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Foreign Direct Investment in India: Sectoral Exceptions and Federal Incoherence Between Centre and States: A Constitutional and Policy Critique

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Abstract
India's Foreign Direct Investment (FDI) policy has evolved to attract global investors, yet sectoral exceptions and state-level disparities continue to pose challenges. This study critically examines the inconsistencies between central FDI policies and state-level regulations, focusing on how these discrepancies affect investment inflows.
Employing a doctrinal legal research methodology, the paper analyzes constitutional provisions, including Articles 246 and 254, and the Seventh Schedule, to understand the division of legislative powers between the Centre and the States. It also reviews policy documents, such as the Consolidated FDI Policy and the Foreign Exchange Management Act (FEMA), alongside case studies highlighting state-level resistance in sectors like multi-brand retail and e-commerce.
Findings indicate that states with robust institutional frameworks, such as Maharashtra and Karnataka, attract higher FDI inflows, while others lag due to factors like inadequate infrastructure and regulatory hurdles. The study underscores the role of institutional quality, as highlighted by Goswami (2024), in influencing FDI distribution across states. Moreover, the research identifies the lack of a harmonized approach between central and state governments as a significant barrier to uniform FDI growth.
The paper concludes by recommending the establishment of a federal coordination mechanism to align FDI policies across different government levels. It advocates for policy reforms that consider state-specific needs while maintaining national investment objectives, aiming to create a more cohesive and investor-friendly environment.

Keywords: Foreign Direct Investment, Sectoral Exceptions, Federalism, Institutional Quality, Investment Policy

INTRODUCTION

Since the economic liberalization of 1991, India has progressively opened its markets to foreign direct investment (FDI), positioning itself as a major global investment destination. The liberalization measures, initiated under the New Industrial Policy, significantly diluted the license- permit regime and allowed foreign capital to flow into key sectors of the economy. Over time, successive governments have further liberalized sectoral limits, introduced the automatic route for various industries, and consolidated FDI norms through circulars under the aegis of the Department for Promotion of Industry and Internal Trade (DPIIT) and the Reserve Bank of India (RBI) under the Foreign Exchange Management Act, 1999 (FEMA).[1]

However, despite an ostensibly centralized policy regime, FDI in India is not without complexities. Certain sectors remain either partially open or entirely prohibited for foreign investors. These include multi-brand retail trading, atomic energy, lottery, chit funds, and agricultural activities (excluding certain plantation sectors), which are governed by sectoral caps and specific entry conditions under the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019.[2] While these restrictions are centrally imposed, their implementation often requires significant cooperation from state governments, particularly in areas where state legislations or administrative control dominate—such as land acquisition, labour regulation, trade licensing, and environmental clearances.[3]

The federal structure of India, as envisaged by the Constitution, divides legislative authority between the Union and State governments. While FDI is regulated under Entry 41 of List I (Union List), state governments exert considerable influence over industries and enterprises under Entry 24 of the State List and Entry 20 of the Concurrent List.[4] This overlap leads to jurisdictional tensions and implementation gaps. For instance, although the central government allowed up to 51% FDI in multi-brand retail trading, several states, including West Bengal and Kerala, opted out

[1] Foreign Exchange Management Act 1999; see also DPIIT, FDI Policy Circular of 2020 https://dpiit.gov.in accessed 15 April 2025.

[2] Foreign Exchange Management (Non-Debt Instruments) Rules 2019, r 16; Consolidated FDI Policy 2020, paras 5.1–5.2.

[3] Rohit Sachdev, 'Doctrinal Conflict in Foreign Investment Regulation in India' (2020) Columbia Journal of Transnational Law https://scholarship.law.columbia.edu accessed 15 April 2025.

