Private Foreign Investment in India: Pain or Panacea?*

Suma Athreye and Sandeep Kapur

1. INTRODUCTION

The 1990s have seen a marked increase in private capital flows to India, a trend that represents a clear break from the two decades before that. In the 1970s there was hardly any new foreign investment in India: indeed, some firms left the country. Inflows of private capital remained meagre in the 1980s: they averaged less than $0.2 billion per year from 1985 to 1990. In the 1990s, as part of wide-ranging liberalisation of the economy, fresh foreign investment was invited in a range of industries. Inflows to India rose steadily through the 1990s, exceeding $6 billion in 1996-97.

Table 1: Recent foreign investment in India, net inflows in US $ billion

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</thead>
<tbody>
<tr>
<td>Direct investment</td>
<td>0.10</td>
<td>0.13</td>
<td>0.32</td>
<td>0.59</td>
<td>1.31</td>
<td>2.13</td>
<td>2.70</td>
<td>3.20</td>
<td>2.06</td>
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<tr>
<td>Portfolio investment</td>
<td>0.01</td>
<td>0.00</td>
<td>0.24</td>
<td>3.57</td>
<td>3.82</td>
<td>2.75</td>
<td>3.31</td>
<td>1.83</td>
<td>-0.06</td>
</tr>
<tr>
<td>Total</td>
<td>0.10</td>
<td>0.13</td>
<td>0.56</td>
<td>4.15</td>
<td>5.13</td>
<td>4.88</td>
<td>6.01</td>
<td>5.03</td>
<td>2.00</td>
</tr>
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</table>

Source: RBI Bulletin: see appendix for details

Table 1 highlights the growth in inflows. To put these figures in perspective, note that the total stock of private foreign equity capital in Indian industry was only about $2 billion in 1990. Or, comparing the flows to broad external sector aggregates, in 1997-98, foreign investment inflows of $5 billion could finance a sizeable chunk of India’s $6.5 billion current account deficit. In the early 1990s the inflows were primarily as portfolio capital (that is, diversified equity holdings not associated with managerial control) but, increasingly, they have come as foreign direct investment. As can be expected, portfolio capital flows are relatively volatile: in the wake of the recent global financial crises, there was a small net outflow of portfolio capital in 1998-99, but inflows have picked up

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again. Provisional figures for the first nine months of 1999-2000 show portfolio capital inflows to be $2 billion, while direct investment inflows were about $1 billion.

India was not unique as a recipient of increased inflows in the 1990s. International flows of private capital to most developing countries rose sharply over this period. The historically low interest rates in the US encouraged global investment funds to diversify their portfolios by investing in emerging markets. International flows of direct investment, which had averaged $142 billion per year over 1985-90, more than doubled to $350 billion in 1996, with the developing countries receiving $130 billion. Host country policies did influence the choice of location for this investment. China received the largest chunk: at $42bn, FDI inflows accounted for as much as a quarter of its gross capital formation in the mid-1990s. Other developing countries, most notably those in the Pacific Basin, also received sizeable flows.

Foreign direct investment flows to India remain small in relation to its economy. At around two to three billion US dollars per year, they amount to less than five per cent of domestic capital formation and thus remain marginal to the investment process. Some commentators believe that if only India could attract enough foreign capital it could move on to a higher growth path. Official policy statements in India seem to endorse this belief: the progress of economic reforms is measured in terms of cumulative foreign capital inflows or, even more optimistically, in terms of approvals granted for foreign inflows. Reality has trailed behind official expectation—over the period 1991 to 1998, actual inflows of foreign direct investment averaged no more than one-fifth the total value of approvals.

The case for foreign capital is usually made as follows. Foreign investment can supplement domestic investible resources in a developing economy, enabling higher rates of growth. As a source of foreign exchange, it can relax potential balance of payments constraints on growth. Profit remittances on account of foreign equity are related to the performance of investment projects, unlike the inflexible repayment obligations of foreign debt: this risk-sharing feature makes foreign equity preferable to foreign debt. Foreign firms contribute to the technological base of the host economy, directly and through technological spillovers, thereby increasing productivity and international competitiveness of the host economy. Global linkages of multinational firms may facilitate the marketing of exports. Besides, in the right circumstances, the presence of foreign firms reduces market concentration and promotes a more competitive market structure.

Critics of multinational firms have long argued against this rosy picture. They claim that multinationals monopolise resources, supplant domestic enterprise,
introduce inappropriate products and technology, and aggravate the balance of payments problems through high remittances. They often use transfer pricing to minimize their tax liabilities. They may also come to wield considerable political influence, distort the path of development, exacerbate income inequality, and exploit the weak environmental standards in developing countries (recall the Union Carbide disaster at Bhopal in 1984).

To a large extent, the overall contribution of foreign capital depends on the motivating factors for foreign direct investment (FDI). Some multinationals invest abroad to benefit from better international organisation of production and location decisions, and are attracted by the high rates of return in the host economy. Crudely speaking, we could refer to such FDI as growth-led and efficiency-seeking. But even a stagnant economy may attract rent-seeking multinationals that have a comparative advantage, over domestic firms, in extracting monopoly rent in protected markets. The relative mix of these two types of FDI determines the long-term benefits and costs of foreign capital. Ideally, a country would like to attract efficiency-seeking FDI and exclude rent-seeking FDI. Of course, from practical or regulatory points of view, it is not easy to distinguish ex-ante between the two types of FDI. A permissive regulatory environment may end up admitting both types, while a restrictive environment may exclude both. In the perverse case, the regulatory environment may create hurdles that rent-seeking FDI alone can jump over. One way to reduce this risk is to promote a regulatory environment that makes it hard to generate monopoly rent, thus making investment less attractive for rent-seeking FDI.

