



**Confederation of Indian Industry**



*Indian agricultural workers in Australia*



*Indian immigrants demanding rights in UK*

## ***Attracting FDI from the Indian Diaspora: The Way Forward\****

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## **Introduction**

The role of the diaspora in the development of their states of origin has been well documented<sup>1</sup>. Diaspora contribution to their state of origin has been made in various ways, through remittances, foreign direct investment (FDI), transfer of knowledge and entrepreneurial networks. India has the world's second largest diaspora next to China with a substantive presence in all the six continents. The contribution of the Indian diaspora to India's economy and society is a matter of great pride and achievement for Indian's the world over. Non-Resident Indians (NRI) and People of Indian Origin (PIO) have transferred knowledge and expertise, added to India's income through remittances and recently have mediated the massive entrepreneurial energy that has led to the rise of India's Information Technology (IT) and IT Enabled Services (ITES) sectors. However, the Indian diaspora has not come forward as investors in the Indian economy in the scale that was expected post-liberalization in the early 1990's. Diasporic FDI, especially in comparison with China, has been very modest in India. This paper investigates some of the major themes as to why diasporic FDI has been so modest and provides some important policy recommendations that will allow for greater FDI from the Indian diaspora. Such analysis and policy recommendations are especially important in the light of the recent Government of India (GOI) and Confederation of Indian Industry (CII) institutional partnership that has led to the formation of the Overseas Indian Facilitation Centre (OIFC) to further the investment and entrepreneurial ties between the Indian diaspora and their country of origin. Section I provides the comparative numbers on Indian and Chinese FDI and explores the dynamics of FDI flows into these economies with special focus on China's unique success in attracting large amounts of diasporic FDI. Section II takes up the discussion on the policy issues that would address India's relative lack of success in attracting FDI.

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<sup>1</sup> Ratha (2005), Global Economic Prospects 2005, World Bank

## **I. Dynamics of FDI in India and China: Role of Diaspora's and MNC's**

A lot has been made of India's relative lack of success compared to China in attracting FDI, and specifically diasporic FDI. Table 1 presents the data for FDI inflows and the percent of gross capital formation accounted for by FDI.

**Table 1: Indian and Chinese FDI**

YEAR	India		China	
	FDI	FDI as % Gross	FDI	FDI as % Gross
	million USD	Capital Formation	million USD	Capital Formation
1982	72	0.2	430	0.6
1983	6	0.0	636	0.8
1984	19	0.0	1258	1.4
1985	106	0.2	1659	1.4
1986	118	0.2	1875	1.7
1987	212	0.2	2314	2.4
1988	91	0.4	3194	2.8
1989	252	0.2	3593	2.8
1990	162	0.1	3488	2.8
1991	74	0.5	4366	3.3
1992	277	1.0	11156	7.4
1993	550	1.3	27575	14.7
1994	973	2.3	33787	15.1
1995	2144	2.8	35849	12.5
1996	2426	2.0	40180	12.4
1997	3857	2.0	44237	12.9
1998	2635	2.6	43753	12.3
1999	2169	2.0	38753	10.9
2000	2315	2.1	38399	9.9
2001	3400	2.5	44240	10.4
2002	3900	2.9	46880	9.9
2003	2470	3.2	52740	10.1

**Source: Global Development Finance Indicators, World Bank**

Table 1 clearly shows that India lagged far behind China in terms of attracting inward FDI through much of the 1980's, with FDI accounting for less than 1% of Gross Capital Formation (GCF) in India. The 1980's saw China undertake rapid reforms and adopt an export-oriented economic expansion policy based on low cost labor. As India underwent economic liberalization, making the economy more outward oriented, inward FDI into India increased rapidly. However, FDI never played as substantial a role in India's capital formation process as it did in China. In 2003, FDI accounted for 10.1% of China's GCF, while it accounted for only 3.2% of India's GCF.

In terms of diasporic FDI, through much of the 1980's and 1990's, about 50 to 60 per cent of FDI came from ethnic Chinese dominated economies of Taiwan, Hong Kong and Singapore<sup>2</sup>. In India, the share of diasporic FDI in total FDI between 1991-2003 stands at around 4.18%<sup>3</sup>. However, the explanation for this relative lack of success in attracting FDI should not be attributed to simplistic explanations such as lack of government initiative alone, there are structural and economic factors that lie behind China's success that India does not possess. Diaspora investment in China, as extensive as it was, was basically limited to low wage manufacturing operations. It was unusually diversified and small scale. Chinese expatriates invested in a wide variety of manufacturing sectors at very small scale, averaging US\$2.4 million<sup>4</sup>. According to Naughton<sup>5</sup>, the diaspora investing in China were not the broad 50 million with *guanxi* (local influence and connections) but overwhelmingly the 6 million nearby Hong Kong Chinese. This doorstep diaspora had unique motivations to invest in China. Labor costs made manufacturing in Hong Kong increasingly uncompetitive. Between 1985 and 1995 Hong Kong manufacturing employment decreased by two thirds or 700,000 jobs. The need to move manufacturing to lower wage countries occurred just as China was opening up. It was China's focus on creating a low cost manufacturing base for exports with the related infrastructure development and facilitation in southern China that coincided perfectly with the need for Chinese entrepreneurs in China's periphery, i.e. in Taiwan and Hong Kong to seek labor cost arbitrage.

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<sup>2</sup> Authors calculation based on International Monetary Fund Statistics

<sup>3</sup> Economic Editor's Conference, November 17-18, 2004, Ministry of Finance, quoted in [indiastats.com](http://indiastats.com)

<sup>4</sup> Huang (2002), FDI in China, Harvard Business School Note, President and Fellows of Harvard College

<sup>5</sup> Naughton (1999), *Between China and the World* in Hamilton (ed) *Cosmopolitan Capitalists*, University of Washington Press

In India's case, none of the two conditions that attracted diasporic FDI holds, i.e. India's competitiveness as a low cost manufacturing base that caters to small production facilities (with average investments of 2-3 million USD) preferred by small scale non MNC entrepreneurs is significantly weaker than most economies in SE Asia including Bangladesh. Second, unlike the Chinese diaspora, the Indian diaspora has far fewer entrepreneurs in small-scale manufacturing. The professional expertise of a diaspora is very important factor in explaining the kind of economic linkages that it would share with the country of origin. As Guha and Ray<sup>6</sup> point out, a significant reason that explains India's failure to tap diasporic investments may be attributed to the fact that most Indian expatriates are either professionals or traders (i.e. retailers, wholesalers or other type of service providers) and lack the learning process in managing export oriented labor intensive manufacturing. Even if cost arbitrage was possible by investing in the Indian economy, it is often not feasible for say Indian entrepreneurs managing pharmacy shops in UK to invest in manufacturing in India given their lack of expertise in running such an enterprise.

