CHAPTER ONE

CHAPTER - 1

INTRODUCTION

I

The economic development of a country involves utilization of resources for increasing the productive capacity of the country. But in most of the developing countries such utilisation becomes rather difficult due to the scarcity of domestic capital and hence there is a need to attract foreign capital.[1] Given the role[2] of foreign capital & technology as an impetus to economic development, the question arises as to which is the best source of importing capital and technology from the developed countries. Private foreign investment (PFI) is one of the oldest and recognized channels for importing capital & technology from the developed countries into the developing countries. Foreign investment especially through multinational corporation has been a subject of animated discussion both in the home and the host countries. The criticisms of these forms of foreign investment in the host countries, especially in the developing countries, has been so virulent that not only the governments of these countries have been forced to frame guidelines for the operations of these firms in their lands but even these firms themselves are reassessing their role in these countries.[3] Much of the criticisms of these firms is based on their failure to contribute positively to the national goals of these countries. It has been observed that these firms have neither contributed to economic growth of developing countries nor transferred modern technology to them. They have also failed to solve the balance of payments problems.

Private foreign investment is a nebulous concept.[4] In wider sense it denotes a wide spectrum of international business arrangement, which range from a licensing agreement for a patent or trade mark use to direct investment through branches and subsidiaries of foreign enterprise, but in essence it entails flow of capital, technology, skill and enterprise, from one country to another country. Such flows, although not a new phenomenon, have assumed significance in the wake of the need and desires of contemporary developing countries to push up their growth rate. In India like in other developing countries, the role of foreign investment in being debated hotly.[5] Today when all efforts are being made to develop the economy, the government and the people expect the foreign firms to play a more positive role in the economic development of India.

In India, the general policy of the government has been to encourage foreign firms to set up industrial ventures in India in collaborations with domestic firms. This policy has been guided by the following assumptions :[6]

1. Foreign investment offer relief to the balance of payments constraint to growth.
2. It bridges the technological gap that exists between domestic firms and foreign firms by facilitating the transfer and assimilation of advanced technical and managerial knowhow & skill and would promote industrial productivity and growth.
3. Partnership of foreign and domestic equity would impair the problems of foreign control and monopoly through dilution in ownership mix, and

4. Given its abundant labour resources and high unemployment rate, the foreign investment flow encourage employment generations.

Guided by the above parameters, policy measures have been introduced from time to time to attract private foreign investment in India.

II

THE PROBLEM AND THE OBJECTIVE OF THE PRESENT STUDY

In India although official aid has played a greater role in India's industrialization since second five year plan, PFI has attracted greater attention in political and economic debate,[7] this despite the fact that the Indian absorption of foreign aid to PFI has been much greater, over the years.[8]

In the debate pertaining to the flow of PFI to India, the central question has been whether the inflow of PFI has benefitted Indian economy or not. There has been controversies relating to the effects of PFI on India's economic development particular in terms of PFI's effect on national income (NI), BOP, enhancement of capacity to invest and research and development (R&D).

Although numerous studies[9] have undertaken to the study the above aspects, these studies have examined the different aspects in isolation and in different time period. Thus, there is a need to study the different aspects at one place to reach a more appropriate conclusion about the impact of PFI on the Indian economy. Thus, the study appears to be justified in view of the shortcomings of the studies undertaken earlier.

The objective of the present study is to examine the impact of PFI on India's economic development. This study specifically examines the nature and impact of PFI on BOPs, NI, investment and local R&D. Other related issues such as governments' policy towards PFI, growth profile of foreign investment in India, theoretical determinants of PFI are also analysed.

III

HYPOTHESIS OF THE STUDY

The central hypothesis of this study is that :

"PRIVATE FOREIGN INVESTMENT ON THE WHOLE HAS PLAYED AN IMPORTANT ROLE IN INDIA'S ECONOMIC DEVELOPMENT".

As a corrollary to the above mentioned central hypothesis, the present study attempts to test the following hypotheses .

(i) **THE PFI HAS HAD A POSITIVE EFFECT ON INDIA'S NATIONAL INCOME.**

(ii) **THE PFI HAS ACCELERATED CORPORATE INVESTMENT IN INDIA.**

(iii) **FOREIGN INVESTMENT HAS CONTRIBUTED IN RELIEVING PRESSURE ON INDIA'S BALANCE OF PAYMENTS.**

(iv) **IMPORTED TECHNOLOGY THROUGH PFI HAVE STIMULATED LOCAL RESEARCH AND DEVELOPMENT.**

IV

SOURCES OF DATA AND METHODOLOGY USED

1. Data

For the purpose of this study, the principle source of information is the secondary data published in various issues of RBI bulletin and the Surveys conducted by RBI on foreign collaboration in Indian Industry[10] Certain other data from other sources like GOI's Economic Surveys, RBI's Reports on Currency and Finance, GOI's Annual Survey of Industries, GOI's National Accounts statistics and CMIE, Bombay's Basic Statistics related to Indian Economy have also been used in the present study.

