STRATEGIC INCENTIVES AND CHALLENGES FOR ENTERING THE INDIAN MARKET

Bruce Miller

cSll, ieciea» of tlw dus.ine&S1 eruuaonrneru. in. ';:'?ndia. f.w,m lh0 UY.>hUcliAf0 ı Uif ou/J ~inrf ';:'?ndependence, tlvio.u9lv lli0 antU-#&wirftv and dioestmeno p}zas.e/ 4 th0 fal0 70s1. c{!,<WMM'k J/ th0 1991 z~ plipsh, the- uda~tWrv of zes.l!UcJAAJ,e; pnactcces- and the- ef1,CO,Wta<JR1n<blUS1 and entice- 11vv1U51 of iodaq. wlucA mak& ';:?n.di,a; aJ1/ {l.uvwa.~) ideal inuesunent. ~and ma|[;f'U!.b ~ co,f1112ani051 h<u11/ aaound. lh0 wodd.

WHY INVEST IN INDIA

India is swiftly becoming recognized as a good investment location. This is despite regional political uncertainty, bureaucratic hassles, power shortages and infrastructural deficiencies which would normally discourage foreign investments. India presents a vast potential for overseas investment arid is now actively encouraging the entrance of foreign players into the country and its markets. No company, either currently a global player or aspiring to become one, can afford to ignore India which is swiftly becoming one of the top three emerging economies in the world.

Today. India is one of the six fastest growing economies of the world. A unique feature of the recent transition of the Indian economy has been high growth together with increased stability. The Indian economy has proven its strength and resilience in its ability to withstand crises in other parts of Asia and the world in recent years. A highlight of the country is its well organized educational system. with internationally recognized excellence in higher education. India has 250 universities and over I 0,000 higher educational institutions producing a million graduates including I 0,000 engineers per year. The main business language used in India is English which is another major attraction for foreign investors. India has developed an impressive R&D infrastructure with !500 research facilities. Over I 00 MNCs have set up research centers in the country. India is at the forefront of knowledge based industries. businesses and service such as IT. biotechnology, bioinformatics and pharmaceuticals, and is well positioned to take advantage of the opportunities arising in the New Economy. The Internet is not just another technology for India. It has triggered a socio-cultural revolution empowering the masses and firing the imagination and ambition of youth.

The Indian economy is now on the verge of a long term sustained increase in domestic demand due to the rising per capita GDP. The domestic demand is projected to double over the ten year period from 1998 to 2007. The number of households with "high income" will be increasing by 60% over the next four years to 44 million households. The per capita income in real terms (at 1993-94 prices) during 2003-04 is estimated to attain a level bf Rs. 11.672. The cumulative average growth for April - December 2003 was 8.2%.

For companies desiring a successful entry into the India market. several factors must be considered for the correct estimation of the country's potential. Underestimation of

Prof Bruce Miller is Professor of' Management at Rajagiri School of Management, Koehl, India.

its complexity in various areas, or overestimation of its possibilities can lead to failure. While calculating, due consideration should be given to the inherent difficulties and uncertainties of functioning in the Indian system. Entering India's marketplace requires a well-designed plan backed by serious thought and careful research as well as proper implementation. For those organizations willing to take the time and make the effort, India is an opportunity for long-term growth and is well worth the effort.

HISTORY

India's economic policy reforms have played a critical role in the performance of the Indian economy since 1991. Among other things, the reforms have involved opening the economy, making it more competitive, getting the government out of the huge morass of regulation, empowering the states to take more responsibility for economic management and thereby creating a kind of competition between the states for foreign investors. As concerns foreign trade and investment two distinct phases can be identified in India - the pre 1991 reforms phase and the post 1991 phase.

THE PRE 1991. REFORMS PHASE

The pre 1991 phase, which stretched over four decades, was marked by extensive regulation of trade and investment. Restrictions on ownership of equity by foreign firms in cases where projects involved substantial inputs of foreign exchange or were export oriented, the specification of sectors in which both foreign financial and technical participation were allowed all reflected the desire to limit foreign control. A preference for technical collaboration agreements as opposed to foreign equity ownership also reflected the desire to promote the twin objectives of freedom from foreign control and utilization of foreign technology and know-how.