India’s experience with private foreign capital is interesting, especially in light of its recent attempts to liberalise a regime that was notoriously hostile to foreign investors. We scrutinise the role private foreign capital has played in India over the last five decades. In particular, we compare the conduct and performance of foreign-controlled firms relative to domestic firms; unlike previous studies that have looked at this issue over short periods of time, we examine long-term trends in relative performance. Our study focuses on aggregate behaviour; this allows us to explore an issue ignored in previous studies, namely the macroeconomic linkage between the overall trade and industrial regime and policy towards foreign capital. Section 2 reviews the policy framework towards foreign capital in India; Section 3 examines the long-term trends in foreign investment; Section 4 assesses the importance of foreign-controlled firms in Indian manufacturing and their performance relative to domestic firms. Section 5 attempts to evaluate the contribution of foreign capital to the Indian economy, including the consequences of recent liberalisation. Section 6 outlines the policy implications that emerge from our analysis.
2. FIVE DECADES OF POLICY CHANGES

Private foreign capital had a substantial presence in Indian industry prior to independence in 1947. Foreign firms, mostly British in origin, dominated India's mining, plantations, trade and much of the fledgling manufacturing base. In the immediate aftermath of Independence, government policy towards foreign capital remained ambivalent, alternating between a nationalist distrust of colonial firms and the hope that new foreign investment could provide the technology and capital essential for rapid industrialisation.¹

The Second Economic Plan of 1957 triggered a switch to a policy of industrialisation through import-substitution. This called for a large increase in domestic investment. At the same time a severe foreign exchange crisis curtailed imports, especially of consumer goods. These events created extremely lucrative opportunities for private investment in India. To exploit these opportunities, Indian business had to turn abroad for technology. For foreign capital, this was an excellent opportunity to jump the newly created tariff barriers. The government invited foreign capital in many sectors, including pharmaceutical drugs, aluminium, heavy electricals and chemicals, and fostered the creation of joint ventures with Indian partners.

However, by the end of the 1960s, in the aftermath of two famines and a humiliating devaluation of the Rupee, the political mood hardened. Major commercial banks were nationalised and the Monopolies and Restrictive Trade Practices Commission was set up. Heightened concern about the foreign-exchange costs of repatriated profits changed the tenor of policy towards foreign capital. Foreign oil-majors were nationalised in the early 1970s. The government did not rule out new foreign investment but now wanted it on its own terms. The Foreign Exchange Regulation Act (FERA) of 1973 introduced a new clause that required firms to dilute their foreign equity holdings to 40 per cent if they wanted to be treated as Indian companies.

There were also new restrictions on technology imports. To minimise the foreign exchange costs of technology acquisition, as far as possible technologies were to be acquired through licensing rather than financial collaboration. Fresh lists were drawn up of industries where foreign collaboration was still considered necessary; others where only technical collaborations was permitted, with curtailed rates of royalty payment; and those where the domestic technological base was considered strong enough to make technology imports unnecessary.

¹ For an interesting study of how early official policy towards foreign capital was shaped by the uneasy, triangular relationship between domestic industrial houses, foreign capital and the government, see Kidron (1965).
Intellectual property rights were severely curtailed by a revised Patents Act in 1970: product-patents were abolished in industries such as pharmaceuticals and chemicals; the duration of process-patents was shortened.

In the 1980s, growing concern about stagnation and technological obsolescence in Indian industry drew attention to the restrictive licensing procedures. Poor quality and high costs in Indian manufacturing probably contributed to the poor export performance, a particular irritant in the wake of the second oil price shock. As a consequence, there was a softening of the regulatory regime. To encourage exports, firms that produced primarily for exports were granted exemptions from the usual FERA restrictions on foreign equity ownership. In an attempt to modernise manufacturing industry, restrictions on technology transfers and royalty payments were relaxed. Where attempts to acquire technology through licensing had failed, foreign equity participation was permitted again. However, despite official claims of simplified procedures and cleared bottlenecks, foreign investment projects were still very vulnerable to bureaucratic discretion: there is little evidence that policy was any more informed about the needs of Indian industry or the nature of the technology market. Foreign equity inflows remained paltry and, to a large extent, Indian industry came to rely on foreign debt capital to meet its foreign exchange needs over this period.

The 1990s began with a major crisis. In the wake of the Gulf War, and the consequent expulsion of Indian expatriate labour from the Middle-East, foreign exchange remittances fell. As the balance of payments position deteriorated, a panicked withdrawal of funds deposited in India by ‘non-resident-Indians’ exacerbated the problem. The real possibility that India might default on its external obligations led to a downgrading of India’s credit rating. As part of the reforms agreed with the IMF, the Rupee was devalued by 20 per cent, and fresh attempts were made to liberalise the trade regime and the regulatory framework. Industrial licensing was abolished in all but a handful of industries.

Foreign direct investment was now permitted in many sectors from which foreign capital had been excluded in the past. These included the infrastructure sectors previously monopolised by state enterprises: power generation, highway and port construction, telecommunications, oil and natural gas exploration. The services sector, where foreign capital had been eliminated as a matter of deliberate policy, was reopened: fresh investment was approved in financial services, retail banking, and recently, in life and general insurance. The government dropped its insistence that foreign equity participation provide specific benefits in terms of technology transfer or export earnings. The limit on foreign equity participation was raised to 51 per cent for most industries, and even 100 per cent in some cases. Restrictions on the use of international brand names were removed. Reforms in
the technology policy have provided greater recognition of intellectual property rights.

Despite the exceptional political instability after 1995, successive governments have continued to court foreign capital even though the liberal stance has not always been consistent. In a sense, the attitude towards foreign capital seems to have turned a full circle. In a pattern reminiscent of the early 1950s, domestic business interests have increasingly lobbied the government for continued protection against foreign capital.

In the last five decades, policy towards private foreign capital has moved closely with exigencies of India’s external payments position, and with changing official perceptions of the role of foreign capital in alleviating or exacerbating that position. The early liberalisation of the late 1950s was in part motivated by a balance of payments crisis. The restrictive regime of the 1970s, and FERA in particular, was influenced by the belief that excessive remittances of foreign enterprises were worsening a precarious balance of payments position. The gradual liberalisation of the 1980s and the major reforms of the 1990s were, to different degrees, responses to external payments difficulties. Of course the balance of payments positions were determined primarily by the overall policy regime, especially trade and industrial policy. Nevertheless the changing policy environment had a direct effect on the extent of foreign capital in Indian industry and its contribution to the economy.

3. PRIVATE FOREIGN CAPITAL IN INDIA: LONG-TERM TRENDS

At Independence, the total stock of private foreign capital in India was valued at Rupees 5.8 billion ($1.2 billion at 1948 exchange rates). By 1995, the most recent year for which comparable data is available, the stock had grown to Rupees 989 billion ($31 billion). As a rough comparison, gross equity inflows have averaged over $4 billion per year since 1995.

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<th>Table 2: Stock of private foreign capital in the Indian corporate sector</th>
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<td>Long-term investment (Rs billion), of which</td>
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<td>1 Direct investment (%) share in total</td>
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<td>2 Portfolio investment (%) share in total</td>
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<td>3 Foreign debt (%) share in total</td>
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</table>

This is private long-term capital in firms, excluding banks. The procedure for classifying equity capital as direct investment and portfolio investment changed in 1992, hence relative shares are not comparable after that year. For a discussion of this and all data sources, see the appendix.
Table 2 profiles the long-term foreign liabilities of Indian firms over this period. The growth rate of foreign liabilities varied across time and investment categories. Foreign direct investment was modest in the 1950s, but grew steadily in the 1960s, its stock rising from Rupees 2.6 billion in 1948 to Rupees 7.4 billion by 1970. In response to policy changes, its rate of growth fell in the 1970s, picked up in the 1980s, but the real surge came after 1992: the stock of direct investment rose from Rupees 38 billion in 1992 to Rupees 94 billion by 1995.

