Chapter I

INTRODUCTION, SIGNIFICANCE OF FDI, OBJECTIVES & HYPOTHESES AND METHODOLOGY OF THE STUDY
1.1 INTRODUCTION

Foreign Direct Investment (FDI) refers to cross-border investment made by resident in one economy (the direct investor) with the objective of establishing a lasting interest in an enterprise. (the direct investment enterprise that is resident in a country other than that of the direct investor (OECD 2008)\textsuperscript{1} The motivation of the direct investor is strategic lasting interest in the management.

FDI is now accepted as an important driver of growth for any economy. It is an important source of non-debt financial resources for a host country for economic development besides it is a medium of achieving technical knowledge and employment generation. Many developing countries formerly skeptical regarding the role of FDI have changed their views\textsuperscript{2} In this context, Multi National Corporations (MNC) have become important actors and promoters of development process in the Indian economy.

India has now entered the second phase of reforms. The economic impact has been encouraging (though slowly) especially on the industrial front through various policies including the policy of complete de-licensing, leading to lesser hassles for the industrialists; ease of entry of foreign investors, leading to more foreign direct investment, especially in consumer goods and durables; and trade liberalization, leading, amongst other things, to liberal imports in the country and also to export competitiveness.

FDIs have strong influence on domestic employment through types of jobs created regional distribution of new employment wage levels, income distribution and skill transfer these direct effects are complemented by indirect or spillover effects.
Indirect effects take place through movement of trained labour from foreign firms to other sectors as well as through the increase of employment in domestic subcontractors. The integration of FDI into Indian economy results often in deep social change. Movement of labour and links with domestic subcontractors to enable transmission of business culture which includes corporate values organizational structures and management practices (Mirza, 1998).

There is a major debate in the literature regarding the impact of FDI on economic growth. The traditional argument states that an inflow of FDI improves economic growth and thereby enhances employment opportunities. Most studies (Hill and Athukorala, 1998) have shown that FDI's social and distributional impact on the host country has been generally favorable in developing countries of various regions. Apart from bringing in a package of highly productive resources into the host economy, there have been a visible positive impact on the creation of jobs not only in those sectors attracting FDI inflows but also in the supportive domestic industries.

The chief objective of this study is to undertake an empirical study regarding generation of income and employment opportunities by FDI during 2000-2010 in India in general and Karnataka in particular.

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 redefined the state's role by expanding it in some areas and reducing it in some others. It tries to provide an optional mix of "Market and State". Owing to the tremendous increase in international capital mobility during the 1990's, the private capital flow dominates with official flows reduced to a trickle.
FDI is guided by the principle lasting interest and creates real assets in the host country. But portfolio investment is guided by the speculative gain and involves in acquiring financial assets such as equities, bonds and debentures. But the flow of portfolio investment creates the climate of confidence, required by the foreign investors and which paves the way for foreign direct investment, and it will helps in the creation of job opportunities in the country. 

Karnataka, a leading investment destination, attracting investments, both domestic and FDI highlight the state's robust financial network. Karnataka India’s eighth largest economy, accounts for around 5 percent of its national income. The state has been ranked the first by the World Bank for its investment climate in a study that has analyzed 16 states, using 46 investment parameters. State has been home to 700 MNC’s and 87 out of 500 Fortune companies of India are operating in Bangalore, in fact, Bangalore is the first stop destination for cuttingedge research in high technology areas like aerospace engineering design Biotechnology & IT. In terms of FDI inflows, India enjoys the third rank as destination for foreign investors, next to USA. Bangalore centre which accounts for FDI investment in Karnataka, ranks the third in the country, contributing 6.39 percent of the total FDI flows into India. Karnataka is one of the India’s leading industrial states, contributing almost 8 percent to the national manufacturing income.

FDI investment channels in India in general and Karnataka in particular have vast potential of generating income and employment at different dimensions. FDI investments in Karnataka widening the gap between urban - rural dichotomy and also it increases the wage differentials in FDI based units on the bases of performance and
skills of labourers. Even though the FDI investment scenario in Karnataka is quite positive in recent years but it concentrated only in few cities in the state. The State Government recognizes, the trends and demands of the skilled labour market in various manufacturing services, Construction, hospitality, FDI based IT, BT, SEZ’s and other sectors. Skill Policy of state government ensuring the adequate availability of technically skilled man power equitable access to all matching between the supply of demand for Skilled labour force, for meeting the challenges of emerging technologies for promoting a strong and symbiotic Public Private Partnership are major objectives of the policy.  

FDI plays an important role in the transmission of capital and technology across home and host countries. Benefits from FDI inflows in terms of job creation are expected to be positive, although not automatic. FDI might enter a labour-abundant country with capital-intensive technologies; however, if the labour laws are not flexible, this would have relatively a small impact on employment generation. On the other hand, the entry of FDI in labour-intensive firms would have a positive impact on equity and poverty reduction if the FDI-enabled firms choose to locate close to suburban/rural areas NCAER (2009).

The large increase in the volume of FDI during the past two decades provides a strong incentive for research on this phenomenon. This study investigates impact of FDI on income and employment generation, using aggregated data for FDI. The choice of research topics has been made in order to allow for the possibility of finding results that can provide knowledge about role of FDI in terms of income and
employment generation, that may help policy makers of both home & host country to take appropriate decisions.

