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Foreign Direct Investment in India: An Analysis

Dipon Ghosh
Assistant Professor, Dept. of Economics, Rabindra Sadan Girls' College, Assam, India

Abstract

The paper briefly explained the concept and definitions of Foreign Direct Investment (FDI) and how it is different from other types of foreign investment. The paper analyzed the theoretical background (OLI paradigm) for the occurrence of FDI both for the investing country and the host economy. At last, the inflow of FDI in India since 1991 has been discussed briefly. It has been explored that liberal economic policy has resulted in increased FDI inflows and the lion's share of FDI inflows has been in the service sector and from Mauritius. But the paper concluded that actually the US based MNCs have routed their investment in India via Mauritius.

Key Words: FDI, OLI paradigm, host economy, service sector, MNCs.

I. Introduction: Foreign Direct Investment (henceforth FDI) comprises of three words, namely, 'foreign', 'direct', and 'investment'. The word 'foreign' needs no explanation. It is understood that it is an investment made by a foreign entity to another country. The word 'investment' means the addition to the existing stock of capital in a country. So, FDI is foreign investment which is clearly different from other types of foreign investment because of the incorporation of the word 'direct'.

There are broadly two kinds of foreign investment such as direct investment and portfolio investment. If the investor directly controls the foreign enterprise his investment is called a direct investment. If he does not control it, his investment is a portfolio investment (Hymer, 1976). Hymer classified direct investment into two types: Type 1 and Type 2.

There are mainly two reasons why an investor will seek control. The first, which he called direct investment of Type 1, has to do with the prudent use of assets. The investor seeks control over the enterprise in order to ensure the safety of his investment. This reason applies to domestic investment as well.

The theory of Type 1 direct investment is very similar to the theory of portfolio investment. The interest rate is the key factor in both. Direct investment of Type 1 will substitute for portfolio investment when the distrust of foreigners is high or when fear of expropriation and risks of exchange-rate changes are high, but its movements will still be in response to differences in the interest rate.

There is another type of direct investment that does not depend on the interest rate and which he called direct investment of Type 2, or *international operations.* In this second type of direct investment, the motivation for controlling the foreign enterprise is not the prudent use of assets but something quite different. The control of the foreign enterprise is desired in order to remove competition between that foreign enterprise and enterprises in other countries. Or the control is desired in order to appropriate fully the returns on certain skills and abilities.

According to the Benchmark Definition by OECD (2008) "Foreign Direct Investment reflects the objective of establishing a *lasting* interest by a resident enterprise in one economy (direct investor) in an enterprise (direct investment enterprise) that is resident in an economy other than that of the direct investor. The *lasting interest* implies the existence of long term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of the enterprise. The direct or indirect of 10% or more of the voting power of an enterprise resident in one economy by an investor resident in another economy is evidence of such a relationship.

…….Direct investment is not solely limited to equity investment but also relates to reinvested earnings and intercompany debt" (OECD, 2008). It needs to be underlined here that main emphasis of the above definition is the *lasting interest* which is supposed to be evidenced by the fact of ownership of at least 10% of voting power because it is assumed to give an investor power to exercise significant influence over the investee. As per this definition, all investment below 10% limit is considered as portfolio investment.

According to the definition laid down by IMF in Balance of Payment Manual 5th Edition (BPM5) (1993), FDI is the category of international investment that reflects the objective of a resident entity in one country (direct investor or parent enterprise) obtaining a 'lasting interest' and control in an enterprise resident in another economy (direct investment enterprise).

Two criteria incorporated in the notion of 'lasting interest' are:

a) The existence of a long term relationship between the direct investor and the enterprise.
b) The significant degree of influence that gives the direct investor an effective voice in the management of the enterprise.

According to the above criteria, Direct Investment enterprises are those in which the foreign direct investor owns an amount of shares or voting power that allows him to participate effectively in the management of the enterprise or in its control.

Thus, most of the definitions stress on the 'lasting interest' between the investor and the investee and 'the exertion of significant degree of influence and control' by the direct investor on the investee. Although there is theoretical difference between FDI and FPI but importance is given to 'control' and 10% cut- off point required for portfolio investment to become direct investment.

The present paper intends to highlight some important aspects of FDI. Most cited definitions of FDI have been given in the introduction in section I. Section II describes the rationale for FDI, section III throws a light on FDI inflows in India and section IV concludes.