[4] Constitution of India 1950, Seventh Schedule, List I Entry 41; List II Entry 24; List III Entry 20.

of the policy due to political and economic concerns.[5] Similarly, the legal and regulatory responses of states to sectors like e-commerce, online gaming, and mining have created significant uncertainty for investors, who face inconsistent treatment across jurisdictions.[6]

This research addresses the growing friction between centrally formulated FDI policies and state- level resistance or divergence. The paper investigates key sectoral exceptions to FDI and analyses how state laws, policies, or executive decisions create inconsistencies that impact legal certainty, investor confidence, and the constitutional balance of power.

RESEARCH QUESTIONS

1. What are the key sectoral exceptions to FDI in India and their justifications?
2. How do state laws or executive actions create friction with centrally governed FDI policies?
3. What are the constitutional implications of this Centre–State incoherence?

LITERATURE REVIEW

"Constitutional Friction in FDI Governance"

Rajesh Sharma (2018), in Foreign Direct Investment: Law and Policy in India, provides a detailed account of how the Indian Constitution allocates legislative competence over foreign trade and investment. He emphasizes that while FDI is governed by the Centre through FEMA and Entry 41 of List I, states exert indirect control via land, labour, and local governance leading to friction in implementation. Sharma particularly critiques the lack of enforceable consultation mechanisms between Union and State governments in matters of FDI sectoral liberalization. Sharma's work establishes the constitutional conflict but stops short of offering structural solutions for harmonization. It also does not engage with newer regulatory frictions in digital sectors such as e- commerce or gaming.[7]

[5] Centre for Policy Research, 'FDI in Retail: A Political and Constitutional Debate' (2014) https://cprindia.org accessed 15 April 2025.
[6] Ranjit Goswami, 'Institutional Factors and FDI in Indian States' (2024) 18(2) Indian Journal of Economic Policy 45.
[7] Rajesh Sharma, Foreign Direct Investment: Law and Policy in India (LexisNexis 2018).

"Sectoral Incoherence and Institutional Divergence"
Ranjit Goswami (2024), in Institutional Factors and FDI in Indian States, presents empirical data showing that states with better regulatory institutions (e.g., Maharashtra, Karnataka) align more readily with central FDI policies. Conversely, states with political resistance or administrative bottlenecks delay or reject central FDI reforms especially in multi-brand retail, liquor, and online platforms. His analysis underscores how FDI inflows are shaped not just by national policy but by sub-national institutional quality. Goswami identifies institutional disparities but does not explore the legal mechanisms—such as constitutional doctrines or conflict resolution tools that can address these inconsistencies between levels of government.[8]

CHAPTER 1

Constitutional and Statutory Framework of FDI in India

India's legal framework for Foreign Direct Investment (FDI) is rooted in a unique constitutional structure that combines centralized legislative power with a federal administrative reality. The division of powers between the Union and the States, though well-articulated in theory under the Constitution, becomes complex in practice when applied to dynamic, globalized areas such as FDI. This chapter examines the constitutional and statutory foundations that govern FDI in India, laying the groundwork for understanding how inconsistencies arise in its sectoral and subnational implementation.

The Constitution of India, through Article 246 and the Seventh Schedule, demarcates legislative competence among the Union and State governments. Entry 41 of the Union List vests exclusive power in the Union Parliament to legislate on "trade and commerce with foreign countries, import and export across customs frontiers."[9] Consequently, the legal authority to formulate and regulate FDI policy lies entirely with the central government. However, investment operations often intersect with matters under State control. For example, Entry 24 of the State List concerns "industries" (subject to provisions of Entries 7 and 52 of the Union List),[10] and Entry 18 governs land – both of which are frequently engaged in the implementation of FDI projects. The Concurrent

[8] Ranjit Goswami, 'Institutional Factors and FDI in Indian States' (2024) 18(2) Indian Journal of Economic Policy 45.
[9] Constitution of India 1950, Sch VII, List I, Entry 41.
[10] Constitution of India 1950, Sch VII, List II, Entry 24; read with List I, Entries 7 and 52.