Industrial policies were dominated with licensing constraints by virtue of which strict entry barriers were maintained. Under the **Industries Development and Regulation Act (1951).** it was mandatory for all companies to get government approval to set up a new production unit or to expand their activities. Approval was also required if the manufacturer wanted to change the line of production. Moreover, when permission was granted, it was very specific to product, capacity and location. The decision to award a license involved many stages and became a highly bureaucratic process, with some elements of state captured by incumbent domestic firms. This and other policies led to a very high degree of bureaucratization of the economy. Many sectors such as textiles were reserved for the small scale sector, thereby making it difficult for domestic firms belonging to these sectors to enjoy economies of scale, and making these sectors unattractive to MNCs.

Indian trade policy before the 1990s focused on import substitution. FOi policy put severe restrictions on foreign investment. The economy was deprived of foreign capital and foreign technology and internationally efficient scales and quality of production could not be achieved. The situation further worsened when foreign firms were required to ddute their equity holdings to less than 40 percent which witnessed multinationals like IBM and Coca Cola closing down their operations in India by the year 1979.

In addition to industrial and trade policies, public sector policy exclusively reserved certain sectors for the public sector. The public sector was also present in almost all parts of the economy - petroleum. consumer goods, tourism infrastructure and services. etc. Infrastructure industries such as power, telecom, air transport, etc., were almost wholly public sector controlled.

To summarize the impact of pre-1991 policies. the Indian industrial structure was weak, both financially and technologically. However. domestic incumbents had been created who were entrenched and this had implications for FOi and for the mode of entry in the 1990s. The major prevailing problems were inefficiencies, high costs, poor management, non-competitiveness, excessive reservation, import controls. lack of export orientation and disincentives to the foreign investors.

POST 1991 REFORMS PHASE

Reforms launched in the early 1990s focused on addressing some of these issues. Economic policies were liberalized with a view towards encouraging investment and accelerating economic growth. Beginning in July 1991, the government introduced a number of changes in the country's regulatory policies under the general acceptance of the policy package known widely as the **Structural Adjustment Programme (SAP).** The important departure from the past was in the form of:

i. Revision of the Industrial Policy Resolution, 1956 and Schedules A & B. resulting in the opening up of many a public sector reserved area;

ii. Doing away with the registration requirements under MRTPA;

iii. Removal of the general ceiling of 40 per cent on foreign-held equity under Foreign Exchange Regulation Act (FERA);

iv. Lifting of the restrictions on use of foreign brand names in the local market;

v. Removal of the restrictions on FDI entry into technology consumer goods;

vi. Abandonment of the phased manufacturing programme (PMP);

vii. Dilution of the dividend balancing condition and export obligations;

viii. Liberalization of the terms for import of technology and royalty payments;

ix. Permission to invest up to 24 per cent in the equity of small scale units;

x. Reduction in tax rates; etc

The reform package as a whole, heralded a departure from the earlier dirigiste regime. FDI flows responded to the new initiatives; annual average inflows increased from around US$ 384 million during the late eighties to around US$ 3 billion during the late nineties to over US$ 12 billion by January 2004. Among other things, the reforms have involved opening the economy, making it more competitive, getting the government out of the huge quagmire of regulation, empowering the states to take more responsibility for economic management and thereby creating a kind of competition between the states for foreign investors.

MARKET POTENTIAL

India is the world's largest democracy, the seventh largest country in terms of size, and second only to China in terms of market size. With a landmass of 3.29 million square kilometers, and a population base of over one billion, India truly represents a mega-market. Growing by the present trend, India will become the most populous country in the world by the year 2044.

India's Population Profile

Years Parameters	*1998-99*	*1999-00*	*2000-01*	*2001-02*
Population in million (Proxy for Market Size)	983	1001	1019	1037

The Indian market reflects considerable diversities in income levels and lifestyles. Recent World Bank estimates place the average annual household income (in terms of purchasing power parity) at approximately US$ 700. But there are many people whose income levels are significantly higher, growing faster and spurring a consumer revolution. There is considerable debate over the dimension and contours of the middle class, the central theme and the target of the new markets of India. *It is believed that most multi-national companies are* coming to *India tempted by the size of the middle class.* While it is difficult to be exact about the number of Consumers that comprise the middle class, estimates range from 300-350 million. The target market segments for aspiration and lifestyle goods are the 35-44 million homes representing the consuming classes and the rich, or some 150 million people.

