutional investors (like insurance companies, pension funds, provident funds, etc.) apart from banks into this market.
- **Credit Enhancement** - One of the major obstacles in attracting foreign debt capital for infrastructure is the sovereign credit rating ceiling. Domestic investors are also inhibited due to high level of credit risk perception, particularly in the absence of sound bankruptcy framework. A credit enhancement mechanism can possibly bridge the rating cap between the investment norms, risk perceptions and actual ratings
- **Simplification of Procedures – Enabling Single Window Clearance** - It is well recognized that while funding is the major problem for infrastructure financing, there are other issues which aggravate the problems of raising funds. These include legal disputes regarding land acquisition, delay in getting other clearances (leading to time and cost overruns) and linkages (e.g. coal, power, water, etc.) among others. It is felt that in respect of mega-projects, beyond certain cut-off point, single window clearance approach could cut down the implementation period.

## 4.2 Public-private Partnership in Infrastructure

The partners in a PPP, usually through a legally binding contract or some other mechanism, agree to share responsibilities related to implementation and/or operation and management of an infrastructure project. This collaboration or partnership is built on the expertise of each partner that meets clearly defined public needs through the appropriate allocation of:



- Resources
- Risks
- Responsibilities, and
- Rewards

#### 4.2.1 What advantages PPPs may provide?

Governments worldwide have increasingly turned to the private sector to provide infrastructure services in energy and power, communication, transport and water sectors that were once delivered by the public sector. There are several reasons for the growing collaboration with the private sector in developing and providing infrastructure services, which include:

- Increased efficiency in project delivery, and operation and management;
- Availability of additional resources to meet the growing needs of investment in the sector; and
- Access to advanced technology (both hardware and software).

#### 4.2.2 How a PPP project is different from a conventional project?

There are significant differences between a conventional construction procurement project and a PPP project that need to be clearly understood. The main differences include:

- PPP projects are different from conventional construction projects in terms of project development, implementation, and management. The administrative and approval processes in the case of PPP projects are also different.
- A PPP project is viable essentially when a robust business model can be developed.
- The focus of a PPP project should not be on delivering a particular class/type of assets but on delivering specified services at defined quantity and levels.
- The risk allocation between the partners is at the heart of any PPP contract design and is more complex than that of a conventional construction project. Both partners should clearly understand the various risks involved and agree to an allocation of risks between them.
- A PPP contract generally has a much longer tenure than a construction contract. Managing the relationship between the private company and the implementing agency over the contract tenure is vital for the success of a PPP project.

#### 4.2.3 Are there any limitations of PPPs?

There are many important economic, social, political, legal, and administrative aspects, which need to be carefully assessed before approvals of PPPs are considered by the government. PPPs have various limitations which should also be taken into account while they are being considered. The major limitations include:

- Not all projects are feasible (for various reasons: political, legal, commercial viability, etc.).
- The private sector may not take interest in a project due to perceived high risks or may lack technical, financial or managerial capacity to implement the project.
- A PPP project may be more costly unless additional costs (due to higher transaction and financing costs) can be off-set through efficiency gains.
- Change in operation and management control of an infrastructure asset
- through a PPP may not be sufficient to improve its economic performance unless other necessary conditions are met. These conditions may include appropriate sector and market reform, and change in operational and management practices of infrastructure operation.
- Often, the success of PPPs depends on regulatory efficiency.

#### 4.2.4 Models of PPP

A wide spectrum of PPP models has emerged. These models vary mainly by:

- Ownership of capital assets;