List (Entry 20: "economic and social planning") further allows both levels of government to legislate on economic issues, creating overlaps in governance.[11]

This constitutional structure has given rise to regulatory ambiguity when states, despite having no power to legislate directly on FDI, influence investment outcomes by exercising authority over allied subjects such as land use, labour laws, environmental regulations, and local trade licensing. The primary legislation governing FDI in India is the Foreign Exchange Management Act, 1999 (FEMA). Enacted to replace the restrictive Foreign Exchange Regulation Act (FERA), FEMA enables the Central Government through the Reserve Bank of India (RBI) – to regulate foreign exchange transactions related to capital account flows.[12] FDI is classified under capital account transactions and is therefore regulated by the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, which lay out sector-specific caps, automatic versus government approval routes, and conditions for foreign participation.[13]

While FEMA establishes a uniform national regime, its implementation can often be impeded at the state level. For instance, a foreign investor entering through the automatic route in a permitted sector still requires state-level clearances—such as for land acquisition, local permits, or environmental consents—which are not governed by FEMA, and may be delayed or denied for political or economic reasons.[14]

The doctrine of repugnancy, enshrined in Article 254, provides that when there is a conflict between central and state laws on matters in the Concurrent List, the central law prevails.[15] However, many of the issues surrounding FDI inconsistencies arise not from direct legal contradiction, but from indirect executive resistance or policy divergence, which Article 254 does not directly resolve. Similarly, the doctrine of pith and substance helps in determining legislative competence by identifying the true nature of a law. If a state's law primarily deals with a subject within its domain, incidental overlaps with Union subjects are permitted.[16] However, this

[11] Constitution of India 1950, Sch VII, List III, Entry 20.
[12] Foreign Exchange Management Act 1999, ss 2(a), 6.
[13] Foreign Exchange Management (Non-Debt Instruments) Rules 2019, r 16.
[14] Rohit Sachdev, 'Doctrinal Conflict in Foreign Investment Regulation in India' (2020) Columbia Journal of Transnational Law https://scholarship.law.columbia.edu accessed 16 April 2025.
[15] Constitution of India 1950, art 254.
[16] State of Bombay v F.N. Balsara AIR 1951 SC 318.

flexibility, while beneficial to cooperative federalism, also allows states to indirectly obstruct central FDI liberalization efforts such as in the case of multi-brand retail, where states have refused to implement centrally approved FDI policies through their local trade regulations or zoning norms.[17]

The Department for Promotion of Industry and Internal Trade (DPIIT) is the key policy body overseeing FDI inflows. It issues periodic consolidated FDI policies, most recently in 2020,[18] and coordinates with sectoral ministries to shape India's investment framework. However, DPIIT lacks binding authority over

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states. There is no constitutionally mandated mechanism requiring state compliance with FDI decisions taken at the Centre—particularly in sectors where implementation intersects with state jurisdiction. This structural deficiency has resulted in fragmented policy implementation: the Centre permits FDI in certain sectors, but states may reject or delay their execution, thereby undermining the policy's intended economic outcomes.[19]

CHAPTER 2

Sectoral Exceptions in India's FDI Policy

Despite India's consistent efforts to liberalize its foreign direct investment (FDI) regime since the early 1990s, a range of sectors remain subject to complete or partial restrictions. These sectoral exceptions form a critical component of the country's investment policy, reflecting considerations of national security, socio-economic sensitivities, and regulatory caution. However, these exceptions also give rise to legal and operational complexities, especially in a federal structure where implementation depends heavily on state-level agencies. This chapter examines the legal architecture and implications of such sectoral exceptions, and how they often create space for inconsistencies between central FDI policies and state-level responses.

Under the Consolidated FDI Policy issued by the Department for Promotion of Industry and Internal Trade (DPIIT), alongside the Foreign Exchange Management (Non-Debt Instruments)

[17] Centre for Policy Research, 'FDI in Retail: A Political and Constitutional Debate' (2014) https://cprindia.org accessed 16 April 2025.

