CHAPTER I
FRAMEWORK OF THE STUDY

1.1 Introduction

The ‘Resurgent India’ to emerge as a major economic power by eliminating poverty and its correlates by 2020 AD requires a substantial acceleration in per capita income growth of more than 7 per cent per annum. To achieve this, which would lead to doubling of per capita income in 10 years, the GDP is to grow at the rate of 8.4 per cent to 9 per cent all through the coming years.

Acceleration of GDP growth to even at a rate of 8 per cent will require an investment rate of 32 per cent of GDP. In contrast the current investment rate has been stagnating at around 24 to 25 per cent of GDP for the last 5 years. The gross domestic savings have been stagnating at 23 to 25 per cent of GDP. Thus, the achievement of a higher economic growth rate depends crucially on the attainment of higher rates of savings as well as investment.

Private sector savings have increased from 18 per cent of GDP in the late 1980s to 25 per cent by the mid 1990s, but the worrying fact is that the public sector savings have fallen drastically from 2.4 per cent to 2.1 of GDP during the same period. However in the changing scenario, one cannot expect a rapid increase in public sector savings. India at the most can mobilize its domestic savings upto 28 per cent. This savings gap has to be filled in by the external savings through foreign capital.

In a situation where the Official Development Assistance (ODA) flows are steadily diminishing; bank credit is available, at high and variable interest rates, and where portfolio investment carries its own risks, economies like India are eager to attract other types of financial flows from abroad to meet their needs.
FDI therefore, has been considered as a major source of funds, for financing the desired level of economic development. The experience of Singapore and South Korea are of other is a case to emulate in this regard. Singapore with a per capita GNP of less than $500 and a 14 per cent unemployment rate in 1960, has become highly industrialized economy with a per capita income exceeding $37930 and almost full employment, the success of which is attributed to Foreign Direct Investment (FDI). Singapore now plays host to more than 3000 international companies in the manufacturing, trading, financial and services sectors.

Although India and South Korea had the same per capita income in 1960, the per capita income of South Korea today is 20 times higher than that of India. Such progress in economic growth of South Korea is also which is attributed to Foreign Direct Investment and more than it to its disciplined and hard working labour force.

But, Foreign Direct Investment is desired as well as feared. It is desired for its productivity, for bringing capital, capital goods, vital inputs, managerial skills, and technology. It is feared for the reason that it may exploit the resources and the people of the host country, and even influence the Government policies of the host country. The economists, who are in favor of it regard FDI as a means of higher income growth and improved standard of living. Today FDI is widely depicted as beneficial under all circumstances. The wide spread acceptance of the policy tenets of liberalization and globalization has given rise to both the temptation and pressures for full liberalization of FDI regime. FDI is often viewed as the most desirable form of international private development capital.

UN (1998) states that “Foreign Direct Investment can be a fruitful form of financial inflow, which is why it is often encouraged as one of the first components of capital inflows to be liberalized” Similarly the World Bank (1998)
too opines "If developing countries are to get more global knowledge, they need to attract more FDI" and OECD (1998) treaties that the characteristics of FDI that support this view include its long-term nature, relative stability, contribution to economic growth, and potential for knowledge transfer. "The crucial linkage between investment and output has been well established and well known" (Robertson). It is generally acknowledged that the link between investment and economic growth no longer needs demonstration. Robertson statement is true not only for developed countries but also for developing countries. A faster economic growth is precondition for alleviation of poverty and hence investment is necessary to achieve the goal.

On the contrary, others fear FDI is East India Company revisited, it is a demon, with its tentacles spreading far beyond our imagination; it brings bad business ethics and even influences the government of the host country. However, the beneficial effect seen to have and weighed its bad ones.

FDI is important for Indian economy as it is not merely money movement, but carries with it important "managerial resources". India has restructured her economic policies since 1991 in order to create suitable investment climate to attract more FDI. India entered into the grip of License-Permit Raj in the 1960s that did much harm than any good, as it was over-regulated and over-protected. The Economist (1966) appropriately described India as a tiger in a cage of its own making. Since 1991, India systematically has opened its doors to Foreign Investors, but this does not mean India has became a capitalist country altogether. As Amal Sanyal (1996) rightly points out that "just as our socialistic

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Managerial resources is a concept originated by Edith Penrose in her studies "the evolution of international Oil business", she refers to the managerial resources as that which firms will mature overtime, and accumulate a package of production technology, management know how, various intellectual property rights, a high credit rating in local/International Capital Markets, and Research and development capability.
pattern was far from socialism, so is our liberalization far from a system of free market”.

Thus, FDI is viewed as an important means to bridge the savings and technology gap of the developing countries and confer myriad benefits in form of increased investment flows, promotion of domestic investment, increased output, employment and exports and for achieving higher productivity and efficiency of resource use. The experience of South Korea a testimony to this fact

1.2 Definition of Foreign Investment

The term foreign investment connotes many things:

According to Encyclopedia of Social Sciences, (1995) “Foreign investment is the export of capital to a region or regions under a political authority, different from that ruling the country in which the owners of capital resides. In the vocabulary of business as well as in the theoretical discussions the term foreign investment is used just as loosely as foreign trade, the former includes not only every form of capital migration across the political boundary but also every form of credit extension by the mother country to a colony like capital invested at home, capital exported abroad may be invested in a variety of ways. They comprise short term trade and finance credit in long term”.

IMF (1997) defines FDI as “An investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor’s purpose being to have an effective voice in the management of the enterprise”.

UNCTAD(1999) defines FDI as “an investment involving a long term relationship and reflecting a lasting interest and control of a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise
resident in an economy other than that of the foreign direct investor (FDI enterprise, affiliate enterprise or foreign affiliate).”

WTO (1996) defines FDI as “Foreign Direct Investment occurs when an investor based in one country (home country) acquires an asset in another country (host country) with the intent to manage the asset”.

OECD (1996) defines FDI as “Foreign Direct Investment reflects the objective of obtaining a lasting interest by a resident entity in one economy (‘direct investor’) in an entity resident in an economy other than that of the investor (‘direct investment enterprise’)”.

FDI is generally defined as “Foreign Direct Investment is the process whereby residents of one country (the source country) acquire ownership of assets for controlling the production, distribution and other activities of a firm in another country” (the host country).

The major features that can be drawn from the above definitions of FDI are:

✓ Control over management policy and decisions by the source country
✓ Control, controlling interests
✓ 10 per cent shareholding
✓ Control refers to discretionary decision making by an investor
✓ It may be possible to exercise control via contractual (non-equity) arrangements. The non-equity forms of FDI include, inter alia, subcontracting, management contracts, franchising, licensing and product sharing.
1.2.1 Portfolio Vs FDI

The term "long term", "control", and "controlling interest" used in FDI definition distinguish FDI from Portfolio Investment. Portfolio investor does not seek control or lasting interest. With Portfolio investment, the enterprise benefits from the finance and (in the case of equity) a sharing of risk. Direct investment can bring additional benefits to improve investment productivity. Investment in management may provide access to better management techniques. FDI provides access to technology; often technology owners are unwilling to make technology available to a partner unless they can retain some degree of management control, which FDI provides.

Foreign investment can take two forms. Foreign equity investors can simply buy a stake in an enterprise or take a direct interest in its management. The first, indirect form of investment is called foreign portfolio investment. Foreign Direct Investment (FDI) involves more than just buying a share or a security. It is the amount of financing provided by a foreign owner who also is directly involved in the management of the enterprise. For statistical purpose, the International Monetary Fund (IMF) defines when the investor holds 10 per
cent or more of the equity of an enterprise. As a rule of thumb, this is usually enough to give the investor a say in the management of the enterprise.

1.3 Pros and Cons of Foreign Direct Investment

Foreign investment, as any other concept of body economic has pros and cons which forms the two faces of it. The views regarding the pros and cons of FDI are so diverse, falling between the extreme of regarding FDI as symbol of new colonialism or imperialism and another view is without it, which the host country cannot survive.

1.3.1 Merits

The pro-FDI arguments grow largely out of the traditional neo-classical analysis of the determinants of economic growth. FDI is typically seen as a way of filling in the gaps between domestically available supplies of savings, foreign exchange, government revenue, and skills and the planned level of these resources necessary to achieve development targets. For a simple example of the saving-investment gap analysis let us recall the basic Harrod-Domar growth model, which postulates a direct relationship between a country's rate of savings (s) and its rate of output growth (g) via the equation \( g = S \times K \) where, K is the national capital-output ratio. If the planned rate of national output growth, g is targeted at 7 per cent annually and the capital-output ratio is 3, then the needed rate of annual savings is 21 per cent [since \( S = g \times K \)]. If the saving that can be domestically mobilized amounts to only, say, 16 per cent of GNP. Then a 'savings gap' equal to 5 per cent can be said to exist. The nation can fill this gap with foreign financial resources [either private or public]; it will be able to better achieve its target rate of growth. Therefore, the first and most often cited contribution of FDI to national development [i.e., when this development is defined in terms of GNP growth rates is its role in filling the
resource gap between targeted or desired investment and locally mobilized savings.

The other important contribution, analogous to the first, is its contributions to filling the gap between targeted foreign exchange requirements and those desired from net export earnings plus net public foreign aid. This is the so-called foreign exchange or trade gap. Another gap, which is said to be filled by FDI, is the gap between targeted governmental tax revenues and locally raised taxes. By taxing Multinational National Companies (MNCs) profits and participating financially in their local operations. The governments in developing countries will be better able to mobilize public financial resources for development projects. In developing countries, there is also a gap in management, entrepreneurship, technology, and skill presumed to be partially or completely filled by the local operations of MNCs. The transfers of knowledge, skills, and technology are regarded as both desirable and productive for the recipient countries.

According to IFC (1997) “The host economy benefits from the additional economy activity, creating employment and tax revenue. Entry by foreign firms can also increase competition in domestic markets, reduce monopoly profits, and stimulate quality upgrades of products and services by all firms in the sector. FDI also stimulates economic growth, and has a larger impact than domestic investment. It also found that far from crowding-out domestic investment, FDI seems to supplement it”.

Moosa(2002) lists the merits of FDI as follows:

- FDI flows continue to expand even when world trade slows down, or when portfolio investment flows dries up. These flows are less volatile than portfolio investment flows, because FDI represents a long-term commitment to the underlying project.
• FDI is an important source of funds for developing and transition countries.

• It involves the transfer of financial capital, technology and other skills desperately needed by developing countries.

• FDI raises income and social welfare in the host country unless there are distortions caused by protection, monopoly, and externalities.

• It contributes to filling the saving and foreign exchange gaps by providing financial capital.

• It provides a vehicle for reviving the domestic capital market through which domestic saving can be channeled to finance domestic investment.

• FDI boosts growth in the host countries through technology diffusion and the transfer of capital.

• FDI can lead to an increase in employment in the host country by setting up new production facilities and by stimulating employment in distribution. It can preserve employment by acquiring and restructuring ailing firms.