For most of this period, foreign portfolio investment was restricted as a matter of deliberate policy. The total stock of portfolio capital was less than Rupees 15 billion in 1992. With liberalisation these portfolio holdings rose to Rupees 200 billion by 1995, though recent financial crises have seen net outflows on this account. Most strikingly, the largest single component of private foreign capital after 1980 has been long-term corporate debt: when foreign equity inflows were restrained during the 1980s, Indian firms made up by borrowing abroad. Even in 1995, foreign corporate debt was more than twice as large as foreign equity capital. Of course, the rupee value of debt is slightly exaggerated by currency devaluation in 1991-92. Thus, the commonly held view that the Indian economy was cut off from foreign capital is not quite true—more accurately, the corporate sector was deprived of foreign equity participation.

Policy changes also affected the sectoral distribution of foreign direct investment, summarised in Table 3. To a large extent, the government managed to direct foreign capital to technology-intensive manufacturing sectors. In 1948, a third of all foreign direct capital was in the primary sector (plantations, mining, and oil), a quarter in manufacturing, and the rest in services (mostly trading, construction, transportation and utilities). Foreign holdings in plantations and mining fell sharply after 1950. The share of oil-refining rose as the oil-multinationals entered in the early 1950s, but as in the service sectors, it fell when many foreign firms were nationalised in the 1970s.

During the 1960s inflows concentrated on manufacturing, especially the technology-intensive industries. By the mid-1990s, manufacturing accounted for about 85 per cent of all foreign direct capital. In absolute terms, the stock of foreign direct capital in manufacturing rose from Rupees 0.7 billion in 1948 to over Rupees 79 billion by 1995. Within manufacturing, the capital goods sector was the predominant recipient of FDI: engineering and heavy chemicals account for two-thirds of all foreign direct capital.

Comparable figures after 1995 are not available but data from the Secretariat of Industrial Approvals provides partial comparison. The energy sector has seen renewed interest among foreign investors: 30% of FDI inflows approved since 1991 are concentrated in this sector. Other sectors with high share in approvals are
telecommunications (17%), transport (8%) and services (9%). Manufacturing accounted for only 17% of the value of FDI approvals over this period.

Table 3: Changing distribution of foreign direct capital stock in India, percentages

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<tr>
<td>Plantations</td>
<td>20.4</td>
<td>19.0</td>
<td>16.5</td>
<td>4.1</td>
<td>8.8</td>
<td>8.5</td>
<td>4.8</td>
</tr>
<tr>
<td>Mining</td>
<td>4.5</td>
<td>2.4</td>
<td>0.8</td>
<td>0.9</td>
<td>0.3</td>
<td>0.6</td>
<td>0.3</td>
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<tr>
<td>Petroleum</td>
<td>8.7</td>
<td>29.7</td>
<td>16.7</td>
<td>4.0</td>
<td>0.1</td>
<td>2.0</td>
<td>2.9</td>
</tr>
<tr>
<td><strong>Total primary sector</strong></td>
<td>33.6</td>
<td>51.2</td>
<td>34</td>
<td>9.2</td>
<td>11.1</td>
<td>8.0</td>
<td></td>
</tr>
<tr>
<td>Food &amp; beverages, tobacco</td>
<td>14.2</td>
<td>6.4</td>
<td>5.6</td>
<td>4.2</td>
<td>6.5</td>
<td>4.9</td>
<td>7.3</td>
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<td>Textiles</td>
<td>39.4</td>
<td>2.7</td>
<td>3.0</td>
<td>3.4</td>
<td>4.6</td>
<td>2.9</td>
<td>3.9</td>
</tr>
<tr>
<td>Transport equipment</td>
<td>1.4</td>
<td>1.2</td>
<td>3.7</td>
<td>5.6</td>
<td>9.9</td>
<td>12.4</td>
<td>10.5</td>
</tr>
<tr>
<td>Machinery &amp; machine tools</td>
<td>1.7</td>
<td>0.8</td>
<td>3.8</td>
<td>7.6</td>
<td>12.1</td>
<td>12.6</td>
<td>11.3</td>
</tr>
<tr>
<td>Metals and metal products</td>
<td>11.3</td>
<td>2.8</td>
<td>8.8</td>
<td>12.7</td>
<td>4.9</td>
<td>5.1</td>
<td>4.6</td>
</tr>
<tr>
<td>Electrical goods</td>
<td>6.8</td>
<td>2.3</td>
<td>6.5</td>
<td>10.5</td>
<td>11.9</td>
<td>11.0</td>
<td>10.8</td>
</tr>
<tr>
<td>Chemicals &amp; pharmaceuticals</td>
<td>3.1</td>
<td>6.4</td>
<td>18.8</td>
<td>32.4</td>
<td>29.6</td>
<td>28.0</td>
<td>22.2</td>
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<tr>
<td>Miscellaneous</td>
<td>9.9</td>
<td>6.2</td>
<td>12.0</td>
<td>10.7</td>
<td>6.1</td>
<td>6.4</td>
<td>12.8</td>
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<tr>
<td><strong>Total manufacturing</strong></td>
<td>27.8</td>
<td>30.0</td>
<td>60</td>
<td>87</td>
<td>85.6</td>
<td>83.2</td>
<td>83.4</td>
</tr>
<tr>
<td>Trading</td>
<td>16.3</td>
<td>5.4</td>
<td>2.6</td>
<td>2.3</td>
<td>0.4</td>
<td>1.1</td>
<td>1.3</td>
</tr>
<tr>
<td>Construction, utilities, transport</td>
<td>11.9</td>
<td>7.6</td>
<td>1.6</td>
<td>0.6</td>
<td>2.2</td>
<td>1.1</td>
<td>0.7</td>
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<tr>
<td><strong>Total services</strong></td>
<td>38.7</td>
<td>19.5</td>
<td>16.0</td>
<td>4.0</td>
<td>5.1</td>
<td>5.7</td>
<td>8.9</td>
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<tr>
<td>Total FDI (current Rs. Million)</td>
<td>2558</td>
<td>5017</td>
<td>7354</td>
<td>9330</td>
<td>17420</td>
<td>38400</td>
<td>94160</td>
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</tbody>
</table>

1992 and 1995 figures use the modified definition of FDI. See appendix.