1.2 Conceptual framework of FDI

The concept of FDI has gained importance only after 1990’s. During 1960’s and 1970’s there was lot of resistance both from government side as well as private industrial establishments in the country. There are fears that foreign firms might displace domestic monopolies, and replace these with foreign monopolies and ultimately ruin the economic sovereignty of the country. The conceptual framework of FDI was gained prominence after the introduction of New Economic Reforms (NERs) in the country during 1990’s, the benefits of FDI was well utilized by liberal or less regulated developed & developing economies in the middle of the 1980’s and early 1990’s. Government of India removed the bottlenecks through introducing Industrial policy of July 1991, and it paved the way for faster movement of foreign private capital or FDI inflows into the country.

Theoretical Framework of FDI in India can be put into four categories. They are as follows:

Private Debt Flows:

They are composed of bonds, bank loans and other credits issued or acquired by private sector enterprise in a country without any public guarantee.

Official Development Finance:

It consists of Official Development Assistance (ODA) and other official flows-
I. Official Development Assistance:

ODA consists of net disbursements of loans and grants made on concessional terms by official agencies of the members of the Development Assistance committee and certain Arab countries to promote economic development and welfare in recipient economies that are listed as developing by the DAC. Loans with a grant element of more than 25 percent are included in ODA. ODA also includes technical co-operation and assistance.

II. Other Official Flows:

These are transactions by the official sector whose main objective is other than development or whose grant element is less than 25 percent such as Official Export Credits, official sector equity and portfolio investment and debt re-organization undertaken by the official sector on non-concessional terms.

III. Private Foreign Investment has two components. They are:

Foreign Direct Investment: Direct investment is assumed to have occurred when an investor has acquired 10 percent or more of the voting power of a firm located in a foreign economy (IMF-2004 a) 12; and

Foreign portfolio investment: Foreign portfolio investment involves-Purchase of existing bonds and stocks with the sole objective of obtaining dividends or capital gains and Investments in new issues of International bonds and debentures by the financial institution or foreign government.

1.2.1 Foreign Direct Investment Entity:

There are different ways in which firms and individuals can hold assets in a foreign country. The definition of “foreign direct investment entity” decides which
of these are considered as direct investment and which firms are considered as multinational enterprises. A foreign direct investment entity has been defined differently for Balance of payment (BOP) purposes and for the purpose of the study of firm behavior. The definition of foreign direct investment as a capital flow and a capital stock has changed correspondingly. Where by residents of one country (the home country) acquire ownership of assets for the purpose of controlling the production, distribution and other activities of a firm in another country (host country).

The two criteria incorporated in the notion of 'lasting interest' are:

1) The existence of a long term relationship between the direct investor and the enterprise; and

2) The significant degree of influence that gives the direct investor an effective voice in the management of the enterprise. The concept of lasting interest is not defined by IMF in terms of a specific time frame, and the more pertinent criterion adopted is that of the degree of ownership in an enterprise.

Definition of FDI

There is no specific definition of FDI owing to the presence of many authorities like the OECD, IMF, IBRD, & UNCTAD. All these bodies attempt to illustrate the nature of FDI with certain measuring methodologies. Generally speaking FDI refers to capital flows from abroad that invest in the production capacity of the economy and are usually preferred over other forms of external finance because they are non-debt creating, non-volatile and their returns depend on the performance of the projects financed by the investors. FDI also facilitates international trade and transfer of knowledge, skills & technology. It also described as source of modernisation and employment generation and economic development, it helps to create more
competitive business environment, increases total factor productivity and improves efficiency of resource use. UNCTAD and OECD have also defined FDI. However, there is a large degree of commonality among IMF, UNCTAD and OECD benchmark definition of FDI. They are a) Controlling interest and b) Long-term interest.

The committee was constituted by the Department of Industrial Policy and Promotion (DIPP) in May 2002 to bring the reporting system of FDI data in India into alignment with International best practices. Accordingly, the RBI has recently raised data on FDI flows from the year 2001 onwards by adopting a new definition of FDI. The revised definition includes three categories of capital, reinvested earning and other direct capital. Previously the data on FDI reported on the BOP statistics used only equity capital.

1.2.2 Components of FDI Flows

The Balance of Payments Manual 5 (BPM5) and the benchmark recommend that FDI statistics can be compiled as a part of the BOP and international investment position statistics. Consequently countries are expected to collect and disseminate FDI data according to the standard components presented in the BPM5. The concept of FDI includes the capital funds that the direct investor provides to a Direct Investment Enterprises from the direct investor. It comprises not only the initial transaction establishing the relationship between the investor and the enterprise but also all subsequent transactions between them and among affiliated enterprises, both incorporated and unincorporated (IMF 1993).
FDI generally consists of three components. They are:

(i) Equity capital;
(ii) Reinvested earning; and
(iii) Other capital.

i. **Equity capital** refers to the foreign investors who purchase the shares of an enterprise in a country other than its own.

ii. **Re-invested earnings** comprise the direct investors' share of earnings not distributed as dividends by affiliates or earnings not remitted to the direct investors. Such retained profits of affiliates are invested.

iii. **Other capital** implies intra-company loans or debt transactions between direct investor (parent enterprise) and affiliate enterprise.

### 1.2.3 Mode of FDI

FDI can select any one mode available to enter the host country. The available modes are as follows:

- **Branches** are never a separate entity from the parent company but outlets of the parent company in foreign countries.