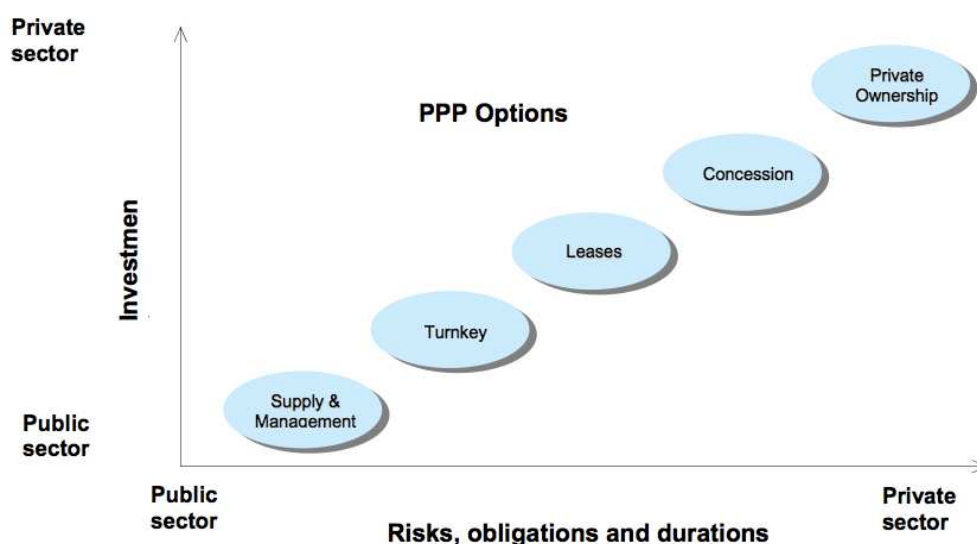
- Responsibility for investment;
- Assumption of risks; and
- Duration of contract.

The PPP models can be classified into five broad categories in order of generally (but not always) increased involvement and assumption of risks by the private sector. The five broad categories are:

- Supply and management contracts
- Turnkey contracts
- Affermage/Lease
- Concessions
- Private Finance Initiative (PFI) and Private ownership.

A categorization of the PPP models together with their main characteristics is shown in table 1. While the spectrum of models shown in the table are possible as individual options, combinations are also possible such as, a lease or (partial) privatization contract for existing facilities which incorporates provisions for expansion through Build-Operate- Transfer.

**Figure 1. Basic features of PPP models**



**Table 1. Classification of PPP models**

Broad category	Main variants	Ownership of capital assets	Responsibility of investment	Assumption of risk	Duration of contract (years)
Supply and management contract	Outsourcing	Public	Public	Public	1-3
	Maintenance management	Public	Public/Private	Private/Public	3-5
	Operational management	Public	Public	Public	3-5
Turnkey		Public	Public	Private/Public	1-3
Affermage/Lease	Affermage	Public	Public	Private/Public	5-20
	Lease*	Public	Public	Private/Public	5-20
Concessions	Franchise	Public/Private	Private/Public	Private/Public	3-10
	BOT**	Public/Public	Private/Public	Private/Public	15-30
Private ownership of assets and PFI type	BOO/DBFO	Private	Private	Private	Indefinite
	PFI***	Private/Public	Private	Private/Public	10-20
	Divestiture	Private	Private	Private	Indefinite

\*Build-Lease-Transfer (BLT) is a variant.

**\*\*Build-Operate-Transfer (BOT)** has many other variants such as **Build-Transfer-Operate (BTO)**, **Build-Own-Operate-Transfer (BOOT)** and **Build-Rehabilitate-Operate-Transfer (BROT)**.

**\*\*\*The Private Finance Initiative (PFI)** model has many other names. In some cases, asset ownership may be transferred to, or retained by the public sector.

The main features of each of the broad categories of the PPP models are discussed next.

#### 4.2.4.1 Supply and Management Contracts

A management contract is a contractual arrangement for the management of a part or whole of a public enterprise (for example, a specialized port terminal for container handling at a port or a utility) by the private sector. Management contracts allow private sector skills to be brought into service design and delivery, operational control, labour management and equipment procurement. However, the public sector retains the ownership of facility and equipment. The private sector is assigned specified responsibilities concerning a service and is generally not asked to assume commercial risk.

The private contractor is paid a fee to manage and operate services. Normally, the payment of such fees is performance-based. Usually, the contract period is short, typically three to five years. But the period may be longer for large and complex operational facilities such as a port or an airport.

*Pros:*

- Can be implemented in a short time.
- Least complex of all PPP models.
- In some countries, politically and socially more acceptable for certain □ projects (such as water projects and strategic projects like ports and □ airports). □

*Cons:*

- Efficiency gains may be limited and little incentive for the private sector to invest.
- Almost all risks are borne by the public sector.
- Applicable mainly to existing infrastructure assets.

#### 4.2.4.2 Turnkey

Turnkey is a traditional public sector procurement model for infrastructure facilities. Generally, a private contractor is selected through a bidding process. The private contractor designs and builds a facility for a fixed fee, rate or total cost, which is one of the key criteria in selecting the winning bid. The contractor assumes risks involved in the design and construction phases. The scale of investment by the private sector is generally low and for a short-term. Typically, in this type of arrangement, there is no strong incentive for early completion of the project. This type of private sector participation is also known as Design-Build.