• FDI initially leads to an improvement in the capital account of the host country.

• FDI is likely to boost productivity if (i) it is export prompting; and (ii) the underlying conditions allow the installation of plants designed to achieve economics of scale.

• FDI boosts the skills of local workers through training.

• FDI helps provide local firms with increased opportunities by establishing links with local suppliers for locally produced goods.

• FDI boosts competition in the host country’s markets.
Walter and Blake (1992) maintain that most host countries hold fears of MNCs, yet almost all not only accept MNCs but actively recruit their FDI via a large array of incentives. Frequently cited key benefits received by host countries from MNCs/FDI presence are: mobilization and productive use of investment capital; Employment generation; Import substitution and export promotion; facility establishment in underdeveloped areas; aid in improving BOP via exports; technology and managerial skill transfer; generation of taxable income.

Brewer et al (1989) highlight the importance of FDI to developing countries as “contributing to capital, technology, entrepreneurship, managerial, professional and technical expertise.” Reuber (1973) points out that FDI carries no fixed debt obligations.

1.3.2 Demerits

Among the acknowledged costs the possible negative effects on the balance of payments, for example, when MNCs subsidiaries located in host countries increase the imports of inputs during payments crisis. It may result in a higher and flow via remittance of dividends and royalties abroad. FDI may have wider technological benefits through its spill-over effect, it and could also discourage the development of technical know-how in the local firms and institutions, the growth of domestic producers and the national economy, if it fails to generate adequate linkages with the local economy. FDI will have fewer beneficial spill-over effects and may be harmful, if one or more of the negative features outline below are present:

- Transfer pricing, which among other things, diminishes the tax revenues going to the host governments.
- The renowned brand names may resort to manipulative advertising which may give rise to economically and socially distorting consumption...
patterns. Some times, such distortions can have a serious detrimental impact, when more costly foreign foods produced under FDI supplant, local and more nutritious diet of poor urban consumers in particular.

- There may be social costs in the form of unemployment when FDI, which is relatively capital intensive, compels labour intensive firms to close down and there is net loss of jobs.

- Environment and natural resource costs may also be involved, requiring careful consideration of the short-term advantages to be gained from an investment and the long-term implications for the countries resource base and general state of the environment.

- An open market in FDI in the print and TV media and in entertainment field also possesses the risk of facilitating hegemony by the dominant USA and other Western culture, rather than providing a window on a multicultural world. FDI in the news and entertainment sector also facilitates subtle and widespread political influence, both through the worldview that is conveyed and by the attitudes adopted towards domestic issues and matters on political agenda.

- Some times even more importantly politico-strategic interests are at stake, as when FDI comprises a large component of total investment and involves loss of control over strategic sectors of the economy.

- Vital infrastructure and natural resource decisions that are made principally abroad may have a considerable impact on the local economy and society and directly or indirectly on socio-economic policy, in such circumstances even the countries' sovereignty may be at stake.

- FDI is motivated by profit and it worsens Balance of Payment (BOP) when dividends and profits are distributed to its home country instead of reinvesting in host country.
Inward FDI is blamed for negative employment effects for retarding homegrown technological progress and it also for worsens the trade balance. A substantial foreign ownership often gives rise to concern about loss of sovereignty and compromise over national security.

Outward FDI is also blamed for the export of employment and for giving foreigners access to domestic technology.

Resources need not come from abroad as investor may also borrow from host countries financial institutions.

Paul Harrison (1995) says "The poor nations are exploited by the great multinational corporations which dominates a growing proportion of economic and social life of the third world. They are the gun, boats, and the soldiers of the new economic style of imperialism."

Moosa (2002) feels that:

- FDI symbolizes new colonialism.
- It results in a loss of sovereignty and in compromising national security. There are several examples of MNCs interfacing with the politics of the host country.
- MNCs are often in a position to obtain incentives (from the host country) in excess of their needs and perhaps in excess of the benefits they bring to the host country.
- MNCs exist and operate primarily because of market imperfections, which preclude the conditions under which FDI supposedly boosts welfare.
- Even if FDI leads to a gain in this world output, it results in some distributional changes between labour and capital.
• The sheer size of MNCs may jeopardize the national independence of the host country.

• FDI creates enclaves and foreign elite in the host country.

• It introduces adverse cultural changes.

• FDI does not perform the function of providing capital for three reasons: (i) it is a relatively expensive source of financial capital; (ii) actual capital flows provided by MNCs may not be large, as they may chose to obtain funds from the local capital market; and, (iii) the capital contribution of MNCs may take a non-financial form (for example, goodwill). By raising capital locally, MNCs crowd out domestic investments, which is perhaps more suitable than foreign investment.

• It is invariably the case that subsidiaries operating in host countries are wholly owned by the parent MNCs the host country has no control over the operations of these subsidiaries.

• FDI can reduce employment through divestment and closure of production facilities. The empirical evidence shows that the overall employment effects of the activities of MNCs on the host country are small.

• Outward FDI destroys jobs at the source country because output of foreign subsidiaries becomes a substitute for exports from the home country.

• FDI leads an increase in wage inequality in the host country.

• FDI is often blamed for its balance of payments effects. The source country faces a sudden deficit when the FDI outflows, whereas the host country faces a peripheral deficit direct profit repatriation.

• MNCs indulge in the production of luxury goods rather than the basic consumer goods needed in developing countries.
• FDI does not play an important role in technology diffusion because (i) inappropriateness of the technology they provide, as it is too capital-incentive, and (ii) the availability of cheaper sources of technology. Moreover, the research and development activities are concentrated in the MNCs home countries.

• MNCs are very powerful negotiators, likely to strike favorable terms in bilateral negotiations with the government of a poor country.

• The costs of training the labour force are not large enough to make a significant contribution to the improvement of the skills of local workers. The practices of MNCs may be irrelevant to the host country, in which case training will not be useful, but may even be harmful. Moreover, it is often the case that MNCs reserve key managerial and technical positions for expatriates.

1.3.3 Reconciling the pros and cons

Repatriation takes place only when the productive activity is profit making and repatriation, to a large extent; can be regulated through tax policies and legislations. Incentive can be created to encourage reinvestment to minimize repatriation of profits. There is also a closer match between the maturing structures of earnings and repayments. For other types of flows, it is often the case of using short-term loans to finance long-term projects.

1.4 Definition and Types of Multinational National Corporation MNCs

The UNCTAD, 1999 defines MNCs as -"Incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates"

According to Weekly and Agarwal (1980), "Multinational corporations are business enterprises that own and manage affiliates located in two or more different countries".
The general text book on International Economics defines - MNCs as "Multinational Corporations are joint firms with their headquarters located in one country, and with a variety of business operations in several other countries”.

Firms become MNCs when they try to undertake FDI. Thus, FDI represents an internal organizational expansion by multinationals. The link between FDI and MNCs is so close that the motivation for FDI has been used to distinguish between MNCs and other firms.

Alan Rugmen also opines that FDI is the method which allows the MNCs its best chance of monitoring the use of its firm’s specific advantages.

Parker classified 613 of the largest manufacturing firms in the world into Multinational Producing Enterprise1 (MPE1) and Multinational Producing Enterprise2 (MPE2).

According to this classification MPE2 represents firms with more than five foreign subsidiaries or more than 15 per cent of sales produced abroad, MPE1 represents firms that are globally less orientated and have 2-5 subsidiaries or 5-15 per cent of sales produced abroad.

According to UNCTAD 1999, MNCS compromise over 5,00,000 foreign affiliates established by some 60000-parent firms. The value of output under the common governance of MNCs amounts to about 25 per cent of global output, one third of which is produced in the host countries. In 1998, foreign affiliate sales were about US $ 11 trillion.

Kindleberger (1976) has noted three forms in the growth of large firm namely, the national firm with foreign operations, the multinational corporation, and the international corporation. In the first case, the foreign activities are small and run by small international division of the firm. In the second case, the parent company opens a branch, a subsidiary, or a joint venture in a foreign land, which is alone a limited degree of autonomy. In the last case, the whole
complex uses its national identity and owes no loyalty to any one country. The last stage is still somewhat theoretical; the large corporations with their worldwide network of organizations, branches, subsidiaries, and joint ventures are still identifiable by their country of origin and nationality of parentage. The MNCs are also, sometimes called as Transnational Corporations that implies that their operations extend beyond the boundaries of the country in which they were originally started.

Higgins (1959) points out that foreign investors and MNCs in the past, preferred investment only in few selected areas like mineral extraction and plantations. Nevertheless, now they are willing to participate in diversified industries provided in host countries to constitute a favorable climate from the investor point of view. Higgins attributes the following advantages due to the MNCs to the host country:

- Political stability and freedom from external aggression.
- Security of life and property.
- Availability of opportunities for earning profits.
- Prompt payment of fair compensation and its remittance to the country of origin in the event of compulsory acquisition of a foreign enterprise.
- Facilities for the remittance of profits, dividends, interest, etc.
- Facilities for the immigration and employment of foreign technical and administrative personnel.
- A system of taxation that does not impose a crushing burden on private enterprise.
- Freedom from double taxation.
- Absence of vexatious controls.
- Non-discriminatory treatment of foreigners in the administration of controls.

- Absence of competition of state owned enterprises with private capital.

- A general spirit of friendliness for foreign investors.

1.5 Approaches to International Business

With the recognition of the crucial role of trade in economic expansion, each firm/nation is now eager to benefit and of the international business. There are several ways to business firms to enter the foreign markets. The most common sequence that firms use to enter the foreign markets to sell their products is:

1. Export of the goods produced in the source country;

2. Licensing a foreign company to use process or product technology.

3. Foreign distribution of products through an affiliate entity; and

4. Foreign production, which is the production of goods and services in a country that is controlled and managed by firm head quartered in other countries.

Steps 3 and 4 involve FDI. Moving from step 1 to step 4 requires a larger commitment of resources and in some respect greater exposure to risk. Though this sequence is chronological path for developing foreign sales, it is not necessary that all steps are followed sequentially as some firms jump immediately to step 3 or step 4.

1.5.1 Choice between exports and FDI

The choice between exporting and FDI depend on opportunities for market growth, production cost levels, and economies of scale.
Generally exports preceded FDI, but after having become familiar with factor and output markets in the foreign country, a firm will establish a production facility. FDI allows a firm to circumvent actual or anticipated barriers to trade. Another motive is the real appreciation of the domestic currency, which reduces the competitiveness of exports.

1.5.2. Licensing a Foreign Company to Use Process or Product Technology

This step may be defined as the supply of technology and know-how or it may involve the use of trademark or a patent for a fee. It offers in one way to overcome entry barriers to FDI. Under these circumstances, licensing offers an opportunity to generate revenue from foreign markets that are otherwise not accessible. Firms prefer FDI to licensing in the case of complex technology or when the risk of leakage of technological advantage to competitors exists.

