

# An Analysis on the Efficacies and Drawbacks of Foreign Direct Investment with Particular Reference to India

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## **ABSTRACT:**

*Presently, the concept of Foreign Direct Investment or FDI is becoming a part of India's economic future which affects the economic growth by stimulating domestic investment, increasing human capital formation and by facilitating the technology transfer in the host countries. India needs FDI for achieving the economic reforms and maintain the pace of growth and development of the economy. Initially, the FDI inflows in India were low due to the policy framework but there is a sharp rise in investment flows from 2005 onwards because of the introduction of the new industrial and economic policy.*

*The aim of this paper is to point out the affirmative and negative implications which affect the economic scenario of our country and will also try to provide certain suggestions or remedial measures which will be helpful towards the country's*

*economy in terms of foreign direct investment.*

## **KEYWORDS:**

Foreign Direct Investment; Economic Growth; Domestic Investment; Human Capital Formation; Technology Transfer; Inflow; Investment; Economic Policy Etc

## **1. INTRODUCTION AND THE CONCEPT**

Foreign direct investment (FDI) or foreign investment<sup>1</sup> refers to the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-

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<sup>1</sup> Role of Foreign Direct Investment in the Development of Indian Economy by Kali Ram Gola, Mridul Dharwal, Ankur Agarwal, available on <http://accman.in/images/feb13/Dharwal%20M.pdf> last visited on dated 30.05.2014 at about 6.06 P.M

term capital as shown in the balance of payments. It usually involves participation in management, joint-venture, transfer of technology and expertise. There are two types of FDI: inward foreign direct investment and outward foreign direct investment, resulting in a net FDI inflow (positive or negative) and "stock of foreign direct investment", which is the cumulative number for a given period.

Capital is stated as the engine of economic growth. Foreign direct investment (FDI) plays an extraordinary and growing role in global business. It can provide a firm with new markets and marketing channels, cheaper production facilities, access to new technology, products, skills and financing. For a host country or the foreign firm which receives the investment, it can provide a source of new technologies, capital, processes, products, organizational technologies and management skills, and as such can provide a strong impetus to economic development. Foreign direct investment, in its classic definition, is defined as a company from one country making a physical investment into building a factory in another country.<sup>2</sup> FDI plays a vital

role in the process of economic development particularly in the capital scarce country, where the domestic base of created assets like technology, skills and entrepreneurship are quite limited. It provides financial resources for investment in a host country and thereby augments domestic saving efforts. It also plays an important role in accelerating the pace of economic growth. FDI provides the much needed foreign exchange to help the bridge the balance of payment or trade deficit. FDI brings complementary assets such as technology, management and organizational competencies and there are spillover effects of these assets on the rest of the economy. FDI is treated as a main engine of economic growth and technological development which provides ample opportunities in accelerating economic development. FDI contributes to exports directly and an enhanced export possibility contributes to the growth of the host economies by relaxing demand side constraints on economic growth.<sup>3</sup>

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<sup>2</sup> Role of Foreign Direct Investment in Indian Small Scale Industries by Prof. M. Ghoshal & Prof. Shilpi Saxena, available on [http://www.ijmra.us/project%20doc/IJMIE\\_MAY201](http://www.ijmra.us/project%20doc/IJMIE_MAY201)

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2/IJMRA-MIE1133.pdf last visited on dated 30.05.2014 at about 5.50 P.M

<sup>3</sup> TRENDS AND DETERMINANTS OF FOREIGN DIRECT INVESTMENT IN INDIA: AN EMPIRICAL INVESTIGATION by Priyanka Sahni, available on [http://www.ijmra.us/project%20doc/IJMT\\_AUGUST](http://www.ijmra.us/project%20doc/IJMT_AUGUST)

One of the most striking developments<sup>4</sup> during the last two decades is the spectacular growth of FDI in the global economic landscape. This unprecedented growth of global FDI in 1990 around the world make FDI an important and vital component of development strategy in both developed and developing nations and policies are designed in order to stimulate inward flows. In fact, FDI provides a win – win situation to the host and the home countries. Both countries are directly interested in inviting FDI, because they benefit a lot from such type of investment. The ‘home’ countries want to take the advantage of the vast markets opened by industrial growth. On the other hand the ‘host’ countries want to acquire technological and managerial skills and supplement domestic Savings and foreign exchange. Moreover, the paucity of all types of resources viz. financial, capital, entrepreneurship, technological know- how, skills and practices, access to markets- abroad- in their economic development, developing nations accepted FDI as a sole

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2012/IJMRA-MT1472.pdf last visited on dated 30.05.2014 at about 5.55 P.M

<sup>4</sup> TRENDS AND PATTRENS OF FDI IN INDIA AND ITS ECONOMIC GROWTH by MR.SHASHANK GOEL; MR. K. PHANI KUMAR; PROF. K. SAMBASIVA RAO, available on <http://www.aijsh.org/setup/business/paper141.pdf> last visited on dated 30.05.2014 at about 5.55 P.M

visible panacea for all their scarcities. Further, the integration of global financial markets paves ways to this explosive growth of FDI around the globe.