The historical dominance of British firms has shown remarkable persistence in post-imperial India. Three-quarters of all foreign capital was British in 1948. This share declined to 40 per cent by 1992, and to 25 per cent by 1996. The share of US firms has risen: since 1991, they have accounted for 22% of the value of all FDI approvals. Germany, Japan, and Switzerland have had a growing presence, and recent approvals have also included firms from South Korea and Australia.

The industrial distribution of foreign capital differs according to the nationality of investors. Multinationals from the US, Germany and Japan have gravitated to technology-intensive manufacturing while traditional investments are still predominantly monopolised by British firms.

Table 4: Countries of origin: stock of foreign direct investment in India

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<tbody>
<tr>
<td>UK</td>
<td>76.6</td>
<td>64.5</td>
<td>53.9</td>
<td>51.7</td>
<td>40.2</td>
<td>28.0</td>
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<tr>
<td>USA</td>
<td>14.5</td>
<td>18.4</td>
<td>21.1</td>
<td>12.9</td>
<td>18.6</td>
<td>24.1</td>
</tr>
<tr>
<td>Germany</td>
<td>1.1</td>
<td>3.1</td>
<td>7.0</td>
<td>16.7</td>
<td>12.4</td>
<td>8.9</td>
</tr>
<tr>
<td>Japan</td>
<td>0.2</td>
<td>0.4</td>
<td>0.4</td>
<td>3.7</td>
<td>5.5</td>
<td>7.6</td>
</tr>
<tr>
<td>Switzerland</td>
<td>2.4</td>
<td>5.0</td>
<td>5.9</td>
<td>3.7</td>
<td>4.8</td>
<td>5.6</td>
</tr>
<tr>
<td>Others</td>
<td>5.2</td>
<td>8.6</td>
<td>11.7</td>
<td>11.3</td>
<td>18.5</td>
<td>26.8</td>
</tr>
</tbody>
</table>
4. FOREIGN-CONTROLLED FIRMS IN INDIAN INDUSTRY

(a) Market Shares

To what extent have foreign-controlled firms dominated Indian manufacturing? The relative share of foreign firms in Indian industry has been a matter of some controversy. Existing estimates—see Kumar (1994) for a survey—are mostly point estimates and provide a poor guide to long-term trends. We estimate the foreign share in Indian industry for the period 1970 to 1994 using unpublished data from the Reserve Bank of India (RBI). The data is constructed from a sequence of surveys of finances of medium and large public limited companies. These surveys identify firms by their country of controlling interest, based on contemporary classification procedures. For much of the period under study, a firm was considered to be foreign controlled if 25 per cent of its equity was held by a single foreign investor, or if 40 per cent of the equity was held in any one foreign country. Effective 1992, the RBI adopted the IMF guidelines: a firm is treated as a foreign direct investment enterprise if 10 per cent of its voting stock is held abroad by a single investor.

We estimate foreign shares in Indian manufacturing as the share of foreign-controlled firms in gross sales. Figure 1 shows that foreign-controlled firms accounted for between a third and a quarter of gross sales in Indian manufacturing over period 1970 to 1994. The foreign share rose slightly from 1970 to 1976 and has declined since. We believe that the sharper decline after 1991 is an artefact of the data: foreign firms seem under-identified or under-represented in recent surveys. Athreye and Kapur (1999) report that foreign shares are high in electricals (especially dry cells and lamps), chemicals (especially pharmaceuticals, plastics, paints, and toiletries), tyres and tubes, cigarettes, aluminium, automotive components. British-controlled firms have the largest share: in 1990-91, they controlled 15 per cent of all sales -- domestic or foreign -- in Indian manufacturing; the share of US firms was just below 5 per cent.

While the Foreign Exchange Regulation Act (1973) compelled many multinationals operating in India to dilute foreign shareholdings to 40 per cent, in most cases the foreign parent managed to retain control over their Indian affiliates with this minority shareholding. Typically, the required dilution was achieved through fresh equity issues and control over such share allocations ensured that domestic shareholdings were fragmented. For instance, 89,000 individuals

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2 These surveys exclude state-owned enterprises, ‘unlisted’ companies and all small firms. As the excluded sectors are predominantly domestically owned, our estimates exaggerate the foreign presence. Moreover, if excluded sectors grow faster (or slower) than the firms in our data set, changes in foreign presence over time are over- (or under-) estimated. Despite these limitations, the data has the merit of being internally consistent and covers a reasonable long period of time. For further discussion, and for a comparison with others’ findings, see Athreye and Kapur (1999).
Private foreign investment in India

together made up the 47 per cent domestic shareholding in Hindustan Lever, while its parent, Unilever, retained 51 per cent (figures for 1980). Importantly, state-controlled financial institutions, which often had significant equity holdings in Indian business houses, did not invest in foreign affiliates -- this removed a possible channel of countervailing power. While the government enforced the complete Indianisation of managerial cadres in India, many minority foreign-owned affiliates found non-equity forms of control over their local management. When foreign exchange was a scarce commodity, control over loans from the foreign parents to the Indian subsidiaries became an indirect channel of control.

Our findings do not support the common-place belief that FERA (1973) curtailed foreign control in Indian industry. As Encarnation (1989) notes, many multinationals ‘continued to turn adversity into opportunity’: in exchange for expanded exports or increased production in priority industries, the government allowed more than a hundred foreign enterprises to retain majority-holdings in their Indian affiliates. The required equity dilutions allowed them to raise fresh capital at a time when access to capital markets was severely restrained by the government. Even though a few multinationals—notably Coca-Cola and IBM—left India in the late 1970s, most chose to stay. Indeed, many foreign-controlled firms managed to consolidate their position in the Indian market. Overall, FERA allowed incumbent foreign firms to preserve their market shares in India, and sometimes to thrive too, even as it deterred new foreign investment.

The gradual decline in foreign market shares, especially in the 1980s, is better explained by the restrictions placed on foreign firms by the overall regulatory framework. Greater selectivity in industrial licensing restrained the growth of many multinationals. Many multinationals were unable to compete against well-organised domestic industrial lobbies. Restrictions on monopoly power (the Monopolies and Restrictive Trade Practices Act) and a diminution of intellectual property rights (the Patents Act) eroded many of the rent-seeking advantages that foreign firms had enjoyed in India. Encarnation (1989) argues that India acquired financial autonomy from foreign enterprises at an early stage by mobilising domestic capital, and then managed to unbundle technology acquisition from equity participation. In part, foreign multinationals were displaced by the growth of state-owned enterprises in some sectors (steel, engineering, chemicals, pharmaceuticals, mining, transport, power), and progressive nationalisation in others (textiles). Despite this gradual erosion in some sectors, multinationals were not quite dislodged from India. Many preserved their foothold in India, and were well placed to recover their position in the 1990s.
(b) Foreign-controlled Firms: Conduct and Performance

Did the foreign-controlled firms in India differ from domestic firms in terms of their conduct and performance? We use the RBI data to compare the conduct and performance of foreign-controlled and domestic firms over the period 1970 to 1994. For each variable under scrutiny, we compare the weighted average for foreign-controlled firms with that for domestic firms.