II. The Rationale for FDI: When we talk of foreign investment there are two countries involved namely the investing country and the host country in which the investment will take place. The need for investment must be felt by both countries. In other words, the benefits of investment should accrue to both the countries. This section is devoted to explain the rationale for FDI.

Why do firms go abroad? Why do they choose to invest in specific locations? These are two questions which need to be answered to explain the theoretical justifications for the investing firms (the investor) to invest in another country.

There are many theories which try to explain the reasons for the domestic firms to go abroad and start production. These are known as the theories of determinants of FDI. The theories of the determinants of FDI can be broadly divided into two parts. First, the theories assuming the perfect market and secondly, the theories assuming the imperfect market. The hypotheses based on the assumption of perfect competition include the differential rates of return hypothesis, the portfolio hypothesis and the output and market size hypothesis. The theories based on imperfect market are industrial organization, internalization, Eclectic Approach, Product Cycle, Oligopolistic Reaction. Other hypotheses include liquidity, currency area, Kozima Hypothesis etc. The theories are not discussed since it is beyond the scope of this article.

One of the most noted works in the literature of FDI is by Dunning (1977, 1981). Dunning's theory of FDI popularly known as 'Eclectic Paradigm' emphasized on three factors to explain the reason for FDI. These are Ownership Advantages (O), Locational Advantages (L) and Internalization Activities (I). This is known as OLI paradigm.

Ownership advantages also known as firm specific advantages are assumed to be exclusive to the enterprises which owns them and at least some of them are likely to be transferable across national boundaries (Dunning, 1981). Owner advantages specific to firms such as skills, R&D, marketing, scientific and technical works if exploited optimally can overcome the additional costs of establishing production facilities in a foreign environment vis -a vis local firms. These advantages must be excludable to compete in a foreign market.

Locational Advantages determine the extent of inflow of FDI in a country. A large market and cheaper cost of production and superior infrastructure are important location specific advantages that a firm looks for investment so that it can reap the benefits of economies of scale. Locational advantages are non-transferable but can be used more than one firm simultaneously.

The third factor is that it must be more beneficial for the firm to use the advantages internally rather than to sell or lease them to other independent firms. This is called ‘internalization’ activity by the firm by Dunning.

This is known as ‘Eclectic Paradigm’ because it could embrace three main vehicles of foreign involvement by enterprises, namely, direct investment , exports, and contractual resources transfers ,for example, licensing, technical assistance agreements, management contracts etc. and suggests which route of exploitation is likely to be preferred (Dunning, 1981). The matrix below summarizes the conditions for the three situations –

Table 1: Alternative Routes of Servicing Markets

		Advantages		
		Ownership	Internalization	(Foreign) Location
Routes of servicing market	Foreign Direct Investment	YES	YES	YES
	Exports	YES	YES	NO
	Contractual Resources Transfer	YES	NO	NO

Source: Dunning, 1981.

Among the OLI determinants of FDI the first and third conditions are firm specific and the second is location specific and has a crucial influence on a host country’s inflow of FDI. If only the first condition is met, firms will rely on exports, licensing or the sale of patents to service a foreign market. If the third condition is added to the first, FDI becomes the preferred mode of servicing foreign markets, but only in the presence of location –specific advantages. With the trinity of conditions for FDI to occur, locational determinants are the only ones that host country governments can influence directly (WIR, 1998).

Attention can now be shifted to the need of the host country for FDI. Why should a country invite FDI? Foreign Direct Investment (FDI) plays a pivotal role in the economic development of the host country. FDI can yield positive effects on a host economy’s development effort (Caves, 1974; Kokko, 1994; Markusen, 1995; Caves, 1996; Sahoo and Mathiyazhagan 2002). FDI can bring the technology diffusion to the sectors through knowledge spillover and enhances a faster rate of growth of output via increased labor productivity in host country (Borensztein, Gregorio and Lee 1995). According to Moran (1998), FDI is a method of transmission of the package of ‘managerial resources’. The package of ‘managerial resources’ may include specialized and technological knowledge in the areas of patents, know-how, sales techniques, managerial expertise etc. which may make a big contribution to the development of the host economy by raising the productivity. According to OECD (2008), foreign direct investment (FDI) is a key element in this rapidly evolving international economic integration, also referred to as globalization. FDI provides a means for creating direct, stable and long-lasting links between economies. Under the right policy environment, it can serve as an important vehicle for local enterprise development, and it may also help improve the competitive position of both the recipient (“host”) and the investing (“home”) economy. In particular, FDI encourages the transfer of technology and know-how between economies. It also provides an opportunity for the host economy to promote its products more widely in international markets. FDI, in addition to its positive effect on the development of international trade, is an important source of capital for a range of host and home economies. In addition to its direct effects, FDI has an impact on the development of labour and financial markets, and influences other aspects of economic performance through its other spill-over effects.