- **Foreign collaborations** are of two types. They are financial collaborations (Joint-venture) and Technical collaborations (Licensing). Under financial collaborations, investing company is called parent company and the host company is called subsidiary. Subsidiaries, depending upon their foreign equity share, are called wholly owned subsidiaries, subsidiary and affiliates. Foreign technical collaborations can be a Franchising, Turnkey Projects and Management Contracts. Under Franchising, Licensee Company is licensed to use trade mark or a specific set of procedures. Management contract provides managerial skills to administer day-to-day affairs.

- **Merger and Acquisition** take place while one firm purchase the other firm and consolidation of two firms loosing their identities to a new firm which represent both. Mergers can take place in three types. They are:

  a) **Vertical mergers** implies merger of firm involved in different stages of the production of a single final product.
b) **Horizontal mergers** imply the merger of two or more firms engaged in similar activity in the same industry.

e) **Conglomerate mergers** involves merger of firms engaged in unrelated activities.

### 1.2.4 Types of FDI

(a) **Inward Foreign Direct Investment:**

This refers to long term capital inflows into a country other than aid, portfolio investment or a repayable debt. It is done by an entity outside the host country in the home country.

(b) **Outward Foreign Direct Investment:**

This refers to long term capital outflow from a country other than aid, portfolio investment or a repayable debt. It is done by an entity outside the host country in the home country.

(c) **Horizontal Foreign Direct Investment:**

This refers to a multi plant firm producing the same line of goods from plants located in different countries.

(d) **Vertical Foreign Direct Investment:**

If the production process is divided into upstream (parts and components) and downstream (assembly) stages, and only the latter stage is transferred abroad. Then the newly established assembly plants demand for parts and components can be met by exports from home-country suppliers. This is what Lipsay and Weiss\(^\text{16}\) (1981:1984) and other researchers describe as “Vertical FDI”, whose aim is to exploit scale economies at different stages of production arising from vertically integrated production relationships.
(e) **Greenfield Foreign Direct Investment:**

Greenfield FDI is a form of investment where the MNC constructs new facilities in the host country.

(f) **Brown field Foreign Direct Investment:**

Brown field FDI implies that MNC or an affiliate of the MNC merges with or acquires an already existing firm in the host country resulting in a new MNC affiliate.

1.2.5. **The Benefits and costs of FDI:**

In the recent years a rapid growth in the flow of FDI creates not only the opportunities but also the challenges for the policy makers in India

**Likely Benefits of FDI:**

- Transfer of capital: FDI might be the solution for developing countries for their inadequate access to foreign capital. It could be the driving force for economic growth and development.
- Employment Generation: MNCs will undoubtedly hire local people. It would be helpful in creating employment opportunity in the host country.
- FDI less volatile than other private flows and provides a stable source of financing to meet capital needs.
- Transfer of technology: With the rise in FDI flows there will be a transfer of technology. Since there is vast scope for spillover effects of technology and productivity in host country’s firms, it will helps in the raise of the income and employment opportunities in the country.

**Likely Costs of FDI:**

Recent years have seen increased public concern that the benefits of FDI have yet to be demonstrated and that, where benefits exists, the benefits of FDI flows are
not equitably shared in the society. The adjustment costs associated with FDI include:

1. Higher short term unemployment owe to corporate restructuring;
2. Increased market concentration; and
3. Incomplete utilization of FDI benefits due to incoherent institutional policies and regulatory conditions, unavailability of skilled labour and proper infrastructure.

The debate on the likely costs & benefits has reached new the heights. Under these circumstances it is important to inform the discussion by drawing lessons from the country's experience and to assist the government in identifying the conditions and policy requirements for maximizing avenues for employment generation and minimizing the risks and potential costs.

1.3 Significance of FDI

FDI plays a multidimensional role in the overall development of host countries. It is often widely discussed in the literature that, besides capital flows, FDI generates considerable benefits. These include employment generation, investment promotion, the acquisition of new technology and knowledge, human capital development, integration of international trade, creation of a more competitive business environment and improved local enterprise development, flows of ideas and global best practice standards and increased tax revenues from corporate profits generated by FDI. (Klein et al., 2001; Tambunan 2005).

While FDI is expected to create positive outcomes, it may also generate negatives effects on the host economy. The costs to the host country can arise from the market power of large scale industries and their associated ability to generate very
high profits or by domestic political interference by multinational corporations. But the empirical evidence shows that the negative effects from FDI are inconclusive, while the evidence of positive effects is overwhelming i.e., its net positive effect on economic welfare (Graham18, 1995).

The importance of FDI extends beyond the financial capital that flows into the country. In addition, FDI inflows can be a tool for bringing knowledge, managerial skills and capability, product design, job creation, quality characteristics, brand names, channels for international marketing of products, etc. and consequent integration into global production chains, which are the foundation of a successful exports strategy. Facilitating flows of FDI, including the technology transfer associated with it, may require the direct and active involvement of the home countries of transnational corporations (TNCs).

UNCTAD (2009),19 research has found that providing tax breaks for small and medium-sized enterprises in developed countries that are willing to invest in developing countries could stimulate such flows. Home country incentive schemes to stimulate linkages between foreign affiliates and domestic firms in India could also helps in terms of generation of employment opportunities in the country.

FDI could benefit both the domestic industry as well as the consumer, by providing opportunities for technological transfer and upgradation, access to global managerial skills and practices, optimal utilization of human capabilities and natural resources, making industry internationally competitive, opening up export markets, providing backward and forward linkages and access to international quality goods and services and augmenting employment opportunities. For all these reasons, FDI is
regarded as an important vehicle for economic development particularly for Indian economy. FDI flows are usually preferred over other forms of external finance because they are non-debt creating, non-volatile and their returns depend on the performance of the projects financed by the investors. In a world of increased competition and rapid technological change, their complimentary and catalytic role can be very valuable.