Franchising is another form of entering a foreign market under contractual agreements. Companies with the brand name of popular products that are popular move offshore by granting foreigners the exclusive right to sell the product at designated area. The parent company provides the technical expertise pertaining to the production process as well as marketing assistance for an initial fee and subsequent royalties related to turnover.

1.6 Types of FDI

FDI is categorised in variety of ways FDI can be classified from the investor’s perspective and from the country’s perspective.

I. From the investors perspective FDI can be distinguished as horizontal, Vertical and Conglomerate FDI. Horizontal FDI is normally undertaken to produce the same or similar kind of goods in the host country, as in the home country. It is undertaken to exploit more fully certain monopolistic or oligopolistic advantages, if expansion were to violate anti-trust laws.
Vertical FDI is undertaken to exploit raw materials or to be nearer to consumers through the acquisition of distribution outlets and Conglomerate FDI it involves both the horizontal FDI and Vertical FDI. It involves mergers and acquisitions.

II. From the perspective of the host country, FDI can be classified into: Import substituting FDI and Export- increasing FDI and Government- initiated FDI.

Import Substituting FDI: Production of those goods previously imported by the host country, which implies that imports by host country and exports by the investing country will decline. The host countries market, transportation costs, and trade barriers will determine this type of FDI.

Export- increasing FDI: it is motivated by the desire to seek new sources of input such as raw materials and intermediate goods. This kind of FDI is exporting in the sense that the host country will increase its exports of raw materials and intermediate goods to the investing country and other countries where subsidiary of the MNCs are located.

Government initiated FDI is the one that is initiated by the Government of host country to eliminate the balance of payment deficit.

III. Kojima classified FDI into Trade oriented FDI (excess demand of exports and excess supply of exports) and anti trade oriented FDI(which has adverse effect on trade).

IV. FDI is also classified into expansionary and defensive types. Chen and Ku suggest that expansionary FDI seeks to exploit firm -specific advantages in the host country. This type of FDI has the additional benefit of contributing to sales growth of the investing firm at home and abroad. On other hand, they opine that defensive FDI seeks cheap Labour in the host country with the objective of reducing the cost of production.
FDI may be categorised to take one of three forms:

1. **Green field Investment**,

2. **Cross Border Mergers and acquisitions (M and A)**

3. **Joint Ventures**.

**1. Green field Investment (GFI):** GFI occurs when the investing firm establishes new production; occur when the investing firm establishes new production, distribution or other facilities in the host country. Host country usually welcomes this as it has job creating potential and value added output.

Sometimes, the term Brown field Investment is used to describe a situation where investments that are formally an acquisition, resembles green field investment. This happens when the foreign investor acquires a firm but replaces almost completely the plant and equipment, labour and the product line. The concept has been used most to describe acquisitions in transition economies (Meyer and Estrin, 1988)

**2. Cross Border Mergers and Acquisitions (M and A):** FDI may occur *via* an acquisition of or a merger with an established firm in the host country. This mode of FDI has two advantages over Greenfield Investment: it is cheaper, particularly if the acquired project is a loss-making operation that can be bought cheaply; and (ii) it allows the investor to gain a quick access to the market. Firms may be motivated to engage in cross-border acquisitions to bolster their competitive positions in the world market by acquiring special assets from other firms or by using their own assets on a larger scale. A large number of MandAs fail in the sense that the firms engaging in this activity do not produce better results in terms of share prices and profitability than those firms that do not indulge in this activity. However, the extent of failure depends crucially on the success criteria, which means that the failure rate may be high or low, depending on these criteria. (Hopkins, 1999)
Cross-border acquisition of businesses is a politically sensitive issue, as most of the countries prefer to retain local control of domestic firms. It follows that, while countries may welcome greenfield investment and foreign firms’ bid to acquire domestic firms are often resisted, and even sometimes even resented. The underlying argument here is that MandAs are less beneficial than greenfield FDI, and even may be harmful, because they do not add up to productive capacity but rather represents a transfer of ownership that may be accompanied by lay-offs or the termination of some beneficial activities. If mergers and acquisitions take place in some sensitive area, such as the media, it may seem like a threat to the national culture and identity. The MandAs accounted for over 80 per cent of the total FDI inflows and over 90 per cent of total FDI inflows in developing countries where the two ratios were 8.9 per cent and 63 per cent respectively for the European union, however, MandAs were important.

3. Joint Ventures

FDI can also take the form of Joint Venture, either with a host country firm or a government institution as well as with another company that is foreign to the host country. One side normally provides the technical knowledge and its ability to raise funds, while the other side provides valuable input through its local knowledge of bureaucracy as well as of local rules and regulations.

VI. Build Operate Transfer or Build Own Operate (BOT or BOO)

A new type of FDI aimed at development of the socio-economic infrastructure in developing countries is called “Build Operate Transfer”(BOT) or “Build Own Operate” (BOO). This type of FDI eagerly sought after for the future economic development and welfare of the people as well as because of the huge funds required to expand or set up.
UNCTAD (2000) categories FDI as following:

1. **Natural Resource Seeking FDI:**

   The Natural Resources Seeking FDI (NRS) is the oldest form of MNC involvement in developing countries. It is undoubtedly, trade creating on the production side. FDI is often a pre-condition for the production of primary commodities for foreign markets, especially in developing countries, and generates a stream of exports of natural resources that would not have otherwise occurred. From the side of inputs used and consumption generated, there are also positive trade effects, since natural resource oriented FDI is usually accompanied by a flow of imports of capital goods specialized in intermediate inputs.

2. **Market Seeking FDI:**

   The marketing Seeking (MS) became predominant motive for investing in the manufacturing sector of developing countries in the 1960s and 1970s during the heydays of import-substitution industrialization. Generally, market seeking investment in manufacturing is a gross substitute for exporting from the home country and its existence is often due to import barriers in the host country. It has trade reducing effects on the production side, but trade creating effects in so far as inputs used in production are concerned. Since import substitution leads to a change in the composition of imports towards intermediate inputs and capital equipment, any market seeking investment will also normally have multiplier effect on domestic demand and production, which could lead to a significant indirect increases in imports.

3. **Efficiency Seeking FDI:**

   The Efficiency Seeking FDI (ES) takes place when the MNCs locate part of their value added chain abroad in order to improve the profitability of their over
all operations. The oldest such investments have been labour seeking investments. As wages rose in the home countries the MNCs sought to obtain access to low cost labour in developing countries by locating in them the labour incentive segments of their production processes.

4. Strategic Asset Seeking FDI:

The Strategic Asset Seeking (SAS) FDI usually takes place at an advanced stage of the globalization of a firm’s activities when firm’s, including a few from developing countries, invest abroad in order to acquire research and development capabilities (the example, Japanese or Korean investment in Micro Electronics in the United States).

1.6 Pre-Conditions for Beneficial FDI

It is well-recognised that for reaping the benefits of FDI, the following preconditions have to be fulfilled:

1. Even and competitive playing field: The foreign investors should be given national treatment so that the level-playing competitive field is available to foreign Investors.

2. Domestic capability to exploit FDI: While a competitive and even playing field creates incentives to upgrade productivity throughout the economy, countries also need domestic the across capable of responding to these incentives. Various studies suggest that higher quality of labour force and infrastructure in a country helps exploit the potential benefits from FDI (Gregorio and Lee, 1998, Caves, 1999; Dzankor and Hoekman, 1998; Mody and Wang, 1997.)

3. Adjusting environmental and social standards: Finally, as globalization gradually leads to the establishment of more international standards for environmental and social aspects of foreign investment, governments need to
adjust their own policy design to fit into the evolving world of norms. If they do not adjust their own norms, foreign investors may be forced to stay out of reputational concerns as or they may face too much competition from domestic firms not subject to stringent norms. On the other hand, tougher standards have costs, which domestic firms may not be able to afford. In that case domestic activity would suffer or be driven into uncontrolled or corrupt “informality”. Analysis of how governments should position themselves to help the drive for better corporate responsibility with effective growth at home are becoming increasingly important.

4. Prudent management of windfall gains from natural resource

Unsurprisingly, as for any investment, a basic pre-requisite for successful foreign investment is a stable macro-economic environment that allows investors to plan. Particular issues here are policies to deal with windfalls resulting from natural resources. Such windfalls resulting from oil, gas and mining project have very often not led to prosperity in the exporting country (Auty, 1993; Gelb, 1988; Sachs and Warner, 1995).

In many developing countries, foreign investors manage the extraction and sale of minerals and fuels. Due to the problems sketched above, such foreign investment in enclave projects has often not been associated with growth and poverty reduction in the host country. This would require prudent macro-economic policies to prevent excessive exchange rate appreciation and policies that minimize the opportunities of insiders for corruption.

1.7 Theories of FDI

With growing importance of FDI, there has been a growing number of theories that explain why MNCs indulge in FDI, why they preferably choose particular geographical country and a particular entry mode. Lizondo (1991) following Agarwal (1980) classifies theories of FDI as the following:
Theories assuming perfect market; Theories assuming imperfect markets; Other theories; Theories based on other variables. The classification can also be made depending on the factors that determine FDI – micro, macro or strategic factors.

1.7.1 Theories Assuming Perfect Markets

Under this category, three hypotheses are studied namely: the differential rates of return hypothesis, the diversification hypothesis and the output and market hypothesis.

1. The Differential Rates of Return Hypothesis

This is one of the first attempts to explain FDI flows. This hypothesis postulates that capital flows from countries with low rates of return to countries with high rate of return move in a process that lead to eventually to the equality of ex-ante real rates of return.

The rationale for the hypothesis is that firms considering FDI behave in such a way as to equate the marginal return with the marginal cost of the capital. The rate of the return is the only criterion upon which the investment depends as this hypothesis assumes risk neutrality. Risk neutrality implies that investor considers that domestic investment [in home country] and FDI as perfect substitutes. Most of the empirical studies aimed at testing this hypothesis failed to provide supporting evidence, as documented by Agarwal (1980).

The major problem with this hypothesis is that it is not consistent with the observation that countries experience inflows and outflows of FDI simultaneously. This is because rate of return in differential rates of return hypothesis implies capital flows in one direction only, from the low rate country to the high rate country, and not *vice versa*. The hypothesis relates FDI to the expected rate of return, which is invariably calculated as the accounting rate of return on invested capital. The problem is that testing is based on the return
calculated from reported profit, which is different from expected and actual profits.

2. The Portfolio Diversification Hypothesis.

In this hypothesis, the choice for FDI is made not only on the basis of expected rate of return but also by the rate of risk. Hence, there is no risk neutrality. The rate of reducing risk via diversification that is relevant to portfolio investment is also used here. Because of risk aversion, a rate of return differential will not induce capital flows in one direction until the differential disappears via arbitrage.

One way to test the hypothesis is to examine the relationship between the share of FDI going to a group of countries and the two decision variables: the rate of return and the risk as measured by variance or the standard deviation of the rate of return. This results provided by studies involving empirical testing of hypothesis offer only weak support, as documented by (Agarwal, 1980).