Another constraint faced by Indian investors is the policy of reservation of several products for small and medium enterprise. This effectively means that larger entrepreneurs cannot produce these products. Worse still, such reserved production lines cannot be expanded and/or upgraded by existing small-scale entrepreneurs through additional investment in plant and machinery. Given the definition is what is small-scale<sup>7</sup>, only those plants and production units that fit that definition are allowed to produce these items.

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<sup>6</sup> Guha and Ray (2000), Multinational versus Expatriate FDI: A Comparative Analysis of Chinese and Indian Experiences, ICRIER Working Paper

<sup>7</sup> According to Micro, Small and Medium Enterprises Development Act of 2006, small and medium enterprises are those that meet the following criteria:

The strength of the Chinese diaspora in managing transnational export businesses based on low cost, small scale manufacturing is further strengthened through a very strong network of ethnic Chinese businesses across the world. This network helps the diasporic entrepreneurial community to reduce the transaction cost of managing trade across borders even without the kind of capital and marketing networks of their larger MNC competitors. As Kao points out, 39% of business relations of Chinese firms in SE Asia were with other Chinese firms<sup>8</sup>. The Indian diaspora lacks such business networks, which is not surprising, given that a very large proportion of Indian diaspora are not directly engaged in manufacturing, but are either professionals or engaged in services oriented businesses. However, the Indian diaspora has been successful in certain niche export-oriented global trading networks, a good example being the diamond cutting and retailing network managed by Indian entrepreneurs based in South Africa, Surat (in Gujarat), Amsterdam and New York. An interesting point that needs to be made here is that

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(i) a micro enterprise, where the investment in plant and machinery does not exceed twenty-five lakh rupees;

(ii) a small enterprise, where the investment in plant and machinery is more than twenty-five lakh rupees but does not exceed five crore rupees; or

(iii) a medium enterprise, where the investment in plant and machinery is more than five crore rupees but does not exceed ten crore rupees;

(b) in the case of the enterprises engaged in providing or rendering of services, as?

(i) a micro enterprise, where the investment in equipment does not exceed ten lakh rupees;

(ii) a small enterprise, where the investment in equipment is more than ten lakh rupees but does not exceed two crore rupees; or

(iii) a medium enterprise, where the investment in equipment is more than two crore rupees but does not exceed five crore rupees.

<sup>8</sup> Kao (1993), The Worldwide Web of Chinese Business, Harvard Business Review, March-April

the development of Surat as a global centre of diamond cutting industry and the emergence of a competitive diamond trading community of Indians across the world did not require SEZs or special government policies. It happened because the right conditions, i.e. skilled entrepreneurs, feasible low cost and small scale manufacturing base (Surat) and existence of transnational business connections strengthened by diasporic links developed over the years.

The importance of being a low cost manufacturing base and having extensive international trade ties is very significant. According to Wei<sup>9</sup>, China's emergence as a low cost manufacturing base and sustained export growth through much of the 1980's and 1990's is an important reason behind its relative success in attracting FDI, not just of the diasporic variety, but in general. Investors, whether diasporic or MNC's from OECD economies will invest in an economy if they see plausible long-term gains. Such gains will arise out of either domestic opportunities in that economy or its ability to be a competitive base for third country exports. India has lagged far behind China in terms of Trade Facilitation and export sector promotion in manufacturing and agriculture, and it is only in recent times that FDI geared towards third country markets has been coming into India. A good example is the automotive parts industry where India has recently emerged as a very competitive player and FDI into this sector has taken off. Given India's large domestic market opportunities, FDI in several other sectors is bound to take off in the coming years. The important point is that policies and investment facilitation are

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<sup>9</sup> Wei (2005), China and India: Any Differences in Their FDI Performance, *Journal of Asian Economies*, Vol. 16, pg. 719-736

part of larger set of factors that influence FDI, they cannot substitute hard economic considerations. Unless India reduces the transaction costs in manufacturing and agriculture, undertakes radical reforms in trade facilitation and export promotion to become an international production hub, and addresses key infrastructure issues such as energy and transportation costs, FDI, whether diasporic or MNC variety, will not reach India. A detailed discussion on the reduction of transaction costs follows in the policy recommendations made in section III.

A good example that supports this argument of FDI dynamics influenced by global market opportunities coupled with diasporic expertise and networks is the IT and ITES sector in India. India's professional IT and management oriented diaspora realized the cost arbitration offered by offshoring IT and ITES work to India. Given the diasporic expertise in this sector and the strong linkages amongst the diasporic community in the Silicon Valley, it did not take long before several start-ups took place in Bangalore and Hyderabad followed by rest of India. As Table 2 below shows, this dynamic of a combination of global market forces and diaspora expertise is clearly reflected in the regional spread of diaspora FDI. The major recipients of diaspora FDI were IT and ITES hubs that tapped on to this winning combination. National Capital Region or NCR (Delhi and Haryana and UP<sup>10</sup>) accounts for 16.11% of diasporic FDI between 1998-2001, Andhra Pradesh accounts for 17.6%, Karnataka for 6% and Maharashtra for around 37%. On the other hand regional centers specializing in small scale manufacturing such as Punjab (0.28%) and Gujarat (2.44%) command modest proportions of inward FDI.

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<sup>10</sup> Noida accounted for a disproportionate share of UP's FDI and such FDI can be safely assumed to be of the IT and ITeS variety).

**Table 2. State wise Distribution of NRI Investment Proposals**

<b>Statewise NRI Investment Proposals Approved (Jan. 1998 to Sept. 2001)</b>		
<b>States/UTs</b>	<b>Amount of FDI Approved (Rs. in Crore)</b>	<b>% to Total</b>
Andhra Pradesh	555.84	17.59
Gujarat	77.04	2.44
Haryana	138.53	4.38
Himachal Pradesh	0.79	0.02
Karnataka	188.78	5.97
Kerala	107.4	3.4
Madhya Pradesh	3.04	0.1
Maharashtra	1169.35	37
Orissa	8.87	0.28
Punjab	8.79	0.28
Rajasthan	60.99	1.93
Tamil Nadu	230.73	7.3
Uttar Pradesh	66.64	2.11
West Bengal	91.47	2.89
Jharkhand	0.2	0.01
Chandigarh	2.98	0.09
Dadra & Nagar Haveli	0.86	0.03
Delhi	326.07	10.32
Pondicherry	13.26	0.42
Daman & Diu	0.25	0.01
State Not Indicated	108.14	3.42
India	3160.02	

**Source: Indiastats Database**

An important point that needs to be made here is that the diaspora had a role as an entrepreneur as well as arbitrators of MNC investment into India in this sector where Indian manager-professionals engaged with MNC's took the lead in bringing significant investment into India. Just like the Chinese diaspora's global networks helped small entrepreneurs to tap the global market successfully, the Indian diasporic network in IT and ITES helped small Indian start-ups (with seed capital of less 3-4 million USD) succeed globally<sup>11</sup>. The transaction costs of exporting services were relatively low in India compared to manufacturing, it did not have to depend on India's poor quality of roads, logistics shipping infrastructure. Proactive policies in the IT sector initiated in the mid 1980's also helped. Thus, given the right conditions, the Indian diaspora will be second to none in seeking economic opportunities in their countries of origin and contribute to its economic growth.