Figure 2 shows that foreign-controlled firms had higher profit margins than domestic firms throughout this period. How did the multinationals maintain these higher profit margins? In theory this could be due to the greater efficiency of foreign firms, or due to their presence in concentrated, and hence more profitable, sectors. While our data does not allow us to test these hypotheses, we do find advertising intensity, measured as the ratio of advertising expenditure to net sales, was greater for foreign-controlled firms (see Figure 3). On the other hand, domestic firms relied more heavily on selling commissions (Figure 4). Of course, different industrial sectors differ in the advertising intensity: the overall difference in marketing strategies might reflect the differences in industrial concentration of foreign-controlled and domestic firms.

Unfortunately, we do not have comparable data for R&D expenditure, but these were typically quite small for all manufacturing firms in India. Based on statistics published by the Department of Science and Technology, Basant (2000) reports that private sector R&D was less than 1% of sales for all of this period. Of course foreign-controlled firms could be expected to rely substantially on technology imports. Figure 5 shows that domestic firms have increased their expenditure on technology imports and, remarkably, have overtaken foreign firms in recent years.

On the whole we find that the differences in the conduct of foreign-controlled and domestic firms were not as strong as the marked difference in their profitability. Kumar (1990) concluded that the profitability of foreign-controlled firms was protected by entry-barriers: in knowledge- and skill-intensive industries, their technological strength, access to global marketing networks and brand names gave them a clear edge over domestic firms. We examine the link between foreign ownership and market-structure later in this paper.

5. THE CONTRIBUTION OF PRIVATE FOREIGN CAPITAL

What has been the impact of private foreign capital on the Indian economy? Those who advocate a more liberal regime claim that FDI will provide the much-needed investible resources and foreign exchange for reviving Indian industry, improve the crumbling infrastructure, modernise the technological base, and foster greater competition in Indian manufacturing. On the other hand, critics of
foreign capital point to the poor record of multinational corporations in India, their excessive profitability, the adverse impact of profit remittances on India’s balance of payments and their limited technology transfer. We scrutinise the available evidence to assess the validity of the rival claims, but it helps to begin on a conceptual note.

Does foreign investment contribute to growth? Casual empiricism does not offer any simple lessons. Countries like China have experienced large FDI inflows and high growth in recent years, while Korea grew rapidly without significant levels of foreign capital. Many Latin American countries have some periods of slow growth despite openness to foreign capital, while much of sub-Saharan Africa has experienced low growth and poor investment flows. Moreover, even if we did find some positive correlation between FDI and growth, the issue of causality remains unresolved. Does foreign capital increase the growth rate, or does the prospect of higher growth attract investment flows? Anecdotal evidence apart, cross-country econometric evidence does not offer stronger conclusions: de Mello (1997), surveying the evidence, concludes that the relationship between FDI and growth depends on country-specific factors.

In theory, foreign direct investment inflows affect economic growth through increased investment in the economy. As a macroeconomic identity, total investment in an economy must be financed each period through foreign and domestic savings, where foreign savings equal foreign equity and debt inflows. Other things being the same, an increase in FDI increases foreign savings and so increases domestic investment. However, it is possible that increases in FDI inflows coincide with a reduction in debt inflows (so that total foreign savings remain constant) or be accompanied by a fall in domestic savings (say, if there is a consumption boom): in each case domestic investment does not rise.

The effect on balance of payments can be similarly analysed. In general, an increase in FDI allows the host country to import more or to accommodate a decline in exports. This is not surprising: indeed, the purpose of foreign savings is to import more in the short run. Thus, at least in the short run, inflows of foreign capital allow the current account to worsen or result in accumulation of foreign exchange reserves. Note that the effect on the balance of payments is the flip side of the effect on domestic savings and investment: FDI can conceivably increase domestic investment, or provide additional balance of payments financing for an existing current account deficit, but cannot do both at the same time.

In general, a FDI-financed, short-run, ability to import more could equally well support a consumption boom or an investment boom. If it is the latter, it would typically result in faster growth and, possibly, increased exports. After allowing for some profit repatriation on account of successful investment, the host economy would still benefit. However, the long-term outcome is not always so
favourable. Singh and Weisse (1998) note that rapid inflows to Mexico in the early 1990s fuelled a consumption boom, accompanied by large current account deficits. If inflows are in the form of portfolio capital (rather than, say, FDI in greenfield ventures), they are more likely to result in consumption rather than investment booms. A significant fraction of recent inflows to India have been flows of portfolio capital, whose direction is easily reversed with changes in market perceptions, as evident from Table 1. A sudden reversal of flows has catastrophic effects on investment, output, and the balance of payments, as evident from the experience of Mexico, and more recently, East Asia. In such circumstances, instability in capital flows results in volatility in economy-wide growth rates.

**a) Savings and Investment**

Theoretical possibilities apart, does FDI increase aggregate investment in an economy? Fry’s (1995) econometric analysis of FDI flows over 1966-88 to 16 large developing countries, including India, cautions against any simple generalisations. Correcting for a host of country-specific factors, he finds that FDI inflows seem to have a negative effect on domestic investment. Other studies, for instance Dhar and Roy (1996), confirm this finding. It could well be that FDI crowds out domestically-financed investment. Alternatively, it could be that FDI inflows rise in recessionary environments -- note the ‘fire-sale FDI’ in wake of the recent South Korean crisis. Fry’s related finding, that FDI flows do not have any significant positive impact on contemporaneous growth rates, is hardly surprising.

FDI inflows may have a more positive contribution in the long-run, and more so for some countries than others. Fry finds that domestic investment and growth are positively related to FDI flows lagged by 5 years. A sub-sample of Pacific-Basin countries does better than the countries outside that region. For the Pacific Basin countries, domestic investment rises by the full extent of the FDI inflow, with generally beneficial effects on growth. Outside the Pacific Basin, FDI appears to substitute for other kinds of foreign flows: FDI inflows were accompanied by lower investment, lower savings and slower growth. In other words, FDI could even be immiserising.

It could be argued that these diverse experiences are related to the overall economic regime of the host country, and that countries with a ‘favourable environment for investment’ do better with FDI than countries with distorted financial or trading systems. Balasubramanyam, et al. (1996) argue that countries with a liberalised trade environment grow better with FDI than countries with distorted trading systems.
In view of this evidence, it may be over-optimistic to believe that growth in FDI alone increases investment and economic growth. It is impossible on the basis of current evidence to make any assertions one way or the other.