### 1.1 What is the meaning of FDI?

The Foreign Direct Investment<sup>5</sup> means “cross border investment made by a resident in one economy in an enterprise in another economy, with the objective of establishing a lasting interest in the investee economy. FDI is also described as “investment into the business of a country by a company in another country”. Mostly the investment is into production by either buying a company in the target country or by expanding operations of an existing business in that country”. Such investments can take place for many reasons, including to take advantage of cheaper wages, special investment privileges (e.g. tax exemptions) offered by the country etc.

FDI<sup>6</sup> refers to the act of investing capital in a business enterprise that operates overseas and in a foreign country. The party

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<sup>5</sup> Available on <http://www.allbankingsolutions.com/Banking-Tutor/FDI-in-India.htm> last visited on dated 01.08.2014 at about 6.53 A.M

<sup>6</sup> Advantages and Disadvantages of FDI, available on <http://www.buzzle.com/articles/advantages-and-disadvantages-of-fdi.html> last visited on dated 30.05.2014 at about 5.27 P.M

making the investment could be an individual, a business corporation, or maybe even a group of companies, and the enterprise that receives the investment will definitely benefit from this. What this ultimately means though, is that the party making the investment has a long-lasting interest in the other party, and they also get a say in matters regarding the functioning of that enterprise. The minimum voting rights, or shares of an enterprise, that a foreign investor is supposed to control is 10%. This holds relevant in cases where a foreign investor opens up a whole new business operation in another country after collaborating with a local player (Green-Field investment), or it simply merges with a local enterprise for the same purpose. In addition to this, FDI is also carried out either horizontally (with an enterprise in the same industry with market expansion as the sole purpose) or vertically (with the aim of sharing resources like capital and expertise).

### 1.2 Definition of FDI<sup>7</sup>

The most widely accepted definition of FDI is known as “the IMF/OECD

benchmark definition” because it was provided by a joint workforce of these two international organizations with the objective of providing standards to national statistical offices for compiling FDI statistics. The gist of the definition is that FDI is an international venture in which an investor residing in the home economy acquires a long-term “influence” in the management of an affiliate firm in the host economy. According to the definition, the existence of such long-term influence should be assumed when voting shares or rights controlled by the multinational firm amount to at least 10 percent of total voting shares of rights of the foreign firm.

Aggregate FDI flows are the sum of equity capital, reinvested earnings, and other direct investment capital; hence, aggregate FDI flows and stocks include all financial transfers aimed at financing of new investments, plus retained earnings of affiliates, internal loans, and financing of cross-border mergers and acquisitions. FDI flows can be observed from the perspective of the host economy, which records them as inward FDI along with other liabilities in the balance of payments, or from the perspective of the home economy, which records them as outward FDI, a category of assets.

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<sup>7</sup> Foreign Direct Investment, Productivity, and Country Growth: An Overview by Silvio Contessi and Ariel Weinberger, available on <http://research.stlouisfed.org/publications/review/09/03/Contessi.pdf> last visited on dated 30.05.2014 at about 5.23 P.M

### 1.3 Types of FDI

Generally FDI can be divided into the following three categories:<sup>8</sup>

- 1) Horizontal FDI arises when a firm duplicates its home country-based activities at the same value chain stage in a host country through FDI.
- 2) Platform FDI Foreign direct investment from a source country into a destination country for the purpose of exporting to a third country.
- 3) Vertical FDI takes place when a firm through FDI moves upstream or downstream in different value chains i.e., when firms perform value-adding activities stage by stage in a vertical fashion in a host country.