The consistent story in this section has been that right economic conditions are critical for attracting FDI, but this does not mean policies and investment facilitation do not help. Investor friendly policies and facilitation centres that reduce the transaction costs of planning and engaging with regulatory compliance are also critical<sup>12</sup>. However, sometimes policies that are over-friendly to FDI while transaction costs (including tax and other regulatory issues) of investment remain high for domestic players can be counter-productive. Such asymmetric treatment of domestic and foreign investment can lead to 'round-tripping', i.e. where domestic investors route their investment through a foreign country to avail the policy benefits of FDI. Both India and China have seen significant round-tripping

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<sup>11</sup> Saxenian (2000), Back to India, Wall Street Journal (Supplement: Technology Journal Asia) January 24,

<sup>12</sup> Wei (2005), China and India: Any Differences in Their FDI Performance, *Journal of Asian Economies*, Vol. 16, pg. 719-736

activity. According to Sicular<sup>13</sup>, about 35% of Chinese FDI through much of the 1990's was of the 'round-tripping' variety. UNCTAD<sup>14</sup> estimates round-tripping to account for about 20-30% of total FDI in China. A very large proportion of what appears to be diasporic 'FDI' is just Chinese domestic capital seeking alternative modes of investment given the policy dichotomy in China. In 2000 Mauritius accounted for 62.3% of India's FDI flows<sup>15</sup>. Mauritius share in FDI flows to India remains high and it can be safely argued that a significant portion of FDI originating out of Mauritius is of the 'round-tripping' variety.

Prolonged evidence of round-tripping is a clear indication that all is not well with in the FDI policy sphere. As Kapoor points out, Indian government should not give any investment incentives to its diaspora greater than what it is willing to give other foreigners and, in turn, both should be close to what the government offers its own residents. It would be a travesty of justice towards the Indian domestic entrepreneur if an incentive structure is created whereby the primary mechanism to gain recognition in India is by leaving the country<sup>16</sup>. The global ambition and success that the Indian domestic entrepreneur has shown in the last 5-6 years should be a matter of great satisfaction to all Indians. The greatest testimony to the productivity and efficiency of Indian domestic enterprise has been the inflows of foreign funds into India's domestic equity markets. The confidence shown by global investors in Indian firms and entrepreneurs has been phenomenal; Figure 1 provides a comparison of three leading emerging economies in terms of net foreign inflows in equity markets.

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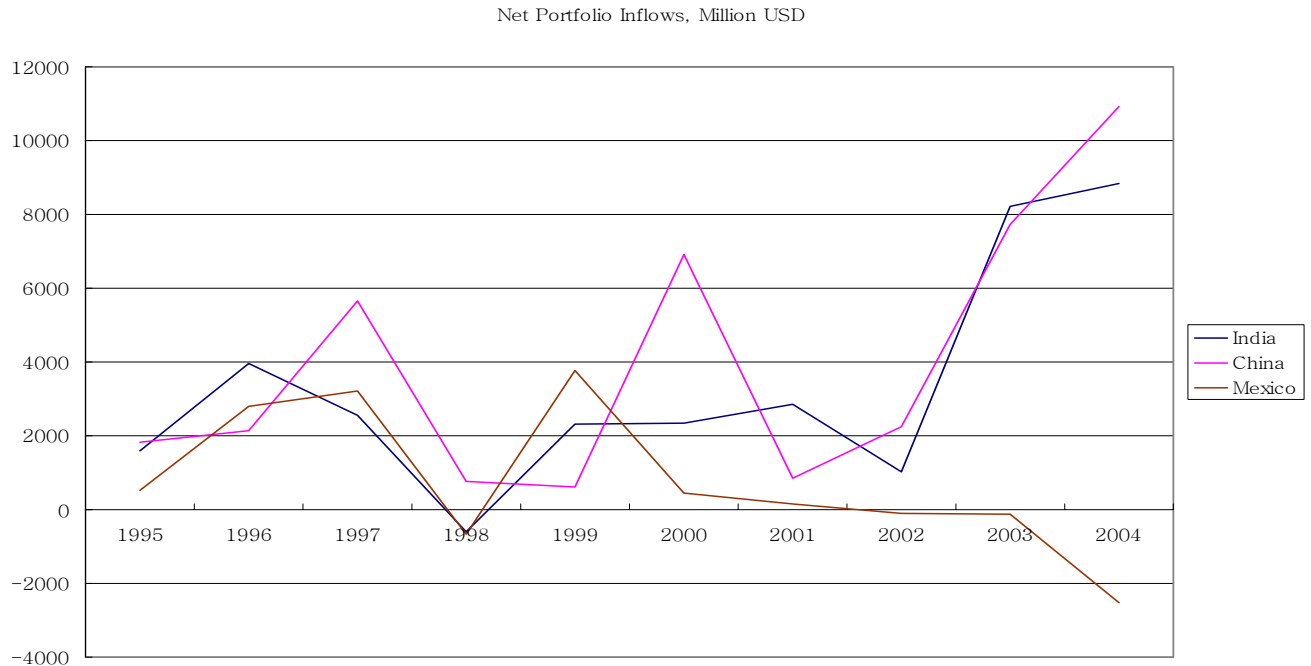
<sup>13</sup> Sicular, T. (1998). Capital flight and foreign investment: Two tales from China and Russia. *World Economy*, 21(5), 589–602.

<sup>14</sup> UNCTAD (2003). *World investment report 2003: FDI policies for development: National and international perspectives*

<sup>15</sup> Reserve Bank of India

<sup>16</sup> Kapoor (2003), *The Indian Diaspora as a Strategic Asset*, *Economic and Political Weekly*, Vol. 38, No. 5, (February 1-7)

**Figure 1. Foreign Inflows into Domestic Equity Markets**



**Source: Global Development Finance Indicators, World Bank**

Figure 1 clearly shows that India has performed on par with China, and much better than Mexico, and economy that is closely integrated with the US, in terms of attracting short-term foreign investment into its equity markets. While part of the story, especially in relation to China can be explained by the fact that India's legal and financial institutions with reference to equity markets is far stronger than China, it is definitely is not the whole story. The sheer volumes of foreign investment in India's equity markets reflect a genuine vote of confidence in India's domestic entrepreneurship and its ability to compete globally.

