Chapter III

ECONOMICS OF FOREIGN DIRECT INVESTMENT

Introduction

Foreign Direct Investment (FDI) is the investment made by one country to other country for the purpose of developing industrial activities. FDI provided mutual help to both the countries. For the home country, it is an investment-generating income and a source for spreading business operations globally, and for the host country, it is source of capital for the development of infrastructure, which is the corner-stone for economic development. Infrastructure development is needed for the growth of domestic trade, foreign trade for reducing imports and external borrowings and for correcting the fiscal deficit. Developing nations are perpetual victims of a resource crunch. They find it hard to develop basic infrastructure which is badly needed for industrial development.

The FDI should be taken in the righter perspective. There is no danger in increasing flow of FDI in India. It is need of the hour that huge investment of FDI should be allowed in most of the sectors of the economy for long-term economic development of the country. Indian Government’s resources are very much limited to overcome the problem of unemployment, modernization of industries including agriculture industry and numerous related problems. The best
solution for this has been found that the large investment of FDI should be allowed. The Economic and Social Survey: 2001 by the World Bank shows that out of $207 billion in FDI flows to developing countries, $40 billion went to China as compared to $2.1 billion for India.

Within the Asian region, Malaysia, Singapore, Korea and Thailand have received much more FDI than India. Because from the point of view of foreign investors, apart from rapid liberalization, other things are also important in determining the choice of destination. In this the share of China is 19.32 per cent while India’s share is only 1 per cent. The above information suggests that there is no need to be afraid that India economy will go in the hands of foreign investors, if the larger investment is allowed. For rapid growth and development, there is need to increase the flow of FDI in coming years by further liberalizing FDI policy so as to make the Indian economy more free and competitive in the global market.

For a long period of time India too much depended on Foreign aids considering it cheapest source of having foreign exchange. Most of us do not known that aid is nothing but a loan. It is concessional loan as the rate of interest to be paid on aids is slightly lower than other loans and the duration of payment is usually longer during which it is to be repaid. This practice was raising the amount of
interest to be paid rapidly and country had to face difficulties in making the payment of interest for which foreign exchange was needed. Therefore to come out from such a situation the country had introduced economic reforms in 1991 and allowed on large scale inflow of foreign direct investment in most of the sectors of the economy. The policy has successfully controlled the crisis of foreign exchange since 1991. However, the progress of FDI is still not satisfactory when it is compared with the other developing countries of the world such as China, Singapore, Malaysia and Korea etc.

India has recently opened up more sectors, including defense, to foreign direct investment. But many developing countries have liberalized their economies even more in the past. The measures undertaken by them have included the rules regarding procedures of investment approvals, removing the controls on foreign exchange transactions, reducing performance requirement and increasing access to sectors as well as the extent of foreign ownership. But only few countries have managed to get huge FDI flows. Multinationals are interests in coming to a country which has a big market because they want to internationalize their operations. They also want to access natural resources and raw materials. Thirdly, they are interested in the quality and cost of labour of the host country, its growth prospects as well as its polices.
High growth prospects are responsible for the biggest chunk of FDI going to China which has had an average GDP growth of 9 per cent over the last two decades. China also has a skilled population which has caused invested heavily in China. Non-Resident Indians too can bring more FDI to India except that they are scattered thinly across the globe and unlike the non-resident chineese who live close to China, most NRIs are not near India. They do not also have as much investable resources because most are professionals. many are also not happy with the existence of corruption and procedural delays in India. India has got a great potentiality for attracting more inflow of FDI.

For capital-scare developing economies, foreign direct investment (FDI) implies access to not only capital, but also advanced technology and know-how, managerial expertise, global marketing networks and best-practice systems of corporate government. FDI inflows are not-debt creating and more stable than portfolio flows that are guided by short-term risk-return pay offs and are prone to quick reversals in the event of adverse expectations. Thus, following withdrawal of most restrictions on cross-border movement of capital in a globalized Economy, almost all developing countries have adopted liberal policies towards FDI for exploiting the virtuous aspects of such flows. Inspite of enabling policies,
however, success in attracting FDI has widely varied between countries.