## 2. CONTEXTUAL BACKGROUND OF FDI IN INDIA

After the Indian independence in 1947, FDI gained attention of the policy makers for acquiring advanced technology and to mobilize foreign exchange resources. In order to boost the FDI inflows in the country Indian government allowing frequent equity participation to foreign

enterprises apart from provides many incentives such as tax concessions, simplification of licensing procedures and de-reserving some industries like drugs, fertilizers, aluminum etc. But due to significant outflow of foreign reserve in the form of remittances of dividends, profits, royalties etc in 1973 government of India set up Foreign Investment Board and enacted Foreign Exchange Regulation Act in order to regulate flow of FDI to India. Further Government of India set up Foreign Investment Promotion Board (FIPB) for processing of FDI proposals in India. The Board is the apex inter-ministerial body of the Central Government that deals with proposals relating to FDI into India for projects or sectors that do not qualify for automatic approval by the Reserve Bank of India (RBI) or are outside the parameters of the existing FDI policy.<sup>9</sup>

It could be observed<sup>10</sup> that there has been a steady build up in the actual FDI inflows in the pre-liberalization period. But measures introduced by the government to

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<sup>8</sup> Foreign direct investment, available on [http://en.wikipedia.org/wiki/Foreign\\_direct\\_investment](http://en.wikipedia.org/wiki/Foreign_direct_investment) last visited on dated 01.08.2014 at about 6.54 A.M

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<sup>9</sup> Impact of Foreign Direct Investment on Indian economy by Mahanta Devajit, Research Journal of Management Sciences, ISSN 2319-1171, Vol. 1(2), 29-31, September (2012), available on <http://www.isca.in/IJMS/Archive/v1i2/5.ISCA-RJMgtS-2012-020.pdf> last visited on dated 30.05.2014 at about 6.05 P.M

<sup>10</sup> Id.

liberalize provisions relating to FDI in 1991 increased FDI Rs.2705 crores in 1990 to Rs.123378 crores in 2010. The list of investing countries to India reached to 150 in 2010 as compared to 29 countries in 1991. Nevertheless, still a lion's share of FDI comes from only a few countries. The growth of FDI gives opportunities to Indian industry for technological up-gradation, gaining access to global managerial skills and practices, optimizing utilization of human and natural resources and competing internationally with higher efficiency.

### 3. AN OVERVIEW OF FDI IN INDIA

The historical background<sup>11</sup> of FDI in India can be traced back with the establishment of East India Company of Britain. British capital came to India during the colonial era of Britain in India. After Second World War, Japanese companies entered Indian market and enhanced their trade with India, yet U.K. remained the most dominant investor in India.

Further,<sup>12</sup> after Independence issues relating to foreign capital, operations of MNCs, gained attention of the policy makers. Keeping in mind the national

interests the policy makers designed the FDI policy which aims FDI as a medium for acquiring advanced technology and to mobilize foreign exchange resources. With time and as per economic and political regimes there have been changes in the FDI policy too. The industrial policy of 1965, allowed MNCs to venture through technical collaboration in India. Therefore, the government adopted a liberal attitude by allowing more frequent equity participation to foreign enterprises, and to accept equity capital in technical collaborations. But due to Significant outflow of foreign reserves in the form of remittances of dividends, profits, royalties etc, and the government has to adopt stringent foreign policy in 1970s. During this period the government adopted a selective and highly restrictive foreign policy as far as foreign capital, type of FDI and ownerships of foreign companies was concerned.

Government<sup>13</sup> setup Foreign Investment Board and enacted Foreign Exchange Regulation Act in order to regulate flow of foreign capital and FDI flow to India. The soaring oil prices continued low exports and deterioration in Balance of Payment position during 1980s forced the government to make necessary

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<sup>11</sup> Supra Note 4

<sup>12</sup> Id.

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<sup>13</sup> Id.



changes in the foreign policy. Thus, resulting in the partial liberalization of Indian Economy. The government introduces reforms in the industrial sector, aimed at increasing competency, efficiency and growth in industry through a stable, pragmatic and non-discriminatory policy for FDI flow.

In this critical face of Indian economy the government of India with the help of World Bank and IMF introduced the macro – economic stabilization and structural adjustment program. As a result of these reforms India open its door to FDI inflows and adopted a more liberal foreign policy in order to restore the confidence of foreign investors. Further, under the new foreign investment policy Government of India constituted FIPB (Foreign Investment Promotion Board) whose main function was to invite and facilitate foreign investment through single window system from the Prime Minister's Office. The foreign equity cap was raised to 51 percent for the existing companies. Government had allowed the use of foreign brand names for domestically produced products which was restricted earlier. India also became the member of MIGA (Multilateral Investment Guarantee

Agency) for protection of foreign investments.<sup>14</sup>

#### **4. POLICY INITIATIVE ON FDI BY INDIAN GOVERNMENT**

Foreign Investment<sup>15</sup> in India is governed by the FDI policy announced by the Government of India and the provision of the Foreign Exchange Management Act (FEMA) 1999. The Reserve Bank of India (RBI) in this regard had issued a notification, which contains the Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000. This notification has been amended from time to time. Department of Industrial Policy and Promotion (DIPP) under the Ministry of Commerce and Industry, Government of India is the nodal agency for monitoring and reviewing the FDI policy on continued basis and changes in sectoral policy/sectoral equity cap which goes from 26% to 100% at present. The FDI policy is notified through Press Notes/ Policy Circulars by the

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<sup>14</sup> Ibid.