Given this context, the Indian entrepreneur deserves as good a deal from the government as that is offered to foreign and diaspora investors. Moreover, the success of the Indian domestic entrepreneur brings us to an important aspect of the investment and business relationship of the diaspora with their country of origin. While the Indian diaspora's occupational composition is less entrepreneurial than the Chinese, tending more towards professionals, it tends to be a high-income and knowledge intensive community. An important aspect of diasporic policy should be to tap the financial and knowledge resources of the Indian diaspora and partner it with Indian domestic entrepreneur. The Indian domestic entrepreneur is perhaps relatively more efficient in negotiating the various transaction costs involved in running business operations based in India compared to his diaspora counterparts. However, financial capital and human capital in terms of managerial, marketing and research resources from the diaspora will add to the Indian entrepreneur's global competitiveness. The diaspora will benefit from the high returns to venture capital in a rapidly growing economy like India, new business contacts that might lead other global opportunities, and new employment opportunities for their professional skills. Section II that follows discusses the policy requirements for FDI, specifically in relation to diaspora.

## **II. FDI Policy: Analysis, Critiques and Policy Priorities for Diasporic Investment**

The requirement for FDI arises out of three basic rationale; first, to meet the gap between required investments to funnel economic growth and national savings, second, to get strategic technology transfer and managerial expertise, and third, to add to the competitive edge for exports given the international linkages (as well as technology and management resource transfer mentioned earlier) arising out of

FDI. According to Reserve Bank of India statistics<sup>17</sup>, exports as a proportion of sales among a sample of 400-odd foreign direct investment (FDI)-controlled firms in India stood at just 11.6 per cent (data up-to 2002). In terms of capital and technology acquisition, only 40 per cent of the funds utilization of such FDI controlled firms went into acquisition of gross fixed assets such as plant and machinery. When compared with corresponding ratios in a similar RBI survey of nearly 2,000 public limited Indian companies, exports as a proportion of sales were higher at 12.6 per cent and a much larger proportion of funds, 48.9 per cent, were used for the acquisition of gross fixed assets. In other words, Indian companies are clearly showing a greater export focus than foreign firms and they are also investing more in plant and machinery<sup>18</sup>.

The better performance of Indian firms in both their ability to export and as well as their ability to invest in new technology (i.e. capital goods) naturally raises questions about the quality of FDI into India, the business rationale that drives it, and the policy environment that sustains it. FDI into India has mostly not been of the export oriented variety that leverages India's labor cost arbitrage as far as the manufacturing sector is concerned. The most visible impact of FDI in the manufacturing sector has been in expanding the range of products available to Indian domestic consumers. The business rationale of FDI into India has been driven large by the desire to profit from India's domestic market and its burgeoning middle class.

This has led to the two related phenomenon in India's inward FDI; first, a large proportion of FDI into India has been of what can be described as the 'tariff jumping variety', in other words, setting up manufacturing facilities in India to

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<sup>17</sup> Reserve Bank of India Bulletin, April 2003

<sup>18</sup> C. Rammanohar Reddy, The Hindu, April 26, 2003

<http://www.thehindu.com/2003/04/26/stories/2003042600161000.htm>

avoid India's import tariffs that still remain one of the highest in the world. This is in direct contrast to a lot of Chinese inward FDI that was geared towards exports. Second, a large proportion of Indian inward FDI has been a business strategy to acquire marketing networks from Indian companies in India's domestic market or expand the marketing abilities of existing subsidiaries. According to Nagesh Kumar, approximately 40 per cent of FDI into India between 1997 and 1999 was using the mergers and acquisitions route to take over Indian companies, increase control in existing subsidiaries by issuing shares at low cost or buy back shares and de-list from the stock exchanges<sup>19</sup>.

Thus, India's FDI policy has at best had very limited success in terms of the macroeconomic priorities that drive the need for FDI, i.e. meeting the savings-investment gap in priority development areas (labor intensive manufacturing, value-added agriculture, energy and infrastructure), technology transfer and adding to export competitiveness, the exception being FDI into IT and ITeS that has met some of these priorities. In terms of diasporic investment, FDI into small scale, export oriented manufacturing that drove a lot of the Chinese growth has been entirely absent from the Indian scene. The important question that arises is how significant is FDI policy alone in this failure? To reinforce the point made in the last section, FDI success is based on economic rationale and efficiency and not just by policy and bureaucratic institutions. As Morriset and Pirnia<sup>20</sup> point out a policy of incentives and will generally neither make up for serious deficiencies in the investment environment, nor will it generate the desired externalities. Long-run strategies of improving human and physical infrastructure sincere efforts to streamline government policies and procedures do much more to improve the

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<sup>19</sup> Kumar (2000), *Multinational Enterprises and Mergers and Acquisitions in India: Patterns and Implications*, Research and Information Systems for Developing Countries (RIS) Discussion Paper No. 5-2000

<sup>20</sup> Morriset and Pirnia (2000), *How Tax Policy and Incentives Affect Foreign Direct Investment*, World Bank Policy Research Working Paper No. 2509, World Bank

chances of attracting investment on a genuine long-term basis. The relative importance of fundamental factors like economic conditions and political climate is underlined by the fact the most serious investors are often unaware of the full range of incentives on offer when they invest, and that they often do not consider alternative locations.

If a liberal FDI policy and the formation of investment agencies are all that were important then the sub-Saharan African countries, which by and large now have the most open policy towards foreign investors in the developing world, should be attracting huge volumes of FDI<sup>21</sup>. The effectiveness of an investment agency depends entirely on the environment within which it operates. An agency working in a poor investment climate with high transaction costs is most likely to be ineffective at attracting investment. Empirical analysis by Morriset<sup>22</sup> indicates that agencies devoting more resources on policy advocacy are more effective because such activity is not only beneficial to foreign but also to domestic investors (yet again underlining our argument against preferential policies towards foreign investors and need to address economy-wide transaction costs issues). By contrast, investment generation or targeting strategies appear expensive and risky, especially in countries with poor investment climates. The Planning Commission's comparative analysis shows that India has a more liberal FDI policy and more investment attracting agencies than Malaysia or China. Yet, the two East Asian countries attract considerably more investment than India. One of the important reasons for this anomaly is that India remains one of the highest transaction cost economies in the world, especially for small and medium enterprise of the type favored by diaspora investors. As a matter of fact, India ranked a lowly 46 among 53 countries in a list compiled by CNN-Time Warner group's Fortune Small

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<sup>21</sup> C. Rammanohar Reddy, The Hindu, April 26, 2003

<http://www.thehindu.com/2003/04/26/stories/2003042600161000.htm>

<sup>22</sup> Morriset (2003), Does a Country Need a Promotion Agency to Attract Foreign Direct Investment, World Bank Policy Research Working Paper No. 3028, World Bank

Business (FSB) magazine for their friendliness to small businesses<sup>23</sup>. Thus, it is not so much the policy realm as the broader issue of policy strategy and implementation that needs to be addressed. The economic basis and incentives that drive FDI and their implication on policy is another area that needs to be better understood. Section III that follows will engage these two areas through policy recommendations.