Consumer Class (Households in million)	1996	2001	2007 (E)
The Rich (Rs 2,15,000 and more)	1.2	2.0	6.2
The Consuming Class (Rs 45,000-2,15,000)	32.5	54.6	90.9
The Climbers (Rs 22,000-45,000)	54.1	71.6	74.1
The Aspirants (Rs 16,000-20,000)	44	28.1	15.3
The Destitute (Below Rs 16,000)	33	23.4	12.8
Total :	164.8	180.7	199.2

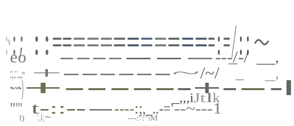
Source: NCAER, E= Estimate

The boom in the consumption pattern in urban areas would also lead to a transition in the rural areas. As per the available data, the percentage of the population lying below the poverty line has also been reduced in a significant manner. In 1987, 39 per cent of the people in rural areas and 38 per cent of the people in urban areas were below the poverty line. However, in a span of the 13 years, the total percentage of population below the poverty line came down to 27 per cent in rural areas and 23 per cent in urban areas. Similarly, per capita expenditure, especially in the urban region is up from Rs 125 per month in 1983 to Rs 854 per month in 2000. All these indicate a growing Indian market.

India is also a very young nation, ***with nearly 70 per cent of its population below the age of 40, and more than 47 per cent below the age of 20.*** This age distribution is of significance to various consumer product sellers, and explains the boom in all Indian cities in consumption of impulse products and leisure-related expenditure in general, since the onset of liberalization. Therefore there is a huge potential to invest in the consumer expendables in India.

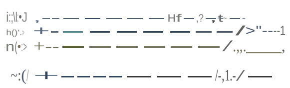
Table shows the trends in the value of the turnover of the major consumer goods Trans National Companies operating in India during the past two decades.

xestle rndia

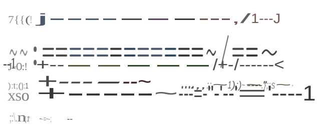


Colgate Palmolive

Philips India



Hindustan Lever



Overview of the Growth in Market Size between 1995 and 2000

Commodities	Compounded Annual Growth Rate
Toilet soap	2.8
Washing cake	5.1
Washing powder	5.9
Toothpaste	19.3
Tooth powder	6.0
Body Talcum powder	13.8
Shampoo Hair	41.1
Oil Face	5.1
Cream	15.8
Packaged Biscuits	13.5
Tea	6.0
Health Beverages	13.7
Leather Footwear	13.7

Source: Indian market demographics report. NCAER. 2002.

THE MANUFACTURING SECTOR

India boasts of having one of the most diversified and largest manufacturing bases in the world. There exists a great potential to invest in major Indian industries. The index of industrial production shows all the major sectors are performing well, except the mining and quarrying sectors where state monopoly is still in the process of being dismantled

Table: *Index of Industrial Production*

Years / Parameters	1999-2000	2000-01	2001-02	2002-03
Industry (major industry and percentage growth in their index over previous year)				
Index of Industrial Production	6.6	5.1	2.6	5.0
Mining and Quarrying	1.0	3.7	0.4	5.0
Electricity	7.3	4 0	3. 1	40
Manufacturing	7.2	5.4	2.9	5.1
Cement	15.4	-0.7	9.7	8.7
Fertilizers	4.8	2.4	-1.0	
Finished Steel	14.0	7.5	3.6	7.6

Source: Index of Industrial Production. Central Statistical Organization, Government of India

SERVICES SECTOR

Investing in the manufacturing sector sounds good. But the most exciting sector in India is the services sector. At present. the share of service in the Indian GDP is a massive 51 per cent. as against 25 per cent for industry and 24 per cent for agriculture. India has become a service economy.

Within this industry the biggest and the fastest growing sectors are communications. computer software and information technology. Within this category, the most promising is computer software export. It grew at an amazing rate of 40-50 percent every year during the 1990s.

The IT sector is one of the fastest growing segments in the convergence sector, growing from Rs. 132 billion in 1992-93 to Rs. 808.84 billion in 2001-02, of which 60 per cent is accounted for by software and the remaining 40 per cent by hardware.

IT penetration:

Parameter	India	World
PC sales (Mn units)	1.7	140 0
PC penetration per 1 000 people	62	26.0
IT spending as % of GDP	0.8	3.6
Internet User Base (Mn Nos)	2.5	407.1
International bandwidth GBPS	10	NA

India provides skilled and qualified labor at competitive wages. It offers to the world IT services. products and technology services and serves as an MNC investment center for IT-enabled services. Of the total software exports of US$ 9.5 billion in 2002-03, ITES and BPO services accounted for US$ 2.3 billion. IT services, products and technology services registered an export growth of 18.3 per cent in 2002-03, whereas BPO-ITES (not necessarily exports) registered a whopping 59.1 per cent growth. This only goes to show the increasing potential in the latter segment in view of India's abundant supply of cheap labor to perform low-end IT tasks.