<sup>15</sup> Foreign Direct Investment in Indian Retail Sector Pros and Cons by K. R. Kaushik & Dr. Kapil Kumar Bansal, International Journal of Emerging Research in Management & Technology ISSN: 2278-9359, available on [http://www.ermt.net/docs/papers/Volume\\_1/Issue\\_1\\_November2012/V2N1001.pdf](http://www.ermt.net/docs/papers/Volume_1/Issue_1_November2012/V2N1001.pdf) last visited on dated 30.05.2014 at about 5.43 P.M

Secretariat for Industrial Assistance (SIA), Department of Industrial Policy and Promotion (DIPP) Ministry of Commerce & Industry. FDI is allowed under Direct Route and Government. The foreign investors are free to invest in India, except few sectors/activities, where prior approval from the RBI or Foreign Investment Promotion Board (FIPB) would be required. FDI in retail sector is allowed through Government Route only.

Starting from a baseline of less than USD 1 billion in 1990, a recent UNCTAD survey projected India as the second most important FDI destination (after China) for transnational corporations during 2010-2012. As per the data, the sectors which attracted higher inflows were services, telecommunication, construction activities and computer software and hardware. Mauritius, Singapore, the US and the UK were among the leading sources of FDI.<sup>16</sup>

#### **4.1 Recent trend of foreign direct investment in India**

During April 2010, Mauritius invested US\$ 568 million in India, followed by Singapore which invested US \$434 million and Japan that invested US \$327 million according to latest data released by

DIPP. It shows that there has been a significant shift in the character of global capital flows to the India in recent years in that the predominance of private account capital transfer and especially portfolio investment increased considerably.<sup>17</sup>

The importance<sup>18</sup> of FDI received special impetus towards the end of 1992 when the Foreign Institutional Investors (FIIs) such as pension funds, mutual funds, investment trusts, asset management companies, nominee companies and incorporated / institutional portfolio managers were permitted to invest directly in the Indian stock markets. In order to attract portfolio investments which prefer liquidity, it has been advocated to develop the Indian stock markets. The foreign portfolio investment not only do they expand the demand base of the stock market, but also stabilize the market through investor diversification.

In order to have a flow of FDI,<sup>19</sup> India maintained Double Tax Avoidance Agreements (DTAA) with nearly 70 countries of the world. India has signed 57 (up to 2006) numbers of Bilateral Investments Treaties (BITS). The numbers

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<sup>16</sup> Supra Note 1

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<sup>17</sup> Supra Note 10

<sup>18</sup> Id.

<sup>19</sup> Id.



of BITS are signed with developing countries of Asia 16, the Middle East 9, Africa 4, and Latin America 1 apart from the developed nations 27. India as the founding member of General Agreement on Tariffs and Trade (GATT), World Trade Organization (WTO), a signatory member of South Asian Free Trade Area (SAFTA) and a member of Multilateral Investment Guaranty Agency (MIGA) is making its presence felt in the economic landscape of globalised economies which will help a conducive and healthy atmosphere for foreign investors and thus resulting in substantial amount of FDI inflows in the country. State wise FDI inflows show that Maharashtra, Delhi, Karnataka, Gujarat and Tamil Nadu together accounted more 75 percent of inflows during 2000-2010 because of the infrastructural facilities and favourable business environment provided by these states. Despite troubles in the world economy, India continued to attract FDI inflows mainly because Government of India open-up with flexible investment regimes and policies prove to be the horde for the foreign investors in finding the investment opportunities in the country.

## 5. PROBLEMS FOR LOW FDI FLOW TO INDIA

India,<sup>20</sup> the largest democratic country with the second largest population in the world, with rule of law and a highly educated English speaking work force, the country is considered as a safe haven for foreign investors. Yet, India seems to be suffering from a host of self-imposed restrictions and problems regarding opening its markets completely too global investors by implementing full scale economic reforms. Some of the major impediments for India's poor performance in the area of FDI are: political instability, poor infrastructure, confusing tax and tariff policies, Draconian labor laws, well entrenched corruption and governmental regulations. Hereby, it has been discussed as follows:<sup>21</sup>

### 1) **Lack of Adequate Infrastructure:**

It is cited as a major hurdle for FDI inflows into India. This bottleneck in the form of poor infrastructure discourages foreign investors in investing in India. India's age old and biggest infrastructure problem is the supply of electricity. Power cuts

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<sup>20</sup> FOREIGN DIRECT INVESTMENT AND ECONOMIC GROWTH IN INDIA by R. ANITHA, International Journal of Marketing, Financial Services & Management Research Vol.1 Issue 8, August 2012, ISSN 2277 3622, available on <http://indianresearchjournals.com/pdf/IJMFSMR/2012/August/8.pdf> last visited on dated 30.05.2014 at about 6.03 P.M

<sup>21</sup> Id.

are considered as a common problem and many industries are forced to close their business.