### **III. Key Recommendations towards Attracting Diasporic FDI**

#### **I. Allow 100 % FDI in retail and Small and Medium Enterprises (SME)**

Currently FDI in retail is allowed only in single brand entities. FDI in SME's is limited to only 24%, with any foreign investment above 24% being subject to industrial license with a mandatory export obligation of 50% of annual production and the manufacturer losing small scale status. Both restrictions are major impediments to FDI, and specifically diasporic FDI. A large number of Indian entrepreneurs in the US, UK and other parts of the developed world are very successful retailers. Their expertise and capital are being prevented from being put to productive use in the Indian economy. A viable retail chain network often creates backward linkages with extremely positive effects on growth of efficient supply chain networks. Such networks in turn reduce cost to market and induce scale economies in several products that then become more competitive in the global market.

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<sup>23</sup> As reported by CNN-IBN on 29<sup>th</sup> June, 2007  
<http://www.ibnlive.com/news/mncs-rule-india-least-friendly-for-small-firms/43863-7.html>

Similarly, the FDI restrictions of SME's are ironic given our earlier discussion of the nature of Chinese diasporic FDI. As was pointed out, Chinese diasporic investment was on average very small (USD 3-2 million), and the export industries invested in tended to be SME's specializing in labor intensive low cost production. The majority of the entrepreneurial class of Indian diaspora does not have the capacity like the large MNC's to invest in large-scale production units. However, they definitely have the managerial expertise and capital to try and venture into small-scale manufacturing. The success of the East Asian SME clusters and the associated role of the diaspora should be followed in India, including tie up of private research centers in India with overseas research centers through the Indian diaspora.

A walk into any furniture, stationary, hardware or electronics store in the industrialized world, especially the US, will show that most of the items that have been reserved for the SME sector (a few examples of which are presented in Table 3 below), are imported from developing countries, especially from China. The Chinese and other Asian exporters of such products into industrialized markets became competitive precisely because of economies of scale, low transaction costs and the ability to invest in quality control and productivity without restrictions. As long as the policy of reservation for the small-scale sector continues with its associated investment and scale of operation ceilings, Indian manufacturers will never be able to compete globally. As was pointed out, that does not mean just the loss of a potentially huge global opportunity; it will mean a gradual loss of the domestic market as well given that the forces of globalization will expose India to competition from China and other Asian countries.

**Table 3 Common Consumer and Industrial Use Products Reserved for SME**

1	Wooden furniture and fixtures
2	Paper envelopes
3	Teleprinter rolls
4	Full PVC footwear (sandals and shoes)
5	Polyethylene and PVC flexible hoses
6	Graphite paints
7	Industrial adhesives
8	Formulated perfumery compounds
9	Steel furniture and storage equipment
10	Rolling shutters
11	Stainless steel utensils
12	Aluminum utensils
13	Voltage stabilizers
14	Electric irons
15	Electric kettles
16	Espresso coffee makers
17	Bread toasters
18	Electrical light fitting chokes
19	Electrical light fittings starters
20	Ball point pens

**List of Reserved Sectors for SSI as notified by Government of India on March, 2007**

II Develop a Strategic Vision for FDI with focus on exports, technology, geographic specialization, and employment creation.

R. Nagaraj<sup>24</sup> argues that the problem is that our FDI policy does not have a focus. In comparison with the Chinese approach, the Indian FDI regime suffers because it is passive (open to all, without any targeting) and not strategic as in China. India's FDI policy should have prioritized investment in labor intensive manufacturing, for acquisition of technology and for the establishment of

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<sup>24</sup> Nagaraj (2003), FDI in India in the 1990's: Trends and Issues, Economic and Political Weekly, April 26, 2003.

international trading channels to facilitate labour-intensive exports. The FDI policy environment also lacks a sense of sectoral and geographic specialization. Certain regions of India, though backward on the whole, possess competitive natural and human resources in certain specific sectors. The FDI requirement and its international marketing network for that sector need to be identified and global leaders in that sector actively wooed with this geographic-sectoral specialization in mind. Businesses respond best to specific proposals with the guarantee of an enabling mechanism, generalized talk of potential and good intentions will not attract serious investors.

### III Reduction in Transaction Costs, Improvement of Infrastructure and Enabling Trade Facilitation

More than any FDI policy, it is the level of business comfort and profitability of operation that attract FDI. As was pointed out in Section II, India had a more liberal trade regime than either China or Malaysia but was not even close to attracting the kind of FDI that these economies attract. Transaction costs of operating a business in India remain prohibitive and infrastructure and logistical support poor. India's export-import infrastructure including the soft infrastructure of information flows and administration of trade flows remain behind the standards set in other Asian economies such as Thailand, Malaysia and China. Transaction costs arising out of poor infrastructure, logistics and administration affect SME's and other smaller players the most. As was pointed out, the average diaspora investor is most likely to be small scale and such investors will feel the persistence of high transaction costs most acutely. Under such conditions, very few diaspora investors are likely to invest. In order to attract FDI, India first must become a competitive production base where people would want to invest. Implementation of Trade Facilitation reforms will lead to stronger trade linkages with ASEAN and other emerging markets in Asia, an imperative if India is to

become a global production hub (prospect of which will attract FDI)<sup>25</sup>. Roy and Banerjee identify five broad areas of reforms in Trade Facilitation<sup>26</sup>:

- Port logistics: Cargo dwell time, warehousing facilities, and rail and road links from hinterland to ports;
- Standards harmonization: Reform of domestic standard-setting and monitoring authorities; move towards regional and global convergence on standards; and mutual recognition agreements;
- Business mobility: Movement of professionals, transparent visa systems; adequate financial systems, including banking, insurance, and clearance mechanism;
- Administrative transparency and professionalism: Simple and transparent procedures for export and import with public-private co-operation;
- Trade information and e-business facilities: Proper channels and access to market information, legal systems, and standards and regulations; e-business infrastructure to enable business-to-business contacts.

While none of the above might seem to be relevant for an agenda of a FDI agency, the importance of these policy areas to FDI is very pertinent and direct. As was pointed out in section II earlier, the FDI agencies that were forums for positive policy advocacy and took action on policy reforms were more successful than the ones that concentrated on trying to create special conditions or special concessions for foreign investors. With this in mind, Trade Facilitation should become an area of priority in the advocacy carried out by India's FDI agencies.