EXTERNAL SECTOR LIBERALIZATION

The average level of tariff in the manufacturing sector has fallen from a high of over 120 per cent during 1991, to the present level of 28 per cent. In the case of the agriculture sector, most of the items have shifted from the list of non-tariff barriers (quotas) to tariff barriers that currently hover between 100 to 150 per cent. The average level of tariff also continues to fall.

INCENTIVES FOR INVESTING IN INDIA

When considering investing in India a business has to first decide which of the numerous resources and markets they wish to have access to and to take advantage of. Incentives and advantages are based upon the perceived benefits to the country as determined by the GOI.

With a middle-class of between 300 and 350 million people and a high income base approaching 44 million households. the direct Indian market is staggering in its potential. The Indian Marketplace is traditionally and historically the most common motive for investment. Include the accessibility of natural resources needed for manufacturing, the availability of reliable networks of transportation, the cost attractiveness. the high levels and supply of well-educated intellectual manpower, engineering expertise and an increasingly impressive economic liberalization, India is an extremely attractive destination.

Joining with, or creating Indian partners. in many cases increases the effectiveness and the incentives available to foreign companies. allowing them to tap the indigenous expertise and resources of the partners. A CII survey of foreign companies doing business in India to chart out the success of their operations echoed the following opinions:

- *It was profitable doing business in India*
- *The investment policies were among the best in the world and conducive to attracting FD/*
- *The demand for their products was very good and they were increasing their production and production capacity*
- *Their companies would like to be the ambassadors of future FOi in India.*

Therefore for most manufacturing organizations the main advantage of entering the Indian market is the market itself. The governmental incentives are both well known and minimal.

Instead. I would like to explore and discuss the areas and systems the GOI has identified as opportunistic for growth through foreign investment and is seeking to encourage. The approach India is seeking to broadcast is that foreign investors can take advantage of both the physical resources and the intellectual resources.

Exporting and development are recognized as the two approaches with the greatest potential for foreign investment growth, without affecting or interfering with the domestic markets. In India, Exports are given top priority through many schemes. While. in fact, the practice of encouraging exports through incentives is followed by almost all nations. India is actively committed to pursuing and improving upon this approach. Exports are mainly supported and supervised by 'Commerce Ministry' of Government of India. Export Promotion Councils have been formed for various product categories.

Exporting takes advantage of the benefits of operating in India with its low costs, abundant resources, excellent infrastructure capabilities, and readily available workforce.

The second method India is actively using to encourage foreign investment is to draw upon the products of its exceptional education system. The quality and intelligence of its engineering, research and technical graduates and professionals provide an excellent base for setting up research and development facilities at a fraction of what the cost would be in the West. Software and hardware development are ideally suited for the Indian business environment.

Broadly, the export incentives for manufacturers are:

(a) Indigenous inputs without payment of excise duty.

(b) No excise charged on final product.

(c) Imported inputs without payment of customs duty.

(d) No export duty on export of final product.

(e) Bank finance on priority basis and at concessional rate of interest.

(!) Exemption from Income tax.

(g) Exemption from sales tax on final product (refund of CST paid on inputs in certain cases).

Foreign companies wishing to take advantage of the opportunities of setting up operations in India are able to choose from a variety of options, depending on the goals and approaches the organization decides upon. The range of plans gives them the choice of deciding whether they wish to use India strictly as a manufacturing base or to also enter the marketplace.

The alternatives include:

EPZ (Export Processing Zones)

EOU (Export Oriented Unit)

SEZ (Special Economic Zone)

STP (Software Technology Park)

EHTP (Electronics Hardware Technology Parks)

EPZ Export Processing Zones

There were eight EPZ's or free trade zones located in different parts of the country. These zones are designed to provide internationally competitive infrastructure facilities and duty-free and low cost environment. Various monetary and non-monetary incentives are granted which include import duty exemption, complete tax holiday, decentralized "single window clearance," etc.

Twenty-five percent of goods manufactured in EPZ's are permitted to be sold in the domestic market. No excise duty is payable on such items and customs duties on imported components is 50% of normal rates. Major exporters are allowed to operate bank accounts abroad to facilitate trade. Companies that sell *in* the domestic market as well as international markets may deduct export earnings from their tax liabilities.

Exporters and other foreign exchange earners have been permitted to retain 25% of their foreign exchange earnings in foreign currency. For l 00% Export Oriented Units and units in Export Processing Zones, Electronic Hardware Technology Parks, retention up to 50% is allowed.