Despite limitations, it remains true that the diversification hypothesis, which considers risk, is superior to the differential rates of return hypothesis.

3. The Output and Market Hypothesis.

According to this hypothesis, the volume of FDI in a host country depends on its market size, which is measured by the sales of a MNC in that country or by the country's GDP. This is very much true in case of import substituting FDI. When size of the market in a particular country has grown to the level warranting the exploitation of economies of scale, the country becomes potential target for FDI inflows. The relationship between FDI and output can be derived from Neo classical models of domestic investment. The rationale for this hypothesis is that firm's increase in their investment in response to their sales.
Most of the studies support relationship between FDI, on the one hand and the sales of foreign subsidiaries on the other. Agarwal warns of the hazards of interpreting the significance of this relationship as the assumption of Neoclassical theories are unrealisti, and though FDI and GDP is highly correlated, this say's nothing about the direction of causality.

Kearney has proved that size does not matter as the countries most favored for investment are not in tune with their size. USA, China, Brazil and UK, turned out to be the top four. Mexico was ranked sixth and India seventh. Needless to say, the ranking of the country from top to bottom of the list didn't exactly match the ranking of countries in terms of size, because of the influence of other detriments of FDI.

1.7.2 Theories Assuming Imperfect Markets

The first economist to point out the structure of the market and the specific characteristics of investing firms could explain FDI was Hymer. Kindelberger (1976) refined and publicized Hymer’s ideas.

1. The Industrial Organization Hypothesis

According to this hypothesis, when a firm establishes a subsidiary in another country it faces several disadvantages in competing with local firms. These disadvantages emanate from differences in language, culture; legal system and other inter country differences. Despite all this firms engage in FDI and there may be some specific advantage arising out of intangible assets such as a well known brand name, patent protected technology, managerial skills and other firm specific factors.

According to Kindelberger, the comparative advantage has to be firm specific, it must be transferable to foreign subsidiaries and it should be large enough to overcome the disadvantages. Firms will be inclined to indulge in FDI in preference to exports if they operate with minimum costs at home, in which
case additional production for exports would move them into a segment of rising costs. Moreover, lower production costs abroad may be achieved because of the procurement of cheap raw materials, an efficient transportation network, superior managerial skills, and non-marketable technology, and substantial investment in R & D in the home country.

Lall (1985) presents the comprehensive list of these advantages, which they argue are more significant to the monopolistic industry. The important advantages of FDI listed out by them are presented in Box 1.1.

**Box 1.1: Advantages**

<table>
<thead>
<tr>
<th>Advantage</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td>Availability of cheap and large capital than domestic firms</td>
</tr>
<tr>
<td>Management</td>
<td>Superior management, greater entrepreneurial ability and hence greater efficiency and ability to take risk or to identify profitable ventures</td>
</tr>
<tr>
<td>Technology</td>
<td>Superior Technology in the form of ability to translate scientific knowledge into commercial use that also involves discovering new processes and products.</td>
</tr>
<tr>
<td>Marketing</td>
<td>The function of market research, advertising, promotion, and distribution.</td>
</tr>
<tr>
<td>Access to raw materials</td>
<td>Privileged access to raw materials arising from the control of final markets, transportation of the product, processing, or the production of the material itself.</td>
</tr>
<tr>
<td>Economies of Scale</td>
<td>The finance and expertise to set up and operate facilities that enjoy these economies.</td>
</tr>
<tr>
<td>Bargaining and political power</td>
<td>The ability to extract concessions and favorable terms from the host government</td>
</tr>
</tbody>
</table>

2. The Internalization Hypothesis

Internalization Hypothesis explains why firms use FDI in preference to exporting and importing from foreign countries. According to the internalization hypothesis, FDI arises from efforts by idea to replace market transactions with internal transactions. Internalization is undertaken to prevent problems arising from imperfections and failure of markets for intermediate goods, including human capital, knowledge, marketing and management expertise. The major
advantages of internalization are; avoidance of time lags, bargaining and buyer uncertainty. Indeed the main motivation for Internalization is the presence of externalities in the goods and factor markets.

There are two problems with the Internalization Hypothesis:

[1] Internalization Hypothesis is too general in nature and it has no empirical content (Rugmen, 1980).

[2] The hypothesis cannot be tested directly (Buckley, 1988)

3. The Location Hypothesis

According to this hypothesis, FDI exists because of the international immobility of some factors of production such as labour and natural resources. This immobility leads to location-related differences of factors of production. One of the major locational related differences in the cost of production is advantage of low wages. That is why countries such as India attract labour intensive production. Moreover, for the same reason the MNCs wishing to invest in North America prefer Mexico to Canada.

However, few economists also opine that high wages may be indicative of high quality of labour. Petrochilos [1989] points out that the cross-country differences in labour productivity can partially explain why the bulk of FDI goes to high wage industrial countries. And the crucial factor pertaining to labour market that will have adverse effect on FDI inflows are labour disputes. In this context, the adverse effect would depend on incidence and severity of industrial disputes.

4. The Eclectic Theory

Dunning (1998) developed the Eclectic Theory by integrating the industrial organization hypothesis the internationalization hypothesis, the internalization hypothesis, and the location hypothesis without being too precise.
about how they interrelate. It explains the ways in which overseas markets are served by enterprises of different nationalities and the industrial-geographical composition of such activities.

The Eclectic Theory tries to answer following questions.

1. Why the demand for particular commodity is not met by local firm or by any foreign firm importing from another country.

2. If a firm wants to expand, why is it not doing *via* other channels?

According to this theory, three conditions must be satisfied if a firm is to engage in FDI. They are:

1) It possesses comparative advantage over the other firms that arises from the ownership of some intangible assets.

2) It must be more beneficial to the firm to use these advantages rather to sell or lease them.

3) It must be more profitable to use these advantages in combination with at least some factor inputs located abroad.

The Eclectic Theory suggests that all forms of FDI can be explained by reference by its conditions it recognizes the advantages arising out of ownership, internalization, and location may change over from time, and accepts that if country specific characters are important determinants of FDI, it may be valid to generalize from one country’s experience to another.

While the Eclectic Theory provides a good explanation for the decision of firms to invest abroad, it seems to us that the theory does not cover the competitive FDI induced by trade restrictions. When a country imposes restrictions on imports of a particular industrial product, there is obviously inducement to multinational firms of the industry to invest in that country. If one or two firms invest, the others must also do so to counter competition and
ensure their market share even if the returns to investment are negligible or negative, particularly for late entrants. Some FDI in the USA and Europe are of this variety. In addition, multinationals may enter a market today even if it is not profitable to do so, because they foresee the future growth and want to have the first entrants’ advantage.

5. The product life cycle hypothesis

According to this hypothesis products go through a cycle of initiation, exponential growth, slowdown, and decline- a sequence that corresponds to the process of introduction, spread, maturation, and sequence. The hypothesis postulates that firms indulge in FDI at a particular stage in the life cycle products that they initially produced as innovations. The first three stages are:

1) Initial production takes place at home country so that it can be close to customer market that it is familiar with and close to its research and development and production unit. As the product is new and its price is inelastic, it charges relatively high price.

2) The second stage is marked by the maturity and export of the products to countries where demand for those products exists. As the demand continues to grow, there will be competition as new firm enters the field. Then the innovative firm resorts to FDI in these countries to meet the local demand.

3) The third stage is characterized by a complete standardization of products and its production process. At this stage it no longer remains as exclusive possession of innovative firm. Price competition from other firms forces the innovative firm to invest in developing countries, seeking cost advantages. The home country will be net importer, while foreign countries are net exporter.
6. The Oligopolistic Reaction Hypothesis

Knickerbockers suggested that FDI by one firm in an oligopolistic environment triggers a similar action by other leading firms in an attempt to maintain their market shares. The oligopolistic reaction increases with the level of concentration, and decreases with the diversity of the product. Flowers tested the hypothesis on FDI by Canada and Europe in the USA. He found a significant positive correlation in the investing countries.

Agarwal (1980) argues that an implication of the Oligopolistic reaction hypothesis is that the process of FDI is self limiting, since the invasion of each others home market leads to an increase in competition and decline in the intensity of Oligopolistic reaction. Yu and Ito argue that firms in the Oligopolistic industries do not only consider their competitor's activities but also the same economic factors as firms in a competitive industry.

1.7.3 Other Theories of FDI

1. Kindelberger Theory of FDI

C.P. Kindelberger (1976) gives a simple formula showing the capitalizing perpetual flow of income to demonstrate the theory of direct investment.

\[ C = \frac{I}{r} \]

Where \( C \) stands for Value of Assets
\( I \) is the stream of Income it produces
\( r \) is the market rate of interest or profit.

2. Kymers theory of FDI

Kymers theory of direct investment states that foreign investors prefer a higher \( I \) (stream of Income it produces) more than a lower \( r \) (market rate of interest or profit). The stream of income that is valued more.
3. The Internal Financing Hypothesis

Internal Financing, here, refers to the utilization of profit generated by a subsidiary to finance the expansion of FDI by an MNC in the country where the subsidiary operates. This hypothesis is based on gambler earnings hypothesis of Barlow and Wender which postulates that MNCs commit a modest amount of their resources to their initial direct investment, while subsequent expansions are financed by reinvesting profits obtained from operations in the host country. According to Froot and Stein, the important reason for external financing being more expensive than internal financing is due to informational imperfections in capital markets. The hypothesis seems to be more appropriate for explaining FDI for two important reasons: (1) the presence of restrictions on the movement of funds, (2) the rudimentary state and inefficiency of financial markets.

Stevens, Severn, Bash, Safarian, Kwack, Hoelscher, stobaugh, have supported the Hypothesis. Hartman provides a tax based explanation in support of this hypothesis. Agarwal also opines that there is empirical support for the hypothesis as FDI is partly determined by the subsidiaries internally generated funds.

4. The Currency Area Hypothesis and the effect of the Exchange Rate.

Aliber put forward the hypothesis to explain FDI in terms of relative strength of currencies. According to this countries with strong currencies tend to be a source of FDI, while countries with week currencies tend to be host countries or recipients of FDI.

The problem with this hypothesis, as pointed out by, Lizondo is that it cannot account for cross investment between currency areas, and for the concentration of FDI in certain industries.

Froot and Stein have come up with a more elaborate theory based on market imperfections. They argue that a weak currency may be associated with
FDI inflows resulting from imperfections in the capital market, and that these imperfections make the cost of external financing higher than the cost of internal financing by analyzing use data, they show that FDI flows are related negatively to the real value of dollar.

Agarwal (1980) rightly points out that the emphasis in the currency area hypothesis is on overvaluation and undervaluation rather than on appreciation and depreciation. Exchange rates are also important for FDI, because FDI is regarded as alternative to exports. Thus if domestic currency appreciates against foreign currency, MNCs based in domestic countries will find it difficult to export, as domestic goods will become less competitive. If the appreciation of the domestic currency persists, the MNCs may find it useful to move abroad, resulting a rise in FDI. Hence changes in the exchange rates in theory are bound, to have an effect on FDI.