Trade has been traditionally considered to be an “Engine of Growth”, a source of competitive pressure on domestic industries and a force of integration bringing national economies closer together. Foreign Direct Investment is increasingly assuming the same role. In fact, FDI become more important than trade as a vehicle for international economic transactions. The role of FDI have changed their views. Most of the countries have liberalized their FDI regulations since the early 1980s. Host countries are actively trying to encourage foreign direct investment to participate in their production activities. They also expect the benefits of FDI to dominate the cost of foreign ownership of local factors of production. However, the attitudes of host countries towards Multinational Corporation (MNCs) have been mixed, although the proponents of FDI seem to have gained the upper hand during 1990s. The subject of private foreign investment in less-developed countries (LDCs) has received only a less sustained any systematic attention in terms of data collection and analysis than many other aspects of economic development.

Marxist considered the private capital and private investment as a natural consequence of maturing capitalism and the last
manifestation of a doomed system before it collapse. However, this prediction has been proved not true. Most developing countries have moved to market oriented, the private sector led economies. This is widespread reduction and removal of trade barriers, regulation of internal markets, privatization and liberalization of technology and investment flows at national level. In this context, Multinational Corporation (MNCs) have occupied a important role in the world economy and the development process. Hence, there is a growing competition among world countries to attract foreign direct investment. Countries are offering several packages of incentives to multinational corporations to make their country a lucrative place for investment. It leads competition to attract FDI to become pervasive, and the result is described as a “cutthroat bidding war”.

The most important reason why countries try to attract foreign direct investment is perhaps the prospect of acquiring modern-technology, interpreted broadly to include both product, process and distribution of technology, as well as management and marketing skills. In spite of increasing importance of foreign direct investment in the economy of developing countries, it is not free from criticisms.

It is criticized for the increasing private activities and reducing state activities in a welfare state like India. It is necessary to point out that the liberalization and resultant foreign direct investment has
not necessarily diminished the role of the state. It has only refined the state’s role by expanding it in some areas and reducing it in some other. It tried to provide an optional mix of “Market and state”. However, the global shift in policy to market orientation and the liberal economic policies have swept aside many east while conventions, hesitation and resultant criticisms that formerly governed inward FDI flows. It resulted in the tremendous increase in international capital mobility during 1990’s. The private capital flow dominates with official flows reduced to a trickle. Therefore, production activities comprise a large and increasing important part of Globalised Economy. Hence, studying foreign direct investment becomes more important.

**Significance of Foreign capital**

The role of FDI has undergone tremendous changes since 1991. It is evident from the changing composition of the foreign capital flow into India. When the whole world is marching ahead toward the “New Order”, India is of no exception to this phenomenon in a globalized and well-integrated world. India’s approach to development witnesses a gradual shift from the inward oriented import-substitution approach to the outward looking approach during the late 1980’s and specifically after experiencing a severe crisis during 1990-91. It ultimately resulted in decontrol, delicensing and pursuance of a more liberal and investment friendly
‘open door’ policy towards FDI. In this context, private foreign capital in general and FDI in particular has been widely recognized as an imperative input for sustainable development. In the process of global integration and Co-operation, the promotion and diversification of trade and FDI assumed greater importance in Indian economy.

The FDI policy change in India attracted controversial opinions not only from the political dais but also from the sphere of intellectuals. Some thinkers have been constantly expressing their worries and concern about the FDI policy of India. For them FDI in India seems to be the road map ultimately end up with emergence of colonialism though not political but economic. This may possible because of India’s past experience of trade-led political colonialism. In spite of the fear expressed by the few, the mainstream economics strongly believe that the flow of FDI into India is of immense importance since it provides a package of capital, foreign exchange, technology, managerial expertise, skills and other inputs considered essential for the development of an emerging economy like India. Moreover it is also important to understand that Indian can not stand alone while the world is shrinking to become a global village with the absence of impediments for the flow of trade and investment across the countries. No country can prosper keeping itself outside the global stream and India is of no exception to this. However, India has to evolve a suitable policy to play carefully in the international economics so as to reap the benefits of investment flow. It seems that
the “leftist” who strongly opposed for FDI into India earlier, still believe that there is over emphasis on FDI in India. With these backgrounds India has already spent 20 years of her ‘open-door’ policy for FDI since 1991.

Hence, it is inevitable to analyse various dimensions of FDI in India such as trends, comparative performance, determinants, impact of FDI on Indian Economy, to provide a reasonable base to evolve and execute the best policies for the benefits of Indian economy as a whole.