Other incentives include:

- Duty-free imports of raw materials and components.
- Tax holiday for a period of 5 continuous years in the first 8 years from the year of commencement of production.
- Exemption from taxes on export earnings even after the period of tax holiday.
- Exemption from central and state taxes on production and sale.
- Permission to install machinery on lease.
- Freedom to borrow self-liquidating foreign currency loans at the prime rate of interest.
- Inter-unit transfers of finished goods among exporting units.
- Decentralized single-window clearance of proposals concerning units in Export Processing Zones.

EOU/EPZ units may export through Export Houses. Trading Houses and Star Trading houses.

While the EPZ's have been under the control of Government Of India, the new attitude has been to involve the public. private, joint sector and State Governments in converting EPZ's into SEZ's.

EOU (EXPORT ORIENTED UNIT)

The Export Processing Zones (EPZs) were intended to provide all internationally competitive duty-free environment for export production in a specifically predetermined location. This concept was extended and expanded to allow for the location of export production units outside the designated export zones. With approval an EOU can be planned any where in India. Even within the factory of the manufacturer, a separate unit for EOU can be set up, thus saving considerably in administrative costs. Eve the use of common utilities in this situation is possible. If export orders dry up, conversion of EOU to OTA unit by exit (de-bonding) is comparatively easy.

Export Oriented Units have evolved into major players in the country's export effort. Their share of the manufactured exports of India has grown from 5% to over I I% between I 991 and 200 I.

The advantages the EDU concept offers* to *businesses include:

- The opportunity to export and still have the opportunity of accessing the Indian market.
- Facilities to obtain both imported and local machinery, equipment. raw materials and other inputs duty free.
- Minimum procedures and documentation to allow a unit to ride "the fast track for export production."
- Insulation from. for the most part. all fiscal levies otherwise applicable to a normal production unit.

SEZ (SPECIAL ECONOMIC ZONE}

A policy was introduced on 1.4.2000 for setting up of Special Economic Zones in the country with a view to provide an internationally competitive and hassle free environment for exports. Units may be set up in SEZ for manufacture of goods and rendering of services. All the import/export operations of the SEZ units will be on self-certification basis. The units in the Zone have to be a net foreign exchange earner but they shall not be subjected to any pre-determined value addition or minimum export performance requirements. Sales in the Domestic Tariff Area by SEZ units shall be subject to payment of full Custom Duty and import policy in force.

Further Offshore banking units may be set up in the SEZs

The policy provides for setting up of SEZ's in the public, private. joint sector or by State Governments. It was also envisaged that some of the existing Export Processing Zones would be converted into Special Economic Zones. Accordingly. the Government has converted Export Processing Zones located at Kandla and Surat (Gujarat). Cochin (Kerala), Santa Cruz (Mumbai-Maharashtra). Falta (West Bengal). Madras (Tamil Nadu), Visakhapatnam (Andhra Pradesh) and Naida (Uttar Pradesh) into a Special Economic Zones.

In addition. approval has been given for setting up of 27 Special Economic Zones in various parts of the country in the private/JT sectors or by the State Government.

Generally, the infrastructure available at SEZ unit is much better than infrastructure available to EOU unit. Customs clearance for exports is obtained within the zone itself. which is convenient.

FOi up to I 00% is allowed through the automatic route for all manufacturing activities in Special Economic Zones (SEZs). except for the following activities:

» Arms and ammunition, explosives and allied items of defense equipment, defense aircraft and warships;

» Atomic substances;

» Narcotics and psychotropic substances and hazardous chemicals;

» Distillation and brewing of alcoholic drinks; and

» Cigarettes/cigars and manufactured tobacco substitutes

[Sectoral norm as notified by Government shall apply to foreign investment in services.]

HIGHLIGHTS AND COMPARISONS OF EOU/SEZ SCHEMES

The highlights of EDU (Export Oriented Unit) and SEZ (Special Economic Zone) are as follows-

- SEZ unit has to be located within the specified zones developed. while EOU unit can be set up at any of over 300 places all over India. [Similarly, STP/EHTP unit can be situated within the zone specifically developed or at any place where EOU can be set up]
- The unit can import capital goods. raw materials, consumables. packing material, spares etc. without payment of customs duty. Similarly, these can be procured indigenously without payment of excise duty. Second hand capital goods can also be imported.
- They have to achieve positive NFE (Net Foreign Exchange Earnings).
- Minimum investment in plant and machinery and building is Rs I 00 lakhs for EOU. This should be before commencement of commercial production. There is no limit for SEZ.