[18] DPIIT, 'Consolidated FDI Policy Circular of 2020' https://dpiit.gov.in accessed 16 April 2025.

[19] Ranjit Goswami, 'Institutional Factors and FDI in Indian States' (2024) 18(2) Indian Journal of Economic Policy 45.

Rules, 2019, India classifies sectors into three broad categories—permitted under the automatic route, permitted under the government route, and prohibited sectors. Among the sectors where FDI is entirely prohibited are lottery and gambling, chit funds, trading in transferable development rights, atomic energy, and agricultural activities not specifically exempted. These restrictions are primarily grounded in moral, cultural, or strategic considerations. For instance, gambling is widely banned across Indian states under public order and morality provisions, while atomic energy falls under the Union's exclusive legislative competence due to national security concerns.[20]

More nuanced, however, are the partially liberalized sectors that allow FDI under strict caps and conditional frameworks. In multi-brand retail, for example, FDI is permitted up to 51 percent, but only with mandatory compliance with backend infrastructure investment, local sourcing norms, and employment targets.[21] Likewise, defence manufacturing permits 74 percent FDI via the automatic route, with provisions for up to 100 percent subject to government approval in cases where the investment brings in new technology.[22] Media sectors, including print and broadcasting, are also capped, ostensibly to preserve national interest and editorial independence.[23]

Yet, the crux of the problem arises not from these limits themselves, but from the jurisdictional friction they generate. Many of these sectors fall into regulatory grey zones where state governments play a decisive, if indirect, role. Multi-brand retail presents a classic example: while permitted at the central level, its implementation is subject to state consent. Several states, including West Bengal, Tamil Nadu, and Kerala, have exercised their discretion to opt out of allowing FDI in this sector, citing political and socio-economic concerns.[24] This federal discretion, though legally permissible, results in a disjointed national investment landscape where the same investor may be welcome in one state and rejected in another.

Agriculture presents another such site of friction. While FDI in core agricultural operations is generally prohibited, there is increasing ambiguity with the rise of agritech platforms, contract

[20] Department for Promotion of Industry and Internal Trade, Consolidated FDI Policy Circular of 2020 (DPIIT 2020) para 5.1; Foreign Exchange Management (Non-Debt Instruments) Rules 2019, r 15.

[21] Consolidated FDI Policy 2020 (n 1) para 5.2.15.3.

[22] Consolidated FDI Policy 2020 (n 1) para 5.2.6.

[23] Consolidated FDI Policy 2020 (n 1) paras 5.2.4 and 5.2.5.

[24] Centre for Policy Research, 'FDI in Retail: A Political and Constitutional Debate' (2014) https://cprindia.org accessed 17 April 2025.

farming, and e-marketplaces. These models blur the lines between permitted digital infrastructure and prohibited core agricultural activity. Since agriculture is a State List subject, any central initiative to liberalise FDI in agritech, warehousing, or logistics must navigate the legal and administrative autonomy of state governments. In many instances, investor proposals have faced procedural delays or rejections, not due to violation of central policy, but because of incongruent or outdated state-level laws.[25]

The regulatory conflict is especially acute in emergent sectors such as online gaming and e- commerce. While FDI is technically permitted in marketplace-based e-commerce models, many states have raised objections on consumer protection or taxation grounds. The case of online gaming is even more complex. Despite significant foreign investment in digital gaming startups under the automatic route, several states including Tamil Nadu and Telangana have imposed sweeping bans on real-money gaming apps, citing public health, addiction, and youth welfare concerns.[26] These bans often run counter to central policy directions and are enforced through state-specific legislation, creating a fragmented regulatory environment.

