CHAPTER TWO

CHAPTER - 2

PRIVATE FOREIGN INVESTMENT IN INDIA : REVIEW OF LITERATURE

Many a studies have been made from time to time to assess the impact of private foreign investment (PFI) on the Indian economy. Micheal Kidron was perhaps first economist to systematically analyse the effects of foreign investment on India.[1] His study generated lot of interest in the subject leading to number of other studies.[2] Even though PFI in India has contributed much less than foreign aid in financial terms, yet it has generated more debate regarding its impact on the India economy.[3] The object here is to review the approaches adopted by these studies and their main findings.

These studies have considered and investigated the impact of PFI on one or the other of following areas.

(i) India's balance of payments (BOPs)

(ii) Augmentation of savings & investment (SI)

(iii) National income and employment

(iv) Research and Development

I

STUDIES RELATING TO PRIVATE FOREIGN INVESTMENT AND INDIA'S BALANCE OF PAYMENTS

Private foreign investment is expected to alleviate the BOP constraint by making available scarce foreign exchange to import necessary capital goods and raw

materials which are required for the ambitious development plans of a developing country like India. In this context, it may be noted that India's Second Five Year Plan had to be substantially pruned in the wake of foreign exchange crises in 1956-1957.[4]

Foreign exchange is required not only to finance necessary imports but also to meet the external debt service obligations. If the export receipts falls short of the import bill, than the foreign exchange can be made available either through foreign aid or PFI. However, with the decline in the availability of official foreign aid in recent years, the requirement of foreign exchange for investment will have to be taken care of by PFI. The available studies have hardly bothered to examine the contribution of PFI in filling the BOP gaps at a point of time. This may be justified on the ground that PFI has contributed much less than official aid in India's economic development in the past.

The studies on foreign investment have generally concentrated on the investigation as to whether PFI have improved or worsened the BOP position of India. The BOP effects of PFI can be looked at from two angles - viz direct effect and overall effects. The direct effect of PFI can be ascertained by comparing the inflow of capital through PFI with the corresponding outflow in the form of dividened, royalties etc. The direct effect of PFI in any year will be adverse if the total outflow is greater than inflow. The overall effect can be calculated by adding the differences between the exports and imports generated by PFI to the direct effects. It may be noted here that the inflow of capital can take place in the form of cash or in kind through supply of capital equipments and technical know-how.

When a foreign firm supplies tangible assets like equipment and machinery it may adjust the sale price against equity claims. Similarly in lieu of fees for technical knowhow equity shares in domestic companies are acquired. In both the cases there is no actual inflow of financial capital from abroad. Therefore, in the analysis of BOP effect of PFI only cash inflow are considered. Further, it should also be noted that sometimes foreigners claims on a host country can increase even without any inflow of either cash or kind. This occurs when retained earning i.e., accumulated profits are converted in equity shares.[5]

In India various studies have been conducted to study the balance of payments effect of PFI. Some studies have examined one effect while some others have examined both the effects, nonetheless, there is a general agreement that PFI in India had a negative effect on BOP. The conclusion of these studies are similar even though they have been conducted during different time period. As mentioned above Kidron[6] initiated a systematic analysis of the impact of PFI on Indian economy. His study covered a time period of 13 years from 1948 to 1961. He found that during this period although foreign investment stake had more than doubled, foreign investors as a whole have taken out foreign exchanges nearly 3 times as much as they contributed directly. For instance the foreign exchange losses (repatriation of capital, payments of dividered, technical, fees etc.) amounted to Rs. 718.4 crores. Whereas the foreign exchange gains through inflow of capital was Rs. 240.1 crores living a debit balance of Rs. 471.3 crores. The contribution of PFI through saving imports and adding to exports was also negative. The shift of PFI from traditional export earner like tea and jute to petroleum and manufacturing sector turned the trade balance to negative in sector where PFI took place.