2. Analysis

For the purpose of analysing the data so collected statistical tools like regression, correlation, test of causality as well as simple tools like ratios, percentages are used in this study. Different methodologies have been adopted to examine the impact of PFI in India. The relevant methodologies are discussed in detail in the relevant chapters.

V

TIME PERIOD OF THE STUDY

Though foreign investment was being attracted right from 1948, the effect of PFI would take time to be felt. In the course of the First and Second Five Year Plans

PFI has entered different sphere of economic activity in India. It was in early sixties that Michael Kidron came out with a detailed study on problems associated with PFI in India.

From 1961 onwards the role PFI has been debated. Many policy changes have taken place, and new guidelines have been formulated. In the light of this a time period between 1961-95 have been considered. This time period is long enough to examine the effects of such policy changes on the flow of foreign investment in India It is also long enough to arrive at an appropriate conclusion about the role of PFI in India.

VI

LIMITATION OF THE STUDY

The main sources of data are those published by RBI, but for the period between 1981 and 1986 data have not been published by RBI, therefore, for this period figures are estimated on the basis of past trends. However, in the light of significant changesin foreign investment policy in India during the said period, it is felt that the use of the estimated data may not alter findings of the study in a significant manner. Further, for the analysis of the impact of foreign investment on B.O.P, the sample size differs from period to period. Selecting the time series framework is useless for any comparison, nevertheless, a comparison between inflow and outflow of foreign exchange during different years will certainly indicate the B.O.P. impact in the absence of a more reliable data than those provided by RBI's survey on foreign collaboration in Indian Industry.

VII

DEFINITIONS

Some of the major terms employed in this study needs to be defined here so that they are understood in the same sense they have been used.

1. Economic Development and Economic Growth

These terms "economic development" and "economic growth" needs to distinguished from each other. For, a country may experience development in terms of rising investment in different sectors of the economy with or without growth, because of the long gestation and low returns typically associated with early stages of capital formation. Whereas, the growth make take place without development because, economic growth implies an increase in national income. This study, however, is concerned with Indian economic performance and foreign investment in the long run (a period of more than 30 years). In this long-run focus, growth and development are synonymous as such they are used interchangeably in the present study.[11]

2. Non-official Sector

It includes corporate, industrial and commercial undertaking, including state owned enterprises - which together constitute the corporate sector for the purpose of the study The Non-official sector also includes banking and insurance companies.

3. Private Foreign Investment

It is defined as investment from abroad in Indian Corporate Sector in the form of equity capital, foreign currency loans and supplier's credit.[13] The foreign investment and foreign capital are used interchangeably in the present study. The special advantages of PFI are firstly, it reduces the need for foreign aid and thus lightens the burden of debt repayment, secondly, being subject to be employed more effectively, and lastly, it adds directly to productive capacity of recipient country. Foreign investment may be in the form of direct investment capital which is popularly known as FDI or in the form of other investment capital.

4. Foreign Direct Investment

Direct investment refers to those investments which are made to create some kind of a permanent interest in an enterprise in another country. This investment takes the form of acquisitions of equity shares in new or existing company in host countries, leading to expansion of the equity base.[14] It may also include portion of re-invested earnings allocable to foreign investors. The acquisition of equity shares confers on the investing entity an ability to exercise control over the decision - making process as well as control over the management of the entity in which it invests. The investor acquires this power to control over the operation by virtue of its owning the capital stock of the entity in which it invest in a major way. However there appears to be no uniformity with regards to degrees of foreign participation in equity share necessary to exercise control over the management.[15]

In this study FDI has been defined in the same way as RBI has defined it because RBI is the main source of data considered for this study.[16] Accordingly, FDI in India comprises of foreign investment in :

(i) Indian joint stock companies which are subsidiaries of foreign companies;

(ii) Indian joint stock companies in which 40 p.c. or more of equity capital is held outside India in any one countries;

(iii) Indian joint stock companies in which 25 p.c. or more of equity is held by an single investor abroad, and ;

(iv) Net foreign liabilities of branches of foreign companies operating in India.