Moreover, it is a well-recognized fact that developing countries lack adequate capital formation for accelerating economic growth. In this case, Foreign Direct Investment (FDI) plays a pivotal role in filling the gap between domestic savings and investment. FDI is a non-debt creating source of external finance. Thus, it is theoretically expected to impose fewer burdens on the host country compared to other sources of external finance. Foreign Direct Investment (FDI) not only fills the gap between domestic savings and investment but also creates desirable effects in the host economy through the transfer of technology, know-how and other resources. That is to say, FDI has positive spillover effects in the host economy.

III FDI in India: Due to the adoption of liberal economic policy since 1991 the inflow of FDI in Indian economy has increased manifold. Two decades have passed since the adoption of economic reform measures in India and a number of changes have taken place during this period including the magnitude of inflow of FDI. The compound growth rate of FDI in India was 4 per cent during 1955-66, which rose to 75 per cent during 1991-98 (Sahoo and Mathiyazhagan (2002). However, with the adoption of reform measures the inflow of FDI has increased steadily. The amount of FDI inflow in 1991-92 was Rs. 351.43 crores which increased to Rs. 121907 crores in 2012-13.

Table 2: FDI inflows since 1991 (Rs. Crores)

Year	Amount	Annual Growth Rate
1991-92	351.43	-----
1992-93	691.20	96.68
1993-94	1861.96	169.38
1994-95	3112.23	67.15
1995-96	6485.36	108.38
1996-97	8752.19	34.95
1997-98	12989.76	48.41
1998-99	13269.23	2.15
1999-00	9259.94	-30.21
Average	**6308.14***	-----
2000-01	10441.14	12.75
2001-02	16071.14	53.92
2002-03	16134.44	0.39
2003-04	9563.91	-40.72
2004-05	14781.37	54.55
2005-06	19270.72	30.37
2006-07	50357.21	161.31
2007-08	65494.98	30.06
2008-09	135145.33	106.34
2009-10	123120	-8.89
Average	**25826.53***	----

Source: Secretariat of Industrial Assistance (SIA), Newsletter, Various Issue, Ministry of Commerce, DIPP.* own computation

In the post reform period, the inflow of FDI increased to a great extent (table 2) proving the effectiveness of the reform measures .It is observed that the FDI inflows stayed low through the nineties and it increased substantially in the first decade of the 21st century. This is clear from the average figures of FDI inflows in two decades. It needs to be answered why FDI inflows in recent has increased?

Table 3: Share of Important Sectors in FDI inflows in India (in percent)

Sectors	from Aug. 1991 to Dec. 1999	From Apr. 2000 to June 2013
Fuels	6.32	4.00
Electric Equip	8.05	1.62
Transportation	8.93	0.83
Chemicals	6.91	4.53
Food Processing	4.10	0.99
Metallurgical	1.09	3.84
Industrial machinery	0.63	1.2
Drugs and Pharma	1.43	5.7
Textiles	1.44	0.63
Service	7.01	19.22

Telecommunications	7.00	6.48
Miscellaneous industries	9.53	3.91

Source: Secretariat of Industrial Assistance (SIA), Newsletter, Various Issue, Ministry of Commerce, DIPP.

Table 4: Share of top 10 countries in FDI inflows in India (in percent)

Country	From Aug.1991 to Sep. 2009	From Aug. 1991 to Dec. 1999	From Apr. 2000 to Dec. 2012
USA	8.12	14	6
Mauritius	39.07	22	38
UK	5.03	4	9
Japan	3.48	5	7
Germany	3.64	4	3
France	1.4	0.18	2
Netherlands	3.95	0.34	5
UAE	1.21	0.06	1
Singapore	7.74	2.15	10
Cyprus	2.65	0.17	4

Source: Secretariat of Industrial Assistance (SIA), Newsletter, Various Issue, Ministry of Commerce, DIPP.

India's FDI figures were understated until 2000-01 because these did not include the reinvested earnings as in the international practice (Ram Mohan, 2008). But the inclusion of reinvested equity does not change the FDI figures in India drastically. According to Mohan, this rise in FDI figures in recent years is due to increase in private equity flows and venture capital flows, both of which are categorized under FDI. It is estimated by the private agencies that private equity accounted for nearly 50 percent of FDI which is higher that the corresponding figure of 18 percent for global FDI.