*Pros:*

- Well understood traditional model.
- Contract agreement is not complex.
- Generally, contract enforcement is not a major issue.

*Cons:*

- The private sector has no strong incentive for early completion.
- All risks except those in the construction and installation phases are borne □ by the public sector.
- Low private investment for a limited period.
- Only limited innovation may be possible.



#### 4.2.4.3 Affermage/Lease

In this category of arrangement, the operator (the leaseholder) is responsible for operating and maintaining the infrastructure facility (that already exists) and services, but generally the operator is not required to make any large investment. However, often this model is applied in combination with other models such as build- rehabilitate- operate-transfer. In such a case, the contract period is generally much longer and the private sector is required to make significant investment.

The arrangements in an affermage and a lease are very similar. The difference between them is technical. Under a lease, the operator retains revenue collected from customers/users of the facility and makes a specified lease fee payment to the contracting authority. Under an affermage, the operator and the contracting authority share revenue from customers/users.

In the affermage/lease types of arrangements, the operator takes lease of both infrastructure and equipment from the government for an agreed period of time. Generally, the government undertakes the responsibility for investment and thus bears investment risks. The operational risks are transferred to the operator. However, as part of the lease, some assets also may be transferred on a permanent basis for a period which extends over the economic life of assets. Fixed facilities and land are leased out for a longer period than for mobile assets. Land to be developed by the leaseholder is usually transferred for a period of 15-30 years.

*Pros:*

- Can be implemented in a short time.
- Significant private investment possible under longer term agreements.
- In some countries, legally and politically more acceptable for strategic projects like ports and airports.

*Cons:*

- Has little incentive for the private sector to invest, particularly if the lease period is short.
- Almost all risks are borne by the public sector.
- Generally used for existing infrastructure assets.
- Considerable regulatory oversight may be required.

#### 4.2.4.4 Concessions

In this form of PPP, the government defines and grants specific rights to an entity (usually a private company) to build and operate a facility for a fixed period of time. The government may retain the ultimate ownership of the facility and/or right to supply the services. In concessions, payments can take place both ways: concessionaire pays to government for the concession rights and the government may pay the concessionaire, which it provides under the agreement to meet certain specific conditions. Usually, such payments by the government may be necessary to make projects commercially viable and/or reduce the level of commercial risk taken by the private sector, particularly in a developing or untested PPP market. Typical concession periods range between 5 to 50 years.

*Pros:*

- Private sector bears a significant share of the risks.
- High level of private investment.
- Potential for efficiency gains in all phases of project development and implementation and technological innovation is high.

*Cons:*

- Highly complex to implement and administer.
- Difficult to implement in an untested PPP market.
- May have underlying fiscal costs to the government.
- Negotiation between parties and finally making a project deal may require long time.
- May require close regulatory oversight.
- Contingent liabilities on government in the medium and long term

In a Build-Operate-Transfer or BOT type of concession (and its other variants namely, Build-Transfer-Operate (BTO), Build-Rehabilitate-Operate-Transfer (BROT), Build-Lease-Transfer (BLT) type of arrangement), the concessionaire makes investments and operates the facility for a fixed period of time after which the ownership reverts back to the public sector. In a BOT model, operational and investment risks can be substantially transferred to the concessionaire. In a BOT model, the government has, however, explicit and implicit contingent liabilities that may arise due to loan guarantees and sub-ordinate loans provided, and default of a sub-sovereign government and public or private entity on non- guaranteed loans.

By retaining ultimate ownership, the government controls the policy and can allocate risks to parties that are best suited to assume or remove them. BOT projects may also require direct government support to make them commercially viable. The concessionaire's revenue in a BOT project comes from managing and marketing of the user facilities (for example, toll revenue in a toll road project) and renting of commercial space where possible. Concessions for BOT projects can be structured on either maximum revenue share for a fixed concession period or minimum concession period for a fixed revenue share, a combination of both, or only minimum concession period.

