



# FDI

## Accounting

### ABSTRACT

*The objective of this paper is to initiate discussions on standardizing the method for measuring Foreign Direct Investment (FDI) across countries. It is important to use consistent method so that there is a faithful representation of a country's investment climate and the information is relevant for the purpose of foreign investors. India and China measures Foreign Direct Investment (FDI) using two different methods. India measures FDI on the basis of equity investments, whereas China includes certain items which do not strictly fall under the purview of FDI. Inclusion of items other than equity increases the reported FDI in China. It is presumed that overall higher reported FDI makes China appear more attractive than India. Our findings suggest that once adjustments for the definitions are made, difference between the FDI in China and India decreases substantially.*

**Keywords:** FDI Inflows, Cross-Border Flows, FDI Stocks and Flows, Round-Tripping, Off-Shore Centers, Reported FDI Data, Reconciled FDI Data, Tax Breaks.

in

India

and

China





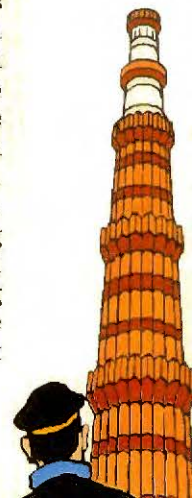
# A Need for Harmonization

M. R. Shollapur, Suneel Maheshwari, Uday Tate

## INTRODUCTION

Foreign Direct Investment (FDI) signifies the real investments in factories, capital goods, and inventories in foreign countries. The inflow of capital is accompanied by a flow of entrepreneurial and managerial skills along with the technology. These investments compliment the domestic savings in financing capital formation of the recipient countries and contribute to the generation of output and employment. FDI triggers technology spillovers and helps create a more competitive business environment in the host country. It has been rightly acknowledged as a stable source of capital for sustainable development in the wake of the volatile international financial markets. Since size of FDI inflows continues to be used as a yardstick to measure the economic development of a country, a new trend has begun among countries towards scaling up their FDI data. In this bid, statistical and accounting treatments are geared for boosting a country's inflows. China and India are among the fastest growing economies in the world and therefore are looking for investment avenues in their respective countries.

India and China are very often quoted in the contemporary literature on FDI and therefore have been selected for a comparative study. The recent United Nations Conference on Trade and Development's (UNCTAD 2005) study on "Prospects for Foreign Direct Investment and the Strategies of Transnational Companies (TNC)" reveals that the investors' attention is shifting away from the traditionally important locations in developed countries in favor of certain emerging markets. "Four of the top five countries are not from developed world. China is considered as attractive location by 87% TNCs. This is impressive even for a country which has been one of the world's largest FDI recipients for quite some time. India's high ranking (India ranks second in the most attractive global business locations and the US is in the third place) is even far remarkable, given that FDI inflows to that country have been modest until recently" (UNCTAD 2005, pp. 12-13). China is perceived to be strong in manufacturing and infrastructure while India is perceived to be strong in services. In Information Technology (IT), China is strong in hardware while India is dominant in software. China is strong in physical markets while India is strong in financial markets. At the high end of the market, China cannot equal India's supply of technical wizards with fluent English. Illiteracy in China is only 9 per cent while in India it is 39 per cent. There exists a wide disparity in both countries with regard to access to basic education. China has maintained its communist political power, while India has attempted to liberalize its economy using a more democratic approach. Both have been regarded as growing countries and are among the fastest growing economies in the world in large part by attracting large amount of FDI. Our paper compares the measurement and accounting issues related to FDI in China and India.