(b) Balance of Payments

While the overall economic stance of the Indian government was marked by ‘export pessimism’, it sought to offset this by imposing export obligations on foreign investment in India. The relative export propensity of foreign and domestic firms has been a controversial issue. Figure 6, based on RBI data, reveals that exports as share of net sales were broadly similar for foreign-controlled and domestic firms, though foreign-controlled firms have performed slightly better in recent years. Our estimates are in keeping with Kumar’s (1994) finding that the export behaviour of foreign-controlled and domestic firms for 1980-81 did not differ significantly. Majumdar and Chhibber (1998) find that, among foreign-controlled firms, there is positive correlation between the level of foreign equity ownership and export performance, but only when foreign affiliates have majority control. They conclude that majority ownership is essential for effective foreign control, and the latter essential for export performance. Such findings, even when true, have to be interpreted cautiously. In the post-FERA regime, firms that exported a ‘significant part of their output’ were allowed foreign shareholdings above the usual 40 per cent. In other words, greater foreign shareholdings might have been a reward for good export-performance rather than its cause. Besides, anecdotal evidence suggests that foreign-controlled firms often used ‘third-party exports’ to meet their export obligations: Peico Electricals, the Indian subsidiary of the electronics firm Phillips, met its export obligations by exporting ‘marine products’ (mostly shrimp).

Of course, export behaviour is only a part of the picture when considering the overall impact on balance of payments. The long-term effects on the balance of payments depends, among other things, on the operating characteristics of FDI enterprises, notably their export propensity, the extent to which they rely on imported inputs, including technology imports, and on the volume of profit-repatriation. There are indirect effects too. Multinationals can conceivably increase the export-propensity of domestic firms through spillover effects. Further, if domestic production by multinationals substitutes for previously imported goods, FDI can reduce the total import bill. Unfortunately, these indirect effects are harder to measure in firm-level data.

Comparing earnings and expenditures in foreign exchange – the latter includes imports of raw materials, royalty payments, technical fees, and dividend remittances -- Chandra (1993) calculated that the net foreign exchange contribution of foreign-controlled firms was negative through the 1960s and
1970s. While this is a reasonable (and frequent) criticism of multinationals, we find both domestic and foreign-controlled firms in India did badly by this criterion. Figure 7 suggests that the net foreign exchange contribution of foreign-controlled firms and domestic firms was broadly similar and, indeed foreign firms may have done better in recent years. Even the RBI’s (1985) fourth survey of foreign collaborations found that, in the post-FERA period, majority foreign-owned subsidiaries exported more than they imported. Besides, it helps to get a sense of the absolute sums involved. Our calculations based on RBI (1993) show that total outgoings of foreign-owned firms (technical fees, royalties, and dividends) averaged $120 million per year through the 1980s. While this was not insubstantial, even moderately successful export performance could have financed these flows.

The real issue, then, is the poor export performance of all manufacturing firms, foreign or domestic. The average export propensity in manufacturing remained low, at around 5 per cent, for most of this period. Nayyar (1978) had arrived at similar estimates for an earlier period. The high profitability in sheltered domestic markets blunted the incentive to export both for domestic and foreign-controlled firms. The high real effective exchange rate (REER), maintained as a part of a policy of import-substitution, and the consequent high cost of imported raw material and inputs, made exports of manufactured goods uncompetitive. As a high-cost economy, India was an unlikely export base for multinationals: regardless of the government’s motives, the major motivation of foreign investors was to jump the quota- and tariff-barriers to the Indian market. The marked reduction in India’s REER after 1985, has improved overall export performance. Where India has a significant cost or skill advantage, as in computer software, exports have surged. Importantly, both domestic-firms and US multinationals operating in India have contributed to this growth.

**(c) Technology: Policy and Reality**

Host country governments often encourage foreign investment in the hope of improving the productivity of domestic firms. Foreign direct investment potentially brings new technologies to the host economy. Technology inflows can also improve the productivity of domestic firms through spillovers, as better production and management techniques diffuse in the host economy. Markusen and Venables (1999) discuss how linkages between foreign and domestic firms can serve as a catalyst for growth.

For the case of India, Basant and Fikkert (1996) find some evidence of positive spillovers of foreign R&D expenditure on domestic firms. Kathuria (1998), in a study of firm level data, concludes that there was a positive productivity spillover
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from foreign to domestic firms. International evidence on the nature and extent of spillovers from foreign to domestic firms is somewhat mixed: see Kokko (1994, 1996), and Haddad and Harrison (1993), for instance.

For much of the period under study, regulation of private foreign capital was accompanied by restrictions that sought to minimise the total cost of technology acquisition, and to unbundle technology acquisition from foreign equity participation. Manufacturing was divided into three categories. Where indigenous technological capability was deemed to be sufficient, no technology imports were permitted. Where the technology was considered simple or stable, licensing was the preferred mode of technology acquisition. Foreign equity participation was permitted only if the technology was sophisticated and unlikely to be available through licensing. Foreign technology collaborations were permitted more readily in sectors with a large technology gap, but the imperative to avoid duplication in technology-acquisition through ‘repeat licensing’ remained strong. Taken to its regulatory extreme, this imperative was bound to create monopolies. FERA, by reducing the likelihood of new foreign investment in India, eliminated the potential technological threat from international competitors. Together these policies allowed existing foreign firms to operate technologies that were internationally obsolete, but nevertheless superior to those used by domestic firms. In many sectors the elimination of effective competition, domestic or foreign, resulted in a more concentrated market structure.

Restraints were placed on the royalty payments: standardised rates of royalty were specified for many industries. The duration of collaboration agreements was often restricted to five years in the belief that long-term agreements might be ‘exploitative’. Intellectual property rights were severely curtailed when the Patents Act was modified in 1970. At one stage, government regulations even required that Indian partners in technical collaboration agreements be permitted to sub-license acquired technology freely to other domestic firms.

To a large extent, the technology policy succeeded in its self-defined objectives. The average duration of collaboration agreements fell and royalty payments were kept in check. Domestic R&D was afforded limited protection in some sectors. Taking advantage of increased competition in international technology markets, Indian firms managed to unbundle technology from foreign equity, especially after the 1970s. Of course, the policy was not always successful. In some cases where royalty payments fell, the less-regulated lump-sum payments rose. In other cases success was achieved at a cost. Where FERA managed to reduce foreign ownership and control, it induced multinationals to tighten contractual provisions of technology agreements. Restraints on equity participation affected the quality and quantity of technology transferred. The requirement that Indian subsidiaries be free to sub-license technologies made
foreign partners wary of transferring valuable technologies. Overall, in some sectors, notably electrical and mechanical engineering, domestic R&D filled the gap admirably, and at much lower cost. In others the exclusion of foreign technology and capital contributed to growing technological obsolescence.