The challenge is compounded by the fact that sectoral definitions themselves are often vague or inconsistently interpreted. Terms such as "backend infrastructure," "marketplace model," or "real estate development" are susceptible to multiple meanings, depending on the regulatory lens applied by state authorities. This definitional ambiguity, coupled with overlapping jurisdictional claims, leads to excessive discretion in the hands of local regulatory bodies, which investors must navigate on a case-by-case basis.[27]

In effect, the existence of sectoral exceptions does not just limit the scope of FDI—it also facilitates institutional and legal dissonance between the Centre and States. Even when central policies allow foreign investment under certain conditions, the successful execution of those investments depends heavily on state-level alignment in areas such as land acquisition, environmental clearance, licensing, and political will. Consequently, the formal legal framework of FDI sectoral regulation,

[25] Arpita Mukherjee and Souvik Dutta, 'FDI in Agriculture: Policy Barriers and Opportunities' (2021)

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Indian Council for Research on International Economic Relations https://icrier.org/pdf/FDI_Agriculture.pdf accessed 17 April 2025. [26] A Vaidyanathan, 'Tamil Nadu Government's Ban on Online Gaming Faces Legal Challenge' (The Hindu, 10 April 2023) https://www.thehindu.com accessed 17 April 2025.

[27] Ranjit Goswami, 'Institutional Factors and FDI in Indian States' (2024) 18(2) Indian Journal of Economic Policy 45.

while seemingly centralised, unfolds through a decentralised and often unpredictable administrative apparatus.

Thus, sectoral exceptions—especially in politically sensitive or hybrid-regulated domains— emerge as sites of federal tension, where the lack of harmonised policy design and definitional clarity leads to legal uncertainty and operational delays. Foreign investors must not only comply with central policy but also navigate an array of subnational interpretations, permissions, and restrictions that collectively determine the real accessibility of the Indian market.

CHAPTER 3

Centre–State Inconsistency in Practice – Case Studies and Policy Analysis

While India's foreign direct investment (FDI) regime is ostensibly centralised under the Foreign Exchange Management Act (FEMA) and related executive policies, the real-world implementation of FDI reveals persistent fractures within India's federal architecture. These inconsistencies arise not from direct statutory contradictions, but from administrative divergence, regulatory discretion, and political resistance at the state level. This chapter examines how FDI permissions often face delay or obstruction in specific states, using targeted case studies to reveal the tension between central policy and state-level execution.

Though the central government permitted 51% FDI in multi-brand retail under strict conditions in 2012, several states, including West Bengal, Tamil Nadu, and Kerala, opted out entirely, citing political and economic concerns.[28] These states exercised discretion over local trade licenses, zoning regulations, and administrative approvals to stall implementation, even in the absence of legal conflict. The opt-in model, while constitutionally sound, fragmented national execution and generated investor uncertainty.

Projects like POSCO's $12 billion steel plant in Odisha and Vedanta's Sterlite Copper unit in Tamil Nadu underscore how state-level environmental, political, and land-related resistance can override central FDI clearances.[29] Despite national-level approval, POSCO withdrew after prolonged delays, while Vedanta's plant was permanently shut down by the Tamil Nadu government citing environmental concerns.[30] The

[28] DPIIT, Consolidated FDI Policy Circular of 2012, para 6.2.16.5; Centre for Policy Research, 'FDI in Retail: A Political and Constitutional Debate' (2014) https://cprindia.org accessed 17 April 2025.

[29] Aditi Phadnis, 'POSCO's Exit Marks End of India's Largest FDI Dream' Business Standard (9 March 2017) https://www.business-standard.com accessed 17 April 2025.

[30] Amrit Raj, 'Why Tamil Nadu Shut Vedanta's Sterlite Copper Plant' Livemint (29 May 2018) https://www.livemint.com accessed 17 April 2025.

Supreme Court later upheld the state's decision.[31] These cases demonstrate that FDI feasibility depends as much on local governance and public perception as it does on central policy.