5. The hypothesis of Diversification with barriers to international capital flows.

Agmon and Lesssard argue that for international diversification through firms, it should fulfill two important conditions. They are 1) there must exist barriers or costs to portfolio flows that are greater than those associated with direct investment. 2) Investors must recognize that MNCs provide an opportunity for diversification that is not possible in other ways.

Eurrunza and Senbet developed a model whereby investors demand diversification, MNCs supply diversification services, an activity that is reflected positively in the price of their stocks.

6. The Kojima Hypothesis

The kojima considers FDI as means of transferring capital, technology, and managerial skills from source country to host country. This approach is described as "Macroeconomic Approach" or "a Factor endowment Approach" as
opposed to the "International Business Approach" to FDI. Kojima classifies FDI into a) Trade Oriented FDI. b) The Anti Trade Oriented FDI.

a) Trade Oriented FDI

It generates an excess demand for imports and an excess supply for exports at the original terms of trade. The investment in host country will be in those areas in which it has comparative advantage and hence this kind of FDI will be in interest of both the countries. Kojima gives the example of Japanese FDI for trade oriented FDI.

b) The Anti Trade Oriented FDI

The Anti Trade Oriented FDI will have opposite effect of those in trade oriented FDI. It promotes unfavorable restructuring in both the countries. Kojima gives the example of use FDI for anti trade oriented FDI.

Petrochilos criticizes Kojima by arguing that Japanese FDI is dictated by the lack of raw materials and other basic resources at home and to exploit low wages else where, and to limit environment pollution at home. Moreover, the Kojima hypothesis instead of explaining the theory of FDI is more like a theory explaining a prerequisite for establishing trade.

1.7.4 Theories Based on Other Factors

There are also other factors that are used to explain FDI namely:

1. Political Risk and Country Risk: Political stability and continuity of reforms rather than backtracking from it plays the crucial role in attracting FDI. China attracts more FDI, despite having communist government because of political stability and home economies know where they stand.

2. Tax Polices: Domestic and foreign tax polices affect the incentive to engage in FDI and by the means, which it is financed. MNCs main motive is profit and
hence they look this matter seriously, as the tax treatment affects the net profitability of their investment.

3. Government Regulation: Government policies are crucial in encouraging or discouraging FDI. Government may offer fiscal incentives, financial incentives, market preferences, low cost infrastructure in order to attract more FDI or it may discourage by slow processing, high tariffs, or even total outright prohibition of foreign investment in certain sectors.

4. Quality of FDI

According to Nagesh Kumar (2002), the development impact of various forms of FDI depends upon at least three factors, namely: the access to new market abroad; the new knowledge brought in; the contribution to local, technological capability building. The quality of FDI inflows can vary a great deal from the host country perspective, depending on the type of FDI received. The quality of FDI, according to Nagesh Kumar will be will be captured by the quality of output or sales of the affiliate in terms of positive externalities, accruing to a typical developing host country. These include: extent of localization of affiliates output; contribution to the development of modern industries; extent of export-orientation; research and development activity of affiliates.

5. Extent of Localization of Affiliates' Output

The depth of production, measured as value added per unit of sales reveals the extent of vertical integration of MNCs in the host economy. The proportion of value added in sales could be an important indicator of quality because it is likely to be related to number of favorable indirect developmental effects, besides being a measure of the direct contribution of an affiliate to the GDP of the host economy. For instance, job creation is likely to be related to the extent of localization, holding the industrial composition of output constant.
6. Contribution to the Development of Modern Industries

The industry composition of the affiliate output is also relevant for the quality of FDI. It matters if the affiliates enters traditional or relatively matured industries and substitutes potential local entrepreneurship or develops relatively technology intensive Industries that are new to the host country.

The MNCs may facilitate rapid technological upgrading of their host countries, because of this many countries encourage MNCs investment in new industries by offering them special investment incentives like tax concession, or pioneer industry benefits.

7. Extent of Export Orientation

Developing countries through their carrot and stick policies have always tried to direct MNCs resources such as international marketing networks for export promotion. Export- orientation can be measured in terms of proportion of sales exported from the host country.

8. R and D Activity of Affiliates

R and D activity of MNCs in host country will add to the quality of their operations. It is also likely to generate externalities in the form of spreading the R and D culture in the corporate sector. The local firms may also absorb significant knowledge in spillovers from such R and D activity.

9. Implication of WTO on Improving Quality of FDI

WTO has made its major impact on improving the quality of FDI in the host country as well as home countries. the WTO impact include the liberalization of trade regime covering both tariffs and non-tariffs and barriers, TRIMS Agreement that seeks to phase out trade related performance requirements imposed on MNCs affiliates and TRIPS Agreement that specifies higher norms of intellectual property and recognition of product patent.
All these in turn will encourage R and D host countries that will have many positive externalities.

1.8 FDI in Developing Countries

Foreign Direct Investment is not new to developing countries. It has fluctuated over time, in tune with the environment for investment, government policies towards foreign direct investment and the broader economic policy framework. Hence, trends in FDI have reflected changes in policy stances by developing countries. During 1950s and 1960s, the major thrust laid on import substitution. In 1970s, it was through natural resource-led development. In 1980s, it was structural adjustment and transition to market economies, and from 1990s, it is an increased role for the private sector. Privatization was given thrust to extent it was dubbed as ‘peoplisation’.

FDI in developing countries has flowed mainly into manufacturing and processing industries. Traditionally FDI has been concentrated in few countries, partly reflecting on the size of their economies and partly on their attractiveness as a location for FDI. In the past attractiveness has been closely linked to possession of natural resource or a large domestic market. But now with the shift toward globalised production and trade, competitiveness as a location for investment and exporting has become the main determinant of attractiveness for FDI.

The largest developing host country, for FDI is China, but Eastern Europe has emerged as an equally important new location for FDI. India is very far from being such a lucrative destination. FDI has also reached the poorest countries, although the actual amounts invested in these poor countries are generally very low, reflecting the small size of their economies.

Hence, FDI has not attracted the economic giants, with large domestic markets only. Nevertheless, Countries of all sizes at different stages of
development from all over the world have attracted FDI worth more than 5 percent of GDP, including Czech Republic and Malaysia. What they had in common was an evolving policy to foreign investors. Countries in South Asia and sub Saharan Africa however, lag behind in the volume of FDI flows, relative to GDP. For a long time, FDI came almost exclusively from the major industrial economies, but from mid 90s the sources of FDI in developing economies have widened and many developing economies have emerged as sources in their own regions. Regional links are also important for FDI from developed economies.

Only recently, a fair number of developing countries have reduced their restrictions, in competition to attract more and more FDI. Restrictions on inflows of FDI have taken many forms, including limits on entry to certain sectors, complex approval mechanisms, high taxes, and complex incentive regimes, restrictions on share of foreign ownership, and restrictions on use of land and expatriate labor. Restrictions have been imposed for many reasons; including concerns over excessive foreign influence and loss of national wealth, desire to promote indigenous entrepreneurship and workers, and desire to achieve transfer of technology and management techniques. Developing countries have reduced their restrictions and have given more incentives. The governments of developing economies in a bid to attract more and more FDI are relaxing all restrictions and norms. To quote the Philippines government advertisement that appeared in Fortune in 1990s, government “to attract foreign companies, the government had felled mountains, razed jungles, filled swamps, moved rivers, relocated towns.... All to make it easier for you, and your business, to do business here...”. A liberal trade and payments regime encourages FDI, but a large state role in economy can also deter FDI. Privatization, disinvestment has a large direct impact on FDI inflows. Privatization can have positive indirect effects on FDI. Although very high effective tax rates can deter FDI, selective incentives can be both costly and ineffective in attracting FDI. Attempts to foster domestic linkages with foreign enterprises have generally been counter productive, too.
Finally, getting policies right may not be enough; active investment promotion may be required as well, unless the domestic market is sufficiently attractive to FDI. Effective promotion involves, image building, investment generation, and investor servicing to influence investment decisions. There is no need to say that promotion without good policies will not work. Nevertheless, to create an enabling environment for FDI, a large unfinished agenda of policy reform remains. Some of the countries that have made progress in reducing restriction are already receiving larger amounts of FDI. Many developing economies have to go a long way toward providing a fully open friendly environment for FDI.

However, these developing economies have expressed serious misgiving about the economic, social, and political consequences of foreign investment. Most commonly, they have feared losing control to foreigners over important parts of their economies and excessive drains on profits as foreigner investor, exercising “Oligopolistic powers” make off with excessive profits.

However developing countries do fear FDI and impose restrictions because of risk/ fear of foreign control, possible inhibitions on local enterprise, anxiety over division of profits, capturing rents.

1.9 Competition to Attract FDI

As there is a major surge in the competition to attract ‘their share of investment growth’, the governments are stretching beyond limits to attract FDI to their respective country. The major cause of worry is that to what extent incentive- competition, in particular, and the high value of incentives is absorbed by particular industry. The competitions for FDI among sub-national governments in countries like India and China has been ‘activated’ and has led to the broader process of reform and policy making which includes regulatory, trade, investment, privatization, and liberalization reforms. This process
strengthens market forces and induces sub-national governments to modernize and organize themselves better, and more flexibility, to enhance the competitiveness of the economies under their jurisdiction. Sub-national governments are learning not only how to negotiate incentives but to help investors identify investment opportunities, target potential investors, coordinate and professionalize their actions, and improve their own learning skills and become 'lean', more efficient and responsive organization themselves.

The prisoners dilemma nature of competition for FDI creates a permanent risk of costly 'beggar-thy-neighbor' bidding wars and downwards pressure on environmental and labour standards that cannot fully be addressed by national governments in absence of international policy co-ordination. The secrecy that tends to surround policy competition, especially incentives based competition, carries major risk for developing and emerging economies as well.

1.10 History of FDI

FDI literally may not be 'as old as the mountains', but many of its vestiges date back to beyond recorded history. The story of the development of developed economies and of developing economies has in it, invariably the role of foreign direct investment, from the Persian Gulf's oil fields to India tea plantation and Malaysia's rubber plantations FDI role cannot be brushed aside. Early in the twentieth century, a large part of the world's infrastructure was developed through foreign direct investment including electric power in Brazil and telecommunications in Spain. British firms invested in consumer goods manufacturing abroad from an early date. German chemical companies before World War I as were US auto manufacturers. Swedish, Swiss, French, and Japanese firm had established foreign subsidiaries at an early date as well. Singer Manufacturing company due to its enthusiastic commitment to FDI, emerged as the world first modern MNCs and was one of the largest firms in the world by 1900.
These investments were based on new technology and management and organizational practices. By 1914, the world stock of FDI was estimated at $15 billion, about one third of all international investment at the time. The United Kingdom was then the largest source of investment, followed by the United States and Germany. The United States was the largest recipient of FDI.