### NEED FOR THE STUDY

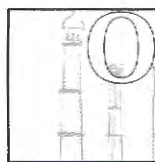
Cross-border capital inflows in contemporary liberalized economic conditions demand fairly high standards of accounting and reporting. In this context, the Organization for Economic Cooperation and Development (OECD) and International Monetary Fund (IMF) are internationally recognized as authoritative standard setters for FDI statistics. Their statistical systems for FDI emphasize the importance of comparability, comprehensiveness, reliability, and timeliness of FDI data. However, countries over the world have found it difficult to follow their strict guidelines in reporting FDI stocks and flows for their economies. For some, it is due to the lack of human and institutional capacity; for others, it may be the disagreement with certain aspects in IMF and OECD's manuals. It is further complicated by the fact that different countries have different FDI regulatory frameworks and reporting standards, therefore follow different FDI data gathering approaches. All this has resulted in inconsistency, incomparability and poor quality of FDI statistics, as well as large discrepancies at the aggregate level. These discrepancies and inconsistencies are prominent between India and China. 'Many of the comparative studies of China and India tend to cast India in an unfavorable light' (Huang, 2007). Our study highlights and reconciles the discrepancies in measurement of FDI between India and China. We do hope that our paper will reinitiate the discussions to implement standardization in measurement of FDI globally.



### REVIEW OF LITERATURE

The interesting point for India-China comparison relates to the respective diasporas. The role of non-resident Chinese in the FDI flows has been commented upon by most experts. Bhattacharyya and Palaha (1996) observe that 'if the contribution of the non-resident Chinese is discounted, the success of India appears to be more pronounced'. Sicular (1998) has found that about 35% of Chinese FDI through much of the 1990's was of the round-tripping variety. Echoing the similar sentiments, Xia (2007) observes that 'FDI figures exaggerate China's supremacy especially if you allow for Chinese domestic investors' round-tripping using foreign vehicles to take advantage of tax breaks'. Further, Haung (1998) opines that round tripping was responsible for at least 23 percent of China's 1992 inward FDI. Pfeffermann (2000) has specifically identified over-reporting of FDI by China and under reporting of FDI by India as two dimensions of huge reported discrepancy between FDI inflows between India and China. John Eliot (2002) points out to the unreliability of Chinese statistics. He observed that while China indeed was ahead of India in terms of actual FDI, the margin was not nearly as large as was generally assumed. Wei (2000) estimates that China's FDI stock figures should be reduced by 60% and flows by 50% to take the Hong Kong effect and round tripping. Srivatsava (2003) is of the opinion that India reports approvals on equity only, while south and southeast Asian countries take project costs which are usually higher than the value of foreign equity by three to four times and hence differences are even more exaggerated. Nagaraj

(2003) asserts that the widely held view of China's ability to attract enormous foreign capital needs to be taken with considerable circumspection. Bajpai and Das Gupta (2004) state that there has occasionally been some skepticism about the authenticity of Chinese statistics and consequently about the actual intensity of the FDI gap between India and China as suggested by the official statistics of the respective countries. While giving a comparative account of development between India and China, Prime (2007) observes that 'the statistics will tell a story of China beating India on indicators ranging from savings and investment, foreign trade and capital inflows, patent application, output growth and per capita incomes'. Even the International Financial Corporation has raised doubts about the correctness of FDI numbers in China and India. It has acknowledged that Indian FDI is hugely under-reported which has been one of the factors behind the gap between the FDI statistics. It is evident from the literature review that the computational gaps in FDI inflows in India and China have drawn the attention of researchers in India and abroad. However, no efforts have been initiated to throw light on the reconciliation between the two with a view to cast India in a favorable light. Our study is an important step in this direction.



### OBJECTIVES AND METHODOLOGY

The following objectives have been set for the study:

- To trace the existing definitional difference of FDI between India and China.
- To measure the differences in the reported FDI inflows in India and China.
- To reconcile the differences in FDI inflows and find out the net gaps in inflows.

Our study covers a period of eighteen years (1991-2008). The data are drawn from secondary sources which include Annual Reports of RBI, World International Reports, UNCTAD's Reports, and Reports of the Ministry of Commerce of the People's Republic of China. For developing a framework for reconciling the reported data on inward FDIs to China, the authoritative opinion of individuals and institutions are considered to grasp the degree of overstatement as well as the suitability of items included in computing FDI inflows to China. To compare FDI measurement in China and India our study is divided into three segments. First, we present FDI inflows in India and China against the backdrop of their regulatory environments. The second section traces the differences in FDI accounting practices between India and China. Finally, we reconcile the differences in FDI inflows and measure the net gaps after reconciliation.