- 2) **Stringent Labor Laws:** Large firms in India are not allowed to retrench or layoff any workers, or close down the unit without the permission of the state government. These laws protect the workers and thwart legitimate attempts to restructure business. To retrench unnecessary workers, firms require approval from both employees and state governments-approval that is rarely given. Further, Trade Unions extort huge sums from companies through over-generous voluntary retirement schemes.
- 3) **Corruption:** Corruption is found in nearly every public service, from defense to distribution of subsidized food to the poor people, to the generation and transmission of electric power. Kumar (2000) observes that a combination of legal hurdles, lack of institutional reforms, bureaucratic decision-making and the allegations of corruption at the top have turned foreign investors away from India. Vittal (2001) states that corruption and misuse of public office for private gain are capable of

paralyzing a country's development and diverting its precious resources from public needs of the entire nation.

Corruption is against the poor people because it snatches away food from the mouths of

the poor. If corruption levels in India come down to those of Scandinavian countries, India's GDP growth will increase by 1.5 per cent and FDI will grow by 12 per cent

- 4) **Lack of decision making authority with the State Governments:** The reform process of liberalizing the economy is concentrated mainly in the Centre and the State Governments are not given much power. In most key infrastructure areas, the central government remains in control. Brazil, China, and Russia are examples where regional governments take the lead in pushing reforms and prompting further actions by the central government.
- 5) **Limited scale of Export Processing Zones:** India's export processing zones have lacked dynamism because of several reasons, such as their relatively limited scale; the Government's general ambivalence

about attracting FDI; the unclear and changing incentive packages attached to the zones; and the power of the central government in the regulation of the zones. India which established its first Export Processing Zone (EPZ) in 1965 has failed to develop the zones when compared to China which took initiative for establishment only in 1980.

6) **High Corporate Tax Rates:**

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

7) **Indecisive Government and Political Instability:**

There were too many anomalies on the government side during past two decades and they are still affecting the direct inflow of FDI in India such as mismanagement and oppression by the different company, which affect the image of the country and also deject the prospective investor, who are very much conscious about

safety and constant return on their investment.

### 5.1 Suggestions for increased flow of FDI into India<sup>22</sup>

Looking at the low- in-flow of FDI in India, the following suggestions are forwarded to improve and increase the FDI flow towards India:

1) **Flexible labour laws needed:**

China gets maximum FDI in the manufacturing sector, which has helped the country become the manufacturing hub of the world. In India the manufacturing sector can grow if infrastructure facilities are improved and labour reforms take place. The country should take initiatives to adopt more flexible labour laws.

2) **Re-look at sectoral caps:**

Though the Government has hiked the sectoral cap for FDI over the years, it is time to revisit issues pertaining to limits in such sectors as coal mining, insurance, real estate, and retail trade, apart from the small-scale sector. Government should allow more investment into the country under automatic route. Reforms like

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<sup>22</sup> Ibid.

bringing more sectors under the automatic route, increasing the FDI cap and simplifying the procedural delays has to be initiated. There is need to improve SEZs in terms of their size, road and port connectivity, assured power supply and decentralized decision-making.

3) **Geographical disparities of FDI should be removed:**

The issues of geographical disparities of FDI in India need to address on priority. Many states are making serious efforts to simplify regulations for setting up and operating the industrial units. However, efforts by many state governments are still not encouraging. Even the state like West Bengal which was once called Manchester of India attracts only 1.2% of FDI inflow in the country. West Bengal, Bihar, Jharkhand, Chhattisgarh are endowed with rich minerals but due to lack of proper initiatives by governments of these states, they fail to attract FDI.

4) **Promote Greenfield Projects:**

India's volume of FDI has increased largely due to Merger and Acquisitions (M&As) rather than large Greenfields projects. M&As not necessarily imply infusion of

new capital into a country if it is through reinvested earnings and intra company loans. Business friendly environment must be created on priority to attract large Greenfields projects. Regulations should be simplified so that realization ratio is improved (Percentage of FDI approvals to actual flows). To maximize the benefits of FDI persistently, India should also focus on developing human capital and technology.