#### 4.2.4.5 Private Finance Initiative (PFI)

- In the private finance initiative model, the private sector remains responsible for the design, construction and operation of an infrastructure facility. In some cases, the public sector may relinquish the right of ownership of assets to the private sector.
- In this model, the public sector purchases infrastructure services from the private sector through a long-term agreement. PFI projects, therefore, bear direct financial obligations to the government in any event. In addition, explicit and implicit contingent liabilities may also arise due to loan guarantees provided to the lenders and default of a public or private entity on non-guaranteed loans. A PFI project can be structured on minimum payment by the government over a fixed contract tenure, or minimum contract tenure for a fixed annual payment, or a combination of both payment and tenure.
- In the PFI model, asset ownership at the end of the contract period is generally transferred to the public sector. Setting up of a Special Purpose Vehicle (SPV) may not be always necessary. A PFI contract may be awarded to an existing company. For the purpose of financing, the lenders may, however, require the establishment of an SPV. The PFI model also has many variants.
- In a PFI project, as the same entity builds and operates the services, and is paid for the successful supply of services at a pre-defined standard, the SPV / private company has no incentive to reduce the quality or quantity of services. This form of contractual agreement reduces the risks of cost overruns during the design and construction phases or of choosing an inefficient technology, since the operator's future earnings depend on controlling the costs. The public sector's main advantages lie in the relief from bearing the costs of design and construction, the transfer of certain risks to the private sector and the promise of better project design, construction and operation.

##### *Pros:*

- Private sector may bear a significant share of the risks.
- High level of private investment.
- Potential for efficiency gains and innovation is high.
- Attractive to private investors in an untested or developing PPP market.
- Most suitable for social sector infrastructure projects (schools, dormitories, hospitals, community facilities, etc.).

Cons:

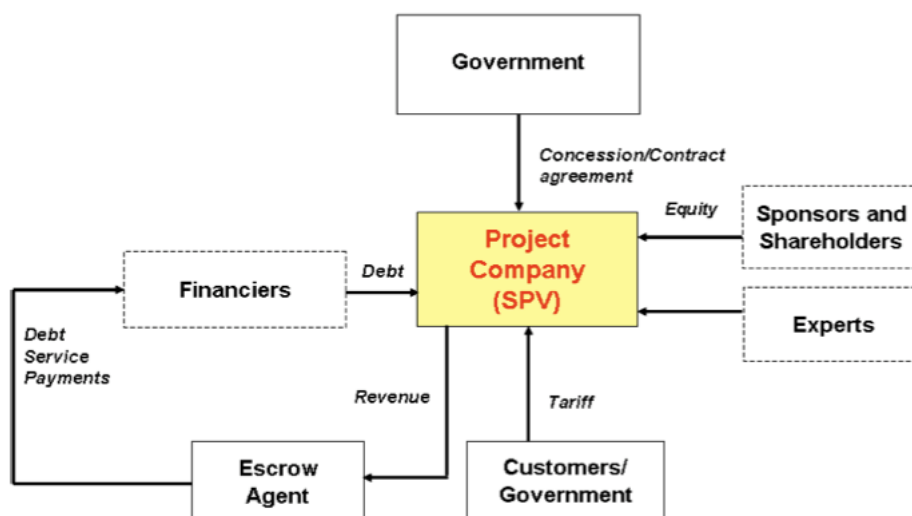
- Complex to implement and manage the contractual regimes.
- Government has direct financial liability.
- Negotiation between parties may require long time.
- Regulatory efficiency is very important.
- Contingent liabilities on the government in the medium and long term.

#### 4.2.5 Understanding the basic structure of a PPP arrangement

A typical PPP structure can be quite complex involving contractual arrangements between a number of parties, including the government, project sponsor, project operator, financiers, suppliers, contractors, engineers, third parties (such as an escrow agent<sup>5</sup>), and customers. □ The creation of a separate commercial venture called a Special Purpose/Project Vehicle (SPV) is a key feature of most PPPs. The SPV is a legal entity that undertakes a project and negotiates contract agreements with other parties including the government. An SPV is also the preferred mode of PPP project implementation in limited or non-recourse situations, where the lenders rely on the project's cash flow and security over its assets as the only means to repay debts

- Figure 2 shows a simplified PPP structure. The actual structure of a PPP, however, depends on the type of partnership model and can be quite complex involving contractual arrangements between a number of parties including the government, project sponsor, project operator, financiers, suppliers, contractors, engineers, third parties (for example, an escrow agent), and customers
- An SPV is usually set up by the private concessionaire/sponsor(s), who in exchange for shares representing ownership in the SPV contribute the long-term equity capital, and agree to lead the project. The SPV may not always be directly owned by the sponsors. They may use a holding company for this purpose.
- An important characteristic of an SPV as a company is that it cannot undertake any business that is not part of the project. An SPV as a separate legal entity protects the interests of both the lenders and the investors. The formation of an SPV has also many other advantages. A project may be too large and complicated to be undertaken by one single investor considering its investment size, management and operational skills required and risks involved. In such a case, the SPV mechanism allows joining hands with other investors who could invest, bring in technical and management capacity and share risks, as necessary

**Figure 2. Typical structure of a PPP project<sup>7</sup>**



- The government may also contribute to the long-term equity capital of the SPV in exchange of shares. In such a case, the SPV is established as a joint venture company between the public and private sectors and the government acquires equal rights and equivalent interests to the assets within the SPV as other private sector shareholders.