### REGULATORY ENVIRONMENT AND FDI INFLOWS

#### India

India's foreign investment policy has come a long way since independence (1947). It followed an import-substitution policy and relied on domestic resource mobilization and domestic firms encouraging FDI

only in higher technology activities. Initially foreign investment up to 40% equity participation was allowed, if the investing firm possessed technology unavailable in India. The strain on foreign exchange resources for dividend repatriation and royalty payments prompted government to go for a selective and restricted approach. But the failure of the Indian industry to develop technology on its own and the consequent decline of competitiveness compelled government to liberalize foreign investment policy. On the whole, these policy changes (1948-90) could not make a significant dent on foreign investment. Consequently, the Government went for an overhaul of foreign investment policy in 1991. The new industrial policy permits automatic approval for foreign equity investments up to 51% so long as these investments are made in one of the thirty-five "high priority industries" that account for a significant share of the total industrial activity. The Ministry of Industry has expanded the list of industries eligible for automatic approval of foreign investments and raised the upper level of foreign ownership from 51% to 74% and further in certain cases to 100%. Cases requiring prior approval are considered by the Foreign Investment Promotion Board (FIPB) in a time-bound and transparent manner. The Reserve Bank of India (RBI) has also simplified procedures for automatic FDI approval.

There are several good reasons for investing in India. Availability of skilled manpower (especially IT manpower) including professional managers at competitive cost, large and rapidly growing consumer market, large and diversified infrastructure, vibrant capital market, large manufacturing capability, English as the preferred business language, developed R & D infrastructure, and a long history of stable parliamentary democracy are the prominent factors. India has an open system with social and political safety valves and a regulatory environment that provides a long-term stability and security to foreign investors. India has now emerged as an overall low-cost base country for doing business, thereby attracting multinationals to locate their business bases in the country. More than one hundred Fortune 500 companies have their presence in India. World Investment Report 2006 rightly observes that "improved economic and policy conditions, especially in India, where the GDP growth rate exceeded 8% and the stock market grew by 36% in 2005, have led to growing

investor confidence in the region" (Narasimhachary and Gangadhar, 2006). India's FDI to GDP ratio works out at 0.8% in 2005. India attracted a cumulative FDI inflow of \$43.29 billion since 1991 up to September 2006. Further, the FDI equity flows were at a record figure of \$ 41.6 billion in 2008. This surge in inflows reflects foreign investors' confidence in fundamentals of the Indian economy.

**China**

China is no longer a centrally planned economy. During the period (1949-1976), China spurred foreign investments and paid back all its foreign loans mostly to the Soviet Union by 1965. After taking over economic policy at the end of 1978, Deng Xiaoping opened China to foreign trade and investment. In the early 1980, the first Special Economic Zone (SEZ) was setup to absorb direct investment from Hong Kong and elsewhere. During the 1980s, FDI inflows grew steadily but remained relatively low largely restricted to joint ventures with Chinese state owned enterprises. After the Beijing Massacre in 1989, the western and Japanese investors withheld investment in China, but the momentum was maintained partly by a new influx of capital from Taiwan. Deng Xiaoping toured Guangdong and Shanghai in early 1994, encouraging a further and much more massive wave of FDI, increasingly in the form of wholly-owned subsidiaries of foreign companies. China's access to the WTO in November 2001 has further accelerated the pace of foreign investments. Attracting FDI is almost a mission at every level of Government of China including the local municipal bodies.

