Chapter 1
INTRODUCTION

International capital flows can be broadly distinguished between debt creating and non-debt creating inflows. While debt creating inflows comprise borrowings, external assistance, and loans of different maturities, non-debt creating inflows consist of portfolio investment, bank deposits, and foreign direct investment (FDI). Non-debt creating inflows can be further categorised into short-term (portfolio inflows, bank deposits etc.) and long-term (FDI) capital flows. Among these different kinds of inflows, the focus of the present research is on longer-term non-debt FDI inflows.

1.1 BACKGROUND

At the outset, it is important to highlight the intrinsic features of FDI that distinguish it from other capital flows and make it an attractive source of external capital for recipient nations. Unlike other capital flows, FDI comprises a package of complementary inputs. Apart from money capital, inflow of FDI for recipient countries implies easy access to advanced technology and know-how, managerial expertise, global marketing networks and the best-practice systems of corporate governance. Moreover, decisions to undertake FDI also underlines a lasting interest on part of the investing entities in the countries of investment. This is in contrast to short-term portfolio flows, which are mainly determined by contemporaneous risk-return payoffs from various national capital markets and are likely to be withdrawn in the event of adverse expectations. The lasting interest with respect to FDI reflects the foreign investor’s commitment to a long-
term relationship with the enterprise in which FDI occurs and is manifested through the
investor's desire to exert significant influence upon the management of the enterprise.\(^1\) The access to various complementary inputs and the stable nature of FDI inflows on
account of the lasting interests of the investors, make these inflows attractive options for
supplementing domestic resources for recipient nations. Historically, however, short
term capital flows in the nature of portfolio investment, formed the bulk of international
capital flows during the later part of the 19th and early 20th centuries. During this
period, the proportion of FDI in global capital flows was relatively low. However, in the
years following the end of the Second World War in the 20th century, FDI gradually
came to occupy a significant part of international capital flows (Hood and Young,
1979).

Apart from its intrinsic attributes, which motivated several nations to tap FDI inflows
for accessing advanced know-how and gaining access to global marketing chains,
government policies in many countries were also responsible for the increasing
importance of FDI inflows in global capital movements after the end of the Second
World War. A significant part of the increase in FDI inflows during this time occurred
due to restrictive trade policies (e.g. tariff barriers, quantitative restrictions on imports
etc.) adopted by various nations. Pursuit of these inward-looking policies encouraged
import-substitution and reduced access to domestic markets for exporting enterprises
from foreign countries. For these enterprises, establishment of local production facilities

\(^1\) Apart from the initial transaction establishing the relationship between the investor and the enterprise,
direct foreign investment (FDI) also includes all subsequent transactions between the investor and the
enterprise, and among affiliated enterprises, both incorporated and unincorporated. See Wong and Adams
(2002).
through direct investment became a more economical alternative for catering to the protected domestic markets.

1.2 THEORETICAL AND EMPIRICAL RESEARCH ON FDI: MAIN ISSUES

The rapid expansion of FDI inflows as a major international phenomenon after the Second World War led to extensive theoretical and empirical research seeking to justify FDI, study its economic impact on the investing (home) and recipient (host) countries, and identify the determinants of FDI. The theoretical research on FDI has been very closely linked with the study of multinational enterprises. As economic institutions, multinational enterprises have been the main transporters of FDI across the world. They also display several distinct behavioural, organisational, and operational features, which posed new research challenges for economists. The analysis of FDI has proceeded simultaneously and the two issues have mostly been addressed together.

Two major schools of thought, the theory of trade, and the theory of the firm, dominate the theoretical explanations of FDI. Within their ‘pure’ versions, none of these theories, however, are able to provide complete explanations of FDI, as distinct from other forms of capital movements, like portfolio investment or foreign borrowings (Lall and Streeten, 1977), on account of their rigid assumptions. However, explanations attempted after introducing suitable modifications in the original general equilibrium frameworks of the trade theory and the theory of the firm, come much closer to justifying FDI. The most conclusive theoretical justification of FDI is provided by an eclectic paradigm, which is commonly referred to as the Ownership (O)-Location (L)-Internalisation (I) framework (Dunning 1976, 1977, 1981, 1988). This thesis aims to address its research
questions pertaining to determinants of FDI on the basis of the theoretical construct of the O-L-I framework.