5. Other Capital Investment

It includes (i) Portfolio investment, and (ii) Foreign currency loans. Portfolio investment can be defined as the acquisition of securities by individuals or institution abroad, without any associated control over, or participation in the managements of the companies whose shares has been acquired.[17] Thus if the non-resident share holding is less than 25%of the total value of ordinary shares, such investments is classified as portfolio investment. It can be further classified into portfolio equity and portfolio creditor (loans and suppliers credit) capital.

The portfolio creditor capital by definition does not confer any ownership right to foreign investors, while portfolio equity investment involve foreign minority participation in risk capital which need not necessarily confer the power to control the enterprise.

Direct investment capital has the following advantages over portfolio investment:[18]

(i) Direct investment brings with itself new techniques of production and new ideas.

(ii) By setting an example and by sponsoring training programmes direct investment is effective in transferring technology and encouraging the growth of skills relating to marketing, financial and technical.

(iii) A part of earning are ploughed back for the expansion or modernisation or invested in allied fields in the recipient countries.

(iv) During periods of economic depression it reduces the burden on B.O.P. as the dividend are related to profit instead of fixed interest charges on bonds and other securities. More over the outflow of foreign exchange starts only from the time the projects goes on stream.[19]

However, there are three serious disadvantages of direct investment capital. Firstly, the foreign investment in equity accompanied by foreign control over the domestic concerns would increase to an extent the degree of foreign control over the economy. Secondly, remmittance on account of royalties, dividend, technical fees which a continued flow of foreign investment may entail, can impair the balance in the host country's international account. Thirdly, there is danger that the standard of pay scales and other components of expenditure incurred on foreign technicians (accompanying foreign capital) are much higher than their domestic counterparts and this leads to a "demonstration effects" within the country that is certainly not conducive either to austerity or to economy or to saving.

6. Multinational Corporation

Multinational corporations (MNCs) or the Transnational Corporations (TNC) can be defined as "Enterprises which own or control production or services facilities outside the country in which they are based.[20] Thus, MNC's have their main operations, mostly manufacturing, also in other countries - developed as well as developing. Since, private foreign investment in developing countries is mostly through MNC's, we would use the terms PFI and MNC interchangeably.

7. Subsidiaries of Foreign Companies

Subsidiaries of foreign companies are defined as a joint stock company incorporated in India under local statute in which a single foreign body corporate holds more than 50% of paid-up capital. A subsidiary can be partly owned or fully owned. A partly owned subsidiary means a foreign equity holding of more 50% but less 100%.[21]

8. Branch of Foreign Companies

It is defined as a company which is direct extension of parent company's operation in India but which is not incorporated in India under Indian Company Act, 1956.[22]

9. Foreign Controlled Rupee Companies (FCRC) [23]

They are Indian joint stock companies which are subsidiaries of foreign companies, in which 40 p.c. or more of the equity capital is held outside India in any one country and companies in which 25 p.c. or more capital is held by a foreign company.

10. Industry Wise Classification

The classification of industries into various types is based on the standard industrial classification, i.e., it is determined by the majority activity as reported by the respective companies.

VIII

ORGANISATION OF THE STUDY

The whole work is divided into seven chapters of varying length. It is a case study of India, conducted against the theoritical discussions relating to the impact of PFI. Each chapter deals with a differentiated theme in terms of emphasis and analysis. The first chapter - the present chapter, states the problem of PFI in India. The major terms employed in the study are defined here.

The second chapter is addressed to the review of literature on PFI and economic development mainly relating to India. This chapter also provides a justification for undertaking the present study. Next, the theory of PFI and its impact on the development of low income host country is outlined in chapter 3.

The policy of Indian government towards foreign investment is analysed in chapter 4. This chapter also examines the growth profile of PFI in India since independence. The changes in composition and the pattern of foreign investment are also discussed.

The impact of PFI on India's economic development is examined in chapter 5 and chapter 6. The balance of payment effect of PFI in India is analysed in detail in chapter 5.

The effect of foreign investment on the national income, corporate investment and domestic research and development is examined in chapter 6. The statistical tools like regression analysis and the Granger test of causality have been used to analyse the above mentioned effects.

The chapter 7, provides a summary of the major findings of the investigation of the study. Certain policy changes are also suggested in this chapter not only to attract more PFI but also to reduce the adverse impact of foreign investment on India's balance of payment.