5) **Develop Debt Market:**

India has a well developed equity market but does not have a well developed debt market. Steps should be taken to improve the depth and liquidity of debt market as many companies may prefer leveraged investment rather than investing their own cash. Therefore it is said that countries with well-developed financial markets tend to benefits significantly from FDI inflows.

6) **Education sector should be opened to FDI:**

India has a huge pool of working population. However, due to poor quality primary education and higher education, there is still an acute shortage of talent. FDI in Education Sector is lesser than one

percent. By giving the status of primary and higher education in the country, FDI in this sector must be encouraged. However, appropriate measure must be taken to ensure quality education. The issues of commercialization of education, regional gap and structural gap have to be addressed on priority.

- 7) **Strengthen research and development in the country:** India should consciously work towards attracting greater FDI into R&D as a means of strengthening the country's technological prowess and competitiveness.

These are some of the measures, adopting which India can attract more FDI towards India and can develop the economy of the country.

## 6. FDI EXPANSION TO LESS DEVELOPED ECONOMIES

Less developed countries (LDCs) have huge untapped natural resources. Moreover, these countries lack the capital investment and the technology to tap into these resources. This provides FDI with a lot of opportunity to exploit these resources and earn high returns on their investments. In recent years, FDI has been used more as a

market entry strategy for investors, rather than an investment strategy. Despite the decline in trade barriers, FDI growth has increased at a higher rate than the level of world trade as businesses attempt to circumvent protectionist measures through direct investments. With globalization, the horizons and limits have been extended and companies now see the world economy as their market. Additionally for investors, FDI provides the benefits of reduced cost through the realization of scale economies, and coordination advantages, especially for integrated supply chains. The preference for a direct investment approach rather than licensing and franchising can also be viewed in terms of strategic control, where management rights allows for technological know-how and intellectual property to be kept in-house.<sup>23</sup>

Less developed countries<sup>24</sup> usually have less stringent labour and environment laws. This provides Multi-national Corporations (MNCs) with an opportunity to lower their cost of production by taking advantage of these loopholes. Labour is usually cheaper and available in abundance

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<sup>23</sup> Foreign direct investment, available on <http://www.dineshbakshi.com/ib-economics/development-economics/169-revision-notes/2146-foreign-direct-investment>, last visited on dated 01.08.2014 at about 7.27 A.M

<sup>24</sup> Id.

in Less developed countries. The MNCs can considerably lower their cost of production. This gives advantage to the MNCs to compete in the international market. Less developed countries understand the importance of FDIs and have special policies to attract them. This might involve tax holidays, provision of cheaper land and government support. All these factors make it an attractive proposition for FDIs to invest in Less developed countries. examples include, tax holidays, Duty exemptions and drawbacks, Export tax exemptions, Subsidized credits and Credit guarantees. Some developing countries provide great promises in terms of being emerging markets. Brazil as well as India and China are all markets with huge populations and growing incomes. As incomes rise, the demand for all normal goods and services will increase, and there is thus potential for substantial profits to be made by companies that manage to establish a presence in these markets.

### 6.1 Foreign Direct Investment and developing countries

Here are some of the main factors that affect FDI in developing countries:<sup>25</sup>

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<sup>25</sup> How can Foreign Direct Investment help developing countries? Available on <http://unlimitedeconomicszone.over-blog.org/article-how-can-foreign-direct-investment-help-developing-countries-108953176.html> last visited on dated 01.08.2014 at about 7.30 A.M

- 1) **Macroeconomic stability:** This is the first thing which firms will look at when deciding where to invest. Stability is very important because it make investment easier since when inflation is stable, firms will be able to take into account the anticipated inflation into their future costs where as if inflation is out of control, firms will hold their investment or won't even invest at all. So, the Government need to foster a stable environment for business investment.
- 2) **Lower Corporate Taxes:** Level of taxation is very important. If taxes are high in a country, firm will not invest because a large proportion of their profits will be confiscated by the state so this is a very strong disincentive to invest. Also, to corporations, corporate taxes are a cost so they will pass it on to consumers through higher prices which lead to a general rise in price levels so lower corporate taxes will make a country more attractive for investment.
- 3) **Skilled Workforce:** Skilled workforce is very important to a firm who is transferring its capital to a

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different place/country because if a country's labour is unskilled, firms who want to invest will have to spend a fortune on training and education of their workforce which costs a lot and will outweigh the likely benefit of moving their production plant/capital to a new country. Also, their costs will also rise due to low productivity which at the end affects their profitability.

