# Foreign Direct Investment in Telecom Sector

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**ABSTRACT**

Foreign Direct Investment (FDI) is an investment in a business by an investor from another country for which the foreign investor has control over the company purchase. Telecommunications in India were formerly provided by state-owned enterprises. The government companies provided all local and long-distance communications within India. Private investment, foreign and domestic was not permitted prior to the opening of the economy in the 1990s. Foreign direct investment in the telecommunications sector increased substantially between 1995 and 1997.

India has several positive attributes that attract FDI in Indian telecommunication sector – a stable political environment, large consumer market, skilled labor force and access to the Asia-Pacific region. There are, however, several barriers to growth in attracting foreign direct investment for the Indian telecommunications sector such as cost of mobile phones and services, high infrastructure costs, tax policies, unclear FDI policy and regulation and corruption.

There are several factors that influence the amount of FDI present for a country and in specific sectors of that country such as level of infrastructure and support for infrastructure in a country, educational characteristics of the workforce and urbanization of the population.

This paper will examine the current status of foreign direct investment (FDI) in the Indian telecommunications sector and the issues facing foreign companies seeking to invest in the Indian telecommunications sector.

**Keywords:** FDI, Telecommunication, Tele Density

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**INTRODUCTION**

In the early 1990s India began to open up an economy that was previously closed to foreign direct investment (FDI). The liberalization in India included the gradual granting of authority for foreign direct investment in specific sectors of the economy. India has received significant inflows of foreign direct investment after liberalizing its economy in 1991. FDI inflows to India have exceeded many other ASEAN countries over time. However, China continues to be the leading destination for FDI in the Asia-Pacific region.

India has achieved substantive improvements in telecommunications access since opening its telecommunications sector in the early 1990s. However, India has realized fewer benefits than were possible during the period of market reform. The slow implementation pace of liberalization, disparity between urban and rural areas and unclear regulations have impeded the flow of investment to the telecommunications sector in comparison to other emerging market economies.

**HISTORY OF INDIAN TELECOMMUNICATIONS**

Prior to 1991 India actively implemented an import substitution strategy. This strategy effectively limited foreign direct investment in almost all major areas of the Indian economy. In 1991 India experienced a balance of payments crisis when foreign exchange reserves ran dangerously low. Subsequent to the crisis the Indian government implemented a structural adjustment plan to stabilize the balance of payments and sustain long-term economic growth. India sought to reduce the role of the government in the economy and create greater market efficiencies. Some of the primary impacts of the plan were to open up the economy to foreign investment and encourage privatization in some formerly state dominated industries. In addition, licensing requirements and import tariffs were reduced.

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**OBJECTIVES OF THE STUDY**

- To study the determinants of FDI
- To know the methods of foreign investment in India
- To analyze the current state of Indian Telecommunications and FDI
- To study issues with Indian Foreign Direct Investment in the Telecommunications Sector

**RESEARCH METHODOLOGY**

Exhaustive literature survey regarding the topic and related concepts has been done. Secondary data inclusive of quantitative and qualitative data as well collected from various sources including books, research papers, newspapers, magazines, and websites is used for the purpose of study.

**DETERMINANTS OF FDI AND THE INDIAN MARKET TRANSITION**

The allocation of foreign direct investment is influenced by many factors including the quantity and quality of the host country's labor pool, the wage rate of the host country labor pool, the host or foreign country's regulatory and legal environment, the size of the host country market for the product, the physical infrastructure of the host country, the political stability of the host country and the tax regime.

The level of education and literacy of the labor pool can influence the amount of FDI received by the host country. Foreign firms would likely invest in locations and labor that can grasp complicated processes and maintain high standards of quality. A skilled and productive workforce can attract manufacturing facilities and services to the host country. The state of the regulatory and legal environment can facilitate a firm's entry into a foreign economy. The location may be chosen to avoid tariffs or other protectionist measures employed by the host country to protect domestic industries. The foreign firm avoids measures to protect domestic industry by becoming part of the domestic industry through local incorporation or partnership with a domestic company.