K.K. Subrahmanian[7] by considering India's second plan period found that the net capital inflow was Rs. 109 crores whereas the combined burden of remittance abroad for the said period came to Rs. 141 crores, thus, the direct foreign exchange contribution made by foreign investors in India amounted to minus Rs. 32 crores. In another study by Subrahmanian[8] covering a period from 1955-56 to 1965-66 the direct as well as the indirect impact of PFI was calculated.

According to this study, the net inflow of capital during the time period 1955-57 to 1960-61 was Rs. 109 crores and the inflow was Rs. 160 crores during 1961-62 to 1965-66. As against this the total foreign exchange outflow on account of PFI were Rs. 165 crores & Rs. 236 crores respectively. The direct net contribution made by PFI to India's BOP during the second and third plans was thus negative, amounting to Rs. 56 crores and Rs. 76 crores respectively. In the same study the indirect effect was also measured in terms of foreign exchange savings through exports and foreign exchange spending through imports and service payments. However, the measurement of indirect effect was based on the data published in R.B.I.'s survey of Foreign Collabration in Indian Industry, 1968. Unlike the direct effect which was measured with the help of data published in various issues of RBI bulletin. In the year 1960-61 the value of foreign exchange earnings through export was 13.68 crores which increased to Rs. 145 crores in 1966-67. The value of foreign exchange outgoings amounted to Rs. 169.0 crores and 316 crores respectively. Thus, the net foreign exchange earning was negative which remained negative through out 60-61 to 66-67. It may be mentioned that service payments in

form of dividened, royalty and technical fees alone absorbed 20% of the export earnings and balance was not sufficient to pay for imports.

One possible reason for negative net foreign exchange earnings is the policy to sell greater part of the output in the domestic market by the companies which have attracted PFI. This is borne out by the fact that the companies referred to above exported annually on an average only 8% of the value of their gross output during 1960-61 to 1966-67.

Brahmanand Prasad[9] investigated the repayment cost of foreign investment in India for two sub-period viz. 1956-62 and 1963-67. However, his analysis deals with direct repayment cost only. According to his study, during the 1956 and 1962 the inflow of PFI took place at an annual average rate of Rs. 22.7 crores But, of this inflow, almost eighty per cent of foreign investment was in kind. Therefore, only a small portion of capital inflows - Rs. 4.6 crores p.a. - represented inward movement of cash from abroad. Against this inflow, the outflows took place at an average rate of Rs.11.6 crores p.a. Thus the net capital transfer due to PFI during the said period was negative to the tune of Rs. 7 crores p.a.

According to Prasad the situation worsened during 1963-67. This becomes obvious when one considers the pattern of inflow and outflow of funds on account of branches of foreign companies and FCRC's.[10] During this period the BOP impact of PFI was adverse, whether one considers cash inflows only or both cash as well as non-cash inflows. For instance between 1963-67 the total annual average inflow was Rs. 16.35 crores, while the cash outflows was Rs. 35.47 crores p.a. leaving a deficit of Rs. 19.12 crores p.a. If only cash inflows are considered

than the deficits amounts to Rs. 31.47 crores p.a. As mentioned earlier Prasad's study did not consider the import and export on account of PFI. This was examined by B.P. Mathur.[11]

He studied the BOP effects of PFI for the time period 1960-70 by analysing the data brought out by RBI in its first two surveys on foreign collaboration. He studied the BOP effects of three categories of enterprises (a) Branches of foreign companies and foreign subsidiaries where more than 50% show capital are held abroad. (b) Minority participation companies, in which less than 50% share capital is held abroad. (c) Where a Indian company has technical collaboration without any equity participation. The BOP effect of each of the above-three groups were measured by taking into account, first, inflow of funds through share capital, second outflow on account of dividened remittance royalty, technical fees and payments to foreign technicians in foreign currency and third, imports and exports affected by the companies.

On the basis of the above, Mathur found that PFI had been responsible for almost 35% of deficit in Current Account during the aforesaid period. Category wise subsidiaries were responsible for 19 p.c, minority companies for 7 p.c and pure technical collaboration for 9 p.c of the deficit in C.A. of India's BOP.