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<sup>25</sup> Jayanta Roy and Pritam Banerjee (2007), Trade Facilitation: The Next Big Step in India's Trade Reform, ICRIER (forthcoming)

<sup>26</sup> Ibid

#### IV. Similar Treatment to International and Domestic Entrepreneurship

Capital and associated entrepreneurship is an important factor of production. The quality of entrepreneurship is the key to allocative and productive efficiency in an economy<sup>27</sup>. To give preferential treatment to FDI over domestic capital and the associated entrepreneurial resources that go with it is to restrict this factor of production from contributing efficiently in the economy. As was pointed out in section II, the success of the Indian entrepreneur is now recognized globally, especially by global financial institutions that are the best arbiters of global firm level efficiency. India should have a holistic investment policy that creates an enabling mechanism for both India's domestic as well as international investors and entrepreneurs, not single out preferential treatment for any one set of investors. Given India's deep savings pool and ability to generate investable capital (the large sums that was raised for Tata's takeover of Corus is a case to the point), this is of the essence.

#### V. Decentralization of Administration Process

A major reason behind China's relative success in attracting FDI has been the relatively higher level of decentralization of the FDI policy and administration process. According to Kundra<sup>28</sup>, the Indian FDI policy process still remains highly centralized in Delhi and that is a major impediment in effective competition between states and efficacy in administration of FDI initiatives in many parts of India. While things have improved in terms of decentralization since Kundra's analysis in 2000, the entire FDI policy environment still remains in centered around Delhi and not the state capitals where they should be given the diversity of India's economic geography.

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<sup>27</sup> Schumpeter (1942), *Capitalism, Socialism and Democracy*, Harper & Brothers, pg 205-210

<sup>28</sup> Kundra (2000), *The Performance of India's Export Zones : A Comparison With the Chinese Approach*, Sage Publications

## VI. Drastically Reduce Overly Bureaucratic FDI facilities

India's bureaucratic set-up maintains several investment and trade promotion bodies that work at cross purposes. There are too many 'single' windows and investment development commissions working at the same time<sup>29</sup>. There is also a lack of policy consistency. For example, the Development India Initiative to showcase India as a manufacturing hub was discontinued without the initiative being allowed to reach a logical conclusion. There needs to be a real 'single window' that draws from the sectoral expertise of the different ministries, and more importantly the private sector. The Ministry of Overseas Indian Affairs can play this role for investment from the Indian diaspora and collaborate with the Department of Industrial Policy and Promotion, and the Foreign Investment Promotion Board, that implement foreign investment policy.

## VII. Private Public Partnership with Private Sector taking the lead

Foreign investors are lured not by the proverbial persuasion of the bureaucracy or the politicians as they are by the broad policy framework, stability of the government and consistency in policy. Thus, having several government dominated investment commissions might not have any positive impact on FDI. Foreign investors are unlikely to be interested in holding talks with bureaucrats,

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<sup>29</sup> FDI policy is formulated by the Department of Industrial Policy and Promotion (DIPP) in the Ministry of Commerce and Industry. The Investment Promotion Desk and the Foreign Investment Implementation Authority, under the Secretariat for Industrial Assistance (SIA) in the DIPP, are concerned with investment promotion and facilitating implementation of approvals. The Foreign Investment Promotion Board (FIPB), based in the Ministry of Finance, is responsible for granting approval for FDI in sectors/activities where prior government approval is required. The Foreign Investment Implementation Authority (FIIA), which is based in the DIPP, provides assistance to foreign investors encountering approval or operational difficulties. The FIIA is assisted by a Fast Track Authority in each sector, and includes representatives across the Government, including state governments, and agencies involved in the particular project.

ex-ministers or experts, however eminently qualified they might be<sup>30</sup>. Foreign investors are more likely to respond to actual business plans and proposals from their business counterparts in India. Thus, the government should let the Indian private sector take the lead and provide the enabling mechanism. In this context, the formation of the Overseas Indian Facilitation Centre (OIFC) by the Government of India which is hosted by Confederation of Indian Industry (CII) is a step in the right direction. By letting CII be the host institution, the Government has effectively acknowledged that the private sector has to take the lead in this process. However, the OIFC has to become more than just a talk shop for it to play the role that has been assigned to it. More specifically the OIFC will have to be nurtured and led by the top leadership in both the government and business because as Morriset analysis points out, agencies that have established reporting mechanisms to the highest country's policy makers (i.e., the president or prime minister) or to the private sector leadership (leading CEO's etc) have been systematically more efficient at attracting FDI<sup>31</sup>.

#### VIII. Networking Overseas Indian Professionals placed in key Decision making positions

A large part of the FDI in the IT and ITES sector was facilitated by Indians placed in key decision making position in Silicon Valley based giant companies. The offshoring of business processes (BPO) also saw many Indian professionals and managers in major MNC's play an important role in mediating the movement of such investment into this industry in India. Thus, it is very important for FDI administrative bodies in general and the OIFC in particular to focus on these groups by maintaining a detailed sector specific database of such highly placed

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<sup>30</sup> Hindu Business Line Nov 5, 2005

<http://www.blonnet.com/2004/11/05/stories/2004110500011000.htm>

<sup>31</sup> Morriset (2003), Does a Country Need a Promotion Agency to Attract Foreign Direct Investment, World Bank Policy Research Working Paper No. 3028, World Bank

Indians and make them a part of the process of by inviting to OIFC deliberations. It is also important to tap diasporic human resource to make Indian enterprise more globally competitive. In firm level perspective this would involve engaging with diasporic managerial, technical and business talent worldwide to work for Indian enterprise. In a more macro-level perspective this would involve tapping diasporic human and financial capita for the development of India's domestic human resources and social sector. India's diaspora include several prominent names in the academic field. India is very likely to face an acute shortage of skilled human resources as the economy grows. The Indian higher education system is in a poor state (with some exceptions like the IIT's and IIM's) and there is a great need for investment in this sphere.

### **Joint Ventures in Education Sector**

India's diaspora include several prominent names in the academic field and there is scope for private diaspora led investment in private higher education. Unfortunately, India is yet to liberalize this sector for FDI. Indian educated professionals have strong links to their alma maters. If FDI led joint ventures (JV) were allowed in higher education (including High School education) there is a wide scope for creating world class technical institutes that draw from the best in India's academia and combines it with European and US investment, expertise and research networks. Such JV's could draw from the expertise of a growing number of retirees who have specialized skills that they can offer even if only on a part time basis. This is particularly the case of retired doctors, engineers, scientists and professors who may well like to visit India especially in winter. Low transaction cost mechanisms that provide a coordinating and information clearing function to match the expertise of retirees to specific institutions, need to be created<sup>32</sup>.

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<sup>32</sup> The use of retirees for social development is mentioned by Kapoor in Kapoor (2003), *The Indian Diaspora as a Strategic Asset*, Economic and Political Weekly, Vol. 38, No. 5, (February 1-7)

## IX. Creative Joint Ventures and Partnership to tap diaspora entrepreneurship

Continuing on the theme of JV's, new and creative mechanisms need to be found to tap diaspora entrepreneurship for India. Joint Ventures and partnerships with Indian stakeholders provide the diaspora a firmer footing and surer way to deal with local risks. A few examples of the many ways by which diaspora entrepreneurship can invest and profit from the Indian market is given below:

### **Marketing Joint Venture**

Establishing retail networks with the diaspora that source dedicatedly from Indian producers through a contractual agreement. Such an arrangement will work especially well in consumer goods, textiles and clothing. CII can contribute to the formation and the marketing through the Indian Brand Equity Fund (IBEF).