According to Rao AVVSK,20 1995, there are also many indirect effects of FDI that are beneficial to the host country’s economy. FDI will create long term advantages in terms of improved productivity and international competitiveness. Development of efficient firms, in Indian economy in general and Karnataka’s economy in particular, that are competitive on world markets can be a proper channel for transferring technological and managerial skills to these economies. These skills will contribute faster industrialization and add to income and employment generation efforts of Indian economy. In addition, FDI can stimulate indigenous entrepreneurship by promoting competition and avenues for sub contracting by local firms. It can also, however, result in mergers and takeovers leading to re-adjustment of industrialization process in the domestic economy.

FDI brings in much- needed capital, technical know-how, organizational, managerial and marketing practices and global production networks, thus facilitating the process of economic growth and development in host countries21. FDI can complement local development efforts by:

❖ increasing financial resources for development;
❖ boosting export competitiveness;
❖ generating income and employment through strengthening the skill base;
❖ protecting the environment and social responsibility; and
❖ enhancing technological capabilities (transfer diffusion and generation of technology). Technology transfer from FDI in turn operates via four related channels:

i) vertical (backward and forward) linkages with suppliers or purchasers in the host countries;

ii) horizontal linkages with competing or complementary companies in the same industry;

iii) migration of skilled labour; and

iv) Internationalization of Research and Development.

The Organization for International Investment\(^{22}\) (OII-2009), cites the benefits of Greenfield investment for regional and national economies to include increased employment (often at higher wages than domestic firms) investments in research and development and additional capital investments invested during the 2000's. India's outward investment, which has grown apace which is also its inward contributing to India's role as a major player in the world economy.

Indian companies are active in Merger and Acquisitions (M&As) in OECD countries as well as Greenfield investments in developing countries\(^ {23}\). This role is also evidenced by India’s increasingly active investment treaty practice. At the same time, the growth rate of employment has lagged behind the overall economic growth rate and obstacles remain to the expansion of activity and therefore employment in the formal sector.

More investment can promote employment growth and so help raise the incomes of the India’s poorest families. Transnational Companies (TNCs) are the
main providers of FDI and are thus an important source of employment. The Trans Nationality Index\textsuperscript{24} (TNI 2008) reveals the importance of TNCs in a domestic economy taking into account the production potential stemming FDI inflows and the outcome of that investment will not generate expected level of income and employment. FDI-enabled firms in manufacturing sectors provide employment to about 15.6 lakh persons accounting for about 4 to 5 percent of the total employment in the organized sector. FDI in manufacturing sectors has significant reach in small cities, thus generating linkages with suburban and rural regions of India, NCAER 2009.\textsuperscript{25} The need of the hour is the removal of economic inequalities through promotion of employment opportunities in the country.

**1.4 Relevant theories of Foreign Direct Investment**

Some important Theories are incorporated here to facilitate, the issues of FDI and its impact on employment generation in India and Consolidated FDI policy framework and its impact on income & employment generation in India in brief.

**Change in the Emphasis on FDI**

In the recent years the emphasis on the concept of FDI is being felt more both at national and international levels. There are many theoretical papers that examine foreign direct investments (FDI)’s issues, and main research on the motivations underlying FDI were developed by J. Dunning,\textsuperscript{26} S. Hymer or R.Vernon. Economists believe that FDI is an important element of economic development in all countries, especially in the developing ones. The conclusion reached after several empirical studies on the relationship between FDI and economic development is that the effects of FDI are complex. From a macro perspective, they are often regarded as generators
of employment, high productivity, competitiveness, and technology spillovers. Especially for the least developed countries, FDI means higher exports access to international markets, and international currencies, being an important source of financing, substituting bank loans.

There is some evidence to support the idea that FDI promote the competitiveness of local firms. Blomstrom\textsuperscript{27} (1994) finds positive evidence in Mexico and Indonesia, while Smarzynska (2002) found that local suppliers in Lithuania benefitted spill over from the potential positive effects that this would have on economy.

Caves\textsuperscript{28} (1996) considers that the efforts made by various countries in attracting foreign direct investments are due to supplying foreign customers. FDI would increase productivity, technology transfer, managerial skills, know how, international production networks, reducing unemployment, and access to external markets.

Lipsey\textsuperscript{29} (2002) concludes that there are positive effects, but there is not a consistent relationship between FDI stock and economic growth. Despite the fact that many researchers have tried to explain the phenomenon of FDI, we cannot say there is a general theory accepted.

But, according to Kindleberger\textsuperscript{30} (1969) everyone agrees on one point, in a world characterized by perfect competition, foreign direct investment would no longer exist. Thus, if markets work effectively and there are no barriers in terms of trade or competition, international trade is the only way to participate international market.
There must be a form of distortion that determines the realization of direct investment, and Hymer\textsuperscript{31} was the first who noticed this. Internalisation theory provides an explanation of the growth of the multinational enterprise (MNE) and gives insights into the reasons for foreign direct investment. Theories of FDI may be classified under the following headings:

1.4 1. Production Cycle Theory of Vernon

Vernon\textsuperscript{32}, in his work on the 'product-cycle' hypothesis, has emphasized that a firm tends to become multinational at a certain stage in its growth. The theory developed by Vernon in 1966 was used to explain certain types of foreign direct investment made by U.S. companies in Western Europe after the Second World War in the manufacturing industry. Vernon believes that there are four stages of production cycle: innovation, growth, maturity and decline. According to Vernon, in the first stage the U.S. transnational companies create new innovative products for local consumption and export the surplus in order to serve also the foreign markets. According to the theory of the production cycle, after the Second World War in Europe has increased demand for manufactured products like those produced in USA.