The stock of world FDI had risen to $66 billion by 1938, with U.K. firms still being the largest investor. More than half of this investment was made in developing countries, mainly in Latin America and Asia. The major sector in which FDI was invested was in agriculture and mining infrastructure.

These patterns shifted after World War II as U.S. firms became the main source of FDI, and manufacturing investment became most prevalent. During the 1950's and 1960's most developing countries pursued "inward-oriented" developing strategies, which emphasized the growth of domestic industry behind trade barriers. Production for the domestic market was encouraged over exports, and imports were discouraged or restricted. Governments played an active role in regulating and directing private business. In doing so, many policy makers were concerned about possible adverse consequences of FDI such as creation of economic dependency, political interference, and weakening of domestic companies. Such policies generally deterred FDI. Thus, FDI was concentrated in import substitution industries through a process known as tariff jumping. This incentive was strongest in countries with large internal markets such as Brazil and Mexico in Latin America. This attracted large volumes of FDI to industries protected from imports.

Escalating commodity prices in the 1970 has had two effects on FDI. First, high prices encouraged increased FDI in extractive sectors, particularly oil and gas. This benefited countries such as Congo, Ecuador, Indonesia, and Nigeria, which saw sharp increases in FDI in the early 1970's.
Second, the balance of payments surpluses of commodity-exporting countries provided an abundant source of investible capital. This money was recycled to developing countries through large-scale sovereign lending by commercial banks. Thus, developing countries became more reliant on sovereign borrowing and less interested in attracting FDI.

Hence during 1970's FDI was stagnant in developing countries. The stagnation continued into the first half of the 1980's as developing economies struggled to restore economic, stability in the face of falling commodity prices, recession in industrial countries, and high global interest rates that together triggered a debt crisis.

Furthermore, the consequences of inward looking, state-oriented economic policies became apparent in low investment productivity and public enterprises mounting losses. Insulation from the global economy led to a collapse in exports and massive balance of payments deficits in many countries.

In response to deep-seated balance of payments and fiscal deficits, many countries embarked on structural adjustment programs, designed to reorient their economies toward private sector production, international trade, and competitiveness. This involved reducing tariffs and other restrictions on trade making currencies convertible for current transactions, and liberalizing the business environment, including deregulation of FDI. In response to these changes, FDI flows to developing countries began to increase in the second half of the 1980's and continued into 1990's as developing countries opened the doors to liberalization of trade policies, both unilaterally and as part of the Uruguay round of multilateral trade negotiations.

The number of bilateral treaties on the promotion and protection of investment have increased almost threefold during the 1990's. Multilateral agreements on investment have also been developed, mainly as part of wider
multilateral agreements such as the North Atlantic Free Trade Agreement (NAFTA). The industrial countries are negotiating a Multilateral Agreement on Investment (MAI) treaty to govern investment flows into these countries and World Trade Organization (WTO) members are increasing the idea of a global investment agreement. The thrust of these treaties and agreements is to continue the liberalization of the policy framework for FDI.

1.11 Determinants of FDI

In the literature, there have been some studies on the determinants of FDI inflow into the host countries. The economic parameters often mentioned as explanatory variables are: growth rate of GDP, state of infrastructure, exchange rate stability, and equitable value of the exchange rate, openness of the economy, legal structure of the host country and the attitude of the government. The models, which are implicit in the study of these variables, are based in a market economy framework. In India the paradigm shift occurred from 1991-92 that is, the Indian think-tank became accustomed to explore the role of market mechanism in explaining the movement of economic variables. This happened from 1991-92 onwards. A broad section of people-executives in the corporate, officials of foreign embassies, academicians, independent consultants and industrialists-often express the opinion that India has a great problem regarding the mind set that is a popular belief is that foreign capital inflow leads to the exploitation of the domestic economy by the owners of foreign capital. There is another popular belief that India suffers from "too much government syndrome", the latter means that the role of government in India is spread everywhere, but ironically, the governance is weak in areas where it is called for. The latter are areas of external security, true safeguards of the downtrodden people, preservation of the environment and a true reform in the financial sector. The perception is qualitative in nature.
1.11.1 Infrastructure and FDI

There is a popular perception that Foreign Direct Investment flows to the region where infrastructure is better. Nevertheless, state of infrastructure in a particular region covers many aspects. Broadly, infrastructure can be placed under two categories.

1) Physical infrastructure; that includes roads, railways and other communication system, the availability of power and other variable inputs.

2) The second category includes those aspects that are non-physical in nature like law and order system, availability of efficient work force, education system, and work culture may be not conclusive to modern age industrial society. In addition, the over all impression regarding the work culture on the mind of the potential investors is important.

The role of government in the development of the economy is important factor in the second category of infrastructure. While government as a facilitator is appreciated, everywhere as it helps rapid economic development foreign investors do not like too much government control, particularly bureaucratic red-tapism.

One study places the situation of infrastructure in the form of an index. Taking the average India situation as a hundred, the study shows the index of Delhi 730, Kerala 162, Punjab 172, Tamilnadu 195, while Gujarat 105, West Bengal 102. States like Rajasthan, Meghalaya, and Manipur are logging behind as their index is far below 100. When we place the flow of FDI in different states in contrast to the indices of infrastructure of different states, we find that while the states successfully attracting FDI are generally the states that have good infrastructure, but the converse is not true. The states having good infrastructure index have not been able to attract FDI.
Box 1.2

Variables Expected to Contribute to Host-country Bargaining Power

<table>
<thead>
<tr>
<th>Back Ground</th>
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1.12 Review of Literature

The available literature related to foreign direct investment in India since liberalization, is massive. The most crucial thing is to review that literature, keeping in mind the objectives of this study.

The literature available is available in the form of – books; articles in Economic Journals, Magazines and News Papers; Reports and Surveys of Government of India, Reserve Bank of India, Ministry of Industries and Commerce, and other private research agencies like CMIE, TATA Services; Reports and Surveys of IMF, World Bank, UNCTAD, OECD, ADB and other international institutions; and Discussion Papers, Research Papers, Occasional Papers of various Research Institutes.

Bimal Jalan (1996) makes a strong case for an aggressive policy of partial disinvestment in profit making enterprises and outright sale of loss making enterprises. The case for privatization is based on the claim that private ownership establishes a market for managers, which improves the quality of management. He is in favor of a more open policy towards a larger role for
foreign capital in the Indian economy. In view of the large size of the economy and the substantial volume of domestic investment, he is of the opinion that foreign investment is unlikely to become the predominant form of capital formation in India or to exceed prudent limits.

Anant R. Negandhi (1966) opines that even advanced countries had to depend on foreign capital in their initial stage of development, and India is now passing through such a transition stage. He further opines that during the period of development, the need for importing capital goods and technical know-how goes on increasing, as exports do not expand in the same proportion as imports, the problem of adverse balance of payments goes on developing in magnitude. While the efforts are being made to bridge, the gap by increasing exports in the long run, during the transition period we have to depend on foreign aid at governmental level or foreign private capital. Among the countries from which foreign private capital can be expected to come, the USA is most important.

Singh (1974) studies has examined and evaluated the investment policy and performance of US subsidiaries in India and compared it with their parent corporation. The study reveals that US Corporation investing in India and presumably in other foreign countries do not adopt their domestic investment policy for their foreign subsidiaries. The economical, political, and other environmental variables have an important impact on the investment policy of US subsidiaries.

Nihar K.Sarkar (1976) has attempted to examine the relevance of foreign investment in economic development of Asian countries. He has illustrated international experience in the field. He opines that foreign investment is not an unmixed blessing hence developing countries should carefully examine the merits and demerits of foreign investment at the time of its entry, case by case. It should also keep contact vigilance over it to see weather the objectives for which foreign investments have permitted has been achieved or not.
Amiya Kumar Bagchi (1972) deals with the history of private investment in India and its determinants during the period 1900-1939. It develops a simple theoretical framework in its first part and tries to isolate the influence on private investment in India of factor supplies as against demand conditions. The author also presents a case study in the economic relations between an imperial power and dependent colony.

LamJalussy A (1961) discusses about the relationship between economic growth and investment policies in highly developed industrial countries. He analyses about stagnating or falling markets with low and uncertain profit margins. The author suggests that any country that concentrates on defensive investment is likely to encounter difficulties in the long run. Although the defensive investment may lead to substantial increase in the labour productivity within existing firms or industries, the scope for such increases will sooner or later exhausted, in the long run rapid increases productivity require major changes in the economy.

Peter H Gray (1972) analyses about the establishment of foreign subsidiary operation by business firm helps the natural transfer of capital from rich to poor countries. This natural process has both positive and negative implication for both the investing and host country.

Michael Kidron (1965) discusses the foreign investment at the time of independence in India and factors which made changes necessary in foreign investment policy of India after the independence.

De Melo, Luiz R. Jr. (1999) tests the hypothesis of increasing FDI for the five Latin American Economies that absorbed most of the FDI in the region during 1970-91 and found that both directions of causality depend on the recipient country trade regime, ranging from import substitution to export.
promotion. Both open economy performance variables and domestic policy variables are shown to affect FDI and growth in long run.

Graham, Edward H (1995) examines the theoretical and empirical literature on the determinants of FDI and the economic consequences of FDI for both host and home countries and concludes, inter alia, that FDI can have both positive and negative economic effects on host countries. Positive effects come about largely through the transfer of technology to productivity increases and improvements in the efficiency of resource allocation. Negative effects can arise from the market power of large foreign firms (MNCs) and their associated ability to generate very high profits or from domestic political interference by MNCs. Empirical evidence however suggests negative effect from FDI is inconclusive, while the evidence of positive effects is overwhelming.

Lall, Sanjaya, and Paul Streeten (1977) examines 88 foreign and locally owned projects in six countries for UNCTAD, using cost-benefit analysis to calculate national income effects and found for 88 projects, FDI had a net positive effect on national economic welfare. The main determining factor of the remaining negative social income effects was the extent of effective protection granted to firms.

Sun, Haishun (1998) analyses the impact of FDI flows into China during 1979-96 and has found that FDI has significantly promoted economic growth in China by contributing to domestic capital formation, increasing exports, and creating new employment. FDI flows also have tended to improve the productive efficiency of resource allocation of the Chinese domestic sectors by transferring technology-promoting exports. On the other face of it, regional disparities has widened, it has contributed to worsen environmental pollution, transfer pricing and it has encouraged round tipping of the capital of Chinese domestic firms.
Theodore Moran (1998) has reviewed three separate sets of assessments of the impact of FDI covering 183 projects in some 30 countries for a period of over more than 15 years. The result of these assessments shows that a majority of the projects had a positive influence on the host national income, but a minority of the projects around 25 per cent to 45 per cent had a clearly negative impact on the economic welfare of the host economy. The difference between positive and negative impacts was accounted for by policy variables that the host countries could control.