### **Production Joint-Venture**

Actively encourage Indian corporates to strategically invest in venture capital funds that serve as a springboard for three way partnerships. The Indian corporate supported venture capital provides a part of the investment, another part is borne by an existing SME entrepreneur, while the third is borne by diaspora FDI. CII can have a dedicated investment wing that brings together the three groups. Such three way partnership can be used to augment existing production facilities, up-gradation, or for new ventures.

### **Diaspora-Small Entrepreneur Group Joint Ventures**

Identify successful small entrepreneurs operating in clusters, or in the same sector/production line in different geographies of India. Help consolidation and corporatization with the help of diaspora investment by selling the investment opportunity to interested diaspora members.

### X. Linking SEZ Development with Diaspora FDI policy

The success of East Asian economies has been built around the promotion of growth poles and innovative economic clusters. These have significantly contributed to generating exports and employment, ushering in latest technology, and attracting foreign investment, mostly from its residents abroad. The involvement of the diaspora of East Asian knowledge workers in USA and OECD countries was critical to the emergence of innovative clusters in East Asia. There is an urgent need to have a coordinated approach on the development of growth poles and clusters in India, and involving the Indian diaspora in its development process. India should not hastily move towards an umbrella legislation of SEZs, recognizing that SEZs are an integral part of regionally oriented growth poles, and hence policies towards them should be taken in a decentralized, localized context. It also must be recognized that innovative clusters are a local phenomenon, but their long-term dynamism rests on their becoming a part of a global network of similar clusters and participating in the circulation of human capital among them. Just like the East Asians, GOI will have to find ways of meaningfully connecting the Indian diaspora with local entrepreneurs, encouraging technical interaction between local and foreign firms with skilled workers from abroad bringing ideas, technology transfers, and access to foreign markets. The coordinated approach

urgently needs a master plan for clusters that should benefit from the rich experience of East Asia<sup>33</sup>.

However, aping the older East Asian model will not succeed in current Indian context because there will be too much government control. The commerce ministry will decide who heads the zones, and the same customs officials with a 'control mindset' will operate there. Not to speak of a host of public authorities involved with the implementation of SEZ policies, adding to the confusion. Bureaucratic approval will be time-consuming, especially if tax incentives and other sops are to be provided. Instead of SEZ India should move towards the modern version of SEZs: freeports. It is a much broader concept than the earlier Chinese SEZs and appropriate for an economy moving towards becoming a developed country. It replicates a First World environment with minimal restrictions, streamlined procedures, sound infrastructure and easy access through world-class ports and airports<sup>34</sup>. This go a long way in attracting SME type entrepreneurship from the diaspora and dealing with India abysmal record on transactions costs of operation for SME's.

## XI. Policies to Convert Remittances into Investment and Create Venture Capital

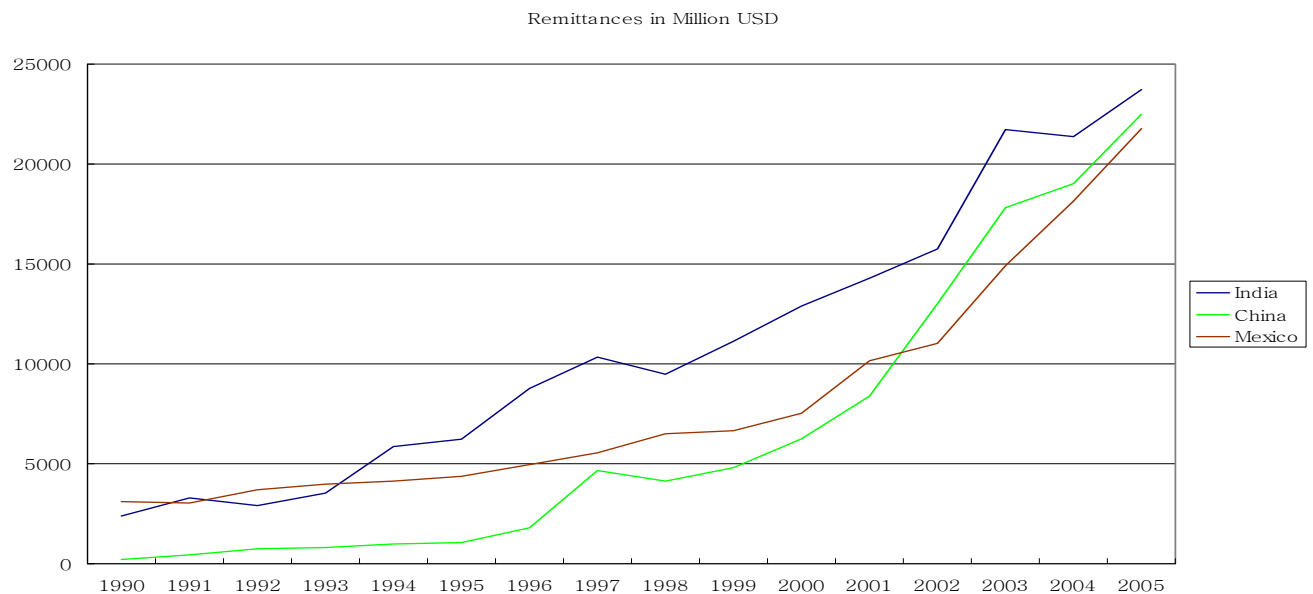
India is the highest recipient of remittances in the world. Figure 2 shows India's global leadership in terms of remittances inflows. India received just under 25 billion USD worth of remittances in 2005, more than 3 times the amount of FDI for the same year (6.6 billion USD).

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<sup>33</sup> Jayanta Roy (2005) Spurring growth through clusters: Coordinated approach needed to promote growth poles and economic clusters, Financial Express, January

<sup>34</sup> Jayanta Roy (2005) Promote Modern SEZ in India, Financial Express, February 24

**Figure 2. Remittance Inflows in Millions USD: India, China and Mexico**



**Source: Global Development Finance Indicators, World Bank**

Diaspora Indians also invest heavily in India’s bonds and funds market. Table 4 shows outstanding NRI deposits to be 32 billion USD in 2005. If such remittances and investable funds are properly harnessed, it can generate vast amounts of capital to finance India’s industrial expansion just like FDI.