- 4) **Minimum Wage:** Firms look at labour as a cost and a production unit. When the government imposes a minimum wage, they simply interfere in the labour market and mass unemployment will be the result. Not only minimum wage hurts workers because firms have to lay workers off, but it also leads to a rise in costs which lowers firms profitability and firms have to pay workers the minimum wage regardless of their productivity which leads to lower productivity in general because whatever the worker produces in one hour, he will get the minimum wage. No wonder why the United Kingdom has a very low productivity among its European trading partners which again leads to

a rise in prices. So abolishing minimum wage is a great job creator and makes firms more inclined to invest and unemployment will fall of course. It is very important to know that there is a direct relationship between wage levels and levels of unemployment.

- 5) **Regulation:** Some regulations are good and need to be in place but most of the regulations are very costly and often seen as unnecessary to firms. Small businesses will get hit the hardest and often due to these heavy regulations, businesses won't start in the first place. In the case of big firms, they might not be hit as hard but this adds to their costs and these costs are passed on to consumers since corporations won't lower their profit margins so regulations won't in some cases help the consumer but in fact, it hurts them. Employment regulations will actually lead to firms not employing workers in the first place because it costs a lot for firms and the fact that firms won't be able to get rid of workers easily scares them away from the beginning so they just won't hire from the beginning. Some employment regulations are good

such as anti discrimination act which stops employers from discriminating on the basis of gender, race and disability. Another good regulation is basic health and safety, not the one we currently have.

- 6) **Free Trade:** Free trade allows firms to move capital around freely and export their products to wherever they want and also import whatever they want. For the sake of this topic, free trade allows firms to freely trade with no restrictions. For example, Imagine a firm in a protectionist country, they can't trade freely due to tariffs, quotas and embargoes. This affect their costs when trying to trade and in some cases, not being able to trade with the world markets means they will have a substantially smaller market to sell their products which minimises their profit levels and they won't be able to achieve economies of scale.

- 7) **National Debt:** If a country has high levels of national debt, this means that the real interest rates are high and if the government doesn't deal with its debts, the investor confidence will fall. Also high levels of taxation will soon follow because the debts will have to be paid of

eventually. Now as i mentioned earlier, high taxes are a disincentive to investment and high interest rates will mean lower borrowing which again puts investment off because it costs a lot to borrow so firms will not invest.

## 7. ADVANTAGES AND DISADVANTAGES OF THE FDI IN INDIA

Instead of calling the “Advantages and Disadvantages” it will be logical to term it as the positive and negative effects or impact of FDI. Below, it has been discussed in detailed:

### 7.1 Advantages/Positive Effect of FDI<sup>26</sup>

- 1) **Growth of Economy-** With the entrance of foreign companies there will be a need to grow infrastructure and automatically real-estate sector will spell the buzz word. Simultaneously for the money

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<sup>26</sup> Foreign Direct Investment (FDI) in Multi-Brand Retail and its probable impact on employment and investment with special emphasis on retail sector-A study by Analjyoti Basu & Bodhiswatta Ghosh, SIT Journal of Management Vol. 3. No. 1. June 2013. Pp. 136-166, available on <http://www.ejsit.org/journal2/journal10.pdf> last visited on dated 30.05.2014 at about 5.51 P.M

lending purpose banking sector will also experience the growth.

2) **Job Opportunities-** Estimates showed that the entrance of FDI will generate about 80 Lakh jobs mostly by retail sector followed by real-estate and it will be followed by the other sectors.

3) **Opportunity for the Farmer and Manufacturers-** Previously in the retailing business the intermediaries have dominated the space between the farmers/manufacturers and the retailers. In this process the intermediaries use to eat up the chunk of the profit as the farmers/manufacturers use to enjoy the losers side in terms of profit. But with introduction of FDI the concept of contract farming or manufacturing is going to capture the scenario where there will be no need for the intermediaries and the manufacturer or farmer can directly come into contact with retailers through contract.

4) **Benefits to Consumers-** With entrance to foreign investment and foreign goods consumers will get variety of products at low prices compared to the market prices. It

will give more choice for international brand at one place.

5) **Infrastructure Development-** India has large production for grains, fruits and vegetables but over the year the problem that surfaced was the lack of storage space which counted for unwanted loss and subsequently supply of crops was hampered. FDI can help it out by putting up lot of technically enabled storage space.

6) **Increase in government revenue<sup>27</sup>-** Government revenues are certainly going to increase a lot because of FDI. Government revenues will increase by 25 to 30 billion dollars which is a really big amount. This government revenue can help a lot in the development of Indian economy.