Thus, American firms began to export, having the advantage of technology on international competitors. If in the first stage of the production cycle, manufacturers have an advantage by possessing new technologies, as the product develops also the technology becomes known Manufacturers will standardize the product, but there will be companies that you will copy it. Thereby, European firms have started imitating American products that U.S. firms were exporting these countries. US companies were forced to perform production facilities on the local markets to maintain their
market shares in those areas. This theory managed to explain certain types of investments in Europe Western made by U.S. companies between 1950 and 1970. Although there are areas where Americans have not possessed the technological advantage and foreign direct investments were made during that period.

2. Market Imperfection and FDI

The product-cycle hypothesis does not resolve the question of why Transnational Corporations (TNCs) prefer to use FDI rather than to license their technology to foreign firms. This issue has been examined with reference to the theory of the firm, prominently by Hymer, Kindle Berger and Caves. Their explanation focuses on the fact that which firms enjoy rents in foreign markets. Such advantages include patented and generally unavailable technology, team-specific management skill, plant economies of scale, special marketing skills, possession of brand name, and so on. The potential gains from these advantages must, of course, outweigh the disadvantages of establishing and operating in a foreign country, such as communication difficulties, ignorance of institutions, new customs and tastes, alien rules and regulations etc. FDI allows firms to exploit their advantages to the full extent so that it can capture all the rents given by the control. Caves argued that such phenomena are due to market failures associated with arm’s-length transactions in intangible assets. Such assets, especially technical knowledge, are public goods, in the sense that their use does not diminish their stock.

Hymer rather argues that a firm undertakes FDI in oligopolist or monopolist goods market in an existing firm in a foreign country in order to control and suppress competition thereby no preserve its rents. It may also establish a subsidiary in a new
market so as to pre-empt the possibility of establishing such a firm by a rival firm. The latter strategy, termed 'defensive investment' may explain some part of FDI. The Hyundai and Marathi Suzuki Motors are stated to have established their foreign subsidiary plants in less developed countries to keep the other out. Another explanation of FDI and the role of TNCs run in terms of market imperfections in the external markets. Faced with imperfect external markets, firms may choose to internalize by using backward and forward integration.

3. The Internalisation Theory

Buckley\textsuperscript{35} and Casson's (1991) theory of transnational corporations traces the emergence of MNCs to internalization of markets. This theory is based on three simple postulates. They are:

i) firms maximize profits in a world of imperfect markets,

ii) when markets in intermediate products are imperfect, there is an incentive to bypass them by creating internal markets (within the firm)

iii) Internationalization of markets across national boundaries generates MNCs.

It is argued that the location strategy of vertically integrated firm is determined mainly by the interplay of comparative advantage, barriers to trade, and regional incentives to internalize. The firm will be multinational whenever these factors make it optimal to locate different stages of production in different countries. Another prediction of this theory is that unless either transport costs are very low or returns to scale at the plant level are high, or the comparative advantage of one location is very significant, the international acquisition and exploitation of knowledge will normally involve international production through a world-wide network of basically similar
plants. Thus, it is the internalization benefit manifesting in the cost-free intra-firm transfer of technology or any other knowledge that motivated a firm to be international.

4. The Eclectic Paradigm of Dunning

The eclectic theory developed by professor John H. Dunning,s36 is a mix of different theories of direct foreign investments, Ownership, Locational & Internalization (OLI).

a) "O" Specific Advantages:

This refers to intangible assets, which are, at, least for a while exclusive possesses of the company and may be transferred within TNCs at low costs, leading either to higher incomes or reduced costs. But TNCs operations performed in different countries face some additional costs. Thereby to successfully enter a foreign market, a company must have certain characteristics that would triumph over operating costs on a foreign market. These advantages are the property competences or the specific benefits of the company. The firm has a monopoly over its own specific advantages and using them abroad leads to higher marginal profitability or lower marginal cost than other competitors. There are four types of specific advantages:

- Monopoly advantages in the form of privileged access to markets through ownership of natural limited resources, patents, trademarks;
- Technology, knowledge broadly defined so as to contain all forms of innovation activities;
- Economies of large size such as economies of learning, economies of scale and scope; and
- greater access to financial capital;
b) 'L' Specific Advantages:

When the first condition is fulfilled, it must be more advantageous for the company that owns them to use them itself rather than sell them or rent them to foreign firms. Location advantages of different countries are key factors in determining who will become host countries for the activities of the TNCs. The specific advantages of each country can be divided into five categories:

- The economic benefits consist of quantitative and qualitative factors of production;
- Costs of transport, telecommunications, market size etc.
- Political advantages: common and specific government policies that affect FDI flows
- Social advantages: includes distance between the host and home countries, cultural; and
- Diversity, attitude towards strangers etc.

c) Internalization or 'I' Specific Advantage:

Supposing, that the first two conditions are met, it must be profitable for the company the use of these advantages, in collaboration with at least some factors outside the country of origin. This third characteristic of the eclectic paradigm OLI offers a framework for assessing different ways in which the company will exploit its powers from the sale of goods and services to various agreements that might be signed between the companies.