- Sometimes, governments want to ensure a continued interest (with or without controlling authority) in the management and operations of infrastructure assets such as a port or an airport particularly those which have strategic importance, or in assets that require significant financial contribution from the government. In such a case, a joint venture may be established. A joint venture is an operating company owned by a government entity and a private company (or multiple companies including foreign companies if permitted by law), or a consortium of private companies.
- Often, an SPV is formed as a joint venture between an experienced construction company and a service operations company capable of operating and maintaining the project.
- Other than its strategic, financial and economic interest, the government may also like to directly participate in a PPP project. The main reasons for such direct involvement may include:
  - To hold interest in strategic assets;
  - To address political sensitivity and fulfil social obligations;
  - To ensure commercial viability of the project;
  - To provide greater confidence to lenders; and
  - To have better insight to protect public interest.

Direct government involvement in a PPP project is usually guided by the legal and regulatory regime of the country and the government policy on PPPs. For example, the government may hold certain defined percentage of the stake in a strategic project such as an airport or a port.

#### 4.2.6 PPP Initiatives in India

The Government of India is promoting PPPs as an effective tool for bringing private-sector efficiencies in creation of economic and social infrastructure assets and for delivery of quality public services. India in recent years has emerged as one of the leading PPP markets in the world, because of several policy and institutional initiatives taken by the central government. By end December 2012 there were over 900 PPP projects in the infrastructure sector. These projects are at different stages of implementation, i.e. bidding, construction, and operational.

##### 4.2.6.1 Approval of Central-sector PPP projects

Since its constitution in January 2006, the Public Private Partnership Appraisal Committee (PPPAC) has approved 307 central project proposals. These include NHs (242 proposals), ports (29 proposals), airports (2 proposals), tourism infrastructure (1 proposal), railways (1 proposal), housing (27 proposals), and sports stadia (5 proposals).

##### 4.2.6.2 VGF for PPP Projects

Under the Scheme for Financial Support to PPPs in Infrastructure (Viability Gap Funding Scheme), 145 projects have been granted approval. Thirteen new sub-sectors have been included in the list of sectors eligible for VGF support under the Scheme. These include:

- Capital investment in the creation of modern storage capacity including cold chains and post-harvest storage.
- Education, health, and skill development.
- Internal infrastructure in National Investment and Manufacturing Zones.
- Oil/gas/liquefied natural gas (LNG) storage facility [includes City Gas distribution (CGD) network]; oil and gas pipelines (includes CGD network); irrigation (dams, channels, embankments, etc); telecommunication (fixed network) (includes optic fibre/ wire/cable networks which provide broadband /internet); telecommunication towers; terminal markets; common infrastructure in agriculture markets; and soil-testing laboratories.

##### 4.2.6.3 Support for Project Development of PPP Projects

The India Infrastructure Project Development Fund (IIPDF) was launched in December 2007 to facilitate quality project development for PPP projects and ensure transparency in procurement consultants and projects.

#### 4.2.6.4 Capacity Building and Strengthening of State and Central Institutions

The National PPP Capacity Building Programme was launched by the Finance Minister in December 2010, and was rolled out last year in 15 States and two central training institutes, viz. the Indian Maritime University and Lal Bahadur Shastri National Academy of Administration. A comprehensive curriculum has been prepared and 11 training programmes conducted to train 154 trainers, who have trained over 1975 public functionaries, who deal with PPPs in their domain.

**Online toolkits for PPP projects** for five sectors were developed and were launched by the Finance Minister. These are available on this Department's website on PPPs, i.e. [www.pppinindia.com](http://www.pppinindia.com). The PPP toolkit is a web-based resource that has been designed to help improve decision-making for infrastructure PPPs in India and to improve the quality of the infrastructure PPPs that are implemented in India. In the past one year, 720 national and international users have availed of this one-of-a-kind web-based resource to structure better PPP projects.