The emergence of digital FDI in online gaming highlights further disjunction between central permissiveness and state prohibition. While the central government allows FDI in online gaming and digital platforms,[32] several states—including Tamil Nadu and Telangana—have criminalised real-money gaming through state laws.[33] In Junglee Games v. State of Tamil Nadu, the Madras High Court struck down such a ban,[34] but new legislative attempts continue to create uncertainty. The constitutional friction here reflects unresolved questions about the reach of state morality laws versus centrally regulated digital spaces.

Investor apprehension about India's regulatory climate is further deepened by instances where central approvals are neutralised by state inaction or opposition. This layered uncertainty, even when not formally unlawful, undermines confidence. Investors have cited inconsistent enforcement and shifting ground realities in their bilateral investment treaty (BIT) disputes, including in Vodafone and Cairn, reinforcing India's reputation for legal unpredictability.[35]

RECOMMENDATIONS

1. Codify Cooperative Federalism in FDI Governance: Introduce a formal Federal Coordination Framework under FEMA or a new enabling statute to institutionalise state consultation in sensitive FDI sectors. This ensures legal uniformity while respecting state autonomy.[36]
2. Mandate Uniform Adoption of Sectoral Clarifications: All states should be required to formally adopt DPIIT's FDI clarifications through executive orders or notifications—ensuring that central guidelines are not diluted at the implementation stage.[37]

[31] Vedanta Ltd v State of Tamil Nadu (2019) SCC OnLine SC 815.

[32] Ministry of Electronics and Information Technology, Draft Rules for Online Gaming (2023) https://meity.gov.in accessed 17 April 2025.

[33] The Tamil Nadu Prohibition of Online Gambling and Regulation of Online Games Act 2022.

[34] Junglee Games India Pvt Ltd v State of Tamil Nadu (2021) Mad HC Writ Appeal No. 755 of 2021.

[35] UNCTAD Investment Policy Hub, 'Cairn Energy v. Republic of India' https://investmentpolicy.unctad.org accessed 17 April 2025.

[36] Government of India, Standing Committee on Commerce Report on FDI in Retail Sector (2013) Rajya Sabha Secretariat https://rajyasabha.nic.in accessed 17 April 2025.

[37] DPIIT, Consolidated FDI Policy Circular of 2020 (DPIIT 2020) para 1.5.

3. Introduce a Grievance Redressal Cell for State-Level FDI Delays: Set up a quasi-judicial authority under DPIIT where foreign investors can report delays caused by state departments, with escalation to the Cabinet Committee on Investment in high-value projects.[38]
4. Adopt a Model State FDI Facilitation Bill: Draft and circulate a model law that states can voluntarily adopt, aligning land, labour, licensing, and environmental approvals with central FDI norms on lines of the model GST law.[39]
5. Expand Judicial Doctrine to Cover Executive Inconsistency: Advocate for judicial recognition of "executive repugnancy", where state administrative resistance frustrates the object of a central law, even without direct legislative conflict.[40]

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CONCLUSION

India's FDI regime, though centrally crafted and globally ambitious, is undermined by federal fragmentation at the implementation level. Sectoral exceptions—when filtered through the complex lens of state autonomy, political discretion, and administrative inertia—generate inconsistencies that hinder investment certainty. This paper has shown that the legal tension between national policy and state-level execution is not merely administrative but structural, rooted in constitutional asymmetries and undefined cooperative mechanisms. Addressing this challenge requires more than policy liberalization it demands institutional innovation. Harmonising Centre–State dynamics, clarifying sectoral definitions, and codifying federal consultation are essential to restoring investor confidence. Without these reforms, India's FDI potential will remain constrained not by legislation, but by the very governance structure meant to uphold it.

[38] Cabinet Secretariat, National Investment Facilitation and Promotion Strategy (NITI Aayog, 2020) https://niti.gov.in accessed 17 April 2025.

[39] Ministry of Law and Justice, Guidelines for Drafting Model Legislation for States (2022) https://legislative.gov.in accessed 17 April 2025.

[40] State of Kerala v Mar Appraem Kuri Co Ltd (2012) 7 SCC 106.