- A bond in prescribed form has to be executed. [B-17 in case of EOU and form prescribed in Special Economic Zone Rules. 2003 in case of SEZ]. There is no physical supervision of customs / excise authorities over production and clearances, but prescribed records are required to be maintained.
- Fast Track Clearance Scheme (FTCS) for clearances of imported consignments for EOU. In case of SEZ units. customs clearance for export and import is obtained within the zone itself.
- Generally, all final production should be exported, except rejects up to prescribed limit.
- Sales within India should be on payment of excise duty. The duty which will be equal to normal customs duty which would be payable on such goods, if imported. However. in certain cases. excise duty payable will be only 50% of normal customs duty payable on such goods if imported into India.
- Sub-contracting of production outside on job work basis is permissible after obtaining necessary permission on anriual basis
- job work for exports is permitted
- Samples can be sold / given free within prescribed limit
- Unutilized raw material can be disposed of on payment of applicable duties
- The unit can exit (de-bond) with permission of Development Commissioner, on payment of applicable duties.
- Central Sales Tax (CST) paid on purchases is refundable (but not local tax). [In case of SEZ unit, supplier does not have to pay CST].
- Prescribed percentage of foreign exchange earnings can be retained in EEFC account in foreign exchange.
- 100% foreign equity is permissible, except in a few cases.
- Supplies made to EOU by Indian supplier are 'deemed exports' and supplier is entitled to benefits of 'deemed export'. Supplies to SEZ are 'exports' and all export benefits are available.
- Restrictions under Companies Act on managerial remuneration are not applicable.
- No restrictions on External Commercial Borrowings.

STP/EHTP UNIT -

The concept of STP/EHTP is similar to EOU/SEZ. The scheme is administered by Ministry of Information Technology. The STP/EHTP unit can be at a place specifically developed for the purpose or it can be located at any place where EOU can be set up. Thus, a STP/EHTP unit can be set up as an EOU unit anywhere in India or as a SEZ unit at specified developed locations in India.

STP (SOFTWARE TECHNOLOGY PARK)

The Software Technology Park (STP) Scheme (under The Ministry of Information Technology, Govt. of India) is a 100% Export Oriented Scheme for undertaking Software Development/IT enabled services for Export using Data Communication links or in the form of physical exports including export of professional services for rendering consultancy services and development of software.

A Software Technology Park (STP) may be set up by the Central Government, State Government. Public or Private Sector undertakings or any combination thereof. An STP may be an individual unit by itself or it may be one of such units located in an area designated as STP Complex by the Ministry of Information Technology.

The features:

- Single Window clearance and approval.
- Income Tax holiday as per Sec. 10A of the IT Act.
- Customs Duty Exemption in full on imports.
- Central Excise Duty Exemption in full on indigenous procurement.
- Central Sales Tax Reimbursement on indigenous purchase.
- All relevant equipment / goods including second hand equipment can be imported (except prohibited items).
- Equipment can also be imported on loan basis / lease.
- High Speed Data Communication Link provided for the export of software.
- No separate Import/Export license required.
- Green Card enabling priority treatment for Government clearances/other services.
- 100% foreign equity investment in the companies permissible.
- Sales in the OTA up to 50% of the FOB value of exports permissible.

- Use of computer imported for training permissible subject to certain conditions.
- Depreciation on computers at accelerated rates up to 100% over 5 years is permissible.
- Computers can be donated after two years of use to recognized non-commercial Educational Institutions/ Hospitals without payment of duty.

EHTP (Electronics Hardware Technology Parks)

The Electronics Hardware Technology Park (EHTP) scheme is a 100% Export Oriented scheme for undertaking manufacture of electronic hardware equipment/components and other items.

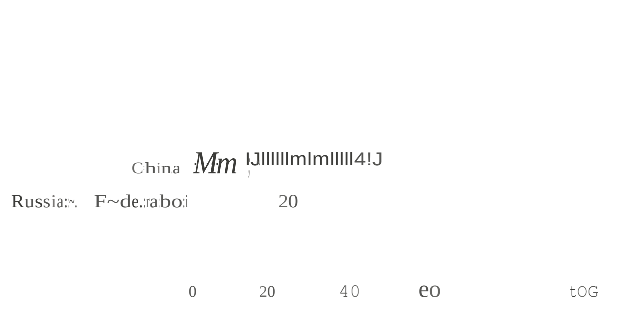
Administrative authority: The Scheme is administered by Department of Electronics. Government of India, New Delhi. The concerned Directors of the STP in the area are nominated as the Designated Officer to implement the scheme and arrange the accords necessary for approvals required under the scheme.