China has many attractions for foreign investments: low wage rates far lower than the developed countries, political stability, good communication and basic skills, flexible labor laws, better labor climate and flexible entry and exit procedures for business. Chinese FDI procedures are easier and decisions are taken rapidly. China is increasing efforts in developing R & D centers and promoting technology transfers. It has also been an attractive base for export manufacturing with 60% of its imports being produced by foreign companies. Over the past twenty years, this inflow has resulted in the establishment of 170,000 foreign funded enterprises in China. China's FDI to GDP ratio was 4.3% in 2005. China reported FDI at US \$92.4 billion in 2008. A comparative performance of India and China in attracting FDI is exhibited in Table 1.

**Table 1: FDI Inflows in India and China**

( Amount in US \$ Billions )

Year Country	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
India	0.03	0.1	0.3	0.6	1.3	2.6	3.6	2.6	2.2	2.3	4.0	6.1	4.6	5.3	6.0	20.3	25.1	41.6
China	4.4	11.0	27.5	33.8	37.5	40.2	44.2	43.8	40.3	40.8	48.8	55.0	53.5	60.6	60.3	63	74.8	92.4

Sources: Ministry of Commerce of the People's Republic of China, World Investment Reports, UNCTAD and Annual Reports of RBI.

Table 1 reveals that FDI inflows in India were negligible in the initial years. There has been a gradual impetus to inflows since 1995 and reached \$ 41.6 billion in 2008. FDI has been a much less important factor in India's growth compared to that of China, where FDI has been a major source of investment and economic growth since China's liberalization. China made rapid strides in attracting FDI: \$4.4 billion (US Dollars) in 1991 and \$92.4 billion in 2008. China has rightly earned a name for itself as the 'manufacturing powerhouse of the world'. Greater

inflow of foreign capital in China is believed to be largely responsible for its exceptional growth. Indo-China comparison demonstrates that India lags behind China and raises a number of questions: Why did not India initiate comprehensive steps in attracting FDI? Are not the prospects of market, national resource, infrastructure, etc; attractive in India? Are there high risks of investment in India? And finally, has India laid down an enabling and investor friendly

environment for the foreign investors? This paper addresses how far these apprehensions are realistic.



### DI ACCOUNTING: DICHOTOMY IN COMPUTATION

The International Monetary Fund (IMF) has guidelines on defining FDI. The IMF definition of FDI includes twelve elements : equity capital, reinvested earnings of foreign companies, inter-company debt transactions, short-term and

long-term loans, financial leasing, trade credits, grants, bonds, non-cash acquisition of equity, investment made by foreign venture capital investors, earnings data of indirectly held FDI enterprises, and control premium and non-competition fee. These items do not necessarily interpret investments only in the sense of assets that lead to production like plant, or machinery. The IMF definition is based on the source of capital funds, not its use. In spite of the IMF's specific guidelines on the components of FDI, there is fundamentally a definitional difference between China and India with regard to FDI. This is presented in Table 2.

Table 2: Existing Definitional Difference of FDI between China and India

IMF	China	India
Equity capital	Equity capital	Equity capital reported on the basis of issue/ transfer of equity or preference shares to foreign direct investors
Reinvested earnings of foreign companies	Reinvested earnings of foreign companies	NA
Inter-company debt transactions	Inter-company debt transactions	NA
Short-term and long-term loans	Short-term and long-term loans	NA
Financial leasing	Financial leasing	NA
Trade credits	Trade credits	NA
Grants	Grants	NA
Bonds	Bonds	NA
Non-cash acquisition of equity (tangible and intangible components such as technology fee, brand name, etc.)	Non-cash acquisition of equity (tangible and intangible components such as technology fee, brand name, etc.)	NA
Investment made by foreign venture capital investors	Investment made by foreign venture capital investors	NA
Earnings data of indirectly-held FDI enterprises	Earnings data of indirectly-held FDI enterprises	NA
Control premium	Control premium	NA
Non-competition fee	Non-competition fee	NA
	Imported Equipment	NA
	Round-tripping of capital	NA

Source: Nirupam Bajpai and Nandita Dasgupta (2004)<sup>21</sup>

It is evident from Table 2 that China adheres to the IMF standard of FDI accounting. It not only includes all the twelve items in its definition of FDI but also considers imported equipment as FDI. In addition, round-tripping of funds has greatly contributed to growth of FDI data. Under round-tripping Chinese residents move money i.e. domestic cash to off-shore centers such as Taiwan, Hong Kong, and Macao that in turn gets invested in mainland China as FDI inflows. Estimates suggest that round-tripping of funds accounted for one-third of FDI inflows. In addition, China includes certain items such as non-competition fees and imported equipment which do not strictly fall under the purview of FDI. As a result, the net FDI inflows into China increase further substantially.