V. Sharan[12] undertook a similar exercise to study the impact of the MNC on India's BOPs for the period 1964-70. He looked at the impact of the operation of MNCS on BOP of the host country from two angles : One is their effect on capital and investment income account and the other their effect on the generations of exports and imports. The above effects were studied seperately for branches of foreign

companies operating in India and the companies incorporated in India but controlled by foreigners (i.e., subsidiaries).

According to Sharan's study during the six-year period between 1964 and 1970, the total outflow of funds on account of branches operating in India was Rs. 97 crores whereas the inflows was only Rs 59.7 crores, thus there was a deficit of Rs. 37.3 crores. In case of subsidiaries the total inflow amounted to Rs. 61.8 crores while the total outflow was Rs. 143.8, thus the outpayments exceeded the equity investment by Rs. 82.0 crores. Of the total payment abroad dividend alone accounted for almost 81 p.c. This was due to higher profitability as well as higher share of parent organisation in equity capital.

As far as exports of subsidiaries operating in India was concerned, he found that during 1964-70, the exports hardly accounted for 1/3 of the imports. On the whole, the conclusion of this study is that the impact of MNC's on India's BOP had been negative. Various outflow far exceeding the inflow, moreover the export generated by the firms lagged far behind their imports.

Another study was conducted by V. Sharan[13] covering a period between 1982 and 1988. In this study he excluded branches of foreign companies, because with enactment of FERA they lost their significance and therefore he concentrated on FCRC's operating in India. During the said period the total inflow on account of equity investment amounted to Rs. 298 crores against this inflow the outflow to talled Rs. 723 crores, thus there was an excess of outflow over inflow to the time of Rs. 425 crores. It was also found that dividend accounted for almost 48 p.c. of the total outflow. The picture does not change much even if trade account is

considered. During the period underconsideration the total value of exports was Rs. 3612 crores while the imports totalled Rs. 4018 crores. This means the net outflow of foreign exchange on trade account was as high as Rs. 406 crores.

Thus, it emerges from Sharan's study that the balance of payments impact of the FCRC's was negative in India. This conclusion is not different from conclusion of his earlier study cited above.

All the studies reviewed above found that the country had to pay a high price on account of PFI as its effect over the years on BOP had been adverse. All the above mentioned studies were conducted at macro-economic level.

However the conclusion does not charge even if one considers the impact of PFI on BOP pertaining to a particular sector. For instance, R. Vedavallis' study traces the BOP effect of foreign investment in Petroleum sector for the period 1955-70 using the transfer of resources approach.[14] His study reveals that between 1955 and 1970 the transfer of resources amounted to $ (-) 2.2 ml, if the retained profit (830 ml) during this period had also been remitted abroad, the negative impact woould have increased to that extent.

Although the studies cited above have come to similar conclusions, they have not examined in detailed the reason for the adverse effects of PFI on India's BOP. This Lacuna is attempted to be rectified in the present study.

Notwithstanding, this review of the literature which shows PFI in unfavourable light with regards to its BOP effect in India, still it does not mean that foreign investment did not play a positive role in economic development of India. The role it plays by

augumenting the domestic resources for investment there by leading to an increase in national income. This requires review of literature relating to PFI and resources for domestic investment and National income (N.I.) in India. This attempted below :

II

STUDIES RELATING TO PRIVATE FOREIGN INVESTMENT AND ACCELERATION IN DOMESTIC INVESTMENT AND NATIONAL INCOME

The long term view of benefits arising out of PFI is based on the perception that such inflows are an important source of foreign savings for the host countries for supplementing their domestic savings for investment. Chenery and Strout[15] provided a detailed theoritical exposition of the manner in which external resources could lead to increase in the overall rates of investment & hence NI in developing countries.