The electric or 'OLI' paradigm suggests that the greater the 'O' and 'I' advantages possessed by firms and more the 'L' advantages in a location outside of home country, the more FDI will be undertaken. Where firms possess substantial 'O' and 'T' advantages but the 'L' advantages favour the home country, then domestic
investment will be preferred to outward FDI, and any foreign market will be supplied by exports. Dunning is conscious that configuration of the O-L-I advantages varies from one country to another and one activity to another and that FDI will be greater where the configuration is more pronounced. Of the theories explaining foreign direct investment, an exceptionally flexible and increasing popular one is the electric theory of John. H. Dunning.37

1.5 Recent Developments in FDI policy

The current investment policy trends can be generally characterized by further liberalization and facilitation of foreign investment. At the same time, efforts to regulate foreign investment to advance public policy objectives (e.g. protection of the environment, alleviation of poverty, and addressing national security concerns) have intensified. This dichotomy in policies and the political will to rebalance the respective rights and obligations of the State and investors are becoming apparent at both the domestic and international policy levels, with emphasis swinging towards the role of the State. The network of international investment agreements (IIAs) has expanded further, while attempts to ensure balance and coherence within the IIA regime are under way. Furthermore, investment policymaking is attempting to reflect the closer interaction between investment policies and other policies, including those relating to broader economic, social and environmental issues. (wir, 2010)38

National policies: regulation gaining ground, as liberalization continues National Investment Regimes (NIR) continued to become more favorable towards foreign investment, while governments have increasingly re-emphasized regulation. Out of the 102 new national policy measures affecting foreign investment that were
identified in 2009, the majority (71) were in the direction of further liberalization and promotion of foreign investment (fig. 1.1). This confirms that the global economic and financial turmoil has so far not resulted in heightened investment protectionism. Policies included, inter alia, the opening of previously closed sectors, the liberalization of land acquisition, the dismantling of monopolies, and the privatization of state-owned enterprises.

Measures to promote and facilitate investments focused on fiscal and financial incentives to encourage FDI in particular industries or regions, including special economic zones; easing screening requirements; streamlining approval procedures; or accelerating project licensing. To improve the business climate, corporate tax rates were also lowered in a number of countries, particularly in developed countries and developing countries like India in South Asia. Growing fiscal strains may eventually result in a reversal in the trend observed over the past decade, however,

Figure 1.1 National FDI policy changes, 1992–2009

Source: UNCTAD’s, World Investment Report-2010
In spite of the general trend towards liberalization, 31 of the new national policy measures were towards tighter regulations for FDI. Accounting for over 30 percent of the total, this is the highest share of such measures observed since 1992, when UNCTAD started reporting these measures. These measures are driven in part by increased concern over the protection of strategic industries, national resources and national security.

Recent crises, such as the turmoil in the financial markets and the impact of rising food prices, have also translated into a will to regulate specific sectors industries. Lastly, emerging economies are giving more weight to environmental and social protection, while LDCs are filling gaps in their regulatory frameworks. As a result, new limitations on foreign participation were introduced in some industries, or procedures for the screening and approval of investments were tightened, sometimes on national security grounds. Greater state intervention in the economy was most obvious in expropriations – which occurred in a few Latin American countries – and an increase, in state participation in companies as part of financial bailout measures.

The expected reversal of temporary nationalizations in sectors often considered strategic could result in governments pushing to have privatized companies remain in domestic hands, or pressuring investors to keep production and jobs at home. As a result, the phasing out of rescue packages will need to be closely monitored, as risks of investment protectionism have not disappeared.

Thirteen of the G20 countries continue to carry outstanding assets and liabilities left as a legacy of emergency schemes. The total amount of public commitments equity, loans and guarantees – on May, 20, 2010 exceeded $1 Trillion.
In the financial sector, several hundred firms continue to benefit from such public support, and in non-financial sectors, at least 20,000 individual firms continue to benefit from emergency support programmes.

1.6 FDI policy Framework in India

It is in this context that it is pertinent looking at what the current FDI policy in India since 1991.

Liberalization and Open Door Policy Since 1991

The policies relating to FDI underwent revolutionary changes in July 1991 as a part of the Structural Adjustment Programmes (SAP) in India since 1991. Industrial policy announced in 1991 was a major initiative towards attracting FDI in India. The policy ensures, automatic approval of FDI up to 51 percent foreign equity capital in high priority industries. This facility was given for foreign participation up to 51 percent of equity capital in 34 industries. The Foreign Investment Promotion Board (FIPB) was also setup to process application of FDI incase not concerned by RBIs automatic approvals. Since 1991 Government of India has been taking several initiatives including enhancement of Foreign equity participation through automatic route, reduction of negative list, provision incentives and opening up more major sectors for FDIs entry.

Approval Mechanism for FDI in India

There are to modalities for FDI approvals. They are RBI and the Government routes. FDI for virtually all items/activities can be brought in through the automatic route under powers delegated to the RBI and for items/activities through government approval. FIPB/Secretariat for industrial Assistance (SIA).
(i) **Automatic Route (RBI):** FDI entering through RBIs automatic route does not require any prior approval.

FDI up to 100 per cent is allowed under automatic route in all activities except following which require approval of the government.

- Activities which require industrial license.
- Proposals for acquisition of shares in an existing India's company in the financial service sector and substantial acquisition of shares and takeovers attracted by SEBI Regulations, 1997.
- Proposals in which the Foreign collaborator has an existing venture/tie-up in India in the same field.
- All proposals falling outside the notified sectoral policy/sectoral caps or under sector in which FDI is not so far permitted.