The economy of the host country plays an important role in determining the allocation of FDI. Stable exchange rates, limited inflation, the size of the relevant market and potential for growth are key determinants in attracting investment. The foreign company may specifically choose to invest in order to meet domestic demand for their products. The political stability of institutions in the host country can be of significant importance in the investment decision. The quality of institutions, amount of corruption and their relationship to a functioning economy has an impact on the location of FDI. Some studies have found a negative relationship between levels of corruption and the inflow of FDI.

The physical infrastructure of a country is very important in attracting foreign investment. The physical infrastructure includes the accessibility and level of telecommunications, transportation networks, electricity, water, sanitation and other related public goods. Countries lacking sufficient infrastructure may be unable to attract FDI and this may also impact the ability of the host country to act as an exporter of goods.

A stable tax regime lowers the risk of investment to foreign firm. The new entrant may also be able to avoid tariffs by establishing a local subsidiary. There has been a substantial amount of literature examining the impact of taxation and exchange rates on the amount of FDI inflows to countries. The literature is mixed and indicates that the level of taxation in a country may encourage or discourage FDI. Similarly, exchange rates may play a role in the decision to initiate foreign direct investment in a country. Tax and other investment incentives may not have a significant impact on the decision to invest.

**METHODS OF FOREIGN INVESTMENT IN INDIA**

There are several methods that a company can employ to enter an approved Indian sector. The options that are used the most include incorporating as an Indian company (a wholly owned subsidiary or joint venture with a local Indian company) or as a foreign company (e.g., case of economies in transition. representative or branch office). Investment amounts in an Indian company are limited to the sector-specific caps on FDI that have been imposed by the government.

The Indian government has an official policy of deciding on proposed foreign direct investment within 30 days. However, this process may entail checks and clearances from multiple agencies that delay the 30-day process. Additionally, the rationale for approving or rejecting proposals is often unclear.11 India established the Foreign Investment Implementation Authority in 1999 to provide greater organization and improve the speed and transparency of the approval process.

Most FDI proposals are eligible for an automatic approval process. Using automatic approval firms can invest funds initially and then submit the appropriate documents to the central bank. Automatic approval can be granted up to the authorized investment limits for the particular industry sector.

**NEW TELECOM POLICIES**

In 1994 India recognized the importance of investment in the telecommunications sector and developed the 1994 New Telecom Policy (NTP). The policy contained several key features that would be necessary to improve India's economic competitiveness. Overall objectives included providing quality telecommunications access on demand for all Indians, ensuring coverage of all areas of the country and developing a viable base to manufacture and export telecommunications equipment. Several specific goals were identified with the intent of achieving those goals by 1997. These targets included increasing the amount of telephone lines to 7.5 million.

The 1994 NTP had mixed results. The 1994 NTP goal of 7.5 million phone lines were exceeded in a few years when installed phone connections reached 8.73 million. However, the rural areas lagged behind in their access to telecommunications. The number of mobile phone customers has not increased as much as anticipated due to unrealized revenues and inability to obtain adequate financing. Private sector investment fell short of the 1994 NTP expectations.

Foreign direct investment in the telecommunications sector increased substantially between 1995 and 1997. The 1997 Asian crisis temporarily reduced the flow of foreign investment. Investment began to focus on the mobile phone service market and building manufacturing facilities for mobile phone handsets.

In 1999 India announced another NTP designed to further liberalize the telecommunications sector. The 1999 NTP was intended to build on the 1994 NTP and further promote the importance of telecommunications to the Indian economy. The 1999 NTP included the objectives of developing an infrastructure to handle media, information technology, telecommunications and other consumer electronics, improve efficiency and transparency, and strengthen telecommunications research and development and manufacturing to enable India to become a major global competitor.