DISADVANTAGES / CHALLENGES FOR INVESTING IN INDIA

Stringent labor laws

Large firms in India are not allowed to retrench or layoff any workers, or close down the unit without the permission of the state government. While the law was enacted with a view to monitor unfair retrenchment and layoff, in effect it has turned out to be a provision for job security in privately owned large firms. This is very much in line with the job security provided to public sector employees. Most importantly, the continuing barrier to the dismissal of unwanted workers in Indian establishments with 100 or more employees paralyzes firms in hiring new workers. With regard to labor regulations and hiring and firing practices, India is ranked 55th and 56th respectively in the GCR 1999. Labor-intensive manufacturing exports require competitive and flexible enterprises that can vary their employment according to changes in market demand and changes in technology. so .India remains an unattractive base for such production in part because of the continuing obstacles to flexible management of the labor force. The World Bank-CII Surveys found that the typical Indian firm reported excess labor of 17% in 2000 and that the labor laws and regulations were the main reason why it could not adjust to the preferred level. These numbers improved sharply to 11% in 2003, reflecting improvements in labor market flexibility in some states. Going forward. key priorities for the central government include the repeal of legislation blocking layoffs in registered firms, and legislation to ease constraints on the hiring of contract labor. But state governments, too, can facilitate labor rationalization, even within the current legal framework.

Figure 2.H. Hiring and Firing Difficulty Indices; (Country 2004)



High corporate tax rates

Corporate tax rates in East Asia are generally in the range of 15 to 30 percent, compared with a rate of 48 percent for foreign companies in India. High corporate tax rate is definitely a major disincentive to foreign corporate investment in India. With respect to tax evasion. India is ranked 48th in the GCR 1999.

Power Distribution

According to the recent Investment Climate Survey for India, access to reliable ***power*** at reasonable cost is the single most significant constraint facing Indian businesses. Nationwide. the shortfall in 2002/03 was estimated at 11.4% for peak demand.

On an average, manufacturers in India face almost 17 significant power outages per month, versus **in Malaysia and less than 5 in China**

Approximately 9% of the total value of output of firms is lost due to power breakdowns compared to 2.6% in Malaysia and 2.0% in China.

The frequency and average duration of outages is so great that generators are used as routinely as any standard industrial equipment in India. Some -61 % of Indian manufacturing firms own generator sets. versus 20% in Malaysia, 27% in China and 17 % in Brazil.

India's blended real cost of power is 74% higher than Malaysia's and 39% higher than China's.

It must be noted that power sector bottlenecks appear to have eased somewhat over the past three years. *For instance, the percentage of Indian firms owning generators declined from over 70% in 2000 to 61% in 2003. This reflects progress with sector reforms.* The enactment of the Electricity Act in 2003 is definitely a step in the right direction. But much more needs to be done to make the enabling legal arid structural environment work.

The Ever Pervasive 'Inspector Raj'

While the License Raj has been substantially reduced at the center, it survives at the level of states, along with a ***pervasive 'Inspector Raj'*** that imposes significant costs on businesses. According to the World Bank's Doing Business Indicators, the median time to start a new business in India is 89 days, compared to 2 days in Australia. 5 days in the US. 18 days in the UK. 36 days in the Russian Federation and 41 days in China. In India, 14.2% of senior management time is spent in dealing with state government officials for various regulatory issues (versus 8.1 % in China or 7.8% in Brazil). Indian manufacturers face. on average, 7.4 visits a year from government officials. Although this has decreased from 11.7 visits in 2000, the fact is that it still compares poorly with a country like Malaysia, where the average number of visits is just 2.8 per year. A key challenge for India is to streamline business entry and operation procedures, so as to reduce delays and opportunities for rent seeking. This may require re-engineering the entire gamut of business regulatory processes. at both the state and local levels, on the basis of clear principles of transparency, absence of discretion, and accountability.

Median Time to Start A Business

Source: World Bank IC Surveys

Accessibility of Finance

Problems in accessing financing are often cited as another major impediment to the performance of small and medium sized businesses in India. Only 54 % of small businesses in India have active bank credit lines against Brazil's 75 %. Addressing this problem requires improvement in the efficiency of SME credit markets through reforms in the legal framework for loan recovery and bankruptcy and improved credit information. At the same time, banks and other financial institutions need to focus on building the necessary capacity for better credit appraisal and risk management.