**Government Route (FIPB/SIA)**

All Investment activities which are not comes under automatic route require prior government approvals for the entry of FDI. The procedure for obtaining government approval is as follows.

All proposals for Foreign Investment requiring government approval are considered by FIPB. The FIPB also grants composite approvals involving foreign financial investment and foreign technical collaborations. For seeking the approval for FDI other than NRI investment and 100 per cent Export Oriented Units (EOUs), application should be submitted to the Department of Economic Affairs (DEA), Ministry of Finance. Proposals received by DEA or generally placed before the FIPB with in 15 days of receipt. The decision of the government in all cases is usually conveyed with in 30 days. FDI application with NRI investment and 100 per cent
EOUs should be submitted to the Public Relation and compliant section (PR&C) of SAI, Department of Industrial Policy and Promotion (DIPP).

Recently, the Department of Industrial Policy and Promotion (DIPP) under the Union Ministry of Commerce and Industry released the Draft press Note on FDI Regulatory Framework consolidating all prior regulations on FDI into one document for comments. It reflects the current “regulatory framework” on FDI in India. While the draft note confirms that: The motivation of the direct investor is a strategic long-term relationship with the direct investment enterprise to ensure the significant degree of influence by the direct investor in the management of the direct investment enterprise.

Further, it goes on to clarify that in India the ‘lasting interest’ is not evinced by any minimum holding of percentage of equity capital/shares/voting rights in the investment enterprise. Analysts and academicians have already pointed to the increasing role of private equity in the observed sharp increase in FDI figures and the increased routing of inflation through the tax heavens in the years since 2005, Chandrasekhar, 2007

**FDI in Retail sector**

“India to frame WTO compatible retail FDI policy” money control.com, dated: 2.8.2011.

While the draft FDI policy on retail is at a fairly advanced stage of approval, a proposed condition may not be compatible with WTO norms. The Committee of Secretaries (CoS) has formed another panel to look into the issue, reports CNBC-TV18’s Malvika Jain.
A three-member secretary panel has been formed to examine the matter in detail. The panel includes Textile Secretary Rita Menon, Secretary in the Micro, Small and Medium Enterprises (MSME) Ministry Uday Kumar Verma and Infotech Secretary R Chandrashekar.

The draft policy had proposed that the foreign front-end retailers will have to source a minimum mandatory of 30 percent of the total merchandise from the local region. This was proposed to take care of the political concerns and benefit the domestic industry.

However, some member of the CoS raised concerns that this may not be compatible with some WTO norms. Every WTO member is required to follow a principle of national treatment which implies that a foreign investor in its shores will be treated in the same manner as its domestic counterparts.

**Foreign Investment Promotion Board (FIPB)**

The FIPB is a specially empowered board chaired by the Secretary, Ministry of Finance (MoF), set up specifically for expediting the approval process for foreign investment proposals. There are no prescribed application forms for applying to FIPB, except in the case of purely technical collaborations. Proposals for FDI may be sent to the FIPB unit, Department of Economic Affairs, Ministry of Finance or through any of India’s diplomatic missions abroad. The government has introduced a mailbox facility for accepting FDI proposals through the Internet and providing an acknowledgement number for these, with the condition that a hard copy should be received in original before the proposal is considered by the government.
Foreign Investment Implementation Authority (FIIA)

The Government of India has set up FIIA in the Ministry of Industry and Commerce to facilitate quick translation of FDI approval and implementation. The organization also provides a proactive one-stop, after-care service to foreign investors by helping them obtain the necessary approvals, sort out operational problems and meet various government agencies to find solutions to problems and maximize opportunities through the partnership approach. FIIA, in accordance with its mandate, assumes the following role:

- Understands and addresses concerns of investors
- Understands and addresses concerns of approving authorities
- Initiates multi-agency consultation
- Refers matters not resolved at the FIA level to higher levels on a quarterly basis, including cases of project slippage on account of implementation bottlenecks

website: [www.siadipp.nic.in/sia/fiia.htm](http://www.siadipp.nic.in/sia/fiia.htm).

Investment Commission (IC)

The three-member Investment Commission, set up in the Ministry of Finance in December 2004 by the Government of India, has Mr. Ratan Tata as Chairman and Mr. Deepak Parekh and Dr. Ashok Ganguly as members. The Investment Commission advises the Government of India on changes in policy and procedures that will enhance investment in India, recommends projects and investment proposals that should be fast tracked/mentored and promotes India as an investment destination.

Secretariat for Industrial Assistance (SIA)
The SIA, functioning with the Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, acts as a gateway to industrial investment in India. It provides a single-window clearance for entrepreneurial assistance and facilitates the processing of investors' applications requiring government approval.

1.6 Objectives of the study

1. To examine the need for FDI in India;

2. To analyze the trends and pattern of FDI flows in India;

3. To study the Investment channels of FDI in India in general and Karnataka in particular;

4. FDI and its impact on income and employment generation during a period of ten years, from 2000 to 2010;

5. To examine the casual nexus between FDI and economic growth in Karnataka during the period, and its role in industrialization of the state; and

6. To offer suggestions, based on the findings of the study.

1.7 Hypotheses of the study

Based on the analysis of the objectives, five hypotheses are framed to test in this study. They are:

1. There is no significant inflow of FDI into Karnataka vis-à-vis other states in India.

2. FDI inflows have not gone into the most vital sectors of the Karnataka’s economy.

3. There has been a significant improvement in employment generation in Karnataka on account of FDI.

4. The FDI further widened the rural-urban dichotomy in the state.

5. The FDI impacted significantly the wage differentials in the industrial sector of Karnataka.
1.8 Methodology and Sources of data

The present study is based on the secondary data published by various agencies and organizations. The data used in this study are aggregate annual time series at current prices, Covering a period of Ten Years, from 2000-2010. To analyze this data, simple statistical techniques like percentages, averages, Standard Deviation and employed in the study.