According to them foreign capital could increase the growth potential of these countries by augumenting the domestic available investible surplus. They felt that in these countries the low level of domestic savings acts as a constaint on the desired levels of economic growth. This constraint can be removed with the help of external resources, launching the developing countries into a path of self-sustaining growth. Although Chenery had provided the framework wherein foreign inflows are seen to result in "Virtous Cricle" of growth for developing countries, very few empirical studies have been conducted in India to study its effect on Saving-Investment and National Income.[16]

K.K. Subrahmanian[17] studied in detail the impact of PFI on the magnitude of investment (I) in India. According to him since capital flows are mainly into the corporate sector the relevant parameter should be the share of PFI in the investment in the corporate sector. This study reveals that PFI accounted for about 14% and 18% of I during the second and third Five year plan respectively. If the PFI and capital inflows from the official sources are taken together, than foreign capital represented 25 p.c. and 27 p.c. of the total investment in corporate sector during 2nd and 3rd plan period. Evidently the share of total foreign capital inflow in capital formation in private sector in India was not only high but also increased in the 3rd plan. K. Jayaraman[18] undertook a cost-benefit analysis of PFI in India Economy for the period 1964-70. His study considered PFI through MNC's only. He found on balance PFI, on the whole, contributed positively. He concluded that as a result of international financial and technical collaboration the industrial base of Indian economy was diversified, leading to the growth of many indegenous units in public as well as private sector. In order to find out the contribution of MNC to national output, he made a comparison in value added by companies in India having foreign financial and technical collaboration and all other companies. This study revealed that the rate of growth in value added by companies with foreign collaboration was much higher (15.4% p.a) than all other companies.

There are many other studies which also been undertaken over the years to study the impact of PFI in Indian economy, these studies have considered cross-country data rather than restrict themselves to India. It may be pointed here that some cross-country studies have also compared the contribution of PFI with that of official external assistance. A review of such studies is attempted below :

Rana P.B.[19] conducted a study to find out whether foreign capital affect growth favourably and which is more beneficial to developing countries-foreign aid or PFI ? Her study considered 14 Asian developing countries (ADCs) including India for the period between 1965 and 1982. She developed a growth equation model with growth rate (GR) as endogerous variable and Aid, PFI as exogenous variables. To answer the above questions the estimated growth equation were obtained by OLS method for the aggregate sample of 14 ADC's. The results obtained not only indicated a positive co-relation between foreign capital and economic growth but also that estimated co-efficient of PFI is approximately two and half times that of the aid variable suggesting that the former had contributed more to growth than the latter. Further when 14 samples countries were segregated into middle income(8) countries and low income(6) countries, on the basis of disaggregèd samples also it was found that foreign capital which included Aid & PFI have made a positive contribution to the growth of the ADCs-while PFI has contributed more the foreign aid to the low income countries it is the other way around for middle income countries. From her study Rana concluded that generally PFI contributed to growth both by increasing resources available for capital formation and by increasing the efficiency of investment. The efficiency of investment increases because PFI is accompanied by superior technology and managerial and technical skill. In another study[20] for the same time period with a reduced sample of 9 developing countries including India she came to a similar conclusion as above.

A study conducted by the Economic and Scientific Research Association (ESRA)[21] for the time period 1973-76, concluded that in general there was a positive co-

relation between economic growth of a country and foreign investment. The study found that countries which followed a liberal policy towards PFI achieved a faster rate of growth. For e.g. in Indonesia foreign investment by the end of 1973 totalled $ 2.75 bl. almost equal to domestic investment as a consequence it achieved on overall growth of around 7.1 pc per annum. Similarly in S. Korea the average annual growth rate in manufacturing sector during the period between 1960 and 1971 was 18.5%. This rate was achieved mainly due to the large influx of foreign capital. In contrast to this India witnessed a growth of 3% during 1973-74 and 2% during 1974-75. The rate of domestic saving was 12.1% in 1973-74 and inflow of foreign resources 0.80% making an aggregate investment rate of 12.9. The corresponding figures of 1974-75 were 11.8%, 2% and 13.8%. According to the study the empirical evidence suggests that roughly 13% rate of saving-investment (SI) brings about a growth of 3% p.a. So, ceteris paribus if SI rate can be increased to 24% of the national income a 6% growth rate could be possible. This would require a substantial amount of foreign investment as the resource gap in India is of the order that cannot be met through domestic efforts alone.