Indian economy has underwent radical changes in 1990s because of the introduction of new economic policy and liberalization in this juncture. The free inflow of capital and Foreign Direct Investment enabled our economy to improve and too enhanced and sophisticated methods and means of production. More specifically, the part played by FDI in promoting the progress of India Economy and Employment opportunity and the inevitable part and parcel of the LPG. The real fruits of Economic reforms not only promoting the welfare of individuals, but also it shows its significant strides in the progress of economy. Policy makers and planners attention is to attract more and huge quantity of Foreign Direct Investment. In a crux the Foreign Direct Investment and role of Foreign Institutional Investors (FII) played an integral part in our economy. The present study through light a synoptic looks about the Foreign Direct Investment and its importance in India it also deals
the various facts and aspects of Foreign Direct Investment and its impact on Indian Economy.

Capital is stated as the engine of economic growth. This statement has gained more importance in the recent times. Traditionally, the various sources of capital for developing countries were—either the demand of their output (raw material) by industrial countries or foreign aid or loans from foreign banks. However, nowadays, the official development assistance flows are steadily declining. Beside others, Foreign Direct Investment as a source of funds has gained very high importance, in recent years.

Foreign Direct Investment (FDI) is an investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy in an enterprise resident in an economy other than that of the foreign direct investor. Individuals as well as business entities may undertake FDI. Such investment involves both the initial transaction between the two entities and all subsequent transactions between them and among foreign affiliates. FDI flows comprise equity and non-equity forms of investment. The equity capital flows comprise the foreign direct investor’s purchase of shares of an enterprise and also include the foreign direct investor’s share in reinvested earnings. Besides, the equity form of FDI also includes short or long-term intra-company loans and debt
transactions between foreign direct investor and the affiliates. The non-equity forms of FDI include investments through such activities as sub-contracting, management contracts, turnkey arrangements, franchising and licensing and products sharing.

Foreign Direct Investment involves the ownership and control of a foreign company in a foreign country. In exchange for this ownership, the investing country usually transfers some of its financial, technical, managerial, trademark and other resources to the recipient country. The international transfer of funds need not be prerequisite for this exchange. The Government of India, in March 2003 revised the FDI definition in line with international practices. The revised FDI data now includes ‘equity capital’ including that of unincorporated entities, non-cash acquisition against technology transfer, plant and machinery, goodwill, business development, control premium, and non-competition fees. It also includes ‘re-invested earnings’ including that of incorporated entities, unincorporated entities and reinvested earnings of indirectly held direct investment enterprises.

Besides, ‘other capital’ including short-term and long-term inter-corporate borrowings, trade-credit, supplier credit, financial leasing, financial derivatives, debt securities, land and buildings are factored in. FDI is seen as a mean to supplement domestic
investment for achieving a higher level of economic growth and development. FDI offer benefits to domestic industry as well as to the consumer by providing opportunities for technological upgradation, access to global managerial skills and practices, optimal utilization of human and natural resources, making industry internationally competitive, opening up exports market, providing backward and forward linkages and access to international quality goods and services.

Foreign investment and technology play an important role in the economic development of a nation. The economic health of the transition countries in Eastern Europe, Russia and Central Asia is well-off due to these inputs. Even the communist countries like China have welcomed the foreign investment to make their economies better. Most of the advanced countries of today developed due to the foreign investment, which played a vital role in making them high-income countries. Economic growth is proportional to the capital formation. Less developed countries having less income and low saving have not been able to take their economies to take-off stage. Hence, domestic resources are supplemented with foreign investment to make the development plan ongoing for better and healthier economy.
Foreign investment gives the facility of imports of capital goods, raw materials and technical knowledge for the growth of an economy. If investment is made in export-oriented industries it promotes exports of host countries and facilitates imports to a large extent. If it is in cost reducing industries, customers get cheaper products which results in general increase in the real incomes of the people. The investments, if used, for structural development leads to the development and growth of all other kinds of industries. Besides giving a general boost up to the industrial development, increased FDI leads favourable impact on the balance of payment position of a country.

International Financial Markets have got a higher degree of strength in liberalization. Globalization has opened the doors almost all over the world for utilizing international financial flows, which have been outpacing the flow of goods and services among trading countries. Developing countries are the recipients of funds from the international markets due to in time availability of external finance in the required amount for their development.