Stiglitz, Joseph E (1998) highlights the role of FDI in promoting trade. He opines it is crucial that FDI and trade should not be confined to small enclaves, even if those enclaves give a temporary boost to national output. The capital that enters a country through FDI typically comes in with management expertise, technical human capital, product and process technologies, and overseas marketing channels. If the host country puts in place the appropriate, complementary policies and structures, FDI can give a boost to the technological level and growth of that country. The fears about FDI in the 1960 and 1970s were based largely on the enclave phenomena in its modern form it is something to attract rather being feared.

Vernon, Raymond (1988) has analyzed the role of MNCs in the globalizing economy and has found that there is inherent tension between Government and MNCs despite the fact that both appears to have a cordial relationship. The world is likely to go through a long period of learning as nation states search for proper responses to the problem s of openness. During that period, MNCs will be vulnerable to the accusation that they are prime cause of those problems. The author calls for restraint from both the sides.

Chauhan, Punam, Gabriel Perez Quiros, and Hellen Popper (1996) have examined the behavior of international capital flows through an empirical analysis of four major components of international capital flows in 15 developing
and industrial countries and come out with the fact that the behavior of short
term investment appears to be sensitive to changes in all the other types of
international capital flows, but direct investment appears to be insensitive to
such changes.

Drabek, Zdenek, Warren Payne,(1999) investigates the impact of non-
transparent government policies on the inflows of FDI and on the basis of
empirical analysis finds that the degree of non transparency is an important
factor in a country’s attractiveness to foreign investors. High levels of non-
transparency can greatly retard the amount of FDI that a country might expect.
Simulations presented in the paper suggest that on average, a country could
expect a 40 per cent increase in FDI from one point increase in transparency
ranking. Similarly, non-transparent polices translate into lower levels of FDI.

Smarzynska, Beata k, and Shang-Jin Wei (2000) highlights the basic
tradeoff in depending on local partners. On the one hand, corruption makes local
bureaucracy less transparent and increases the value of domestic partner to cut
through bureaucratic maze. On the other hand, corruption decreases the
effective protection of the investor’s intangible assets and lowers the probability
that disputes between foreign and domestic partners will be adjudicated fairly,
which reduces the value of having a local partner. The importance of protecting
intangible assets increases with the investor’s technological sophistication.
Empirical tests of the hypothesis on a firm level data set show that corruption
reduces inward FDI and shifts the ownership structure towards joint ventures.

Wei, Shang-Jin (1999) studies the sample of 14 countries having BITS
with the host countries and finds that no robust support in the empirical
evidence for the efficient grease hypothesis. Instead, the paper finds that taxes,
capital controls, and corruption all have large, statistically significant negative
effects on FDI .Bureaucratic corruption adds to the burdens of taxes and capital
controls rather than reduce them.
Aitkin, Brian, and Ann Harrison (1999) using panel regressions of more than 4000 Venezuelan plants between 1976-1989 finds an increase in foreign ownership is correlated with the decline in the productivity of larger wholly domestically owned firms in the same industry as MNCs tend to invest in more productive sectors and more productive domestic firms. The benefits of FDI have largely been internalized by joint ventures. For smaller local firms in the same industry lead to rises in productivity due to linkage spillover effects. The output of domestically owned firms contacts in response to a rise in foreign share. If foreign investors increase their total sales in an industry by 10 per cent points, output produced by plants without foreign investment in that industry declines by 12.58 per cent points, suggesting that FDI reduces domestic plants productivity in the short run by forcing domestic firms to contract, there by increasing their average costs.

Barrel, Ray and Nigel Pain (1997) studies the estimates of the efficiency spillover from FDI for the UK and West Germany and finds that each one percent rise in stocks of inward investment raised labour augmenting efficiency by 0.27 per cent over the period between 1972-95 in West Germany and by 0.26 per cent in the UK’s Manufacturing sector. In UK inward FDI over 1985-95 seemed to raise manufacturing output by 12.5 per cent or 1.2 per cent per year, accounting for 30 per cent of the growth of the UK’s manufacturing sector over the last ten year period.

Toshihko Kinoshita (1997) has reviewed the determinants and impact of FDI on host countries and the donor country (Japan) Itself. The factors according to author the determinants for Japanese FDI are: maturing of Japanese economy, larger markets in the US of A , NAFTA and Europe, low Labour costs, the necessity of securing the supply of energy and other natural resources to Japan.
The study commissioned by the Ministry of Industry, Government of India (1993) have analyzed the price element in the competitive strategies adopted by China, Indonesia, Korea, Malaysia, Singapore, Taiwan, Thailand with India and it has come out with following study conclusions:

- In term of openness Indian polices are comparable with that of Korea, Taiwan, and Indonesia but is restrictive when compared to Singapore and Thailand.

- In terms of regulatory requirements Indian polices were comparable with majority of countries expect Singapore and Thailand.

- India has highest rates of corporate and individual taxes and highest tariff barriers among the study countries.

In an Research Document by South Centre (1997) draws attention to the costs of inviting FDI which tend to be overlooked in the current climate of enthusiasm regarding FDI. It also suggests that developing countries can gain from collective co-operation rather than competition among themselves by offering greater incentive package to attract FDI.

Bhattacharyya and Satinder Palaha (1996) has discussed in length about the polices that are boosting and the factors that are hindering inward FDI inflow in India in relation to China and ASEAN. The Author suggests following factors to boost FDI inflow into India: Simplification of entry routes, Raising of equity ceiling, Introduction of negative list, Simplification of the operating system and procedures, IPR legislation, Comprehensive dispute settlement board

Mohammed Saqib (1997) analyses performance of FDI in India vis-à-vis other countries competing to attract FDI inflow and has come out with following study conclusions.
• Consumer goods sector has in fact attracted more FDI due to high protection accorded to the consumer good sector.

• Investment into export oriented labour intensive industries has not been forthcoming due to the Labour rigidities and the decentralized production structure.

Bishwanth Goldar, Etsuru Ishigami (1998) analyse trends, patterns of FDI in Asia with special focus on FDI flows from Japan, and the study reveals that; a) The flow of FDI in Asia has shifted over time from Asian New Industrialized Economies (NIEs) to ASEAN and further to China, b) Japan continues to be the main source of FDI flows into Asian economies. Japan share however have came down relatively with increasing FDI flow from the US of A and Europe Union, c) Japanese FDI have played a crucial role in promoting the economic growth of East and South East Asia, through cost reduction and export promotion.

Kamal Saggi (2002) has bought out few crucial factors which are mentioned below:

• Little is known about the relative role of Trade and FDI as mechanism of technology transfers.

• The role of trade in encouraging growth hinges critically on the geographical scope of knowledge spillovers.

• A well-developed paradigm seeks to explain the emergence of MNCs, given the existence of viable alternatives such as exports, licensing and joint ventures.

• Local policy often causes foreign firms to opt for licensing or joint ventures over FDI.

• Polices designed to lure in FDI have proliferated in recent years, but it is difficult to base the case in favor of these polices on the notion of positive spillovers from FDI to domestic firms.
to attract more than what is attracting. The China example can be emulated for utilizing FDI to improve its exports.

- Sometimes the location issue becomes important for the inflow of FDI and the nature of industry becomes related to that.

Jiangho Zhang and Haico (2003) examines the relation between FDI and International Trade. The linkage between FDI inflow from the home country to the host country and exports from host country to home country and after analyzing through econometric analysis conclude that the country of origin differences and characteristics of MNCs has positive relationship.

Nagesh Kumar and Jaya Prakash (2002) have analyzed the relationship between FDI, growth and domestic investment for a sample of 107 developing countries for the 1980-99 period and have came out with following study conclusions:

- The effects of FDI on growth could be of dynamic nature which may have 2 rounds of effects namely a competition effect for domestic enterprises in the industry of the foreign entrant that is generally negative and a subsequent round could include a usually favorable externality on domestic investment because of backward linkages.

- Out of 81 countries included, the causality test between FDI and economic growth suggests existence of causality only in case of 28 countries. Unidirectional Causality from FDI to economic growth was observed in 12 countries. Growth rate is found to attract FDI in 11 countries. Feed back causality i.e., two ways interaction has been detected in five countries. In rest of 53 countries, the direction of causality is not pronounced and hence the test is not able to determine the direction of it.
Mani Sunil and Nand Kumar Parmeshwari (1993) has analyzed the relative importance of private loans vis-a-vis FDI as a source of external capital to India. Debt creating nature of financial flows in total financial flows in total financial flows increased during 1980s. but during 1990s the FDI inflows relatively to pre-liberalization has increased. The authors also have examined various ramifications of the strategy of attracting FDI since 1991.

IFC (1997) studies the impact of corruption and the quality of public investment and concludes that if a highly corrupt country raises the level of public investment, the productivity of the new public investment will be low, and private investment falls. It also appear from the data that as the poor quality public investment is put in place and corruption under control, private investors are able to discern the difference and react by increasing their investment.

Michael Klein, Carl Araon, and Bita Hadjimichael (2001) brings out the fact that FDI can reduce poverty, as it is key ingredient for successful economic growth in developing countries. This is because the very essence of economic development is rapid and efficient transfer and adoption of best practices across the borders. FDI is particularly well suited to affect this and translate it into broad growth, not least by upgrading human capital. As growth is the single most important factor affecting poverty reduction, FDI is central to achieving the goal. The following factors are listed out by the authors through which FDI reduces poverty; It helps to reduce adverse shocks to the poor resulting from financial instability as it did during the recent East Asian crisis, FDI improve corporate governance and it is not easily subject to asset stripping that may render property rights and FDI generates taxes that support the development of a safety net for the poor.

Beata K Smazynska and Shang-Jin-Wei (2002) makes an effort in four different areas to enhance the ability to detect the possible dirty secret that MNCs flock to countries with weak environmental protection and that this is
particularly the case for more pollution intensive industries. Pollution haven Hypothesis has got most supportive evidence from this study as country environmental standards is measured by its participation in international environmental treaties.

Peter J Buckley, Jeremy Clegg, Chenqui Wang, and Adam R Cross (2001) investigates from viewpoint of China, the preposition that economic and technological conditions in a host country modify the relationship of inward foreign Direct Investment with growth. The results demonstrates that FDI favors growth in the economically stronger provinces, and that the full benefits of FDI are realized when competition in local markets is at its strongest.

Biswaït Dhar, Sachin Chaturvedi (1998) has strongly bought out the significant changes that foreign investors enjoy in the foreign Investment Regime. The foreign investors would not only enjoy the advantages of 'National Treatment' and 'Most Favored Nation' treatment they also would have the unrestricted rights to transfer, particularly from their host countries, any payments that would have the unrestricted rights to transfer particularly from their host countries, any payments that would not be tempered with any obligations to their home or to the host states.