The studies reviewed above have generally come to the conclusion that PFI favourably affects the economic growth of countries like India. However, M.R. Aggrawal's study comes to a different conclusion. He examined statistically through regression analysis the contribution of PFI on the economic development of selected developing countries including India for the period 1963-73 & 1973-83. He found that the impact of PFI on the economic development of LDC's measured in terms of PCI or rates of growth of GDP is weak. Further PFI and domestic savings in the developing countries are generally iniversely related. This means

that foreign investment through TNC's cannot be used in general as means of supplementing domestic saving in order to achieve faster pace of economic growth in countries like India. It means that the developing countries have a tendency to substitute foreign savings for domestic savings. However, the result so obtained in this study is explained by the practice of TNC to borrow locally rather than bringing new capital into the country.[23]

III

STUDIES RELATING TO FOREIGN TECHNOLOGY AND LOCAL RESEARCH AND DEVELOPMENT (R&D)

Technological progress is generally accepted to be at the heart of development process.[24] This is so because technical progress by increasing the productive capacity of a country helps to improve their economic performances. The recognisation of technology as a dynamic factor in economic growth has led the technology deficient developing countries to import technology from the developmed world. Typically enterprises in developing countries with or without PFI first import technologies and than undertake research and development (R&D) to assimilate the imported technology into domestic production process.[25] In India several studies have been concluded to examine this relationship between import of technology and its impact on domestic R&D.

Sanjay Lall[26] undertook an exercise to examine the relationship between import technology and research and development for the year 1978. He empirically tested the relationship for a sample of 100 Indian engineering firms with the help of regression analysis. He considered the amount of royalty payment as an indicator

of the value of technology imported. His study found that amount of royalty payment was positively related to R&D expenditure. This means that as the import of technology increased, expenditure on R&D in Indian firms would also rise. This type of inference is however misleading. One cannot argue that India should enlarge the import of technology in order to encourage local R&D, For, the objective of encouraging local R&D is to make the country self reliant in technology.

Homi Katrak's[27] study attempted to answer two questions relevant to the R&D First, has the imported technology a stimulating effect on local R&D. Second, whether expenditure on R&D are likely to differ between certain types of enterprises. He examined the relationship using the data provided by Department of Science and Technology for the year 1978-79 and RBI data for the period 1964-70 and 1975-78. He like Lal, found that R&D intensities were positively related to expenditures on imported technologies. In addition he also found that larger the size of enterprise higher would be expenditure on local R&D. The two studies cited above did not separate the import of technology by firms with foreign ownership and control and firms with domestic ownership. This was done by K.K. Subramanium in his study[28] for the period 1964-1970 and 1977-1981. He examined the relationship between IT & R&D under 3 different ownership / control group. The groups considered were (i) Foreign subsidiary (ii) Joint ventures (iii) Wholly owned Indian firms with foreign technical collaboration. The regression result indicated that the marginal propensity to R&D investment relative to technology import of foreign subsidiary group was significantly different from that of the other two groups. It was observed that elasticity co-efficient had a negative sign in the case of the former

group as against positive signs and value greater than unity in case of joint ventures and pure technician collaboration. According to him, this implied that the relationship between R&D and it is that of substitutability and not complementanity in the case firms under foreign ownership or control. Thus, firms under foreign control ownership acquired foreign technology from foreign sources but donot back up the import with indigenous R&D efforts in the same intensity as firms under Indian Ownership or Control.

A similar study was conducted by Kumar N[29] to examine the influence of technology imports on local R&D activity by taking into account the mode of technology imports. For the purpose of seperating the influence of the two mode of technology imports namely through FDI & through licensing on industrial R&D intensity, the data for forty three industries was analysed. His findings reveals that the nature of influence of the two modes of technology imports on R&D intensity was quite different. FDI had a negative association with R&D implying that, industries dominated by foreign controlled firms spent lower on R&D on the other hand lisensing had a positive association with R&D intensity.