World Investment Report, 1995 prepared by United National Conference on Trade and Development and Published by UN, New York and Geneva is based on Annual review of the trends in FDI in various places. It shows that international investment by
transnational corporations supersedes trade and is the best mechanism for international business integration. It has become a major engine in global growth of the economies.

Flow of foreign investment started in India in 1980. Government of India released the policy in respect of oil exporting developing countries (OECD) with a good package of following exemptions:

(i) Countries can invest upto 40 per cent in equity of new ventures without linking to technology transfer.

(ii) Non-resident Indians’ (NRIs) investments were allowed in Indian Industrial Units under defined conditions.

Considerable interest is now being shown in measures that might promote FDI and allow it to make a greater contribution to the development of the recipient countries. In determining the flow of foreign capital controls exercised by the host country over the conditions of entry of foreign capital, regulations of the operation of foreign capital and restrictions on the remittance of profits and the repatriation of capital are far more decisive.

The central problem now is for the recipient country to devise policies that will succeed in both encouraging a greater inflow of FDI and ensuring that it makes the maximum contribution feasible
towards the achievement of the country’s development objectives. The task of development requires both more effective government activity and more investment on the part of international private enterprises. Foreign Direct Investors must be aware of the developmental objectives and the priorities of the host country and understand how their investments fit into the countries development strategy. The contribution of FDI has to be interpreted in terms beyond private profit. At the same time, the government must realize that if risks are too high or the return on investment is too low, international direct investment will be inhibited from making any contribution at all. Development planning requires the government to influence the performance of FDI, but in doing this, the government should appreciate fully the potential contribution of this investment and should devise policies that will meet the mutual interests of foreign direct investors and host country. This calls for most intensive analysis of the consequences of FDI and for more thought and ingenuity in devising approaches that favour the mobilization of FDI while ensuring its most effective “Planned performance” in terms of the country’s development programme.

At present, the policies taken by the developing countries reveal a mixed picture of restrictions and incentives. On the one hand, the foreign investors’ freedom of action may be restricted by a variety of governmental regulations that exclude FDI from certain
“Key” sectors of the economy, impose limitations on the extent of foreign participation in ownership or management, specify conditions for the employment of domestic and foreign labour, limit the amount of profits and impose exchange controls on the remission of profits and the repatriation of profits. On the other hand, a progressive liberalization of policy toward FDI has occurred during recent years. Many countries now recognize that an inflow of FDI may offer some special advantages over public capital and a number of investment incentive measures have been adopted recently or are under consideration.

Foreign capital played an important role in the early states of industrialization of most of the advanced countries of today, like the countries of Europe (including the Russia) and North America. Though the problems of development of developing countries of today are not very much similar to those faced by the advanced countries in the past, there is a general view that foreign capital, if properly directed and utilized, can assist the development of the developing countries.

Economic growth is a function of, among other things, capital formation. In the developing countries, the per capita income and savings rate being very low, domestic capital formation is inadequate to give a ‘big push’ to the economy to take it to the ‘take-off’ stage.
Hence the domestic resources may be supplement with foreign capital to achieve the critical minimum investment to break the vicious circle of “low-income-low savings-low investment-low income.”

Another way by which foreign capital helps accelerate the pace of economic growth is by facilitating essential imports required for carrying out development programmes, like capital goods, know-how, raw materials and other inputs and even consumer goods. The machinery, the know-how, and other inputs needed may not be indigenously available. Further, the demand spurt created by large-scale investments may necessitate import of consumer goods. When the export earnings are insufficient to finance such vital imports, foreign capital should help reduce the foreign exchange gap.

Foreign investments may also help increase a country’s export and reduce the import requirements if such investments take place in export-oriented and import competing industries.

In the sphere of international economics, one of the most significant developments of twentieth century has been the growth of the so called multinational or transnational corporations (TNCs). A TNC is usually so called because while it has production or distribution affiliates located all over the globe, management control
of its operations is usually centralized. Though these TNCs existed even in the 19th century, the present century has witnessed their phenomenal growth. In a pioneering work, Barnett and Muller (1974) have attempted to document the growth of these TNCs. Though there are differences over the precise definition of these corporations, there is little doubt that today these TNCs control about 40 per cent of world production and probably an even larger percentage of world trade. Sales of foreign affiliates of TNCs were in excess of about $4.8 trillion in 1991 which was about twice the level in the early eighties and slightly more than the world exports of goods and services (World Investment Report, 1994). To a large extent this growth has been a natural outcome of the increasing internationalization of all economies consequent to the spread of instant global communications. This rapid expansion of FDI in the last decade or so has been fueled by the privatization programmes of many developing economies (particularly in East Europe) and the generally favourable foreign investment policies in Asia and other developing regions. What has been of particular interest to analysts has been a study of the nature of investment flows of these TNCs often referred to as foreign direct investment (FDI).