**CURRENT STATE OF INDIAN TELECOMMUNICATIONS AND FDI**

India has the second largest telephone network among the emerging economies (after China). The Indian telecommunications sector received 99.5 billion rupees (approximately $2.3 billion) in FDI from August 1991 through March 2004. These inflows have largely funded mobile telephone manufacture and services. India is actively seeking additional inflows to provide universal telephone access for all Indian citizens.

Indian Tele density, representing the number of phones per 100 people, is very low compared to other nations of comparable population and GDP. Presently, India has more than 900 million phones divided almost evenly between fixed and wireless phones. The major Indian cities account for most of the Tele density in the country. Tele density in rural areas is quite low and the phone infrastructure that is available often does not work at least part of the time.

Tele density is increasing; however, most of the new Tele density is related to mobile phones. Foreign direct investment in the private sector has focused almost exclusively on mobile phone operations and manufacturing. From April 2004 through March 2005, 18.6 million mobile phone connections were added compared to 3.3 million fixed phone lines. There are estimates indicating that India will have 1200 million mobile phone users by the end of 2017. There are a substantial number of mobile phone operators and this has promoted competition and benefited consumers through reduced cost of handsets and service contracts. Telecommunications growth by the state owned enterprises have primarily occurred in the area of fixed phone lines.

Recently, the Indian government has indicated that the telecommunications sector requires $68.6 billion in investment to provide broadband services and 150 million new telecommunications lines. Foreign firms wishing to invest in the Indian telecommunications sector are currently limited to owning 74 percent of local companies that provide mobile telephone access, basic, long-distance telephony and other related services. Internet-related services are excluded from the 49 percent cap and can be funded via FDI up to 100 percent. Up to 100 percent of FDI is permitted for manufacturing activities. Chief management is required to be Indian residents. The new policy includes restrictions on subscriber privacy.

However, it has been estimated that some companies have already made investments in Indian telecom companies beyond 74 percent via alternative financing methods. Recently, there have been additional attempts to clarify regulations and improve coordination among the different branches of the Indian government responsible for regulating telecommunications investment. New foreign direct investment is expected to come from current investors. Up to 32 telecommunications companies entered the Indian market through joint ventures in 1995. Many of these companies have since exited the market including AT&T, British Telephone, France Telecom, Swiss com (Switzerland), and Telstra (Australia). Presently, there are six major foreign telecommunications companies in the country and they are all from the Asia-Pacific region (Singapore, Hong Kong, and Malaysia).

There are six large telecommunications companies (Vodafone, Airtel, Idea, Bsnl, Tata Docomo, Reliance) that have a nationwide presence in India and several smaller companies that focus on specific regions. One of the six large companies (Bsnl) is a state-owned enterprise with a large fixed line network. The Telecom Regulatory Authority of India (TRAI) projects foreign and domestic investment of $12 billion over the next two years in Indian telecommunications networks. It is anticipated that most of the new investment will be raised from financial institutions and public offerings.

Currently a small proportion of customers provide the largest shares of revenue. Costs are projected to decline in both long-distance and mobile telephony along with an attendant reduction in revenues. The telecommunications sector has received some useful tax incentives during the implementation of the New Telecom Policies. These incentives include amortization of telecommunications license fees, tax exemptions on venture capital finance and loans and favorable importation of some equipment at lower customs duty rates. Additionally, there are some exemptions from capital gains taxes.

**ISSUES WITH INDIAN FDI IN THE TELECOMMUNICATIONS SECTOR**

India has several positive attributes that attract FDI in telecommunication sector – a stable political environment, large consumer market, skilled labor force and access to the Asia-Pacific region. FDI inflows have assisted in helping India provide telecommunications access to more of its population than might otherwise have been possible. There are, however, several barriers to growth in attracting foreign direct investment for the Indian telecommunications sector. These barriers include the cost of mobile phones and services, high infrastructure costs, tax policies, unclear FDI policy and regulation, the legal climate, the status of rural areas and corruption.