#### 4.2.6.5 Monitoring of PPP Projects

With an increasing reliance being placed on PPP projects across many wings of the government, it has become necessary to adopt a well-defined institutional structure for overseeing contract performance effectively. The Institutional Framework requires project authorities to create a two-tier mechanism for monitoring the performance of PPP projects:

- A PPP Projects Monitoring Unit (PMU) at the project authority level
- A PPP Performance Review Unit (PRU) at the Ministry or State Government level, as the case may be.

The PMU is to prepare a report to be submitted to PRU within 15 days of the close of the relevant month. The report is to cover compliance of conditions, adherence to time lines, assessment of performance, remedial measures, imposition of penalties, etc. The PRU is to review the reports submitted by the different PMUs and oversee or initiate action for rectifying any defaults or lapses.

#### 4.2.6.6 PPP Rules and PPP Policy:

Following the recommendations of the Committee on Public Procurement, the Prime Minister's announcement regarding transparency and accountability in procurement, and preparation of the Public Procurement Bill, and to ensure that PPP projects are procured and implemented by following laid down processes and observing principles of transparency, competitive bid process, affordability, and value for money, the draft PPP Rules and PPP Policy have been prepared. These have undergone extensive consultation process at central and state government levels for finalization.

Global experience indicates that PPPs work well when they combine the efficiency and risk assessment of the private sector with the public purpose of the government sector. They work poorly when they rely on the efficiency and risk assessment of the government sector and the public purpose of the private sector. India should be careful not to undertake PPPs that do not apportion risks and responsibilities sensibly. Moreover flexibility needs to be built into arrangements so that the contract can be withdrawn and put up for rebid when the private party underperforms. The government needs to study the PPP experience and build some central capacity to help ministries, authorities, and states structure contracts and renegotiate troubled ones.

## 5 Models of Foreign Investment

### 5.1 Why the need for foreign investment?

- In most developing countries like ours, domestic capital is inadequate to meet the purpose of economic growth.
- The inflow of foreign capital helps in removing the balance of payment over time.
- By taxing the profits of foreign enterprise, the developing countries mobilize funds for development projects.

- Foreign capital contributes to the generation of employment.
- Foreign investment fills the gaps in management, entrepreneurship, technology and skill.

## 5.2 Forms of Foreign Investment

- It includes foreign direct investment (FDI) and foreign portfolio investment (FPI)
- Foreign direct investment is the investment in physical assets by foreign individuals, companies or financial institutions.
- Foreign portfolio investment is the investment made in financial assets. It includes investments made by foreign institutional investors.

## 5.3 Foreign Direct Investment

- Investment in the businesses by foreign citizens usually involving majority stock ownership of the enterprise
- Joint ventures between the foreign and domestic companies

### 5.3.1 Forms of FDI

There are two types of FDI

- **Greenfield Investment:** It is the direct investment in new facilities or the expansion of existing facilities. It is the principal mode of investing in developing countries.
- **Mergers and Acquisition:** It occurs when a transfer of existing assets from local firms takes place.

### 5.3.2 Why FDI preferred?

- It is of non-debt creating nature.
- It is also less prone to quick reversals. South-east Asian crisis emanated due to the reversals of short-term capital inflows.

### 5.3.3 Forbidden Territories

FDI is not permitted in the following industrial sectors:

- Arms and ammunition
- Atomic Energy
- Railway Transport
- Coal and lignite
- Mining of iron, manganese, chrome, gypsum, sulphur, gold, diamonds, copper, zinc
- Retail trading, except single brand product retailing
- Gambling & Betting
- Lottery

### 5.3.4 Foreign Investment Promotion Board

- It offers a single window clearance for foreign direct investment proposals in India that are not allowed access through the automatic route.
- It comprises Secretaries from Department of Commerce, Department of Industrial Policy & Promotion and Ministry of External Affairs as members, with Secretary in Department of Economic Affairs in the Ministry of Finance as the chairperson.



- To expedite flow of foreign investment into the country, the Union government has allowed the FIPB to clear proposals from overseas entities worth up to Rs. 1,200 crore. Earlier the limit was Rs. 600 crore.

### 5.3.5 Invest India to promote FDI

Invest India has been constituted to promote FDI. The company with Rs. 10,000 million will have 49 percent share from government and 51 percent from FICCI. The principles of the company are to promote FDI in the country, to provide processing facilities to foreign investors and act as coordinator among various ministries and also to provide feedback to the government on industrial policy.