Steven Globerman and Daniel Shapiro (2002) have indicated that governance infrastructure is an important determinant of both FDI inflows and outflows. An investment in governance infrastructure is an important infrastructure not only attracts capital, but also creates the conditions, under which domestic MNCs would emerge and invest abroad. It would appear that investments in governance infrastructure are subject to diminishing returns so that the benefits in terms of inflows are most pronounced for smaller developing economies.
Nagesh Kumar (1998) has felt that the policy liberalization has not yet helped India to improve her share in FDI outflows from major European source countries or the USA. The other major trend is the recent approvals of FDI aim at exploring India’s sizeable domestic market that contradicts with the reforms objective to encourage exports by inviting quality FDI and utilizing the MNCs experience as export platform.

Ruddar Datt (1995) has warned about the dangers of FDI inflows into India. He feels FDI is catering to the needs of the upper-middle and affluent classes, thus concentrating on the 180 Million consumers in the Indian economy. In this sense, they foster a new consumer culture of colas, jams, ice creams, processed goods. Consequently, there is an utter neglect of the wage good sector. MNCs are entering into the production of goods like potato chips, wafers, bakery production; foods processing etc are rapidly displacing labour working in the small-scale sector as SSIs are closing unable to face the competition. The unrestricted entry of MNCs in soft areas has dangerous implication on both production and employment patterns.

Mathur.RB (1991) strongly advocates FDI as the only long term solution to country’s problem of foreign exchange. The author strongly advocates privatization, as there is serious resource crunch and inefficiency in public sector. India should emulate China and Singapore to attract FDI, so that the pace of exports could be given a major boost.

Reint Gropp and Kristiana Kostial (2001) have analyzed the tax harmonization versus tax competition. The OECD countries with high corporate taxes have experienced both high net outflows of foreign Direct Investment and a decline in corporate tax revenue. The authors after analyzing the data feel that level of tax rates is only one of the many determinants of capital flows. Others including infrastructure, the skills and productivity of the labour force and structural rigidities also play a role. Hence, the challenge for policy makers will
be to balance what are in many ways, contradictory demands and to find a package those appeals to international investors and firms while keeping an eye on the sustainability of the fiscal position.

Dean A Derosa (1998) traces the evolution of foreign trade and investment polices in developing Asian countries vis-à-vis emerging market countries and other developing countries in the rest of the world since mid-1980s. The analysis reveals that Non-Asian emerging market countries have made appreciable progress in closing the 'trade policy gap' with leading East Asian economies. If the narrowing of the trade policy gap between Asian and Non-Asian emerging market countries continues, the large share of FDI flows to developing countries enjoyed by East Asian Countries during the last decade should be expected to erode.

Nicholas Stern (2001) has thrown light on investment climate among Indian states citing the survey conducted by the World Bank and CII, states that the entrepreneurs viewed Maharashtra, Karnataka, Gujarat, Tamilnadu, and Andhra Pradesh as better place to produce then Delhi whereas Punjab, Kerala, West Bengal and Uttar Pradesh were perceived to be worse. The estimated cost difference between the best and the worst states was about 30 per cent, which is a very large hurdle for the poor-policy states to overcome in trying to attract investment.

He also opines that the ‘Good Climate States’ have higher wages, perhaps reflecting the use of higher quality labour as better workers migrate to the good production locations. Or it may be reflect higher payments for the same skills in good climate states which would indicate that some of the productivity gain from the better climate is being passed through to the workers. Perhaps both the explanations are relevant.
Qiuemi Yang (2002) have used neo classical production function for the case study of China incorporating education to neo classical model and has concluded that the difference in the return rates of capital between Shanghai and poor regions has reduced and it also emphasizes the important role of human capital in equalizing rates of return to capital between a rich region and poor region. The empirical results also prove that FDI inflows to a region of China are positively related to its level of human capital development. This result confirms to Lucas argument.

Oliver James (2002) had attempted to access two distinct effect of FDI on economic growth. Multiplicative variables have been used to bring out the result, which suggest lower the human capital level is, the more efficient FDI assuming the existence of absorption capability. Results also foresee a natural slowdown of Chinese growth as the economy moves closer to the technological frontier. Thus, the author suggests it seems important that the Chinese authorities stimulate local research and development make China achieve innovator status.

UN’s current studies (1990) focuses on shift from foreign debt to FDI and the reasons for slow movement of FDI to least developing countries and suggestions to improve it. The fundamental problems confronting developing countries, which act as hurdles for attracting FDI, according to studies, are low income, slow growth, poor infrastructure, and inadequate human resource development.

UNCTAD (1988) discusses the effects of FDI on development through trade. It stress on the fact that trade has traditionally been the principal mechanism linking national economies, but FDI does not have similar linking function. The trade effects of FDI depend on whether it is undertaken to gain access to natural resources or to consumer markets or whether FDI is aimed at exploiting locational comparative advantage or other strategic assets such as research and development capabilities. The study also notes that impact on FDI
on development goes well beyond its linkages with trade. The study also contributes to the debate on investment incentives by analyzing them from their theoretical and empirical perspectives and identifying aspects that require further attention and analysis. It has analyzed various types of incentives and international experiences in dealing with FDI incentives.

OECD Proceedings (1999) has reviewed the economies of Indonesia, Malaysia, Philippines and Thailand and the role of FDI in recovery of the respective economies. The study highlights the role of FDI in driving export-led growth especially in electronics sector, in these economies. The study draws on the experience of the four ASEAN countries to suggest that a more balanced treatment of foreign investors that allows foreign MNEs to play a greater role in domestic economy could yield substantial benefits in terms of restoring investor confidence and placing economic development in the 4 ASEAN countries on a more sustainable basis in the future.

Charles Oman (1999) analyses competition among governments to attract FDI has come out with following findings and policy conclusions:

- Incentive based competition for FDI is a global phenomenon.
- As barriers to international investment have fallen over the last two decades, the significance of competition for FDI has increased.
- Incentive based competition can be intense, but the evidence, which is insufficient to draw more than tentative inferences, suggests that only in particular industries (e.g., Automobiles) or for particular investment projects (especially large ones) and in some industries is intense only during particular periods.
- Most incentive-based competition is effectively intra-regional, since much of the real investment for which national and sub-national
governments compete is investment, which the investor intends in principle to locate in a particular region.

- While the evidence does not clearly point to any inexorable tendency towards global bidding wars among governments in their competition creates a permanent danger of such war.

- Even in the absence of global bidding wars for FDI, the distortionary effects of incentives, which tend to discriminate against smaller firms, against local firms, and against firms in sectors or types of activity, that are not targeted can be significant.

OECD Proceedings (1999) has focused on the benefits from FDI and the effectiveness of individual country polices and second on corporate codes and the OECD Guidelines for the MNCs. The proceedings has highlighted following points:

- There is spectacular growth in FDI but in few countries. Inflows of FDI have increased by 39 per cent globally in 1998, amounting to $460 billion in developed and $166 billion in developing countries. Transition economies accounted for $19 billion and least developed countries $3 billion.

- Substantial benefits of FDI are acknowledged by the impacts of FDI are well known: it contributes to management, capital, technological capacities, and expertise, and they can facilitate the integration of local industry into global production and distribution net work. The proceedings also highlights the impacts of the incentives or subsidies on actual investment decision is anecdotal as they are very costly and impose constraints on future polices.

Theodore H Moran (2000) has analyzed the benefits and opportunities of FDI The author lists out three effects on part of authorities to accomplish new
agenda to integrate world scale manufacturing into the global regional sourcing network of the parent and policies aimed at reinforcing the longer-term stability of investment agreement in natural resource and private infrastructure projects, in the developing countries and economies in transition.

The three effects listed by the author are:

I. Support for extending and toughening the exercise to make transparent and then to limit, locational subsidies and locational incentives of all sorts.

II. Mobilization of a campaign to halt, and roll back, the use of rules of origin and anti dumping regulation to protect producers and divert investment flow from one region to another.

III. Participation in initiatives within multilateral financial

Magnus Blomstrom, Arikokko, and Mario Zelan (2000) analyse firm and host country strategies. The central theme of the study the behavior of MNCs of and their affiliates and the impact of inward FDI on the host economy will vary between industries and countries. The technology imports of MNCs affiliates consistently seem to increase with various proxies for the competitive pressure and the level of education in the host market. The policy conclusion suggests that government policies aiming to create a competitive climate and improve labour quality are relevant alternatives to formal technology transfer requirements. Policies focusing on the environment in which foreign firms operate must be direct.

1.13 Statement of the Problem

Along with studies that are reviewed, many more studies are enlisted in bibliography. However, none of the studies examines FDI in India in depth. Despite the fact, FDI during the period of liberalization and after, there has been lot of changes in terms of pattern of trends and impact on the Indian economy.
While discussing on the impact of liberalization policies some have analyzed the FDI in general but there lacks an in-depth study of FDI since liberalization. It is, therefore, necessary to undertake an independent enquiry on FDI in India, focusing on the period since economic liberalization.

As brought out earlier, though a number of studies have been undertaken regarding liberalization policies and FDI but not much has been highlighted on direction and pattern of FDI as a whole. Hence, the current study is an attempt to fill the gap in literature on the impact of liberalization on Foreign Direct Investment in India.

1.14 Objectives of the Study

The following are the objectives of the present study:

1. To analyse the pattern, extent and direction of Foreign Direct Investment in India;
2. To identify and compare the sectors and regions which are attracting Foreign Direct Investment;
3. To review the government policies and programmes to attract Foreign Direct Investment;
4. To find out factors promoting/hindering the Foreign Direct Investment in India.
5. To compare policies of China with India and find the reasons for China's success in attracting more FDI.
6. To suggest suitable measures for stepping up Foreign Direct Investment.
1.15 Hypothesis

The study seeks to verify the following hypotheses:

1. FDI inflows and economic expansion are positively related;
2. FDI is flowing into few sectors and regions; and
3. Positive policy response is more important determinant of FDI inflows.

1.16 Methodology

The present study makes use of secondary source of data collected from the publications of Government of India, Reserve Bank of India, Ministry of Industry and Commerce, World Bank, and IMF, UNCTAD, Centre for Monitoring Indian Economy (CMIE), Government of China, other than books, Journals and Periodicals. The reference period of this study relates from 1981 to 2002. Relevant statistical techniques, especially regression, have been used in the study along with simple ratios and averages. The specific econometric models used are discussed in the respective sections. These are the main methods of compilation and interpretation of results which are elaborately discussed in the study.

1.17 Chapter Scheme

The study contains seven chapters.

The first chapter is introductory which after giving the overview of the study on FDI sets out the problem.

The second chapter discusses the trend and pattern of FDI in India during pre-liberalisation period.

Whereas in third chapter the trends and pattern of FDI in India during post liberalisation is analysed.
In fourth Chapter the determinants and impact of FDI in India are identified.

The fifth chapter is devoted to reviewing policies of FDI in India after liberalisation.

The sixth chapter compare the FDI policy between China and India to draw the lessons for higher FDI inflow to India.

The last chapter summarises the findings.

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