Lee and Mansfield (1996) find that foreign investment by US multinationals, and the magnitude of associated technology transfers, depends significantly on investors’ perceptions about the security of intellectual property (IP) rights in host countries. According to their 1991 survey of 100 US multinationals, India was perceived to have a poor IP rights regime, and worse than that in 13 other large developing countries in their study. About 44 per cent of the multinationals considered IP protection in India too weak to permit them to transfer their newest or most effective technology to Indian subsidiaries or joint-venture partners, or to licence technology to Indian firms. In chemicals and pharmaceuticals, this reluctance was reported by 80 per cent of the firms. Lee and Mansfield find that the volume of FDI flows was directly related to perceived levels of IP protection, correcting for other variables, such as openness to trade and the degree of industrialisation. Further, they find that in countries where IP protection was perceived to be poor, a greater proportion of the US firms’ direct investments was associated with pure sales and distribution or rudimentary production.

Since 1985, the liberalisation of the technology policy has allowed firms operating in India to acquire technology more easily in international markets. Basant (2000) finds that Indian firms have increasingly turned to collaboration with foreign firms as a means of acquiring technology: there were twice as many foreign collaborations approved in 1997 as in 1991. Among these, licensing as a form of technology transfer declined while the share of technical collaborations rose. More significantly, more than three-quarters of the collaborations involved some form of foreign financial and equity participation. The increased tendency towards collaboration between domestic and foreign firms through joint ventures is not entirely new. Even in the 1960s, collaboration was the preferred form of investment because joint ventures allowed the technological strengths of the foreign partner to be combined with the domestic firms’ ability to cope with the local specificities.

(d) Market Structure

Generally speaking, the relationship between openness to foreign investment and market structure is complex. Caves (1996) notes the positive relationship between the extent of foreign investment and the degree of market concentration found in empirical studies. In theory this could be due to rent-seeking foreign investment being especially attracted to sectors or countries with high concentration (and high profitability). Even so, the short-run effect of foreign entry, especially when it is
greenfield investment, is to increase the number of firms and reduce concentration. The long-run effects depend on the nature of competition between entrants and incumbents. If incumbent firms are moderately competent, there may well be virtuous cycles of technological competition. On the other hand, inefficient domestic firms with poor learning capabilities would lose market share to foreign firms. Insurmountable technological barriers and economies of scale may drive incumbent firms to the fringes. Foreign entry might thus increase market concentration through mergers and acquisitions, and occasionally, through predatory-pricing.

In the Indian context, there is evidence that industrial concentration and foreign presence were positively correlated across industrial sectors. Figure 8 shows that, at the level of 3-digit industry sector classification, there is some positive correlation between foreign shares and the Herfindahl index of industrial concentration in 1994. The relation is not very strong because some sectors from which foreign capital had been systematically excluded earlier (metals and metallurgical industries in the public sector and textiles in the private sector) also had high levels of concentration. Besides, correlation does not imply causation. For most of this period prior to 1990, both foreign shares and the pattern of industrial concentration in India were influenced primarily by industrial policy, and its attendant control of production capacities.

In the post-liberalisation period, there is a tendency towards increasing concentration in some sectors. Basant (2000) points out that multinational companies have been remarkably active in acquisitions, accounting for nearly a third of all corporate acquisitions over the period 1991-1997. Hindustan Lever, a 51 per cent foreign-owned subsidiary of the Anglo-Dutch Unilever, is one of the largest multinationals in India, with interests in soap, detergents, tea, processed food, cosmetics, edible oil, etc. In a series of mergers and acquisitions after 1992, Hindustan Lever has acquired Tata Oils (its principal rival in oil), Brooke Bond Lipton (previously an associate company, India’s largest in food and beverages), Pond’s India (cosmetics), Kwality, and Milkfood (both processed foods). It has also formed joint ventures with many US firms keen to invest in India, and has acquired a pre-eminent position in its sectors of operation. MNCs have also used their controlling block of shares to increase their equity ownership. For example, British American Tobacco has tried to consolidate its position in its Indian affiliate, ITC, by buying shares at a discount.

In cases where FDI has involved greenfield investments by new entrants, the effect on market structure has been more positive. Sectors such as automobiles and consumer durables had long been protected from foreign competition, an exercise in the best traditions of the infant-industry argument. The absence of competition -- foreign or domestic -- contributed to poor industrial performance. It
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engendered supply scarcity, poor product-quality, and technological obsolescence. Liberalisation of these sectors has generally increased competition. This suggests that while a more open stance towards foreign capital is generally desirable, it is important to consider the form in which FDI occurs. Foreign inflows that amount to increased shareholding in existing multinationals will not lower market concentration; the entry of new firms could create a more competitive environment. To that extent, greater openness to foreign investment flows is not a substitute for an active competition policy.

6. CONCLUSIONS

For much of India’s post-independence period, the regulation of private foreign capital had a rationale. The aim was to tilt the balance of incentives away from old foreign capital and in favour of new, growth-oriented, foreign investment. Limitations on the extent of foreign equity ownership, the imposition of export obligations and the outright regulation of the technological characteristics of foreign-collaboration agreements aimed to create entry barriers that would deter rent-seeking FDI without shutting the door to efficiency-seeking FDI. In theory, this was a valid intervention. In practice, the regulation did not work according to the intention. The recurrent concern with foreign exchange outflows created a restrictive regime with a whole range of ancillary regulations. Restrictions on operational freedom of firms, combined with poor protection of intellectual property rights, choked-off fresh inflows of technology-intensive FDI. Entrenched foreign capital, predominantly of the rent-seeking variety, did not leave India. Apart from the standard hysteresis effects that accompany investment decisions, various restrictions (say, against ‘repetitive technology imports’) preserved pockets of monopoly rent in the economy, and made it worthwhile for incumbent multinationals to stay. For them, even small advantages, in terms of technology and marketing networks, translated in to substantial profit differentials over domestic firms. Thus, for multinational firms that hung on, the ability to operate in protected markets constituted an indirect subsidy that more than compensated for the costs of operating in a regulated regime.

Overall, this perverse outcome proved costly. Through the 1970s and 1980s, India wanted foreign capital to boost exports; the kind of FDI that survived was attracted primarily by access to the Indian market. India wanted foreign capital to improve its technological base; the absence of sufficient safeguards to intellectual property rights was a substantial impediment to the transfer of technology. The absence of foreign competition exacerbated monopoly power in many industries.