***Industrial and Trade* Policy**

Industrial policy continues to present obstacles to doing business in India. Some of the key industrial policy reforms required include: eliminating preferences, product reservations and investment ceilings for small-scale producers, all of which have the unintended consequence of preventing smaller firms from growing, reaping economies of scale, and competing on world markets, easing constraints on FDI, and revamping bankruptcy legislation. Trade policy reforms also need to be accelerated. In particular, the government needs to move aggressively to reduce import tariffs to a single rate (say, 10%) over the next three to four years and phase out remaining tariff exemptions, specific tariffs and anti-dumping duties.

VAT

One of the biggest barriers to competitiveness is the lack of a unified *VAT regime* across states. VAT (Value Added Tax) is a general consumption tax assessed on the value added to goods and services. It is a *general tax* that applies, in principle, to all commercial activities involving the production and distribution of goods and the provision of services. It is *charged as a percentage of price,* which means that the actual tax burden is visible at each stage in the production and distribution chain. Value Added Tax (VAT) is unanimously acknowledged to be a major reform in the indirect taxation system for the following reasons:

- It eliminates the cascading effect of taxes;
- It promotes competitiveness of exports;
- It has a simple and transparent structure; and
- It improves compliance.

Presently there are more than 120 countries in which VAT is in force. Only the USA and India are amongst the more populous countries that do not have a VAT. There was a high likelihood of VAT being introduced in at least the major states in April 2004. This remains an urgent priority for state governments.

Interstate Differences

The World Bank-Cll Surveys indicate significant inter-state variations in the investment climate. and also on how investors perceive the investment climate across states. In the 2003 Survey, as in the previous one. respondents were asked to rate all states other than their own for their general investment climate. The outcome was a rating pattern where the six states that attracted almost all the FDI were rated to have a better investment climate by the majority of respondents. These 'better climate' states are Maharashtra. Delhi. Gujarat. Andhra Pradesh, Karnataka, Punjab, Tamil Nadu and Haryana. The first three states are also the only ones to have registered growth in per capita incomes greater than 6.5 %. Although these rankings are broadly consistent with the earlier rankings in 2000, there are some important changes. While there has been a decline in the scores of Gujarat and Tamil Nadu, Delhi has moved up the rankings. Differences in the quality, availability and cost of infrastructure are critical in explaining the differences in investor perception of the investment climate across states. Our analysis indicates that the main reason why the 'better climate' states have been rated thus, and more important, why these states attract almost all FDI to India. is to be found in their better physical infrastructure-and particularly, power supply.

THE FUTURE

Many foreign investors find that, frequently. they have little or no control over external events which can adversely affect the commercial viability of their investments and future business plans in India. These developments include:

- slow-down in government decisions due to political instability
- adverse changes or unpredictability on foreign investment, import. ownership, pricing or tax issues
- cultural problems. delays or legal disputes due to local partners and suppliers
- labour unrest and industrial action
- disruption of normal business due to social and political unrest
- corruption and bureaucratic inefficiency
- unexpected delays and cost-overruns due to overlapping governmental jurisdiction
- fluctuation in interest. inflation and currency rates

India has recognized these problems and has been taking a proactive approach to entourage increased development and investment in the export manufacturing and service areas. There is still room for improvement, but for the time being, in these fields. India is underrated and undervalued. Couple this with its almost unlimited potential for production as well as being a market unto itself and it is apparent that now is the beginning stage of the economic boom. As both India and the world recognize this, the advantages and incentives will not need to be as attractive as they currently are. The opportunities are here and the time is now.

THANKS

I would like to thank the three students who helped me in the preparation of this paper. Without their diligence and commitment this project could not have been completed. I am sure that these MBA Seniors are going to be successful in whatever they will encounter in the future and wish to share the credit for this project with them. Thank you: Mahesh Ramaranjan. Roji Chakco and Swaroop Abraham.

REFERENCES

K.S. Chalapati Rao. M.R. Murthy and K. VK. Ranganathan. "Foreign Direct Investment in the Post Liberalisation period: An Overview".

VN. Balasubramanyam and Vidya Mahambare. "Foreign Direct Investment in India". Lancaster University Management School Working Paper

PL Beena. Laveesh Bhandari. Suman BhaumikSubir Gokarn and Anjali Tandon. "Investment Strategies in Emerging Markets"

Bajpai. Nirupam. Tianlun jian, and Jeffrey D. Sachs. "Economic Reforms in China andlndia: Selected Issues in Industrial Policy", *Development Discussion Paper No580, April 1997, Harvard Institute for International Development. Harvard University.*

Ministry of External Affairs. Government of India. "India 2003-2004 Reliable Business Partner Attractive FOi Destination"

Rashmi Banga. "Impact Of Government Policies And Investment Agreements On FOi Inflows", *Indian Council for Research on International Economic Relations.*