## 5.4 Foreign Institutional Investors

- Foreign Institutional Investors (FII s) means an entity established or incorporated outside India which proposes to make investment in India. Positive tidings about the Indian economy combined with a fast-growing market have made India an attractive destination for FIIs.
- FII inflows are called 'hot money' because they can be taken out any time.

### 5.4.1 Entry Options

A foreign company planning to set up business operations in India has the two following options.

#### 5.4.1.1 Incorporated Entity

- By incorporating a company under the Companies Act, 1956 through Joint Ventures; or Wholly Owned Subsidiaries
- Foreign equity in such Indian companies can be up to 100% depending on the requirements of the investor, subject to equity caps in respect of the area of activities under the Foreign Direct Investment policy.

#### 5.4.1.2 Unincorporated Entity

- As a foreign Company through liaison office/representative office, project office and branch office.
- Such offices can undertake activities permitted under the Foreign Exchange Management Regulations, 2000.

## 5.5 Recent Initiatives to promote Foreign Investment

### 5.5.1 Expansion of Qualified Foreign Investors (QFIs ) Scheme:

- In Budget 2011-12, the government, for the first time, permitted Qualified Foreign Investors (QFIs), who meet the know-your-customer (KYC) norms, to invest directly in Indian MFs.
- In January 2012, the government expanded this scheme to allow QFIs to directly invest in Indian equity markets.
- Taking the scheme forward, as announced in Budget 2012-13, QFIs have also been permitted to invest in corporate debt securities and MF debt schemes subject to a total overall ceiling of US\$ 1 billion.
- In May 2012, QFIs were allowed to open individual non interest-bearing rupee bank accounts with authorized dealer banks in India for receiving funds and making payment for transactions in securities they are eligible to invest in.

- In June 2012, the definition of QFI was expanded to include residents of the member countries of the Gulf Cooperation Council (GCC) and European Commission (EC) as the GCC and EC are the members of the Financial Action Task Force (FATF).

### 5.5.2 Initiatives to attract FII Investment

- As regards FII investment in debt securities, there has been progressive enhancement in the quantitative limits for investments in various debt categories.
- The FII limit for investment in G-Secs (government securities) has been enhanced by US \$ 5 billion, raising the cap to US \$ 20 billion.
- The scheme for FII investment in long-term infra bonds has been made attractive by gradual reduction in lock-in and residual maturity periods criteria.
- In November 2012, the limits for FII investment in GSecs and corporate bonds (non-infra category) have been further enhanced by 5 billion each, taking the total limit prescribed for FII investment to US\$ 25 billion in G-Secs and US\$51 billion for corporate bonds (infra+non-infra).
- FII debt allocation process has also been reviewed for bringing greater certainty among foreign investors and helping them periodically re-balance their portfolios in sync with international portfolio management practices.

### 5.5.3 Liberalization in External Commercial Borrowings Policy during 2012-13

The important steps taken in the arena of external commercial borrowings (ECB) policy liberalization include:

- Enhancing the limit for refinancing rupee loans through ECB from 25 per cent to 40 per cent for Indian companies in the power sector
- Allowing ECB for capital expenditure on the maintenance and operation of toll systems for roads and highways so long as they are a part of the original project subject to certain conditions, and also for low cost housing projects.
- Reducing the withholding tax from 20 per cent to 5 per cent for a period of three years (July 2012- June 2015) on interest payments on ECBs.
- Introducing a new ECB scheme of US \$10 billion for companies in the manufacturing and infrastructure sectors.
- Permitting the Small Industries Development Bank (SIDBI) as an eligible borrower for accessing ECB for on-lending to the micro, small, and medium enterprises (MSME) sector subject to certain conditions.
- Permitting the National Housing Bank (NHB)/ Housing Finance Companies to avail themselves of ECBs for financing prospective owners of low cost / affordable housing units.

### 5.5.4 Impact:

- Improved capital flows in recent months, particularly FII flows
- The resulting increase in capital flows has more than balanced the widening current account deficit in recent months.
- Volatility remains high because of high share of FII flows in total capital flows and the week-to-week variation in such flows
- The share of ECB's has increased substantially for a long time now. However the increase in ECB's in the recent period caused some concern given the depreciation of rupee as it would mean a higher debt service burden in rupee terms that could impact profitability and balance sheets of corporate borrowers.



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