## 7.2 Disadvantages/Negative Effect of FDI

The disadvantages or negative effect of FDI can be summarized as follows:<sup>28</sup>

1) **Drainage of Country's Revenue-** It is said that the foreign countries investing in India will earn the profit

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<sup>27</sup> What is FDI? Available on <http://www.indiastudychannel.com/resources/147116-FDI-or-Foreign-Direct-Investment-India.aspx> last visited on dated 30.05.2014 at about 5.36 P.M

<sup>28</sup> Supra Note 26

in India and invest in their own country and in this way they will drain away our country's wealth and stock it in their country for their own overall development.

- 2) **The Domestic Retail Sector will Lose-** The domestic retail marketers may not be competitive enough to tackle the international players and might lose the market and even may perish away.
- 3) **Loss of Jobs-** Small retailers and people working under the intermediaries may lose their jobs as the entrance of FDI is going to spell doom upon the intermediaries.
- 4) **Bring Down Prices Initially-** The entrance of the foreign players may bring down the prices initially but in the long run when these players get hold of the market will use their monopoly power to operate the market.
- 5) **Remunerative Prices Initially to Farmers -** Again the farmers may get the remunerative prices initially but once the market is captured by the foreign players and local supply-chains are deleted at that time the monopoly will come into action where the farmers will be forced to

sell their products to a stipulated foreign buyer.

- 6) **Disintegrate Existing Local Supply Chain(s)-**As retailers are going to set up direct linkage with the farmers so local supply chain(s) will be disrupted.

- 7) **Destruction of small entrepreneurs<sup>29</sup> -**

The biggest fear from FDI is that it is likely to destroy the small entrepreneurs or small kirana shops as they will not be able to withstand the tough competition of big entrepreneurs as these entrepreneurs are going to provide all the goods to the consumers at much lesser prices.

- 8) **No real benefit to farmers<sup>30</sup> -**

Critics of FDI are also of the view that it is a fallacy that the farmers are going to benefit in any way because of the entry of foreign chains in India rather it will make the Indian farmers a slave of these big chains & the farmers will entirely be on their mercy. Thus, FDI is only going to deteriorate the already miserable conditions of Indian farmers.

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<sup>29</sup> Supra Note 27.

<sup>30</sup> Id.

So, hereby, the merits and demerits of FDI has been discussed in detailed; therefore, it is for us to decide whether the FDI is actually benefitted our economy or it can be considered as a burden on our economy. It is high time to think about this and make a call whether to encourage it or discourage.

## 8. CONCLUSION

Developing countries<sup>31</sup>, emerging economies and countries in transition have come increasingly to see FDI as a source of economic development and modernisation, income growth and employment. Countries have liberalised their FDI regimes and pursued other policies to attract investment. They have addressed the issue of how best to pursue domestic policies to maximise the benefits of foreign presence in the domestic economy. The study Foreign Direct Investment for Development attempts primarily to shed light on the second issue, by focusing on the overall effect of FDI on macroeconomic growth and other welfare-

enhancing processes, and on the channels through which these benefits take effect.

FDI as a strategic component of investment is needed by India for its sustained economic growth and development through creation of jobs, expansion of existing manufacturing industries, short and long term project in the field of healthcare, education, Research and Development (R&D), etc. Government should design the FDI policy such a way where FDI inflow can be utilized as means of enhancing domestic production, savings and exports through the equitable distribution among states by providing much freedom to states, so that they can attract FDI inflows at their own level. FDI can help to raise the output, productivity and export at the sectoral level of the Indian economy. However, it can observed the result of sectoral level output, productivity and export is minimal due to the low flow of FDI into India both at the macro level as well as at the sectoral level. Therefore for further opening up of the Indian economy, it is advisable to open up the export-oriented sectors and higher growth of the economy could be achieved through the growth of these sectors.<sup>32</sup>

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<sup>31</sup> Foreign Direct Investment for Development, MAXIMISING BENEFITS, MINIMISING COSTS, -ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, available on <http://www.oecd.org/investment/investmentfordevelopment/1959815.pdf> last visited on dated 30.05.2014 at about 5.20 P.M

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<sup>32</sup> IMPACT OF FOREIGN DIRECT INVESTMENT ON INDIAN ECONOMY by B Venkata Suresh and K Ramakrishna, Int. J. Mgmt Res. & Bus. Strat. 20, available on

At the present world, the Indian Economy is growing at a very rapid speed, so, the whole world is looking at India as a best investing option; therefore, it is for us to decide whether to allow or not to allow such giant in India. Therefore, the policy makers as well as the governmental agencies need to look at this matter very seriously so that our Indian economy will grow with the competitive world but at the same time it should not be at the cost of our Indigenous people or our own traditional knowledge. Hence, it is required to frame such steps and policies which will be helpful in all round development of our economy and which can also safe-guard the interest of our country people.

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