Table 2 further reveals that the Indian FDI statistics looks significantly small in relation to that of China. India did not consider any other items other than equity capital reported on the basis of issue or transfer of equity or preference shares to foreign direct investors. India strictly goes by 'productive assets' criterion in computing FDI. It excluded other components such as reinvested earnings, inter-company debt transactions, overseas commercial borrowings etc. which are included in other country statistics including China. Of these, the important component of FDI is 'reinvested earning' which deserves special attention.

China includes reinvested earning as a separate item of FDI, however India does not. India has multinationals for many

years and many of them have reinvested their earnings in India over the years. Citibank, P&G, for example, do not repatriate their profits, instead they use them for expansion within India. Reinvestment by multinationals was not considered in computation of FDI in India. However, China includes such reinvestments in its FDI computation. Similarly \$300 million brought by FIAT in non-equity form to compensate losses made by its Indian subsidiary was not considered as part of FDI in India. Further, hundreds of millions of dollars invested through venture capital route also do not form part of India's FDI statistics. As a result, the actual inflows in India were substantially underestimated in FDI reporting in comparison with other countries. There was a vocal effort to change FDI measurement in order to synchronize it with the rest of the world. Accordingly, the Government of India constituted in 2002 a committee to bring the reporting of FDI data in alignment with the international practices and changed the definition of FDI in 2003, with retrospective effect from 2001 (The Hindu, June 2003). According to the new definition retained earnings and inter-company debt transactions of foreign companies operating in India constituted FDI, in addition to the original dollar equity investments. As per the new formula, India's FDI inflows shot up to \$9-10 billion a year compared to an average of \$4 billion. FDI investment ranged from US \$20 billion to US \$42 billion from 2006 to 2008. Thus, a change in definition would increase India's FDI figures manifold helping it project itself as a more attractive destination of foreign investment vis-à-vis China. A reconciliation of the FDI inflows on a compatible basis would therefore make the comparison between FDI investments for two countries more equitable.

**BASIS OF RECONCILIATION**

The authoritative opinions of the well known individuals and regulatory institutions are considered to workout the arithmetic of reconciliation:



- "A large scale share of investment inflow in China represents round tripping-recycling of the domestic savings via Hong Kong to take advantage of tax, tariffs and other benefits offered to non-resident Chinese. This is estimated to be in the range of 40-50 percent of the total FDI" (IFC, Global Financial Report, 2002).

- "China's figures are over inflated by a factor of one-third. This scales down FDI inflows into China to around \$26 billion. Half of China's FDI inflows are believed to be round tripping. These scales down to \$13 billion. A large chunk of China FDI (40 percent) goes into real estate. Chinese FDI figures are more like \$8 billion" (Parth Ghosh, 2003).
- "China includes all the components of IMF in its definition of FDI. It also classifies imported equipment as FDI, while India captures these as imports in its trade data. China's FDI numbers also include a substantial amount of round tripping. Especially the fact that FDI inflows in India are entirely measured on equity investments while ignoring other components implies that FDI inflows into India have been underestimated" (Nirupam Bajpai & Nandita Das Gupta, 2004).
- "World Bank reports have estimated that almost 50% of China's foreign investment could be domestic cash" (Vidyasagar, 2005).

From the preceding observations, it is clear that there is a need to make necessary adjustments in China's FDI statistics. The items that China includes in its FDI, but do not strictly fall under the purview of FDI are to be excluded. China's FDI inflows are reconciled considering Parth Ghosh's observation and are presented in Table 3.