Internationalization, in the form of FDI began in the late nineteenth century. The Victorian and Edwardian era saw the creation of many of the great vertically integrated multinationals that
we would recognize today – colonial plantation companies such as lever Brothers (now Unilever) investing in West African vegetable oil plantations, Cadbury’s in cocoa, Dunlop in rubber. Britain, as the great imperial power of the time, dominated world international business, with over 45 per cent of the world’s total stock of FDI in 1914. Thus it is clear that the philosophy of FDI is not the product of new scenario, but its origin lies in the late nineteenth century.

**Definition of Foreign Direct Investment**

Foreign direct investment is used to create or purchase facilities for undertaking direct production, usually jointly with an Indian partner. Foreign direct investment provides investment capital as well as modern technology, increasing the growth rate of GDP and employment. Export oriented foreign direct investment is particularly useful as it provides automatic access to world markets and boosts domestic export (as well as employment) through backward linkages with the domestic economy.

Foreign direct investment (FDI) is a term used to denote the acquisition abroad of physical assets, such as plant and equipment, with operational control ultimately residing with the parent company in the home country. It may take a number of different forms including.
• The establishment of a new enterprise in an overseas country – either as a branch or as a subsidiary.
• The expansion of an existing overseas branch or subsidiary.
• The acquisition of an overseas business enterprise or its assets.

At the very outset it is necessary to define the forms which foreign participation can take. TNCs can interact with host countries via FDI, portfolio investment, exports or licensing of technology and patents. FDI has a very special meaning in that it refers to flows of equity capital into a subsidiary where the foreign investor (or TNC) has a controlling interest. Traditionally, this is defined as the TNCs share of total equity capital exceeding 10 per cent or 25 per cent. However, the basic issue is to attempt to distinguish FDI flows from portfolio investment. While the former is considered long-term investment the latter is typically guided by short-term considerations of speculative gains. On the other hand, a TNC export to a host country and then switches to domestic production when entry barriers (like tariffs) make exports uncompetitive or when such a move is necessary to internalize certain owner-specific advantages.

However, it is clear that the essential criteria should be ‘controlling interest’ and ‘long-term interest’. Thus licensing or sale of a technology without any financial flows can also give the foreign investor control of the recipient firms’ decision process. From the
point of view of LDCs, in particular, the relevant factor is technology inflows and this inflow can take place without any corresponding financial inflows of capital. There is, therefore, no necessary link between technology flows and capital flows (see, Casson and Pierce, 1987). In this light, for example, it would seem wise to include in the concept of FDI is that it must involve ‘control’ by the foreign interest and ‘long-term’ considerations.

Thus in nut shell it may be said that FDI is used for purchasing facilities to undertake direct production, usually in partnership with an enterprise from the host country. The FDI flows increase the growth rate of GDP and employment. It also brings in capital investment and modern technology. The export oriented MNCs increase export of the host country which reduces the crises of foreign exchange. The MNCs choose a country for FDI where usually low cost of labour and vast market is available so that the profit can be maximized or rate of return is more attractive and safe than other countries as well as the export procedure is simple.

**The scope for Foreign Direct Investment**

Some of the chief industries, especially export industries, of underdeveloped countries have been built up largely by direct foreign investment. Leading examples are the oil industries of the Middle East and Venezuela; the rubber estates and tin mines of
Malaya and Indonesia; the tea estates of India and Ceylong; the sugar estates of Cuba and the British West Indies; the banana estates of Central America and the copper mines of Northern Rhodesia and Chile. In some countries, direct foreign investment has played a leading part also in the field of railways, electric power, and other public utilities, and in international trade.