It is necessary to distinguish between firm FDI and FDI through private equity or venture capital in so far as the impact of FDI inflow in domestic economy is concerned. Firm FDI brings technology, export linkages and management. Private equity brings mainly management. Although the BoP effects of both the types of FDI is same, but the contribution to domestic economy significantly differs.

Besides private equity has a shorter time horizon than the firm FDI, which is considered virtually permanent in nature. Thus, it is similar to portfolio inflows which have less stability than firm FDI.

The changes also took place in the sector-wise and country-wise composition of FDI inflows in India since 1991. There has been fall in the share of electrical equipment, transportation, food processing, fuels and chemicals from 1991-1999 to 2000-2013. It is remarkable to note that the share of the service sector in total FDI inflows has increased from 7 percent in 1991-1999 to 19.22 percent in 2000-2013.

The number of countries investing in India increased during the reform period. In 2000 the FDI proposals of 86 countries were approved by the Indian Government as compared to 29 countries in 1991. But still the lion's share of FDI comes from a few countries as given in table 4. It is seen that from the table that from the period from 1991 to 1999 the share of Mauritius (22 percent) tops the list among ten countries followed by USA (14 percent), Japan (5 percent), UK and Germany (4 percent), Singapore (2.15 percent), Netherlands (0.34 percent), France (0.18 percent), Cyprus (0.17 percent) and UAE (0.06 percent). But for the period from 2000 to 2012 there has been a significant shift in the share of different countries. Again, it is observed that lion's share of FDI inflow was from Mauritius (38 percent) followed by Singapore (10 percent), UK (9 percent), Japan (7 percent), USA (6 percent), Netherlands (5 percent), Cyprus (4 percent), Germany (3 percent), France (2 percent) and UAE (1 percent).

Thus, it is clear that there has been a paradigm shift in the share of different countries in respect of FDI inflows since 2000. The most remarkable is the large share of Mauritius which is 39 percent for the period ranging from 1991 to 2009 (upto September) and the fall in the share of USA since 2000.

A question will naturally arise in mind that why or how is Mauritius investing such a huge amount in India surpassing other developed countries such as USA, UK, and Japan etc.? The actual fact is that the MNCs set up in Mauritius by the US firms are investing such a huge amount in India. This means that US companies have routed their investment in India via Mauritius. It is due to the different tax treaty for different countries to invest in India. For example, the tax treaty between Mauritius and India stipulates a dividend tax of five per cent, while the treaty between Indian and the US stipulated a dividend tax of 15 per cent (World Bank, 1999).

The India-Mauritius Double Taxation Avoidance Agreement (DTAA) was signed in 1982 and has played an important role in facilitating foreign investment in India via Mauritius. According to the DTAA between India and Mauritius, capital gains arising from the sale of shares are taxable in the country of residence of the shareholder and not in the country of residence of the company whose shares have been sold. Therefore, a Company resident in Mauritius selling shares of an Indian company will not pay tax in India. Since there is no capital gains tax in Mauritius, the gain will escape tax altogether (NCAER, 2009). This is precisely the reason why FDI inflow from Mauritius has been high; on the other hand, the share of other major countries is low.

IV Conclusion: The paper tried to provide a preliminary knowledge of FDI. The paper briefly explained the theoretical base regarding the rationale for FDI. All the theories have not been explained because this is beyond the scope of this paper. The 'Eclectic Paradigm' is explained because it is one of the most comprehensive and cited theories of determinant of FDI. The paper also analyzed the need for FDI inflow in developing and underdeveloped economy (host country).The paper showed the FDI inflows in India since 1991 in table 2 and sector-wise and country-wise composition of FDI inflows in table 3 and table 4 respectively.

The paper concludes that the rise in FDI inflows in India in recent years is due to hike in private equity which is also considered as FDI as per international best practices. The rise in private equity inflows is not economically viable so far as the impact of FDI in the domestic economy is concerned because it has a temporary impact in the economy.

The sector-wise composition shows that the lion's share of FDI inflows is in the service sector in recent years and the country-wise data show that a large share of FDI inflow was from Mauritius. There has been the rise in the share of Singapore, UAE and Cyprus in the share of FDI inflows in the last decade. But actually the US based MNCs established in Mauritius have routed their investment through Mauritius to reap the benefit of tax treaty signed between India and Mauritius, that is, DTAA.

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