Apart from trying to justify FDI, the theoretical literature has also attempted to identify the determinants of FDI. These theoretical determinants of FDI relate to sources of firm-specific ownership advantages and country-specific locational attributes. Firm-specific ownership advantages, typically, construe sources of oligopolistic advantages for large transnational firms, which impart them greater competitive advantages over domestic counterparts in foreign countries, and encourage them to undertake FDI for establishing local production bases. While the ownership advantages relate to the supply-side determinants of FDI — according to the O-L-I framework — various locational characteristics of host nations encompass demand-side determinants. Most of the host-country characteristics that are decisive for FDI pertain to cost-reducing locational advantages for foreign firms, apart from other significant factors like size of the domestic market and nature of host country government policies. Among these two distinct categories of determinants influencing FDI, the present research focuses on the demand-side factors.

The theoretical literature on FDI does not usually distinguish between determinants of FDI in terms of developed and developing countries. This distinction, however, is critical, particularly with respect to the demand-side determinants. Given ownership advantages, decisions to undertake FDI are determined entirely by host-country characteristics. Since developed and developing countries have significant differences between their economic structures and institutions, country-specific features encouraging FDI are also expected to be different between them. This issue has been
addressed by the empirical research on the determinants of FDI, which has sought to set
apart the factors influencing FDI in developing countries, as distinct from those in
developed nations. Empirical studies have identified several distinct determinants of
FDI for less developed countries (LDCs). These studies have also indicated that the
volumes of FDI as well as its sectoral (industrial) composition in LDCs depend not only
on the degree of development in host countries, but also on various exclusive country-
specific factors.

1.3 FDI IN INDIA

The main thrust of this research is on the determinants of FDI in India. The subject of
FDI in India has attracted the attention of academic economists as well as policymakers.
India, like many other developing countries, initially followed an inward-looking
development strategy of import substitution and a restrictive policy towards FDI.
Greater attention was devoted to achievement of self-reliance through mobilisation of
internal resources. Even within this restrictive policy framework, the decades of 1950s
and 1960s had relatively liberal foreign investment regimes. But the 1970s witnessed
much greater controls on foreign investment with the enactment of the Foreign

From the middle of the 1980s and the beginning of the 1990s in particular, India has
experienced significant relaxations in its foreign investment policies. These relaxations
have been part of the larger process of reforms initiated in various sectors of the
economy. The external sector of the economy has witnessed progressive withdrawal of
various external capital controls and concomitant encouragement to private capital
inflows. The policy stance has also been in favour of greater reliance on non-debt creating capital flows, in place of debt flows.

The new policies have succeeded in enhancing foreign capital inflows in the Indian economy. From a paltry share of only 1.5 per cent in total capital inflows (net), the share of non-debt creating flows in total capital flows has increased to 46.6 per cent in 2002-03\(^2\). In 2002-03, FDI flows comprised 38.5 per cent of total capital flows, compared with 1.4 per cent in 1990-91. With the volume of FDI inflows into India increasing significantly from only US$97 million in 1990-91 to more than US$6 billion in 2001-02, India has emerged as one of the leading FDI destinations among developing countries (UNCTAD, 2003).