The cost of handsets and mobile services is high relative to the average income of Indians. The average mobile phone handset can cost almost $66 and phone service can costs $5 per month. The average Indian salary is generally low and this amount is even lower in rural areas where the bulk of the population (approximately 72 percent in 2003) lives. In addition, the average monthly revenue per mobile phone customer has dropped noticeably to $8 in 2004. The average Asia-Pacific mobile phone service provider receives $17 in monthly revenue. Average revenue per mobile phone subscriber is expected to decline 13 percent annually through 2017.

The share of tax revenues received by the Indian government as a percentage of GDP has shifted between eight and nine percent. This compares unfavorably with other developing nations over a similar time period such as Indonesia (13 to 16 percent) and Malaysia (14 to 20 percent). In addition, there is a large and vibrant underground economy in India that pays little or no taxes. The condition of roads, public transit and phone service unreliability my shift FDI to countries other than India. Only 57.35 percent of the road network was paved in India as of 1999. The telecommunications infrastructure is lacking in comparison to other Asian countries. Indian telephone faults per 100 phone lines were 126 in 2002. This compares unfavorably to Malaysia (40 in 2001), the Philippines (5.2 in 1997), and Thailand (19.8 in 2001). Indian fixed line phone connections have been growing slower than mobile phone connections. The slow growth of fixed phone lines also contributes to lower Internet penetration. As of 2003 India had 17.49 Internet users per 1,000 people and most of these users likely reside in urban areas. Other developing countries have higher Internet penetration rates – China (63.25 per 1,000 in 2003), Malaysia (344.1 per 1,000 in 2003), Philippines (44.03 per 1,000 in 2002), Thailand (110.5 per 1,000) and Vietnam (43 per 1,000 in 2003).39 India's low tele density and low growth in fixed telephones will likely hinder the provision and access to high-speed Internet services.

Tax policy has at times been disjointed and acted as a barrier to investment. It is estimated that Indian taxes exceeded other potential FDI destinations from at least 2000 through 2003. There are multiple domestic taxes and these taxes especially impact mobile phone operators. Indian states have implemented individual taxes and this has been a disincentive to the free movement of manufactured goods within India including mobile phones. Until recently India had implemented a time-consuming tax reimbursement policy whereby firms had to pay a central sales tax and then were reimbursed at a later date for their payment. Moreover, tax law has been unclear on the treatment of research and development and this may have discouraged this activity.

Telecommunications licenses to private phone operators have been granted on an arbitrary basis at varying prices. Phone licenses have been issued separately for international service, long-distance service, and basic and cellular mobile phone services. These licenses all have different fee structures and conditions. The regulations on foreign ownership have been unclear and have led to confusion. Previously, foreign-owned firms are limited to 49 percent ownership of an Indian company providing telecommunications services. However, in the past it was technically possible for a foreign entity to have up to 74 percent total ownership in an Indian telecom firm through direct and indirect investment methods. The exploitation of this apparent loophole has caused some elements of the Indian government to oppose further increases to the FDI cap in the telecommunications area. The Indian government has recently clarified the discrepancy in investment and allowed companies in non-compliance with the 74 percent investment rule four months to reach compliance.

The legal and regulatory environment in India is relatively transparent but very slow. Litigation and enforcement of contracts can take years and even decades to resolve. This has Report of the Committee on Compilation of Foreign Direct Investment in India. Economist Intelligence Unit caused many foreign companies doing business in India to ensure that disputes are subject to international arbitration. The legal system is fair but a backlog contributes to very slow resolution of cases. In addition, policies may also be implemented that have a greater benefit for domestic industries in comparison to foreign firms.

Rural areas are expected to account for the majority of future growth in mobile telephone subscribers. However, persons living in rural areas are the poorest people in India and the least able to afford handsets or the telephone services. Currently, it is estimated that only 24 percent of towns with a population of 50,000 or less have mobile phone coverage. This is in sharp contrast to towns with populations of 50,000 or more who have mobile phone coverage of 94 percent or greater. In March 2003 overall teledensity in urban areas was 15.16 and the teledensity in rural areas was 1.49. It is estimated that approximately one third of the rural villages in India lack even basic telephone service.