The data have been extracted from the following sources

3. Economic survey of India, Government of India, various issues
4. The Karnataka Development Report, Government of Karnataka, various issues
5. UNCTAD, WIR, series, various issues
8. SIA & Department of Industrial Policy and Promotion (DIPP) Ministry of industries and Commerce, Government of India, New Delhi. (Website: www.dipp.nic.in)

1.9: Tools applied:

Concordance Coefficient:

Concordance Coefficient is used to measure the Sectoral Changes. The formula used for calculating Concordance Coefficient (W) is given as below:

\[ w = \frac{12 \sum_{i=1}^{n} (x_i - \bar{x})^2}{m^2 (n^3 - n)} \]
In the above formula $\bar{x}$ represents the grand mean of the ranks of selected sectors ($n$) during the selected time periods ($m$) and is estimated with the following formula:

$$\bar{x} = \frac{m(n+1)}{2}$$

In the formula for Concordance Coefficient ($W$), $x_i$ represents the sum of the ranks allotted to the $i$th Sector ($i = 1,2,3,4,...,n$) during the selected time periods under study.

The value of concordance coefficient measures the degree of agreement between the Sectors. A complete randomness in ranking leads to $W = 0$ on the one hand and perfect agreement among patterns result in $W = 1$, on the other. The greater the departure from complete agreement, the smaller is the value of concordance coefficient. If ‘$W$’ takes only non-zero value, whatsoever, then there is a certain amount of agreement among the Sectoral Changes.

**Chi-square ($\chi^2$) test:** In the present study, Chi-square ($\chi^2$) was calculated by using the following formula.

$$\chi^2 = m(n-1)W$$

If $\chi^2$ table value exceeds the calculated $\chi^2$ value, the coefficient of concordance is not significant and there are no significant changes in the Sectoral Composition. On the other hand, if calculated $\chi^2$ value exceeds the $\chi^2$ table value, the coefficient of concordance is significant and there are significant changes in the Sectoral Composition.

**1.10 Limitations of the study**

There are certain limitations in the present study. They are:

1. Calendar year data published by Secretariat for Industrial Assistance (SIA) is used in the study due to non-availability of segregated data on FDI from Reserve Bank of India (RBI) sources, regarding data pertaining to firm level FDI investments in Karnataka.
2. Monthly data on FDI and FII were used because the annual data are not sufficient to conduct the casual test.

3. Annual data regarding employment generation through FDI based units in Karnataka, from department of Statistics and Economics, Govt of Karnataka has not maintained data base on FDI units in the state.

1.11 Plan of the Study

The study has been presented in six chapters as detailed below:

**Chapter-1:** Introduction, Significance of the study, Objectives, Hypotheses and Methodology of the study pertaining to FDI

1.1 Introduction
1.2 Conceptual framework of FDI
1.3 Significance of FDI
1.4 Relevant theories on FDI
1.5 Policy relating to FDI in India
1.6 Objectives and Hypotheses of the study
1.7 Methodology and Sources of data
1.8 Limitation of the study
1.9 Plan of the study

**Chapter-2:** Review of Literature and Need for the Study

2.1 Review of Literature
2.2 Relevance / need for the study
2.3 Statement of the problem
Chapter-3 : Trends, Pattern and Volume of FDI in India

3.1 Introduction
3.2 Trends Pattern of FDI Flows in India
3.3 Trends in Global FDI Flows
3.4 FDI Inflows into India
3.5 Percentage Composition of FDI in GNP
3.6 Country Wise Share of FDI Flows in India
3.7 Sectoral Distribution of FDI flows
3.8 Status of FDI Approvals State wise during 2009-2010
3.9 Employment Scenario in India
3.10 Sector-wise Employment
3.11 Impact of Global Meltdown on Employment Generation

Chapter-4 : FDI and its Impact on Karnataka’s Economy: An over view

4.1 Introduction
4.2 Policy Framework for Attraction of Private Investments
4.3 Growth areas of Karnataka
4.4 Advantages for Karnataka
4.5 Attraction of Private Investment into Karnataka
4.6 Policy Framework for Attraction of Private Investments.
4.7 State-Wise Distribution of FDI.
4.8 Investment Flows into Karnataka.
4.9 Trends of FDI Flows into Karnataka.
4.10 Sector- wise FDI Approved by FIPB in Karnataka.
4.11 State Wise Break-up of FTT Approvals


Chapter-5 FDI and its Impact on income & employment generation in Karnataka.

5.1 Introduction


5.3. Part-B: Impact of SEZ’s on income and Employment Generation in the state of Karnataka.

5.4 Part-C: Geographical Concentration of FDI in Karnataka.

Chapter-6 Major findings of the study, policy recommendations and conclusion.

6.1 Introduction and rationale for FDI

6.2 The Major findings of the study

6.3 Policy recommendations and Conclusion.
References

15. UNTAD, World Investment Report 2004, p.345


24. Trans Nationality Index (UNCTAD- TNI, 2008)


42. money control.com dated: 2.08.2011