**Table 4. Outstanding NRI Deposit**

Outstanding NRI Deposit	
Year	USD million
1991	13986
1992	13549
1993	15015
1994	16230
1995	17166
1996	17446
1997	20393
1998	20369
1999	20498
2000	21684
2001	23072
2002	25174
2003	28529
2004	33266
2005	32975

**Source: Indiastats.com**

Remittances can often play a significant role in providing working capital. Accumulation of capital from remittances might not necessarily show up as investment in enterprise defined by the formal sector, though such a phenomenon is not uncommon. The more substantive impact of remittances is likely to be felt through the easing of credit constraints in relatively poorer households that enable incremental investment in the more productive use of existing economic resources. For example, remittances might allow credit constrained households to invest in better technology for agriculture or expand informal retail businesses.

Linkages between private investment and remittances have been established by a number of studies. Mishra<sup>35</sup> found that a 1 percentage point increase in remittance inflows into 13 Caribbean countries increased private investment by 0.6 percentage point. Massey and Parrado<sup>36</sup> found that remittances are associated with a greater likelihood of investment in Mexico. On his work on the Philippines, Yang found that an increase the flow of remittances (for the purposes of Yang's paper, from positive exchange rate shocks) led to greater entry into relatively capital-intensive enterprises by migrants' origin households<sup>37</sup>. Aggarwal et al in their analysis of remittance flows to 99 countries for the period 1975-2003, find that remittances have a significant and positive impact on bank deposits and credit to GDP<sup>38</sup>.

Return migrants can use their savings to invest in SME upon their return to their country of origin. Such entrepreneurial activity can be better organized if there

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<sup>35</sup> Mishra, 2005. Macroeconomic Impact of Remittances in the Caribbean. *Unpublished paper*, International Monetary Fund

<sup>36</sup> Massey and Parrado. 1998. International Migration and Business Formation in Mexico. *Social Science Quarterly*. Vol. 79, No. 1. Pg. 1–20.

<sup>37</sup> Yang (2005), International Migration, Human Capital, and Entrepreneurship: Evidence from Philippine Migrants' Exchange Rate Shocks, World Bank Policy Research Working Paper 3578, World Bank

<sup>38</sup> Aggarwal, Demirgüç-Kunt and Peria (2006), Do Workers' Remittances Promote Financial Development? World Bank Policy Research Working Paper 3957, World Bank

was a policy environment that helped sustain it. Many countries such as Philippines and Mexico now actively help return migrants with investment advice and facilitation to enable productive investment of their savings from abroad<sup>39</sup>. The investment of such savings is effectively a form of ‘FDI’. In India’s case, such remittance oriented FDI is pretty common in regions like Gujarat and Punjab where family networks draw capital from their members working abroad to finance their enterprise. Table 5 presents the potential for venture capital that can be drawn from diaspora that can fund entrepreneurial energies and ideas in India.

**Table 5. Potential Pool of Venture Capital Resources from Diaspora Investors**

		Diaspora Population	Diaspora GDP Millions (USD) 2004	Average Savings % (using National Average)	Possible Venture Capital Flows
1	Australia	190000	4257	23	196
2	Austria	11945	294	25	15
3	Canada	851000	20564	24	987
4	France	65000	1194	20	48
5	Germany	35000	815	21	34
6	Hong Kong	22000	577	31	36
7	Italy	71500	1113	21	47
8	Japan	10000	372	25	19
9	New Zealand	55000	814	24	39
10	Portugal	70000	614	16	20
11	Singapore	307000	7117	44	626
12	Spain	29000	351	25	18
13	Switzerland	13500	457	28	26
14	Sweded	11000	312	23	14
15	United Kingdom	1200000	31062	13	808
16	United States	1700000	60032	14	1681
	<b>Total</b>	<b>4641945</b>	<b>129947</b>		<b>4612</b>

**Source: Authors Calculations using data from World Bank Development Indicators and Ministry of Overseas Indian Affairs**

<sup>39</sup> Rath and Kloosterman (2000). Outsiders Business: A Critical Review of Research on Immigrant Entrepreneurship. International Migration Review. Vol 34, No. 3.

Table 5 uses the population and per capita income of the diaspora Indians living in the industrialized economies (OECD countries) to calculate diasporic GDP<sup>40</sup>. It then uses the national savings rate (average) to calculate potential savings. Under the assumption that about 20% of such savings will be potentially invested by diaspora members in high-risk/high return investments such as venture capital entrepreneurship, it arrives at a figure of a potential pool of USD 4.6 billion that can be generated *annually* to support entrepreneurship in India. While this might seem simplistic, it is not that far fetched from reality that if the right mix of policies targeted diaspora populations in each country with the correct venture capital investment options, such long-term venture capital investments can be made feasible. Thus, the policy environment on FDI needs to take a broader view on the concept of foreign capital being invested in Indian enterprise and pay more attention to such SME activity being financed by diaspora networks. More importantly, diaspora networks could be organized into investment co-operatives that work with diaspora centric venture capital firms so small remittances can be channeled into bigger investment projects. The IT and ITES sector has seen the rise of Indian venture capital firms that work with the diaspora to channel their savings into Indian start-ups. It is time to create a policy environment and take initiatives to do the same for the manufacturing sector SME.

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<sup>40</sup> Table 4 assumes diaspora per capita income to be just 80% of national per-capita averages for France, Spain, Italy and Portugal where Indian diaspora is mostly considered to be working class.

## **Conclusion: The Critical Role of the OIFC**

The Overseas Indian Facilitation Centre (OIFC) is definitely a step in the right direction in trying to create policy environment that would lead to tapping the vast reserves of entrepreneurial talent and capital among the Indian diaspora. The fact that the private sector in the form of the CII is the host institution should make it a more professional institution that focuses on hard business issues rather evolving into another 'talk-shop'. The OIFC located within the CII is expected to play a crucial role in bringing together Indian and diasporic entrepreneurs together, working out investment opportunities and creating global production and marketing networks. The OIFC should also make an attempt to tap the power of Indian remittances through investment workshops and partnering with diaspora oriented venture capital firms. Diasporic savings can play a huge role for Indian entrepreneurs seeking capital. The OIFC should not ignore the SME route for FDI by the diaspora. Investment into low cost labor intensive SME was what drove the Chinese FDI engine and in large part the early Chinese export boom in the late 1980's and early 1990's that fed the Chinese economic transformation in later years. Therefore, a major policy priority for the OIFC should be to push for removal of the reservation policy for the small-scale sector, along with the curbs on diasporic investment into SME and in retail where the Indian diasporic enterprise has been extremely successful. Along with this recommendation, OICF and the Ministry of Overseas Indian Affairs should present the key recommendations of the paper to the Cabinet for their speedy implementation. At the end of the day, the process of attracting FDI depends on the economic rationale and productive environment available in an economy. Thus, the larger policy framework would be to address the issues of reduction of transaction costs, efficacy of infrastructure inputs and commercial facilitation. However, this is a long-term incremental process, the current order of business being to maximize on the existing opportunities. The OIFC is expected to provide muscle to that current agenda.



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