While the inflow of capital in any form supplements the inadequate savings of low-income counties, direct investment has various advantages over loans (including export credits). Loans leave an aftermath of interest charges and repayments, which often become a serious burden on the budgets and foreign-exchange reserves of the borrowing countries. It is true that loans could be spent in ways which increase output, taxable capacity and export earnings, but often they are not; they may be used for what seems an urgently-needed expansion of social services or to tide over a deficit in the balance of payments which turns out to be a long-period rather than a temporary deficit, so that the loans merely postpone the need to reduce levels of consumption. Direct investment leaves no such aftermath. The Government of the country incurs no obligation to make payments if the industry goes through a lean period it is the foreign shareholders who suffer.
Direct investment has other advantages also. It often introduces new industries or improved methods. It provides employment and sometimes specialized technical training for local workers. It contributes to local public revenue; for instance by paying income tax and in many cases export duties. If it establishes or expands export industries it increases exports and thereby foreign-exchange earnings. A number of large foreign companies (notably those owning estates) provide housing and social services for their workers.

Most underdeveloped countries, however, are very nationalistic. Against these advantages of foreign direct investment is the great disadvantage, from their standpoint, that it places control over part of their economic activity in the hands of foreigners. Some countries feel that large foreign companies may interfere in their political and economic life, introducing an element of foreign domination or, in the case of ex-colonies, re-introducing ‘colonialism’ through the back door. Moreover, most underdeveloped countries are socialistic in their outlook and consider that certain key industries, such as public utilities and steel mills, should be owned by the state rather than by private capital, whether foreign or local. Owing to these attitudes the scope for foreign direct investment has been substantially reduced during the middle of the 20th century. But now all countries – developed, developing and
underdeveloped are encouraging flow of FDI with incentive packages.

More directly, many countries have come to realize that an inflow of foreign capital can offer some unique qualitative advantages. For no problem of productive use arises with foreign direct investment: by its very nature, a foreign investment necessarily entails the identification of an economic opportunity, the formulation of a productive project, and its efficient implementation. Especially significant is the merit that foreign direct investment has in carrying with it an integral ingredient of technical assistance—the managerial and technical knowledge which are usually in even shorter supply than capital. As an instrument for transmitting technical and organizational change, integrating technical and financial assistance, and helping to overcome the skill and management limitations in development, the private foreign investment has a distinct advantage over foreign public capital.

To provide an analytical basis for understanding the rationale and effects of foreign investment policies in the host countries, we should weigh the benefits of foreign investment against its costs. After assessing what difference the presence of foreign owned capital might make to the real income of the recipient country, we may then appraise existing policies.
Some concerns regarding foreign direct investment are as follows: One, it can stifle the growth of domestic firms. While this may happen in a few cases, foreign direct investment usually promotes investment and growth of domestic firms through joint production, as can be seen from the experience of our automobile industry. Two, foreign direct investment can possibly make excessive returns in highly protective markets when domestic prices are significantly higher than international prices. This is largely mitigated by our high corporate tax rates. Nevertheless, if we want to use foreign direct investment on a large scale, we should continue to reduce our tariffs and quantitative restrictions on imports, especially those on consumer goods, and usher vigorous competition by allowing many multinational companies in a sector that it opened to foreign direct investment (rather than creating foreign monopolies, such as Maruti until recently). Three, foreign direct investment can lead to foreign domination. This concern is outdated and exaggerated. China, Malaysia and Singapore, some of the largest recipients of foreign direct investment, are subject to no more (in fact less) pressures than India. Foreign direct investment can earn profits only when the particular investment is profitable. Thus it does not create the kind of economic crisis that poorly managed foreign debt has created in many developing countries. Since foreign direct investment is often used to finance imports of capital and other
inputs, its contribution to domestic inflation or currency appreciation is usually marginal.

**Benefits of FDI**

The inflow of private capital contributes to the recipient country’s development programme in two general ways by helping to reduce the shortage of domestic savings and by increasing the supply of foreign exchange. To this extent, the receipt of private foreign investment permits a more rapid expansion in real income, eases the shortage of foreign exchange, and removes and necessity of resorting to a drive toward self-sufficiency and the deliberate stimulation of import-substitution industries out of deference to foreign exchange considerations. Beyond this initial contribution, the essence of the case for encouraging foreign investment is that in time, as the investment operates, the increase in real income resulting from the act of investment is greater than the resultant increase in the income of the foreign investor. There is a national economic benefit if the value added to output by the foreign capital is greater than the amount appropriated by the investor: social returns exceed private returns. As long as foreign investment raises productivity, and this increase is not wholly appropriated by the investor, it follows that the greater product must be shared with others, and there must be some direct benefits to other income groups. These benefits can accrue to (1) domestic labour in the form of higher real wages, (2)
consumers by way of lower prices, and (3) the government through expanded revenue. In addition, and of most importance in many cases, there are likely to be, (4) indirect gains through the realization of external economies.