However, despite significant procedural relaxations and liberal policies, FDI inflows in India, though much higher than the past, has not been able to reach the levels of the ASEAN economies or China. The difference between China and India in this regard is particularly noteworthy (Guha and Ray, 2001). During 2002, FDI inflows into China were worth US$52.7 billion, while similar inflows into India at US$4.7 billion, were less than 10 per cent of that of China\(^3\). As a percentage of GDP, India's total FDI stock was just above 6 per cent, while that of China was more than 36 per cent in the year 2002\(^4\). Other major economies in South East Asia like Hong Kong and Singapore, as well as leading Latin American economies like Brazil and Mexico, have been consistently able to attract greater FDI inflows, compared to India. Apart from its inability to attract as much FDI as the mentioned economies, it has also been noted that

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\(^2\) See RBI (2002-03).
\(^3\) See UNCTAD (2003) and RBI (2002-03).
\(^4\) See UNCTAD (2003).
the proportion of actual FDI inflows into India is quite low compared to the total investment approvals issued.

1.4 RESEARCH QUESTIONS

India’s relatively poor performance in attracting FDI inflows compared to many other developing economies raises questions regarding the determinants of FDI in India. It also attracts attention to the constraints impeding FDI inflows into India, given the low levels of ratios between approved and actual investment. Most of the empirical studies regarding FDI in India have either focused on the impact of FDI on the domestic economy, or on the identification of determinants through a broad macro-economic approach, which includes India among a group of host countries. Some recent studies, however, have attempted to specifically investigate the host-country determinants for FDI in India (Guha and Ray, 2001; Eapen and Hennart, 2002). However, on the whole, there is limited evidence of empirical research focusing on identification of determinants for FDI in India at a disaggregated level (i.e. in terms of industry and region-specific features), as well as on the constraints to FDI flows.

The primary objective of this research, therefore, is to capture the industry-specific and region-specific determinants of inward FDI in India and to identify and analyse the constraints limiting FDI inflows across industries and locations.

As mentioned earlier, this research proposes to address these issues within the theoretical premise of the O-L-I construct. Based on the theoretical foundation of the O-L-I framework, the present research aims to empirically identify the country-specific determinants of FDI in India. The country-specific determinants that are likely to affect
incoming FDI are to be grouped in industry and state-specific categories for examining their effect on incoming FDI flows. In addition, this research also attempts to provide a detailed analysis of the constraints affecting FDI inflows across industries and locations.

1.5 STRUCTURE OF THE THESIS

The thesis is organised into seven chapters.

Chapter 1 provides a background to the subject and highlights some of the main aspects of FDI inflows into India. It also draws attention to some of the research issues involved. Thereafter, it sets out the main research questions addressed in the thesis.

Chapters 2 and 3 provide reviews of the theoretical and empirical literature on FDI. The thrust of Chapter 2 is on an overview of the theoretical literature. It studies the main theoretical explanations of FDI offered by various strands of thought, like the theories of international trade and the firm, and examines in detail the eclectic O-L-I paradigm and its main features. Chapter 3 reviews the empirical literature pertaining to study of determinants of FDI. In course of the review, the chapter outlines the different approaches employed for identifying determinants of FDI and the main determinants identified. It also provides a brief review of the empirical studies relating to FDI in India.

Chapter 4 discusses the policies and trends pertaining to FDI inflows in India since independence. It distinguishes between these issues over two periods of time. The first period spans policies and trends of FDI inflows into India since independence and till the beginning of economic reforms in the early 1990s. The second period concentrates on the post-reform years. The chapter aims to capture the gradual transition of FDI
policies in India from a largely restrictive to a significantly liberal regime. It also provides a statistical analysis of the trends of FDI inflows into India during the two periods and highlights their salient aspects.

Chapters 5 and 6 address the primary research questions through empirical analysis. Chapter 5 studies the industry and state-specific features that are significant in determining FDI inflows into India by employing tools of applied econometrics. It also attempts to identify country-specific determinants for FDI in India through a macro-level analysis. Chapter 6 presents a detailed analysis of the nature and pattern of constraints affecting FDI inflows in India on an industry and location-specific basis through descriptive statistical methods. It also attempts to identify the determinants of these constraints through econometric analysis.

Chapter 7 summarises and concludes.