The period since 1990 has seen stronger economic growth. Foreign exchange reserves are buoyant at around $35 billion. The euphoria surrounding international
capital flows has generated a new enthusiasm for foreign investment. Proponents of openness argue for further liberalisation of the economy, and for altering the economic regime to attract foreign capital. Large inflows of foreign capital, they claim, are necessary for transforming India’s stagnant economy. Critics of liberalisation point to the dangers of excessive openness. They point out that openness only encourages the inflow of portfolio capital or ‘hot money’, whose volatile flows expose the economy to destabilising influences, and that large-scale foreign investment will undo the carefully achieved self-reliance in Indian industry.

Should India adopt a more open stance to private capital flows? Rodrik (1999) argues that the benefits of openness to foreign capital are generally exaggerated. It is hard to deny that Indian industry needs fresh investment but the hope that openness to FDI alone can achieve this is misplaced. With FDI accounting for less than five percent of gross capital formation in India, its contribution to overall investment will be marginal in the short run. In the Indian context, growth-led FDI is more likely than FDI-led growth. To that extent, foreign capital is neither necessary nor sufficient for growth in India. Further, even as foreign direct investment is encouraged, it may be necessary to regulate the relatively volatile flows of portfolio capital, possibly through selective taxation of such flows.

Greater openness to foreign capital may be desirable but is not a substitute for policies that improve the incentives for long-term investment. By international standards, the investment environment in India -- for foreign and domestic firms - - is still highly regulated. In many sectors investment decisions are still subject to discretionary control, and that control is used to protect entrenched public sector and private sector companies. Even when the government resorts to market-friendly methods of allocating investment rights, it does not quite get it right: the auction of telecommunication licenses was followed by ex-post changes in the allocation rules. In the absence of political stability, policy changes carry little credibility amongst investors. Surveys of international business investors refer repeatedly to the ‘difficulty of doing business in India’, a portmanteau term that refers to anything from lack of transparency to poor infrastructure facilities that lower the economy-wide return on capital. (As evidence of procedural complexity, consider the phraseology of reformed policy requirements: even in sectors where foreign investment is readily allowed, firms must secure ‘automatic approval’.)

Some commentators believe that foreign investment can play a crucial role in removing infrastructural bottlenecks, and thereby increase productivity of existing capital. Infrastructure has largely been a state monopoly in India. Given the poor performance of public sector enterprises, and the reluctance or inability of the domestic private sector to invest in these sectors, the hope is that foreign
investment will take care of power generation, highways, ports and roads. However, the principal reason that makes these sectors unattractive for domestic investors, namely the low rate of return in the short run, holds for foreign investors too. In the past India has resorted to the World Bank to overcome such capital market deficiencies. Is there a case for using direct incentives to attract private foreign investment in infrastructure, say, as in the provision of profit guarantees to attract Enron Corporation in power generation? Evidence suggests that the net pay-off to such sweeteners is negative in the long run; they often encourage ‘roundtrip’ capital flows and may even prove counter-productive if they generate domestic hostility towards foreign capital. The frequent calls for a ‘level-playing field’ between Indian and foreign-controlled firms are indicative of this hostility. The creation of a broad political consensus about the role of foreign capital is crucial to maintaining inflows.

How should technology policy be reformed? In general, there is a case for allowing firms greater freedom in their technology acquisition decisions, and greater recognition of their intellectual property rights. To some extent, such reforms are likely to be forced upon India as part of the WTO reforms (note their emphasis on TRIPs and TRIMs). For most sectors, this is not necessarily to India’s disadvantage. However, in some sectors the allocation of intellectual property rights may have stark implications. For instance, patent rights conferred upon biotechnology firms may have drastic consequences for agriculture; patent rights of pharmaceutical firms may have implications for the availability of low-cost drugs in India. Indeed, if the new WTO regime makes it harder to deny intellectual property rights, it may even make sense to inhibit foreign investment in these high-risk sectors. However, for most of the manufacturing sectors, the gains from greater recognition of intellectual property probably exceed the downside risks.

Within manufacturing, is there a case for selectivity or preference among industries? Critics of foreign capital complain that an open door policy towards foreign capital has encouraged investment in ‘inessential’ consumer goods and other non-priority sectors. Foreign entry in the more visible consumer goods industries—Pepsi, Coca-Cola, Kentucky Fried Chicken, etc.—provide ready ammunition for these critics. While there may be a case for influencing the industrial composition of FDI, it is sobering to note that discretionary control failed miserably in the past. Policy-makers in India were usually poor judges of India’s needs, and there is little reason to believe that they will do better in the future. There is the risk of substantial divergence between the intended policy and the bureaucratic implementation of it. Besides, a discretionary environment also creates the possibility of lobbying and rent-seeking behaviour, especially in industries that have concentrated domestic interests. Cross-country experience
suggests that multinationals have a comparative advantage in rent-seeking, and may be able to use a discretionary regime to their advantage. A non-discriminatory system would be safer. For the same reason, it is best to avoid discretionary environments that favour foreign capital in export-oriented sectors or in technology-intensive sectors: once entry has occurred, it is hard to monitor fulfilment of export obligations or to penalise the failure to do so.

Should multinationals be regulated at all, and if so, how? The anti-competitive behaviour of some multinationals is a legitimate cause for concern. Multinationals that entered India through joint-ventures have sometimes tried to oust their Indian partners. Hindustan Lever’s mergers and acquisitions after 1992 have been a subject of monopoly enquiry, and correctly so. On the strength of anecdotal evidence, the aims of greater competition seem far from being the reality. In the past monopoly regulation has concentrated on identifying monopolies and restricting their growth through licensing. An altered regulatory environment is now needed to check anti-competitive conduct. Apart from restraining the abuse of monopoly power, it is important to promote effective competition in Indian manufacturing.
(Detailed discussion of data sources and related statistics are included in an Appendix available directly from the authors. It is also available electronically at http://www.econ.bbk.ac.uk/faculty/kapur/fididata.pdf)

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Note: Manufacturing covers medium and large public limited firms in Reserve Bank of India survey data. Data after 1991 is not strictly comparable with that for earlier years.
Figure 2(b): Profits before tax as share of net fixed assets, percentage
Figure 3. Advertising expenditure as share of net sales, percentages
Figure 4. Selling commission as share of net sales, percentages
Figure 5: Technology imports (royalty + technical fees) as share of net sales, percentage
Figure 6: Export intensity: exports as share of net sales, percentage

Year

Domestic firms
Foreign firms
Figure 7. Net foreign currency earnings as share of net sales, percentage
Figure 8. Industry concentration and foreign share across industrial sectors, 1994

Foreign share in net sales of industrial sector (%) vs. Herfindahl index (%)