Some benefits from foreign investment may also accrue to consumers. When the investment is cost-reducing in a particular industry, there may be a gain not only to the suppliers of factors in this industry through higher factor prices but also to consumers of the product through lower product prices. If the investment is product-improving or product-innovating, consumers may then enjoy better quality products or new products.

In order that labour and consumers might gain part of the benefit from the higher productivity in foreign enterprises, the overseas withdrawal by the investors must be less than the increase in output. But even if the entire increase in productivity accrues as foreign profits, there will still be a national benefit when the government taxed these profits or receives royalties from concession agreements.

From the standpoint of contributing to the development process the major benefits from foreign investment are likely to arise in the form of external economics. Besides bring to the recipient
country physical and financial capital, direct foreign investment also includes non-monetary transfers of other resources-technological knowledge, market information, managerial and supervisory personnel, organizational experience, and innovations in products and production techniques—all of which are in short supply. By being a carrier of technological and organizational change, the foreign investment may be highly significant in providing “private technical assistance” and “demonstration effects” that are of benefit elsewhere in the economy. New techniques accompany the inflow of private capital, and by the example they set, foreign firms promote the diffusion of technological advance in the economy. Technical assistance may also be provided to suppliers and customers of the foreign enterprise. In addition, foreign investment frequently leads to the training of labour in new skills, and the knowledge gained by these workers can be transmitted to other members of the labour force, or the newly trained workers might be later employed by local firms.

**Arguments in Support of Foreign Direct Investment**

The arguments in favour of FDI grow largely out of the traditional neo-classical analysis of the determinants of economic growth. Foreign private investment (as well as foreign aid) is typically seen as a way of filling in gaps between the domestically available supplies of savings, foreign exchange, government
revenue, and management skills and the desired level of these resources necessary to achieve growth and development targets. If the nation can fill this gap with foreign financial resources (either private or public), it will better be able to achieve its target rate of growth. Therefore, the first and most often cited contribution of private foreign investment to national development i.e., when this development is defined in terms of GNP growth rates—an important implicit conceptual assumption is its role in filling the resource gap between targeted or desired investment and locally mobilized savings. This ultimately increases the growth of the GNP and employment.

A second contribution, analogous to the first, is its contribution to filling the gap between targeted foreign exchange requirements and those derived form net export earnings plus net public foreign aid. This is the so-called foreign exchange or trade gap. An inflow of private foreign capital can not only alleviate part or all of the deficit on the balance of payments current account but it can also function to remove that deficit over time if the foreign owned enterprise can generate a net positive flow of export earnings. Unfortunately, as we discovered in the case of import substitution, the overall effect of permitting MNCs to establish subsidiaries behind protective tariff and quota walls is often a net worsening of both the current and capital account balances. Such deficits usually
result both from the importation of capital equipment and intermediate products (normally from an overseas affiliate and often at inflated prices) and the outflow of foreign exchange in the form of repatriated profits, management fees, royalty payments, and interest on private loans. The third gap said to be filled by foreign investment is the gap between targeted governmental tax revenues and locally raised taxes. Hence taxing MNCs increases tax revenues of the government at various levels.

Fourth and finally there is the gap in management, entrepreneurship, technology, and skill presumed to be partially or wholly filled by the local operations of private foreign firms. Multinationals not only provide financial resources and new factories to poor countries, they also supply a “package” of needed resources including management experience, entrepreneurial abilities, and technological skills that can then be transferred to their local counterparts by means of training programmes and the process of “learning by doing”. Moreover, according to this argument MNCs can educated local managers about how to establish contacts with overseas banks, locate alternative sources of supply, diversity market outlets, and in general, become better acquainted with international marketing practices. Finally, MNCs bring with them the most sophisticated technological knowledge about production processes while transferring modern machinery and equipment to capital-poor
Third World countries. Such transfers of knowledge, skills, and technology are assumed to be both desirable and productive for the recipient nations.

Having presented a brief theoretical background of economics of Foreign Direct Investment, the next chapter presents the Theories and Policy of Foreign Direct Investment in India.