Notes and References

1. (a) Chenery H. : "Foreign Assistance and Economic Development", American Economic Review, September, 1966. (b) Griffin K : "Foreign capital, Domestic Savings and Economic development", Bulletin of the Oxford institute of Economics and Statistics, (BOIES) May 1970.

2. Role of foreign capital has been discussed in detail in chapter - 3.

3. For discussion on impact of foreign capital see : (a) Papanek G : "Aid, Foreign Private Investment, Savings and Growth in Less Developed countries, Journal of Political Economy, (81) January - February, 1973. (b) Singer H. : "The Distribution of Gains Between Investing and Borrowing Countries", American Economic Review, May 1950. (c) Kennedy C. and Thirlwall A.P. : "Foreign Capital, Domestic Savings and Economic Development, Some Comments", Bulletin of the Oxford Institute of Economics & Statistics, May 1971

4. Subrahmanian K.K. : Import of Capital & Technology. People's Publishing House. 1972. p.8.

5. IGIDR : India Development Report, Oxford University Press, New Delhi, 1997, pp. 129-133.

6. Subrahmanian K.K. : Op. cit. p.1.

7. Discussion on the economic and political effects may be found in : (a) Mishra V. "FDI in India", GDIDR Series, Vol-I, 1992, p.6. (b) Swamy D.S : MNCs and the World Economy, Alps publishers, New Delhi, 1980, p. 130. (c) Martinussen J : TNCs in a Developing Country - The Indian Experience, Sage Publications, New Delhi, 1988, p. 82. (d) Mende T : From Aid to Recolonization - Lessons of a Failure, Pantheon Books, New York, 1973, p. 129

8. According to Kidron M, the ratio of foreign aid to PFI in India works out to be 6:1 for the period 1948-1961. c.f : Kidron M. : Foreign Investment in India, Oxford University Press, London 1965, p. 299.

9. These studies are reviewed in chapter - II of this study.

10. Various issues of RBI Bulletins referred are June 1958, January 1967, March 1967, May 1976, March 1978, April 1985, April 1991 Feb. 1993, August 1993, August 1994, November 1994, September 1995 and September 1996.

11. A discussion of growth and development are found in the following studies : (a) Byres.n : "The Role of Capital in Economic Development", in Ellis H.S. and Wallish. H.G. (eds.), Economic Development for Latin American, Macmillan and Co., London, 1961, pp. 110-111. (b) Lewis A. W. : The Theory of Economic Growth, George Allen & Unwin Ltd, London 1963, p.11. (c) Katz. SS : External Assistance and Indian Economic Growth APH, Bombay; 1968, pp. 5-7.

12. See RBI Bulletin Sept. 1996, p.413.

13. Till 1964-65 the relevant data on PFI was published in the form of outstanding foreign business investments. From 1965 to 1985 it was published in form of outstanding liabilities in the corporate, industrial and commercial enterprise, from 1985 onwards the data are given in the form of outstanding foreign liabilities in corporate sector.

14. Sen P. : "FDI - A solution to BOP Problems ?", EPW, 29th July 1995, p. 1921.

15. For instance according to Dunning a 30 p.c ownership of share by a foreign investor with no other individual holding more than 10 p.c. of the total equity capital is considered as sufficient to exercise control. See : Dunning J.N : Studies in International Investment, George Allen and Unwin Ltd, London, 1970, p.5. As per IMF's BOP Manual (5th edition) on the other hand, a direct investment enterprise is defined as a enterprise in which a direct investor who is a resident in another country owns 10 p.c. or more of the ordinary share or voting power, c.f. : RBI Bulletin, Sept. 1996, pp. 412-413.

16. RBI : Bulletin April 1991, p. 338.

17. RBI Bulletin : Ibid.

18. Chadda T. R. : "Problems of PFI in India", Indian Journal of Commerce, Dec., 1961, Vol. 15, Part. IV.

19. See, Assocham Bulletin, July, 1995. p. 7.

20. UN : Department of Economic and Social Affairs : The Impact of Multinational Corporations on Development and on International relations. (E/5500/Rev.1/ST/ ESA/6) New York, 1974.

21. See : Indian Company Act 1956, Sec-4 (7), Reproduced in Ramaiya A : Guide to the Companies Act, 13 Ed., Wadhwa & Co., Nagpur 1995, p.85.

22. Indian Company Act, 1956, Sec-591, defines a foreign branch as a joint stock company incorporated outside India but which has a place of business in India. See : Ramaiya : A : Ibdi, p. 2817.

23. RBI : Bulletin, November 1994, p. 1395.