Table 3 presents comparative FDI inflows between China and India after incorporating appropriate adjustments. The reported FDI inflows to China are reduced by a factor of one-third in the first instance, considering the over inflation in the reported FDI data. From the balance, 50 per cent is reduced further as half of the China's FDI inflows are believed to be round-tripping. Subsequently, a 40 per cent deduction is made so as to set-off the FDI inflows into real estate. The resultant data denotes the reconciled amount of FDI that is comparable to FDI inflows to India. It is evident that the gaps between FDI inflows in China and India after reconciliation are not phenomenal and the gap has even decreased over a period of time. The global investors, therefore, need not have any apprehensions about India's dwindling FDI inflows vis-à-vis China.

**Table 3: Reconciliation of China's FDI Inflows**

(Amount in US \$Billions)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Reported FDI Inflows to China	4.4	11	27.5	33.8	37.8	40.6	44.2	43.8	40.3	40.8	48.8	55	53.5	60.6	60.3	63	74.8	92.4
(Less), over inflation(a factor of one third)	1.4	3.7	9.2	11.3	12.5	13.4	14.7	14.6	13.4	13.6	16.3	18.3	17.8	20.2	20.1	21.0	24.9	30.8
	3	7.3	18.3	22.3	25	26.8	29.5	29.2	26.9	27.2	32.5	36.7	35.7	40.4	40.2	42.0	49.9	61.6
(Less) , Round tripping (50%)	1.5	3.6	9.1	11.2	12.5	13.4	14.7	14.6	13.4	13.6	16.2	18.3	17.8	20.2	20.1	21.0	24.9	30.8
	1.5	3.7	9.2	11.3	12.5	13.5	14.8	14.6	13.5	13.6	16.3	18.4	17.9	20.2	20.1	21.0	24.9	30.8
(Less), FDI to real estate (40%)	0.6	1.5	3.6	4.5	5	5.3	5.9	5.8	5.4	5.4	6.5	7.3	7.1	8.1	8	8.4	10.0	12.3
Reconciled FDI inflows	0.9	2.2	5.6	6.8	7.5	8.1	8.9	8.9	8.1	8.2	9.8	11.1	10.8	12.1	12.1	12.6	15.0	18.5
Indo-China FDI Gaps (Before Reconciliation)	4.1	10.9	27.2	33.2	36.2	37.6	40.6	41.2	38.1	38.5	44.8	48.9	48.9	55.3	54.3	43.3	49.7	50.8
Indo-China FDI Gaps (After Reconciliation)	0.8	1.9	5.3	6.2	6.2	5.5	5.3	6.2	5.9	5.9	5.8	5	6.2	6.8	6.1	4.3	5.0	4.0

Source: Calculations using data from Table 1 on the basis of reconciliation framework.



## CONCLUSION

The preceding discussions reveal that there are cross-country differences in computing FDI which are likely to lead to wrong conclusion about a country's potential attractiveness and credibility. There is a need for a globally acceptable definition of FDI and its universal implementation. In addition, management control is regarded as a prerequisite for the non-residents to manage the assets for being considered as FDI. There is also an inter-country variation in defining the share of equity holding for the purpose of management control; there is a need to dispense with these variations. China, for example, offers substantial tax benefits to foreign investors whereas India does not distinguish

between foreign investment and indigenous investment for corporate taxation. This fiscal bias tends to distort the FDI inflows and makes the data incomparable. However, reducing FDI gaps through accounting adjustments alone does not serve the purpose. It is imperative to create viable, efficient, and friendly investment climate to attract large sums of FDI. Bureaucratic tangle, infrastructure drawbacks, labor laws, work culture, etc. should be addressed for creating an enabling environment. In addition, there is a pressing need to inject an entrepreneurial sense in the overseas residents to boost FDI inflows. We hope our paper brings these issues to light and initiates a meaningful discussion regarding the consistency in FDI measurement and its universal implementation.

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