The studies reviewed above by using firm level data for a particular industry or industry level data have come to similar conclusion. However, even if firm-level data for a cross-section of industries are considered, the conclusion does not vary as substantiated by Siddharthan's Study.[30] The study was conducted for the period 1983-84 covering a sample of 166 firms belonging to Chemical, electronics, industrial machinery, automobiles and low technology industries like textile and others in public as well as private sectors. He hypothesized that relationship

between expenditure on technology-import and 'in house' R&D was positive for private sector industries, since most of the Indian R&D was of adaptive nature. In case of public sectors units the relationship could be negative because they do a lot of innovative R&D. His study found that the relationship between import of technology and R&D expenditure was mainly complementary for private sector firms, but for public sectors there was a negative relationship, thus confirming the hypothesis. This means innovative R&D in public sector units led to a decline in the dependence on import of technology.

Notwithstanding, the broad agreement about the relationship between imported technology and R&D, still these studies have not examined the possibility of a lagged relationship between the payment for imported technology which are made generally a year after the import and R&D which starts with the import of technology. The lagged relationship pointed above therefore have been examined in the present study.

IV

JUSTIFICATION FOR THE PRESENT STUDY

It becomes clear from the review of the literature that several studies have been undertaken to examine the impact of PFI on Indian economy. It may be noted that most of the studies have examined only one aspect of the affect of PFI. For example some have examined BOP implications while some others have analysed the effect of PFI on NI or R&D. It is difficult to draw firm conclusions from these studies about the contribution of PFI to Indian economy. For, although these

studies are unanimous regarding the adverse impact of PFI on India's BOP,[31] they differ in respect of PFI's impact on growth of NI[32] in India. Similarly, when mode of import of technology is considered to examine the effect of PFI on R&D it becomes difficult to draw a clearcut conclusions. It is particularly so when Public Sector and Private Sector are considered separately.

One important objective of recently introduced economic reforms in India is to encourage PFI.[33] This has been done with a view to make Indian industries globally competitive. The Indian business class unlike in the past, has accepted this policy change. As a result of encouragement, the PFI has tremendously in increased in recent years. The time is ripe for a fresh study of the impact of PFI on Indian economy. Such a study should consider the important aspects of PFI in relation to Indian economy at one place Besides, analysis of PFI, consideration of the impact on the economy over a long period of time is desirable and necessary to form an appropriate opinion regarding the impact of PFI in India. A longer period is also necessary because the effect of investment on NI through multiplier and acceterator takes time to bear fruit. Therefore the present study covers a long period of more than 30 years from 1961 onwards to examine the following aspects of the impact of PFI in India.

1. Impact of Private Foreign Investment on India's BOPs

As mentioned earlier number of writers have examined the impact of PFI on India's BOPs. However, most of these studies relate to the period upto fifth five year plan. In the present study, therefore an attempt has been made to extend the coverage

in terms of time period. Not only this, various possible reasons will be provided to explain the negative impact, if any, of PFI on BOPs.

2. Impact on India's National Income

Similarly to study the impact of PFI on India's national income, the time period covered has been extended to incorporate the latest data available. Not only this, a different means has been attempted by using the Granger test of causality to examine whether PFI determines economic growth or depends upon economic growth.

3. Acceleration in Investment

As mentioned earlier, only few studies have been conducted to analysis the impact of PFI in augmenting the investment in India. The present study therefore, attempts to study this aspects of PFI, especially in the corporate sector in India with the help of log regression analysis. Moreover, the impact of other variable in corporate investment will also be studied.

4. Impact of Foreign Investment on Research and Development in India

To study this impact, the data pertaining to Indian corporate sector in general, and foreign controlled rupee companies in particular will be analysed with the help of the statistical tool of regression. Before taking up these aspects, an attempt is made in following chapter to examine the theory of PFI and cost and benefits of foreign investment.

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