India suffers from real and perceived government corruption and this has hampered the attraction of foreign direct investment. Transparency International, an organization that tracks corruption in countries via the use of surveys, currently assigns India a Corruption Perception Index of 2.8 for 2004. An index rating below 3 indicates that the country is perceived to have serious and rampant corruption as a cost of doing business. In 1995 the index for India was 2.78. India has shown no discernable improvement in the perception of corruption in the country. This has likely had a negative effect on foreign direct investment to India.

## DETERMINANTS OF FDI IN THE INDIAN TELECOMMUNICATIONS SECTOR

There are several factors that influence the amount of FDI present for a country and in specific sectors of that country. The determinants of foreign direct investment in economies have been examined by various authors. Many of these studies have identified very useful variables relating to the flow of FDI. However, the primary focus of their research has been estimating total FDI flows at a national level. We will examine some sector-specific determinants of FDI for the Indian telecommunications sector.

The variables below were chosen based on their potential relationship to the telecommunications sector and their use in previous studies of FDI country flows. Most of the variables below have been included in previous country studies of FDI determinants. All of the variables and data (except FDI) are taken from the World Development Indicators database produced by the World Bank.

- The level of infrastructure and support for infrastructure in a country is an important factor in attracting FDI. Tax revenue as a percentage of GDP is used as a proxy for the level and support of infrastructure.
- The educational characteristics of the workforce play an important role in attracting FDI. The adult literacy rate of the population is used as a proxy to represent the educational level of the workforce.
- The urbanization of the population represents improved infrastructure and modernity. The urban population as a percentage of the total population is used as a proxy to represent the society's increasing modernization and ability to attract FDI.
- The degree to which the economy has been liberalized and is open to foreign trade should influence FDI. Imports as a percentage of GDP is used as a proxy to represent the economy's level of openness.
- A growing labor supply can indicate a growing and healthy economy. The annual amount of labor available in the workforce is used to represent this measure.
- High levels of government debt can signal poor governance and act as a disincentive to invest. The amount of public debt in US dollars is used to represent this aspect of the economy.

## CONCLUSION

The allocation of foreign direct investment is influenced by many factors including the quantity and quality of the host country's labor pool, the wage rate of the host country labor pool, the host or foreign country's regulatory and legal environment, the size of the host country market for the product, the physical infrastructure of the host country, the political stability of the host country and the tax regime.

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There are six large telecommunications companies (Vodafone, Airtel, Idea, Bsnl, Tata Docomo, Reliance) that have a nationwide presence in India and several smaller companies that focus on specific regions. One of the six large companies (Bsnl) is a state-owned enterprise with a large fixed line network. The Telecom Regulatory Authority of India (TRAI) projects foreign and domestic investment of $12 billion over the next two years in Indian telecommunications networks.
The telecommunications sector has received some useful tax incentives during the implementation of the New Telecom Policies. These incentives include amortization of telecommunications license fees, tax exemptions on venture capital finance and loans and favorable importation of some equipment at lower customs duty rates. Additionally, there are some exemptions from capital gains taxes. India has several positive attributes that attract FDI in telecommunication sector – a stable political environment, large consumer market, skilled labor force and access to the Asia-Pacific region. FDI inflows have assisted in helping India provide telecommunications access to more of its population than might otherwise have been possible.

There are, however, several barriers to growth in attracting foreign direct investment for the Indian telecommunications sector. These barriers include the cost of mobile phones and services, high infrastructure costs, tax policies, unclear FDI policy and regulation, the legal climate, the status of rural areas and corruption. Factors affecting FDI in Telecommunication sector are level of infrastructure, educational characteristics of work force, urbanization of population and the degree to which the economy has been liberalized and is open to foreign trade.

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